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# Joint Operations in the Upstream Oil and Gas Sector

## The Ugandan perspective

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## 1. Introductioin

Joint operations by way of unincorporated or contractual joint ventures feature prominently in the upstream petroleum sector which is the segment of the industry that finds, develops and produces crude oil and gas.The rationale behind these joint operations is sometimes misunderstood especially by countries at early exploration stage and the regulatory regime in place may be unfavourable for their formation stifling the growth and progress of the sector. In this publication, we provide a discussion of joint ventures explaining how they arise, the rationale for their creation and the attendant regulatory considerations.

## 2. Early exploration days

Joint operations become inevitable as the sector gathers steam and Uganda's journey from crude oil exploration to discovery is testament to this. Early exploration activities in frontier basins are often dominated by small size companies that are more amenable to risk at this stage compared to the larger independents and majors which may be more reluctant to assume projects whose probability of success is uncertain. These early operations are often undertaken by a single company and involve lower levels of technical complexity and modest financial exposure.

As continued exploration and development activities become more complex and expensive, companies usually come together to assume joint operations. In 1998, the Government of Uganda ('GoU') signed 2 Production Sharing Agreements ('PSAs') in respect of 2 oil blocks with Australian incorporated company Hardman Resources and Jersey domiciled Heritage Oil that revived exploration operations.In 2001, these companies ceded 50% of their PSA rights by way of farm out to Energy Africa scaling up exploration operations. The search for oil and eventual first discovery was now undertaken by way of joint operations even with the subsequent acquisition of the shareholding of Energy Africa and Hardman Resources by Tullow Oil.

The proposed sale in 2009 by Heritage Oil of 50% stake in the Blocks it held to Italian oil major ENI aborted when Tullow Oil exercised its pre-emptive right acquiring full ownership of the underlying rights. Upon closure of this transaction, Tullow Oil divested or farmed out two thirds of interests in Blocks 1, 2 and 3A to French oil major Total and the China National Offshore Oil Corporation (CNOOC) in 2012 with each party holding 33.33% and operating one of the Blocks. Tullow Oil intends to further reduce its interest in the foregoing Blocks to remain with 11.76% stake by transferring the rest to CNOOC and Total. When the Uganda National Oil Company ('UNOC') backs in with respect to Blocks 1,2 and 3A in exercise of the statutory government participation in the existing joint operations, the parties interests will be further reduced prorata to raise UNOC's mandated 15% share.

## 3. Farm outs

At the heart of upstream oil and gas joint operations are farm outs. Also known as assignments, farm outs represent transactions where holders of petroleum rights (PSAs or similar arrangements namely licenses or concessions with the relevant government) transfer or divest part of their interest to others for consideration. A party transferring the right is said to be farming out ('farmor') while the acquiring party is farming in ('farmee'). No subject in the industry has been so controversial and generated as much dispute so far in East Africa as these farm out arrangements.

Though farm outs are viewed by some as creating an opportunity for the oil companies to rake in windfall profits, they indicate a vibrant oil and gas sector that is charting a path of growth and progress. It is rare that early exploration activities in frontier basins can attract larger independents or majors. However, once the prospects of finding commercial reserves improve owing to the early activities of the junior companies, the larger independents and majors are likely to acquire stakes in projects by way of farm out or assignment. Countries that place onerous requirements on rights transfers may stifle the growth and inflow of investment to the sector. The onerous requirements can include though not limited to the approval conditions as well as punitive fiscal impositions that tax investments as opposed to profits resulting from business operations.

Farm outs or assignments are differentiated by the stage at which licence rights are divested. Farm outs at exploration may involve the carrying out of seismic surveys/works as well the drilling of exploratory wells.

Appraisal farm outs include activities that establish the size, nature and properties of crude oil discoveries while assignments at development stage comprise participation in the monetization of the discoveries made, usually via bearing some of the farming out party's costs associated with the development. Some countries take a position of taxing this consideration that is essentially earmarked for future spend in the sector reducing the capital/investment available for the core petroleum operations.

Farm out transactions are envisaged under the provisions of Uganda's Petroleum (Exploration, Development and Production) Act, 2013. Section 87 of the Act provides that a license issued under the Act may not be transferred without the written consent of the Minister responsible for Energy in consultation with the Petroleum Authority of Uganda. The consent by the Minister may not be unreasonably withheld unless he or she has reason to believe that public interest or safety is likely to be prejudiced by the transfer.

## 4. Rationale for farm outs

When a farm out transaction closes, two or more persons become party to a PSA or similar arrangement and agree to act together in a joint venture and accordingly divide the risks, responsibilities and rewards of the joint petroleum operations. There are several reasons for joint petroleum operations enabled by farm out transactions explained above as we set out below.

- Joint operations enable risk sharing that no single party may be able or willing to bear. The perils in the upstream oil and gas industry are systemic or diversifiable. Diversifiable risks such as political and geological risk can be mitigated by diversification of PSA or similar rights while systemic risks such as price volatility cannot be alleviated by diversification.
- Through farm outs, oil companies are able to spread the risk of failure by holding small stakes in several PSAs or licenses as opposed to a large holding in a single PSA. This risk mitigation is also beneficial to the government as it gives it leverage to press for greater resource wealth from the sector on account of diminished risk.
- Joint operations facilitate capital raising for the oil companies to meet their work obligations under the PSA or similar rights. The party farming in may have the financial and technical resources but lacks exploration acreage yet the divesting party has the acreage but is short on funds to fulfill the PSA work commitments.
- Oil companies are able to participate in multiple projects. They free up capacity and resources by participating across several projects simultaneously rather than playing in only one project achieving the same overall economy of scale.
- A joint venture with multiple parties in an oil and gas project can help reduce political risk as as the parties are likely to include majors with extensive resources to resist expropriatory actions as well as companies from multiple foreign jurisdictions that may take an interest in the treatment the host Governments are offering the companies domiciled therein.
- Joint operations allow skill sharing and the parties to the operations are able to pool their expertise and capacity together in a manner that best complements the joint venture and avoids unnecessary duplication. It also affords the parties to observe and learn new skills from each other.

## 5. Consideration for farm outs

The consideration at farm out can be cash, carry or a combination of both. Cash reimbursing past costs of the party divesting the upstream petroleum interest may be extended. It can be the actual past costs incurred or (more rarely since the oil price crash in 2014/15) a payment in excess. With a carry, the party farming into a petroleum right assumes the farmors future exploration and development cost commitments as agreed.

Sometimes, the consideration is deferred until the realisation of certain milestones. Below are the common forms of consideration at farm out arrangements.

a. Cost reimbursement involves a reimbursement of some or all of the past costs incurred during exploration operations.
b. Cash in excess of cost reimbursement means a reimbursement of all the past costs incurred during

exploration activities plus a premium, which implies an economic profit, though this will likely be reinvested in the project.

c. With a hard carry, farmee assumes a portion of the farmor's future exploration and development cost commitments under the PSA. However, the carried costs are not recoverable subsequently by the farmee (ie the acquirer) from the crude oil share of the farmor when production begins.

d. Under a soft carry, the farmee assumes a portion of the farmor's future exploration and development cost commitments under the PSA. These carried costs are however recoverable subsequently by the farmee from the crude oil share of the farmor when production begins.

e. With a contingent carry reimbursement, the farmee can seek to reduce the level of risk associated with its investment into a PSA by deferring part of the consideration payable on the completion of the transaction. The deferred consideration element is paid later on the crystallization of predefined milestones.

f. The consideration can also be by way of asset swaps involving the exchange of assets with or without a cash element. Asset swaps are possible where the party farming into a PSA is short of cash.

## 6. The Joint Operating Agreement

Once a farm out transaction closes and the parties agree to work together via an unincorporated joint venture, it is necessary to agree on a Joint Operating Agreement (JOA) which enables long term collaborations between groups of companies in the upstream oil and gas that have come together to share costs, risks and operations via joint activities.

The JOA establishes common operational standards that regulate the horizontal relationship between the parties to the joint operations and sets out the parameters for the allocation of risk, responsibilities and rewards of the petroleum operations between the parties to the joint operations. It is a cornerstone contract and often the starting point for further essential agreements relating to crude oil processing, transportation and sales.

At common law, parties to contractual joint operations are jointly and severally liable for any arising liability but in some instances the JOA is able to defer this position through provisions that reallocate and apportion joint operation liabilities to the various parties to the petroleum operations.

It is also possible to carry out these joint operations via an incorporated joint venture (ie a joint venture company 'JVC') though these are not very common in the upstream petroleum sector. The JVC holds the PSA or similar right and the shareholders in the company are the parties that wish to collaborate together and their relationship amongst others is regulated by a separate shareholder agreement. Below are the key differences between the unincorporated and incorporated joint venture arrangements.

| Issue | Joint Operating Agreement | Shareholder's Agreement |
|---|---|---|
| Project vehicle | • Unincorporated joint venture of persons associated by contract | • An incorporated Joint Venture Company |
| Capacity of the participants | • Parties contract to operate a joint venture | • Shareholders in the JVC |
| Scope | • Defined variously by the scope, excluded and associated undertakings in the JOA | • Defined by the objects of the JVC and by a defined list of applicable matters |
| Commitment of the participants | • No exclusive commitment to the business of the JOA, subject to implication of fiduciary duties | • May be some obligations of shareholders to prefer the JVC's business and may be some exclusive commitments, and the directors will owe statutory duties |
| Funding | • Parties fund their individual contributions via cash calls | • JVC is funded by cash flows and shareholder contributions |

| Issue | Joint Operating Agreement | Shareholder's Agreement |
|---|---|---|
| Management and operational control | • Single party operator, subject to operating committee involvement | • Board of directors, subject to shareholder voting for certain reserved rights |
| Contracting | • Operator contracts as agent for the parties | • JVC contracts in its own right without shareholder liability |
| Voting deadlock resolution | • Rarely addressed in detail | • Provision for buy out between dissenting shareholders |
| Employees | • No JOA- employed staff | • JVC has employees |
| Asset ownership | • Parties do not contribute assets to the JOA | • Shareholders can transfer assets to the JVC |
| Accounting | • Party-operator maintains expense and production accounts, but not joint venture profit and loss accounts | • JVC maintains profit and loss accounting |
| Returns to participants | • Parties have defined petroleum entitlements disposed by way of lifting agreements | • Dividend returns to shareholders |
| Transfers of interest | • Parties interest transfers subject to transferee approval and possible pre-emption | • Shareholder transfer subject to pre-emption |
| Termination | • Parties resolution or loss of concession. Termination events for operator insolvency or unremedied default | • Shareholder resolution or loss of business purpose. Termination events for any shareholder's insolvency or unremedied default |

***Source: Joint Operation Agreement. A Practical Guide by Peter Roberts***

## 7. Provisions in the JOA

The JOA is a living contract regulating active joint relationships for a long term. It must therefore have the necessary flexibility to evolve and react to the changing operational, commercial and regulatory circumstances over the lifetime of the PSA or similar arrangement. Some of the provisions a JOA may contain include but are not limited to:

- The commencement and term of the JOA;
- Surviving provisions in the JOA even when the PSA comes to an end;
- Pre-JOA arrangements;
- The parties to the JOA ;
- Collateral support provisions by the parties to the JOA;
- The participating interests of the parties to the JOA;
- Government participation provisions in the JOA;
- Provisions on carried interests;
- The scope of the joint operations;
- Excluded operation from the Joint activities;
- Exclusive operations mechanics;
- Selection of the operator;
- The role of the operator;

- Removal of the operator;
- The role of the operating committee;
- Mechanics of the operating committee;
- Sub operating committees;
- Voting controls in operating committees;
- Work programmes and budgets;
- Authority for expenditure;
- Contract awards;
- Petroleum allocation;
- Petroleum lifting;
- Transfer mechanics in the JOA;
- Pre-emption rights;
- Change of control;
- Affiliate transfers;
- Withdrawal from the joint operations;
- Operators liability to the parties;
- Liability of the parties;
- Third party liabilities;
- Liability and insurance;
- General liability provisions;
- Provisions for the decommissioning phase;
- Default provisions;
- Dispute resolution provisions;
- Accounting procedure provisions;
- Confidentiality provisions;
- Warranties and representations.

## 8. Conclusion

As highlighted in the body of this publication, JOAs help establish the relationship between two or more oil companies for the purposes of sharing risks, liabilities and benefit in a PSA or similar agreement. The participating parties recognise the enormous risks involved in the oil and gas industry and normally mitigate such risks through joint ventures. The parties contribute towards the joint operations based on their participating interest and share the liabilities and benefits accordingly. The joint operations are overseen by the operator who is in charge of the day to day activities of the JOA.

Where the JOA includes the National Oil Company as a party, depending on the stage at which the National Oil Company(NOC) backs in, an entirely new JOA may be negotiated or the NOC may back into the existing JOA. Uganda recently prepared a Model JOA that the Government will, going forward, require new entrants to agree to during the bidding process for new blocks. In a bid to protect the rights of the NOC given that it would in most cases be a minority shareholder, the Government would be very interested in how clauses that provide for the operator, voting rights, pre emption rights, liabilities especially environmental, exclusive operations and default are closed out.

Given the importance of joint operations in optimising investment in exploration and development, it is critical that the law and practice in host jurisdictions does not create barriers to their implementation, either via taxation or by other regulation.

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From 2004 to 2008, he worked in Russia where he led Deloitte's oil and gas industry group and established Deloitte's office in Sakhalin. He moved to East Africa in 2009 leading Deloitte's energy and resources industry group in Uganda, Kenya, Tanzania, Rwanda, Ethiopia and Mozambique. He was initially based in Kampala, Uganda later relocating to Dar es Salaam, Tanzania. Bill returned to the UK in 2014 supporting Deloitte UK teams working on outbound projects investing in Africa and was a key member of Deloitte UK's energy and resource practice until his retirement from the firm in September, 2018.

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Denis leads the energy and tax practice at Cristal Advocates. He is qualified both as a Lawyer and Chartered Accountant with vast experience serving various industries in Sub Saharan Africa. Before joining Cristal Advocates. He had worked for close to 10 years with Deloitte and Touche where he started his career and rose to senior managerial positions.

At Deloitte, he lived and worked in Uganda, Kenya, Tanzania and the United Kingdom for over 6 years and subsequently became the firm's chief of staff for the Energy and Resources Industry Group seeing him play a lead advisory role in Uganda, Kenya, Tanzania, Mozambique, South Sudan, Somalia and Ethiopia.

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Prior to joining Cristal Advocates, he had worked as a Private Secretary to the President of the Republic of Uganda. During this time, he participated in several public and private sector engagements that included advising and coordinating activities relating to oil and gas as well as infrastructural projects of national significance. John had earlier worked with the Post Bank Uganda Limited and Shonubi Musoke and Co. Advocates.

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Dickens was instrumental in UNOC's formation and initial period of operation and also served as its head of Contracts, Negotiations and Advisory until May 2018. Prior to joining UNOC, Dickens was Legal Counsel at the Petroleum Directorate of the Ministry of Energy playing key legal advisory roles on the negotiation and implementation of PSAs, Joint venture and other oil and gas agreements. He was also part of the team that shepherded the process of enacting the current Ugandan oil and gas Legislations and Regulations including the local content requirements.

He is a certified project control specialist (IFP) and holds a Master of Laws Degree in Petroleum Law and Policy from the University of Dundee in the United Kingdom, a Post Graduate Diploma in Legal Practice and a Bachelor of Laws degree from Makerere University. ■

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