Unitization: Comments on 2020 AIPN Model International Unitization and Unit Operating Agreement

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AIPN 2020 UUOA


The AIPN’s Guidance Notes to the 2020 AIPN UUOA are a helpful resource when considering the 2020 AIPN UUOA.

What is unitization?

An oil or gas reservoir may straddle adjacent contract areas. Unitization is the process whereby the straddling reservoir is jointly developed by the interest owners in the adjacent contract groups. Joint development of a straddling reservoir is more economical and efficient than separate developments by the adjacent contract groups. A key principle of unitization is that the straddling reservoir is physically developed as though the boundary between the contract areas does not exist.
The petroleum laws of the host country will almost always set out a framework for unitization within that country, and most will require that a straddling reservoir is unitized. The degree of regulation of unitization varies enormously across host countries, with developing countries and countries with a short history in the oil and gas sector tending to have less prescriptive legislation than countries that are more developed or have a more established oil and gas sector.

**The Unitization and Unit Operating Agreement – UUOA**

The unitization agreement between the parties in the groups who hold the adjacent contracts sets out the terms on which the straddling reservoir will be jointly developed. This typically results in a unit whereby all resources and facilities are jointly owned and each group’s share of production and costs is based on its agreed share of the unit, regardless of the location of the facilities. In some circumstances the parties will enter into two separate agreements in respect of: (i) the formation of the unit, and the allocation of unit costs and production between the contract groups (a “unit agreement”); and (ii) the operation of the unit reservoir (the “unit operating agreement”). However, it is more common for the commercial and operational provisions to be combined in a single agreement – a unitization and unit operating agreement – the UUOA. The UUOA creates an unincorporated joint venture among the groups and their participants. UUOAs are private contracts between the interest owners, and even though they are usually subject to host government approval, they are not in the public domain.

A typical UUOA can broadly be divided into three distinct sections: (i) commercial provisions relating to sharing of the unit hydrocarbons – tract participations, redeterminations and adjustments (to production and CAPEX); (ii) the unit operating provisions (which are similar to the provisions in a joint operating agreement) – appointment of the Unit Operator and rules relating to the Unit Operating Committee; and (iii) legal and other provisions, including force majeure, default, withdrawal, termination and dispute resolution provisions. A UUOA (unlike a JOA) will also normally address Non-Unit Operations, being either: (i) operations undertaken by an individual contract group with respect to a non-straddling reservoir within the wider “unit area”; or (ii) operations undertaken by an individual contract group outside the “unit area” but utilising unit facilities. A number of the Schedules to a UUOA are crucial to the unitization process, notably the “Redetermination Technical Procedures” which apply to a redetermination of each contract group’s unit equity share (which are often called “Tract Participations”). The Unit Accounting Procedure is also often subject to particular scrutiny.

A UUOA is generally a complex agreement which requires significant input from legal, commercial and technical specialists including reservoir engineers who are deeply familiar with the characteristics of the unit reservoir. Due to the complex nature of a typical UUOA, it is not uncommon for it to take more than a year for the unit parties to agree on the final UUOA.

**2006 AIPN UUOA**

In recognition of the increase in the number of unitizations worldwide, in 2006 the AIPN produced a model form Unitization and Unit Operating Agreement and
supporting Guidance Notes. The 2006 AIPN UUOA was based on the AIPN’s model form Joint Operating Agreement which was tailored for a unitization scenario and expanded to cover issues that are unique to unitized reservoirs.

Since then the 2006 AIPN UUOA has served as the starting point for unitization negotiations in a myriad of situations and jurisdictions, and has brought a level of harmonization to documenting unitizations internationally. However, there is no “one size fits all” UUOA due to the unique nature of each unit. The final shape of the UUOA will be influenced by (amongst other things): (i) the characteristics of the particular straddling reservoir (e.g. oil or gas, and large or small reservoir); (ii) the country in which the straddling reservoir is located (or countries in the case of a cross-border unitization); and (iii) the context in which the unit is being developed (e.g. as part of an integrated project or as a standalone development). Whilst the 2006 AIPN UUOA proved to be extremely relevant as a starting point for the unitization negotiations, typically parties using the 2006 AIPN UUOA would have to amend, supplement, discard or substitute certain provisions of the 2006 AIPN UUOA in order to achieve their commercial and/or legal objectives.

**2020 AIPN UUOA**

**Scope**

The 2020 AIPN UUOA amends certain provisions of the 2006 AIPN UUOA but it does not materially change its scope or application. Like its predecessor, the 2020 AIPN UUOA:

- is of *single country application*, and does not address the additional complexities that arise when the unit area straddles the boundary between two (or more) countries;
- is not *jurisdiction specific*. It is worth noting that the AIPN UUOA is not used in the US, the UK or Norway;
- applies to *production sharing contract regimes*; and
- includes *alternative provisions* and *optional provisions* on a range of issues to provide maximum flexibility to the parties negotiating a UUOA based on the AIPN model form.

Whilst the 2006 AIPN UUOA assumed that the individual contract Groups had performed exploration and appraisal activities prior to the unitization occurring, the 2020 AIPN UUOA now contemplates Exploration Activities and Appraisal Activities being performed under the UUOA. The 2020 AIPN UUOA also now provides the option to extend the application of the UUOA to downstream of the Delivery Point under the Groups’ contracts, to cover the scenario where the groups are jointly participating in a downstream project.

**Pre-unitization Matters**

The 2006 AIPN UUOA addressed pre-unitization expenditures by creating the ability
for the contract groups to re-allocate costs incurred by the individual groups prior to the unitization occurring so that the costs are shared by the groups in accordance with their respective shares of the unit. The 2020 AIPN UUOA expands the pre-unitization provisions to also address re-allocation of production from the unit area before the unitization occurred. It is rare for production to start from a unit area prior to the unitization, but the situation can occur where one group starts to produce hydrocarbons from within its contract area without knowing that the reservoir straddles another contract area.

**Unit Interests**

Under the 2006 AIPN UUOA each unit interest holder had a “Unit Interest” and is obliged to pay its “Unit Interest” share of all Unit Account Costs. The “Unit Interests” are determined by a simple mathematical formula -

\[
\text{Unit Interest} = [(\text{Tract Participation of Group}) \text{ Tract A} \times (\text{Party's Group Interest}) \text{ Tract A}] + [(\text{Tract Participation of Group}) \text{ Tract B} \times (\text{Party's Group Interest}) \text{ Tract B}].
\]

The 2020 AIPN UUOA now also includes a “Unit Paying Interest” which describes a party’s share of the expense obligations under its Joint Operating Agreement as distinct from such party’s participating interest. This governs the situation where, pursuant to carry or other commercial arrangement, a party’s obligations in respect of expenses are different from its participating interest.

**Unit Area**

The UUOA will define the "Unit Area" and will often separately define the "Unit Interval". The "Unit Area" refers to a surface area within specified geographic coordinates, providing a horizontal view of the unit. The "Unit Interval" provides a vertical view of the unit and will normally be defined by reference to selected reservoirs, selected depths or all depths. Reaching a common understanding on the "Unit Area" and "Unit Interval" usually requires substantial negotiation between the contract groups’ technical teams. The 2020 Exhibit B (*Definition of Unit Area and Unit Interval*) contains material changes to its predecessor, including defining the Unit Area by reference to a Coordinate Referenced System to remove any ambiguity in the unit boundary coordinates.

**Tract Participations, Redeterminations and Adjustments**

Each contract group’s tract participation (that is, its equity interest share of the unit) determines that contract group’s entitlement to hydrocarbons produced from the unit area and its share of unit costs. When the contract groups enter into the UUOA the precise characteristics of the straddling reservoir are not known, and therefore the contract groups’ initial tract participations are determined based on a simple understanding of the reservoir derived from each group’s exploration and appraisal data. Most UUOAs will provide for one or more redetermination(s) of the tract participations after production start-up as more information is gained about the reservoir’s characteristics and reserve profile. A redetermination results in a change to each contract group’s percentage share of the unit, and an adjustment to the sharing of production and expenditure to put the contract groups in the place they would have been in if the revised tract participations has applied from the
The provisions of the 2006 AIPN UUOA in respect of (i) tract participations; (ii) redeterminations; and (iii) adjustments remain largely unchanged in the 2020 AIPN UUOA. The 2020 AIPN UUOA still provides:

- an optional process for expanding the Unit Area if another accumulation of hydrocarbons is found to be in “Pressure Communication” with Unit Substances;
- either automatic or optional (to be agreed) redeterminations on the occurrence of specific trigger events, including (i) existence of Sufficient New Data; (ii) production levels reaching a specific threshold; or (iii) a specific anniversary following start of production;
- a range of possible bases for conducting the redetermination including (a) “Hydrocarbons Initially in Place” (HIIP) – which refers to hydrocarbons in situ at the time of unitization (and is the most straightforward and common redetermination basis); and (ii) “Estimated Ultimate Recovery” which refers to the volume of hydrocarbons expected to be produced; and
- a process for adjusting hydrocarbon and CAPEX allocation between the contract groups (on a look back and look forward basis) as a result of the redetermination. The 2020 AIPN UUOA has introduced an alternative process for adjusting hydrocarbon production following a redetermination. Alternative No. 1 follows the most common industry practice by entitling the under-produced group to recover the shortfall in its allocation of production by requiring the over-produced contract group to deliver hydrocarbons in kind. The new Alternative No. 2 provides for the over-produced group to make cash payments to the under-produced group for the value of their over-produced quantity, and would apply in the case that the over-produced group is not able to provide production in kind due to its long term hydrocarbon supply obligations.

Some changes have been made to the Redetermination Procedures in Exhibit E to the 2020 AIPN UUOA but the process remains broadly intact. Far more radical changes have been made to the Redetermination Technical Procedures in Exhibit F to the 2020 AIPN UUOA. The 2006 Redetermination Technical Procedures were criticized by technical unitization experts for being too prescriptive and often not fit for purpose. Each unit reservoir has unique characteristics and it often proved unworkable to apply the AIPN’s 2006 Redetermination Technical Procedures to the particular unit. The AIPN’s 2020 Redetermination Technical Procedures adopt a more principles-based approach which is more versatile and less likely to become redundant as technologies and standard industry practices evolve over the life of the UUOA.

**Unit Accounting Procedure**

The Unit Accounting Procedure in Exhibit C of the 2020 AIPN UUOA has been completely revised to be consistent with the 2012 AIPN Model Form Accounting Procedure, with selected improvements and amendments to apply the accounting procedure to a unit context.
**Operational Provisions**

The provisions relating to Non-Unit Operations, and use and expansion of Unit Facilities remain largely unchanged in the 2020 AIPN UUOA. The rights and obligations of the Unit Operator (including in relation to the Unit Operator’s liability) have been tweaked but not materially altered. That said, the Unit Operator’s reporting obligations, HSE obligations, and obligations with respect to work programs and budgets, AFEs and appointing contractors are slightly more onerous. There is a new (optional) right for the Non-Operators to remove the Unit Operator (by vote based on percentages to be agreed) if the Unit Operator either admits allegations that it (or its Affiliates, employees etc.) violated Anti-Bribery Laws and Obligations (a new defined term) or the Unit Operator is finally adjudicated that such breaches took place. Only (primarily) cosmetic changes have been made to provisions relating to the establishment and governance of the Unit Operating Committee – the 2020 AIPN UUOA preserves the possibility of at least three different voting thresholds for different unit matters.

The provisions relating to decommissioning, and the preparation (by the Unit Operator) and approval (by the Unit Operating Committee) of the Decommissioning Work Program and Budget are largely unchanged. Decommissioning is an area where the provisions in the 2020 AIPN UUOA may not be fit for purpose in the context of a specific unitization. The decommissioning provisions in a UUOA will generally need to dovetail with the groups’ decommissioning obligations in their underlying contracts – which may themselves differ.

**Default**

Under the 2006 AIPN UUOA, a default arises if a party fails to pay its share of unit account expenses, or to provide any required security (if applicable). Now a party may (optional) also be in default if it fails to perform its indemnity obligations under its contract or the UUOA, or if it is in default under its JOA (thereby stapling JOA and UUOA defaults). The situation remains that if a defaulting party fails to cure its default, the non-defaulting parties in its contract group have primary responsibility to cure the default, and if the default is remedied within the contract group they are entitled to exercise their remedies under the relevant JOA. If, however, the entire defaulting party’s contract group defaults (defaulting group parties), the parties in the other contract group (non-defaulting group parties) have the option to contribute the shortfall amount and then elect to do one of the following:

1. require the defaulting group to withdraw from the UUOA and assign their interests to the contributing non-defaulting group parties for no consideration;

2. require the defaulting group parties to sell their unit interests to the contributing non-defaulting group parties for an agreed “Buy-out Price”. The references in the 20026 AIPN UUOA to alternative valuations based on appraisal value, gross book value and discount to market value have been deleted, and the parties are now free to agree on the “Buy-out Price”. In the absence of agreement on the “Buy-out Price”, it will be determined by an expert on the basis of the fair market value of the defaulting group parties’ Project Interests less (i) amounts in default; (ii) costs to obtain the valuation; and (ii) a
specific percentage discount (to be agreed) to the fair market value;

3. require that the defaulting group parties offer to assign part of their interests to the non-defaulting group parties, in which case a (new) Withering Interest formula and Withering Interest Price applies to the assignment; or

4. enforce any security provided by the defaulting group parties.

It should be noted that the transfer or assignment of the defaulting group’s interests to the contributing non-defaulting group parties may be a hard remedy to enforce in practice. In a UUOA context, the defaulting group’s interests in the unit will derive from its underlying contract which is unlikely to be capable of transfer under the UUOA (as this would require the consent of the host government (or its national oil/gas company) as a party to the contract as the granting authority). Therefore, unless the defaulting group’s underlying contract was also transferred to the contributing non-defaulting group parties, the status of the transfer or assignment of the defaulting group’s interests under the UUOA to the contributing non-defaulting group parties is questionable.

**Withdrawal**

Fairly minimal changes have been made to the Withdrawal provisions in the 2006 AIPN UUOA. Article 15 of the 2020 AIPN UUOA continues to provide that any party who is not in default can withdraw from the UUOA, provided that it also withdraws from its contract and JOA. In practice, it is not uncommon to include a provision in a UUOA that restricts the right to withdraw until after the development phase when unit costs will reduce and production should begin. However, under the 2020 AIPN UUOA the withdrawing party remains liable for its share of the costs of unit operations in which it agreed to participate prior to withdrawing. If any other parties in the withdrawing party’s contract group do not wish to withdraw, the withdrawing party may transfer its unit interests to those other parties in its contract group. If, on the other hand, all the parties in the withdrawing party’s contract group (withdrawing group parties) wish to withdraw from the UUOA, the withdrawing group parties may transfer their unit interests to the parties in the other group who wish to receive these transfers (non-withdrawing group parties). The rationale for this provision is to allow the non-withdrawing parties to acquire the rights they need to continue to conduct unit operations under the UUOA following withdrawal from the unit by the withdrawing group parties. However, such transfer of unit interests from the withdrawing group parties raises the same issues mentioned above regarding the practical implications of the same without the transfer of the withdrawing group parties’ corresponding interest in their contract (without host government consent).

**New Concepts in 2020 AIPN UUOA**

The 2020 AIPN UUOA has also introduced the following new concepts:

**“Indivisible Obligations”**. These are obligations derived from the group’s separate underlying (production sharing) contracts that are conflicting and relate to operational matters where it would not be feasible or appropriate to perform the operation differently in respect of each contract within the combined unit (e.g. in
relation to local content requirements). Article 4.9(C) governs the obligations of the Unit Operator in respect of Indivisible Obligations. Ideally such conflicts in the contract obligations should be addressed by an amendment to one of the contracts and/or in the Government approval of the UUOA.

**Government Consent for Change of Control:** New Article 14.3(A) (derived from the AIPN Model JOA) provides an obligation on a party which is subject to a Change of Control to obtain necessary Government consents and replace existing Security if required.

**Anti-Bribery and Corruption:** The 2020 AIPN UUOA introduces (optional) stronger undertakings in respect of anti-bribery and corruption and sanctions matters.

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