Farm-outs

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1. Introduction

A farm-out is a particular type of transaction used to dispose of an interest in oil and gas assets and is a variation on the asset sale transaction. This chapter sets out some of the principal legal matters surrounding farm-out arrangements and their documentation. The first two parts of the chapter explain what a farm-out is, how farm-outs differ from more traditional sales and purchases of oil and gas assets and the particular reasons why a company may choose to farm-out part of its interests in an oil and gas asset. The last part of the chapter examines the issues surrounding the documentation of farm-out arrangements and the key considerations that parties should take into account in agreeing to farm-out terms.

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2. Farm-out agreements defined

Often the term farm-out agreement is used interchangeably with sale and purchase agreement and it can be difficult to distinguish between a true farm-out and other types of disposal of part of an interest in a concession. In practical terms it does not make much of a difference as to what a document is called, so long as the document accurately describes the commercial intention of the parties (including the timing of the transfer of the interest and the consideration for that transfer).

In its conventional sense, a farm-out agreement describes an arrangement whereby one party (the 'farmor') transfers an interest in a concession to another party (the 'farmee') in return for the farmee performing certain work obligations or paying a share of certain costs relating to the concession. The farmor is said to farm-out its interest in the concession, whereas the farmee is said to farm-in to the concession. The term farm-out agreement is used synonymously with farm-in agreement.

A simple form of farm-out can be described as follows:

- The farmor holds a 100% interest in concession A.
- The farmee agrees to perform certain defined work obligations (and/or to pay a defined share of the costs of such work obligations) on behalf of the farmor.
- In return, the farmor will transfer a 50% interest in concession A to the farmee and retain a 50% interest.

Often the term 'promote' is used to express the ratio that the farm-in obligation expenditure bears to the interest being transferred by the farmor to the farmee. A one-to-one promote (also known as a 'ground floor promote') can be illustrated using

the example above, where the farmee pays for all the costs relating to the 50% interest in the concession and in return the farmor transfers the 50% interest to the farmee. In contrast a two-to-one promote is used to describe a situation where the farmee pays for all the costs relating to a 100% interest in the concession, but in return only acquires a 50% interest from the farmor. The promote levels might not be whole numbers and may change depending on the stage of works undertaken.

In broad terms, the key differences between a farm-out structure and a conventional sale and purchase agreement structure are as follows:

- Consideration – in a sale and purchase of an interest, the consideration is generally cash, whereas in a farm-out agreement, the consideration will usually be the performance of obligations and/or the payment of a certain share of costs payable under the concession. However, the farm-out agreement may also require an upfront cash payment (in addition to or instead of such other performance or payment obligations).
- Retained interest – in a sale and purchase agreement, the seller may dispose of its entire interest in the concession, whereas in a farm-out agreement, the farmor will generally only dispose of part of its interest in the concession (with the farmor retaining the remainder of its interest).
- Timing – in a sale and purchase agreement, it is highly unlikely that the seller will transfer the interest in the concession prior to the consideration being paid by the buyer. In a farm-out agreement, the transfer of the interest in the concession may occur upon fulfilment of the farm-out obligation, but will often take place upon the execution/completion of the farm-out agreement (following the satisfaction of any necessary conditions precedent, such as receipt of the necessary governmental and third party approvals).
- Stage of petroleum field development lifecycle – an asset sale and purchase can occur at any point or during any phase of the petroleum field development lifecycle, from exploration through to production. In contrast, farm-outs will tend to occur in the exploration, appraisal or development phase of the lifecycle and not in the production phase.

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3. Reasons for using a farm-out

Many of the reasons behind a party wishing to farm-out some of its interests in a licence or concession are very similar to the reasons why a party may wish to sell part of its interest through any other type of asset disposal (eg, a partial asset sale under an asset sale and purchase agreement). The key objectives of the farmor may include the following:

- Sharing of financial responsibility for work commitments – farming-out part of its interest will enable the farmor to reduce its financial exposure to a project and provide a means of financing any necessary works that are to be carried out. This may be particularly helpful where there are costly minimum work obligations that are required to be fulfilled under the terms of the concession, but which the farmor is not capable of meeting (or is reluctant to meet) on its own. Alternatively, the farmor may be partnered with one or more third parties who, acting through the joint operating committee under

the joint operating agreement (JOA), bind the farmor to carry out a work programme (in the absence of any non-consent rights for the farmor under the JOA) that the farmor is not able to fund. In either case, the farmor may be restricted from obtaining conventional forms of financing, for example debt financing from banks, which are typically unwilling to lend in order to support exploration activities. Depending on the structure of the farm-out, the farmee may agree to perform and pay for the works that are required to fulfil the minimum work obligations, or to fund a certain portion of the costs that the farmor would otherwise be liable to pay in carrying out the approved work programme.

- Reduced exposure to risks – by reducing its equity interest in the concession, the farmor will be less exposed to any risks that may arise in relation to the project (whether such risks are technical, geological, financial, commercial or political).
- Building knowledge and sharing of skills – a farmor may use the farm-out structure as a way of bringing in new partners with new expertise and different skill sets.
- Ability to participate in a greater number of projects and/or focus on core assets – by rationalising its interest in the project that is subject to the farm-out, the farmor may free up time and resources to be able to participate in a greater number of projects and/or focus on strategic assets and projects.

The farm-out structure can be attractive for farmees because it requires relatively low upfront capital investment, with the benefit of upside potential (in particular where the farm-out occurs at the exploration stage of the petroleum lifecycle).

4. Different types of farm-out

Farm-outs can occur at different stages of the petroleum lifecycle.

If a farm-out is undertaken during the exploration phase of an asset, typical obligations that the farmee agrees to undertake will include seismic exploration work and the drilling of exploration wells. Often the farm-out work obligations are linked to the minimum work obligations of the underlying concession (to the extent permitted by the relevant governmental authority). The transfer of the interest in the concession will often be effected once the obligations under the farm-out agreement have been fulfilled by the farmee.

In the appraisal phase, a farm-out agreement will typically specify the drilling of appraisal wells and other appraisal activities. The transfer of the interest in the concession is commonly effected either on the fulfilment of the obligations specified in the farm-out agreement or upon signing/completion of the farm-out agreement (following the receipt of any necessary government and other consents). Given the stage of the project, the farmee is likely to want the transfer of the interest to be completed prior to fulfilment of the work obligations to ensure that it is able to participate fully in any development of a discovery and the decision-making under the JOA with respect to any future development.

In relation to farm-outs that occur during the development phase of an asset, the

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farmee will often agree to assume responsibility for the obligations attaching to the interest being transferred, and to cover the farmor's share of the development costs until a particular point in time (eg, first production). The farm-out agreement may permit the farmee to recover its costs subsequently, through taking the farmor's share of petroleum once production starts.

5. Documentation and key clauses

A number of standard-form farm-out agreements are in circulation. The most commonly used standard form is the model farm-out agreement published by the Association of International Petroleum Negotiators (AIPN) in 2004 (which at the time of writing is in the process of being reviewed and updated). However, while standard forms and model contracts can form a useful base for negotiations between parties, they will not fit every transaction and will necessarily need to be amended and tailored (sometimes quite heavily) to fit the specifics of the particular transaction and the underlying petroleum licensing laws and regulations of the host country.

As mentioned above, there are many similarities between farm-out agreements and sale and purchase agreements, and several of the provisions that are found in sale and purchase agreements will often be found in farm-out agreements as well.

However, the following provisions and issues are of particular relevance to farm-out agreements.

Assignment of interest: The farm-out agreement will set out the interest that is to be transferred to the farmee. It is a core obligation on the farmor to assign and transfer the interest to the farmee, and on the farmee to accept such interest.

Timing of transfer of interest: The farm-out agreement will generally provide for the interest to be transferred from the farmor to the farmee either upon entering into the farm-out agreement or upon satisfaction of the farm-out obligation (with the latter formulation often referred to as an 'earn-in'). Generally, farmees will prefer the transfer of the interest to occur upon execution of the farm-out agreement (following the satisfaction of any necessary conditions precedent such as government or partner consents), as it increases the certainty of them receiving the interest in the concession and will give the farmee greater control over decision-making under the JOA while they are performing the farm-out obligation. There may also be financial or tax reasons why this earlier transfer may be preferable (eg, an upfront transfer may be required in certain jurisdictions to ensure any amounts expended by the farmee as part of the work obligation are cost-recoverable under the relevant concession). Conversely, farmors will tend to favour a later transfer of the interest on completion of the farm-out obligation, for the obvious reason that they prefer not to transfer the interest until the consideration has, in effect, been paid.

Conditions precedent: If the interest is to be transferred upon execution of the farm-out agreement, it may be necessary to include certain conditions precedent to that assignment. For example, in the majority of jurisdictions the consent of the relevant governmental authority will be required in order legally to effect a transfer

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of an interest in a concession. Additionally, if there is an existing JOA in place, the consent of the other JOA parties will usually be required, and it may be necessary to include as a condition precedent the waiver or non-exercise by the other JOA parties of any pre-emption or preferential rights they may have. If there is no existing JOA in place, the parties to the farm-out agreement may wish to include negotiation of a JOA as a condition precedent to the transfer of interest (and possibly append to the farm-out agreement a set of agreed principles upon which those negotiations relating to the JOA will be based). However, for certainty, it may be preferable to agree a form of JOA in parallel with the farm-out agreement, and for the agreed form of the JOA to be appended to the farm-out agreement when it is signed.

If the transaction is structured as an earn-in and the interest is to be transferred upon the fulfilment of the farm-out obligation, it is likely that the conditions set out above will also still need to be fulfilled in order legally to effect the transfer of the interest. Therefore, if this formulation is adopted, care will need to be taken to ensure that nothing prevents the intended operation of the farm-out agreement after completion of the farm-out obligation (eg, through the exercise of any pre-emption rights under a pre-existing JOA or through the refusal of any necessary governmental consent to the transfer of the interest). In a UK context, it is common for farmors to ask the Department for Energy and Climate Change to confirm (on signing the farm-out agreement) that it has no objection in principle to the proposed transfer. While the Department for Energy and Climate Change may consider issuing such a confirmation if it has received sufficient information to enable it to consider the assignment, it will not be able to issue any binding undertaking, and the formal consent procedure will need to be followed by the parties at the applicable time. However, the receipt of confirmation that the department has no objection in principle will often provide both the farmor and the farmee with some comfort that consent will forthcoming upon fulfilment of the relevant farm-out work obligation.

The farm-out agreement will normally include a long-stop date by which the conditions precedent must have been satisfied. If the conditions precedent have not been satisfied by such date, there will normally be a termination right for each of the parties. If the farmee has expended any sums of money prior to the date of termination, the farm-out agreement may need to include provisions to deal with the reimbursement of such amounts to the farmee in the event the farm-out agreement is terminated because the conditions precedent have not been satisfied.

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Ownership interests: The farm-out agreement will set out what the interests in concession will be once the interest has been transferred to the farmee. This will need to be reflected in any new JOA that is entered into, and any existing JOA will need to be amended to reflect the new participating interests.

Consideration: The consideration for the transfer of the interest from the farmor to the farmee may be an upfront cash payment, an agreement by the farmee to pay a certain amount of money towards certain specified costs, an agreement by the farmee to undertake the performance of certain specified work obligations (eg, the acquisition and processing of a certain amount of seismic data or the drilling of a

well), or a combination of these. The AIPN's model farm-out agreement contains two alternative sections for consideration: one dealing with a situation where the consideration is the performance of work obligations and one dealing with a situation where the consideration is a cash sum. However, it recognises that the potential variations on forms of consideration are virtually unlimited. Whatever form the consideration takes, the farm-out agreement will need to describe the consideration in a clear and unambiguous way.

Where the consideration requires the payment by the farmee of certain amounts, this may be structured as a carry of the farmor's payment obligations (possibly up to a set cap, or until a defined point in time, such as first production).

If the consideration includes an obligation to undertake certain works, there will need to be a clear definition as to what the works are, so that the parties minimise the risk of a dispute as to whether or not the works have been fulfilled. The definition of the work obligation will usually require input from technical, legal and commercial specialists of the parties. If the farm-out obligation includes the drilling of a well, the farm-out agreement might specify the location and depth of such well (or mechanisms by which these are to be agreed between the parties and/or the parties to any existing JOA after signing of the farm-out agreement). The farm-out agreement will also usually set out deadlines by which such works have to be fulfilled and may also specify the standard to which the farmee must perform such works. The farm-out agreement may include clauses that provide for the deemed satisfaction of the defined work obligations in certain circumstances; for example, (as in the AIPN model farm-out agreement) if the farmee has expended a certain amount of money in carrying out the works and/or the farmee has encountered insurmountable difficulties when performing the farm-out obligation (provided that the amount spent by the farmee is over a certain amount).

Please note that this is an extract from the full chapter.

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