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# New International AIPN Oil and Gas Farm-Out Agreement

June 19, 2019

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In June 2019, the oil and gas industry body, the Association of International Petroleum Negotiators (AIPN), published a revised version of its model form international farm-out agreement. The publication of this new model form agreement is a reflection of the increased sophistication, and continuing evolution, of the farm-out market.

Like the predecessor 2004 model form, the new 2019 version of the agreement deals with the transfer of a portion (but not all) of the ownership (known as a "participating interest") in an upstream oil and gas asset from one party to another. The updated version provides for more detailed drafting of key provisions, reflecting recent practice, and also offers a broader set of alternatives to parties negotiating a farm-out transaction. As with all model forms, and as the new guidance notes state, it should be used only as a guide to inform the possible structure of an agreement, and not applied dogmatically. The new model form is most appropriate in the context of an exploration asset, rather than a development or producing asset.

Farm-out agreements do not typically exist in a contractual vacuum. Where there is more than one owner of an asset they will typically regulate their relationship in relation to that asset under a joint operating agreement. Farm-out agreements need to take into account, and interact appropriately with those joint operating agreements (as well as applicable law and any other relevant contracts) to avoid inconsistencies and minimise the prospect of dispute.

**What is a farm-out agreement?**

Farm-out agreements are used in the oil and gas industry across the globe. They borrow their name from historical practices in the agricultural sector, where undertaking work on farmland would entitle a person to a legal or beneficial interest in that land. Farm-out agreements are often governed by English law, New York law or the laws of the jurisdiction in which the assets are located.

A farm-out agreement operates as a type of sale and purchase agreement under which a seller (the "farmor") agrees to transfer part (but not all) of its interest in an upstream asset to the buyer (the "farmee"), in exchange for that buyer agreeing to undertake (or fund) work obligations such as acquiring seismic data or drilling wells in respect of that asset. In the context of the oil and gas industry, the upstream "asset" being transferred is usually an interest in a licence, production sharing contract, or other concession, granted by a government to a company to explore for and produce oil and gas.

### Work obligations and the timing of the transfer of the asset

A key issue in relation to the structure and negotiation of farm-out agreements is the timing of the transfer of legal title to the asset from the farmor to the farmee and the nature of the consideration being provided by the farmee in exchange for that interest in the asset.

In some transactions, the consideration is limited to financial payments (as a lump sum and/or an ongoing commitment to fund some or all of the farmor's share of costs – known as a "carry").

For others, the consideration involves undertaking work obligations. Where work obligations are involved (either to be performed or paid for by the farmee) as part of the consideration, transfer of title to the asset may occur after the completion of the relevant work, such that the interest in the asset has been *earned* by the farmee. More commonly however, the transfer of title happens as soon as possible after any necessary third party consents are obtained, with a potential requirement in work obligation transactions to re-transfer the asset back to the farmor if the farmee fails to satisfy those work obligations. Usually the farmee will only perform the actual work obligations itself if it is, or becomes, the operator of the relevant asset (otherwise such work is usually performed by the operating co-venturer at the farmee's cost).

For transactions based solely on cash consideration, it is common for title transfer to occur upon payment.

### Timing of payments

Issues can arise under any of the potential transaction structures described above. If the farmee starts paying money to the farmor prior to obtaining all necessary third party consents and before completion of the transaction, the farmee may (depending on the circumstances) become entitled to a refund if completion of the transaction fails to ultimately occur. That scenario arose when EnQuest became entitled to a refund of amounts paid by it into an escrow account in connection with its aborted deal with PA Resources to acquire an interest in the Didon oil field in Tunisia. In such a case, a farmee may wish to consider the financial capability of the farmor to repay funds and the need for credit support or security to stand behind that potential refund. However, a farmee should also be aware that entitlements to refunds and any termination rights will depend on the circumstances and the terms of the relevant farm-out agreement. For example, a farmor may argue that the farmee should not be entitled to a refund on a failed transaction if the expenditure that has been carried by the farmee would not have been approved by the farmor in the absence of a signed farm-out agreement with the farmee.

Alternatively, in transactions where the farmor agrees to transfer title to the relevant asset to the farmee when all necessary third party consents are obtained but before all the work obligations have been completed (or paid for), the parties may wish to consider whether a re-transfer and/or damages for breach of contract is sufficient. Either remedy can give rise to complications. Liability for, and the quantification of damages in respect of, a failure to perform or fund work obligations under farm-out agreements can give rise to complex disputes, such as that which arose, but was ultimately settled out of court, between Dana Petroleum and Woodside in relation to drilling exploration wells offshore Kenya. In the case of a re-transfer of the asset, governmental and third party consents may be required, re-transfer terms may need be agreed, and pre-emption or similar rights held by other co-venturers will need to be considered, all of which could frustrate the operation of the proposed remedy.

**Consideration structures**

The new AIPN model farm-out agreement refers to the following two kinds of consideration structures that reflect the common transaction structures described above:

- cash payments for: (i) costs incurred by the seller in relation to the assets; and (ii) a “premium” to reflect the value of the relevant asset; and

- a carry in relation to the performance and funding of the acquisition and processing of seismic data and/or the drilling, logging, testing, completing (or plugging and abandoning) of wells.

Some farm-out agreements include one or both of those arrangements, potentially together with other forms of consideration.

The new AIPN model form agreement includes a reference to capping the carried amount of work obligation costs that the farmee is required to pay, which is a commercial point for negotiation.  If there is no cap, the parties may wish to clearly define what is, and is not, within the scope of the obligation and how decisions which could have cost consequences will be made.  For example, the parties may negotiate whether or not unexpected costs associated with environmental clean-up following a spill are within the scope of an uncapped carry.  The parties may also wish to consider, how third parties, such as drilling contractors, will be engaged and paid.

Any farmee providing a carry will also want to ensure that payments in respect of the carry can be offset (or recovered), at the prevailing rate, against its tax liabilities and this can impact upon the structure and drafting of the payment provisions.

**Trends in consideration structures**

In addition to the consideration structures referred to in the AIPN model form farm-out agreement, oil and gas companies are becoming increasingly commercially creative.  For example, consideration structures can include:

- production “kickers”, being payments (that may be capped) which are contingent on cumulative production over time and/or which may be calculated based on the oil price over time;

- asset swaps, involving the trade of participating interests in assets in both directions, together with any necessary balancing payments;

- the granting of a royalty under which the seller becomes entitle to a share of the buyer's production entitlement (usually net profits) for the life of the field or some other timeframe; and

- deposits and deferred milestone payments.

The parties will also need to negotiate responsibility for any transfer taxes and other transaction costs.

**Other trends in farm-out agreements, including in respect of risk allocation**

The farm-out market varies between jurisdictions and involves a wide range of factors, including oil price movements, regulatory and legal changes, changes in exploration and development costs and the relative bargaining position and commercial imperatives of buyers and sellers.

In our experience, parties to farm-out agreements are focusing their due diligence activities and negotiations (in addition to the consideration structure) on key matters such as:

- political risk and the existence or otherwise of bilateral investment treaties and other forms of investment protections (including in respect of the risk of expropriation and currency controls);

- shareholder expectations, including those in respect of climate change considerations;

- "bankability" and the ability to raise debt finance for development or production assets (which can be of particular interest to small, mid-cap and private equity backed companies);

- decision making rights and the power to influence, impose outcomes on, or exercise veto rights over, counterparties;

- compliance with laws, including anti-bribery and corruption laws, sanctions regimes and anti-trust and competition laws;

- creditworthiness considerations and whether or not credit support or security in respect of obligations must be issued to, or obtained from, third parties; and

- the extent to which risk and responsibility is shared between buyers, seller and other third parties and what exclusions or limitations of liability (if any) will apply.

Model form agreements such as the new AIPN model form international farm-out agreement can provide a very helpful tool and useful starting point to assist parties to negotiate efficiently and effectively.  In our experience, farm-out agreements and other kinds of sale and purchase agreements can become bespoke and highly tailored agreements, carefully drafted to address the particular circumstances of the relevant transaction.