Lowe observes in summarising, that farm-out agreements are very much a function of tax rules, and that otherwise, the agreements will vary widely according to the goals of the parties. For this reason, farm-out agreements need to be flexible, and to this end, Lowe provides many possible alternative provisions.

2.4 Sole Risk and Non-Consent

Articles

Ryan G.L.J. "Sole Risk and Non Consent from Oil and Gas Exploration" [1983] ***Australian Mining and Petroleum Law Association Yearbook*** **272**

Ryan provides a clear and detailed examination of how sole risk and non-consent provisions operate in the context of oil and gas joint venture agreements. The author emphasises the need for very careful consideration to be given to commercial and technical issues in the drafting of such clauses, in particular as to what types of work can be the subject of a sole risk or non-consent programme, and the premiums associated with them. Ryan offers suggestions as to how sole risk issues of indemnity of non-participants, supervision, non-interference, time limits, joint venture and sole risk interests, and sharing of data may be approached. The paper sets out the factors to consider in measuring the success of a sole risk programme; the legal difficulties arising in relation to the interests in the joint venture of the non-participating venturers in the event they elect not to participate in further operations of the sole risk programme; the size and source of funding for any buy back premium; and taxation considerations attaching to any buy back scheme.

On the issue of whether a court would consider a buy back premium to be a legal 'penalty', Ryan submits that a court would not find the premium to be a penalty, as there has been no breach of contract. Similarly, even if the non-participating venturer loses its entire interest in a sole risk programme, the question of penalty would not arise, as the loss of interest is not due to a breach of contract, but is a consequence of electing not to participate.

Pliner R. and Coyle M. "The O'Dea-Allstates Case and the Implications for Exploration and Mining Joint Venturer Agreements" (1983) 2(3) ***Australian Mining and Petroleum Law Association Bulletin*** **37**

Pliner and Coyle examine the findings of the *O'Dea* case, and conclude that the premium paid for a non-participant to buy-back into a sole risk activity would not be considered a 'penalty' as there is no breach of contract involved. The non-participating party had made a voluntary decision not to contribute - the buy-back premium is merely a price to be paid to enable it to re-enter the sole risk activity, not an assessment of damages. Neither would a buy-back clause be considered a forfeiture of interest even where the non-participating party is unable to financially contribute the buy-back premium, as the resulting 'forfeiture' of interest is not a consequence of a failure to perform a covenant as required under the laws of forfeiture.

Cases:
O'Dea v Allstates Leasing System (WA) Pty Ltd (1983) 152 CLR 359

Nicholls R.C. "Some Practical Problems of Joint Venture Agreements - Independent Operations (Including Some Tax Aspects)" (1981) 3 *Australian Mining and Petroleum Law Journal* 41

Nicholls notes that the consequences of non-participation in mineral and petroleum joint ventures can vary according to differences in exploration technique, size, stages of development, timing of exploration and development, and proximity to markets and modes of transport, so that the need for sole risk or non-consent provisions in a joint venture will be a matter of the commercial deal struck between the particular parties. In relation to independent petroleum operations, Nicholls sets out the issues and drafting alternatives for non-participation in seismic and geophysical operations, obligatory drilling operations, and non-obligatory operations, detailing the problems associated with defining "obligatory well," "exploration well" and "development well." A practical discussion of the drafting issues surrounding production, cash and acreage penalty clauses follows, with examples given of various types of production penalties, highlighting the different treatment of the 'recoupment element' and 'multiple element' of the penalty. Nicholls observes the differences found in independent mineral operations, and notes that dilution and mandatory transfer of interest may apply to only part of the mineral concession, and that mandatory transfer may be used as an alternative to, or in conjunction with, a production penalty. He observes that in mineral operations, it is not unusual for a non-consenting party's working interest in the concession to be converted into either (i) an overriding royalty or gross revenue interest; (ii) a carried interest; or (iii) a net profits interest.

The second part of Nicholls paper identifies the tax aspects and treatment of (a) a cash penalty; (b) a production penalty; (c) an acreage penalty; and conversion of the non-participating party's working interest to (d) a carried interest; (e) a net profits interest; and (f) a net profits interest.

Waite J.H. "Sole Risk Mining and Petroleum Joint Ventures: The Australian Position" [1986] *Australian Mining and Petroleum Law Association Yearbook* 185

Waite provides a practical and detailed discussion of the problems and implications with regard to sole risk and non-consent provisions in 'hydrocarbon' joint ventures. The three major types of 'premiums', namely acreage penalty, production penalty, and cash penalty are discussed in detail covering legislative considerations, tax implications, legal consequences of changes in equitable interests in sub-areas, and the economic rationale of the quantum of 'buy-back' and other penalties. He argues that a production in kind penalty is to be preferred, and that where premiums and reimbursement of costs are made from profits of production, the order of priority should be the order in which the wells were drilled, and that the option of non-consent should be available to both obligatory and non-obligatory work equally. The final section of Waite's paper gives practical guidance on criteria to take into account when constructing an independent operations penalty clause, and emphasises the need to consider technical issues such as ownership of petroleum under a production penalty.

Moroney D.F. "Sole Risk in Mining and Petroleum Ventures: An International Perspective" [1986] ***Australian Mining and Petroleum Law Association Yearbook*** **164**

Moroney gives an extensive and detailed discussion of sole risk and non-consent operations in the oil and gas industry from a practical and commercial perspective. He acknowledges the underlying economic rationale (to permit protection of resources and maintain freedom to explore) and psychological reasons (to maintain sense of independence) for sole risk clauses and points out that sole risk clauses can promote harmonious relationships between joint venturer merely by the fact of their existence. He observes the growing tendency to merge sole risk and non-consent clauses, and warns against the use of 'old style' operating agreements that may be structurally mismatched with 'modern' sole risk clauses. Despite this merging, he notes there is still a difference in perception that sees the non-participation (with the majority) in a non-consent operation as being more reprehensible than non-participation (with a minority) in a sole risk operation, explaining the reason for the greater penalty attaching to the former.

Moroney argues that there is no good reason to prohibit sole risk of obligatory work, and despite the difficulties in formulating a reasonable penalty, suggests that sole risk of geophysical surveys should not necessarily be prohibited either. On the other hand, the commercial difference between drilling an exploration well and a development well should be reflected in different penalties and rules contained in the sole risk clause.

The three different forms of penalty (production, cash and acreage) are discussed, and Moroney advises that penalties need to be considered from the point of view of the particular tax regimes (eg. will penalty payment be liable to income tax, or capital gains tax for the sole risk participant) and legal regimes (how will the local regulatory authority treat change of ownership inherent in varying rights to oil among the licensees.) Moroney describes the two types of oil fiscal regimes which exist in the world, namely royalty and tax regimes (where royalty is charged on a joint and several basis, but taxes are levied on an individual basis) and production sharing regimes (in which a 'contractor' (licensee) is responsible for the conduct and cost of all operations net of all taxes, and the host Government (or its national oil company) contracts to share oil produced. As sole risk operations were conceived of under royalty and tax regimes, there can be considerable commercial and accounting problems arise when sole risk operations are carried out under a production sharing regime. Moroney outlines the economic issues, and suggests that by providing in the agreement for 'cost oil' (allowed by percentage to the 'contractor' to cover production costs) and 'profit oil' (balance of oil produced which is shared between the 'contractor' and host Government) to be split in participating shares, some of these problems can be overcome.

Saville K.R. "Comment on Sole Risk in Mining and Petroleum Ventures"[1986] ***Australian Mining and Petroleum Law Association Yearbook*** **224**

Saville characterises sole risk and non-consent clauses as merely a pre-agreed form of 'deadlock' breaker, serving mainly as an inducement for parties to resolve their dispute some other way. He

notes that such clauses vary considerably, and the wide range of possible wordings should reflect the commercial and technical solutions adopted by the parties. Saville argues that penalties for non-consent situations should not be higher than those for a sole risk activity - commercially a high sole risk premium will encourage work in the area by stronger parties as will a high penalty against non-consent. He observes that mineral operations do not usually contain 'full-blown' sole risk and non-consent clauses for historical, practical and psychological reasons.

As to the fixing of premiums and penalties, Saville argues that production in kind penalties are the most commercially appropriate remedy—other penalties are deficient as the value of what is taken away from the non-participating party (eg. loss of acreage, relinquishment, dilution, mandatory sale) bears no real relation to the costs of the operation in which the party has not participated. He asserts that clauses which set out the level of premium impose unnecessary rigidity. Rather the premium should be based on the participating party's success. In order to provide better flexibility in determining a more appropriate and fairer premium, Saville proposes a 'bid' system for sole risk exploration and appraisal wells. He discusses what type of work sole risk and non-consent should apply to, and argues that sole risk of seismic surveys should be permitted, but restricted for development work. Two further situations in which sole risk should be allowed are (i) where the sole risk of a single development will not disrupt the joint venture and (ii) where a party has undertaken exploration or appraisal well sole risk, in which case it should be allowed to proceed with development without the need for majority agreement. With respect to the latter situation, Saville is critical of the sole risk clause in the APEA form that requires a sole risk party to refer the matter back to the operating committee for 'appropriate action.'

Saville disagrees with other authors, in arguing that the priority for payment of profits of production should proceed such that the participants of the most recent (last) well are paid first and the participants in the earliest (first) well paid last, to establish a positive bias towards continuing development of a discovery. His solution to the problem of compulsory participation of non-consenting parties (who after paying premiums and rejoining operations, share only in the costs of abandonment) is to establish an abandonment (rehabilitation) fund into which a proportion of sales is paid throughout production.

Beal A.J. "Comment on Sole Risk in Mining and Petroleum Ventures: An International Perspective" [1986] ***Australian Mining and Petroleum Law Association Yearbook*** **180**

Beal sets out the issues to be considered before participating in a proposed sole risk project, and argues that participants and non-participants need a clear and unambiguous understanding of the scope of the project, in order to assess the geological and commercial risks and determine what its participating interest might be if it joins. He proposes a mechanism in which each party is entitled to nominate a maximum level of participation, which should not exceed its relative participating interest, the balance of which is taken up by the party serving the sole risk notice. The notice itself should: (i) specify the nature of the sole risk project in considerable detail (including location, geological prognoses and objectives of the well, proposed drilling programme and detailed Authority For Expenditure); (ii) define the extent of each type of operation (including the precise point at which the project ends; the extent of drilling; clear definitions of each type of works) and (iii) set out the procedures to be followed if the project is successful. Beal offers suggestions to achieve flexibility and a fair balance of rights between participants and non-participants, and recommends giving the drafted sole risk clauses a 'dry run.'

Penman C. "Sole Risk Operations in Petroleum Joint Ventures" (1993) 12(2) *Australian Mining and Petroleum Law Association Bulletin* 100

Penman's article gives a clear and concise overview of sole risk operations in the context of a petroleum joint venture. The changes in rights and obligations of all joint venture participants pursuant to sole risk activities being undertaken are discussed, including the role of operator, sharing of information, indemnity to non-participants and the effect on joint venture interests. A brief overview is given regarding the structuring of appropriate penalty provisions.

Wilson P.J. "Taxation Aspects of Sole Risk or How to Make the Tax System Work for You" (1986) *Australian Petroleum Exploration Association Journal* 123

Wilson describes the taxation implications of a sole-risk program and the taxation results that may be expected to flow to a sole-risk party and a non-sole-risk party. The taxation implications are considered under the headings of (i) income tax); (ii) resources rent tax; and (iii) resource rent royalty. The paper also considers how the tax system can be used to diminish the incentive for a company to allow a party to undertake a sole-risk operation.

Legislation:
Income Tax Assessment Act 1936 (Cth) Sections 6, 25, 26, 82 and 124

Books

Manning W.F. "Some Practical Aspects of Resources Joint Ventures" in W.D. Duncan (ed), *Joint Venture Law in Australia*, The Federation Press, Sydney 1994, Chapter 10

Manning gives a clear and concise overview of the context of Australian mining and petroleum joint ventures and explains how Australian legal and tax circumstances affect choice of structure, and how the Australian physical environment and the conditions of holding tenements will impact on deadlock breaking procedures. Noting that arbitration or good faith provisions are not likely to be effective in resolving a deadlock, he discusses options open to joint venturers where there is failure to reach agreement.

Manning discusses in plain and practical terms, what sole risk involves and noting that mineral joint ventures do not easily lend themselves to sole risk, he goes on to discuss what types of petroleum operations may be amenable to sole risk and the problems associated with determining the "successfulness" and suitable "rewards" for the sole risk of: (i) seismic surveys; (ii) exploration drilling; (iii) appraisal drilling; (iv) development drilling; and (v) construction and expansions of infrastructure.