

# JVs FOR E&P

Joint ventures are becoming the new transaction of choice. Up-front preparation is key to achieving the most profitable structure.

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Joint ventures (JVs) in the oil patch are not a new phenomenon, but in today's uncertain capital and commodity-price environments, they have become increasingly popular with companies focused on shale plays. Traditional acquisition and divestiture (A&D) deals have long been the transaction of choice in the U.S. upstream sector, but the collapse in capital markets in late 2008 has accelerated the trend to JV transactions.

The probability that JV partnerships will run smoothly, not to mention profitably, depends on up-front preparation. To achieve the best outcome, the JV must be structured correctly, requiring detailed planning long before the deal is signed.

The upstream energy sector has historically seen the formation of many JVs. Two main types stand out: the cross-sector JV, where complementary skill sets are combined, and the asset exploitation JV, where the focus is on cost and synergy.

There are numerous examples of both types and certain companies have formed several JVs. ConocoPhillips exemplifies the cross-sector trend with its announcement in July 2009 of a JV with Abu Dhabi National Oil Co. (ADNOC) to develop and process sour gas from Shah gas field. Other ConocoPhillips JVs include the cross-sector, 50/50 JV with EnCana Corp., announced in 2006, which pools large Alberta oil-sands leases from EnCana with expansions in Conoco's U.S. refinery capacity. An example of an asset-exploitation JV is Aera

Energy LLC, the Shell E&P/ExxonMobil JV that is focused on California oil fields.

JVs are not always successful; ventures involving national oil companies in a number of Latin American assets are proof of that. As JVs develop in the upstream E&P sector, particularly among companies exploiting emerging shale-gas resources, the parties must be fully conscious of the risks and realize these complex deals take time, effort and patience to construct correctly.

## Transaction of choice

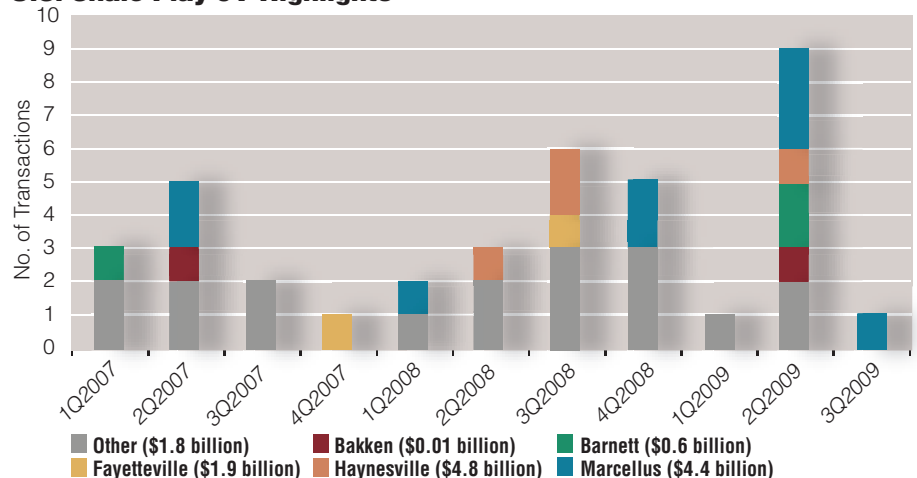
"Joint venture" is a relatively loose term. It speaks to the intentions of two or more companies to collaborate on a specific project or area for a reasonable period of time. This can include private-equity investments with finite time horizons.

JV activity in the U.S. and specifically in shale plays is on the rise. BG Group recently announced its first major upstream investment in the Lower 48 with a JV in upstream and mid-stream programs with Exco Resources Corp. in the Haynesville shale. Enerplus Resources Fund also recently announced a JV, with Chief Oil & Gas LLC in the Marcellus shale. Both transactions illustrate why more companies are turning to JVs.

Gordon J. Kerr, Enerplus chief executive officer, recently said, "The joint venture with Chief has given us entry into one of the best shale-gas plays in North America. We have great confidence in our partner's experience

**Shale-play joint ventures account for the lion's share of the \$13.5 billion in such transactions since first-quarter 2007.**

## U.S. Shale-Play JV Highlights



Source: Company Reports; IHS Herold; Tudor, Pickering, Holt & Co.

Pressure from banks to improve liquidity this fall is likely to continue fueling robust JV activity.

and, through our ability to expand our interests and share knowledge between our organizations, we believe we can create significant long-term value for our investors.”

This increase in activity was evident in the second half of 2008 during the collapse of the financial markets. There was also a large jump in the second quarter of 2009, with nine JV transactions—seven in shale plays, and two in the Gulf of Mexico—and one in the Marcellus as of the end of August.

In terms of value, shale-play JV activity accounts for the lion’s share, with 87% or \$11.7 billion of the \$13.5 billion in JV transactions since first-quarter 2007.

Although Chesapeake Energy Corp.’s recent four JV transactions ranged from \$1.9 billion to \$3.3 billion, many JVs involve minimal dollars. Often the arrangement simply involves the pooling of assets or acreage, and therefore flies below the radar.

In the U.S., the increase in JV activity is a logical progression. The E&P universe is splitting into two camps: companies with cash but without shale, and generally smaller companies with shale but less liquidity.

The impetus behind the current spate of JVs can be summarized for sellers as liquidity, monetization and upside retention. For buyers, resource access, technology and dollar exposure (for foreign buyers) are the drivers.

In the capital-constrained world of late 2008 and 2009, smaller E&P companies focusing on unconventional resources have been particularly vulnerable, because unconventional resources require significant capital.

Consider a moderate-sized acreage position in the Marcellus shale, where 100,000 acres might imply close to 1,000 wells. At \$4 million per well, this adds up to \$4 billion. Put another way, to develop the acreage in under 15 years implies using six rigs, each drilling one well per month, resulting in a drilling capex budget of \$288 million per year.

In deeper formations, well costs can be

more than twice those in the Marcellus, and land costs can be five times higher. Many shale plays will also require new gas gathering lines, as well as compression, processing and water-treatment facilities. It quickly becomes apparent why small companies such as Exco, and even larger companies such as Chesapeake, pursue JV partners.

Bank consortiums that were willing to lend capital in early 2008 and previous years have been applying pressure to many of their smaller E&P clients to strengthen balance sheets, cut back capital programs and look at monetization options. Selling production reduces cash flow, and selling a majority stake in the company or selling the assets can be complicated by debt covenants, so attention has turned to seeking JV partners in undeveloped shale positions. Pressure from banks to improve liquidity this fall is likely to continue fueling robust JV activity.

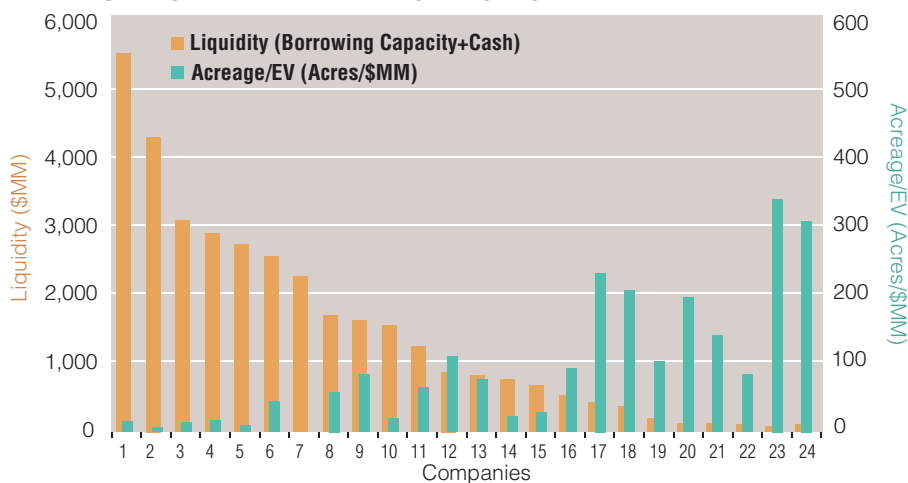
Another important JV rationale is the human element—two heads are better than one. In the Exco-BG pairing mentioned earlier, Exco has an excellent upstream operational team while BG has a leading LNG, midstream, storage and gas marketing skill set in the U.S. Similarly, Range Resources Corp. can focus on drilling and development in its recent Marcellus JV, while MarkWest Energy Partners LP brings knowledge of gathering, processing and fractionation.

Benefits StatoilHydro may have received from its JV with Chesapeake include setting up a partner for international unconventional resource technology growth; creating synergy with a U.S. gas trading and marketing business; accessing a large resource base with premium operator skills; and increased exposure to a stable fiscal region—diversified from Norway.

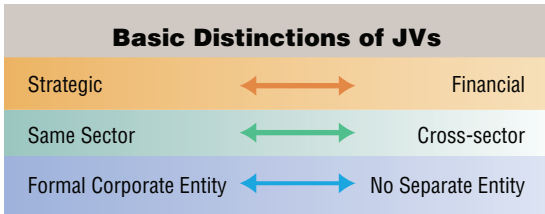
JVs are also compelling when two operators have offset acreage. Frequently, a large, experienced company wishes to increase scale and improve efficiency to reduce costs. A smaller company with offset acreage, meanwhile, sees an opportunity to pool data on well results, type curves, cores, seismic, services, etc., and to take

**The E&P universe has split into two camps: companies with cash but without shale, and generally smaller companies with shale but less liquidity.**

**E&P Liquidity And Shale Acreage Highlights**



Source: Company reports; Factset data as of Sept. 1, 2009



advantage of the larger company’s purchasing power.

**JV structures**

JVs are highly customized. The potential partners determine a structure and an agreement that fits their particular requirements. There are three broad categories of structure (see graphic above).

Strategic JVs are often open-ended, with no definitive end date, and they include an area of mutual interest (AMI) agreement that creates a zone of noncompetition for a specified period, allowing both partners to lease and add additional acreage to the drilling program.

Financial JVs are driven by a monetization event and therefore have a relatively shorter life. They often make more sense for companies with a build-and-sell model.

Whether to pursue a formal corporate entity depends on the companies involved. Creating a formal entity improves the liquidity of the investment, which is a more attractive option to financial players. Strategic players will be comfortable without a formal corporate entity and would paper the deal with highly customized joint exploration and development agreements (JEAs and JDAs), purchase and sale agreements (PSAs), and/or the joint operating agreement and the AMI.

There are various options for corporate structure of JVs established as subsidiary legal entities. Other than structure, the big buckets of JV

considerations are operations, legal, governance and management.

**Defining scope**

Scope is a key consideration in addressing the balance between specific limitations and operational flexibility. The scope for E&P companies generally boils down to accurately defining the counties and boundaries where the partners will pursue development jointly. A scope that is too restrictive limits the scale of the synergy, while one that is too broad is unwieldy and could limit independent action.

The duration and legal limitations pertaining to the region of noncompete must be discussed and decided early on. Business scope rather than regional scope must also be carefully defined in cross-sector or multiple-sector JVs.

It is useful to spell out a partner’s responsibilities with respect to intellectual property gained through operations; responsibility of the operating partner to standard care of management; and sharing and evaluation of asset opportunities.

**Transferability**

Another significant issue is transferability. JVs with private-equity backing are generally limited to seven years or less, with exit strategies and transferability defined at the outset.

Some JVs prescribe a right of first refusal or the less-defined right of first offer to the other party. The standard necessary to withhold consents on transferability, be it financial capability or otherwise, must be considered. While not common, a list of prohibited transferees might make sense in situations where midstream control concentration should be avoided.

Change-of-control language may refer to a tag-along right where a minority partner is protected if the majority or operating partner sells

**Joint ventures are highly customized according to partners’ specific needs.**

JV Considerations		
Operations	Legal	Governance & Management
<ul style="list-style-type: none"> <li>Scope of operations</li> <li>Valuation determination</li> <li>Due diligence</li> <li>Ownership rights</li> <li>Depth/formation rights</li> <li>Future drilling commitments</li> <li>Development plan</li> <li>Capital contributions</li> <li>Midstream operations</li> <li>Leverage existing capabilities</li> <li>Marketing arrangements</li> </ul>	<ul style="list-style-type: none"> <li>Title transfer</li> <li>AMIs</li> <li>Joint exploration agreement</li> <li>Joint development agreement</li> <li>Purchase and sale agreement</li> <li>Indemnification</li> <li>Exit mechanisms</li> <li>Health, safety &amp; regulatory</li> <li>Consents</li> <li>Service agreements</li> <li>Break-up fees</li> <li>Liquidated damages</li> <li>Transferability</li> </ul>	<ul style="list-style-type: none"> <li>Corporate structure (LLC, LP or C corp)</li> <li>Corporate jurisdiction</li> <li>Board members</li> <li>Manager vs. committee</li> <li>Decision-making body</li> <li>Voting</li> <li>Outsourcing services</li> <li>Arbitration</li> </ul>

**Parties anticipating a joint venture should consider a range of issues.**

Source: Tudor, Pickering, Holt & Co.

Clear delegation of control is important as a twinned organization is inherently more complex.

its entire position, or above a certain threshold of its position. In this case, the minority partner has the right to join the transaction.

### **Valuation and vision**

In typical A&D deals, the buyer generally values the assets higher than the seller. But a JV requires alignment on value and a similar plan for creation of value.

Assumptions and modeling approaches should be relatively transparent between parties. Otherwise, a disparity could delay the development and its potential. Using a JV advisor could assist in the selection of appropriate partners and help with the merging of economic valuation concepts and models.

### **Financial, operating aspects**

Mechanisms for defining and approving the development plan, typically a five-year plan updated annually and monitored quarterly, should be discussed up front. In cases involving international companies, the foreign entity may provide staff to the domestic operator to improve alignment and facilitate learning.

Decisions around well locations, AFE approval, and deepening or sidetracking wells may cause disagreement. Therefore, the organizations must ensure high levels of transparency and meet regularly in technical or operating committee meetings or more informal settings.

Upstream JV partners will usually address their approach to midstream build-out. Generally, the JV partners will cooperate on a plan to construct and jointly own the midstream or partner with a third-party provider of midstream services. Separate marketing of fluids may provide more independence but could negatively impact minority shareholders and be a conflict of interest.

In determining the financial plan for the JV, the key ingredient is clear definition of the budget and strategic plan. Capital by category, an allowable range of budget variance and time limits for counterproposals should be defined at the outset. If a new entity is formed, procedures on incurrence and management of debt and tax strategies are critical areas to discuss up front.

Mechanisms and details for capital contribution vary. Everything is influenced by the style of the deal; capital up front will differ from cash-plus-carry payments. Capital contribution may be cash-call-based or tied to strategic plan threshold points. Carry portions may have a time limit, and if the operator fails to fulfill the program within a preset period, the carry may be eliminated.

Carry contributions tend to be limited to well drilling only, while geology and geophysics items, gathering, etc., are heads-up.

One of the most significant challenges in relatively unproved acreage is balancing the opposing tendencies of one party to want financial commitment and the other to want an opportunity to exit should results not meet ini-

tial expectations.

Situations involving a failure to contribute may ultimately result in reduction of position or unit, dilution of interest, buy-out rights or liens. Escrow accounts are sometimes set up to hold a few months of capital and operating expenses. The return of cash must be discussed as well as mandatory distributions, the amount retained for operations, taxes and contingencies.

### **Management, operating considerations**

The management structure may be set up as a board of managers or an operating committee. Voting requirements for various levels of decisions may require unanimous, majority or supermajority approval. Veto powers for minority interests in certain circumstances may be requested. The partners will also have to discern which decisions require board approval versus operating committee approval or sole discretion.

Generally, operatorship stays with the originator. But if the larger company has extensive shale experience, for example, then operatorship would be transferred or shared. Operatorship generally depends on which partner has the better cost-control competencies, not who is the largest.

Clear delegation of control is important as a twinned organization is inherently more complex. Responsive decision making with alignment on process improvement is critical in shale-play development. Small companies with fewer bureaucratic procedures may get frustrated with larger organizations. The most successful organizations allow group think but also ensure clear authority for efficient decision making.

To break deadlocks, the JV may define a lock-up period to allow time for agreement before mediation or binding arbitration. Ultimately, dissolution of the venture may have to be considered for certain deadlocked disagreements. This is the exception, not the rule, however, as many successful JV examples prove such agreements can be highly beneficial to all parties. The key to success is thorough planning at the start.

JVs require a great deal of detailed thought and planning up front and, therefore, take longer to consummate than a typical purchase-and-sale agreement. In an uncertain economy and with the continuing popularity of capital-intensive unconventional assets, specifically shale gas, we do expect to see JVs among both U.S. and international companies to remain the transaction of choice for some time to come. When key considerations are taken into account, JVs can result in a pairing that becomes much more than the sum of its parts. □

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