Chapter 1: Introduction

1.1 Scope

(a) Objective

The joint operating agreement (JOA) is one of the most important documents in oil and gas transactions.[1] JOAs regulate the rights and duties of the parties to a joint venture (JV) aimed at the exploration and exploitation of oil and gas.[2] Most of the duties under a JOA rest with the operator – that is, the party responsible for the administration of the day-to-day activities of the JV. The operator is usually the party with the highest level of participation and interest in the enterprise; therefore, JOA models and studies commonly focus on the operator's perspective. However, such ventures are not the exclusive preserve of the operator: non-operators also make a vital contribution to the success of joint operations.

Non-operators retain a smaller working interest in the JV, as they usually have fewer financial and technical resources than the operator.[3] This creates an environment in which little attention is paid to non-operators. Their situation is akin to that of minority shareholders, which similarly have less say than majority shareholders in the conduct of a company's operations. However, they still have shares in the company, along with their own views on how the company should be run.[4] It is thus necessary to understand the different needs and perspectives of non-operators in order to arrive at an efficient, reasonable and fair agreement.[5] If the perspectives of non-operators are ignored, it is extremely difficult to create a

1 "Probably the most significant contract used in the upstream business is the JOA. It sets out the fundamental and overarching relationship among joint venture parties from the initial exploration to the ultimate production of hydrocarbons." A Timothy Martin, "Model Contracts: a Survey of the Global Petroleum Industry" (2004) 22 J Energy & Nat Resources L 291.

2 For the purposes of this book, JOA and JV have the same meaning.

3 This is not a hard and fast rule – there are a number of instances in which the operator will not hold the greatest working interest, but these are more likely to arise in a major transaction where several large oil companies are participating in the same consortium.

4 Because of these similarities, commentary on the situation of minority shareholders is provided where appropriate (although it is beyond the scope of this book to provide a comprehensive analysis of this position). For further information see Victor Joffe QC *et al*, *Minority Shareholders: Law, Practice, and Procedure* (3rd ed, OUP, Oxford 2008), AIJA Law Library, *Protection of Minority Shareholders* (Wolters Kluwer, London 1997), AJ Boyle, *Minority Shareholder"s Remedies* (CUP, Cambridge 2002), Robin Hollington QC, *Minority Shareholders" Right"s* (3rd ed, Sweet & Maxwell, London 1999).

5 While JOAs are commonly analysed from the operator's perspective, some authors have also recognised the importance of non-operators, such as John BB Bullough, "The Norwegian Experience – The Role of a non-operator" (1996) 11 Oil and Gas Finance & Accounting, and Peter Roberts, *Joint Operating Agreements: A Practical Guide* (Globe Law and Business, London 2010) pp244-245.

balanced instrument. Consequently, critical problems may arise and potentially jeopardise the existence of the consortium, as the cooperation of all participants is crucial to success. Moreover, the JOA usually remains in force for the entire duration of the petroleum title, which can last up to 30 years.[6] The JOA should thus offer reasonable terms for all contracting parties, from the beginning until the end of the agreement.

Today, major oil and gas companies are increasingly withdrawing their investments from mature provinces such as the United Kingdom and Norway[7] and reinvesting in other jurisdictions that promise greater rewards. These companies are in turn being replaced by small or medium-sized independent companies, which commonly have less experience and lack the financial resources to operate in the exploration and production (E&P) phases.[8] In other words, the traditional framework of JOAs – based on a strong, dominant operator – is radically changing. Some JVs are now composed of several parties in a more equal position.

Many oil and gas regions have already reached maturity, so this trend is set to continue – even if new technology extends the life of current fields.[9] This new scenario requires more balanced agreements to govern joint operations. It is thus more crucial than ever to understand the perspectives of non-operators, as these will assume even greater significance in future JOAs, where the parties are in a more equal position.[10] It is also possible that some operators might not use JOAs for certain activities in mature provinces, as the costs and risks might not justify joint efforts under a consortium agreement. In such cases, careful risk and cost analysis should be undertaken to determine the most appropriate basis on which to proceed.

The aim of this book is to analyse the most widely used JOA standard model forms from various jurisdictions – in particular:[11]

- the Association of International Petroleum Negotiators (AIPN) Model (the international model);
- the Oil and Gas United Kingdom (OGUK) Model (the British model);

6 "Joint operating agreements are designed to last for the life of the field, during exploration, appraisal and development. Amendments, though not rare, are less common than might be expected for a document with a 30-year lifespan." Charez Golvala, "Upstream joint ventures – bidding and operating agreements" in Geoffrey Picton-Turbervill (ed), *Oil and Gas: A Practical Handbook* (Globe Law and Business, London 2009) pp45-46.

7 "The UK government has for some time recognised that the maturing provinces of the North Sea, coupled with more recent smaller developments, have created a need for a change in its approach to licensing and taxation." Dow, "The 20th Round Standard Form Joint Operating Agreement" (2003) 1 OGEL.

8 'Twenty years ago Southeast Asia was a hotbed of international exploration activity, and Indonesia represented fully half of that activity. Indonesia still represents a large share of the activity in the region but the region is not the focus of attention it was back then. Southeast Asia has moved from center stage. Furthermore, SE Asia has matured significantly in the past two decades. So have other regions of course." Daniel Johnston, "Contract Terms Worldwide: A Case for New Frameworks" (2004) 2 (3) OGEL.

9 "The basins of this planet have matured perhaps more quickly than many of us anticipated." *Ibid.*

10 Such scenarios might exist where operators are not the dominant party in the enterprise. For example, independent companies are more commonly found in onshore operations, but this scenario is unusual in offshore operations, as the risks and costs are much more significant. However, generally this is not an ordinary situation, as the operator is in a better position to control the joint operations. Consequently, major companies prefer to secure their assets in an efficient operation conducted by them. Nevertheless, some major developments will require the participation of several major companies together, which will also lead to the same point where the parties are in a position of equals.

11 See Chapter I, section 1.2.

- the American Association of Professional Landmen (AAPL) Model (the American model);
- the Canadian Association of Petroleum Landmen (CAPL) Model (the Canadian model);
- the Rocky Mountain Mineral Law Foundation (RMMLF) Model;
- the Greenlandic model;
- the Norwegian model; and
- the Australian Mineral and Petroleum Law Association (AMPLA) Model (the Australian model).

The aim is to arrive at an understanding of how each of these models treats and positions non-operators and their major concerns.

Finally, it is crucial to distinguish between these different perspectives and views as outlined and any misalignment of interests[12] that might occur in a JOA. While the different views often relate to the individual roles of the parties, they do not signify a misalignment of interests. Rather, the different views and perspectives of non-operators will always exist, from the moment that a JV is established until it ends.[13] It is these different views which are fully analysed in the following chapters.

(b) Unbalanced provisions, imbalance of power

Ideally, a JOA should contain balanced provisions which reflect the concerns of all parties involved. However, this is not usually the case – current JOAs tend to reflect the wishes of the operator.[14] But the success of oil and gas operations clearly depends on the contributions of all parties (such operations often involve extraordinarily high expenditures over lengthy timeframes).[15] The question is thus: why are JOAs so often unbalanced? The answer to this question lies in the context and history of oil and gas operations.

The operator's position of strength has its origins in the first JOA established back in 1956 (ie, AAPL JOA Form 1956), and still prevails today[16] – it is considered the 'traditional' approach. This fact is clearly recognised by most academics and professionals involved in oil and gas operations.[17] The oil and gas industry has always assumed a need for a strong operator which can dominate the consortium and set the pace of operations.[18] The unbalanced relationships that result do not facilitate a high degree of non-operator participation, but are rather biased in favour of the operator.[19] But why was it considered necessary to give one party so much authority over the others?

12 "The interests of the parties in their joint venture should be ostensibly the same – that is, to produce the greatest possible quantities of petroleum on the most cost-effective basis. This alignment of interests will be recognized in the JOA, but there could also from time to time be some misalignment between the interests of the parties which the JOA will also need to accommodate." Peter Roberts (n 5) p17.

13 See note 5.

14 "(T)raditionally the perception has been that the operator has *de facto* much more to say over the entire project and is best positioned to take the initiative; thus the operator is rewarded with greater power, rather than greater profits." Scott Styles, "Joint Operating Agreements" in John Paterson, Greg Gordon (eds), *Oil and Gas Law: Current Practice and Emerging Trends* (DUP, Dundee 2007) pp277-278.

15 See Chapter I, section 1.3.

16 See notes 17 to 27.

Commentators identify three reasons why operators have traditionally been favoured in JOAs. The first theory is based on the fact that the operator has the most onerous obligations under the JOA and should thus enjoy certain benefits in order to compensate it for this burden. The second is based on the formation of the consortium: the theory is that the leader of a JV needs a greater incentive to encourage it to assume this position. The third – and the most widely accepted among commentators – concerns the operator's level of commitment. Oil and gas operations involve significant risks and costs; it is therefore important to secure a high level of commitment from the operator towards the success of the JV. At the same time, the operator's greater level of commitment reduces the risk of it trying to make more profit or recover any losses when negotiating the JOA, which it might seek to do it were a smaller participant.[20] In addition, circumstances often require the operator to cover the costs of operations in advance; these are subsequently reimbursed by the non-operators in proportion to their shares.[21] A stronger operator can more easily deal with any advance payments that might be needed.

The first and second theories above are likely to be raised by an operator during the negotiation phase to support its claims for a higher percentage of interest from the JV, as Terence Daintith explains:

> *Usually, but by no means invariably, the operator will be the party holding the largest percentage interest or one of its affiliated companies. Reasons for this include a perception on the non-operators that the operator should hold a substantial interest as evidence of its commitment to the project and the fact that operators themselves are usually not keen to take on the burden of operatorship if they have only a minor share of equity. Furthermore bidding groups are usually organized by an operator who makes it clear from the start that it requires a major interest.*[22]

However, the third theory, which is founded on economic reasoning, is the most persuasive. Ernest Smith and Kenneth Mildwaters explain this theory as follows:

> *The operator under an international JOA is usually the party with the largest interest in the concession. A party with a less substantial interest may be hesitant to commit scarce personnel and technical resources to the management of the host government agreement, and the other participants may doubt that party's commitment to the project or fear that*

17 See Terence Daintith, Geoffrey Willoughby (eds), Adrian Hill, *United Kingdom Oil & Gas Law* (3rd ed, Sweet & Maxwell, London 2009) p1140, Gerard MD Bean, *Fiduciary Obligations and Joint Ventures: The Collaborative Fiduciary Relationship* (OPU, Oxford 1995) pp14-15; Kenneth Charles Mildwaters, *Joint Operating Agreements, A Consideration of Legal Aspects Relevant to Joint Operating Agreements used in Great Britain and Australia by Participants thereto to Regulate the Joint Undertaking of Exploration for Petroleum in Offshore Areas with Particular Reference to their Rights and Duties* (PhD thesis presented to the University of Dundee, 1990) p427; John Wilkinson, *Introduction to Oil & Gas Joint Ventures: Volume one, United Kingdom Continental Shelf* (OPL, Ledbury 1997) p40; Ernest E Smith *et al*, *International Petroleum Transactions* (3rd ed, RMMLF, Westminster 2010) p542; Sandy Shaw, "Joint Operating Agreements" in Martyn R David, *Upstream Oil and Gas Agreements* (Sweet & Maxwell, London 1996) p19-21; Antony Jennings, *Oil and Gas Exploration Contracts* (2nd ed, Sweet & Maxwell, London 2008) p17-27; Hew Dundas, "Joint Operating Agreements: An Introduction" (1994 Summer Programme: UK Oil and Gas Law, CPMLP 09/09, 1994) pp5-11.

18 *Ibid*.

19 See Chapter I.

20 *Ibid*.

21 Claude Duval *et al*, *International Petroleum and Exploration Agreements: Legal, Economic & Policy Aspects* (2nd ed, Barrows, New York 2009) p298.

22 Terence Daintith (n 19) p1140.

its motivation arises from a desire to profit from the position, rather than from the success of the operations.[23]

The operator is usually the Participant with the largest interest. The rationale behind this is that the Participant with the largest interest will incur the greatest expenditure and greater commitment will be generated in matters of co-ordination and conduct of the Operations. It is hoped that a prudent and economic management and conduct will result.[24]

The government might also play an important role in determining the higher interest of the operator, as in some cases the applicable legislation will require that the operator retain a certain minimum percentage of interest for the entire duration of the JOA, subject to its removal if this obligation is not complied with.[25]

It is further evident that both non-operators and host governments sometimes fear that an operator with a smaller interest might not dedicate the necessary effort and commitment to such operations; the operator is thus likely to be the party with the greatest interest and the strongest position in the JV.

It could additionally be argued that it is the nature of business that the party in the strongest negotiating position gets the most benefits.[26] While in general terms this may be true, in the oil and gas context this scenario is slightly different. First, the operator will have no wish to shoulder all of the risks and costs of the operations itself, as these could be extremely high. Consequently, the operator needs partners to share the risks and cost involved. Second, non-operators are not only part of the JV, but also jointly liable for operations conducted by the operator in relation to third parties and the host government. Third, the assets of oil and gas companies are usually spread out across different investments, so no party is generally in a realistic position to conduct all operations alone. It is thus important for all parties (including the operator) to maintain a certain equilibrium in their roles within the consortium, as in the end this will benefit all of them.

If the parties do not establish a balanced agreement, this could cause problems later on.[27] First, unbalanced provisions can create uncertainty, as a non-operator could seek court protection or relief against unfair provisions (although such protection is difficult to obtain in practice). In extreme cases, draconian provisions might prevent non-operators from continuing as parties to the agreement, which might jeopardise the whole consortium. If this happens, the operator will have to find new partners and negotiate another JOA; at the same time, it might even become embroiled in litigation or arbitration with its previous partners. Consequently, an unbalanced JOA can cause serious damage to the consortium and indeed to the operator itself.

23 Ernest E Smith (n 19) p542.
24 Kenneth Charles Mildwaters (n 19) p427.
25 See Chapter III, section 3.2.
26 "The greater the number of parties and the bigger the issues, particularly if they are wholly or in part political, the more complex the negotiations tend to be, but even bilateral negotiations on comparatively minor issues can become complicated." Professor RW Bentham, "The Negotiation of Agreements" (1987) 5 J Energy & Nat Resources L p134.
27 "But at the same time drafting which is ambiguous or over-clever should as a rule be avoided, since although this may solve, or appear to solve, immediate problems it can lead to trouble in the future, and the agreement should, in my view, be the bedrock upon which the parties found their future relationship." *Ibid* p139.

While the adoption of unbalanced JOAs within the traditional matrix may be understandable, albeit risky, it will become less suitable for future operations as more oil and gas regions reach maturity. Mature regions are less attractive to major or large companies, as most of the reserves have already been produced, leaving only small or medium-sized fields to be explored. In this scenario, large companies are increasingly migrating towards new regions where large reserves are still untapped. As these large companies exit mature regions, they are replaced by mainly small and medium-sized companies. The whole paradigm of the JOA thus changes radically. The operator is no longer in a dominant position to the non-operators, but rather in an equal position. As a consequence, an unbalanced JOA is no longer tenable, as the parties will seek to negotiate another agreement based on equitable grounds, which reflect the views and concerns of all parties.

That said, the parties' respective bargaining positions will remain unequal, and the dominant party is always likely to seek the best outcome for itself. This lack of equality can prove problematic where the smaller party tries to secure the inclusion of optional provisions in a model form. Optional provisions will not be implemented unless they are beneficial to the stronger party.[28] Therefore, the current standard forms do not provide truly balanced terms, as it is unlikely that under current operations the parties will achieve such balance by themselves.

The extent of this imbalance is clearly seen in the roles of the parties in the consortium. Although the agreement refers to 'joint operations,' the reality is quite different: instead, one party performs and conducts operations, and the others mainly contribute financially. When it comes to the costs and liabilities of the enterprise, however, all parties are jointly liable for all operations performed under the petroleum title (except on limited grounds related to gross negligence or wilful misconduct).[29] In other words, the costs and liabilities are shared, but the conduct of operations is not. The situation of non-operators is even more complicated, as in most cases they cannot even participate in decisions concerning the operations, as is fully explained in the following chapters. In other words, non-operators are in a similar position to passengers on public transport: they share the costs of the transport, but they cannot determine the route or the final destination (unless the non-operators can effectively control the operating committee). However, in oil and gas operations, this lack of participation might have severe consequences, as is discussed in the following chapters.

(c) Conclusion

Within the traditional framework of oil and gas operations, one party is granted extensive rights and powers in order to secure the performance of operations.[30] Historically, it was considered necessary to put the operator in such a strong position,

28 PR Weems, M Bolton, "Highlights of Key Revisions – 2002 AIPN Model Form International Operating Agreement", 1 OGEL 5 (2003) p32.

29 See Chapter III, section 3.2.

30 "Like standard oil and gas leases and deed clauses creating an exclusive right, on-shore operating agreements entrust virtually all significant managerial decisions to one party." Ernest E Smith (n 19) p835.