

Upstream Joint Ventures: Are Default Remedies Effective
in Decommissioning Stage?

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List of abbreviations

The following table describes the significance of various abbreviations and acronyms used throughout the thesis.

AAPL	American Association of Petroleum Landmen
AIPN	Association of International Petroleum Negotiators
AMI	Area of Mutual Interest
CAPL	Canadian Association of Petroleum Landmen
DSA	Decommission Security Agreement
E&P	Exploration and Production
IOC	International Oil Companies
JOA	Joint Operating Agreement
JOC	Joint Operating Committee
ManCom	Management Committee
NCS	North Continental Shelf
LC	Letter of Credit
PI	Participation Interest
PSA	Product share Agreement
UKCS	United Kingdom Continental Shelf

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1 Introduction

The JOA is a common agreement that oil companies, producers and investors, in their search for and production of oil and/or gas, come together to make a “Joint Venture” (JV). The purpose of a JV is to develop and produce oil and/or gas in an economically viable manner. It also assists oil and gas companies to mitigate the risk existed in different stages of lifecycle of a field.¹ In this way, most JVs go through the same phases, which are contingent on the nature of their activity that might be upstream, downstream, pipeline, etc.

The upstream JV, also known as the “Exploration and Production” (E&P), are formed to pursue the commercial purpose of exploration and exploitation of petroleum resources under an exclusive exploration and production license granted by a host government. It is usually an unincorporated association of (E&P) companies as participants with exclusive rights to extract petroleum from deposits within the license area. The upstream is a multistep process which encompasses different phases of activities, including exploration, development planning, development capital investment (project execution), production, and decommissioning.

Billions of dollars are invested every year in the upstream projects. This huge amount of investments will be done mainly in accordance with the terms and conditions of a JOA, which imposes an obligation on all participants to contribute funds to shared activities. Fundamentally, a JV agreement requires all participants to pay their share of expenses (operating or capital) upon a cash call by the operator; however, should any of the investors fail to pay its share. Such a failure will normally constitute a “Default” under the terms and conditions of the JOA.

¹ International Petroleum and Exploration Agreements (2009) p.285

Historically, the default provision found a place in JOAs after 1970. Prior to that, it was uncommon for JOAs to mention default provisions; but some changes to the structure of the E & P industry have made the issue of default topical, primarily due to a higher participation of smaller E & P companies that have limited financial strengths relative to the major (International Oil Companies) IOCs. The major IOCs will also be disciplined by the fact that they often will do business with each other in several jurisdictions. A growing number of maturing fields in the North Sea and the making new regulatory rules for decommissioning² were other reasons that made defaults a topical issue and growing with a need for effective mechanisms as a deterrent against the occurrence of defaults in JVs.

The most common definition of default is failure to finance contributions to the JV and accumulation of repeated late payments. There are, however, other sorts of actions that may be viewed as a default too (broad definition). As Duncan provides, “failure to participate appropriately” in a specific commitment, or “misusing asset of JOA” may constitute a default,³ but none of these instances have been addressed in an international JOA as a default made by non-operator parties. Rather, what has been addressed as other forms of default is a “material breach of any material obligations,”⁴ “Insolvency event”⁵, “failure to implement a DSA [Decommissioning Security Agreement],”⁶ etc.

In contrast to the broad definition theory, some scholars believe it is better to narrow the definition of default to party’s failure to meet the amounts ordered by the operator when

² When it comes to the terms, there is duplication in terminology between "abandonment" and "decommissioning". The author tries to refer more to "decommissioning", which reflects the modern usage of disposing of any infrastructure used to explore, produce or raise oil and/or gas. "abandonment", however, has used more for discarding property with an implied disownment of title or any on-going liability, or used where a well that is not in use because it ceased to produce natural gas or because it was a dry hole is discarded.

³Joint Venture Law In Australia (2012) p.364

⁴ AMPLA art 1.1

⁵ AMPLA art 1.1

⁶ OGUK JOA art 17.1

they are due. Any other failures, in their opinion, in the terms of a JOA, might be seen as violation of general liability of either non-operators or operator, and thus outside the default's scope.⁷

Although the latter opinion is compatible with most of the current JOAs, the provided examples of the Australian JOA (AMPLA) illustrated that the concept of default is not narrowed just to failure to pay contribution share, and instead might include non-payment based defaults, contingent on the definition that relevant JOA has submitted. For the purpose of this paper, however, we will just discuss about the narrow definition of default (i.e. payment-based default).⁸

The payment-based failure (i.e. default) normally occurs in two cases. First, such a failure may occur due to a defaulting party's precarious financial situation, and second when a party wilfully wants to attempt to take advantage of a default as a mechanism for escaping its commitments to the project for reasons which will be discussed in the paper. Both of these phases have been increased as smaller, non-governmental companies; often with lesser financial strength have taken the major players' place in the industry. A further reason for a possible increase in the occurrence of default might be the current state of JOA default's provisions and the manner in which these establish consequences of and remedies against default. Most the JOA's approaches to deter a default are effective only if a defaulting party to a JOA have enough incentives and a desire to remain a participant in the JV.As will be discussed further, during the decommissioning phase or in the case of an unsuccessful project, such incentive and desires may be insufficient as a deterrent against defaulting party and become a risk for co-venturers. It would, therefore, seem meaningful to further investigate this issue to analyze how effective current default mechanisms in JOAs are. The issue of effectiveness of the default mechanism will be crucial also for the non-defaulting parties of a JOA; since, generally, in case of any

⁷ Roberts (2012) p.187

⁸ Other aspects of the default are fully discussed in the following sections.

default, they usually will have to pay the defaulted amount to avoid suspension, cessation, and pause of the project. This is the main topic to be considered and discussed in this thesis.

The last point that has to be kept in mind is the particular point of E&P at which a default may occur. The importance of this matter is that the effectiveness of a remedy is highly dependent on the stage where the default happens. If it happens at the production stage, most of proposed remedies in the next chapters are sufficient; conversely, as will be examined further, they are insufficient at the decommissioning or exploration phase.

1.1 The Significance of the Default in the Decommissioning Phase

The decommissioning activities, which apply to removing the redundant petroleum infrastructure, are extremely costly; in contrast to the cost associated with the production phase, there is no resultant revenue or benefit therefrom. Nonetheless, current international legal frameworks impose on states with petroleum activity to ensure decommissioning of disused infrastructure.⁹ Thus, to this end, typically the JOAs spell out a wide range of rights and duties for operators and non-operator parties. Among those, the obligation to make proportional contributions to expenses of decommissioning is an emphasized duty which requires all parties to be responsible for it. Therefore, indisputably, any kind of failing to fulfill this commitment will constitute default under the application JOA. Such default will impede the JV and be detrimental to and have an adverse effect on a diverse group of stakeholders, ranging from co-venturers, (including the smaller oil companies with limited financial resources), to host governments.

The nature of decommissioning activities obliged by almost all current JOAs is such that it engages different groups of stakeholders with competing interests, the first being host governments. If a company does not take responsibility for decommissioning, a host

⁹ Hammerson, 2011 p.440

government does not have any latitude to deviate from the decommissioning burden; otherwise, it might be convicted in the International Court of Justice due to its breach of international obligation for the disposal of installed infrastructure. As mentioned, decommissioning operations are highly expensive; for instance, decommission costs for the UK within the next thirty years will be between £15-19 billion,¹⁰ therefore, when a company dodges of its obligations, the host government of the project must take some of the cost and risk. The governments' objective is, therefore, to assure that parties to a JOA have the financial means to meet their obligations and are not going to pass on their decommissioning's burden to the host states.

The second group with a benefit that is strictly tied up to a perfect performance of decommissioning is oil companies. These business parties to a JOA always want to make certain that their JOA partner can meet its decommissioning obligations; otherwise, they have to pay an additional share of the defaulted sum – a miserable situation for co-venturers which usually arises when they are confronted with an additional liability.

The third group of interest stakeholders as far as decommissioning is third party licensees (buyers) with a purchased share of interest that, as result of discretion from an authority, can be possessed by an operator at the wellhead.¹¹ This matter may make a paradoxical situation for a third party who, on one hand, was supposed to be an owner of interest and, on the other hand, has a share of interest that is possessed.

And, eventually, environmental non-governmental organizations and lobbies are the last group that follows all relevant decommissioning programs to ensure that all aforementioned groups comply with their decommissioning obligations.

The previously stated groups were examples of influential players in the industry with benefits that are crucially dependent on a perfect performance of decommissioning. So,

¹⁰ See, for example, <http://www.oilandgasuk.co.uk/cmsfiles/modules/publications/pdfs/OP082.pdf> or <http://www.oilandgasuk.co.uk/2013-economic-report.cfm>.

¹¹ We will further discuss in chapter 4.

any default, particularly financial default, in the decommissioning phase, might be a great threat for these major players in the industry. Therefore, anticipating robust deterrence against default in the decommissioning phase is an absolute necessity for those players.

Given the importance of default for stakeholders of the industry, it might be surprising that the effectiveness of most taken approaches to cease a default is still in doubt. Therefore, the abovementioned groups would seem to be interested to find new way to provide highest protection for themselves; otherwise any kind of default will lead them to great economic loss. But finding the new ways primarily requires to understand the problem and this is why the topic deserves to be considered fully.

Before turning to the discussion of default in more detail, it is necessary to say a word about the methodology and framework within which the default in decommissioning is analyzed.

1.2 Methodology

For the purpose of the thesis, the author have selected a number of commonly used and publicly known JOAs that he considers relevant and representative of present practice with respect to treatment of default to examine. These JOAs relate to different legal jurisdictions and there may be issues on their detailed interpretation and application that he is not familiar with. Nonetheless, the concepts contained in these selected default provisions lend themselves to the type of conceptual analyses below. It should also be mentioned that relevant academic sources to the topic are still fairly limited and even the few just that have dealt with it have primarily discussed the enforceability of default remedies. In spite of that, the author have included reference to some court judgments and academic researches that are shown in the reference list.

1.3 Structure

Since the first instances of defaults, law scholars proposed some solutions, nonetheless, the relevance of the default issue was largely considered theoretical. This trend has changed over the years and the relevance of defaults as a legal issue in JOAs has become less theoretical. As step toward examining the issue, this paper tries to:

- Draw a general perspective of the default and study the features of common default provisions, without examining their effectiveness in respect to JOAs (chapter 2),
- Review the various security arrangements that may be adopted and analyze their positive and negative aspects without examining their effectiveness in respect to JOAs. (Chapter 3),
- Consider differences between default provisions and securities of various JOAs, analyse that difference and examine potential effectiveness of proposed remedies in section 2 and 3 in decommissioning phase in the following JOAs:(i) the American Association of Professional Landmen (AAPL) Model, (ii) The Association of International Petroleum Negotiators (AIPN) Model (the International model), (iii) the Norwegian model, (iv) the Oil and Gas United Kingdom (OGUK) Model (the British model), (v) the Canadian Association of Petroleum Landmen (CAPL) Model (the Canadian Model). (chapter 4),
- And eventually, following the exercise undertaken in Chapter 3, postulate a suggestion and draw a conclusion with a wide look to the discussed approaches (Chapter 5).

1.4 Delimitation:

As noted, the default might be in form of non-payment and at different stages of an upstream project. For the purpose of this paper, however, we will just discuss financial default (i.e. non-payment based default) assuming occurrence related to the decommis-

sioning phase. Moreover, the default is a multidimensional topic and the the issue of default is concerned to many different topics including not limited to insolvency, illiquidity, default judgment, etc. The present thesis does not aim to consider any of these topics. Rather, the paper will focus on the financial sort of default that may occur in the decommissioning phase of an upstream project. Therefore, working on either the downstream or other forms of cooperation, like production sharing agreements, is not within the scope of this study either.

In respect to examining current approaches against the default, it is also necessary to mention that the thesis is only concentrated on examining the enforceability of those approaches, not their enforceability¹², although it is sometimes difficult to stay far away from examining the enforceability of a specific mechanism.

¹² The enforceability of default is already dealt with in many other academic researches and judicial decision. For further information see: DAINITH, T. C. & WILLOUGHBY, G. D. M. 1984. Manual of United Kingdom Oil and Gas Law, PAWLOWSKI, M. 2010. Chattel leases: relief against forfeiture? Landlord and Tenant Review, 14(2), pp. 59-62

2 Default Provisions

2.1 Introduction

For a long time, the petroleum industry was unfamiliar with the concept of default, but that era ended some time ago. Despite this fact, the apparent simple notion of default is still in its earliest stage of serious study. Thus, this topic deserves to be examined in a separate chapter.

As mentioned briefly, the JOA will provide for parties an obligation to pay their proportionate share of expenses and the individual rights to offtake and sell the petroleum produced. The general purpose of the default provisions of JOAs is to incentivize the parties to the JV to fulfill their obligations by establishing consequences for failure to do so. In the section we will see what those consequences are and to what extent they may decrease a willful default.

2.2 Purpose of Default Provisions

As expressed above, long-term petroleum Joint Operating Agreements, by their nature, require an ongoing injection of funds, as they are capital intensive and long-term investments. Any default may scale back, hinder, or worse still, stop this process. From another perspective, the prospect of a default may be financially catastrophic for small players; particularly when a large co-licensee defaults. In such a situation, on the one hand, small investors will suffer uncertainty about the future of the field in the absence of that large co-licensee, and on the other hand they too are at risk of default, if they cannot fund the defaulted amount within the specific period, which itself is normally too short. Therefore, a standard default provision must to some extent ensure that non-defaulter parties continue the consortium, notwithstanding the occurrence of default, and it must act as permanent threat, with severe consequences, for those parties who do not meet their commitments.

2.3 Different types of Default Provisions

2.3.1 Lien

Early default provisions comprised solely of a lien formula whereby a party had to provide a first-ranking lien or mortgage to cover its participation interest in order to guarantee payment of its share of expenditures. In contrast, the modern JOAs have attempted to combine the lien with other approaches to enhance the effectiveness of default provisions.¹³ Therefore, nowadays, the JOAs do not confine themselves only to the lien. Regardless of this difference between the old and the modern default provisions, both maintain that any occurrence of default may authorize the holder of the lien, which is normally an operator, to foreclose the lien pursuant to the relevant JOA on the arm's length principle; taking the proceeds of the sale to recover the defaulted sum.¹⁴ So, theoretically, the lien seems to be practical and effective.

However, from a practical point of view, there are some difficulties with implementation of a lien. First, the process for registration of a lien is not easy. For instance, a lien constitutes some "registrable charge"¹⁵ and, if it not registered within a specific period in accordance with the relevant act, it cannot be performed against a liquidator or other creditors. Second, enforcement of a lien may not be possible in some international jurisdictions.¹⁶ Finally, most liens are attached to the production stage, so it would be of little use or no use at all in cases where production had not yet commenced or when it has finished.

More difficulties might appear in the process of enforcement of a lien. Most aspects of a lien literally couch in municipal laws which may hamper or delay performance of a lien. For instance, in *Cal-Cut Pipe v. Haradine Petroleum*, one of the main issues addressed by

¹³ For example, AIPN JOA art 8.4.d

¹⁴ In some host countries, implementing such foreclosure of interest is dependent upon host state regulations.

¹⁵ Black, & Dundas, (1992-1993) p.70

¹⁶ Josephson , 2003, p. 21

the appeal was the question of fact and the definition of “valid lien” under the California Oil and Gas Lien Act.¹⁷ This case indicates a tie between liens and their relevant national law, this in turn increases the risk of adverse intervention by the courts or arbitration, and, subsequently, will result in a delay in foreclosing a lien.

Some other disadvantages, of using a lien (or mortgage in a similar sense), are: (i) Priority: for the cases where a grantor of a lien has had some other commercial debt prior to granting the lien to non-defaulter parties to a JOA, which might mean the holders of the lien are not first-ranking in the list of possible possessors. However, the issue is easily resolved, if a JOA, like with Form 610, obliges its parties to grant a firsthand lien. (ii)Publicity: in most cases, the grantor of a lien has to publicize its registration of the lien. Under this mandate parties are reluctant to publicize their commercial relations. (iii) Complexity: logically, all parties, regardless of their share of interest or their financial strength may be a defaulter. For this reason, the JOAs containing liens may require all parties to issue a lien over their PIs in favor of each other. The result will be some multilateral liens that will follow a time consuming and complex registration process which will ultimately increase the difficulty of effecting them.¹⁸

As a final point, the performance of the lien is possible if the non-defaulting parties have a power of attorney to foreclose the lien. However, in the absence of a power of attorney granted by the defaulting party, the non-defaulters may face some problems implementing the lien and, consequently, they may not be able to recover the default amount.

¹⁷ Cal-Cut Pipe & Supply, Inc- v.-Haradine Petroleum, Inc. [1973]35 Cal. App. 3d 359

¹⁸ Roberts (2012) p.195

2.3.2 Forfeiture

As noticed above, if a party fails to pay its share of expense, then that party is under default. Under a typical JOA, thereafter, that defaulting party will receive a default notice, issued either by an operator or a non-operator, which asks the defaulter to remedy its default within a specific period of time, called the grace period. Under a usual JOA, failure of a defaulting party to remedy its default within the grace period will result in the default period whereby the defaulter has some time, normally 30 to 60 days, to remedy its default. In the meantime, the ManCome suspends some of its rights. These rights can include the right to vote, access to information, lift field output, etc. More severe measures are brought into force, if the default lasts longer than the default period and, ultimately, all of the defaulter's rights will be forfeited.¹⁹ Under this circumstance, the participant's interest is usually transferred to non-defaulting parties proportionally. Performance of such involuntary transfer of interest may be hampered by the defaulting party's avoidance of transferring its interest or signing the related documents. For this reason, some JOAs may require each party to grant a written power of attorney in favor of each other to mitigate such risks. Moreover, a JOA might provide that performance of such forfeiture shall be contingent on the host state's approval.

In drafting first versions of this radical clause (i.e. forfeiture), the writing committees presumably have concluded that a complete deprivation of a defaulter's interest is the best means of securing both the operator and non-operators. Therefore, the forfeiture was supposed to act as a robust deterrent against default, however, subsequent difficulties and concerns demonstrated that the mechanism may be some way from a perfect solution.

Most common concerns posed by scholars relate to unenforceability of the forfeiture as a remedy in an international setting. For instance, Australia and, New Zealand's legal

¹⁹ The abovementioned passage, thus, can be considered as a "platform"/ reference for reviewing each of the JOAs' default provisions in chapter 4.

frameworks recognize the mechanism as the penalty and, consequently, unenforceable. Under certain circumstances, those legal frameworks permit a defaulting party to claim relief from performed forfeiture that constitutes a penalty.²⁰ Overall, if the forfeiture goes to the courts, they mostly hold the forfeiture void, although it is not unusual for the courts to award an “ordinary damages for the breach”, which is enforceable, or a “compromise” to defer application of the forfeiture, as a second chance for defaulter, rather than recognizing the forfeiture as null.²¹

Another difficulty with the application of forfeiture is that its implementation may sometimes lead to a conflicting situation in cases where a defaulter has been deprived of its PI within the consortium while it still has its concession granted by the host government. This may decrease the effectiveness of the forfeiture and place the non-defaulter in a confusing situation whereby they cannot expel a defaulter. Therefore, the forfeiture remedy must be applied such that the forfeiture of defaulter’s interest will also cause the quashing of its concession under the concession agreement.²²

The forfeiture might be laudable in principle but it has the basic shortcoming of being insufficient where the value of the forfeited PI is much less than the amount in default, specifically in the primary and final phases of a project.

The combined difficulties described above highlight the non-defaulting parties’ lack of protection against the willful default of a party who attempts to take advantage of any loop-holes within a signed JOA to relinquish its commitment. However, it can be said ,the solution is a properly structured agreement, negotiated with parties about the provision, will not only avoid enforceability issues, but will also mitigate the risk of adverse

²⁰ Gundersen (2004) p.2

²¹ Jobson -v- Johnson [1999] 1 WLR 1026. See ,similar example, in Cavendish Square Holdings BV, Team Y&R Holdings Hong Kong Ltd v Talal el Makdessi (2012), Dunlop Pneumatic Tyre Co., Ltd. v. New Garage and Motor, Ltd., [1915] A.C. 79

²² Roberts (2012) p.198

intervention by the courts. Ameliorating the forfeiture by using any of the following approaches is another solution that can be offered to avoid the enforceability problems.

2.3.3 Buy-out Option

Regarding to the interest of a defaulting party, it has been described in some JOAs²³ that non-defaulters may purchase a defaulting party's interest. The mechanism enables a party to buy-out the PI of a defaulter on an appraised value, based upon the defaulter's contributions and other forms of engagement during its participation in the JOA. Contingent on preliminary negotiation of a JOA, the mechanism might also require a sale of the defaulting party's interest to a third party entering the agreement.²⁴

While a buy-out option may be an appropriate equitable alternative to forfeiture, due to the undesirable penal nature of forfeiture, it has varied problems of its own. First, the consideration for such a purchase would be given on the basis that it must be assessed on a fair market value and with possibility of engaging expert assistance to establish such value. Such a mechanism, however, may not be applicable where a purchaser cannot buy on the basis of fair market value. The issue would be highlighted especially in cases where the defaulting party is an oil giant and non-defaulters are small investors. Using expert services also raise questions in respect to how to choose an expert and what procedure must be used.²⁵ Alternatively, a set purchase price can be offered as the value of the PI, but this approach does not readily sit with the fact that the buy-out's function is to avoid the penal nature of the forfeiture. Buying PI for a set purchase price, which is normally lower than true value, could be considered as some sort of penalty and unfair.²⁶

²³ See, for example, OGUK JOA art 17.6.3; AIPN JOA art 8.4.D.2

²⁴ Pereira,(2012) p.14

²⁵ Joint Venture in International Arena (2010) p. 31

²⁶ Ibid.

The second problem that may arise is intentional default in cases where a party aims to flee its undertaking and sell its interest before defaulting. (Particularly at the exploration or decommissioning stages where there is no profit).²⁷

2.3.4 Withering Interest

The second possible option to moderate the potential impact of forfeiture remedy is a formula called “Withering Interest” whereby an occurred default in JOA entitles non-defaulting parties to deprive a defaulter of its share of interest in proportion to the amount in default, rather than forfeiting the defaulter’s entire interest.

Despite the advantage that withering interest provides in that it does not result in a “penalty problem” (like with forfeiture), it is highly likely that a potentially defaulting party may exploit the withering during the decommissioning of a project by an intentional default. The consequence of such a default would be beneficial rather than adverse for that party as he is able to save the payment and, in return, he will only lose a small part of his PI, which does not worth more than the amount of the default. Moreover, losing part of the PI in the last stage of a project will result in a lesser share of interest and, subsequently, less liability for a prospectively defaulting party. On the other hand, non-defaulting parties would not be interested in taking the potential defaulter’s PI that brings a higher share of interest and, respectively, more liability for more liability for decommissioning.²⁸

2.4 Conclusion

Applying a default provision, whether it is a pure forfeiture, buy out, or withering, might be performed in full recovery of when a default has occurred, such that all non-defaulting

²⁷ We will further consider how many of intentional default can be hindered by issuing a security.

²⁸ Roberts (2012) p.201

parties are satisfied with the remedy. However, in practice, existence of the listed difficulties demonstrates that the default provisions have basic, structural problems and more well-structured remedies should be replaced with them to assure non-defaulting parties that they will recover the amount in default where the forfeiture of interest is worth less than the amount in default, or where the forfeiture is not enforceable.

The effectiveness of the default provisions under the specific phase of decommission will be discussed in chapter four, but before that it seems to be necessary to see what other remedies normally collaborate with default provisions within the JOAs.

3 Security Interest

3.1 Introduction

As previously mentioned, there are situations where provisions of default are inadequate remedy to resolve a default. So, most JOAs, since 1980, tend to add more mechanisms, known as securities, to fill this legal gap and provide the highest possible protection against any kind of default. The securities, ranging from up-front cash call to letter of credit(LC), are employed to (i) assure parties that required funds for decommissioning would be available, (ii) protect non-defaulters parties to a JOA, (iii) comply with host states international commitments for decommissioning, (iv) and provide the required circumstances for the sale of the field to a third party.²⁹

A security might ensure the payment of the cost, but this sureness can be achieved if a security is offered quick enough. Presenting security very late in the field's life may result in the withdrawal of a party who could potentially give such a security. In this situation, the failure to provide a required security may be contemplated as default, even though the consequence of that default at the last stages of a project may not be severe. Since at the maximum, it may likely lead to forfeiting the defaulting party's worthless PI.

It is offered, therefore, that a security should be presented when the "discounted cost of abandonment exceeds a pre-determined proportion of the disconnected value of the remaining reserves (50%-75%)."³⁰ In practice, a security is necessary when "the net remaining value of the field is equal to or below 150% or 135% of the projected cost of decommissioning."³¹

²⁹ Ayoade (2002) p.25

³⁰ Mankabady (1997) p. 614

³¹ Ibid.

The application of these securities should, however, be considered in light of the scope of this fact that securities and forfeiture provisions are two executive arms of a JOA in against default and, consequently, none of them can be applied alone (i.e. they come in collaboration with each other and not as substitute). Correspondingly, this chapter will examine common securities in JOAs to see what their positive and negative points are in general.

3.2 Security Forms

3.2.1 Upfront Cash Call

A security might be provided in cash. Theoretically, a JOA might require its parties to provide enough accessible upfront cash before starting each of triple stages (i.e. exploration, production, decommissioning). In this case, whether the requested amount is put into a trust fund or an account, the parties may be reluctant to tie up cash flow by paying into a trust fund or joint account. Additionally, in some instances of a JOA, a tax relief mechanism is recognized for cost of payment guarantees and LC, while such a tax relief is held invalid when it comes to cash payments made into an account or trust fund.³²

Moreover, this kind of security highly depends on the data, awarded before each of the stages, which anticipate the required future expenditure of a phase. Nevertheless, it is always presumable that the data will change during the triple phase. Therefore, the amount of upfront cash is not certain. In addition, providing upfront cash might be impossible for small investors within the industry since their financial strength is often limited.³³

More difficulty arises in regards to the timing of a cash call. As mentioned above, the timing of a security is an important issue that must be considered seriously, however, with this sort of solution (i.e. cash call), it is often very difficult to predict the timing of cash

³² Hammerson,(2008) p. 13

³³ Pereira (2012) .p 41

calls. Each step of a project might last for several years or even face temporary cessation.³⁴ Thus, it is very difficult to ask parties to provide upfront cash.

3.2.2 Guarantee

In a petroleum venture, it is highly likely that parties issue a guarantee in favor of operator or other co-venturers to secure their financial commitments. It is also more likely that the guarantee will be from a party's parent company or from its bank with one difference, and that is that a bank will charge for issuing a guarantee while a parent company normally is obligated to do it free.

Most JOAs also determine what requirements the guarantor must have and must retain within the life of the guarantee to ensure that the creditworthiness of the guarantor will be stable and valid until last day of the guarantee. So a guarantee for such required stability should also be expressed as irrevocable, although it does not mean that provisions contained in a guarantee should be written without any possibility for changes to the underlying contract. Also, every guarantee demands that its own specific requirements must be proven before the entitlement to payment under a guarantee occurs.

(i) Third Party Guarantee

Based upon this mechanism, a guarantor, normally banks, issue a guarantee of the future expenditure in return for collateral provided by a borrower of guarantee. A third party guarantee, whether issued by banks or other financial institutes, has proven to be the vehicle of choice for many co-venturers, as it has the advantage that the guaranteed sum is confined only to an investor's share of costs, which is particularly suited to small companies.³⁵ However, providing such security is difficult and expensive, particularly

³⁴ Ibid.

³⁵ Kemp (1992) p. 11

when the borrower investor has one field or limited existing infrastructure to put as the collateral before the guarantor. In addition, if a guarantor wants to foreclose the collateral, it will turn to a co-licensee and the disposal liability applies to him, which may give rise to some internal problems.³⁶

The next problem that investors may face is increasing guarantee's charges, as the collateral, which is normally a specific field, becomes close to its decommissioning dates. This is mainly because the greater risk of default at decommissioning makes guarantors concerned with their own risk exposure. Consequently, the fees are increased and an investor's bargaining powers are reduced.

(ii) Parent Company Guarantee

It is not uncommon in the industry for international oil companies to be asked by their subsidiary companies to provide a guarantee for their commitment. The rationale behind for such a request is that most IOCs have a reputation and power to uphold and carry out any commitment taken by them or their subsidiaries. The mechanism, nevertheless, would not be an attractive option when the parent's financial strength is not strong or it does not have enough valued property within the realm of host state's jurisdiction to be attached to the guarantee.³⁷ Furthermore, there is always the risk of crisis that hinders a parent to carry out its commitment or ruin the companies' reputation and, consequently, render the guarantees worthless. In addition, for the parent existence of such guarantees, especially when it is an open-ended guarantee can drastically reduce the parent's borrowing powers for emergencies and may put their property "to claim from all corners of the globe under a

³⁶ It is necessary to mention that analyzing future participants of a JOA is one of approaches that oil companies take before participating in JOA to avoid possible problems. This shows how it is important for oil and gas companies to have commonalities with their future fellow JOA members. Therefore, existence of non-professional party, like banks, among some professional oil companies may automatically arise some problems.

³⁷ International Petroleum and Exploration Agreements (2009) p.286

variety of legal systems.”³⁸ The mechanism, therefore, may not be impressive for co-venturers to a JOA.

3.2.3 Trust Fund

One of the other common securities that may be proposed in against the default is establishing a trust fund. This is simply a fund for a share of decommissioning cost that co-venturers have to inject their shares into it, in accordance to their PI, plus to a requisite sum “on the basis of ratio of present production to anticipated future production.”³⁹ This may be “the most effective way of dealing with security defaults”⁴⁰ for number of reasons; for example, it may reduce the likelihood of defaults more than other approaches in later stages of a field since it is not based merely on PI which loses its worth during the decommissioning stage. Therefore, the approach can be an attractive remedy for both investors and governments, although this attraction to some extent depends on the issue of tax treatment, whether the contributions are tax deductible or not, since if they are not, parties may be reluctant to pay their contribution in Fund.⁴¹ Thus, it can be said that parties always need “to reconcile the desire for high returns with the need for security”.⁴²

In order to have ongoing injections of money to the fund, the operator party has to state expressly state how much has to be set aside for the fund and over what period. For this purpose, it “has to compare the field revenue with the cost of decommissioning to

³⁸ Ibid.

³⁹ Testa, (2013) p.16

⁴⁰ Hammerson,(2008) p. 13

⁴¹ Existence of tax deductible for contribution is a vital issue for small companies particularly when their parent company guarantee may face objection from other parties, and they cannot afford an expensive third party guarantee (bank) and the last alternative is a Trust Fund. In such a situation, paying great amount tax, plus huge amount of cash call can be unbearable load for small investors.

⁴² Upstream Oil and Gas Agreements: with precedents(1996) p. 235

determine a unit cost per barrel of production"⁴³ to estimate how much money is required for the abandonment costs, however, there is always the possibility of misleading estimates. Furthermore, international oil companies, like as mentioned in upfront cash call, are commonly reluctant to tie up their cash flow by paying into a trust fund. Therefore, employment of the remedy may be reduced just to a time when other securities become inadequate or are not renewed.

The mentioned problems were the main reasons why parties often trend to securities issued by banks or parent companies, even though in practice there may be no difference in their final function.

3.2.4 Letter of Credit

By putting some forms of collateral before the banks or other financial institutes, they issue a promise to pay any defaulted sum, as soon as there is a presentation of the required documents (normally administrative and legal documents). This is one of the most common forms of securities, called letter of credit. The cost of the LC is contingent on the issuer bank and the period that it covers, but normally banks issue an LC for a 12-month period and it has to be renewed each year.

Although the LC is very common procedure in some petro-states, especially in UK where companies, due to the invalidity of tax deductibility of trust funds, prefer to substitute it with LC, the solution has some disadvantages. They are as follows:

- Expense involved with issuing, negotiating, and other fees (like amendments), can make LCs expensive. The paperwork can be very time consuming and cumbersome to produce.

⁴³ Mankabady (1997) p. 614

- Unless a specific strategy is utilized, the actual cost of decommissioning infrastructure can increase due to uncertainties surrounding expense estimation.
- Strict regulations are held for payment that sometimes makes the process too difficult for non-defaulters or governments to get back to the defaulted amount. Unless all the documents are 100% compliant with the terms and conditions of the LC, the bank will not issue payment.
- In most JOAs, particularly in the OGUK, the issuing bank must be a prime bank located in the jurisdiction of the host state. This makes the process difficult for IOs that do not have ample assets inside the host country to take a LC.
- There is still the risk that the issuing bank or financial institute may be financially unable to provide the promised funds at a future date.⁴⁴
- Political issues between the issuer bank's country and the borrowers of LC may impede performance of LCs.⁴⁵

On the plus side, however, there are also some benefits for LCs including: “creating an absolute obligation on the bank to pay on the face of a declaration and not one conditional upon showing that the event specified in the bond ha[s] in fact occurred,”⁴⁶ and “the cost

⁴⁴ Ayoade(2002) p.25

⁴⁵ Cordero Moss(2014) p.66

⁴⁶ Mankabady (1997) p. 614

of a bank guarantee or a bond provides tax breaks that are not available for payment to a trust fund."⁴⁷

3.3 Conclusion

The foregoing chapter aimed to show the main differences in the listed securities to draw their positive and negative points in general. The main differences in the offered securities seems to be between cash-based approaches (trust fund and cash call), and the guarantee-based means (whether the guarantees or LC).

Despite these differences, all of the mentioned securities have one common feature. None of them can provide a perfect protection against default. They have fundamental problems which provide an opportunity for a potential defaulting party to exploit their pitfalls and escape its commitments.

⁴⁷ Ibid.

4 Current Practices of Default Remedies

4.1 Introduction

In 2005, the insolvency of the operator of Ardmore oil field triggered a warning for all petro-states. The operator, Tuscan Energy (Scotland) Ltd, went insolvent while the decommission cost of the field has been estimated £5 million.⁴⁸ In such a situation, the UK government was required to take the responsibility of decommissioning.

Although the matter was resolved later by a third-party company, the case drew governments' attention to the importance of failure of payment in form of insolvency or default in the later stage of a field where a prospectively defaulter party has the opportunity to back out from his duty for decommissioning and use possible legal gaps inside the JOAs to escape from the consequences of its default.

Accordingly, this section of the study analyzes and examines the most widely-used JOA forms to see to what extent provided mechanisms in sections 2 and 3, or as we call them, two executive arms against default, can protect the non-defaulters and government against a potential defaulter in the decommissioning phase.⁴⁹

This chapter considers key structural remedies and their fundamental problems in respect to some current JOAs. Every JOA will start with a brief description of its default provision and security interest, and then the efficiency and security of that provision will be examined.

⁴⁸ Hammerson, 2011 p.452

⁴⁹ As previously described, not all mechanisms in section 2 and 3 are brought within JOA's context. Every JOA, depending on its background, choose some or all those mechanisms.

4.2 AAPL JOA Model Form

The American Association of Landmen, up until now, produced different versions of its Joint Operating Agreements (JOA). The most significant and important of these agreements, adopted thus far, has been 610 version. This version is used for U.S. onshore reserves and adopted in 1989. Regardless of its age and usage, the form 610 is one of the most commonly used forms, and some of its provisions have been universally reflected in other JOAs.⁵⁰ Besides that, the form is still in use in North America. To fully understand the modern JOAs' standards demands to examine the form in detail. It would therefore seem meaningful to consider the form.

4.2.1 Form 610

In regards to the default, the form 610 prescribes a wide range of remedies. These range from the suspension of rights to low degrees of common forfeitures.

Failure to take action to cure a specified default in the default notice within 30 days of receiving the notice will commence the default period. Initially, the defaulter will automatically lose the following rights: to receive operational information, to participate or elect in an operation (even if the party has previously elected), and the right to obtain proceeds from the sale of production (often called its entitlement).⁵¹ These rights (potentially suspended) are meant to be without limitation to provide the highest liberty for non-defaulters to do whatever they wish to do; however, such liberty may leave some legal gaps for potential abuses by non-defaulters. For instance, if non-defaulters are attempting to rid of a party from a successful project, any small delay in payment of

⁵⁰ <http://www.landmanblog.com/the-aapl-form-610-model-form-operating-agreement/>

⁵¹ AAPL JOA Model form 610 art VII.D.1

expenditure could be used as an excuse for them to put a party under pressure by suspending most of his rights, and ,subsequently, to force that party to leave the consortium. In such cases, even a trivial default may bring a costly deprivation for a defaulting party. In order to avoid any abuses, the AAPL's Authors Committee could have enumerated and categorized all the rights that might be suspended due to the default in a comprehensive list. Other vital rights that could be enumerated are: the right to take part and vote in the JOC, the right to participate in AMI acquisitions, the right to receive notices of future well projects, and the right of the defaulting party to offset any debt owing from another party to the defaulter (whether under the JOA or any other commercial relation).⁵²

Alternatively, if 30 days have lapsed and the default period is launched, the defaulter might be deemed a non-consenting party⁵³ and the defaulting party will be blocked for the specific joint-operation which will then be undertaken by others.⁵⁴ By proceeding non-consent, the non-defaulting co-ventures cannot ask for or sue for any unpaid amounts of projects the, as, defaulting party had been proposed as non-consenting party. Therefore, if the operation results in a dry hole or any other failure, it is not possible to reclaim the unpaid costs from the defaulting party.

The JOA as well provides that failure to cure default within the default period (i.e. 30 days) might be a reason for non-defaulting parties to demand a security (in the form of an upfront cash call) for future expenditure.⁵⁵ It seems the authors of the form were aware that some parties would go against the agreements; either they would not be able to pay their dues, or would delay. Such parties would be categorized as untrustworthy, so it has been suggested that a defaulting party can be asked to make advance payments of the

⁵² Like as AIPN JOA art.8.6

⁵³ Non consent traditionally used when a party, because of its view on the commercial success of a developing reserve, is not interested to participate in the production of a discovery.

⁵⁴ AAPL JOA Model form 610 art VII.D.3

⁵⁵ AAPL JOA Model form 610 art VII.D.4

estimated cost of a project in which the defaulting party has elected to engage, and whereby the party has been assured that such payment is an integral part of the main project (such as decommissioning).

Harsher approaches will be performed against the defaulter when default period ends 120 days after receiving notice of default. In this time, non-defaulting parties will be allowed to execute the lien and securities which are granted in favor of non-defaulters.⁵⁶ Additionally, they can collect the defaulter's proceed from sale of oil and/or gas.⁵⁷

Although all these stated remedies are regulated in a complex yet subtle manner, the form leaves some key issues open. The most serious of these concern the question of sufficiency of lien in the decommissioning phase. The form contemplates three different types of collateral: (i) on oil and gas that have been produced, (ii) on equipment that have been used to extract crude oil, and (iii) on oil and gas that remains underground. While the parties are allowed to present each of these options, as the collateral for the lien, the form has not addressed the fact that at the end of field life, access to these options will not provide any benefit for non-defaulters since there is no oil left and production is over. Normally, under this circumstance, the value of equipment is also much lower than the cost of liabilities.

Next issue is timing of the required security (i.e. upfront cash call). As mentioned earlier, a security should not be asked too late; otherwise a defaulting party might withdraw from providing the security, but surprisingly, hereunder, a security is demanded from a party who is already in default and if it intends to use default to escape its commitment, it will not be interested to provide upfront cash, even if failure to pay the required advance payment may result in foreclosing its lien, particularly when its lien is worth less than the amount in default.

⁵⁶ AAPL JOA Model form 610 art VII.B

⁵⁷ Ibid.

It seems, therefore, although AAPL 610 provides some approaches to manage the default process, it avoids taking strict forfeiture as a main approach. Instead, it prefers to prevent parties from default by applying pressure (in the forms of lien, security interest and possessing proceed from sale); however, these sorts of approaches will not be effective when parties are in the decommissioning phase. The JOA also lacks practical, effective examples of security interests. The form just points to upfront cash as security and leaves the choice of security up to the parties. One may argue that is positive, rather than negative, that the form gives such liberty to parties to negotiate their desired security, but from another perspective, not mentioning securities might indicate that the form did not paid attention to the importance of securities.

On other hand, the JOA clearly provides one necessary element for enforcement of lien: power of attorney, which is purposed to circumvent legal obstacles in transferring interest and liens, although there are limitations in enforcement of that in some judicial system (specifically in U.S. courts).⁵⁸

4.3 AIPN Model Form

Undoubtedly, the AIPN model form is one of the most remarkable and widely used agreements in the petroleum industry. The 2012 version of this model should be considered a leading form that some of its provisions have become boilerplate clauses in the industry. However, the form is still inadequate and ill-adapted in some of its scopes. Discussion ensues.

4.3.1 Definition of Default under the JOA

Like form 610 of AAPL, an explicit provision is dedicated to the meaning of default; however, its broad definition of default is distinct from similar models. Unlike Article 8 of

⁵⁸ Black, and Dundas, (1992-1993) p. 72

the 1995 version, the Article 8.1 of 2012 version defines the default not only as failure of payment upon request, but also, failure of providing required security under the contract can form a default.⁵⁹ Moreover, if a party fails to post or maintain security, the non-defaulting parties must post a security or pay the operator the necessary funds to obtain the requisite security.⁶⁰ On that account, the amount in default might also be all cost paid by non-defaulting co-venturers in posting security on the defaulter's behalf.

Another positive feature in regard to definition is that the model clearly expresses the possibility of situations where the defaulter is an operator and assigns a special paragraph to address the operator's breach.⁶¹

This broad definition is intended to provide a more secure space for participants and create a strong threat to deter default as much as possible.

4.3.2 Default provision under the JOA

A defaulting party's rights are temporarily suspended within five business days after receiving a default notice.⁶² These strict rules are outlined on the form. During the period of suspension, the defaulting party is prevented from: (i) participating, voting at ManCom, (ii) receiving data and other pertinent information relating to operating projects, (iii) receiving its entitlement, and (iv) transferring its interest.⁶³

While defaulting party has thirty days' time in the AAPL standard form to remedy its default⁶⁴, the stipulated grace period (five days) in the AIPN model seems quite

⁵⁹ AIPN JOA art 8.1 (A)

⁶⁰ AIPN JOA art 8.3 (A) (2)

⁶¹ AIPN JOA art 8.3 (D)

⁶² AIPN JOA art 1.1 (Default Period definition)& art 8.1(B)

⁶³ AIPN JOA art 8.2 (A)

⁶⁴ AAPL JOA Model form 610 art VII.D.1

insufficient for the defaulter to cure its default. Moreover, a broad area of rights is reflected within the form that is probably without any parallel in any other JOAs. Although the rationale behind this broad sanction is the fact that the defaulting party has broken an agreed contract between co-venturers, and so it should be “disenfranchised and rendered unable to enjoy certain of rights”⁶⁵, this point should bear in mind that the high numbers of suspensions might lead to a complete deadlock and interruption in the defaulter’s daily tasks, and subsequently may disable the party to cure its default within default period. Furthermore, loss of rights should be expressed as such to be “in discretion of non-defaulting parties”⁶⁶, but deprivation of rights to transfer, as an instance, is not always in discretion of non-defaulters. For example, it might be of some benefits for non-defaulters if a defaulting party has chance to transfer its PI to a third party.

From positive perspective, the JOA obliges operator to ask non-defaulting parties to pay an amount in default to keep the process of consortium; otherwise, they will be known as defaulters.⁶⁷ The operator in turn is required to pay the indebtedness to which the additional share of expense is applied; otherwise the operator might be known as defaulter too.⁶⁸

The operator is also allowed to sell the defaulting party’s share to recover the amounts owed by the defaulting party and to fund a reserve for the defaulting party's share of decommissioning costs.⁶⁹

Four optional harsher remedies will apply on a defaulting party if it fails to remedy its default by the 30th day of default period.⁷⁰ But before processing those remedies, it is

⁶⁵ Roberts (2012) p.192

⁶⁶ Ibid.

⁶⁷ AIPN JOA art 8.2 (b)

⁶⁸ BG International Limited v. Canadian Superior Energy Inc., 2009 ABCA 73

⁶⁹ AIPN JOA art 8.4 (A)

necessary to mention that the thirty days is a reasonable time for a defaulter to address the consequences of default, but there is a likelihood a co-venture can fall into default two times within one year. In order to avoid such continuous defaults that might be done intentionally to see the results of a specific project, the committee added an optional expedited forfeiture clause that limits the thirty-day default period to fifteen days in any subsequent default.⁷¹

Like as usual, strict forfeiture policy is the first and most commonly selected form of provision of default. Under the AIPN, strict forfeiture, as the name implies, is the toughest of the provision of default, as it requires the defaulting party to transfer its interest in the operating agreement and the underlying host government's contract to the other co-venturers.⁷² Less drastic than strict forfeiture is buying out the defaulting party's interest with regards to fair market value and assistance from an independent expert in the case of dispute between parties.⁷³ To further reduce the risk of enforceability of buy-out under some jurisdictions, the buy-out is payable in four equal installments over an eighteen-month period.⁷⁴ A third approach comes in the form of a withering option, which requires the defaulting party to grant part of its participating interest in the corresponding project in which it is in default to any non-defaulting party desiring to own of it. The final provided alternative under AIPN 2012 is foreclosing a defaulting party's mortgage or security and its derived products and/or proceeds from its pro rata share of interest under the JOA.

By performing buy-out as an alternative, the parties would likely have to achieve the result of omitting the defaulter without making a foul in the jurisdiction that forfeiture, as a default remedy, may be unenforceable. For this reason, the committee offered buy-out as

⁷⁰ AIPN JOA art 8.4 (D)

⁷¹ AIPN JOA art 8.4 (D)

⁷² AIPN JOA art 8.4(D), Alternative Provision I

⁷³ AIPN JOA art 8.4 (F) (1)

⁷⁴ Weems and Bolton,(2002)

an option, although there is still this concern that a party may intentionally default and misuse the buy-out option as a means to avoid the undesirable results of a project. In this situation, the defaulter, in fact, will force the other parties to purchase its participating interest at fair market value. For example, in the decommissioning phase, those participating interests are basically less valued than future liabilities, and a party can deliberately default to avoid higher cost liabilities rather than gain money from selling its (near worthless) participating interest.

Withering also enables a non-defaulting party to have the option to require the party in default to offer to assign a part of the defaulting party's participating interest in the corresponding exploitation area. As a remedy, the "withering" clause is more proportionate than a complete forfeiture because it is measured against the extent of the default, and therefore tries to avoid the enforceability concerns with "disproportionate" remedies. In addition, the new remedy (i.e. withering) also provides continuity by enabling the defaulting party to remain in the rest of the project. But there are some serious difficulties of implementation, such as the complexity of calculating withering interest, which is exemplified by its provision in the 2012 JOA. Accordingly, the selection of such an approach as the main approach included in a JOA agreement may lead to protracted negotiations. Another concern, a common one in all proposed approaches, is that under some circumstances the option may be served as a means for a defaulter to rid itself of an interest in a less-desirable exploitation area.

4.3.3 Security Interest under the JOA

In terms of making adequate security in the atonement phase, Article 10.4 of the 2012 version provides for the co-venturers to “make a preliminary plan for the Decommissioning of facilities and the abandonment of wells”.⁷⁵ This plan should comply with the procedures set out in Exhibit E, which recognize creation of a trust fund. Parties are

⁷⁵ AIPN JOA art 10.4

required to contribute to the trust fund by paying annual cash call when the operator announces a “Trust Fund Cash Call” on the “Trigger Date.” As an alternative to payment, a party can elect to provide security rather than cash call at or before the due date of the relevant trust fund cash call.⁷⁶

The JOA also offers an option to create a reserve fund where a party is in its default period. This mechanism is aimed to create a fund which includes an amount “equal defaulting party's participating interest share of the estimated decommissioning costs to the extent the defaulting party has not yet provided for decommissioning security under Article 10”.⁷⁷

As will be discussed further below, both these funds seem to be plausible approaches to secure decommissioning liabilities; nonetheless, their effectiveness, specifically when a party intends to escape its liabilities, is far less clear.

The first point to contemplate in regard to trust fund is that while annual transfer of cash call on the trigger date may discourage any party from default, it is still doubtful whether the mechanism can be a strong deterrent in a case where the remaining reserves of petroleum are worth less than the liabilities. As was noted earlier, the direct consequence of failure to pay cash call, including a cash call for the trust fund, is a default which brings the right of a non-defaulting party to lift the defaulting party's production share. However, it is imaginable where a party pays trust fund cash call for a presumptive 10 years. At the ninth year, however, the party fails to pay its share of the trust fund cash call since the worth of remained petroleum resources is less than the amount that party should pay for its share of the trust fund cash call. In other words, the consequence of such a default would be beneficial since that party can save the payment and, in return, it will only lose its worthless PI.

⁷⁶ Ibid.

⁷⁷ AIPN JOA art 8.4.C

As shown above, a party can elect to provide another security rather than cash calls. However, even this mechanism does not resolve aforementioned issues nor does it provide a less risky approach for non-defaulter parties. Based upon Exhibit E, failure to renew or replace a security is considered default for a party. It is presumable, for instance, that a party renews its security until the last year of JOA and at the end of project, intentionally defaults by failing to renew or provide a replacement for its security. This failure has more adverse effects for non-defaulter parties than the failure of paying cash into the trust fund. Since, in the former that a defaulting party, at least, has paid some parts of its share of cost, in the latter, however, that defaulting party has always provided security in the form of a lien, or any other form, and in the event of default it simply does not renew its security, without paying its share of interest.

The reserve fund is the second possible proposed fund to cure the default problem. The use of reserve funds is a widespread means in PSA regimes and, in case of the default, it is mostly proposed to refill the trust fund.⁷⁸ Successful performance of this system may also face some similar difficulties as the trust fund, specifically when the value of the assets is not sufficient to secure possible costs in an abandonment phase. In other words, this provision, which is designed to secure decommissioning liabilities, is not really effective unless the fund is worth enough to cover the cost. In addition, there is always the chance that creation of such funds, whether reserve or trust funds, might tempt host governments to add the requirement of creation of such a fund before awarding any licenses. Small investors are the first group of investors that such a requirement by host states might adversely affect them.

⁷⁸ Pereira (2012) .p 38

In an effort to address the legal development and modern practice of the industry, the AIPN revised the 2002 version and released a newer, 2012 JOA in February 2012. The 2012 displays both positive and negative aspects in this regards.

On the positive side, many new alternative provisions are added in regard to the default issue. Most of those stated choices are as same as 2002 version, but they have been brought in new form to be workable. This makes the 2012 a flexible document which offers its signatories a great opportunity to modify the contract based upon their desires. In fact, all attempts have been made to tell the JOA's participants that the outcome of any kind of default should be proper to defaulted amount and parties should refrain from looking at the clause as a penalty tool. The 2012 JOA also contains an advanced set of provisions concerning the later phases of a project. These provisions require the operator and non-operator to make a preliminary plan for decommissioning, estimate its relevant budget, furnish security for it and eventually conduct the decommissioning in accordance with the decommissioning procedures set out in Exhibit E of the JOA (2012).

On the negative side, one issue that continues to be mentioned is the absence of strong regulations to deal with default in the decommissioning phase. It means that there is always the possibility that a recipient of notice of default leaves the agreement intentionally and avoids repaying its debt. Furthermore, the huge number of alternative results in endless negotiations and debates among parties since every issue, even some less important ones, must be subjected to election and long negotiation. On the other hand, the existence of these large number of elective options impedes us from a gaining a set of international standards. However, as Josephson provides,

“The international industry is comprised of a wide variety of participants - from publicly-traded super-majors to small private promoters to state-owned oil companies - each with broadly different expectations and agendas. In an effort to achieve the widest possible use of the model form, the AIPN has adopted and is intent on maintaining the concept of including options and alternatives where necessary to reflect legitimate differences of

opinion and practice in the international industry. However, such a criticism is easily made if one assumes that one's favored position on an issue will be adopted in the model form. This assumption is not a safe one given the significant differences in practice and opinion which exist on a variety of issues in the international petroleum industry. In any event, the AIPN model forms have served to set standards in several areas".⁷⁹

4.4 Norwegian JOA Model Agreement

The North Sea can be described as a halved basin between Norway and the UK; the Norwegian half is less mature than the other, but it is growing rapidly to become a full, mature area. Because of this, it is natural that more concerns are expressed on efficacy of decommissioning approaches taken in North Continental Shelf (NCS). This part of the chapter, therefore, will examine the current Norwegian agreements, composed of the Joint Operating Agreement and Decommissioning Security Agreement, and will look at how decommissioning is dealt with in NCS.

4.4.1 Description of Default Provision under the JOA

In general, the JOA adopts similar mechanisms commonly found in other JOAs, but in an unusual manner, the form starts by mentioning the non-defaulting parties' duty to take any unpaid amount and continues by allowing non-defaulters to possess the defaulter's share of the petroleum produced.⁸⁰ Further, the model provides five days for a defaulter to remedy its default or the suspension of rights period will commence. During this suspension, the defaulting party loses its right to vote and access to data for as long as the

⁷⁹ Josephson (2003) p. 8

⁸⁰ Norwegian JOA art 9.1

default exists. In the meantime, the defaulting party will be bound by decisions issued by ManCom.⁸¹

The first difficulty that may arise, in respect to article 9.1, is that the defaulter has only five days to pay the amount in default. Failure to meet its share of the cash call after five days will result in the suspension of rights. It seems that the turnaround time is insufficient, especially given the large sums of capital involved. Small companies particularly may face difficulty in coming up with such huge amounts of cash. In contrast, the given deadline before forfeiture is addressed in a more satisfactory manner whereby a defaulter has three months to restore the situation to its former condition.⁸²

Another interesting facet of the JOA is its unusual mandate which makes the defaulting party bound to the ManCom's Resolution when its rights, including the right to acquire information, are suspended. However, a deadlock may arise when a defaulting party passing its default period intends to sell its PI to avoid further consequences of the default. In such a situation, that party will need some information, in response to the PI's possible buyers, from the relevant production license to evaluating the scope of its alternative liability, as well as the removal schedule to give the buyers what information they need. Under this circumstance, on one hand, that defaulting party cannot sell its PI and, subsequently, avoid default's aftermath and on another hand the party has to wait for the ManCom's permission about its PI.

The JOA also provides that a penal interest might be imposed on a defaulter. This solution is aimed to be a decisive factor against default. Surprisingly, however, the JOA fails to indicate whether a defaulting party should be charged during the grace period or when the period is over. Such uncertainty may result in irrational discrimination between an honest party who is trying to restore the situation and a party intending to leave the JOA.

⁸¹ Norwegian JOA art 9.2

⁸² Norwegian JOA art 9.3

Furthermore, the penalty is an unnecessary burden on defaulting parties, specifically when the parties are small companies with financial strength that is considerably less than that of giant oil and gas companies.

When a default lasts for more than three months, non-defaulting parties are entitled to send a request for transferring a defaulter's PI. But before that, the operator must notify Norwegian governmental authorities about the default and the decision made for transferring the defaulter's PI to non-defaulters. However, the transfer of the defaulter's PI should not be done in the sense of a strict forfeiture; rather, the defaulter is compensated for its investment and the maximum value of this compensation is the book value of the investment.⁸³ This means the model lacks a strict forfeiture and instead provides an equalized version of a buy-out option which will not be sufficient when the interest worth less than amount in default.

The process of transferring PI is not as easy as it appears. At the time of assigning the defaulting party's share of interest, most of the defaulter's ongoing liabilities will be transferred to the non-defaulting co-ventures, except those related to the unsettled issues at the time of the transformation.⁸⁴ Some difficulties may arise when we deal with the term of "at the time of the assignment" since the definition of this term is not clear. This difficulty lies in the fact that there is neither preliminary work nor clear wording in the provision to clarify the true meaning of the term.⁸⁵

Reference to this sort of transfer between defaulters and non-defaulters is aimed by the Norwegian government to not engage in a defaulter's ongoing liabilities. In fact, the

⁸³ Norwegian JOA art 9.3

⁸⁴ Norwegian JOA art 9.4

⁸⁵ Discussing about time of the assignment is out of purpose of this paper. For further information, see: Nørskolje&gass, Norwegian Oil and gas Association recommended guidelines for decommissioning security agreement for removal obligations – use of model.

government puts the defaulter and non-defaulters vis-à-vis (as opposed to the defaulter and the government) to stay away from carrying out any unpaid amounts or performances of decommissioning at its own expense, with the resultant cost then falling on the taxpayer. Collaboratively, the Norwegian Petroleum Act also provides the same criterion for situations where defaulter is a third party to the license. Accordingly, two separate situations are presumable at the time of assigning defaulting party's share of interest. First, in cases where a defaulter's liabilities transfer to the non-defaulting co-ventures and the defaulter is an original licensee, and second, in cases where the defaulting party is actually a third party assigned by original licenses. In respect to both of these positions, the question arise that addresses to what extent the Norwegian system has provided security to assure that non-defaulting parties can get back the amount in default from the defaulter, whether the defaulter is original licensee or a third party to the license. The following section will proceed to answer this question.

4.4.2 Security Interest under the JOA

(i) In cases where the defaulter is the original licensee

As noted above, a reasonable predictability is considered by transferring a defaulter's liability to non-defaulting parties to ensure the government that abandonment of a field will not enforce any encumbrance on it. However, in regards to non-defaulting parties, the JOA is quite silent. With the exception of cursory references to possible guarantees for abandonment expenditures in respect of the JOA,⁸⁶ potential methods of security interests have not been listed in the Norwegian system. That makes it clear why the system is vulnerable. Even a review of disposal plans, which are examined by the author, revealed that the securities have not been considered in the disposal plans.⁸⁷ The defaulting licensee

⁸⁶ Norwegian JOA art 24.3

⁸⁷ Disposal plan of Statfjord A

has a liability vis-a-vis with the other licensees for its share of costs related to disposal of the facilities that existed at the time of transferring its participating interest. So, it is the non-defaulting party's responsibility to take a position on whether or not, and if so, how, it should protect itself. The result of this evaluation will determine which kinds of guarantees are proper, and how they should be performed. Nonetheless, due to a lot of uncertainty, it would be really hard to make follow the same form for all JOAs. It is, therefore, barely feasible to prepare a standard, united set of agreements to be recommendable for all operations under the Norwegian system because the condition of every decommissioning may vary considerably from case to case since the procedure is subject to extensive and stringent regulations which make the process more complex. However, the inability to achieve a standard form should not be an obstacle to procure a mechanism for a non-defaulter against defaulters. As we have seen, the only provided solution so far is possessing the defaulter's participation interest, which is worthless when the oil does not remain.

(ii) In cases where defaulter is third party

In contrast to the former situation, the security interest is well developed when it comes to relation of non-defaulters, seller and purchaser. Based on article 5-3 of the Norwegian Petroleum Act, the assignor of a licensee is alternatively liable toward the other parties for its financial obligation in regards to facilitates which existed at the time of the transfer⁸⁸, the seller, however, has this right to get back the amount it is owed by the purchaser of the amount that is actually be given as default. Every government policy issues different approaches to secure the mentioned right, mostly pertain to various backgrounds they have. According to these backgrounds, Norwegian Oil and Gas Association propose some

⁸⁸ Section 5-3 of the Petroleum Act

possible options which shall be categorized as common securities against defaults (including guarantee, lien) and, the Norwegian DSA.⁸⁹

4.4.3 Norwegian Decommission Security Agreement

With a growing number of mature fields in the North Sea, a question arose as to what forms of security can be taken to constitute a reasonable protection. Accordingly, the issue was brought and eventually dealt with in a separate, independent form which was generally referred to as a Decommissioning Security Agreement. This agreement is “an attempt by the co-venture to supply sort of financial security in the form of a guaranteed source of funds that may be accessed if the need arises in order to pay for the actual cost of decommissioning installation.”⁹⁰ For this purpose, these kinds of agreements are employed both by Norway and the UK even though (i): parties to the agreement, (ii) the provision of guarantees and (iii) rules relating to removal obligation⁹¹ are different in Norway and the UK.

(i) Parties to Norwegian DSA:

As in the UK, the DSA governs the relationship between co-ventures. In the case of Norway, the agreement is restricted between the assignor of a license who transfers its participation interest⁹² to an assignee. This is to be diverged from performed DSA in UK where the DSA is aimed to protect licenses against a possible defaulting party who has its share of the cost of decommissioning paid by non-defaulting parties, while in Norway the DSA is used as a means to secure a seller of a license from an alternative liability that may

⁸⁹ Norwegian DSA, because of its importance and great details, will be discussed in an independent section.

⁹⁰ Oil and Gas Law: Current Practice and Emerging Trends (2011) p. 406

⁹¹ Discussing about this topic is not dealt with in the paper

⁹² Norwegian PA ,section 10-12

arise if the buyer avoids paying their share of decommissioning. This means the Norway regime has only examined a default between buyers and sellers and leaves the issue blank when it occurs between first hand licenses. It is clear, then, there is no necessity for the British DSA to cover the relation of sellers and purchasers since a seller will be protected primarily by buyers committing to guarantees for the other licensees in the form of an existing DSA which the buyer joins. From this point of view, the UK model of DSA seems to be more progressive than its Norwegian ones.

(ii) Provision of guarantee:

The proposed DSA by the association has provided two main forms of guarantees. They are LC, which should be differentiated from common securities against default⁹³ and, the parent company. As noted above, the LC must be renewed annually based on a re-calculated present value of estimated future removal costs. A number of circumstances, including the buyer not fulfilling their liability to annually renew the LC or the issuer bank's rating falling below a given level, will give sellers the right to foreclose the LC and put the guaranteed amount in the bank as security for future possible liabilities for removal obligations. The second possible means of protection, according to the Norwegian Oil and Gas Association's guideline, is a parent company mechanism. In this particular mechanism, the buyer has the opportunity to provide a parent company with a guarantee for potential future decommissioning costs. The buyer's parent company, however, has to have good credit to assure the seller that it can easily pay out a sufficient amount when the time comes to meet their decommissioning obligations, otherwise the buyer must acquire a LC. In such cases, a LC will replace the parent company.⁹⁴

The DSA has employed a detailed provision whereby the buyer shall deliver the renewed LC no later than ten working days before the expiry of the LC, and failure of the buyer to

⁹³ they were independent documents while this LC is just performable under a DSA,

⁹⁴ Norskolje&gass, guidelines for decommissioning (Appendix 2) – (Agreement B, 3.1)

deliver the renewed LC will give seller the right to foreclose the LC.⁹⁵ The big advantage brought here is that the seller has enough time to draw on the LC if it feels the buyer does not intend to renew the LC, especially in cases where a party has intended to delay the renewal until the LC's expiration date and to avoid its commitments. In such cases, the holder of the expired LC cannot claim to get the amount back, but by employing the time limitation, it has 10 days to draw on the LC and, of course, a surety of losing a worthy LC can inhibit a possible defaulter.

In reviewing the Norwegian DSAs, this point should be considered that all licenses under the Norwegian system have special features, and a potential DSA must be examined with regards to its situation, both in regard to what is being sold and who the purchaser is, so the reviewed DSA was a sample of the used DSA, not a standard version of all DSAs in NCS.⁹⁶

As we noted above, notwithstanding the merits of the Norwegian system, the system has not dealt with the issue of intentional default. Default provisions are confined to a balanced form of buy-out provision, in which the defaulter does not suffer any kind of harsh punishment, and securities provisions are mostly concerned with the decommissioning liability between seller/purchaser of a license. Moreover, it has not been clarified in the JOA's provisions or the PA whether the regime between seller and purchaser is applicable between first hand licensees or not.

It is also necessary to mention that the system is not necessarily adaptable to all countries, especially developing states where their level of foresight, budgetary planning and careful fiscal management on the part of the government are completely different, and, even more, their decommissioning plan will not be examined case by case.

⁹⁵ Norskolje&gass, guidelines for decommissioning (Appendix 2)– (Agreement B, 4.5)

⁹⁶ Osmundsena & Tveter (2003) p. 1582

4.5 British JOA Model

The best statement of UK Continental Shelf (UKCS) is Styles' description: "If there is one word can that best describes the UKCS at the beginning of the second decade of 21th century, it is mature."⁹⁷ As UKCS becomes a mature hydrocarbons province, a growing numbers of fields near the end of their lives and, pursuant to that decommission, becomes a more vital issue. Accordingly, since the 1960s and 1970s, the industry has begun to take issue with more careful considerations. As the result, the JOA's revision committee dealt with the issue in one separate decommissioning security agreement. The committee also revised Article 17 of the JOA in a way to cover both the default resulted from failure to pay share of interest, and the default resulted from failure of a party to implement a DSA. This article should be read in collaboration with DSA. In the following, we firstly examine the relevant provision of JOA and then will process the DSA.

4.5.1 Description of Default under JOA

It has already been observed that the British Model uses a wide definition of default that encompasses any failure in performing a DSA (in the case that a DSA exists).⁹⁸

Similar to many JOAs, a default process starts through a grace period for a defaulter to remedy its default (six days). In the meantime, the operator must inform the non-defaulters within three days to pay the amount in default within six days or they will also fall into default.⁹⁹ If the defaulting party does not pay the amount within six days, first it lose the right to take a production share,¹⁰⁰ then it face suspension of its rights, including the right to vote in the ManCom, to obtain access to information, and eventually the right to

⁹⁷ Oil and Gas Law: Current Practice and Emerging Trends(2011) p.1

⁹⁸ OGUK JOA art 17.1

⁹⁹ OGUK JOA art 17.2 (b) (c)

¹⁰⁰ OGUK JOA art 17.4

withdraw from the agreement and transfer its share of interest (excluding the extent explicitly allowed in the JOA).¹⁰¹

If the default lasts for more than 60 days (reduced to 30 days¹⁰² in cases where default is pertinent to fund the costs of an exploration well),¹⁰³ a forfeiture mechanism will be performed, although its performance is highly contingent on the permission of the government.¹⁰⁴ Correspondingly, a deadlock might occur when the government does not approve of a proposed forfeiture from the parties, since the defaulter will lose its license in the JOA, but it can maintain the license given by the government.

Similar to the Norwegian model, forfeiture will not be executed in its strict form. The defaulter will be compensated for its investment, if the development plan is already executed and production has started.¹⁰⁵ Therefore, the model avoids performing a strict forfeiture.

While the JOA establishes several remedy provisions against default in the production stage, it is silent about providing security forms in the decommissioning stage where forfeiture is not sufficient. This gap will be clearer with considering this fact that under the Petroleum Act 1998, parties are not enforced to accept a decommissioning security agreement providing detailed rules on possible securities. So it might be interpreted as an indication of the possibility that parties to the sole JOA may have more opportunity to escape their commitment when they come to decommissioning, if they have not agreed on the DSA. Respectively, the JOA could either mention a proper solution (like as a trust fund) within the JOA to meet decommissioning cost, or make the DSA mandatory for

¹⁰¹ OGUK JOA art 17.5.1, 17.5.2, 17.5.3

¹⁰² The rationale behind the imposition of shorter period in exploration is that a short period within exploration of a well may hinder a party who intends to default the cost of drilling then remedy its default, while staying far away risk of forfeiture, to see the well proves to be dry hole or not

¹⁰³ OGUK JOA art 17.6.1

¹⁰⁴ OGUK JOA art 17.6.3

¹⁰⁵ OGUK JOA art 17.7

parties to adopt. Notably, to state that the idea of not providing security inside of JOA is derived from the governing belief on the UK regime that it is not necessary for security to be provided *ab initio*. Instead, the securities are only necessary in the case of existence of a request from the Secretary of State in that it is not satisfied because of the licensee's financial strength to meet future decommissioning expenses.¹⁰⁶ Furthermore, much of the decommissioning details are dealt with in the UK's Petroleum Act 1998. This fact had probably made this assumption for authors of the JOA that it is not necessary to refer to the same issues within the JOA. However, both these ideas cannot challenge the logic that adopting some kind of compulsory security tools and writing decommissioning regulation within JOA will give parties great incentive to agree on explicit terms of decommissioning or possible securities inside of the JOA, not in the form of external regulations.

4.5.2 British Decommission Security Agreement

The British JOA's default provision has been examined in several other publications, but, surprisingly, the DSA has not been explored by scholars. The DSA, thus, deserves to be considered separately.¹⁰⁷

Similar to the Norwegian system, the basic role of a DSA is to oblige parties to provide a security for their future decommissioning expenditure. However, these parties to the agreement are not limited to the existing licensees. The DSA may involve former licensees. These licensees have no obligation to provide security and they are solely a party to the DSA to ensure that current licensees can meet their financial obligations. Other companies and secretaries of state may also want to be a party to the DSA. The

¹⁰⁶ DECC Guideline ,p. 118

¹⁰⁷ Prior to analyzing the existing DSA, it makes sense to explain that the content of a DSA and what is called decommissioning agreement (or plan) overlaps each other. In other words, making a clear boundary between these agreements is not always an easy job. No absolute standard form of these agreements has ever been developed, and JOA parties are authorized to modify these models to the extent they want, so parties may consider security provision in a decommissioning agreement or vice versa.

former may wish to enforce security if they are ever asked to carry out any decommissioning, and the latter may intend to control any amendments to the DSA.¹⁰⁸

Security under the DSA might be in three different forms. The first form is the trust fund, which requires parties to the DSA to provide cash by paying into a trust fund. The second way is providing guarantee, whether from a parent company or a bank, and the third one is LC issued by a bank.

The first serious issue that may emerge in the DSA is the time of the agreement. Although no definite time is required, the agreement should be processed at the same time as the main JOA is accepted or prior to any development plans of a field. The question of how co-venturers of a JOA are expected to reach a consensus on an extremely time-consuming and complex process while lots of uncertainty exists about the future of a field is a serious problem. In fact, such processes may raise serious difficulties for the parties. They must have long negotiations to agree on a complicated document prior to knowing whether or not there will be profitable reserves, and if so, whether the block will produce oil or natural gas (or both) and in what quantities, etc. The parties, in brief, are supposed to decide on a topic without having any certainty of discovery or development of the field. Because of these questions, thus, it would not be easy, prior to a discovery being made, to firmly plan a decommissioning security agreement.

In regards to the time issue, the next noteworthy point is the concept of a trigger date, which is aimed for by the parties in a DSA to avoid tying up cash to a decommissioning fund too early. This approach is the same as what we brought forth in AIPN, and, as mentioned in AIPN, it cannot fully hinder defaulting parties who want to use the default as an exit strategy.

The concept of an “Agreement to Agree” is another aspect of the time issue. According to English law, when parties make a contract on major terms (rather than detailed provision)

¹⁰⁸ Hammerson,(2008) p.12

and leave the details open and subject to further negotiation, the contract would be considered an agreement to agree, which is an unenforceable, preliminary contract.¹⁰⁹ This kind of agreement is similar to DSAs which normally are agreed on prior to the filing of a field of development plan, so the DSA may not be legally binding under English law. This point disappoints parties to the DSA from an agreement that has been designed to curb the potential problems that may arise in respect to a party's liability.

Whatever difficulties exist in regards to the "time issue," what is most significant in conclusion of highlighted issues is that a decommissioning security agreement, due to its high importance, has to be done as soon as possible to meet possible decommissioning costs. The aforementioned problems, thus, should not be a reason for delay in agreeing to the agreement.

The second significant issue that appears is the risk factor. Every company is exposed to a number of risks inherent in a venture (like volatility of oil and gas prices). Risks might have materially adverse effects on a party's financial commitments. They increase the uncertainty of reserve estimates that usually happen due to complexity and unsureness of the processes of estimating oil and gas reserves and, consequently, raise doubts on determining how much of a reserve is ample for paying decommissioning expenditures.¹¹⁰ A reasonable risk factor must be adopted to tackle the uncertainties surrounding an expense estimation. As British Department of Energy and Climate Change (DECC) guidance provides,

- "The need for and the amount of this will vary depending on the complexities of the facilities to be decommissioned but in most circumstances will add 50% to the total cost estimate".¹¹¹

¹⁰⁹ Cordero Moss(2010) P.75

¹¹⁰ Further info, see http://www.talismanenergy.com/upload/ir_briefcase/178/01/annual_information_form.pdf

¹¹¹ DECC Guideline ,p. 118

Notwithstanding the fact that financial security is one of the paramount relevant issues to a JOA, and, supposedly, must be compulsory, there is no mandate to oblige parties to enter into a DSA, however, there are some provisions that persuade parties to agree to a DSA. They have been expressed by Mark Hammerson :

- “(a) Section 38 of Petroleum Act 1998 allows the Secretary of State to investigate a company's financial resources to carry out decommissioning and to request security if he feels that the resources are inadequate.
- (b) Lastly, section 30 allows the Secretary of State to imposed decommissioning liabilities on parent companies. Although, according to the government "the option of securing more widely will be pursued only in cases where it is judged that satisfactory arrangements, including financial, have not or will not be made to ensure that a satisfactory decommissioning program is carried out. It is important to note that decommissioning is not an issue that can be ring-fenced at subsidiary company level. Parent companies will be keen to see that adequate security has been put in place.”¹¹²

Moreover, The DECC, as the responsible authority for licenses, in case of uncertainty about financial strength of a company, will not assent to give an award or assignment. For these reasons, many parties prefer to enter into a DSA and enjoy the benefit that can be brought afterwards.

¹¹² Ibid

As referred, the DSA provides the financial securities examples which can be in forms of cash, irrevocable standby LCs issued by a prime bank or corporate bonds from a prime bank. These forms of security must be “...issued by a body established in an EU or OECD country with a UK lending or insurance office and which have an AA rating or Better...”.¹¹³ However, not all the forms of securities are allowed. Parent companies guarantee, due to the following reasons, is excluded from list of acceptable possible securities. The reasons are: first, avoidance of any possible litigation which may arise where a parent company claims a guarantee is issued in related to an underlying contract, instead if the decommissioning security agreement and the guarantor is not obliged to pay the money. Second, existed difficulties for enforcing a guarantee through foreign courts where occur when a parent company is overseas and it does not have enough property in the state. Such cases can bring up probable delays in imposing a parent company guarantee.

Another ground that creates difficulty in enforcing a parent guarantee is that some parent company may have scarcely sufficient financial strength to pay decommissioning expenditure. This, therefore, runs the risk of inability of JOA’s parties to recover decommissioning cost.

Lastly, identical to AIPN, a LC in DSA must be renewed annually, and any failure by a party to renew its security will be considered a default; however, this also has the same problem we’ve already mentioned.

¹¹³ DECC guideline ,p. 118

4.6 Canadian JOA Model Form

As a result of an increasing trend among Canadian international companies, which are always seeking new investing lands, the Canadian Association of Petroleum Landmen has published various versions of a model form operating agreement, which are commonly used in the Western Canada basin. Each of these versions, which is referred normally as the CAPLs, includes progression from the previous one, which makes them noteworthy to review. As far as this paper is concerned, however, discussion about versions from 1990 and 2007 is enough and extensive because of their frequent utilization.

4.6.1 1990 version

Like its precedents, which were usually abridged about default, the 1990 simply creates a lien and charge in favor of the operator to secure payment of a party's share of expenditure.¹¹⁴ It also gives authority to the operator to perform some prescribed rights including but not limited to suspending the defaulter's right to get information and privileges with respect to operations¹¹⁵, drawing on the lien by selling the defaulting party's interest in the consortium¹¹⁶, possessing its revenue of sale of production¹¹⁷, etc.

By giving unlimited rights to operator, the JOA used an uncommon approach that easily creates opportunity for operator to abuse for an operator. Although most of the given rights arise from the lien issued in favor of operator, the JOA had to provide further clarification or effective mechanisms to hinder an operator from any possible abuse or exploitation.

¹¹⁴ CAPL OP (1990) art 505 (A)

¹¹⁵ CAPL OP (1990) art 505 (b)(ii)

¹¹⁶ CAPL OP (1990) art 505 (b)(vi)

¹¹⁷ CAPL OP (1990) art 505 (b)(v)

Furthermore, this point can be perceived from comparison between the 1990 version and AIPN that the 1990 involve a relatively modest number of elections. This is because the 1990 is written for parties mostly from Canada and, naturally, they have much more uniformity in their expectations than international parties.

4.6.2 2007 version

Contrary to common procedure about default writing, the form first develops in a soft security interest paragraph and exacerbates the default aspects in the default provision. So we follow the same plan.

In a surprising statement, the sub clause 5.03C provides that the operator may demand non-operators to prepare financial security pertaining to the activity and their share of costs for an approved contract in a manner satisfactory to the operator. The operator must reasonably act and believe that the non-operator might be unable to pay those costs as and when they become due.¹¹⁸ This sub clause is in fact the 503(a) in the 1990 version, which is clarified by moving the clause under the “Security for Payment” section in 2007 version. This shifting is a significant improvement on the 1990 version, since it impedes the reader from misunderstanding the clause as an alternative.

In relation to this financial security, two mandatory criteria and one option can be inferred. These are the objective standard that the operator "reasonably believes" that the non-operator may be unable to pay¹¹⁹, and the standard that the Operator “must act reasonably” in doing that.¹²⁰ The JOA also give this option for the non-operator subject to the default notice which gives it the opportunity to notify the operator of its objection and refer the

¹¹⁸ CAPL OP (2007) art 5.03 C

¹¹⁹ CAPL OP (2007) art 5.03 C (a)

¹²⁰ CAPL OP (2007) art 5.03 C (a)

matter to dispute resolution¹²¹, albeit this right of non-operators will be disentitled under specific circumstance.¹²²

This described approach of security interest is clearly distinct from similar means taken by other JOAs. It grants much power to the operator to determine which party needs to bring a security; however, the form fails to address the reverse situation where non-operating parties reasonably believe the operator needs to show its financial resource.

Possible remedies in the JOA are not summarized to the security interest. Clause 5.05B provides a list of remedies, under the default provision, which shall be hired by the operator in case of default. First, the operator issues a default notice to the defaulter and non-defaulters to inform them about the default.¹²³ Then the defaulting party shall remedy its default within five days or risk several consequences (grace period).¹²⁴ If the defaulter does not remedy the default within the grace period, the default period will begin by paying charge and interest on the defaulted amount, and continues by suspending the defaulter's rights, limited to operational information and prohibition for participating operational activities. If the default lasts for more than thirty days, then the default will be forfeited by losing its production share to the other parties and its rights over joint property and by assuming them as a non-participating party in any of the consortium's activities. If the default persists for more than sixty days, then part of the defaulter's PI and lien will be possessed by the non-defaulting parties.¹²⁵

Accordingly, at the most severe form of forfeiture, the operator might take steps to enforce the lien "by taking possession of and using free of charge the defaulting party's Non-Operator's Working Interest and in the Joint Lands and other Joint Property". However, it

¹²¹ CAPL OP (2007) art 5.03 C (B)

¹²² CAPL OP (2007) art 5.03 C (D)

¹²³ CAPL OP (2007) art 5.05 (B) (G)

¹²⁴ CAPL OP (2007) art 5.05 (B)

¹²⁵ CAPL OP (2007) art 5.05 (A) (B)

is always likely that an operator overrides its authority. To avoid such misuse, the 2007 procedure sets out an extensive (although incomplete) set of recommendation which explicitly specify: “The seizure and sale remedy in this paragraph (5.05B (G): i) is an exceptional remedy that would only actually be used in extreme cases”. The procedure, then, is followed by an emphasis that any proposed disposition from operator has to be confirmed by an authorized court and then it can be sold by an operator. Unlike the 1990 version, the operator is also allowed to possess oil or natural gas at the wellhead, rather than sending a notification to a third party, like as AAPL, who has bought exploited oil or gas from defaulting party. However, the effectiveness of this mechanism can be reduced where a defaulter may seek interim relief from the courts against imposition of this remedy.¹²⁶ So, the operator should pay enough attention on way it is going to use the remedy.¹²⁷

Under a typical international operating agreement, many detailed provisions are designed to secure non-defaulting parties’ rights against a defaulting party. These provisions expressly entitle aggrieved parties to perform specific fulfillment (like seeking compensation, or possessing defaulting parties’ participating interests). In contrast, domestic operating agreements lack in such facets and mostly are only limited to general issues among JOA’s parties. Based upon these reason, it can be concluded that the 1990 JOA has been designed with particular emphasis on those standards and customs of the Canadian industry. This is a feature that makes it far away from an international JOA model. Correspondingly, the JOA as a domestic operating agreement has just reflected need of a specific group of players in Western Canada, where it is most commonly used. As a result, the JOA is not able to be an international, performable JOA outside of Canadian borders.

The 2007 version is much better than 1990. It avoids pure forfeiture and rather takes an approach mixed between lien and withering option. It also has provided sharper focus on

¹²⁶ Spurn, (2008-2009) ,p. 455

¹²⁷ CAPL OP (2007) Para 5.05B(G)

securities than 1990 and has succeeded to establish a fair system of securities; however, this does not necessarily mean that the mentioned securities can deter occurrence of default at the decommissioning. Besides that, the form unusual reliance on the old mechanism, like lien, is unaccountable while the form is almost new.

In respect to the operator, the JOA demonstrates a new perspective. It gives complete authority to the operator. The operative even does not have to show its financial strength to the non-operators. Overall, the 2007 can be summarized the most different JOA among all its similar models.

4.7 Conclusion

The JOAs are progressed to provide circumstance for oil companies to share their resources, risks and benefits. They have similar purposes and similar approaches in treatment to different issues. They often, therefore, contain similar procedure in dealing with the default. They give a grace period to the defaulter and then apply unrelenting pressure on that party to recover its default as soon as possible. This pressure begins by suspending its crucial rights and persists to the harshest remedy that is forfeiture. In the meantime, non- defaulter parties, who have contributed the amount in default, will have right to execute some remedies and claims for their debt. More than one of these features may be existed in any Joint Operating Agreement.

On the other hand, the details of treatment to the default vary with respect to the JOAs' backgrounds, parties, etc. For instance time passage and persistence of default have different consequences in different JOAs or Norwegian JOA is a dictated form while AIPN is based on negotiations of parties. But the main commonality that might be seen among JOAs is their inability to provide a robust deterrence against the intentional default. This is why the JOAs forms cannot be a stopgap for non-defaulters.

5 Conclusion and recommendations

5.1 Recommendations

In regards to the default issue, establishing a trust fund is nearly the best solution that the industry has come up with to now; however, as we have seen, the mechanism still has problems in the decommissioning phase. The most important of these problems is that the mechanism still cannot really threaten a prospective defaulter who willfully wants to default. But what the paper recommends is converting the attitude of threatening a defaulter to encouraging that defaulter to stay in consortium. In other words, we can use current approaches - not a threat - to encourage them by giving more benefits to stay in the consortium. For example: there can be a clause, in respect to the trust fund, which allows the trustee of the fund to invest the amount in the fund to a separate investment and keep the return revenue until last day of decommissioning. Parties can take their share of revenue in proportion to their participation interest, if they have paid their decommissioning share of interest.

Therefore, there is no need to invent some new ways. Improving the current approaches and turning them to more effective remedies might be the best solution.

5.2 Conclusion

The purpose of all oil and gas projects is to find, extract, refine and to sell petroleum. In this way, they require continued injections of funds and long lead times to extract oil and/or gas in pretty difficult environmental conditions with indefinite outcomes. Any interruption, therefore, in that financial process may lead a longer lead time for projects and a real failure. The industry, therefore, is significantly exposed to economic factors.

One of the costly processes of extracting hydrocarbons, which is highly dependent on the injection of funds, is the decommissioning process. This process raises complex financial issues for most petroleum companies, even the giant ones, who usually face a major

challenge in providing enough funds for the decommissioning. Financial issues also concern governments of the host states since, as they become closer to the end of a field, the decommission process and, pursuantly, its financial problems become a more vital issue. For this reason, the companies make their exploration, production and decommissioning mostly in joint venture agreements to mitigate the risk of projects and share the substantial capital expense. However, it is highly likely that a co-venturer of a JOA will fail to pay their share of the expenditure, whether intentionally or unintentionally. Therefore, most JOAs provide a standard default provision to deter any failure of payment and to assure that non-defaulter parties are not forced to bear any additional liability for decommissioning. So the purpose of a default provision is to act as a constant threat to deter the default and hinder parties who do not have the intention to meet their commitments.

A threat, however, must be adequately large to be effective, but some serious gaps impede the default from being large enough and, subsequently, effective enough. These gaps may tempt a party to a JOA to exploit them to get less liability and a lesser share of expenses than other members of a joint venture.

The most common form of a default provision brought within JOAs is a forfeiture mechanism (and its varied versions) whereby a defaulter, in the case of unremedied defaults, will lose its participation interest - but it is by no means free of problems. For instance, executing defaults in some jurisdiction will be held unenforceable, or the lack of a power of attorney may impede non-defaulters from recovering the amount in default but, more importantly, the most serious weaknesses of the forfeiture will appear when the value of the forfeited asset is such that the asset is valueless. Under this circumstance, acquisition of the asset only adds more liability for non-defaulters.

A default provision is only one method through which states and companies deal with defaults. Security for future expenditure and ongoing liabilities is the second most common approach offered by JOAs. Providing such securities, which are mostly based on

financial strength of their provider, theoretically can stop most of the intentional and non-intentional defaults, but even this solution has its own pitfalls, particularly for small oil companies with financial strength that is limited. The efficiency of the securities also, like with forfeiture, decrease when they come to the decommissioning stage since a prospective defaulter, because of the aforementioned reasons, might easily avoid providing security or renewing it.

As we noted under the discussion of different JOAs, most of the solutions mentioned in the paper have advantages and disadvantages which may vary in accordance with the particular stage of the project, or the host state's regulation. For instance, liens seldom occur because of their problems in many developing countries or parent guarantee may not be possible in UK. Thus, performing contractual remedies, whether provision or securities, against a defaulter in an international setting default is more difficult than the same situation in a national scope. But the clear fact is that none of the JOAs analyzed in this paper offer perfect financial security or forfeiture provision from the beginning to the end of a project.

As long as these problems are still in petroleum sectors, and default provisions are not strong enough, we will see companies that will threaten the existence of consortiums, and if the parties do not prepare a well-built, well-written anti-default solution in their JOA, then no mechanism will be available to resolve the problem of effectiveness. So, the risky petroleum investments require more practical ways to guarantee an investment with the lowest numbers of default. Nevertheless, as this research argued the current default provisions, which are designed to stop defaults, this may not have been a real threat to the prospective defaulters who willfully want to default and lose their liability, specifically during the decommissioning when the trend for a party to default is at its highest point and the loss of participation interest is at its most meaningless point.

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