Chapter one: General provisions

1.1 Industry characteristics and types of contract

From the point of view of a consortium, the Accounting Procedures are presented as an appendix to the Joint Operating Agreement (JOA). This formally indicates a relationship of subordination between the principles, standards, procedures, rights and obligations featured in the Accounting Procedures to the main body of the JOA. The parties to a joint venture are the operator and the non-operators. From a host government point of view, there might be other Accounting Procedures in the host government contract between the government (or its national oil corporation (NOC)) and the investors. The parties to this venture would be the relevant government and the concessionaire or contractors. This latter form will be analysed in the final chapter of the book.

In general, the primary goal of the Accounting Procedures is to detail the steps to be followed by the operator when both allocating the costs relating to joint operations and stating the costs incurred for the non-operators.

The Accounting Procedures are set out in simple language, and they are easy to read. However, a more critical view and a deeper reading enable a better understanding of the rules and procedures featured in the Accounting Procedures, and of the relationship between the rights and duties of the operators and non-operators. The reader must understand the strategic interests of the operators and non-operators, the historical background which serves as the cornerstone of the industry, the typical types of contracts used, the main types of businesses and the principal characteristics of the oil industry. The industry is characterised by its complex operations, where ventures are highly risky and demand large financial resources to be invested. In turn, this leads to the creation of joint ventures. Projects take a long time to mature, with investments being recovered over long time periods.[1]

In this business environment, a number of variables are considered in the strategic development processes of oil and gas companies. These variables include issues relating to geopolitics, technology, political and business risks, the national and international interests of various stakeholders, organisational structure, price volatility, high costs, market positioning and market dynamics,[2] and how these

1 José A Bucheb, "Business partnerships in E&P activities in Brazil" in Rio Oil & Gas Expo and Conference Annals, Rio de Janeiro, 2006; Haroldo Lima, *Oil in Brazil: the situation, the model and the current policy* (Synergia, Rio de Janeiro 2008).

2 Daniel Yergin, *Oil: a story of money, greed and power* (Scritta, São Paulo 1992); Samuel B Katz, "Types of international petroleum contracts: their history and development" in Richard Steinmetz, *The Business of Petroleum Exploration* (American Association of Petroleum Geologists, 1992); José E Thomas, *Petroleum Engineering Fundamentals* (Interciência, Rio de Janeiro 2001).

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issues interact with one another.[3] All this has a direct impact (which is not always clearly and objectively realised) on the way businesses in the oil industry are designed and run. These factors also impact on the contracts developed to manage the relationship between the participating companies in a wider perspective, and also between companies and states as represented by governmental entities. As Daniel Yergin states:[4]

> *The equation – oil equals power – had already been proved on the battlefields of World War I, and from that conflict emerged a new era in relations between oil companies and nation-states.*

The peculiarities of the oil and gas industry force both the oil companies and states to establish contractual relationships to regulate their specific interests. On the one hand, governments aim to optimise the use of oil and gas resources available in their territory, to promote national interests for the benefit of society as a whole and to appropriate economic income for the state, which will ultimately be turned to the benefit of society. On the other hand, oil and gas companies aim primarily at maximising their return on the capital invested.

Although they hold apparently conflicting interests, governments and oil and gas companies should not be viewed as standing at two opposite poles. In fact, they have the same goal, in the same way as operators and non-operators, which paradoxically act as both partners and competitors in the same markets. In this context, it should be emphasised that companies involved in joint ventures in the oil and gas industry should act together, but always through alliances that focus on minimising their financial exposure and the risks inherent in exploration projects.[5] They also aim to capture the necessary competence (technological, financial and political), but they must be flexible when considering whether they should leave or continue to participate in a particular project, and they must therefore maintain their independence and autonomy. These are the major characteristics of such partnerships.[6]

Such alliances are meant to last the necessary time to run a given project, or for the term of a production sharing contract or a concession agreement. In practice, however, the parties to joint operating agreements are competitors and they seek to preserve their corporate autonomy. They join forces to share risks and optimise their investment portfolio and their short, medium and long-term corporate strategies.

Usually, the host government will own any natural resources below the ground. As a consequence, the interested parties should obtain permission from the host government to explore those resources. Thus, different types of contract for oil and gas exploration and production have been developed to meet the different goals of governments and companies, according to the legal systems in particular countries. The most frequently used forms of contract developed to manage relationships

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3 Patrícia Carvalho, *Joint Venture – An economic and legal vision for business development* (Juruá, Curitiba 2008).

4 Daniel Yergin, *Oil: a story of money, greed and power* (Scritta, São Paulo 1992).

5 José A Bucheb, "Business partnerships (joint ventures) in exploration and production of oil and natural gas in Brazil" in Márcia CP Ribeiro and Oksandro Gonçalves (eds), *Business Law Journal* 7, Jan–June, 2007.

6 Patrícia Carvalho, *Joint Venture – An economic and legal vision for business development* (Juruá, Curitiba 2008).

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between parties in the oil and gas industry are concessionary agreements, production sharing contracts, service agreements and hybrid forms.[7]

Concessionary agreements (also known as licences, leases or tax regimes) give oil and gas companies the right to undertake exploration and production activities in a given area offered by the state (typically, through a bidding process). The oil and gas company (or a group of companies in a joint venture) bears all of the risks, but has the right to keep all production it manages to extract. The host government is compensated by taxation.

Production sharing contracts are widely used by developing countries as they are perceived as giving more control and participation to the state, although such control can in fact be achieved under any contract. In this type of contract the contractor undertakes the same risks as those under a concession contract. But the key difference here is the possibility for the investor to recover its costs and to take only part of the production.

Service agreements in turn – which are apparently more simple – indicate that the state is hiring services from an oil and gas company or joint venture. This contract can be framed as a pure service contract where the state retains the risks and benefits of exploration. However, where the contract has risk provisions, the risks are fully assumed by the contractor as a risk service contract. Under this type of arrangement, the contractor will have higher revenues than under typical service contracts, so as to reflect the economic relationship between risk and return.

Although these are the traditional models in the oil and gas industry, there is some disagreement between authors and scholars regarding the main characteristics of each kind of contract. Thus, in addition to knowing the general characteristics for each type of contract (ie, its classification and denomination), it is important to examine all the essential features of each system and also the peculiarities of each contract entered into.[8] Different contracts will contain differing ownership rights, accounting rules and obligations.

This is a complex industry, in which professionals (including dealers, consultants and accountants) must go beyond a traditional/literal reading of the Accounting Procedures to achieve successful outcomes. The professional must bear in mind that, in order to achieve success (particularly on the part of the company for which they work), they will have to recognise the relationships, connections, causes and effects of major investments, competitor companies, different oil and gas fiscal systems, specific contracts and differing corporate goals that underpin the relevant commercial relationships. Moreover, the interpretation of state interests is as important as these corporate relationships and interfaces. States will typically participate in production sharing contracts and service contracts (mainly those with risk provisions), either directly or through a state-owned oil company. When analysing contracts and planning how obligations will be met and how the rights of operators and non-operators under the Accounting Procedures will be executed, it

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7 Samuel B Katz, "Types of international petroleum contracts: their history and development" in Richard Steinmetz, *The Business of Petroleum Exploration*, (American Association of Petroleum Geologists, 1992).

8 Daniel Almeida de Oliveira, "Pre-salt: The new regulatory framework for exploration and production of oil and natural gas in Brazil" in *AGU Journal*, Year IX, issue 24, 2010.

will be important to examine the relationship between corporate and governmental interests.

Last but not least, unitisations must be considered. On the one hand, when a joint venture is created, a company will undertake procedures to choose and define the partners that best suit its interests. On the other hand, in unitisations, there are mandatory partnerships formed by companies which do not necessarily have common interests or knowledge to be shared, but must comply with relevant state laws.[9] In these cases, the Accounting Procedures will regulate both joint and unitised operations. However, the complexities of unitisation issues are beyond the scope of this book.

1.2 The purposes of the Accounting Procedures and the 'no gain, no loss' principle

According to Gallun and Wright,[10] the Accounting Procedures deal with several issues such as:

- how cash will be provided to the operator by the non-operators to fund joint operations;
- the timing and content of settlement statements and billings;
- exchange rate benchmarks relating to payments in foreign currency;
- timing and procedures for audits; and
- cost allocation rules and the management of materials and equipment, among others.

The accounting procedure is an integral part of any JOA. The accounting procedure specifically addresses issues related to the maintenance of the joint account; specifically, the determination of appropriate charges and credits applicable to the joint operation.[11]

From a formal viewpoint, and as is clear from the text above, the main objective of the Accounting Procedures is to establish equitable methods to allocate and charge costs between the companies within the joint venture, so that none of them faces a gain or loss as a result of their involvement in the business relationship.

A literal interpretation of the primary objective of the Accounting Procedures may lead to a simplistic understanding of what they bring to the relationship between the parties to joint operations. In practice, the text explaining the primary objective of the Accounting Procedures introduces a highly important principle in this relationship, which is mentioned in nearly all models of Accounting Procedures. This is the 'no gain, no loss' principle. In short, none of the parties should make a gain or a loss in relation to the other partners. Some models explicitly mention the operator,[12] and implicitly the non-operators; and other models use a more comprehensive term – 'parties'.[13]

In sum, the fact that one party is the operator does not allow it to have any kind

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9 José A Bucheb, "Business partnerships in E&P activities in Brazil" in Rio Oil & Gas Expo and Conference Annals, Rio de Janeiro, 2006.

10 Rebecca Gallun and Charlotte J Wright, *International Petroleum Accounting* (PennWell Books, Tulsa 2005).

11 Rebecca Gallun, John W Stevenson, Linda M Nichols and Charlotte J Wright, *Fundamentals of Oil & Gas Accounting* (4th edn, PennWell Books, Tulsa 2001).

12 Greenlandic JOA Accounting Procedure Model (Article 1, item 1.1); OGUK JOA Accounting Procedure Model (Article 1, item 1.2); AMPLA Petroleum Joint Operating Agreement Model (Article 1, item b).

13 2012 AIPN Model Form International Accounting Procedure.

of profit margin from the costs charged to the joint account. The operator is only allowed to be reimbursed for costs incurred while managing the operations.[14] On the other hand, it does not have to incur possible losses in the process.

Duval *et al* state[15] that the model JOAs used internationally prevent the operator from making a profit arising out of its management of operations:

> *The model JOAs used internationally generally favor the operator under the rationale that the operator is not authorized to profit from its operatorship. The 2002 AIPN model JOA reflects the general principle underlying JOAs when it states that the operator is to 'neither gain a profit nor suffer a loss' from performing its duties under the JOA. … the operatorship is not seen as a vehicle for enhancing the operating party's profit.*

How should the no gain, no loss concept be interpreted? In the last sections of the Accounting Procedures, the internationally used models provide that the operator is allowed to charge to the joint account some items which will be priced according to a pricing model (not the book value) and are measured according to the accounting standards.[16] We should understand this concept in light of replacement cost, which leads us to interpret the no gain, no loss concept as being an economic principle, and not just a mere accounting principle.[17] According to this viewpoint, goods or services will be measured not by how much they previously cost, but by the price to be paid for future acquisition in the event of having to replace those that have been used in the joint operations. Thus, the amounts charged to the joint account, when goods and services are provided by the operator, will be different from those in the book, making accounting profit possible for the operator.

The use of historical costs for acquiring such goods and services could harm the no gain, no loss concept, since the operator could be forced to replace the goods at a higher cost than that of the acquisition cost. An argument against this methodology would be: what should be done when the price of the goods and/or services is less than that in the book of the operator? Once again, according to our interpretation, economic concepts should be used. By intending to level down the price of the items provided by the operator, the operator would suffer an effective loss, since it has already spent capital to acquire them at a price which is higher than that which is to be reimbursed. Thus, it is not easy to apply a simple interpretation in relation to this issue; in those cases allowed in the contracts, whereby the operator provides goods or services at current market prices, the cost or market price must be used (ie, the higher price).

In the following chapters, we set out a more detailed description of accounting issues. We will attempt to provide an understanding of the operations and procedures listed in the Accounting Procedures, not only from the operator's viewpoint but also from the non-operators' perspective – information which is not provided in most of the literature in this field.

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14 José A Bucheb, "Business partnerships (joint ventures) in exploration and production of oil and natural gas in Brazil" in Márcia CP Ribeiro and Oksandro Gonçalves (eds), *Business Law Journal* 7, Jan–June, 2007.

15 Claude Duval and six others, *International Petroleum Exploration and Exploitation Agreement: Legal, Economic and Policy Aspects* (2nd edn, Barrows, New York 1986), 294–295.

16 In the AIPN model, the sections relating to this issue refer to sections 2 (Direct charges) and 4 (Acquisition of Material).

17 José A Bucheb, "Business partnerships (joint ventures) in exploration and production of oil and natural gas in Brazil" in Márcia CP Ribeiro and Oksandro Gonçalves (eds), *Business Law Journal* 7, Jan–June, 2007.

1.3 Joint accounts, credits and currency exchange

In joint operations, all the parties are responsible for their proportional share of costs, and in return receive a share of oil and gas production in proportion to their working interest.

The costs incurred by the operator in contributing to the joint operations are recorded in the joint account. Thus, the joint account relates to all the costs associated with a specific joint operation; therefore, they are the responsibility of all the working interest owners.[18]

It should be stressed that the joint account must not be confused with a joint bank account (ie, the account from which payments to suppliers are made and in which cash calls are received). The joint account is an accounting concept. It represents all the costs charged to the venture, which will be shared by all the working interest owners according to their proportionate interest. In other words, the joint account refers to the record of costs which will be shared by the working interest owners, and are kept in accrual basis (ie, the costs and possible revenues will be registered according to the generating factor, and not to an effective payment or receipt).

The joint bank account is that to which payments and receipts of the joint venture are made when joint operations are being managed. It is opened under the name of the operator and is controlled by it.

However, in some countries, such as Brazil, when the unitisation of a reservoir extends to areas that are still not licensed (ie, where the ownership remains with the Brazilian government), all the costs to develop that area and produce oil and gas must be incurred by the working interest owners, who are further reimbursed in kind. In other words, in this instance, the companies will carry the Brazilian government; and, in turn, the government will reimburse them by using its production share of oil and gas. In this case, the cash calls (received) and payments to suppliers will have different percentages from those in the unitised reservoir because the carrying parties must pay the amount relating to the government, the carried party. Thus, the deposits (cash-calls) in the joint bank account will comprise the amounts relating to the working interests of the carrying parties plus the amount related to the carried party, whereas the records in the joint account will be reported according to the proportionate working interest of all parties in the unitised reservoir.

In relation to the joint bank accounts, one of the most common items found in the Accounting Procedures states that each joint operation must have only one bank account. The bank accounts of the parties are rarely used. This is to ensure that the resources of the parties are not confused with those of the joint operation, as can be seen in some model contracts:

> *1.6.7 If the Agreement provides that Operator may not commingle monies received for the Joint Account with Operator funds not related to Joint Operations, then the provisions of this Section 1.6 for payment of Cash Calls shall also apply to Operator.*[19]

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18 Rebecca Gallun and Charlotte J Wright, *International Petroleum Accounting* (PennWell Books, Tulsa 2005), 367.

19 AIPN, "AIPN Model Form International Operating Agreement" (2012), 5. Available at www.AIPN.org.

4.2 Bank Accounts
The Operator shall establish separate bank accounts in Kroner and other currencies in which Cash Calls are made to cover transactions for the Joint Account.[20]

3. Joint Account
3.1 Maintenance of the Joint Account
…
(c) The Joint Account must be held in a separate bank account and must be maintained in Dollars … [21]

In some countries, it is necessary to open a bank account in the local currency; in others, the account may be in US dollars. In these cases, any gains or losses resulting from exchange rates should be debited or credited to the joint account.

This is an extract from the chapter 'General provisions' by Eduardo G Pereira, Carlos Eduardo Vieira da Silva and Eduardo Seixas in Accounting Procedures in Joint Operating Agreements: An International Perspective, *published by Globe Law and Business.*

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20 Greenlandic JOA Accounting Procedure Model, 14.
21 Australian JOA Model Form (AMPLA, Melbourne 2011), 63.
22 Rebecca Gallun and Charlotte J Wright, *International Petroleum Accounting* (PennWell Books, Tulsa 2005), 373.