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INTERNATIONAL JOINT VENTURES: OIL & GAS

This note examines joint venture structures commonly used in international oil and gas upstream exploration and production operations, focusing on the contractual framework and underlying key terms governing the relationship between the joint venture partners.

by *Anna Nerush, Haynes and Boone LLP*

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SCOPE OF THIS NOTE

Joint ventures are a common and well-established feature of the international oil and gas industry. There are many reasons why oil companies, from small operators to super-majors, elect to collaborate on upstream projects. Such projects are expensive and risky, both in terms of costs, ability to monetise the investment and the nature of operations, as many of the underlying assets tend to be located in geologically challenging environments. All upstream development projects require substantial capital injections throughout the project cycle from exploration to production, with deepwater and liquefied natural gas projects posing additional technical and geological challenges. Operating such assets through a joint venture enables partners to:

- Reduce costs and risks associated with large scale exploration and production (E&P) operations.
- Diversify their asset portfolio and therefore the cashflow in respect of projects in different phases of development.
- Capitalise on the know-how and technology obtained from JV partners to ultimately maximise production and monetise their investment.

This note examines joint venture structures commonly used in international oil and gas upstream E&P operations, focusing on the contractual framework and underlying key terms governing the relationship between the joint venture partners.

For a glossary of some of the key, industry-specific abbreviations used in this note, and their meanings, see *Glossary* below.

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UPSTREAM PROJECT LEGAL FRAMEWORK

While there is some variation in host government contracts granting hydrocarbon rights, with certain jurisdictions including the US notable for their unique system of land ownership rights, in general the overall legal framework of upstream projects is as follows:

- Host country constitution laws and regulations, with overarching impact.
- An instrument between the host government (the State) and the international oil and gas company or companies (IOCs), granting the rights to hydrocarbons.
- In the context of a joint venture, an agreement among the IOCs (which may also include the national oil company (NOC)).

Although the precise form of joint venture structures varies, with particularly bespoke arrangements at the third level between IOCs, there are certain structures that are commonly adopted by IOCs to contract with States to develop projects. In a production sharing contract or agreement (PSC or PSA), the State typically grants IOCs an exclusive right to explore within a defined geographical area (the Contract Area) and ultimately produce and sell oil and/or gas. Alternative structures include:

- A licensing regime, adopted by jurisdictions such as the UK, Norway and Russia.
- The use of concessions, where the State receives its share of the "take" through taxes and royalties (Pakistan and Egypt).
- Risk service contracts, where the IOC receives its profit through a fee structure (Malaysia).
- A hybrid, where the State, as constitutional owner of the hydrocarbons, receives its "take" through marketing its own share of production.

Some mature provinces, such as Nigeria, have a complex combination of joint ventures with the NOC and PSCs that has built up over time.

Whatever form the host government agreement takes, it is essential that it is consistent with the legislative and regulatory framework of the host country. Particular consideration should be given to the potential for a conflict of authority where there are strong regional and/or federal issues, particularly with respect to PSC fiscal terms and recovery of costs, as is for example the case with the regional government in the Kurdistan Region of Iraq and the federal government of Iraq.

Any such agreement or licence is generally of a long term nature and the availability of meaningful investor protections, the stabilisation of taxation treatment and the legislative framework will be key considerations for IOCs in structuring their investment vehicle.

For the purposes of this note, it is assumed that the host government agreement is a PSC (and is treated interchangeably with a PSA), with more than one IOC being involved.

PSC: A BRIEF OVERVIEW OF COMMON TERMS

Under a PSC, the State retains ownership of the oil or gas produced within the Contract Area, subject to the IOC's individual entitlement to its portion of the production. The State will typically take production under the PSC via a State-owned NOC and it is common for the NOC's share of financial obligations, as one of the contractors under a PSC, to be funded (carried) by the IOC. Difficulties can arise where the NOC is responsible for meeting cash calls itself.

While each jurisdiction tends to have its own model PSC, there are three general overarching commercial principles that are typically present:

- The IOCs bear the entire risk of the project, including full financial responsibility.
- The IOCs commit to fulfil an agreed scope of works, known as minimum work commitment.
- The IOCs are entitled to recover a percentage of their project costs from the oil produced within the Contract Area. The IOCs' ability to recover such costs is dependent on the success of the project and whether there is actual production, making projects of this nature financially very risky.

Generally, the IOCs will be entitled to recover some of their costs up to a pre-agreed percentage of production, known as "cost oil". If cost oil is not sufficient to cover the operating costs of an asset, typically the balance will be carried into the next production period. The remaining production, known as "profit oil", is split between the IOCs and the NOC using an agreed formula, with the IOCs' profit share being subject to income tax.

There are a number of other common fiscal terms seen across PSC jurisdictions, such as royalty and bonus payments, which are payable by the IOCs to the State:

- **Royalty.** A payment on gross production (often with an option to take in kind) calculated on the basis set out in the PSC.
- **Bonuses.** It is common for the IOCs to be expected to make a number of one off payments during the term of the PSC, for example on the date of signing of the PSC (known as a signature bonus) and at later stages upon production reaching certain agreed levels (known as a production bonus).
- **Taxes.** The IOCs may be subject to a number of taxes in addition to income tax payable on profit oil, such as export/import taxes and duties and stamp duty. Generally, the IOCs will seek to obtain exemptions from certain taxes and duties in order to monetise their investment faster, as well as seeking protection from any subsequent changes in the law or taxation regime that may adversely impact their position, or the operations.

The overall tax breaks and percentage of costs recoverable by the IOCs will depend on the jurisdiction. Naturally, those individual PSC terms in jurisdictions offering higher rates of potential recovery are most commercially attractive to the IOCs. These will tend to be the most high risk and underdeveloped hydrocarbon provinces.

Recovery of costs is one of the key issues that most commonly gives rise to disputes between the IOCs and the State, and for this reason, commercial negotiations will be focused from the outset on the scope of recoverable operations and applicable limits on recoverability. The PSC will set out which costs are recoverable by the IOCs and the order of priority for such recovery. Generally, recoverable costs include production, exploration, development, marketing and decommissioning costs; however the exact scope of, for example, what constitutes "production operations" and related production costs, will be negotiated on an individual basis.

Typically, the PSC will also provide for the establishment of a management committee (ManCom) comprising members designated by the State and the contractor entity (the Operator, in the case of an unincorporated joint venture or an appointed representative in the case of an incorporated joint venture). A number of key operational matters, such as work programs and budgets and development plans, will typically be subject to approval by ManCom, to be proposed by the Operator for review and approval by ManCom following approval by the operating committee (OpCom).

The terms of a joint operating agreement (JOA) or shareholder and operating agreement (SHOA) need to be considered and structured within the agreed cost recovery framework to avoid conflict with the PSC, and this may ultimately adversely affect an IOC's ability to recover its costs. For example, under an unincorporated joint venture structure, each party may deal with its entitlement to production as it wishes; however, should the parties agree separate marketing arrangements under the JOA, there may be a conflict with the cost recovery regime under the PSC, if, for example, the PSC provides that costs are only recoverable on a joint basis (that is, by the Operator entity). The result can be that each IOC ultimately assumes liability for its own marketing costs, despite having expressly agreed otherwise between them. In mature provinces such as the UK Continental Shelf (UKCS), or in the case of gas developments where offtake is more complicated, it is common to have common stream agreements or other joint marketing agreements administered by the Operator.

JOINT VENTURE STRUCTURES

Unincorporated joint ventures (UJVs) and incorporated joint ventures (IJVs) are the most commonly used structures in international oil and gas projects. Both UJVs and IJVs allow the venture partners to set clear parameters governing their relationship as project participants and to establish rules for conducting operations under the underlying host government agreement (whether a PSC, licence or other agreement with the State).

The fundamental difference between the two structures is that an IJV involves the creation of a separate legal entity (similar to a traditional incorporated joint venture) and the UJV does not, with each joint venture participant acting as a separate legal entity under an umbrella joint operating agreement governing the relationship between the joint venture parties. It should be noted that a UJV structure may not be permitted in some jurisdictions, which may require, as a condition of the granting of the relevant rights, that the underlying PSC or licence is held, and operations conducted by, a legal entity incorporated in the host country.

See also *Unincorporated joint ventures and joint operating agreements* and *Incorporated joint ventures and shareholder and operating agreements* below.

UJVS AND IJVS: CONSIDERATIONS AND DIFFERENCES

Structuring considerations

A number of key factors influence the decision whether to adopt a UJV or an IJV structure; the relevant jurisdiction of incorporation; the nature of the holding company and shareholder structuring; and whether or not partners invest directly or through special purpose vehicles or other bespoke ownership structures. Such factors include, for example:

- Bilateral investment treaties (BITs).
- Multilateral investment treaties (for example, the. Energy Charter Treaty).
- Enforcement of arbitral awards (for example, the New York Convention).
- Tax (for example, double taxation treaties and withholding tax).
- Local procurement laws.

In the UKCS, the UJV structure is extremely prevalent for tax reasons, and this is the structure contemplated by the Oil & Gas UK (OGUK) standard documents. This is particularly notable in the context of decommission arrangements, for example the OGUK decommissioning security agreement, under which the Operator has an important role.

Key differences

There are a number of key differences between a UJV and an IJV, summarised in the following table.

	UJV	IJV
Formation and contractual framework	Each party enters, on its own behalf, into a joint operating agreement (JOA) which provides a contractual framework for the management and operation of the E&P asset and sets out the rights and obligations of each party in relation to the other joint venture parties.	An IJV is a separate legal entity incorporated subject to the statutory and regulatory requirements of the jurisdiction of its incorporation. The IJV is formed pursuant to articles of association, charter or other similar founding document, with the terms governing the relationship between the JV partners and the operation of the IJV set out in a shareholder and operating agreement (SHOA).
Management and control	One of the parties is appointed as Operator responsible for day-to-day technical operation and management of the asset as well as communication and engagement with third parties (for example, the government and contractors) on behalf of all joint venture partners. The scope of the Operator's duties and its discretionary powers are set out in the JOA, with ultimate decision making (subject to matters reserved for ManCom approval under the PSC) delegated to the operating committee (OpCom) consisting of a representative from each of the parties.	As a corporate entity, an IJV is managed by a board of directors (subject to matters reserved for ManCom approval under the PSC), appointed by the shareholders in accordance with, and subject to, duties and obligations set out under applicable local law. Provisions around board representation, rotation of senior roles and decision making are usually among some of the most negotiated SHOA provisions.
Liability	The liability of each joint venture partner is limited by reference to its overall percentage interest allocated to it under the relevant host government agreement (subject to any subsequent partial divestment or increase). It should be noted, however, that most host government contracts provide for joint and several liability of the joint venture partners with the State, and will often require a further level of protection by seeking guarantees from their respective ultimate parents to secure their obligations. Therefore, while the liability of the partners in relation to	The liability of each shareholder in the IJV is limited to its contribution and assets of the IJV. A parent corporate guarantee securing the obligations of the IJV under the host government contact is likely to be required by the State. In the case of independent E&P companies, this requirement is often fulfilled by way of performance bond.

	one another and certain third parties may be limited in the JOA, the liability of the JV partners in relation to the State is frequently joint and several. It is also important to note that in a UKCS context the JOA parties (and former JOA parties) have joint and several liability for decommissioning liabilities under the *Petroleum Act 1998 (as amended by the Energy Act 2008).*	
Assets, profit sharing and costs	Each party in the UJV effectively holds an interest in the joint operation's assets proportionate to its participating interest under the PSC. A party may seek to use its share in the joint assets as security for its own funding commitments, however, the ability to do so may be restricted under the terms of the JOA, and this, together with structural considerations, may mean it is not as attractive to potential lenders. The joint operations under a UJV structure are funded via cash calls issued by the Operator on the basis of an agreed work program and budget and subject to the terms of the JOA. Each party owns its share of production and is entitled to take, market and sell such share as it wishes. In practice, the Operator often markets and sells petroleum on behalf of all the parties and distributes each party's profit share subject to a set of separate offtake and marketing agreements (for example, a common stream agreement). In the case of offshore developments, the Operator may also have first call in natural gas for use as fuel gas on offshore platforms.	Equity or debt financing can be sought by the IJV in its own right, as a legal entity. Typically, the working capital and operating costs of the IJV will be funded by its shareholders on the terms agreed and set out in the SHOA. Assets are owned by the IJV and can be used as security by the IJV. Profits are paid to the shareholders through dividend payments on the basis of a dividend policy agreed and set out in the SHOA.
Tax	Tax is levied at the JV party level with each party treated independently for tax purposes. Each JV party can offset its losses incurred in connection with the UJV against income elsewhere within its group.	Taxes are paid at the IJV level at the applicable rate before profits are distributed to the shareholders. Depending on the structure which is adopted each shareholder is responsible for any tax payable on its dividends and profits received from the IJV. Profits and losses cannot be offset against other income outside the IJV.
Accounting	UJV cash calls are paid to an account held by the Operator (whether commingled with its own funds, or a separate account, as agreed in the JOA) and the Operator accounts to the UJV partners on the basis of an accounting policy agreed by the parties under the JOA for all payments received and made with respect to the joint operations.	The IJV will have its own bank accounts with authorised signatories agreed and designated by the parties in the SHOA. The IJV will prepare and file accounts in accordance with the accounting standards and principles agreed by the parties and required under applicable laws.
Termination	The parties can agree to terminate the JOA subject to any residual liabilities.	Termination of the IJV is more complicated as it will require the dissolution of the corporate entity, which will be subject to the applicable laws of the country of incorporation.

UNINCORPORATED JOINT VENTURES AND JOINT OPERATING AGREEMENTS

Generally, a UJV structure encompasses each of the IOCs entering into a PSC with the State and a NOC (which represents the State's interest under the PSC) in consideration for an individual participating interest (PI) under the PSC, corresponding to that party's share of rights and obligations under the PSC. States will usually require that the overall liability of contractor entities under the PSC is joint and several.

The IOCs and NOC will each enter into a JOA with one of the IOC parties, usually the one with the largest PI, and possessed of the requisite technical capabilities, appointed as Operator to carry out the joint operations on behalf of the JOA parties, subject to the approval of the operating committee. The JOA provides a detailed framework for conducting operations, and allocates risks and rights between the parties.

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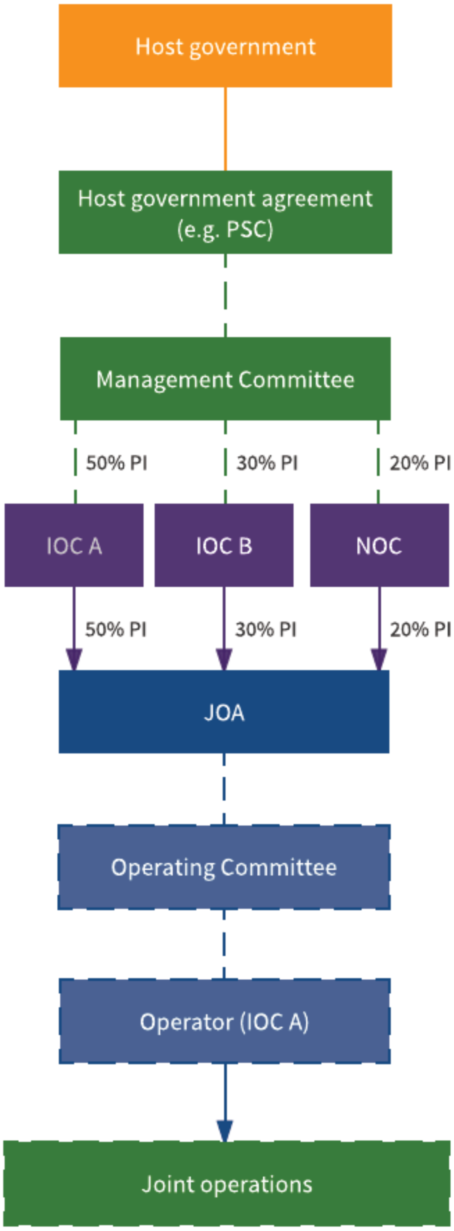
Typical UJV structure



JOINT OPERATING AGREEMENTS

JOA features

Common characteristics of an oil and gas UJV include:

- Co-ownership as tenants in common of all assets of the project.
- Common participation in the control of, and contribution to the costs of, the project.
- Specified rights and entitlements for each party to its proportion of the production, pro-rata to its PI share in the profits, losses and liabilities of the project.
- The day-to-day operations of the project managed by an Operator appointed by the project parties.

Model JOAs

A JOA governs the relationship between the parties for the joint development of hydrocarbons from the Contract Area, allocating benefits, costs and obligations between the parties in proportion to their PI under the PSC (or licence or concession).

There are a number of jurisdiction-specific model JOAs that have been developed by various industry bodies such as the Association of International Petroleum Negotiators (AIPN) and OGUK. A model JOA provides the parties with a framework of all material JOA features to be tailored to the specifics of the deal. Although the AIPN 2012 Model JOA is arguably the most used model JOA in international UJVs, there are a number of other industry associations which have produced model forms specific to their jurisdictions, such as:

- The American Association of Petroleum Landmen (AAPL), USA.
- Canadian Association of Petroleum Landmen (CAPL), Canada.
- OGUK.
- Australian Mining Petroleum Law Association (AMPLA), Australia.

The AIPN 2012 Model JOA was developed for use in a wide variety of jurisdictions and while it offers a form reflecting common industry practices, it is designed to facilitate a focused discussion of commercial terms rather than offer a standardised solution. Most of the legal concepts and mechanisms in the AIPN 2012 Model JOA are common law-based and therefore need further consideration and analysis when used in civil law jurisdictions. For example, obligations to act "in good faith" or "reasonably" have different legal standing in common and civil law jurisdictions. Many civil law jurisdictions recognise some form of good faith on contracting parties in their civil codes, whereas under English law, there is no universally defined or implied duty of good faith (*MSC Mediterranean Shipping Company SA v Cottonex Anstalt [2016] EWCA Civ 789*), therefore any such obligation to the extent, for example, it relates to the Operator's duties, should be expressly set out in the JOA.

Careful consideration must also be given to the underlying host government agreement and the statutory and regulatory framework of the host country, as the enforceability of many JOA provisions, for example governing transfer of a PI, or default, will be dependent on the applicable law and terms of the PSC.

There are a number of practical issues that must be considered for coverage in a JOA (and which commonly give rise to disputes between the parties), such as those relating to:

- The scope of the relationship between the parties and the Operator's role.
- Liability of the relevant parties, limits on liability, and the nature of claims (including for decommissioning liability).
- Management and control.
- Non-consent rights and sole risk.
- Funding and funding obligations of the parties.
- Default and the consequences of default.
- Transfer of PI.

The position a party may pursue and ultimately accept on the above, and other issues arising under a JOA, will to a great extent depend on whether it is the Operator (wishing to retain greater control and discretion in the way joint operations are conducted and accounted for to non-operator parties) or a non-operator party and/or a minority stakeholder (wishing to obtain as much information from the Operator and exercise a higher degree of influence on the way the joint operations are conducted, ensuring protection of minority interest).

Common JOA provisions include:

- Scope.
- Term.
- Appointment, removal and resignation of Operator.
- Scope of Operator's duties and limitation on liabilities.
- Operator personnel and secondees.
- Operating Committee role and responsibilities.
- Work programs and budgets.
- Operations by fewer than all parties.
- Default.
- Disposition of production.
- Decommissioning and abandonment.
- Surrender, extensions and renewals.
- Transfer of interest.
- Withdrawal.
- Relationship of parties and tax.
- Confidentiality.
- Intellectual property.
- Force majeure.
- Applicable law.
- Dispute resolution.
- Allocation of cost.
- Accounting procedure.
- Lifting procedure.
- Decommissioning procedure.
- Anti-bribery compliance.

JOA key provisions and practical issues

There are three key underlying principles of a JOA, which must be considered in a practical context:

- **Not a partnership.** The JOA is generally drafted so as to avoid being deemed a partnership, while at the same time performing a similar function to a partnership agreement, in order to take advantage of a more favourable tax treatment.
- **Liability of the Operator.** The Operator should receive neither gain nor suffer loss from its position as Operator.
- **Liability of the parties.** The liability of the JOA parties in relation to one another is several and not joint.

Practical issues arising under a JOA

Relationship between the parties

The precise formulation of the relationship between the parties as set out in the JOA needs to be considered within the context of the applicable governing law. In certain civil law jurisdictions, agency rules may have an impact on the scope of the Operator's duties and in others, a JOA may be treated as a joint venture even if the contract expressly specifies otherwise. While only a minority of jurisdictions set out in law the nature of the relationship of the parties under a JOA, if operating in one of those that does, for example Brazil, it is important to ensure that the JOA is consistent with the form provided under the law.

Anti-bribery and corruption

Due to the nature and scale of operations and the complexities of contractual relationships with suppliers, contractors and governments, the oil and gas industry is particularly vulnerable to bribery and corruption risks. The operation of anti-bribery legislation and regulations may mean that JV partners find themselves liable for the actions of partners acting on their behalf and under their auspices. Most IOCs have strict internal anti-bribery and corruption procedures and policies and the principles adopted under the JOA will need to be consistent with those policies and applicable anti-bribery laws. For example, the OGUK JOA has been updated to reflect the requirements of the UK *Bribery Act 2010* (UKBA)

Although it is common for the parties to agree to be bound not only by relevant local laws but also wider reaching international laws such as the Foreign Corrupt Practices Act 1977 (FCPA) and the UKBA, it is important to consider the particular extent to which the relevant statutes apply to each party and the proposed operations and the nuances of such laws. For example, a properly reported facilitating payment may be permissible under the FCPA, but is prohibited under the UKBA. The AIPN 2012 Model JOA contains a number of mutual compliance warranties and cross-indemnities, and most IOCs will insist on receiving a certificate of compliance from JV partners, however the importance of a fully-considered and effective policy and reporting procedures cannot be underestimated, as even alleged breaches can have serious financial and reputational consequences.

Operator: duties and liability

- The Operator's obligations and their ultimate enforceability must be considered expressly by reference to the applicable laws. For example, the parties may wish to expressly impose a duty on the Operator to act in good faith; however, as noted above, the concepts and duties of implied good faith, fair dealing and fiduciary duties may vary by jurisdiction.
- Certain civil law jurisdictions contain restrictions on the release or limitation of an Operator's liability, therefore the enforceability of any such limitation or release will depend on the position under the applicable law. Often, the parties will seek to negotiate carve outs from exemptions on the Operator's liability, for example for breach of anti-bribery and corruption laws, gross negligence and wilful misconduct. It is important to consider whether these concepts are prescribed by statute or whether the parameters need to be clearly set out in the JOA; for example, under English law, there is no set definition of "gross negligence" or "wilful misconduct". Choice of law will therefore be an important issue in international JOAs, especially where NOCs are party (as these will traditionally favour the domestic legal system).
- The ambit of indemnities and the duty to mitigate losses should also be carefully considered as the JOA is likely to contain a number of cross-indemnities. In some jurisdictions, a provision framed as an "indemnity" may effectively operate as a guarantee, while certain civil law jurisdictions, for example, France, have a different test to establish causation and loss than that which applies in English law. In some jurisdictions, such as England, there may be no automatic duty on a party to mitigate its indemnified loss, and the parties will need to make express provision in the JOA if they want the Operator to have a duty to mitigate its losses, which may give rise to a subsequent indemnity claim by the Operator against the non-operator parties.

Control and funding

Subject to specific decisions reserved for ManCom review and approval under the PSC, OpCom is the ultimate decision making body at the UJV level and generally consists of a representative from each JOA party. Decisions at OpCom level are based on representations made by the Operator and are passed if the agreed threshold of votes is achieved or exceeded. Each of the JOA parties will have its own position as to the level at which the voting pass mark should be set, largely depending on its own PI and expectations. It is not uncommon, especially in circumstances where the agreed pass mark is low and subsequently a party can be "voted in", for different thresholds to be agreed for different types of matters, with a number of key matters being subject to a high pass mark or a unanimous decision. An example of key matters reserved for unanimous approval are approval of:

- Field development and decommissioning plans.
- Abandonment of wells.
- Determination of commercial discovery.
- Relinquishment or surrender of all or part of the Contract Area.

Further consideration should be given to the voting pass mark in the context of the process for approval of annual work programs and budgets prepared and tabled by the Operator. To avoid delays or deadlock in approving these, and for ultimate continuity of the venture, such matters are typically decided subject to an agreed pass mark, rather than unanimous agreement. Although the actual pass mark will vary between ventures, this is one of the areas which gives rise to a number of practical issues as there is a risk of a party being "voted in" and committed to an operation or an expense in which it may not wish to participate. For example, in a vote between the following JOA partners:

Party	**PI (%)**
A	40
B	20
C	15
D	25

	100

In circumstances where the pass mark is set at 65% or more, there is a potential for a number of partners to be "voted in" by virtue of, for example, Parties A and D voting affirmatively. A higher pass mark of, for example, 85% is more likely to protect minority participants (although Party C is at risk). In a structure where there are one or two parties with a large PI, it may be commercially advantageous to set the pass mark at a level whereby at least one of those with a minority interest must agree together with the larger participants. The underlying share of a party's participation and its commercial interests and voting powers are likely to change throughout the life of the venture as parties divest and new parties buy into the UJV, therefore control and decision making should be an ongoing consideration.

Consideration must be given to local laws and regulations as some jurisdictions have introduced model form JOAs and strict statutory requirements with respect to certain JOA matters. For example, in Ghana, pursuant to the recently implemented Petroleum (Exploration and Production) Act 2016 and Petroleum (Exploration and Production) (General) Regulations, 2018, all decisions and approvals of the OpCom require the unanimous vote of the national oil company, GNPC Exploration and Production Company Limited GNPC and the contractor group.

A party may choose to opt out of an operation proposed as a joint operation by the Operator, by exercising its right of non-consent, however the exercise of such right gives rise to a number of practical implications.

Non-consent rights and sole risk

Also referred to as operations by fewer than all parties, the non-consent and sole risk provisions enable one or more parties to pursue activities that are not undertaken for the joint account as exclusive operations, whether because an operation is approved at OpCom level but a party declines to participate in it through its rights of non-consent or an operation is proposed but not approved by OpCom. There are some complicated practical implications of opting out of joint operations and conducting exclusive operations which will need to be addressed in the JOA, for example responsibility for, and consequences of, exclusive operations, use of joint property, production sharing and the reinstatement of a non-consenting party.

Issues with "going non-consent":

- The right to opt out may not always be available. The JOA will usually stipulate which operations can be proposed for exclusive operations and which must be performed as joint operations, that is, by all the parties. Typically, a JOA will contain a prohibition on exclusive operations until the minimum work obligations (agreed with the State under the PSC) are fulfilled in order to keep the parties focused on their commitments to the State. There may be other operations that the parties agree may not be conducted by fewer than all parties, for example operations pursuant to an approved development plan.
- Exercising its right of non-consent does not automatically release the non-consenting party from its liability for its PI share of costs of the proposed operation. *Ithaca Energy (UK) Ltd v. North Sea Energy (UK) Ltd [2012] EWHC 1793 (QB) (03 July 2012)* highlighted the importance and complexity of drafting opt out provisions in JOAs. In this instance a party having voted against drilling of a well sought to rely (unsuccessfully) on its non-consent rights under the JOA, which allowed a party to opt-out if the proposed well was an "appraisal well", to avoid payment of its share of drilling costs. The provisions under the JOA in question were not dissimilar to those seen in the AIPN 2012 Model JOA. The case provided a rare opportunity for judicial consideration of what constitutes an "appraisal well" and the operation of non-consent provisions, emphasising the importance of the technical parameters and terminology used by the Operator in its proposals.
- If the non-consenting party, having exercised its right to opt out of a joint operation, subsequently decides that it wants to participate in the exclusive operation, it will not only have to pay its PI share of costs incurred by the consenting parties in conducting the exclusive operation but also pay a hefty cash premium to the consenting parties to compensate them for taking the risk. Cash premiums range from 400% to 1,000% of the non-

consenting party's PI share of specific costs incurred by the consenting parties and are designed as a deterrent to parties "going non-consent" and to keep the group together throughout the venture.

Funding, default and remedies

The UJV is funded through cash calls issued by the Operator to the other parties on the basis of approved work programmes and budgets (subject to any authorised over-expenditure). Generally, any default or shortfall in funding by a party will be assumed and allocated pro rata between the remaining parties. As a result, while the initial partner group may seem financially robust and commercially aligned, the risk of partner default, especially in the circumstances where a financially weaker party enters the venture, must be considered when drafting default and remedy provisions.

In addition to the insolvency and breach of material terms events of default commonly seen in joint ventures, a party will be in default under the JOA if it fails to:

- Pay when due its share of joint account or exclusive operation cash calls and charges.
- Provide or maintain security required under the JOA or the PSC (or any decommissioning security agreement).
- Perform its indemnity obligations under the JOA or the PSC.

Usually, a party will be deemed to be in default within a set number of business days after receipt of a default notice until full repayment of the default amount plus interest (the Default Period). During the Default Period, a number of rights otherwise available to the party in default (the Defaulting Party) under the JOA will be suspended for the duration of the default, for example the right to:

- Attend or vote at committee OpCom meetings.
- Take its entitlement to production.
- Consent to or reject transfers of PIs by other parties.
- Transfer its own PI except to a non-defaulting party.
- Access certain information.
- Participate in operations voted on during the Default Period (to the extent such operations are permitted to be carried out by fewer than all parties under the JOA).

There are multiple remedies available and the exercise of one remedy (unless it is forfeiture) does not preclude the non-defaulting parties from exercising such remedy again, or from exercising another remedy available to them under the JOA. However, availability and/or enforceability of certain remedies may vary depending on the applicable laws. For example, certain remedies requiring money or interests to be held on trust by the non-defaulting parties may need to be modified in jurisdictions which do not recognise trusts and similarly forfeiture of PI may be deemed penal or unconscionable in some jurisdictions.

It should be noted that usually, whether under the PSC and/or local law, any assignment or transfer of a PI (including that of a withdrawing or Defaulting Party) will be subject to State approval, which in itself gives rise to potential practical issues, which are considered in more detail in *Transfer of participating interest* below.

In addition to any remedies and rights available under applicable law, if the Defaulting Party fails to fully remedy the breach by a set date, any non-defaulting party may, in order to recover its portion of the default amount, in its discretion and at any time:

- Require the Defaulting Party to forfeit its rights, title and beneficial interest under the JOA and the PSC (Forfeiture).
- Require the Defaulting Party to sell its PI at a discounted price to non-defaulting parties (Forced Sale/Buy-Out).
- Require the Defaulting Party to gradually reduce its PI in proportion to the amount in default (Withering).
- Enforce its security on the Defaulting Party's PI.

Considering each of these remedies in turn:

Forfeiture. A non-defaulting party (or a majority of non-defaulting parties, depending on the JOA), may require the Defaulting Party to completely withdraw from the JOA and assign its PI to willing non-defaulting parties. Such withdrawal and assignment by the Defaulting Party is usually free of cost to the non-defaulting parties and is without any compensation to the Defaulting Party.

There may be an argument that the use of Forfeiture as a remedy for default may amount to a penalty or unconscionable conduct and therefore may not be enforceable in certain jurisdictions. Although there are no English law cases directly on enforceability of JOA forfeiture provisions, the recent Supreme Court decisions in *Cavendish Square Holding BV v El Makdessi and ParkingEye v Beavis [2015] UKSC 67* support the position that, at least under English law, forfeiture provisions are enforceable provided the test set out by the Supreme Court is satisfied. For further analysis, see Legal update, Penalty clauses: the "haphazardly constructed edifice" is rebuilt but not extended (Supreme Court).

Although the judgment restores the ability of parties to make their own bargains, and confirms the court's role in giving effect to the will of the parties, working out what is a "legitimate interest" that should properly be enforced for the purpose of applying the new tests may not be straightforward. However, given that:

- The JOA will be negotiated between parties who are able to make their own appraisal of the demands and consequences of their commitment;
- The venture is inherently an expensive, high risk operation involving common commercial endeavour, planning and requirement to make prior commitments that can be relied upon; and
- Defaults are burdensome and problematic for the other partners and efficient continuation of the venture requires effective measures for handling of significant defaults,

in the absence of evidence that the other parties' conduct is in bad faith, a Defaulting Party is likely to find it difficult to obtain relief on the grounds that such remedy or conduct is unconscionable, that is, that the other parties should not be permitted to use or insist upon their legal rights to take advantage of the Defaulting Party's special vulnerability or misadventure for the unjust enrichment of himself, or that such a remedy is outside the norm of the oil and gas sector.

Forced Sale/Buy-out. This is a common alternative to Forfeiture, requiring a Defaulting Party to be bought out at a discounted valuation. As the discount is calculated by reference to the fair market value, buy-out clauses give rise to a high risk of litigation as the parties are likely to disagree on price. Unlike Forfeiture, the Defaulting Party receives some value for its interest; therefore non-defaulting parties will want to see a high discount rate to fair market value to reflect the default circumstances and the additional risk assumed by them.

Withering. The Withering option gives the non-defaulting parties the right, during an approved development plan, to acquire a part of the PI in the actual exploitation area to which the default relates. This "withering interest" is calculated by reference to a detailed formula previously agreed in the JOA. Although Withering may be considered to be a more proportionate remedy than complete Forfeiture, the formula will, in the first instance, generally require extensive negotiations and there is arguably a risk that it is open to manipulation by a party as a means of reducing its interest and liability in less productive assets.

Enforcement of security. In addition to the other remedies available to non-defaulting parties set out above, such a party may elect to enforce any subsisting mortgage interest on the Defaulting Party's PI. Enforcement of security, while offering a greater degree of certainty, will be subject to the provisions of the PSC and local law requirements, and may be cumbersome to enforce (for example, depending on the jurisdiction, the enforcing party may have to go through a court process to enforce its security and obtain relevant ministerial consents to the transfer of an interest).

Transfer of participating interest

In addition to a payment or tax on assignment that may be payable to the State under the PSC or local law, a transfer of a PI (whether on default or withdrawal by a JV partner) is likely to be subject to some or all of the following restrictions:

- Consent by non-transferring JV parties under the JOA.
- Consent by the State under the PSC and/or local law.
- Anti-monopoly or other government agency consents or approvals.
- Rights of pre-emption by non-transferring JV parties under the JOA.
- Rights of pre-emption by the State under the PSC and/or local law.

There may be exceptions to some of the restrictions where such transfer is:

- To an affiliate of an existing JV party (subject to the affiliate having the appropriate technical and financial capabilities).
- Part of a package deal (that is, the underlying transaction involves a sale of various interests in multiple licences or PSCs).

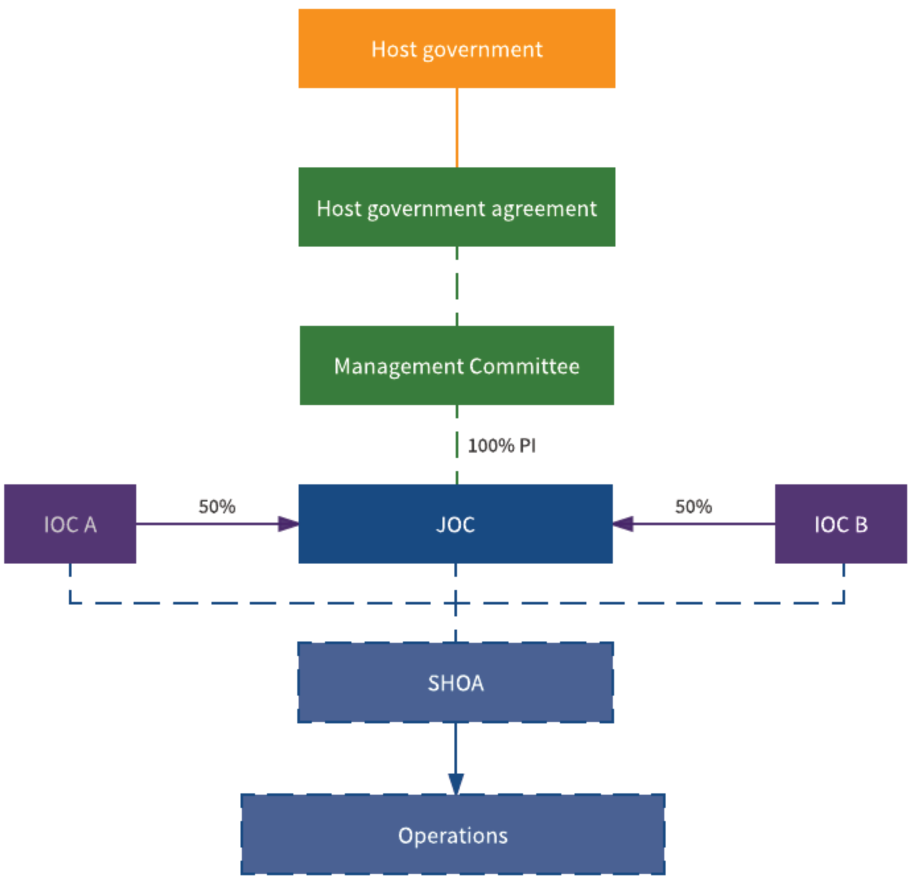
There are a number of jurisdiction-specific issues that may arise on a transfer of PI, for example, the position under the AIPN 2012 Model JOA, which is based on common law principles, is that pending the State approval to a transfer of a PI, the transferring party holds its PI on trust for the non-transferring party or parties, with parties issuing powers of attorney to implement the transfer. The mechanism for the implementation of the transfer and associated documents will need to be considered and structured accordingly when dealing with civil law jurisdictions, where the mechanism of a trust either does not exist or is subject to bespoke rules deviating from common law norms, or where the issuance and validity of powers of attorney may be subject to requirements that differ from those seen in common law jurisdictions.

INCORPORATED JOINT VENTURES AND SHAREHOLDER AND OPERATING AGREEMENTS

There are a number of ways in which an IJV can be structured and the particular form of corporate organisation will typically ultimately depend on what is most commercially optimal for its shareholders, together with the particular legal requirements of the host country. The IJV structure generally involves several IOCs creating an incorporated joint operating company (JOC) which will directly or indirectly hold the licence or participating interest under the PSC. The corporate structure can range, at its simplest, from IOCs being direct shareholders in the JOC, to a more complicated structure where IOCs invest in a holding company which is the ultimate parent of the JOC. In some circumstances, the JOC may not be the licence or PSC holder and instead will provide services and operate the asset on a fee basis under a services contract with the licence holder (often another group entity). The terms governing the relationship between the JOC shareholders and the operation of the JOC will be set out in a SHOA, which is in effect a hybrid between a conventional shareholders' agreement and a JOA.

For the purposes of this note, it is assumed that the JOC is the direct contractor entity under the PSC as well as being the operator of the asset.

Practical Law
Example IJV structure



SHAREHOLDER AND OPERATING AGREEMENTS

The SHOA combines principles seen in a conventional shareholders' agreement, such as shareholder and board decision-making, corporate governance structure, dividend distributions policy and provisions around the transfer of shares, with certain aspects of a JOA, such as those dealing with operating committee involvement, annual work programmes and budgets and marketing of petroleum. Depending on the complexity of the overall corporate structure and shareholder base, a SHOA may also contain mechanics enabling the shareholders to sole risk or non-consent to certain proposed operations, and allow such operations to be carried out by the JOC on behalf of fewer than all parties (with back-in rights at a premium).

SHOA anatomy

Provision	Key areas covered
Scope of business activities	• Scope of JOC's business activities • Whether JOC's activities are limited to operating the asset or if it is free to engage in other business activities
Members	• Mechanics for shareholder meetings • Reserved matters and voting pass marks (if not subject to unanimous vote) • Deadlock resolution mechanism e.g. escalation
Board of directors	• Right to appoint directors (usually the number of board nominees a shareholder is entitled to appoint will depend on the size of its shareholding in JOC) • Removal and resignation of directors • Mechanics for meetings, quorum and voting • Matters reserved for the board and whether certain matters such as approval of work programs and budgets are subject to a higher than majority pass mark
Operating Committee (OpCo)	• Consisting of a representative of each shareholder who is not a director of JOC, OpCo is generally responsible for day-to-day operation of the asset and employment of subcontractors • Scope of duties • Mechanics for meetings and quorum
Funding	• JOC is funded by shareholders on the basis of cash calls issued by JOC • JOC can borrow funds subject to any restrictions under the SHOA • Individual shareholders may raise funds from third party lenders subject to any restrictions under the SHOA
Dividend	• Profit and dividend policy setting out the mechanics and priority for payments made out of JOC's profits
Marketing of petroleum	• Rights to sell and market petroleum vest in JOC • JOC's marketing policy and mechanics for sale of crude/gas
Indemnities	• Mutual cross-indemnities by the SHOA parties for specified types of loss
Default	• Events triggering default and mechanics for curing and/or enforcing default • Remedies e.g. forced sale to non-defaulting parties, lien over defaulting party's shares in JOC
Transfer	• Parameters on any restrictions on transfer or pledging of shares to third parties e.g. outright prohibitions or subject to partner consent, pre-emption • Permitted transfers e.g. to affiliates • Change of control of JOC and/or its shareholders may require notification and/or approval from the State.
Governing law and dispute resolution and boiler plate provisions e.g. confidentiality, third party rights, assignment, notice	

GLOSSARY

Abbreviation	Meaning
AIPN	Association of International Petroleum Negotiators
Contract Area	A defined geographical area under the PSC within which the IOC has an exclusive right to explore and produce petroleum
E&P	Exploration and production
FCPA	Foreign Corrupt Practices Act 1977, as amended, 15 U.S.C. §§ 78dd-1, et seq
IJV	Incorporated joint venture
IOC	International oil and gas company
JOA	Joint operating agreement
JOC	Joint operating company
ManCom	Management committee
NOC	National oil company
OGUK	Oil & Gas UK, the representative body for the UK offshore oil and gas industry
OpCom	Operating committee
Operator	A contractor entity designated and appointed as operator under the JOA
PI	Participation interest under the PSC
PSA	Production sharing agreement
PSC	Production sharing contract
SHOA	Shareholder and operating agreement
State	Host government
UJV	Unincorporated joint venture
UKBA	UK Bribery Act 2010
UKCS	United Kingdom Continental Shelf