



BELL GULLY



Disjointed Joint Ventures: Pohokura Gas Balancing Litigation

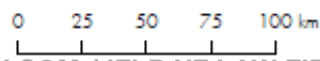
AMPLA Conference 2011
19 - 22 October 2011

David Coull
Partner
Bell Gully

Introduction

- *Todd Pohokura v Shell Exploration & OMV* (the Pohokura gas balancing litigation)
- Significant litigation involving disagreements as to production levels and gas off-take procedures
 - against the background of breakdown of JV relationship
- Other NZ case law relevant to joint venture relationships/disputes
- NZ courts have considerable experience in oil and gas litigation
 - likely to be directly relevant to comparable Australian situations

Location of Pohokura field



Pohokura litigation

- Pohokura gas and condensate field is located offshore Taranaki
- Gas produced is piped to onshore Maui high pressure gas transmission pipeline and through the North Island gas transmission network
- Demand for Pohokura gas entirely domestic
- Unincorporated joint venture between Shell (48%), OMV (26%) and Todd Energy (26%)
- Shell is operator; Shell and OMV can pass operating committee resolutions by majority vote

Primary legal issues considered by the High Court

- Claims under the JOA:
 - breach of Articles 10.1 and 10.3 of the JOA (largely based on AIPN Model Form)
 - breach of implied obligations of good faith by Shell and OMV
 - breach of fiduciary duties by Shell as the operator
- Off-take rules of “no effect” because Ministerial consent not obtained under section 41 of the Crown Minerals Act 1991
- Off-take rules breached the Commerce Act 1986
 - involved claims under sections 27, 29 and 30 (substantially lessening competition, exclusionary conduct and price fixing)

The proceeding

- High Court - 42 day hearing
- Judgment under appeal to the Court of Appeal (currently adjourned pending settlement discussions)
- Damages sought by Todd: \$320 million (plus exemplary damages of \$600 million)
- Extensive discovery (which directly influenced the outcome)
- Numerous interlocutory applications and decisions
 - evidential, causes of action, recusal of judge
 - costs hearing/award
- No stone left unturned by the parties

Basic timeline

- Preceded by much litigation between Shell and Todd (e.g., Maui and Pohokura operator removal proceedings) and a very strained relationship between them
- Pohokura discovery was made, and the JOA was amended to provide for the joint marketing of gas
- Authorisation obtained from NZ Commerce Commission for the joint marketing of sales gas
- In 2004, Shell and OMV told Todd they no longer wanted to jointly market gas with Todd and that they would separately market their gas entitlements

Basic timeline contd...

- At the same time, Shell and OMV concluded an “Alignment Agreement” (not known to Todd) under which they agreed to act together in relation to:
 - commissioning of facilities
 - rights and obligations to take gas
 - gas balancing and nominations
- Operator developed and presented a FDP to the JV with a view to FID
 - expectation in FDP was production at 70 PJ/a
 - all parties concluded conditional contracts to sell their gas entitlements (to enable FID commitment)

Basic timeline contd...

- FID taken June 2004
 - production facilities to have a nameplate capacity of 86 PJ/a
 - working assumption that plateau production would be 70 PJ/a
- Gas balancing discussions commence
 - Shell and Todd technical personnel wanted a GBA (to manage daily gas division and off-take)
 - marketing personnel had different view
 - Todd didn't want to constrain ability to take maximum proportionate entitlement
 - Shell didn't want to let Todd get ahead where there was risk the other venturers may not catch up

Basic timeline contd...

- Each party wanted a different form of GBA – ultimately, no GBA agreed
- Gas off-take rules and nomination protocols
 - primarily dealt with mechanical processes for hourly/daily nominations but allowed some degree of underlift/overlift
 - Shell/OMV reached common view about content of rules without Todd
 - Shell/OMV wanted to produce at a lower average rate of 70 PJ/a whereas Todd wanted to produce at “full steam”
 - Todd voted against off-take rules but they were approved by majority vote
 - Todd’s view based on legal advice was the rules were inconsistent with Article 10.1 and that such rules need unanimous agreement

Basic timeline contd...

- Work Programmes and Budgets
 - each WP&B from 2006 onwards proposed a level of production consistent with projections in the FDP and FID approval
 - Todd objected to each WP&B on basis it wrongly constrained production levels Todd was entitled to under JOA
- Drivers for different production rates?
 - Todd had flat profile contracts supplying base load requirements, and a 100% owned field which gave it flexibility
 - Shell and OMV's contracts had more "swing" and gave the gas purchasers more flexibility over each supply year
 - Shell and OMV used their majority voting position to limit production to 70 PJ/a when the field could have been produced at a higher rate

Breach of the JOA

- JOA based on 1995 AIPN Model Form
- Primary argument based on Article 10.1 of the JOA

Article 10.1 Right and Obligation to Take in Kind

Except as otherwise provided in this Article 10 or in Article 9, *each Party shall have the right and obligation to own, take in kind and separately dispose of the share of **total production available to it under this Agreement** in such quantities and in accordance with such procedures as may be set forth in the off-take agreement referred to in Article 10.2 or in the special arrangements for Natural Gas referred to in Article 10.3 provided that Operator shall have the right and authority in conducting the Joint Operations to use or flare as much Petroleum as may be reasonably required by it, and the quantities so used or flared shall be excluded from production estimates to be provided by Operator.*

Contract interpretation principles

- Well established legal principles applied
 - derived from *Investors Compensation v West Bromwich Building Society*
 - applied in NZ in *Boat Park*, *Gibbons Holdings* and *Vector Gas*
- Relevance of:
 - subsequent conduct/documentation (mutual vs unilateral)
 - U.S. experts – on meaning and intention underlying oil and gas JOAs
 - relevance of JOA boilerplate and headings
 - extrinsic material

Article 10.1 – Todd arguments

- Article 10.1 sets the right and obligation of each party to take production from the field
 - entitlement based on its proportionate share of “total production available”
- Article 10.1 creates an inflexible and constant right and obligation for each party to take its share of all production
- JV is stuck with inflexible position unless parties unanimously agree otherwise under Article 10.3 (i.e., a GBA)
- Majority cannot use voting position at OC to approve off-take rules and WP&Bs which fix annual production at 70 PJ/a
- Operator must produce “full out” at all times (and budget process limited to determining cost of production rather than to the quantities produced)

Article 10.1 – Court’s analysis

- Article 10.1 applied to each party’s share of actual production from the field as available to it under the JOA
- A key focus was on the meaning of “total production available”
 - Todd adopted a literal interpretation – the production that may be “available” is reflected in the capacity of the facilities constructed
- Fine linguistic points indicated intent that Article 10.1 refers to physical gas quantity reaching point where joint ownership ends
- Article 10.1 proviso allowing operator to flare petroleum suggested focus on quantities actually produced and available for delivery
- Contrast with “total available production” used in Article 10.2(b) (relating to oil lifting agreements)

Other indicia

- Todd pointed to other JOA provisions indicating intention to encourage petroleum exploitation but these were not sufficient to justify interpreting Article 10.1 to allow the minority to force operations up to full capacity at all times
- Reliance on internal documents outside the contract:
 - Todd pointed to Shell internal documents which supported Todd's interpretation
 - Court had regard to post-contractual conduct in the form of internal documents/papers, but not sufficient to contradict other indicia
- Todd's approach would create an "inflexible obligation":
 - an underlifter's share taken by another party who could take it
 - underlifter not entitled to compensation – rather would be liable for damages for not taking its share

Commercial considerations – inflexible obligation

- JOA suggested a flexible obligation for each party to take its entitlement:
 - other provisions contemplated underlifts/overlifts
 - link to the WP&B – “total production” should reflect the extent of production the operator has budgetary approval for
 - determining production levels fell within the scope of the JOA. Part of the operator’s task and the operating committee’s jurisdiction
- Todd’s approach would mean production dictated by the facilities’ nameplate capacity:
 - unrealistic to expect parties to commit to produce at levels over which they have no control for very long periods
 - inflexible commitment ignored possibility of changes to parties to JOA and also operational considerations

Article 10.1 - conclusion

- More than Article 10.1 would be required to impose an inflexible regime on the parties.
- Article 10.1 can be interpreted to accommodate an annual budget (and some flexibility):
 - link to budget setting process important to the overall conclusion on Article 10.1
- Court found that operator's WP&B setting following year's level of production can properly be approved by the majority
- Todd's interpretation that failure to agree a GBA forces parties into an inflexible commitment would put at risk investment returns for all parties and could not be sustained

Article 10.3 – special arrangements

- Article 10.3 provides for special arrangements for disposition of gas

Article 10.3 Natural Gas

The Parties may enter into special arrangements for the disposal of Natural Gas which are consistent with the Development Plan and subject to the terms of the Permit. Those arrangements may provide for joint marketing and sales of Natural Gas as may be agreed between the Parties from time to time.

- Article 10.3 is permissive rather than mandatory. Although a GBA was likely contemplated, there was no requirement to have one

Off-take rules a special arrangement?

- Shell/OMV argued that the off-take rules were “special arrangements for the disposition of natural gas”
 - did not require unanimity as they were “arrangements” and not an agreement
 - requirement for them to be consistent with FDP would not be necessary if unanimous agreement was required
- Todd’s position was they were not because agreement was required
 - parties must “enter into” them
 - arrangements may provide for joint marketing and sales “as may be agreed between the parties”

Court's approach to Article 10.3

- Court held Article 10.3 permitted special arrangements to be made by majority resolution of the OC
 - JOA made it clear the only forum for decisions was the OC
 - if the subject matter of such arrangements fell within the scope of the JV, reference to “the parties” to be interpreted as arrangements made by OC
 - arrangements for the disposal of natural gas came within scope of JV and were not in the list of unanimous matters
- Court's conclusion influenced by:
 - unrealistic to expect the procedural and mechanical matters not sufficiently addressed in Article 10.1 would simply take care of themselves
 - interpret JOA to provide a commercially workable set of procedures
 - if OC could not decide “special arrangements” by majority, then the JV could be paralysed and the minority could dictate production outcomes

Additional considerations

- Todd pointed to internal Shell documents raising doubts about the lawfulness of regulating gas off-take by a majority vote
 - Court considered the evidence but found it was not probative in establishing the “objective intention of the parties”
 - Court reluctant to deprive off-take rules of special arrangement status given the doubts essentially related to questions of law
- Todd argued the off-take rules were a GBA “in drag” (and both would constrain production). Court held off-take rules more limited
- Shell’s alternative ground also upheld
 - even if “special arrangements” required unanimity, the OC could still approve mechanisms to allow Article 10.1 to work (i.e. operationalising the JOA)
 - this basis would allow approval of limited off-take rules which provided for ascertaining quantities to enable Article 10.1 to work

Good faith obligations – two broad categories

- Implication in law based on nature of contractual relationship
 - trend towards implying a term requiring good faith
 - Court prepared to broaden good faith obligation (based on Australian cases)
- Extended good faith obligation to intra JV decisions made by a majority under the JOA
- Implication of good faith a constraint against perverse or irrational decision making, and an answer to Todd's concern the minority venturer was vulnerable to the majority
- Court held Todd could not establish JV majority had voted arbitrarily or perversely in approving the WP&Bs

Implication of good faith term

- Implication based on the factual matrix of the contract
 - *BP Refinery* tests, glossed by *Belize Telecom* decision
- Todd argued Shell/OMV breached implied obligations of good faith by voting in favour of resolutions approving the off-take rules and the WP&B. Obligations pleaded were:
 - to act honestly and reasonably having regard to interest of the other venturers
 - not to prevent JV party from enjoying full benefit of JV and its investment
 - not to exercise power or discretion for purpose extraneous to the JV
- Court tested allegations against background that off-take rules and WP&B had been approved in accordance with the JOA

Implication of good faith term

- Court held that specific forms of good faith pleaded by Todd did not arise within the Pohokura JOA contractual relationship
 - OMV/Shell free to protect own commercial interests in decisions relating to the JV
 - all parties had regard to their own commercial interests in decision making
 - parties don't need to have regard to interests of other venturers and subjugate their own interests
 - in this instance, parties free to act for purposes extraneous to the JV
- Exhaustive definition of obligations in JOA entitled the parties to protect and advance their own commercial interests
- There was an implied term not to act dishonestly or in bad faith

Lack of good faith established

- Lack of good faith shown by:
 - Shell/OMV covertly concluding an Alignment Agreement (committing themselves to vote together at the operating committee)
 - Shell's initiatives to prepare itself for separate gas marketing before telling Todd joint marketing initiatives were at an end
- Court found Shell's purpose re governance of JV was not to harm Todd. Rather it was to best advance Shell's wider interests
- Court held lack of good faith not sufficient to taint the decision to approve off-take rules or WP&B such that those decisions should be struck down
 - inevitable Shell/OMV would promote flexible off-take rules irrespective of alignment agreement
 - decision as to production level not arbitrary, and consistent with the FDP

Breach of fiduciary duty

- Todd alleged Shell as operator breached fiduciary duties owed to Todd in that it:
 - failed to act in best interest of Pohokura joint venturers
 - preferred the interests of some of the venturers over others
 - exercised JOA powers for extraneous purpose (i.e., to suit its commercial purposes)
- Fiduciary obligations not arise simply by virtue of one party being the operator:
 - their existence and extent requires situation-specific analysis to determine the extent to which venturers repose trust and confidence in the operator
 - some aspects of operator role may create fiduciary obligations but other aspects may not

Breach of fiduciary duty contd

- JOA described the parties' respective rights and obligations in much detail:
 - but the fiduciary duty exclusion did not extend to operator
- Shell argued that in proposing the off-take rules and WP&B the venturers did not abrogate their decisions to the operator:
 - although Shell's proposals as operator were influenced by its perspective as a venturer, it did not suppress information or mislead the JVPs when seeking approvals
 - any venturer could seek more information or argue their view in the OC. It was the OC who approved the off-take rules/budgets not the operator
- Court held no fiduciary duties were owed – venturers not vulnerable to discretionary judgments made for them by operator

Crown Minerals Act

- Section 41 requires transfers and certain dealings relating to petroleum permits to obtain Ministerial consent
 - if not obtained, the agreement is of no effect
 - relevant limb applies to “*agreements which impose an obligation relating to or affecting the production of petroleum or its proceeds*”
- Typically applies to product sale agreements, royalties and some operational contracts
- Purpose of provision to ensure Crown knows who controls or influences permits
- Court held that intra JV arrangements such as off-take rules are not caught

“A last word”

“I take the unusual step of recording my view that the issues this judgment leaves the parties to grapple with ought to be resolved by negotiation between them, not by further litigation. I venture that view not as a Judge apprehensive that the Court of Appeal might arrive at a different review on any of the material issues. Rather, I do so as a New Zealander concerned that the resource vested in these parties by virtue of the permit they have from the Crown deserves to be managed without the significant inefficiency caused by the distraction of this dispute.”

Key Themes

- Costs judgment
 - “Litigious equivalent of trench warfare: well resourced combatants taking every point”
 - Judge ordered a 40% uplift on the usual cost award in favour of Shell/OMV
- Levels of analysis
 - fine linguistic and syntactic analysis
 - overall commercial common sense and the bigger commercial picture
 - desire to achieve workable solutions and set of procedures consistent with original intention of the parties
- Development/production JOAs should not simply rely on the AIPN form – needs to be tailored to specific circumstances

Key Themes

- Desirability of ensuring material contractual arrangements are in place prior to FID
- Established contractual interpretation principles and doctrines applied
- Central importance of the “background facts and circumstances” and overall factual matrix
- Rejection of approach seeking to adduce evidence from overseas legal experts as to matters of interpretation
- Contractual and legal analysis influenced by the conduct of the parties in the years running up to the litigation and the conduct of the proceeding

Questions?

david.coull@bellgully.com
