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Oil and Gas Farmout Agreements: Issues and Approaches from the Farmee's Perspective

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SUMMARY

Farmout agreements are a regular part of the oil and gas industry, as persons holding permits and licences endeavour to share the risk and the cost of exploration and development, Typically, a farmout will involve a person holding a permit or licence or an interest in a permit or licence under an existing unincorporated joint venture (the farmor) agreeing with another person (the farmee) to assign to the farmee an interest in the permit or licence and the associated joint venture in consideration for the farmee carrying out or funding defined work within the permit or licence.

The paper considers farmout agreements from the farmee's perspective, and concentrates on the issues and approaches to them when used in oil and gas exploration and development in the Australian offshore area. The issues are dealt with in four categories: (1) farmout issues; (2) joint venture issues; (3) regulatory issues; and (4) revenue issues.

The accompanying paper by Andrew Thompson looks at farmout agreements from the farmor's perspective. Many of the issues are similar, but the perspective is clearly different. This makes the negotiation of farmout agreements an interesting exercise.

INTRODUCTION

As a good working definition of a farmout, the following will be adopted:

> "A farmout normally involves the farmee committing itself to carrying out certain tasks including expenditure in relation to the property held by a

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participant of an unincorporated joint venture in order to earn an interest in that property."[1]

Others have chosen to extend the concept to cover any contractual arrangement involving an assignment for consideration of a partial interest in a mining or petroleum tenement and associated assets with the reservation to the assignor of the remaining interest (usually in the context of an unincorporated joint venture, either an existing one or one which is brought into existence by the farmout), and even to the acquisition of shares in an incorporated joint venture. In this paper the concept will be limited to its normal meaning as described above. Thus, in the oil and gas context, a typical farmout will involve a person holding a permit or licence or an interest in a permit or licence under an existing unincorporated joint venture (the farmor) agreeing with another with another person (the farmee) to assign to the farmee an interest in the permit or licence and the associated joint venture (if it already exists) in consideration for the farmee carrying out or funding certain defined work within the permit or licence (such as a specified survey program or the drilling of a well) or the expenditure of a certain sum of money.

This paper will consider farmout agreements in the oil and gas industry from the farmee's perspective. In order to place some bounds upon the scope of the paper, consideration will be limited to oil and gas exploration and development in the Australian offshore area; that is, looking at the use of farmouts under a petroleum licensing regime. The rather different context of a regime based upon production sharing contracts will not be considered. The essential elements of a licensing regime, as found in the Australian offshore area, is that the sovereign power which owns or controls the resource, acting under statutory authority, grants concessions in the form of permits, leases and licences allowing access to explore for, develop facilities for the recovery of, and recover and sell petroleum from a specified area. Licensing regimes such as this are found in many countries with a common law background (for example, Papua New Guinea where the system is basically similar to the Australian offshore licensing regime).[2]

Having limited the scope of the paper in this way the focus will be principally upon Commonwealth legislation, in particular the *Petroleum* (*Submerged Lands) Act 1967* and associated legislation) of the Commonwealth.[3]

1 Charles Birch, "Choosing the Right Joint Venture Structure for a Farmin or Farmout" (2002) 5(1) *Journal of Taxation* 60 at 61.

2 Different licensing regimes use different names for their statutory concessions. In the Australian offshore area, there are exploration permits for petroleum, retention leases for petroleum, production licences for petroleum, infrastructure licences, pipeline licences and access authorities. In Papua New Guinea, under the *Oil and Gas Act 1998*, there are petroleum prospecting licences, petroleum retention licences, petroleum production licences, processing facility licences and pipeline licences. In this paper, the expression "permits and licences" is used to embrace all such statutory concessions.

3 As this paper was being written, the *Offshore Petroleum Bill 2005* was, after a very long period of gestation, introduced into the Commonwealth Parliament, together with five supporting Bills. They constitute a substantial rewrite of the *Petroleum (Submerged Lands) Act 1967* and associated Acts of the Commonwealth, without major policy changes. This paper will refer throughout to the existing Acts (which are still current

However, it should be remembered that the Commonwealth legislation does not cover those parts of the offshore area which are internal waters (that is, waters on the landward side of the territorial sea baselines) and the territorial sea itself (the outer limit of which is for this purpose three nautical miles from the baselines). Together, these form the coastal waters of the adjacent State or Territory. By virtue of s 5 of the *Coastal Waters (State Powers) Act 1980* (Cth), the legislative powers exercisable from time to time under the constitution of each State extend to the making of laws applying to the coastal waters of the State. Furthermore, the *Coastal Waters (State Title) Act 1980* (Cth) has vested in each State the same right and title to the property in the sea-bed beneath the coastal waters of the State, and the same rights in respect of the space above the sea-bed, as would belong to the State if the sea-bed were the sea-bed beneath the waters of the sea within the limits of the State (subject to certain reserve rights of the Commonwealth). The *Coastal Waters (Northern Territory Powers) Act 1980* (Cth) and the *Coastal Waters (Northern Territory Title) Act 1980* (Cth) make similar provisions in respect of the Northern Territory. Hence, it is the *Petroleum (Submerged Lands) Act* of the relevant State or Territory which applies in the internal waters and the territorial sea, hence State or Territory stamp duty legislation is also applicable to transactions involving property in these coastal waters.

From the farmee's perspective the issues concerning farmout agreements will be grouped into four categories:

1. Farmout issues.
2. Joint venture issues.
3. Regulatory issues.
4. Revenue issues.

The term "farmout" will be used throughout and "farmin" (or "farm-in") will be avoided. There is an historical meaning of "to farm" or "to farm-out" which predates the petroleum industry. According to *Oxford English Dictionary*, it meant "to take or hold for a term at a fixed payment, or to let to another for a fixed payment: as, land to a tenant (now rare), the proceeds of customs, taxes, tithes, etc, or labour". The owner of an estate, or a right to collect money, was said to "farm out" his estate or right to another person. There was no concept of "farming in". Although in the resources context a "farm-in" is regarded as the obverse of a "farm-out", viewed from the other side, this can be confusing. Furthermore, there is an inherent confusion in the terms "farminor" (the perpetrator of the action) and "farminee" (the recipient of the action), and the alternatives of "farmoutor" and "farmoutee" are verbally grotesque. The term "farmor" will be used to mean the person which farms out its estate or interest (or part of it), and "farmee" to mean the person which receives the estate or interest (or part of it) in return for the expenditure of money or the performance of work. This is consistent with the

law) with footnote references to the Bills designed to replace them and corresponding provisions in them.

usage of the Association of International Petroleum Negotiators (AIPN) in its model Farmout Agreement, and generally it seems with American usage.[4]

FARMOUT ISSUES

Risk and Reward Apportionment

In general terms, the purpose of farmouts is the reduction or sharing of risk for the farmor. The cost of petroleum exploration and development, particularly offshore, is extremely high, and there is no assurance of success. During the exploration phase, before any discovery has been made, and even after discovery when a field is being appraised for development, very large expenditures will be required with no certainty that they will be recovered out of the proceeds from future production. If the farmor's objective is therefore to lay off this risk, the farmee's objective must be to ensure that it is sufficiently rewarded (at least with the anticipation of a share of future production) for the assumption of part of the risk.

The appropriate risk/reward equation will always depend upon the circumstances, including the circumstances of the parties themselves (which of them has funds available, what their other obligations might be and what their expectations are) and those which are external to the parties (the prospectivity of the area, its closeness to markets and the current oil or gas prices in the marketplace). Therefore, although there are a number of model farmout agreements – and the AIPN 2004 International Model Farmout Agreement is a good one – no model agreement will fit all circumstances and they need to be individually negotiated and drafted. The AIPN model agreement recognises this in that it contains various alternative clauses and optional provisions and is accompanied by a very helpful User's Manual which explains many of these.[5]

Nature of the Earning Obligation

From the farmee's perspective, a proper description and specification of the work to be performed or the expenditure to be incurred in order for the farmee to earn its interest under the farmout agreement is of critical importance. The earning obligation might be one of the following:

4 See for example the comprehensive and definitive article by John S Lowe, "Analyzing Oil and Gas Farmout Agreements" (1987) 41 *Southwestern Law Journal* 759. Also, Williams & Meyers, *Oil and Gas Law,* Vol 8 "Manual of Terms", which has a definition of "farmout" and an extensive description of "farmout agreement" but in relation to "farm-in" says that it is a term "used in several countries" to describe the agreement from the point of view of the farmee rather than the farmor (see pp 436-7).

5 The AIPN 2004 International Model Farmout Agreement and User's Manual are available from the Association of International Petroleum Negotiators (AIPN) at its website www.aipn.org/model agreements.

1. It might be a specific piece of work or program of work, such as the drilling of a specific well or the carrying out of a specified length of seismic survey of a particular standard. This might be in fulfilment of a work commitment which forms one of the conditions of the permit or licence and which has to be completed within a certain time in order to keep the permit or licence in good standing.
2. It might be the funding of a certain percentage of a program of work, either required as a work commitment or already specified in a work program submitted by the operator and accepted by the operating committee of the joint venture.
3. In the case of either (a) or (b), the danger for the farmee is that the specified work or program may be either uncosted or may suffer a significant cost overrun, which the farmee would have to meet (either wholly or proportionately). Therefore, a further alternative to either (a) or (b) might be for the farmee to be obliged to fund the work or program subject to a capped amount.
4. If no specific work or program is required at the time of the farmout, the farmee's obligation may be to meet expenditure on the permit or licence up to an agreed amount. If there is an existing joint venture, this would normally mean that the farmee meets the operator's calls on the farmor until this agreed limit has been reached. If the farmor owns 100% of the licence or permit, it may simply be an obligation for the farmee to expend this amount of money on exploration within the area according to the farmee's own program (subject to any work commitments under the permit or licence).

What is the Interest Earned?

The farmee will normally earn an undivided percentage interest as tenant in common in the permit or licence (subject to the approval and registration requirements under the relevant legislation which are dealt with under Regulatory Issues). If there are other assets associated with the operations, which might include existing facilities in the area (although this is unlikely during the exploration phase) or contractual rights relating to the engagement of a seismic survey vessel or the hire of a drilling rig, then the farmee would expect to get the same percentage interest in these. If the farmor is already part of a joint venture for the exploration and development of the area, and it is farming out its joint venture obligations, then the farmee would in addition expect to earn the same percentage participating interest in the joint venture with proportionate rights under the joint operating agreement.

Where the farmee expects to earn an interest in contractual rights as well as in the permit or licence itself, then the farmout agreement would need to provide for an assignment of those contractual rights, and the farmee will need to be sure, and check at the outset, that the contractual rights are assignable. Although choses in action are generally assignable, a provision in a contract specifying that the rights under it cannot be assigned, or cannot be assigned without the consent of the other party, can render any purported assigned ineffective.[6] The assignability of contractual rights under an existing joint operating agreement is one of the Joint Venture Issues dealt with below.

When is the Interest Acquired?

Broadly, farmouts may be structured in two ways:

(a) as a deferred transfer farmout, under which the interest to be earned by the farmee is not assigned to it until the earning obligation has been completed; or

(b) an immediate transfer farmout under which the interest to be earned by the farmee is assigned to it at the outset, or is subject to reassignment if the earning obligation is not fulfilled.

From the farmee's perspective, an immediate transfer farmout is preferable in that it provides greater security. It is submitted that the correct conveyancing form for such farmout is an assignment defeasible upon a condition subsequent; in other words, there is an immediate assignment of the interest but it is subject to a defeasance condition which, if not satisfied, defeats the assignment and treats the interests of the farmor and farmee as if the assignment had never occurred.[7] However, this concept is at odds with the general treatment of immediate transfer farmouts in most farmout agreements, and probably also with the way in which the authorities deal with them under the approval and registration provisions of the relevant statutes. Most draftsmen of immediate transfer farmouts, instead of including a defeasance condition, make specific provision for reassignment of the interest if any of the obligations are not fulfilled. This may have revenue implications which are dealt with under Revenue Issues.

Although most farmouts will provide either for deferred transfer or immediate transfer, there is a hybrid type. This is where provision is made for the interest to be assigned in steps as the earning obligation is progressively fulfilled. Technically, it is possible to provide, for example, that at the end of each quarter part of the aggregate interest which the farmee will earn is assigned to it in proportion to the part of the earning obligation fulfilled in that quarter. However, the implementation of this can become complex. Unless the farmout agreement can successfully provide for a deemed assignment of the proportionate part of the interest at the end of each quarter, then a quarterly assignment instrument may be required, which may need to be separately approved and registered under the relevant statute. Therefore, although this might appear to be a sensible

6 *Linden Gardens Trust Ltd v Lenestra Sludge Disposals Ltd* [1993] 3 AII ER 417 in which the House of Lords decided that an assignment of contractual rights in breach of a prohibition against such assignment is ineffective to vest the contractual rights in the assignee (see Lord Browne-Wilkinson at pp 431-2).

7 See *Halsbury's Laws of England* (4th ed, Reissue) Vol 42, paras 740-742 about Conditions of Defeasance.

compromise between the interests of the farmor and the farmee, it does not appear to have been used to any great extent.

What are the Liabilities being assumed by the Farmee?

The liabilities to be considered are those other than the earning obligation itself. Indeed, under some farmout agreements, which effectively give the farmee the option to earn an interest, the requirements on the farmee to earn the interest are not really obligatory.

Whether the farmee, in performing its earning obligations, is assuming other liabilities will largely depend upon whether or not the farmee is to become the operator. This is one of the Joint Venture Issues dealt with below. If the farmee is the operator, then its liability would depend upon whether it is acting as principal or agent, and what the joint operating agreement or farmout agreement provides in respect of indemnities for the operator from the other participants. Generally, in the oil and gas industry, operators operate on the basis that they are principals, but with a full right of reimbursement proportionately from the other participants except to the extent that the operator has done anything which is wilfully wrong or reckless. Thus, even if the operator is negligent, it would expect its liabilities to any third party to be covered proportionately by the other participants (American precedents do sometimes carve out "gross negligence", although the meaning of this term is uncertain in Anglo-Australian jurisprudence).[8]

The farmee should be closely interested in such provisions in the joint operating agreement or farmout agreement whether it is the operator or a non-operator, although of course its perspective will be different in each case. If it is the operator, it will want to restrict the exceptions in the general indemnity and right of reimbursement provided by the other participants (including the farmor), and if it is a non-operator it may wish to see these exceptions expanded.

Interest in the Whole or Part only of the Permit or Licence

The issue is whether the farmee can acquire an interest in part only of the permit or licence.

Under the *Petroleum (Submerged Lands) Act,*[9] it is apparent that the title to a permit or licence can only be transferred as a whole. If there are two or more registered holders of the title, each must execute the transfer to the transferee or transferees (each of whom must also execute). Two or more registered holders hold the title as though they were joint tenants, each with an undivided interest in the whole. This legal title cannot be subdivided into percentage interests, although

[8] On the role and liability of an operator, see generally H Kevin McCann, "The Role of an Operator under a Joint Venture Agreement" (1982) 4 AMPLJ 256.

[9] See s 78(3) and compare Offshore Petroleum Bill s 258.

different percentage interests can be recognised in an instrument approved under s 81 of the Act[10] as a dealing in the permit or licence.

Commercially, parties might want to give effect to a farmout transaction in respect of particular blocks but not all the blocks in a permit or licence or, perhaps more commonly, in relation to a particular field identified within the permit or licence. It is uncertain whether effect can be given to this by an instrument approved and registered under s 81 although its scope appears to be very broad. Subsection (1)(c) includes within its scope:

> "the determining of the manner in which persons may exercise the rights conferred by, or comply with the obligations imposed by or the conditions of, an existing title (including the exercise of those rights or compliance with those obligations or conditions under cooperative arrangements for the recovery of petroleum)."[11]

It is suggested that ingenius drafting of a farmout agreement relating to part of a permit or licence could bring it within the description of this paragraph and allow such a farmout agreement to be approved and registered under s 81.

JOINT VENTURE ISSUES

Is there an Existing Joint Venture?

Farmouts are entered into in two distinct situations:

(a) where the farmor is already in joint venture with one or more other parties in relation to the permit or licence and as a result has a beneficial interest of less than 100% in the permit or licence (although it might possibly be the only registered legal holder of it); and

(b) where the farmor is the sole legal and beneficial owner of the permit or licence and therefore there is no existing joint venture.

In the first situation, one would expect there to be a joint operating agreement in place under which the existing parties have participating interests corresponding to their beneficial percentage interests in the permit or licence. In that situation, the farmor will be intending to farmout not only a proportion of its interest in the title but also the corresponding proportion of its participating interest. Its ability to do so, with or without the consent of the other participants in the joint venture, will depend upon the assignment clause in the joint operating agreement. That clause may contain pre-emptive rights which oblige the farmor, before assigning an interest to the farmee, to first offer the interest to the other participants on the same terms.[12]

[10] Compare Offshore Petroleum Bill ss 269 and 270.
[11] Compare Offshore Petroleum Bill s 269 item 3.
[12] In relation to pre-emptive rights, see generally H Kevin McCann, "Pre-emptive Rights in Resource Joint Venture Agreements" [1990] AMPLA Yearbook 445.

Clearly, therefore, the farmee has a strong interest in the assignment clause of the joint operating agreement and any restrictions it may contain. But the farmee's interest should not be limited just to that clause. The joint operating agreement is, effectively, the "constitution" of the joint venture into which the farmee will be entering if the farmout is successfully carried through. The farmee needs to know the terms on which it will hold the interest it acquires, including such details as the right of representation on the operating committee, the voting procedures and the percentage vote required for different types of decisions, the duties of the operator, the way in which future work programs and budgets will be set, and the way in which liabilities are shared. Where the farmout is of an interest in an existing joint venture, the farmee would be ill advised to proceed with it without obtaining a copy of the joint operating agreement and reviewing it thoroughly.

In the other situations, where the farmor is the sole permittee or licensee and there is no existing joint venture, the result of the farmout will normally be to bring into an existence a joint venture between the farmor and the farmee. Consideration needs to be given in advance to the terms of this joint venture. Farmout agreements take different approaches to this issue. At one extreme, the farmor and the farmee may negotiate and settle a complete joint operating agreement which is annexed to the farmout agreement and is set to come into operation when the farmee's earning obligation has been fully discharged. At the other extreme, the parties may simply acknowledge the need for a joint operating agreement at a later date and agree to negotiate in good faith to put it into place at the appropriate time. From the farmee's point of view, this latter approach is not very satisfactory as there will merely be an unenforceable "agreement to agree" on how its future relationship with the farmor will be determined.

The AIPN model farmout agreement assumes that a joint operating agreement is necessary and several alternatives are provided to deal with the situation. One of these, falling between the two extremes identified above, is for the parties to agree to negotiate in good faith and execute a joint operating agreement based on the principles attached as an exhibit to the farmout agreement itself. Another alternative commonly used is for the initial agreement to be expanded into a farmout and joint venture agreement which contains many of the essential operating provisions to govern the relationship between the farmor and the farmee during the earning period. This will normally continue in existence after the earning period until it is replaced by a full joint operating agreement. From the farmee's perspective, this is a reasonable arrangement, although it does mean that a more comprehensive agreement needs to be negotiated and settled at the outset.

Whether the Farmee is to be the Operator

In either of the situations identified above, it is possible for the farmee to be the operator during the earning period. Whether this is appropriate will depend upon the circumstances. Where there is an existing joint venture, there is likely to be an existing operator which may or may not be the farmor. The existing operator will only stand down in favour of the farmee if the earning obligation is a work commitment which will during the earning period be the work program of the joint venture, and the farmee has the technical ability to carry out this work commitment. If this is not the case, then the arrangement would normally be for the farmee to fund the existing operator to manage and operate the work commitment during the earning period in accordance with the terms of the joint operating agreement as though the farmee were already a participant pursuing a sole risk undertaking.

In the other situation, where there is no existing joint venture, either the farmor or the farmee will need to act as operator, and the choice is likely depend upon which has the technical capability or the available slot with a drilling contractor.

Voting Arrangements

This will principally be an issue where there is an existing joint venture and joint operating agreement. If the farmee is carrying out or funding the major work on the permit or licence during the earning period, it will want to participate in joint venture decision-making on the operating committee, directly or indirectly, even if it has not already become a joint venture participant. There are a number of different possible circumstances, as follows:

1. If the farmee has entered into a deferred transfer farmout, it will not have a seat at the decision-making table of the operating committee during the earning period. It might therefore want to require that the farmor during this period votes on the operating committee in accordance with the wishes of the farmee, at least in relation to operational matters. If this is not acceptable to the farmor, the farmee might at least require consultation in advance in relation to any decisions on which the farmor needs to vote.
2. If the farmee has entered into an immediate transfer farmout, it would normally expect to have a seat on the operating committee as soon as the farmout agreement has become effective. This may not be until the agreement has been approved or registered by the designated authority under the relevant statute. During the interim period, if the earning obligations commence (as they often do before approval and registration), the farmee may wish to provide that the farmor must vote in respect of the farmee's prospective interest in accordance with the farmee's directions. The farmor may resist this on the basis that the farmee's interest is still contingent.
3. With an immediate transfer farmout, even after approval and registration, the farmor may insist upon controlling the vote attached to the interest being earned until the completion of the earning obligations. From the farmee's perspective, such an attitude is difficult to justify and should be resisted.

Restrictions on the Farmor's Rights during the Earning Period

In deferred transfer farmouts, where the farmor is left in control of the interest being earned until the completion of the earning obligations, a further issue from the farmee's perspective is whether there should not be restrictions placed on the farmor's rights during the earning period. For example, if the farmor is the sole permittee or licensee, should it not be restricted from placing any charge or other encumbrance on the permit or licence during the earning period? If the farmor is a participant in an existing joint venture, appropriate restrictions might relate to the farmor's ability to approve work programs and budgets, enter into any sole risk undertakings, assign, charge or otherwise encumber its participating interest, consent to an assignment by any other participant, agree to the abandonment of any well, or withdraw from the joint venture.

Farmee's Right to Sell Down during the Earning Period

In the past, when multiple dealings in permits and licences were more common, it was not unusual for a farmee during the earning period to want to pass on to another party part of its earning obligation in return for an assignment of part of the interest being earned or the right to acquire it.[13] For an entrepreneurial farmee with limited financial resources, the ability to do this, if necessary, is desirable. This would generally need a specific right to assign under the farmout agreement itself. Furthermore, where the farmor is in an existing joint venture, it would be a further dealing (or sub-farmout) of the interest under the joint operating agreement and may only be possible if permitted by the assignment clause in that agreement as well. If there are pre-emptive rights under the joint operating agreement, they may be triggered by a further dealing by the farmee during the earning period. Also, many joint operating agreements specify a minimum participating interest so that multiple dealings in interests do not dissect the underlying permit or licence into too many fragmentary parts and do not make the joint venture unworkable through the introduction of too many new participants. A minimum participating interest would often be 5%, meaning theoretically that there could be up to 20 members in the joint venture, although a joint venture of that size is almost unimaginable.

Right of Farmee to Second Staff to the Joint Operations

If the farmee is not the operator, it may have an interest in seconding members of its staff to the farmor (if it will be carrying out joint operations on behalf of itself as the farmee) or to the operator of the joint venture of which the farmor is part. The farmee might look at this possibility if it wants to monitor the joint operations from the inside during the earning period, or if the area is highly prospective and

[13] *Australian Energy Ltd v Lennard Oil NL* [1986] 2 Qd R 216 is an illustration of multiple dealings in permits and licences (in this case, a Queensland Authority to Prospect) and the problems that these practices (common in the past) gave rise to.

development (in which the farmee expects to participate) is likely to follow the earning period.

Liability and Insurance

If the farmee is the operator during the earning period, it will be concerned about its liability to third parties during that period. Should there be circumstances outside the farmee's control where the farmor should share those liabilities? Normally, where the farmee is in control of the work on the permit or licence during the earning period and fully funding it, one might envisage that the liability for any consequences should rest with the farmee. However, natural disasters or other extraneous events during the earning period might cause loss or damage to other parties which the farmee had no means of preventing. There is a case to say that the farmor, as a beneficiary of the work being carried out, should share this liability.

Alternatively, or perhaps in addition, the farmee may need to consider whether it needs to take out insurance during the earning period to cover such liabilities, and also the consequences of its own negligence.

REGULATORY ISSUES

Ministerial Approval and Registration

The need for statutory approval and registration has already been mentioned in a number of contexts. I shall examine the need for this under the *Petroleum (Submerged Lands) Act* of the Commonwealth.[14]

A farmout of a permit or licence in the offshore area will have one or more of the following effects:

(a) the creation or assignment of an interest in an existing title;
(b) the creation or assignment of a right (conditional or otherwise) to the assignment of an interest in an existing title; or
(c) the creation or assignment of an option (conditional or otherwise) to enter into a dealing having the effect referred to in para (a) or (b).

As such, it will be a dealing to which s 81 of the *Petroleum (Submerged Lands) Act*[15] applies and will be of no force insofar as the dealing would have that effect until the dealing has been approved and registered in accordance with that section. Under the Commonwealth Act, approval is required from the Joint Authority for

[14] For an analysis of the provisions, see Tim Warman, "Transfer of, and Dealings in, Titles under the *Petroleum (Submerged Lands) Act 1967* (Cth) within the Western Australian Adjacent Area" (2000) 19 AMPLJ 54.

[15] Compare Offshore Petroleum Bill ss 269 and 270.

the adjacent area in which the licence or permit is situated (consisting of the Commonwealth Minister and the relevant State or Territory Minister), and the dealing must be entered in the Register by the Designated Authority (being the relevant State or Territory Minister).

For the farmee wishing to obtain a valid interest in a permit or licence, these requirements are of vital interest and concern. The assignment of an interest to the farmee under the farmout agreement, either immediately or on a progressive or deferred basis, will be of no effect without ministerial approval and registration. Where a farmout is done on an immediate assignment basis, and the earning obligation is not completed, the re-assignment of the interest in the permit or licence to the farmor would also require approval and registration (which should be of concern to the farmor).

It is common therefore to find in farmout agreements a provision such as the following:

> "Each dealing evidenced by this Agreement as having one or more of the effects described in section 81(1) of the *Petroleum (Submerged Lands) Act* is of no force or effect until it has been approved, and an entry has been made in the register pursuant to section 81(12) of the Act."

Section 81(12) provides that:

> "If the Joint Authority approves a dealing, the Designated Authority shall endorse on the original instrument evidencing the dealing and on one copy of that instrument or, if the original instrument was not lodged with the application, on 2 of the copies of that instrument a memorandum of approval and, on payment of the fee provided by the Registration Fees Act, make an entry of the approval of the dealing in the Register on the memorial relating to, or on the copy of, the title in respect of which the approval is sought."[16]

Until that occurs, the farmee's expectation of acquiring an interest in the permit or licence is "of no force" (a term which is interpreted to mean "ineffective" and therefore not capable of being enforced) in order to create or assign an interest, although it is not illegal.[17]

However, other provisions of the farmout agreement which do not themselves involve a dealing in the permit or licence may still be binding contractual obligations. This may leave a farmee in the unenviable position, pending approval and registration under s 81, where it is bound to carry out its earning obligations although it is not assured of obtaining an effective assignment of the interest. The only sure way of avoiding this problem is to delay the commencement of the work or expenditure constituting the earning obligations until approval and registration have been completed, but this is not always practical. The procedures for approval and registration can take up to three months (even longer in some cases) and commercial realities may require work to commence before then.

[16] Compare Offshore Petroleum Bill s 276.

[17] The corresponding provision (before amendment in 1985) in the *Petroleum Act 1967* (WA) was applied in *Swan Resources v Southern Pacific Hotel Corporation Energy Pty Ltd* [1983] WAR 39 with Burt CJ and Wickham J adopting different interpretations.

Some farmout agreements endeavour to overcome this problem by providing that, during the period between the date of the agreement and the satisfaction of the approval and registration conditions, the farmor shall hold the farmout interest on trust absolutely for the exclusive benefit of the farmee. I do not see how this solves the problem. The declaration of a trust is the creation of an equitable interest which would itself constitute a dealing in the permit or licence. If appropriately drafted, it may be argued that the trust created is not an interest in the permit or licence itself but in the future production from it if exploration and development is successful, but I am doubtful that this would take it outside the scope of s 81. In any event, for a farmee seeking an interest in an exploration permit, it is not very satisfactory to be told that, in the absence of approval and registration, it may acquire a right to a share of future production which may not occur until many years hence.

Transfer of the Permit or Licence to Include the Farmee

A farmee, particularly at the exploration stage, will usually be content with a registered equitable interest in the permit or licence. However, in some instances, it may be important for the farmee to actually become one of the title holders. As titles under the *Petroleum (Submerged Lands) Act* can only be held by multiple parties as joint tenants in undivided shares, the introduction of a new title holder requires a transfer from the existing holder or holders (say A and B) to themselves plus the new titleholder (say A, B and C).

Under s 78 of the Act,[18] a transfer of a title is of no force until it has been approved by the Joint Authority and an instrument of transfer has been registered in accordance with that section. The section spells out in detail the procedure to be followed, which will finally result in the transferee or transferees becoming the new registered holder or holders of the permit or licence. If this is the outcome required by the farmee, then it will need to observe in detail the provisions of the section.

Foreign Investment Approval

If the farmee is a foreign person as defined in the *Foreign Acquisitions and Takeovers Act 1975* (Cth), and the interest to be acquired by it under the farmout exceeds certain thresholds, that acquisition may be subject to approval under that Act. More specifically, the Commonwealth Treasurer may decide that it is not in the national interest to allow the acquisition to proceed and may issue an order to this effect under s 19(2) prohibiting the proposed acquisition.

The *Foreign Acquisitions and Takeovers Act* is administered in accordance with the government's foreign investment policy and with the assistance of the Foreign Investment Review Board (FIRB), an advisory body which has no specific statutory basis or power. The foreign investment policy is (rather inadequately)

[18] Compare Offshore Petroleum Bill s 256.

explained in the booklet entitled "Australia's Foreign Investment Policy: A Guide for Investors".[19] This booklet makes the statement that:

> "Proposals to acquire an interest in an existing mineral exploration right (through, for example, 'farm-in' or 'farm-out' arrangements or a re-arrangement of interests in a joint venture agreement) are exempt from examination under the Foreign Acquisitions and Takeovers Act."

Although it is not clear, it is assumed that this applies to oil and gas farmouts as well. "Mining" is stated to include the extraction of hydrocarbons and the stated policy is that: "Proposals to be examined in the mining sector (ie those valued over $50 million) will normally be approved unless judged contrary to the national interest."

The Commonwealth Treasurer generally acts on the recommendation of FIRB but is not bound to do so. The procedure for a party such as a farmee seeking clearance of a potential acquisition is to prepare a Notice under s 25 of the Act and submit it together with such other detailed information and submissions as may be required or considered desirable to the Executive Member of FIRB in the Treasury in Canberra. Submissions must be considered within 30 days and a further 10 days is allowed to communicate the Treasurer's decision to the applicant. As a result of these statutory periods, if an applicant has not received a response within 40 days, it can generally proceed on the basis that there is no objection to the acquisition.

Chapter 11 of the *Australia/United States Free Trade Agreement*, which entered into force on 1 January 2005, has eased the foreign investment restrictions for US investment in Australia. The threshold for review by FIRB of investment in Australian businesses (other than in financial companies and sensitive industries such as nuclear facilities and materials) has been increased to A$800 million.[20]

Therefore, the farmout of Australian licences and permits to US farmees has been considerably liberalised.

Trade Practices Act

Because upstream oil and gas exploration and development is a very competitive business in Australia with a significant number of participants (both small and large) trade practices issues do not usually impinge upon the acquisition (through farmout or otherwise) of an interest in a permit or licence. It is highly unlikely that a farmee entering into a farmout agreement will be engaging in an activity which might substantially lessen the competition in a market or lead to the creation of a monopoly.[21]

[19] Last issued in September 1992.

[20] The Australia/US Free Trade Agreement has been implemented by the *US Free Trade Implementation Act 2004* (Cth). Schedule 5 amends the *Foreign Acquisitions and Takeovers Act 1975*.

[21] *Trade Practices Act 1974* (Cth) ss 45 and 46. See also R I Cottee, "Comment on Assignment Clauses in Mining and Petroleum Joint Ventures" [1986] AMPLA Yearbook 141.

However, where a pipeline is involved, trade practices issues may be relevant. For example, if the farmee is seeking to earn an interest in a permit or licence which is adjacent to a producing off-shore field connected to the coast (and to markets) by an existing pipeline, where the farmor is the owner or one of the owners of the producing field and the existing pipeline, then future access to the pipeline may be important. This will be an issue under Pt IIIA of the *Trade Practices Act*.[22]

REVENUE ISSUES

Income Tax

One of the main rationales for farmouts, rather than a direct sale or assignment of interests in permits and licences or the sale of shares in a company which is the holder of permits and licences, is that a farmee which expends money on earning an interest will generally be able to obtain its own tax deductions for that expenditure.

The main attraction for a farmee will normally be that expenditure on exploration or prospecting for petroleum (defined to include geological, geophysical and geochemical surveys and exploration drilling and appraisal drilling) is deductible outright in the year in which it is incurred.[23] Such expenditure is deductible against income from any source. However, expenditure on development drilling for petroleum, or on operations in the course of working a petroleum field, are specifically not deductible under this provision.[24] Furthermore, for exploration or prospecting expenditure to be deductible, the person claiming the deduction must satisfy at least one of three activity tests:

(a) the person must carry on "mining operations" (defined to include operations for the purpose of obtaining petroleum);
(b) it must be reasonable to conclude that the person proposed to carry on such operations;
(c) the person must carry on a business of, or a business that included, exploration or prospecting for minerals (including petroleum) and the expenditure was necessarily incurred in carrying on that business.[25]

One would normally expect that a farmee will satisfy one of these tests.

Where the expenditure is on a depreciating asset that is first used for exploration or prospecting and one of the three activity tests above is satisfied, an immediate deduction is available for the cost of the asset under the ordinary capital allowance provisions rather than the exploration or prospecting provisions.[26] Prospecting or mining rights and information are depreciating assets and an

[22] See especially ss 44B, 44C, 44H and 44ZZ.
[23] See *Income Tax Assessment Act 1997* s 40-730.
[24] *Income Tax Assessment Act 1997* s 40-730(2).
[25] Section 40-730(1).
[26] See *Income Tax Assessment Act 1997* s 40-80.

immediate deduction is available for their cost when they are first used for exploration or prospecting.[27] The costs of acquiring such items therefore become depreciable against assessable income under the new uniform capital allowance rules.[28] When rights and information are disposed of (for example, by an interest in them being assigned by a farmor to a farmee), a balancing adjustment may be required. The balancing adjustment rules of the uniform capital allowance system generally apply to such assets acquired after 1 July 2001,[29] and not the capital gains tax provisions.[30]

Previously, there was a deduction for "allowable capital expenditure".[31] In the past, where a farmout involved a payment by way of reimbursement from the farmee to the farmor, and that payment could be related to undeducted allowable capital expenditure of the farmor, it was possible for the farmee and the farmor to agree that the whole or part of that payment (not exceeding the undeducted amount of the allowable capital expenditure) could be allocated to the allowable capital expenditure. This was done under s 124AB of the *Income Tax Assessment Act 1936* which was transferred to the *Income Tax Assessment Act 1997* as part of subdiv 330-E (Selling a right or information). However, that subdivision (along with the whole of Div 330 relating to mining, including "petroleum mining", and quarrying) was repealed in 2001. As a result, provisions in farmout agreements and other agreements for the assignment of interests in petroleum permits and licences relating to the reallocation of allowable capital expenditure are no longer pertinent.

Project expenditure that is not the cost of a depreciating asset may be deductible over the estimated life of the project under the pooled project expenditure provisions.[32] An analysis of those provisions is beyond the scope of this paper.

Capital Gains Tax

A farmout involves the disposal of assets by the farmor to the farmee, and a corresponding acquisition by the farmee. As such, it is a transaction which may result in capital gains tax (CGT) for the farmor and the creation of a cost base of the relevant assets for the farmee. Shortly after the introduction of CGT, these matters were considered by the Commissioner of Taxation in *Income Tax Ruling*

27 Sections 40-30(2) and 40-80(1).

28 For an analysis of the impact of these rules, and other new tax measures, see R Henderson, C Franchina and H Wiseman, "Buying and Selling Petroleum Interests – Impact of Tax Consolidation and Other Tax Reform Measures" (2005) APPEA Journal 643.

29 Subdivision 40-D. This appears now to apply to mining information although TR98/3 (see below) had ruled that such information is not property and therefore the balancing adjustment provisions in subdiv 330-480 (now repealed) did not apply to it.

30 R Henderson, C Franchina & H Wiseman, op cit n 28, at 644.

31 *Income Tax Assessment Act 1936* Pt III, Div 10 and the *Income Tax Assessment Act 1997* subdiv 330-C.

32 See the *Income Tax Assessment Act 1997* subdiv 40-I (capital expenditure that is deductible over time) which was introduced in 2001.

IT2378 dealing with the practical application of the capital gains provisions as they affect farmout arrangements entered into for the purpose of exploration for and discovery of minerals (including petroleum).[33]

Although IT2378 adopts a wider meaning of farmout than discussed in this paper, and although having been issued in December 1986 it is in some respects out of date (referring to old section references), much of it is still pertinent. In considering the disposal of an interest in a prospecting right under a farmout arrangement for a commitment to undertake exploration expenditure without any further consideration, the Ruling states as follows:

> "Subsection 160ZD(2) operates in the circumstances to deem the consideration for the disposal for capital gains purposes to be the market value … of the asset at the time of disposal. The time of disposal, ascertained in accordance with the provisions of section 160U, would generally depend on the terms of the agreement between the parties. In the case of an up-front transfer of an interest in a prospecting right at the wildcat or grass roots stage, the market value at the time of disposal would generally be low if not nil. In the event that a discovery is made subsequent to the date of disposal which greatly increases the value of the interest, that, of course, will not alter, with the benefit of hindsight, what was the market value at the date of disposal. By the same token, if unsuccessful exploration subsequent to the date of disposal results in a reduction in the then value of the interest, that will not alter what was the market value of the interest at the date of disposal."[34]

Much of IT2378 is concerned with the proper determination of the value of a prospecting or mining right for these purposes. It contains some very detailed but highly relevant hypothetical examples.

The acquisition and disposal of mining information is problematical. There is a definition of "mining, quarrying or prospecting information" in s 40-730 of the *Income Tax Assessment Act 1997* covering geological, geophysical or technical information that relates to the presence, absence or extent of deposits of minerals (including petroleum) in an area. However, in *Taxation Ruling TR98/3*, the Commissioner has made the following points about such information:

- mining information itself is not a CGT asset, although the physical medium embodying it (paper, computer memory, floppy disk) is a CGT asset which normally has a negligible value;
- exploration or prospecting expenditure incurred in obtaining mining information does not form part of the cost base of a mining, quarrying or prospecting right; and

33 For commentary on CGT generally and IT2378 in particular, see R J Vann, "Impact of Tax Changes – Capital Gains Tax and Mining" [1987] AMPLA Yearbook 468. See also G S Pratt, "Disposal of Mining and Petroleum Interests and Current Revenue Considerations – Capital Gains Tax Impacts" [1988] AMPLA Yearbook 322.

34 IT 2378 (dated 24 December 1986) para 8.

- costs incurred in acquiring mining information (for example, relevant exploration or prospecting expenditure) do not form part of the cost base of goodwill for the purposes of working out a capital gain on the disposal of goodwill.[35]

It is noted that the Commissioner's position in TR98/3 departs from his earlier view expressed in IT2378 that exploration and prospecting expenditure is capital in nature incurred "in respect of" the prospecting right. The Commissioner appears now to consider that "in respect of" means expenditure incurred to acquire or improve the property and because information may be about a certain prospecting right does not mean that it is in respect of a prospecting right.[36] Neither tax ruling would appear to apply if the prospecting or mining rights or information were acquired after 1 July 2001 and are dealt with under the uniform capital allowance provisions rather than the CGT provisions (as suggested above).[37]

If the farmor acquired the prospecting or mining rights or information, which are the subject of the farmout, before 1 July 2001, it will be concerned about the basis on which the consideration for the farmout, namely the farmee's earning obligation, is apportioned between the permit or licence, the associated information and other assets for CGT purposes. From the farmee's perspective, it will want to treat the earning obligation either as expenditure on exploration or prospecting, or the acquisition of a depreciable asset (prospecting or mining rights or information) to be used for exploration or prospecting, so that it can claim an income tax deduction for the full amount immediately.

Royalties

A royalty is imposed upon petroleum recovered from submerged lands adjacent to the Australian coast by the *Petroleum (Submerged Lands) (Royalty) Act 1967,*[38] but by virtue of s 4A the Act only applies to:

(a) the North West Shelf exploration permits;
(b) leases that are related to the North West Shelf exploration permits; and
(c) licences that are related to the North West Shelf exploration permits.[39]

This is part of the political deal whereby petroleum resource rent tax was applied to offshore projects (principally Bass Strait) except the North West Shelf. The Commonwealth levies crude oil excise and a royalty on the North West Shelf, and the Commonwealth shares the royalty with Western Australia.

The prescribed rate for the royalty is 10% of the value at the well-head of the petroleum. However, this prescribed rate may be varied in respect of petroleum

[35] TR 98/3 (dated 18 March 1998) para 8.
[36] Charles Birch, op cit n 1 at 90.
[37] See under "Income tax" and R Henderson, C Franchina & H Wiseman, op cit n 28.
[38] To be replaced by the Offshore Petroleum (Royalty) Bill 2005.
[39] Compare Offshore Petroleum (Royalty) Bill s 5.

recovered under a secondary licence, or where a licence is granted after the surrender or cancellation of an earlier licence.

The royalty is payable to the Designated Authority by the permittee or licensee, which means that in the case of joint holders they would be jointly liable for it. The farmee will only share this liability when the permit or licence is transferred to include it as one of the holders. Before that point in time but after the farmee has received an assignment of a beneficial interest in the permit or licence, the farmee can expect that the farmor will require the farmee to bear a proportionate part of the royalty. However, this of course only arises when petroleum is produced.

Although it is not likely to be relevant for most farmouts, I mention for completeness that the crude oil excess, which was introduced by the Whitlam Government in August 1975 is imposed under the *Excise Tariff Act 1921* (Cth) upon the entry of the oil for home consumption. The *Petroleum Excise (Prices) Act 1987* (Cth) establishes the prices in relation to which the excise is imposed. The system has been greatly complicated since October 1984 by the arrangements introduced by the government to encourage development of fields that had not been developed because of inadequate returns. As a result, there are now different prescribed rates of excise for:

(a) oil discovered before 18 September 1975 ("old oil");
(b) oil discovered before 18 September 1975 but not developed as of 23 October 1984 ("intermediate oil"); and
(c) oil produced from naturally-occurring discrete accumulations discovered on or after 18 September 1974 ("new oil").[40]

Petroleum Resource Rent Tax

Petroleum resource rent tax (PRRT) was introduced in 1987 and is imposed by the *Petroleum Resource Rent Tax Act 1987* (Cth) in respect of the "taxable profits" of certain petroleum projects. The rate of tax is 40%. As with all federal taxes, for constitutional reasons, the Act which imposes PRRT is separate from the Act under which it is assessed. The latter Act is the *Petroleum Resource Rent Tax Assessment Act 1987* (Cth) which, like most such legislation is a complex verbal maze. One needs to glean, first of all, that the petroleum projects to which PRRT applies are only those under an "eligible production licence" which is defined to mean a production licence "other than a production licence that is related to one of the North West Shelf exploration permits". The main operative provision is s 21 under which PRRT is payable "in respect of the taxable profit of a person of a year of tax in relation to a petroleum project". The meaning of "taxable profit" is determined under s 22; basically, it is the amount by which assessable receipts exceed deductible expenditure.[41]

[40] See Department of Parliamentary Library Research Note on "Crude Oil Excise and Royalties" No 29, 2000-01.

[41] For a commentary on PRRT in its formative stages, see R E S Argyle, "Resource Rent Tax – The Commonwealth Proposals" [1984] AMPLA Yearbook 283.

For the purposes of a farmout, the most relevant provision of the *Petroleum Resource Rent Tax Act* is s 48A relating to the transfer of part of an entitlement to assessable receipts. The section applies if a person enters into a transaction that has the effect of transferring part only of the person's entitlement to derive, after the transfer, assessable receipts in relation to a petroleum project. Under the provisions of the section, the purchaser is taken to have derived receipts and incurred expenditure, and the vendor is taken not to have derived the receipts or incurred the expenditure.

It is appropriate for the farmout agreement to make provision to facilitate the application of s 48A for the benefit of both the farmor and the farmee.

Goods and Services Tax

As the general application of goods and services tax (GST) is well known; it will not be described in this paper. The provisions which are particularly pertinent to mining and petroleum joint venture and farmout arrangements are those pertaining to GST joint ventures and the sale of a going concern.[42]

In mining and petroleum joint ventures, one company (the manager or operator) often acquires or supplies things for the joint venture on behalf of the other joint venturers. Rather than each joint venturer being required to account for its share of such supplies and acquisitions, they may apply to the Commissioner to be treated as a GST joint venture. The effect of forming a GST joint venture is that one member, known as the joint venture operator, pays the GST and is entitled to the input tax credits on supplies and acquisitions it makes on behalf of the other joint venturers for the purposes of the joint venture. Companies can form a GST joint venture in this way if each company:

(a) is a party to the joint venture agreement;
(b) is registered for GST;
(c) accounts for GST on the same basis (that is, cash or non-cash); and
(d) participates in the joint venture.[43]

The joint venture operator (unlike the other companies) does not have to be a party to the joint venture agreement. This reflects the practice (more common in the mining industry than the petroleum industry) where the joint venture operator is sometimes a stand-alone company which is not itself a joint venturer.

If there is an existing GST joint venture at the time of a farmout, the farmee will be concerned to know when and on what basis it will become a member of the GST joint venture. This is something which should probably be covered in the farmout agreement.

[42] See generally W D Thompson, "GST and the Resources Industry" [2000] AMPLA Yearbook 430 and in particular pp 449-453 about supplies of going concerns and pp 456-460 about GST joint ventures and groups.

[43] *A New Tax System (Goods and Services Tax) Act 1999* s 51-10.

The application of GST to the farmout transaction itself is a matter which has caused considerable difficulty. In its publication *Mining and Energy & The New Tax System,*[44] the ATO provided the following example of a farmin/farmout arrangement:

> "The Outback Exploration company has a permit to explore Tenement One. The Fareast Exploration company agrees to undertake the seismic survey required by the permit. In exchange, Outback Exploration grants Fareast Exploration an interest in the tenement of five per cent of future production. For GST purposes, Outback Exploration's granting of a right (or interest in the tenement) represents a taxable supply by Outback to Fareast. The work done by Fareast Exploration is the consideration for the supply. This transaction will therefore be subject to GST. The supply of the seismic survey by Fareast is also a taxable supply from Fareast to Outback. This is a barter so both sides of the transaction are taxable supplies."

If this is the case, then both the farmor and the farmee would need to account for GST and each (separately) could claim an input tax credit. For the farmee to do this in respect of the taxable supply of an interest in the permit or licence, it would need to request a valid tax invoice from the farmor. Not only is this inconsistent with current practice in farmout arrangements, but the farmor may be reluctant to issue a tax invoice given that the assignment of an interest in the permit or licence is conditional upon the farmee completing its earning obligations. These issues were very well analysed in an article in the AMPLA Journal in November 2000 and a number of different solutions were proposed to the "double GST" problem.[45]

The first possible solution is to treat the farmout transaction as the supply of a going concern. The supply of a going concern is GST-free in the following circumstances:

(a) the purchaser (that is the farmee) must be registered or required to be registered for GST;
(b) the supplier (that is the farmor) must carry on the business until it is sold;
(c) all the things required for the continued operation of the business must be supplied;
(c) both parties must agree in writing that the supply is of a going concern; and
(e) the supply must be for consideration.[46]

The Australian Tax Office issued a GST Ruling on this subject in October 2002[47] which does clarify, and in some cases expand, the circumstances in which the ATO will apply the exemption. In elaborating upon all of the things that are necessary for the continued operation of an enterprise, the Ruling has introduced a new concept of "operating structure and process". It does not attempt to define this term but states that "the structure and processes used by the supplier in the

44 Second Edition Revised 30/5/2000.
45 See Tania Mykyta, "Farm-in Arrangements in the Mining Industry: the GST Implications" (2000) 19 AMPLJ 247.
46 *A New Tax System (Goods and Services Tax) Act* s 38-325.
47 GSTR 2002/5 (dated 16 October 2002).

operation of the development enterprise must be supplied by the supplier to the recipient if the recipient is to be placed in a position to continue to operate the enterprise in the future".[48] There follows a non-exhaustive list of all things commonly necessary for the operation of an enterprise: premises, statutory licences and permits, quotas or similar statutory authorisations, the benefit of covenants under a lease, goodwill, restrictive covenants, intellectual property, franchises and staff.

Generally, the new Ruling concentrates more on the necessity for the supply of the business operation and structure rather than requiring the supply of each individual business asset. Furthermore, the Ruling recognises that it may not be possible for a supplier to transfer or convey some of the things necessary for the continued operation of the enterprise. This may apply to statutory licences, permits and quotas and also to rights under an existing contract. In these circumstances, surrender and re-issue of the statutory rights or novation of the contract by a third party may be sufficient, and be taken to be a supply to the recipient.

Subject to observing the requirements, it should normally be possible for a sale of a resource project to be treated as a supply of a going concern. The more difficult case is the sale of an interest in a joint venture, or the assignment of it pursuant to a farmout. There has to be doubt whether a separate joint venture interest (which is really a slice of a larger pie) is a separate enterprise in the relevant sense. This issue is dealt with at para 195 of the Ruling which states as follows:

> "Whether or not a business structure is a joint venture is a matter of fact. If the business structure is a joint venture, then each joint venturer is an entity which is capable of conducting an enterprise. Provided that all the requirements of section 38-325 are satisfied, it is possible for a joint venturer entity to make a GST free 'supply of a going concern'. This may be when part or all of the enterprise conducted by the joint venturer is supplied, provided that what is supplied is all of the things that are necessary for the continued operation of the 'identified enterprise'."[49]

This must be our guide when drafting farmout agreements which are intended to be the supply of a going concern for GST purposes. If this result is achieved, then there will be no GST on the supply by the farmor to the farmee, no need for a tax invoice and no input tax credit which the farmee can claim. However, this does not alter the application of GST to the other side of the transaction. The farmee will need to account for GST on the consideration it provides (work or expenditure) and may need to supply a tax invoice for this to the farmor if the farmor wants to claim an input tax credit.

The second possible solution, which may solve this "double GST" problem, is for the farmout agreement to be treated as a joint venture agreement for GST purposes (which may be separate and in addition to the underlying joint venture if

[48] GSTR 2002/5 at paras 75-82.
[49] GSTR 2002/5 para 195.

there is one). This would require the cooperation of the farmor and the farmee in registering their arrangements as a GST joint venture and for the farmee to be nominated as the joint venture operator for this purpose. Once registered, the supply of goods and services to each other within the GST joint venture would not be "taxable supplies" and would therefore be free from GST.

However, this second solution depends upon the farmout arrangement being properly characterised as a joint venture. Doubts have been expressed as to whether this is correct.[50] If it is not a joint venture but merely a contractual relationship then GST will apply as described in the example quoted above, treating it as a barter transaction with taxable supplies on both sides.

Registration Fees

Registration fees are applicable to both transfers of permits and licences under the *Petroleum (Submerged Lands) Act* and to dealings in them. The fees are imposed under the *Petroleum (Submerged Lands) (Registration Fees) Act 1967* (Cth).[51] In relation to a transfer of title, the fee is at the rate of 1.5% of the value of the consideration for the transfer or the value of the title transferred, whichever is the greater, or if the amount of that fee is less than the prescribed amount, the fee is the prescribed amount. The prescribed amount is currently $810. Similarly, in relation to dealings, the fee is at the rate of 1.5% of the value of the consideration for the dealing or, in certain cases, the value of the interest dealt with.

The Act does not provide which party should pay the registration fee, but normally it is the party wanting to have its interest brought into effect by the registration of a transfer or other instrument which is obliged to pay the fee. However, it is possible for a farmout agreement to provide that, as between the farmor and the farmee, the registration fee is to be borne jointly (or even by the farmor) and this might be a point of negotiation for the farmee.

With an immediate transfer farmout, where the earning obligation is not completed, the farmout agreement will generally provide for a reassignment of the interest. This would seem to be a second dealing with the permit or licence which should attract a second application of the registration fee, and in these circumstances it is the farmor which is interested in ensuring that the assignment is given effect. Therefore, the farmor will probably need to pay the registration fee applicable to the reassignment, although the farmout agreement might provide (more in hope than in expectation) that the departing farmee will pay it.

The application of the registration fee a second time to the reassignment is not something which appears to have attracted much attention. Where a farmout agreement provides for a separate instrument of reassignment to be executed by the farmee (perhaps under a power of attorney given to the farmor) then I do not see how this second application of the registration fee can be avoided. If the

50 Tania Mykyta, op cit n 45 at 254-5 referring to *Pursell v Newberry* (1968) 118 CLR 381.

51 To be replaced by the Offshore Petroleum (Registration Fees) Bill 2005.

farmout agreement provides for an automatic and self-executing reassignment at a certain point in time when the farmee has failed to complete the earning obligation, then possibly the farmout agreement as a whole will be treated by the Designated Authority as one dealing with only one application of the registration fee.

Stamp Duty

Finally, it should not be forgotten that, for dealings with permits and licences within the coastal waters which are under State or Territory jurisdiction, State or Territory stamp duty will be applicable. However, with the separate stamp duty legislation of six States and the Northern Territory to consider, that is a topic which is beyond the reasonable scope of this paper.

CONCLUSION

Farmout agreements will continue to be a common feature of the oil and gas industry because of the compulsion to share risk. But if the farmor's objective is to lay off part of the risk inherent in exploration and development, the farmee's objective must be to ensure that it assumes this risk on acceptable terms. The farmee must weigh up not only the commercial terms offered to it but also the various farmout, joint venture, regulatory and revenue issues covered in this paper.

From the farmee's perspective, a farmout should be a real opportunity to increase its oil and gas reserves through participation in exploration and development; not just a risky venture on a licence or permit held by another.

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