



## JOINT OPERATING AGREEMENTS IN OIL AND GAS INDUSTRY: THE CONSEQUENCE OF SOLE RISK AND NON CONSENT CLAUSES TO JOINT OPERATION



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### ABSTRACT

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The paper examines the Joint Operating Agreement (JOA) with a view to ascertaining the purposes of sole risk and non-consent clauses in JOA and their incompatibility or otherwise with the joint objectives of the agreement. The nature of Oil and Gas Industry is such that involved very huge costs and project risks are enormous, especially where the project requires new infrastructure for successful undertaking. Even the few Oil companies that are capable of conducting such projects are usually not willing to take the huge risks alone. For such reasons therefore, Oil Companies in other to mitigate its various levels of costs and risks make joint applications for licence acreage. The purpose of this application is to enable two or more companies to share costs, risks and benefits in agreed proportions in the licence acreage regime they obtained together. The method commonly used by Oil Companies in achieving these joint objectives is through JOA. The paper adopts doctrinal methodology where relevant primary and secondary data were utilised. The paper observed that parties to JOA used sole risk and non-consent clauses in order allow dissenting parties an opportunity to benefit from their omission without terminating the main agreement of the parties. The paper recommends that parties shall from the onset recognise the consequences of JOA and couched the sole risk and non-consent clauses in a flexible manner that will not jeopardise the objectives of JOA. That is to say, the clauses should not be used in a manner that will defeat the major aim of the parties' relationship.

### 1. INTRODUCTION

The nature of petroleum Industry is such that involved very huge costs and project risks are enormous, especially where the project requires new infrastructure for successful undertaking. Even the few Oil companies that are capable of conducting such projects are usually not willing to take the huge risks alone. (Sayer, 1999) For such reasons therefore, Oil Companies in other to mitigate its various levels of costs and risks make joint applications for licence acreage. The purpose of this application is to enable two or more companies to share costs, risks and benefits in agreed proportions in the licence acreage regime they obtained together.

The method commonly used by Oil Companies in achieving these joint objectives is through Joint Operating Agreements (JOA) (Shaw, 1996). It is unincorporated joint venture between the companies which governed their relationship towards joint ends, (Styles, 2007) and it takes effect when joint application became successful by government award of licence.

However, JOA intended to cover all joint activities covered in the licence up to termination or surrender of the licence. JOA enable joint exploration, appraisal and development of acreage and the satisfaction of licence obligations as contained in the licence terms (Shaw, 1996). The JOAs generally stated the percentage interests of all parties as relate to costs, risks and benefits as agreed by parties.

For smooth running of day to day activities of joint operations one of the parties will be appointed as operator on behalf of others. Usually, a party with largest percentage interest will be the operator. Operator's activities are subject to supervision and controlled of established committee know as Joint Operating Committee (JOC) in which all the parties has a representation. The JOC reserved the power for approval of projects proposed by the operator. The JOC exercise its role through casting of votes by all the parties' representatives in accordance with pass mark procedure. Pass mark is the percentage interest share of votes which a proposal by operator must be obtained before the JOC may make a binding decision (Styles, 2007). However, parties voting interest is proportionate to percentage interest hold in the JOA.

The importance of pass mark in determining the decision of JOC makes it the most crucial factor in negotiating JOA, as it stated the necessary percentage interest of votes require for a decision (Shaw, 1996). Parties with smaller percentage interest in the JOA will make sure that the pass mark provision is high to enable them control the decision of JOC in the management of JOA. On the other hand, if the pass mark provision is low, parties with larger percentage interest will have the opportunity to control the decision of JOC. In practice, most JOAs set 70% as the pass mark (Styles, 2007).

Pass mark cannot accommodate the interest of all parties to JOA, two ways by which parties further protect their interests when failed through pass mark is by Sole Risk and Non Consent Clauses provided for under the JOA.

Therefore, it is the intent of this paper to examine the purposes of these clauses in JOAs and their incompatibility or otherwise with the joint objectives of JOA. For purposes served by each clause, this paper will discuss them separately. The final part however, draws conclusions in respect of points discussed by the body of the paper. The next sub heading discusses common features of JOA.

## **2. COMMON FEATURES OF JOA**

When parties decided to enter into JOA, different issues needs to be considered for the smooth running of successful JOA. Therefore, a well-designed JOA must address those needs in order to be beneficial to all the parties concerned. Those issues that need to be specifically address include: parties, the operator, the extent of the acreage to be covered by the agreement (scope), the profit sharing arrangement, contribution as to the cost of the project; pass mark clause, non-consent and sole risk provisions, default clause, fiduciary duties and JOC. In this regard, failure to properly address these issues can lead the parties to an unnecessary litigations and re-negotiations.

JOAs are usually established on a standardized form first developed by a model form in 1956 by American Association of Petroleum Landmen (AAPL). The AAPL model form was created to serve as a basic guide in drafting agreements between the parties concerned subject to such modifications that suits parties.

In Nigeria, the National Oil Company which is Nigeria National Petroleum Corporation (NNPC) partner with multinational companies for JOAs. The JOA is the basic, standard agreement between

the NNPC and operators. It sets the guidelines/modalities for running the operations. It is different from the Memorandum of Understanding (MOU). While it contains the basic understanding on the joint Venture, the MOU is a response to the specifics of fiscal incentives.

NNPC opined that: One of the partners is designated the operator. The NNPC reserves the right to become an operator. All parties are to share in the cost of operations. Each partner can lift and separately dispose its interest share of production subject to the payment of Petroleum Profit Tax (PPT) and Royalty. The operator is the one to prepare proposals for programme of work and budget of expenditure joint on an annual basis, which shall be shared on shareholding basis.

Each party can opt for and carry on sole risk operations. Technical matters are discussed and policy decisions are taken at operating committees where partners are represented on the basis of equity holding.<sup>1</sup>

Most developing countries like Nigeria insist on insertion of national economic interest clause which provides for the transfer of technology by the participating multinational companies. The highlights of JOAs in Nigeria include: the participation agreement which sets out the level of participation of each party in running the affairs of the company; the agreement determines the interests and obligations of parties and the agreement ownership of production facilities and assets. For instance, of the six JOAs between NNPC and multinational companies in Nigeria the parties clearly stated the interests of the participation parties as follow:

#### *2.1. Shell petroleum development company of Nigeria limited (SPDC)*

The Joint venture operated by SPDC accounts for more than forty percent of Nigeria's total oil production (899,000 barrels per day (bpd) in 1997) from more than eighty oil fields. The JOA is composed of NNPC (55 percent), Elf (10) and Agip (5 percent) and operates largely onshore on dry land or in the mangrove swamp.<sup>2</sup>

#### *2.2. Chevron Nigeria limited (CNL)*

The Joint venture between NNPC (60 percent) and CNL (40) was considered in the past to be the second largest producer of oil (approximately 400,000 bpd), with the area of fields located in the Warri region west of the Niger river and offshore in shallow water. It is reported to aim at increase production to 600,000 bpd.<sup>3</sup>

#### *2.3. Mobil producing Nigeria unlimited (MPNU)*

The Joint venture between NNPC (60 percent) and MPNU (40 percent) operates in shallow off Akwa Ibom state in the South-eastern delta and averaged production of 63,000 bpd in 1997, making it the second largest producer, as against 543,000 bpd in 1996.

#### *2.4. Nigerian agip oil company limited (NAOC)*

A joint venture operated by NAOC and owned by NNPC (60 percent), Agip (20 percent) and Phillips Petroleum (20 percent) produces 150,000 bpd mostly from small onshore fields.

#### *2.5. Elf petroleum Nigeria limited (EPNL)*

A joint venture between NNPC (60 percent) and EPNL (40 percent) produced approximately 125,000 bpd during 1997, both on and offshore. Elf and Mobil are in dispute over operational control of an offshore field with a production capacity of 90,000 bpd.

#### *2.6. Texaco overseas petroleum company of Nigeria unlimited (TOPCON)*

A joint venture operated by TOPCON and owned by NNPC (60 percent), Texaco (20 percent) and Chevron (20 percent) currently produces about 60,000 bpd from five offshore fields.

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<sup>1</sup> <http://www.nnpc.gov.ng>> accessed on 20/08/2015.

<sup>2</sup> Ibid.

<sup>3</sup> Ibid.

### 3. JOAs DISTINGUISHED FROM JVC

It is important at this juncture to state that there is difference between JOAs and Joint Venture Contract (JVC). JOA is a form of joint venture agreement or rather the concept evolved from JVC as it is commonly called, therefore it is only natural to define what a joint venture is. There is no legal or acceptable definition of the term “Joint Venture” but rather it is the coming together of two or more organisations or companies to form a business venture with a view of achieving certain aims and objectives which could be profit as in the case of a partnership agreement or production of oil as in the case of a joint operating agreement. The joint venture could either be an “incorporated joint venture”, “corporate partnership” or “contractual joint venture”. The contractual joint ventures are sometimes referred to as “unincorporated joint venture”, JOA’s most commonly fall under the contractual joint venture (Sayer, 1999). The other forms of joint venture listed above are important but for the purposes of this discussion the main focus is going to be on the contractual joint venture which the JOA is under.

According to Peters and Kumar JOA for all intent and purposes is different from JVC and they conclude in the following words:

Joint venture embodies an agreement between the parties for an enterprise created for single a project, involving a sharing of project risk. Together with the participation in the management and control of the venture, the co-venturers’ contribution creates a common interest in the success of the project. The JOA is widely used as a legal structure for natural resource exploration and development. There is co-ownership of property of the venture and input in its management. The fact that the venture is limited to a defined geographic area as it sets the boundaries of relationship between the co-venturers’. The JOA’s main difference from the joint venture is the possibility of sub-ventures being formed through the sole risk and non-consent operations. JOA’s are the contractual nexus balancing exploration and production expectation interests against conflict a particular regulatory regime. JOA is a flexible document that can be moulded to meet expectations and desires of parties. It encourages exploration and development, while neither forcing a party to participate in expensive risk venture non-prohibiting a party from prospering and conducting ventures when the requisite operating committee pass mark vote is not attained. JOA offers the oil and gas industry a flexible, well written document to govern international oil and gas operations (Peters and Kumar, 2012).

### 4. SOLE RISK CLAUSES IN JOA

The concept of Sole risk in JOA came into operation when project proposal failed to obtained pass mark in JOC. Parties that voted in favour of the failed project proposal can undertake the project on sole risk basis rather than joint operation and not withstanding its rejection by the JOC. The participating parties however, will share the costs, risks and benefits borne out of the project and will indemnify non participating parties from third parties claim in respect of the said project (Taylor and Wilsor, 1992).

The purpose of sole risk clause therefore, is to permit minority party or parties who was or were in support of project proposal which was rejected by JOC, to conduct the project without participation of majority and do so on his or their own risk. The majority will take no part in such project as relate to costs and risks and also take no share in the benefits of the project. But most JOAs make provision as to measures which non participating majority can join the project operation later, usually on a high premium (Styles, 2007). The clause is therefore aimed at protecting the economic interest of minority party or parties to JOAs by given them opportunity to conduct project in which they have an economic interest but was rejected by JOC.

Sole risk project is quite distinct from the joint operation projects of the whole JOA as such the participating parties to the project will make necessary arrangement on the conduct of the project so as not to jeopardise the conduct of joint operation. Operator is the most likely party to conduct

sole risk project due to the nature of his percentage interest. While the sole risk project is in progress the JOA will normally provide that the JOC composed of participating parties in the sole risk project should manage the project where operator is not a participating party (Styles, 2007).

JOA however, set out projects that can be conducted on sole risk basis which include: seismic, drilling, appraisal drilling, testing and development (Mandler, 2008). The clauses are not applicable to works which are obligatory under the licence regime as all parties to the JOA agreed to pay its share for the obligatory works to keep the licence in operation (Christopher, 1993).

Sole Risk clauses are more common in United Kingdom JOAs than in American JOAs where operator has more control of the operation of JOA.

#### *4.1. JOAs Functions and sole risk clauses*

The rationale behind JOA is to jointly share costs, risks and benefits in accordance with the percentage interest of all parties to the JOA during the life of the licence obtained from the Government. Nevertheless, sole risk clauses allowed minority parties to conduct a project despite its rejection by the majority. The action of minority parties participating in sole risk project created a sub-venture within Joint Venture (Bean, 1995) which obviously works contrary to the aims and functions of Joint Venture. Conducting projects by minority on their own risk without contribution from the majority redefines the scope of the JOA with the minority parties relate in sub-venture and with the co-venturers in the JOA as whole.

The division however, would affect the smooth conduct of JOA as the sub-venture project participated by the minority may have an impact on the whole JOA as to issue of joint property, the taxation regime of the sole risk project and its results which will flow the sub-venture and JOA parties as whole (Wilson, 1986). The sub-venture created by sole risk project will effect changes in rights and obligations of all parties to the JOA (Bean, 1995).

Some commentators maintained that the freedom accorded to minority parties to conduct project on their own risk will give them opportunity to drill and exploited licence, which is better than not drilling at all, especially where the duration of licence is short (Monerey, 1986). And that the presence of such clauses reveals the inherent flexibility of unincorporated joint venture arrangement to allow the wish of one party or parties in the JOA to undertake a project not approved by JOC (Christopher, 1993).

Sole risk clauses 'has much potentials to disrupt ordinary joint venture' (Saville, 1986) as it created a lot of technicalities and hardships on JOAs as relate to taxation regime, premium related issue, indemnity, use of joint property and the conduct of JOA hand in hand with sub-venture of sole risk parties. For instance, in indemnity cases, possible claims against non-participating parties are enormous, especially in relation to tort committed, contract concluded by operator outside his authority or for breach of licence terms or statute (Christopher, 1993). And in a situation where a party is in default in sole risk project only, the JOA must specify the consequences of such default and its impact on the sole risk parties' interest in the JOA. (Christopher, 1993). The above hardships and technicalities created by sole risk clauses are against 'the ultimate end of a joint venture which is to promote the several interests of each party, the means which require common endeavor, the pooling of resources, co-operation and mutual dependence.' (Finn, 1998).

## **5. NON CONSENT CLAUSES IN JOA**

JOA makes provision for non-participation of a minority party or parties in a project which they voted against but approved by JOC as joint project. This is usually a protection to minority parties who were not willing to participate in a particular project. The difference between non consent clauses and sole risk clauses depend largely on the amount of support a project proposal received at the JOC (Shaw, 1996). In both instances, there exists a non-participation of some parties. In non-consent clauses, the majority consented to conduct the project and will share the costs, risks and

benefits (if any) in the project. The non-participating parties were exonerated from any contribution or risks. Non consent clauses are not usually provided for except in development of a discovery which involved high costs (Taylor and Wilsor, 1992). Non consent clauses are less common in United Kingdom and Australian JOAs as it is more popular in American JOAs. The rationale for non-inclusion was to encourage participation of all parties to joint approved works (Christopher, 1993).

#### *5.1. JOA Functions and non-consent clauses*

Main duty of parties to JOAs is to pay their contribution once operator gives them notice. Failure to pay within the time specified amount to default which has negative impact on the defaulter and the rest members. However, non-consent clauses relieved a party from being a defaulter despite non contribution and placed a greater burden on the rest of the participating members who will bear the costs, risks and benefits (if any) of the project in accordance with their percentage interest (Styles, 2007). There is provision for penalty in case of late participation by non-consenting parties which is usually high.

The non-consent clauses directly work against aims and functions of JOA which is joint sharing of all costs, risks and benefits during the life of a licence (Roberts, 2008). The clauses create a way for minority parties to invest their capital in another project they considered more important and more beneficial and opt for non-consent right. Non consent clauses in JOA will not be applied to licence obligations, which parties accepted from the onset (Shaw, 1996).

The non-participation of minority parties to approved joint project placed greater burden on participation parties which works contrary to the underlying philosophy of JOA for common participation of parties throughout the life of the licence. This has impact on the accounting book, profit sharing, penalty related issue and other activities of JOA.

## **6. CONCLUSION AND RECOMMENDATIONS**

JOAs established a special relationship between two or more oil companies for the purpose of sharing risks, liabilities and benefit in a licence regime. The participating parties recognised the enormous risks involved in oil and gas industry and want to mitigate such risks through joint venture. The parties will contribute towards licence activities based on percentage interests and will share the liabilities and benefits on such percentage interests.

JOC controlled the activities of the operator who is in charge of day to day activities of the JOA. JOC's control is through voting by all the representatives of participating parties. However, JOA allows a party or parties to undertake a project on sole risk basis which JOC rejected through sole risk clauses. It also allows a party or parties to choose not to participate on a project approved by JOC through non consent clauses. Both clauses allow non participation of some members to a certain project. But these clauses created a lot of complexities on the smooth conduct of JOA and work against the underlying philosophy of JOA which is joint sharing of risks, liabilities and benefits from the beginning to the end.

In view of the above, this paper recommends that parties shall from the onset recognised the consequences of JOA and couched the sole risk and non-consent clauses in a flexible manner that will not jeopardise the objectives of JOA. That is to say, the clauses should not be used in a manner that will defeat the major aim of the parties' relationship.

It further recommends that both clauses should be retain in JOAs as they are important factors that always encourage parties to consent to JOAs from the onset, having in mind that certain options and rights are present when it comes to decisions reached by JOC.

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