HERBERT SMITH FREEHILLS

MISALIGNMENT ON EXPENDITURE – PARTNER FUNDING AND SOLE RISK

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PODCAST

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This post will focus on the circumstances in which low oil price environments may spur disputes between partners under Joint Operating Agreements ("**JOA**"), with a focus on disputes in respect of funding and approval of joint operations.

WHAT IS A JOINT OPERATING AGREEMENT?

The exploration, development and production of hydrocarbons is characterised by high risks and costs with projects often running into the billions of dollars. Oil & Gas companies typically allocate and manage such risk and costs by partnering with other companies to explore, appraise, develop and produce the hydrocarbons. The JOA is the vehicle used for this allocation of risk and reward.

The JOA sets out the percentage interest of each of the participant. Subject to a few exceptions, all of the rights and liabilities of the parties under the JOA arising in connection the licence will be shared between the parties in proportion to those percentage interests. The JOA governs the decision making process for joint operations, the funding of joint operations, the procedures and rules for the entry of new partners and how existing partners may exit the project (whether voluntarily or otherwise). The JOA typically also appoints one of the partners as operator to carry out joint operations and for itself and on behalf of non-operators. JOAs are often based on model forms, particularly the AIPN model form.

COMMON DISPUTES IN RESPECT OF WORK PROGRAMME AND BUDGET ("WP&B")

DISPUTES IN RELATION TO APPROVAL OF THE WP&B

Under the JOA, the operator's authority to act and conduct operations under the JOA is subject to the supervision, control and approval of the operating committee ("**OpCom**"). Each party to the JOA will have voting rights that are typically proportionate to its percentage interest in the JOA. Generally speaking, an Operator's ability to conduct Joint Operations – and to demand that the other participants contribute their share of the costs – is based on the approval by OpCom of a WP&B covering the operations in question..

In the context of low oil price, and in particular cash flow challenges that many industry participants are facing, there may be a divergence in strategies and priorities within the OpCom. This may lead to disagreements on whether or not to undertake certain activities in any given period, with some parties to the JOA wanting to proceed with activities and others wanting to preserve cash by delaying or suspending investment.

There are two types of JOA provisions which can often help resolve some such disagreements: sole-risk and non-consent provisions.

A sole-risk provision is a useful deadlock provision in a situation when a proposal submitted to the OpCom fails to get the necessary approvals. In such a situation, a party in favour of the proposal may utilise the sole-risk provisions to propose that the operation be undertaken at the sole risk of a sub-set of partners. Not every activity can be undertaken on an exclusive basis, however. Most JOAs contain a list of prohibited exclusive operations whereby all parties need to participate or not in order for the activity to be undertaken. A non-consent provision may apply when a proposal has received sufficient support to gain OpCom approval, but one party voted against and does not want to participate in it. A non-consent clause may allow that party to "opt out" of the operations in question (.

The provisions can lead to high value disputes if partners do not agree on their scope or effect, given that they can significantly amend the allocation of risk, costs and rewards from the assets in question. For instance, partners who vote against an activity may argue that the relevant activities cannot be sole risked or dispute the relationship, in financial terms, between the sole-risk activity and Joint Operations.

Other types of disputes arising in these situations may involve disagreements as to whether an operator that voted against a particular activity is still required (or entitled) to perform the activity on behalf of the non-operating parties who voted in favour, and whether the non-participating party has a right to "back-in" to the operations at a later date.

Even where sole-risk or non-consent provisions are not triggered, disputes over WP&Bs can have significant consequences. For example, disputes can arise where a cash-constrained partner seeks to block the conduct of operations that the other partners consider critical to the development of the assets, as the other partners seek a resolution to the commercial impasse. For example, JOAs often provide that an operator may proceed with operations required to meet mandatory minimum work obligations under the host State agreement, but there is also recent English case law where the Operator has argued that the other participant was under an implied obligation to vote in favour of particular work.

DISPUTES AFTER APPROVAL OF THE WP&B

There is also scope for dispute following agreement of the WP&B, if the parties' commercial aims diverge (for example, if one party wishes to save cash).

For example, there may be a debate as to whether elements of proposed operations were in fact covered by the WP&B, or whether an Operator is (given developments since the WP&B was agreed) entitled to cash call for all the amounts included in the WP&B.

Further, in addition to the WP&B, many JOAs provide for specific work above a certain threshold or in relation to specific contracts to be put to a vote of the OpCom, either in the form of authorisation for expenditure or for approval of the contract itself. Under some JOAs, this vote is informational only, but this is not always the case.

The operator may wish to revise the WP&B (e.g. in the event of a cost overrun or where new and unanticipated work is required), but while certain non-operators may vote against such revision.

Accordingly, disputes may arise where the WP&B has been approved but an approval for expenditure is blocked or where one party refuses to pay the costs associated with a contract after the contract is entered into if the contract was not awarded in accordance with the JOA requirements.

These issues arise regularly in practice. For example, the ICC published details of an arbitration involving a non-operating party which refusing to pay cash calls in relation to additional drilling work, arguing that they were not covered by the WP&B. The operator argued that, while the costs may have exceeded the budget, they were costs incurred in joint operations. The tribunal found against the operator which had failed to prove that the costs were covered by the WP&D – another reminder of the importance of adhering strictly to the JOA requirements.[1]

MITIGATING THE RISKS OF DISPUTES

One critical factor in these disputes is the relationship and communication between the parties. If operators and non-operators communicate regularly to should seek to communicate in an effort to understand their respective economic circumstances and drivers, there is a greater chance that any potential flash points will be identified sufficiently in advance for commercial solutions to be agreed, without the issue escalating into a dispute. Where disagreements do arise, operators and non-operators can improve their position by ensuring they follow accurately the provisions of the JOA – so that, for example, an operator does not give a non-operator the opportunity to argue that a cash call or contract award is invalid because the precise formalities were not followed, and a non-operator ensures that it uses its contractual rights to hold the operator to account.

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[1] Reported as Case No.1 in 'ICC Awards on JOA Disputes', ICC Dispute Resolution Bulletin (2019), Issue 3, p.37.

[Navigating the low price oil environment]

KEY CONTACTS

If you have any questions, or would like to know how this might affect your business, phone, or email these key contacts.

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