Changing the Rules of the Game: Issues that arise under the 2002 AIPN JOA when a host government mandates a "replacement contract"

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Introduction

Certain countries are changing the rules in the oil and gas sector. Some recent examples in the Western Hemisphere include Venezuela, Ecuador, and Bolivia, which have offered companies “replacement contracts.” To account for these changes, oil and gas companies operating in these countries are faced with two options: accept a “replacement contract” or lose their interests.*

Renegotiation to allow for a “replacement contract” has been accepted as a pragmatic reaction to such a Hobson’s choice. International oil and gas operations are typically conducted under joint operating agreements (“JOAs”), and each participating company may have a different view as to whether to accept a “replacement contract” and, if so, under what terms? Some companies may decide to fight to protect their contract and legal rights through arbitration and litigation, while others are interested in finding the best negotiated solution. As there may be varying views among the parties to the JOA as to how best to proceed, conflicts and competing interesting are likely to result.

This article provides an overview of the issues parties to a JOA will likely confront when a host government mandates replacement of the host government oil and gas contract. Our analysis will focus on the most current form of JOA used in the international oil and gas industry – the 2002 AIPN Model Form International Operating Agreement (the “2002 AIPN JOA”).† The relevant sections of the AIPN 2002 JOA are explored and questions are presented on the potential issues that could surface when the underlying host government oil and gas contract becomes the target of replacement. In light of today’s era of resource nationalism that has taken root in certain countries, oil and gas companies need to be cognizant of these issues. Careful consideration should be given to these issues when drafting JOAs or when analyzing existing JOAs that are impacted by a host government’s insistence on replacement of existing contracts. Neither the 2002 AIPN JOA nor any other related model form explicitly anticipates and provides language addressing the “replacement contract” issue discussed in this article.

* As a consequence of a total loss, subject to a claim of expropriation, or a forced sale on terms that do not fully value the oil and gas interest.
† Capitalized terms not defined in this article or those used in the 2002 AIPN JOA.
Definition of “Contract”

The preamble of the 2002 AIPN JOA explains its purpose is to govern the respective rights and obligations of the participating companies’ operations under the “Contract.” Article 1.14 defines “Contract” and provides,

Contract means the instrument identified in the recitals to this Agreement and any extension, renewal or amendment thereto.

In light of a replacement host government contract, this definition of “Contract” is problematic. Is a “replacement contract” an “extension, renewal or amendment” of the original contract? The 2002 AIPN JOA does not define the terms “extension, renewal or amendment.”

Definition of Joint Operations

Article 1.39 defines “Joint Operations” as:

those operations and activities carried out by Operator pursuant to this Agreement, the costs of which are chargeable to all Parties.

As explained later in this article, Joint Operations relate to the operations conducted under the Contract, including “joint exploration, appraisal, development, production and disposition of Hydrocarbons from the Contract Area.” Do Joint Operations apply to operations under a “replacement contract”? Any change to the definition of “Contract” will necessarily impact the definition of “Joint Operations.”

Effective Date and Term

Article 2 defines the term of the Contract as follows:

This Agreement shall have effect from the Effective Date (as defined in the preamble to this Agreement) and shall continue in effect until the following occur in accordance with the terms of this Agreement: the Contract terminates; all materials, equipment and personal property used in connection with Joint Operations or Exclusive Operations have been disposed of or removed; and final settlement (including settlement in relation to any financial audit carried out pursuant to the Accounting Procedure) has been made.

Thus, the 2002 AIPN JOA continues in effect until the “Contract terminates.” Although the 2002 AIPN JOA provides certain events that trigger termination, the model form is silent on the exact meaning of termination. Does a “replacement contract” equate to termination of the original contract?
Scope of the JOA

Article 3 of the 2002 AIPN JOA provides that the scope of the agreement is “to establish the respective rights and obligations of the Parties with regard to operations under the Contract, including the joint exploration, appraisal, development, production and disposition of Hydrocarbons from the Contract Area.” This language is similar to language found in the preamble, which provides that “the Parties desire to define their respective rights and obligations with respect to their operations under the Contract.” Is negotiating and entering into a replacement contract “with regard to operations under the Contract . . . from the Contract Area”? Alternatively, do such activities “arise under or relate to” the Contract so as to allow the JOA to govern the Parties’ rights and obligations when dealing with a “replacement contract”?

Rights and Duties of Operator

Under Article 4.2 of the 2002 AIPN JOA, the Operator has “all of the rights, functions, and duties of Operator under the Contract and shall have exclusive charge of and shall conduct all Joint Operations.” In addition, the Operator is to “perform Joint Operations in accordance with the provisions of the Contract . . . .” In essence, the Operator is in charge of “Joint Operations,” which is defined as “those operations and activities carried out by Operator pursuant to this Agreement, the costs of which are chargeable to all Parties.” Is the negotiation and execution of a “replacement contract” an operation or activity carried out under the JOA? And does the Operator have the right to negotiate and execute a “replacement contract”?

Limitation on the Operator’s Liability

One of the most important aspects of the 2002 AIPN JOA is the protection given to the Operator in performing (or failing to perform) its duties and functions as Operator. Under Article 4.6, the Operator’s exposure is limited:

[Except as set out in Article 4.6(C)], neither Operator nor any other Indemnitee (as defined below) shall bear (except as a Party to the extent of its Participating Interest share) any damage, loss, cost, expense or liability resulting from performing (or failing to perform) the duties and functions of Operator, and the Indemnitees are hereby released from liability to Non-Operators for any and all damages, losses, costs, expenses and liabilities arising out of, incident to or resulting from such performance or failure to perform, even though caused in whole or in part by a pre-existing defect, or the negligence (whether sole, joint or concurrent), gross negligence, willful misconduct, strict liability or other legal fault of Operator (or any such Indemnitee).

Thus, the Operator has liability only in cases of Gross Negligence.

Article 1.36 defines “Gross Negligence” as:
any act or failure to act (whether sole, joint or concurrent) by any person or entity which was intended to cause, or which was in reckless disregard of or wanton indifference to, harmful consequences such person or entity knew, or should have known, such act or failure would have on the safety or property of another person or entity.

Does “gross negligence” include the Operator’s acceptance or refusal of a “replacement contract”? Is the Operator’s acceptance or refusal of a “replacement contract” an act that is intended to cause harmful consequences of the non-operators?

In addition, an optional provision under Article 4.6 exempts the Operator from “Consequential Losses”:

Notwithstanding the foregoing, under no circumstances shall Operator (except as a Party to the extent of its Participating Interest) or any other Indemnitee bear any Consequential Loss or Environmental Loss.

Article 1.13 defines “Consequential Losses” as:

any loss, damages, costs, expenses or liabilities caused (directly or indirectly) by any of the following arising out of, relating to, or connected with this Agreement or the operations carried out under this Agreement: (i) reservoir or formation damage; (ii) inability to produce, use or dispose of Hydrocarbons; (iii) loss or deferment of income; (iv) punitive damages; or (v) other indirect damages or losses whether or not similar to the foregoing.

Thus, under these provisions, the Operator is not liable for any loss or damage resulting from such things as the inability to produce, use or dispose of Hydrocarbons and loss or deferment of income. Does accepting or refusing a “replacement contract” constitute an inability to produce or loss of income such that the Operator is exempt from liability?

**Removal of the Operator**

Article 4.10 of the 2002 AIPN JOA allows the Non-Operators to remove the Operator if it commits a material breach of the JOA:

Subject to Article 4.11, Operator may be removed by the decision of the Non-Operators if Operator has committed a material breach of this Agreement and has either failed to commence to cure that breach within thirty (30) Days of receipt of a notice from Non-Operators detailing the alleged breach or failed to diligently pursue the cure to completion.
Is the Operator obligated to negotiate or accept a “replacement contract”? If so, does the Operator’s failure to accept or refusal of a “replacement contract” constitute a “material breach” and justify removal of the Operator?

**Voting Procedures**

Article 5.9 of the 2002 AIPN JOA sets forth two voting alternatives:

**ALTERNATIVE NO. 1**
Except as otherwise expressly provided in this Agreement, all decisions, approvals and other actions of the Operating Committee on all proposals coming before it shall be decided by the affirmative vote of _______________ (_____%) or more Parties which are not Affiliates then having collectively at least __________ percent (___%) of the Participating Interests.

**ALTERNATIVE NO. 2  (From Paragraph (A) to (C))**
Except as otherwise expressly provided in this Agreement, decisions, approvals and other actions of the Operating Committee on all proposals coming before it shall be decided as follows.

* * *

(16) All other matters within the Operating Committee’s authority.

Under Alternative No. 1, all decisions of the Operating Committee are to be decided by the affirmative vote of a certain percentage of Participating Interests. This is commonly called the “passmark vote.” Is the acceptance or refusal of a “replacement contract” subject to this passmark vote? As discussed later in this article, this provision could be in conflict with the unanimity requirement for modification of the JOA.

Alternative No. 2 provides three different passmark voting options for different issues upon which the Operating Committee could vote. None of the current options in the 2002 AIPN JOA addresses “replacement contacts.” However, item 16 is a catch-all option for “all other matters within the Operating Committee’s authority.” Does a “replacement contract” fall under this option subjecting the acceptance or refusal of a “replacement contract” to the appropriate passmark vote?

**Voluntary Surrender**

Article 11.1 of 2002 AIPN JOA governs the Parties’ ability to surrender the Contract Area:

A surrender of all or any part of the Contract Area which is not required by the Contract shall require the unanimous consent of the Parties.
Thus, unless required by the Contract, any surrender of all or part of the Contract Area requires unanimous consent of all Parties. Is the acceptance of a “replacement contract” a surrender of the existing contract such that unanimity approval is required?

Withdrawal or Abandonment

Article 13.9 of the 2002 AIPN JOA addresses the Parties’ withdrawal from the JOA:

In the event all Parties decide to withdraw, the Parties agree that they shall be bound by the terms and conditions of this Agreement for so long as may be necessary to wind up the affairs of the Parties with the Government, to satisfy any requirements of the Laws / Regulations and to facilitate the sale, disposition or abandonment of property or interests held by the Joint Account, all in accordance with Article 2.

Unanimity of the Parties is required for a sale, disposition or abandonment of property or interests held by the joint account. Is the acceptance of a “replacement contract” a withdrawal that requires such unanimity? What impact does this have on the voting requirements for the Operating Committee discussed above?

Relationship of the Parties

Article 14.1 of the 2002 AIPN JOA describes the Parties’ relationship. Specifically, Article 14.1 provides,

The rights, duties, obligations and liabilities of the Parties under this Agreement shall be individual, not joint or collective. It is not the intention of the Parties to create, nor shall this Agreement be deemed or construed to create, a mining or other partnership, joint venture or association or (except as explicitly provided in this Agreement) a trust. This Agreement shall not be deemed or construed to authorize any Party to act as an agent, servant or employee for any other Party for any purpose whatsoever except as explicitly set forth in this Agreement. In their relations with each other under this Agreement, the Parties shall not be considered fiduciaries except as expressly provided in this Agreement.

Thus, there is no agency or fiduciary relationship among the Parties. Is each party free to determine whether or not to agree on a “replacement contract”? What impact would that have on the voting requirements discussed above?
Conflict of Interest

Article 20.2 addresses conflicts of interest among the Parties. In particular, Article 20.2(C) provides,

Unless otherwise agreed, the Parties and their Affiliates are free to engage or invest (directly or indirectly) in an unlimited number of activities or businesses, any one or more of which may be related to or in competition with the business activities contemplated under this Agreement, without having or incurring any obligation to offer any interest in such business activities to any Party.

As explained above, there is no agency or fiduciary relationship among the Parties. And under Article 20.2(C), each party is free to conduct business that competes with JOA activities. But if the Contract terminates, the JOA also terminates and these protections disappear. Will a “replacement contract” cause a conflict of interest to occur among the Parties?

Modification

Article 20.9 of the 2002 AIPN JOA governs modification of the JOA and the Contract:

Except as is provided in Articles 11.2(B) and 20.8, there shall be no modification of this Agreement or the Contract except by written consent of all Parties.

Under this provision, unanimous written consent of all Parties is required to modify either the JOA or the Contract. Is the acceptance of a “replacement contract” a modification of the Contract such that unanimity is required? And if the Parties are unable to unanimously agree, are the non-consenting Parties relieved of all existing obligations? How does this provision comport with the voting requirements discussed above?

Conclusion

As discussed above, the Parties to JOAs will confront a host of issues should their host government mandate replacement of their existing exploration and exploitation contracts. In addition, going forward, companies using the 2002 AIPN JOA should carefully consider how their JOA should address this situation. One possible recommendation is to revise the language of the JOA to provide that a “replacement contract” is an amendment of the Contract and the JOA continues to apply. The Parties will then need to decide whether the amendment of the Contract requires a unanimous vote or a specified passmark vote that is less than unanimous. Alternatively, the Parties could consider the “replacement contract” to be a new contract that is not covered by the JOA. As explained above, however, the latter option leaves open questions about the obligations between the Operator and Non-Operators where the “replacement contract” is considered a new contract and the current JOA does not govern operations associated with the “replacement contract.” These are but a few suggestions. And one thing is certain – as countries change the rules of the game, the JOA needs to be evolve to address and anticipate the fluidity of the legal and commercial landscape.