Joint ventures and operating agreements

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The recent marked increase in petroleum exploration in New Zealand together with the floating of several new New Zealand oil exploration companies on the New Zealand Stock Exchange has focused the public's attention on the activities of the oil explorers and the various agreements under which they conduct their activities. This paper examines the joint venture concept as it relates to the oil industry, explains the background to the development of the agreements under which most of these companies are participating in their respective exploration activities, gives a brief synopsis of these agreements, and highlights some of the problems, both legal and practical, that have been and may in future be encountered arising out of the joint venture structure and the joint venture operating agreements.

I. PETROLEUM JOINT VENTURES

The joint venture concept is used by the oil industry as a convenient way of sharing the great risks attached to its activities. They are not separate legal entities and they differ from ventures in other industries in that they are cost sharing rather than profit sharing arrangements. Normally the revenue from production is not accounted for within the joint venture as each partner disposes of its own share of oil and gas entitlement. There is no obligation to involve other participants in the disposal of proceeds from production and consequently the principal function is the collation and allocation of the joint operating expenditure.

This paper does not attempt to review the difficult issues that arise in any analysis of whether a joint venture is or is not in fact a partnership; nor does it attempt to predict what recognition, if any, the courts in New Zealand would give to the draftsman's attempts in a joint venture agreement to differentiate between a joint venture and a partnership in any particular circumstances. For the purposes of this paper the "joint venture" is assumed to have now been accepted as being distinct from a partnership in spite of the definition of partner-

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The authors gratefully acknowledge the assistance they have had in writing this paper from the numerous papers and commentaries given at recent conferences of the Australian Mining and Petroleum Law Association.

ship in section 4(1) of the Partnership Act 1908: "Partnership is the relation which subsists between persons carrying on a business in common with a view to profit."[1]

This definition appears to apply equally to a joint venture. Nonetheless there is limited recognition in the Income Tax Act 1976 (section 214C(2) includes a definition of a "Petroleum mining venture" and a joint venture, unlike a partnership, is not required to file a tax return) and internationally the petroleum and mining industry community generally have formed and contracted with joint ventures for many years and the joint venture operating agreements have developed into a form where they are relatively standard, in concept at least, worldwide.

Broadly speaking there are two main distinctions between a partnership and a joint venture. The first of these is that a joint venture is normally formed to carry on business on a particular project or in a particular licence area rather than on a general basis. This difference can become blurred as joint ventures are sometimes formed on a general basis (perhaps limited to a country or an area of a country rather than to a licence block or to a particular project) and partnerships are sometimes formed for a specific activity of a limited duration. The second (and more fundamental) difference arises from the relationship to each other of the parties to a joint venture and the features of this relationship that differ from a partnership relationship are:

(a) the participants hold their interest in the assets of the joint venture in common and not jointly,

(b) their liability is (stated to be) several,

(c) they receive the product produced as a result of the joint venture activity separately and in kind, and

(d) an "operator" is appointed to act for the participants and carry out the operations of the joint venture on their behalf and no other joint venturer can (theoretically) bind the joint venture.

It is a common feature of all joint venture agreements that they contain a clause similar to the following:

> Except as otherwise specifically provided in the Licence, any Mining Licence or in this Agreement the liability of the Parties hereunder shall be several and not joint or collective and each party shall be responsible only for its individual obligations hereunder. It is expressly agreed that it is not the purpose or intention of this Agreement to create any mining partnership, commercial partnership or other partnership and nothing in this Agreement shall be construed as creating any such partnership or giving any Party any of the rights of or subjecting any Party to any of the liabilities of a partner.

Whether such a clause would be as all embracingly effective as it purports to be is a question that has been discussed in numerous overseas legal papers and theses (although remarkably infrequently by the courts) but is not within the further ambit of this paper. It is in itself an interesting subject worthy of academic research as to our knowledge there has been no detailed study made of the legal status of those already in existence.

1 A "joint venture" is not included among the exceptions in s. 4(2).

II. DEVELOPMENT OF A STANDARD JOINT VENTURE OPERATING AGREEMENT FOR PETROLEUM CORPORATION OF NEW ZEALAND (EXPLORATION) LIMITED ("PETROCORP EXPLORATION")

Up until 1980 there had been, by comparison with current exploration activities, relatively little petroleum exploration carried out in New Zealand either onshore or offshore. The two principal joint ventures existing up until that time in the petroleum exploration field were the Shell BP Todd Joint Venture formed for petroleum exploration generally and, later, for the Maui Development, they were joined in a separate joint venture by the government-owned Offshore Mining Company Limited, and the Crown/Hunt Petroleum Joint Venture formed for exploration in the huge licence areas of the Great South Basin. The Crown's involvement in the latter was through a Crown Participation Deed.

In October 1980 the Ministry of Energy invited applications for offshore petroleum prospecting licences covering the Taranaki Basin and the Western Platform, south of the Taranaki Basin. As a result of these applications 19 licences were issued. The government acting in accordance with well publicised government policy elected to participate, through Petrocorp Exploration, in 10 of these, with development entitlements ranging from 51% to 25.5%. The extent of Petrocorp Exploration's involvement was determined prior to the granting of the licences, and where Petrocorp Exploration elected to participate it did so as a joint licensee and subsequently as one of the parties to a joint venture operating agreement drawn up between the participants. This practice has continued in the issuing of subsequent licences.

Because of Petrocorp Exploration's involvement in a large number of these licence areas it was considered highly desirable that a standard operating agreement be developed to cover these licence areas. This was thought necessary

(a) to ensure that government policy relating to petroleum exploration and development was correctly interpreted and incorporated into the respective joint venture operating agreements;

(b) to facilitate the obtaining of the necessary ministerial consent. All recent petroleum prospecting licences contain a requirement that a joint venture agreement be drawn up and submitted to the Minister of Energy for his consent and the Ministry's familiarity with a standard document has facilitated this procedure.

It should be noted that the policy adopted by Petrocorp Exploration went against the normal industry practice of the operator preparing the joint venture operating agreement; but this is not uncommon where there is participation by the host government.

Joint venture operating agreements as they relate to the oil industry have been developed over a period almost as long as the oil industry itself. The provisions of these agreements are in the most part standard worldwide. In the United Kingdom the British National Oil Corporation agreement, in its various forms, has become the accepted norm in the North Sea. In America there are model operating agreements developed by societies such as the American Petroleum Institute and the American Association of Land Men. In addition most of the oil majors have their own standard agreements.

The principles followed in the preparation of the standard joint venture operating agreement were that first it was absolutely essential that the document be based on generally accepted principles within the oil industry, and that secondly all aspects of the agreement (with the exception of those relating to government policy) be freely negotiable. Because of the similarity of British and New Zealand law Petrocorp Exploration adopted the British National Oil Corporation standard operating agreement (for the fifth round of North Sea licensing) as the basis for the preparation of the standard form of joint venture operating agreement for the 1981 and subsequent licence areas in which Petrocorp Exploration is a participant.

Although, as is mentioned later in this paper, problems have been encountered, the standard agreement as it finally evolved has received widespread acceptance within the industry: The current and planned drilling operations of both the Benreoch and Penrod 78 drilling rigs are being conducted in accordance with the provisions of the standard agreement. It is this standard agreement to which most of the comments in this paper relate.

III. PETROLEUM JOINT VENTURE OPERATING AGREEMENT — SYNOPSIS

A typical petroleum joint venture operating agreement provides for the formation of a joint venture whereby the participants agree:

(a) to contribute certain percentage amounts to the cost of operations;

(b) to own any assets purchased for the joint venture as tenants in common in those percentage shares;

(c) to own any petroleum produced as a result of those operations in the same percentage shares;

(d) to appoint an operator for the conduct of the operations of the joint venture;

(e) to form an "operating (or management) committee" to meet from time to time to review the work carried out by the operator and to give the operator further instructions and authorisations for future operations;

(f) to provide what percentage vote is required for decisions of the operating committee:

(g) to allow for operations (other than the compulsory work required under the licence) to be carried out by less than all the parties (known as "sole risk" operations);

(h) to provide for the taking in kind by each of the participants in their percentage shares of any petroleum product produced from the joint venture;

(i) generally to cover the preparation by the operator of programmes and budgets, default by a participant, assignments of interests, withdrawal from the joint venture, and the usual housekeeping matters such as control of public announcements, arbitration, *force majeure;* and

(j) to govern the method by which the operator is reimbursed for expenditure incurred on the joint venture's behalf through a detailed set of accounting procedures.

This paper attempts to cover only some of these matters — mainly those that presented difficulties, both practical and legal, at the time the joint venture agreements were being drafted and negotiated, and subsequently as the agreements have been put to test in practice.

IV. THE OPERATOR

Normally one of the participants is appointed the operator — often it is the participant with the highest percentage interest or, in New Zealand (as Petrocorp Exploration usually has the highest percentage interest), the company that formed the group that lodged the original licence application. The accounting procedures of petroleum joint venture agreements usually contain the following statement of principle:

> The purpose of this Accounting Procedure is to establish the principles of accounting which shall truly reflect the Operator's actual cost to the end that the Operator shall, subject to the provisions of the Agreement and this Accounting Procedure, neither gain nor lose by reason of the fact that it acts as the Operator.

The principle that the operator is not to make money out of its operatorship would tend to give rise to a belief that an operatorship is not something that would be sought after, but in fact the reverse applies. It is often said that it is a fiction to believe that the operator does not make money out of being operator but, that aside, there are other obvious advantages for an active oil company in having responsibility for the conduct of joint venture operations as these involve the use of existing staff and facilities which otherwise might not be fully employed. However, the fact that the accounting procedures contain this statement gives the operator some bargaining power in negotiating the limitation of the operator's liability for damages or losses that arise as a result of its acts or omissions as operator.

The operator is usually given fairly wide powers to carry out the joint venture operations (on behalf of the participants in the joint venture) through its subsidiaries, its agents or its contractors under the overall supervision and control of the operating committee.

Forms of agreement differ as to what powers are granted to the operator and those which are left with the operating committee. But, provided that the operator acts within the bounds of its authority as set out in the agreement (usually with the additional qualification that its actions must be in accordance with "good and prudent oil and gas field practice and with that degree of diligence and prudence reasonably and ordinarily exercised by experienced operators engaged in a similar activity under similar circumstances and conditions") then the operator is excluded[2] from all liability unless arising from its "gross negligence" or its "wilful misconduct".

2 The following is a typical clause:

> The Operator shall only be liable for any loss or damage which results from its Wilful Misconduct provided that in no circumstances shall the Operator be liable for any lost production or loss of profits or other consequential losses whatsoever or howsoever arising.

The term "gross negligence" appears to arise from American authorities and is not a term which would have an immediately ascertainable meaning under New Zealand law unless it was defined in the agreement. To avoid doubt, therefore, it is advisable that the terms "gross negligence" and "wilful misconduct" be defined in the agreement if they are to be used. Under almost all the joint ventures that the writers have been associated with the operator's liability has been limited to losses arising from its wilful misconduct which is defined as:

> An intentional and conscious or reckless, disregard of:
>
> (a) any provisions of this Agreement; or
>
> (b) any agreed programme[3]
>
> not justifiable by any special circumstances, but shall not include any error of judgment or mistake made by any director, employee, agent or contractor of the Operator in the exercise, in good faith, of any function authority or discretion conferred upon the Operator.[4]

Additionally the operator is invariably exonerated from liability for consequential losses, which, bearing in mind the huge sums of money that can be involved in petroleum exploration and development, is inevitable and is widely accepted throughout the industry, not only in relation to operators but also in respect of contractors (e.g. drilling companies) engaged to work in petroleum exploration or development generally.

The operator, in the course of a typical petroleum exploration and development joint venture, will enter into many contracts on behalf of the joint venture. It is common for a provision to be included in petroleum joint venture agreements specifically providing that the operator enters into such contracts as agent for the parties "notwithstanding that the names of the non-operators do not appear on any such contract". This provision protects the operator (provided that it has acted in accordance with the terms of the agreement) as its co-venturers would be unable to disclaim the contract. It is also of potential benefit to the co-venturers who might not have direct recourse against a defaulting contractor if the operator entered into the contract as a principal rather than as an agent. Some operators (or their legal advisers) take the view that it is necessary to stipulate in any contract entered into by the operator on behalf of the joint venture the names and the percentage interests of all the parties to the joint venture. In this way, it is argued, effective notice is given to the contractor of the share of the liability under that contract that each party in the joint venture has assumed. If this precaution is not taken (or even if it is) the question arises as to whether the contractor has sufficient notice of the existence of a joint venture by the participants. The licence itself is a public document but it does not specify the shares in which the licence is held — it simply states the names of the holders of the licence without specifying how the licence is beneficially divided between them. This is consistent with section 21 of the Petroleum Act 1937 which provides:

3 E.g. an exploration or appraisal programme that has been agreed upon by the operating committee.

4 In New Zealand most contractors would have difficulty in proving lack of knowledge of a joint venture or its participants for any particular licence. The Contracts (Privity) Act 1982 could therefore improve a non-operator's position in these circumstances.

> If a licence is held by two or more persons, those persons shall be jointly and severally liable for the due observance and performance of the terms and conditions of the licence.

Section 21 is limited in its application to the liability of the participants to the government for failure to perform the terms of the licence but points to the difficult question as to whether a contractor, if there was a dispute about payment owing under a contract or the performance of the contract, could issue proceedings against the most substantial participant for the full amount owing on the basis that the operator was acting as agent for the principals (being the joint venture participants) and that each is jointly and severally liable as in a partnership, for the debts of the joint venture. As Merralls pointed out in 1981[5], even if the contractor has notice of the limitations of liability of each of the participants in a joint venture, the contractor would only be subject to those limitations if the liability was expressly apportioned in the contract.

Under section 24 of the Petroleum Act 1937 the Minister is required to keep open for public inspection:

(a) a copy of each licence issued by the Ministry,

(b) the register of dealings in those licences, and

(c) every true copy of such other document or class of document as may from time to time be specified by the Governor-General by Order in Council.

As yet no Order in Council has been passed requiring that joint venture operating agreements, for instance, be made public so while a public register is kept with each licence showing dealings with interests in that licence the actual documents themselves are not available for public inspection. There can thus be no implication of public knowledge.

It is desirable, therefore, that in any contract entered into by the operator in its own name it disclose that it is acting as agent for the participants in a joint venture. The onus would then be on the contractor to establish that the operator has the required authority to enter into the particular contract although in our experience this precaution is rarely taken by contractors in the oil industry. The ideal contractual relationship between the operator and a contractor would be where the operator stipulates its agency and the contractor agrees that the participants are severally liable only for the percentages specified in the contract. This ideal situation is in practice rarely achieved.

Normally the standard petroleum joint venture agreement allows the operator to commit the joint venture to expenditure up to a certain limit (during the exploration stage perhaps $500,000) without reference back, if the other terms of the agreement relating to approved budgets and expenditure have been correctly followed, to the operating committee. The joint venture agreement also authorises expenditure by the operator in emergencies (such as oil spillage pollution) over and above the set limits provided that prompt reporting back

5 "Mining and Petroleum Joint Ventures: Some Basic Legal Concepts" J. D. Merralls, Q.C. Victorian Bar: A paper presented to the annual conference of the Australian Mining and Petroleum Law Association, Melbourne, 1981.

to the operating committee is made. And, most importantly for the operator, the agreement provides that the operator is to be indemnified by the other participants (to the extent of their respective percentage shares) for all expenditure incurred within those limits (or outside those limits with the authority of the operating committee)[6].

It is important for the operator to ensure, if the indemnity in the agreement, or at general law, is to enable the operator to pass on to the other participants their share of the liability under the contracts it enters into, that the terms of the joint venture operating agreement be strictly followed and proper authority obtained from the other participants before the contract is signed. A receiver or liquidator of a participant in a joint venture would scrutinize the actions of an operator extremely carefully before admitting liability for unpaid calls for amounts owing under contracts entered into by the operator on the joint venture's behalf.

This brief summary leaves a number of unanswered questions but the law on this aspect of petroleum joint venture agreements, especially in New Zealand, is in its infancy and it can be reasonably safely predicted that litigation on one or other of the aspects arising out of the operator's relationship with the joint venture will come about in the not too distant future as the number of joint ventures established for petroleum exploration and development in New Zealand increases.

V. THE OPERATING COMMITTEE

The operating committee usually consists of representatives from each of the participants in the joint venture although it is usual for a minimum percentage[7] interest share to be stipulated as being required to be held by a participant before it can appoint a representative to attend and vote at the operating committee meetings. This minimum is important because of the proliferation (especially in Australia but now also in New Zealand) of relatively small oil companies acquiring interests in petroleum joint ventures. If a participant's interest is below the maximum percentage that party can only participate in the decision-making process of the operating committee if it joins with another company so that their combined percentage interests exceeds the minimum required.

6 The following clause expresses the general law indemnity of an agent but operators often insist on its inclusion in joint venture operating agreements as an additional precaution:

> Each of the Non-Operators, proportionate to its Percentage Interest, hereby indemnifies and agrees to hold harmless the Operator against any claim of or liability to any third party resulting from any act or omission of the Operator or its agents and employees in conducting the Joint Operations in accordance herewith; provided however, that the Operator shall not be indemnified or held harmless by the Parties for any loss, damage, claim or liability covered or which should have been covered by insurance or resulting from the Wilful Misconduct of the Operator or its agents and employees, but no act or omission of the Operator, its agents and employees, shall of itself be deemed Wilful Misconduct if it is done or omitted at the instruction of, or with the concurrence of, the Non-Operators.

7 Five percent is not uncommon.

The operating committee meets perhaps once or twice per year but normally the operator fully consults with each of the participants by telex or by telephone, and there are also reporting requirements upon the operator which are considerably increased when operations such as the drilling of a well are being carried out.

The operating committee's function is to establish general policy and procedural guidelines for the conduct of the operations by the operator. The operating committee also considers and approves the budget prepared by the operator, and it decides upon the preferred interpretation of seismic data and fixes the location of a well.

It should be noted that in all recent joint venture agreements to which Petrocorp Exploration is a party the percentage interest has been structured to ensure that the affirmative vote of Petrocorp Exploration is required for the making of any decision of the operating committee. The usual petroleum joint venture agreement allows the participants to bring experts with them to meetings of the operating committee. These experts can then put forward the participants' technical point of view in respect of, for instance, a well location or the interpretation of seismic data. In practice, however, the main function of the operating committee is to consider, discuss, and if appropriate approve the operator's recommendations.

Under petroleum joint venture agreements the normal voting procedure on the operating committee is that a party has a vote equal to its percentage interest. This is complicated in New Zealand if Petrocorp Exploration is a participant in that its working interest (i.e. its share of costs of the joint venture) during the exploration and appraisal stages of a petroleum joint venture is less than its actual percentage interest (i.e. its share of the joint venture assets and the licence).

The New Zealand Government's policy in respect of exploration is that through Petrocorp Exploration it will in general make a 40% contribution to the cost of any approved exploration and appraisal programme and would normally require a 51% interest in any commercial discovery that is developed as a result of that exploration and appraisal programme and would then contribute 51% of the development costs. There is however provision for the government to contribute less than 40% of the exploration costs for a correspondingly smaller share in development. In all recent joint venture agreements to which Petrocorp Exploration is a party (with one historical exception dating back to the time before the new government policy guidelines were issued) its vote is equal to its percentage interest, not its working interest, i.e. 51% not 40%.

The fixing of the percentage vote required for a decision of the operating committee is a difficult negotiating point at the time the joint venture agreement is prepared — if there are two or three parties with almost equal percentage interests then it would not be uncommon for unanimity to be required for the making of any decision by the operating committee. When there are numerous parties some of whom have only small percentage interests, it will be necessary, to ensure that decisions can actually be made by the operating committee, that a percentage be fixed which could involve the wishes of one or more participants being overridden in the decision-making process.

VI. OBLIGATORY WORK

It is important to ensure in a petroleum joint venture agreement that the work stipulated in the licence as being obligatory under the licence is incorporated into the joint venture and made obligatory upon all participants under the agreement.[8] It would be an unfortunate state of affairs indeed if a group of companies joined together in formulating a work programme for the purposes of applying for a licence or having the licence issued to them, and then some of those parties were able to elect not to contribute to the cost of the work that is compulsory under the licence and to which they have agreed on acceptance of the issuing of the licence to them.

Therefore New Zealand petroleum joint venture operating agreements usually require that the work obligations in the licence be a compulsory obligation, in respect of its percentage share, on every participant in the joint venture. This in itself is uncontroversial but unfortunately the method of framing the work obligations in licences in New Zealand created a problem. The Appendix contains a not atypical work programme in a licence. There the work programme is set out in stages — once (but in other licences it is sometimes twice) during the five year term of the licence a decision has to be made by the participants whether to make a commitment to the Secretary of Energy to carry on to the next stage of the compulsory work.

Not unreasonably it was argued on behalf of some participants that they should be given the opportunity, bearing in mind that once the commitment is made the work would be compulsory, to disagree with the operating committee's assessment of the results of the work completed in the previous period of the licence and to opt out prior to the commitment being made to the Secretary. There is no doubt that there could be genuine geological or seismological grounds for a participant to disagree with another as to the importance of the interpretation of seismic data or information obtained on wells drilled in the previous period of the licence, and so a way had to be found to meet the point.

It was therefore agreed that any party that did not wish to continue onto the next stage of compulsory work should withdraw from the joint venture (rather than the others undertaking the work on a sole risk basis). Accordingly fairly elaborate provisions have been included in the recent joint venture agreements to provide for the operating committee to meet immediately prior to the time when the commitment is due to be made (in the specimen licence in the Appendix the commitment is required after 3 years of the term of the licence have elapsed) and for the operating committee to make a decision whether or not to commit to carrying out the next stage of the work programme. If any party wishes not to make that commitment then it is entitled to assign its interest or, failing that, to withdraw from the joint venture (this being the only exception to the prohibition on withdrawal before compulsory work is completed) without compensation. The other parties must either find another

8 "Sole risk" work is conducted by fewer than all the participants. Sole risk work is discussed infra in Part VIII.

party to take up the percentage interest of the withdrawing party or take it up themselves.

Once the commitment has been made to the Secretary of Energy, that part of the work programme on which the commitment has been made then becomes compulsory work under the joint venture agreement. There is, to our knowledge, one New Zealand joint venture where a number of participants have elected to withdraw without compensation rather than to join in the commitment and continue onto the second stage of the work programme.

VII. SOLE RISK

It has been common in petroleum mining joint ventures to allow some sort of flexibility in the work that can be carried on in a particular licence area by providing for sole risk operations. This means that work is carried out by less than all the participants at their sole risk. There is no recourse to the other joint venturers for their share of the cost of the operations whether they be seismic operations, drilling a well past its basement depth, running a string of casing, drilling another well, or something else.

As already mentioned the concept of sole risk operations runs contrary to the concept that the work programme in the licence must be carried out in terms of the licence and so sole risk is normally prohibited in respect of the work prescribed in the licence. However for additional exploration work, as an example, over and above that prescribed in the licence, the usual petroleum joint venture agreement provides that if one party wishes to carry out operations that the others do not wish to participate in it may do so at its own risk and expense (and provided it does not interfere with the joint operations).

For offshore exploration and development the costs are extremely large and the party carrying out sole risk operations therefore, should it make a discovery, must be entitled to receive a substantial reward for undertaking the risk that it did. It is not uncommon in Australia and other countries for a sole risk party that drills a discovery well to be entitled to receive from any of the other joint venturers that wish to participate in the development of the well, ten times the amount of the cost of the well that the joint venturer would have paid had it participated. In New Zealand the government has set a limit of six times the cost of the work as the reward (or the penalty depending from which side it is looked at) that a sole risk venturer can receive from its co-joint venturers as a condition of their obtaining the benefit of the sole risk work carried out. Obviously it would be impossible for most participants to pay in cash six times its share of the cost of, for example, a well, so in the standard form of agreement adopted for Petrocorp Exploration joint ventures there is provision for an immediate cash payment of the share of the cost of the well plus a penalty of six times that cost (making, in reality, a 700% penalty which the government has accepted) with the penalty payment coming out of production from that well at a later date.

The standard agreement contains an indexing provision so that the penalty maintains its value in real terms and also a formula for establishing the value of the petroleum produced from the well for the purposes of ascertaining that value in relation to the penalty payable. The dual aims of having a large penalty for sole risk are first to discourage participants from opting out of the non-compulsory work of the joint venture but secondly, and conversely, to provide some encouragement to a participant to take the risk of carrying out exploration work in which the others do not wish to participate.

It would be fair to say that a higher penalty would be appropriate for offshore exploration activities, particularly the drilling of a well.

For onshore exploration, where the costs are so much lower, higher penalties are not as common, and as many exploration and appraisal wells in an onshore context often become producers, there are usually varying degrees of penalties for different types of sole risk operations. For instance drilling an appraisal well after a successful discovery well is not nearly as risky as drilling a wild-cat exploration well and the penalty (or reward) would normally be less accordingly. There are relatively few onshore joint ventures in New Zealand at present although these are bound to increase as more licences are issued and the present penalty of 600% will probably need to be reviewed for both onshore and offshore exploration.

For both onshore and offshore joint ventures sole risk has been extended also to development work. Obviously the amounts involved for development of a field offshore are massive and as a result sole risk development, as a matter of policy, is actively discouraged so as to ensure that all participants join in the development of the field and contribute their share to the cost of that development.

In a New Zealand context this has been taken to the stage (in Petrocorp Exploration joint ventures) where any party not joining in a development is required to withdraw from the joint venture and the licence without compensation. This could be said to be harsh (bearing in mind the amounts already expended to get to the development stage) but by its very harshness is intended to ensure, insofar as is possible, that no party not contributing to development expenditure can still retain an asset that, in spite of the penalty, will produce a cash flow at some stage in the future without the outlay of any development funds or the taking of any further risk.

Other concepts in this area are the payment of an overriding (usually small) royalty out of production to the non-participant; or reimbursement to the non-participant of all its costs incurred up until the time of its election not to participate in the development.

VIII. DEFAULT

> It will be held to be a penalty if the sum stipulated for is extravagant and unconscionable in amount in comparison with the greatest loss that could conceivably be proved to have followed from the breach.[9]

9 Lord Dunedin in *Dunlop Pneumatic Tyre Co. Ltd.* v. *New Garage and Motor Co. Ltd.* [1915] A.C. 79, 87.

The default provisions of petroleum joint venture agreements are one area where standardisation has not occurred. This is because on the one hand the non-defaulting participants endeavour to ensure that if there is a default the defaulting party is quickly removed from the joint venture and alternative arrangements made for its share to be paid; while on the other hand participants seek to avoid the consequences of this type of forfeiture being regarded as a penalty and thus being void or resulting in equitable relief against forfeiture being available to the defaulting party.

A default, especially during a time of high cost for the joint venture, can cause serious problems in the continuation of the joint venture operations if provision is not made for the default to be immediately rectified. However it is often not possible for participants to be committed to suddenly undertaking a further share of costs when their cash flow predictions have been based on a lower percentage share having been required at that time.

During the exploration stage of the petroleum joint venture, perhaps with a drilling rig on site, it is essential that all payments be met as they are called. The costs are high and any delay can bring about large additional costs as the daily rates paid for drilling rigs and associated equipment are frightening. The petroleum joint venture agreement will therefore usually provide that the non-defaulting participants will immediately contribute their pro-rata share of the amount in default. Most participants, however, require that there be a limitation on this increased liability and a compromise that has been negotiated in some cases is to limit this obligation to Authorities for Expenditure (AFEs)[10] that have already been approved.

If there is not such a limitation it is not inconceivable that the obligation to pay an additional amount might force one of the non-defaulting participants into default, with the resultant crumbling of the whole joint venture.

The default provisions will in all cases provide that interest be paid by the defaulter on the amount in default and that if the default continues for a specified period of days the interest of the defaulting party in the licence and the joint venture will be forfeited to the other parties without compensation (during the exploration stage at least). There is justification for this type of forfeiture, as we have already discussed, but at the same time, admittedly often in hindsight, the interest forfeited may be of considerably greater value to the non-particpants than the cost to them of the default.

In New Zealand most joint venture agreements to date contain this type of forfeiture provision for the exploration stage of the joint venture and litigation arising from similar provisions has to our knowledge been instigated in various states of Australia. Recently there have been cases[11] in both Australia and New

10 An AFE is issued by the operator pursuant to the approved budget and is more specific than the budget itself — for instance an AFE might cover the cost of the drilling of a well or the carrying out of a seismic survey.

11 See for example *O'Dea and Others* v. *Allstates Leasing System (W.A.) Ltd. & Others* (1983) 57 A.L.J.R. 172.

Zealand where, in motor vehicle leasing transactions, the lessor has endeavoured to extract from a defaulting lessee all payments due under the lease nothwithstanding that the lease has been terminated early and the leased chattel sold. Relief has been granted to the lessee in these cases on the basis that the failure to make an allowance for early re-possession of the vehicle was penal in that it could not be said to be a genuine pre-estimate of the lessor's damages. Under a petroleum joint venture, of course, forfeiture can be of benefit to the defaulting party in that it is released from any further obligation to pay its contribution to joint venture costs, whereas in the *O'Dea* case[12] the lessee lost the vehicle but still had the obligation to pay.

The position in the development stage of a joint venture is more clear. There, undoubtedly, there is an asset which is in the process of being developed and, depending on what stage the default has happened, the defaulting party may have expended already large sums of money in its contributions to the cost of the development. There seems little doubt that forfeiture without compensation here would be struck out as a penalty and/or the doctrine of equitable relief against forfeiture applied. Therefore methods have been devised which, while excluding the defaulting party from direct participation in a development, endeavour to give some compensation (usually in the distant future) to the defaulter either

(a) by a dilution of its interest under a prescribed formula, or

(b) by repaying to the defaulter, out of production, all its costs incurred up until the time of the default, usually after the non-defaulting participants have been reimbursed in total for their costs.

Either of these methods (and there are others) could, conceivably be held to be penalties (but there is less chance of their being so than forfeiture without compensation) as there is an element of penalty in both of them. Since the case *Shiloh Spinners Ltd* v. *Harding*[13] there has been some controversy as to whether the courts still recognise an unfettered discretion to grant relief against forfeiture and in the Canadian case *Oil City Petroleums (Leduc) Ltd* v. *American Leduc Petroleums Ltd*[14] relief was not granted where a default resulted in an oil well not being drilled. Ford J.A. stated:[15]

> It is my opinion that the quotations, as well as others I have perused, support the view that the facts and circumstances of each case must be considered in the light of the objects sought to be achieved by the parties to the contract; and having regard, also, to the nature of the oil production business with pressure being constantly exerted in pushing forward oil-drilling operations.

The question of whether or not it was in that particular case "just and equitable" to grant relief against forfeiture can be readily related to the test laid down in *Shiloh Spinners Ltd* v. *Harding* of "the right of courts of equity in appropriate and limited cases to relieve against forfeiture for breach of covenant or condition."[16]

12 Supa n. 11.
13 [1973] A.C. 691.
14 [1951] 3 D.L.R. 835.
15 Ibid. 843.
16 [1973] A.C. 691, 723.

The essential pre-requisite for this would appear to be that given in *Stockloser* v. *Johnson*:[17]

> . . . first, the forfeiture clause must be of a penal nature, in the sense that the sum forfeited must be out of all proportion to the damage; and, secondly, it must be unconscionable for the seller to retain the money.

Bearing in mind then that a participant joining a petroleum joint venture is aware of the necessity for all parties to contribute promptly their respective contributions to the costs of the operations, and that the participants have all willingly adopted default provisions, however they may be drafted in the joint venture agreement, it is arguable that provisions similar to those set earlier would not be open to challenge by a defaulting party (or its liquidator) on the grounds that the forfeiture was inequitable.

A further problem arising on a default, if forfeiture is resorted to, is that the forfeiture provision in the joint venture agreement will normally require that once forfeiture has taken place the defaulting party will execute all necessary documents to transfer its interest in the licence to the non-defaulting parties pro rata. To support this a power of attorney, in favour of the operator, should ideally be included in the default provisions. However, many companies are reluctant, in the face of stringent forfeiture provisions, to give away what may turn out to be their last chance to dispute the forfeiture by granting such a simple means to the operator of obtaining the necessary assignments of their interests. This becomes particularly important if the participants have found a new party to join the joint venture in place of the defaulting participant but cannot validly transfer to the new participant the interests in the agreement and the licence.

In the absence of a power of attorney (and assuming the defaulting party refuses to execute the transfer documents) an action against the defaulting party for specific performance of the provisions requiring the execution of the necessary transfer documents would be necessary. It is in this type of action that the issues relating to forfeiture could be argued without the necessity for the defaulting party to institute court proceedings itself. If possible, then, a power of attorney in favour of the operator, exercisable only if forfeiture takes place, should be included in the default provisions of petroleum joint venture agreements.

Further issues arise in relation to whether the forfeiture provisions or their alternatives create some form of charge in favour of the other participants, and, if they do, whether these charges should be registered. These complex issues are beyond the bounds of this paper.

IX. ASSIGNMENTS AND TRANSFERS OF INTEREST

As by the very nature of a joint venture each participant owns its share in the assets of the joint venture in common, rather than jointly, there is no

17 [1954] 1 All E.R. 630, 638 per Denning L.J.

reason why the right to assign that interest should not be available to them. Recently in New Zealand there was been a proliferation of assignments of interests because companies with larger interests often wish to reduce that interest and to take up interests in other joint ventures and thus spread their risk. On the other hand it is important to the continuing participants that a third pary to be introduced into a joint venture be financially capable of meeting its obligations. Therefore, there is normally no free right of assignment (except to a subsidiary) without the consent of the other parties which cannot be unreasonably withheld.

Additionally, because the existing participants may wish to increase their participation in a particular joint venture in the event of an assignment, pre-emptive rights are often granted to them so that if a participant wishes to sell all or part of its interest (interest here being all or an indivisible part of a participant's interest as opposed to a right to production or some lesser interest than a full percentage interest in the joint venture) it must first offer that interest to its co-venturers. Alternatively the proposing transferor must strike a bargain with a third party on the terms of the assignment and, before proceeding to the transfer, offer the interest to be assigned to the co-venturers on the same (or financially equivalent) terms as agreed with the third party.

It is not common in petroleum joint venture operating agreements to deem a take-over of a participant as an assignment requiring the consent of the other participants or giving them a pre-emptive right.

X. CONFIDENTIALITY AND PUBLIC ANNOUNCEMENTS

The subject of confidentiality and public announcements is of particular relevance at this point of time because of the intense public interest in current drilling activities. As regards confidentiality the joint venture agreement will usually require that most data and information acquired or received by any participant in the joint venture be held confidential during the continuance of the agreement and for a period of up to five years thereafter. The data cannot be divulged in any way to any third party without the prior written approval of all the participants. The only exceptions to this rule being to affiliates, proposed assignees, consultants and banks (but with the proviso that a similar confidentiality requirement is accepted by them) and to the extent that the information has already become public knowledge.

The general requirement of joint venture operating agreements is that no party to the joint venture shall issue or make any public announcements regarding the joint operations unless prior to making such announcement it obtains the approval of the operating committee to the form of the proposed announcement. This is subject always to the proviso that approval shall not be required if such announcement is necessary in order for that party to comply with any applicable law, or the regulations of a recognised stock exchange. It is usual procedure for the operator of the joint venture to be responsible for the making of all press announcements or public announcements, usually on a specified day of each week. In New Zealand these are usually made on a Friday afternoon after the closing of the stock exchange.

This course was adopted by the industry to ensure that there is only one spokesman for the joint venture, and that all announcements are accurate assessments on the current status of the well. It is not difficult to imagine the problems faced by an operator in endeavouring to reach agreement amongst the participants on the wording of the public announcement especially in joint ventures where there is a large number of participating parties. The representatives on the operating committee may each have different motives for the way they would like the press release to be phrased to achieve the maximum possible benefit for their respective companies. For instance a publicly listed company may prefer a favourable interpretation of results to date. A non-listed participant, on the other hand, would be inclined to be more conservative so as to ensure that it is not associated with an announcement that might, in hindsight, be seen as misleading.

Unfortunately, although the intention of the provisions are abundantly clear, the reality is that if a party does make a public announcement or statement which has not been approved by the other parties there is little that the other parties can do about it. This is because although this would constitute a technical breach of the terms of the joint venture (and probably a breach of the duty of good faith owed by each of the joint venturers to the others), the other parties would need to establish loss or damage to make any action for breach of contract or the breach of the fiduciary duty worthwhile. It would be possible to obtain an injunction to stop such an announcement being made in breach of the terms of the agreement but it is doubtful, in practice, that there would be sufficient prior knowledge of the proposed announcement to enable this to be done. Additionally, of course, the participants have no control over interpretations placed on these announcements by sharebrokers and other so-called experts that are not parties to the joint venture operating agreement. The result of such comments by these experts is a proliferation of rumours and a confused public.

XI. CONCLUSION

This paper has set out the basic concepts of petroleum joint ventures and the agreements by which they are formed. By way of background the New Zealand Government's policy on oil exploration and its participation in such exploration has been explained, as has the effect this policy has on the structure of the joint ventures in which Petrocorp Exploration is a participant. This paper has also touched on some of the legal and practical difficulties that petroleum joint venture operating agreements present and has suggested practical measures to overcome some of these. Unfortunately some of these issues are complex and they, and others not mentioned, require rather more detailed study than could be attempted in a general paper of this nature. These issues should be discussed in depth in the future so that areas of uncertainty in the agreements and in industry practice can be clarified and, if the present standard forms of agreement are found to be inadequate, appropriate changes made.

APPENDIX

SAMPLE PROSPECTING LICENCE TERMS

1. This Licence is subject to the completion of a Joint Venture Agreement, to be drawn up between all participants in this Licence, a signed copy of which is to be referred to the Minister of Energy within three months after the issue of this Licence or by such other time as the Minister of Energy may agree.

2. The Licensee shall carry out the following work programme:

(a) Complete a semi-detailed grid of approximately 2300 kilometres of new seismic using a 2km x 2km grid over the whole of the Licence area, in the first year of the Licence.

(b) Complete any additional detailed seismic that may be required prior to drilling and drill a well, in the second year of the Licence.

(c) Drill a well in the third year of the Licence.

(d) Prior to the end of the third year of the Licence make a firm commitment by notice in writing to the Secretary of Energy to carry out the next two years programme which begins on 15 May 1984 and which is detailed in (e) below;

or

surrender this Licence before 15 May 1984.

(e) During the period 15 May 1984 to the expiry of the Licence on 14 May 1986 drill three wells.

3. The annual fee required by section 47M(1)(f) of the Petroleum Act 1937 and the First Schedule of the Petroleum Regulations 1978 shall be $1,112.

4. The Licensee shall pay to the Secretary of Energy a royalty at the rate of 12.5 percent on any petroleum produced under this Licence or any mining licence resulting from this prospecting licence and granted in accordance with section 11 of the Petroleum Act 1937.

5. The deposit or bond required by sections 8 and 47M(1)(h) of the Petroleum Act 1937 and the First Schedule of the Petroleum Regulations 1978 as security for compliance by the Licensee with the terms and conditions of this Licence is $22,250.