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International
Accounting Standards
Board

INFORMATION FOR OBSERVERS

Board Meeting: **20 July 2006, London**

Project: **Short-term Convergence: Interests in Joint Ventures**

Subject: **Scenarios (Agenda Paper 12B)**

Scenario 1

Basic facts

Background

Four entities (the participants), A, B, C and D, each have rights to extract minerals from adjacent areas. Each entity has financed their respective acquisitions.

The participants enter into a contract to explore, develop and extract minerals from the combined area (the field).

A Joint Operating Agreement (JOA) covers the exploration, development and production arrangements. A legal entity is not established.

Each entity retains its legal ownership of the extractive rights for its defined area but the JOA establishes terms to develop and produce all of the hydrocarbons from the field. The effect is that the mineral reserves of the adjacent areas are pooled and these reserves will be proved up, developed and produced over the life of the JOA.

The JOA is for an indefinite period of time (to represent the estimated economic life of the field). Cancellation of the contract requires the unanimous consent of all of the participants. In the event of cancellation, all of the participants must agree on how to dispose of the joint assets (such as the equipment). The mineral rights would revert back to each participant. That is to say, they each would assume control of the rights they previously contributed to the JOA.

The JOA gives the participants the pre-emptive right to acquire the interest of a participant wishing to dispose of its interest in the arrangement. If they do not wish to exercise those pre-emptive rights, an exiting participant can sell their interest to a third party.

Participation rights

The participation percentage of each participant is determined in the JOA and is based on their respective share of the acreage held and contributed to the geologic area.[1]

A participant can elect not to participate in a designated activity, such as a new production or exploration well. The JOA provides for the sharing of the outputs and expenses to be adjusted based on which activities each participant contributes to. For example, if entity B elects not to participate in a particular drilling operation, entity B's output rights will be adjusted.

Operating arrangements

One participant has been designated as the operator.

The participants establish a 5-year strategic plan which covers the strategic financial and operating decisions of the joint arrangement. The plan is updated annually. The plan must be approved by all of the participants. The operator develops the field, within the strategic policy framework agreed to each year.

Each participant receives a share of the output from the field in proportion to each participant's interest, as outlined earlier.

Each participant is free to deal with its share of the production as it sees fit.

The operator:

- acquires all the equipment used in the joint operations, in its own name. However, the equipment is under the joint control of all the participants, who must all agree on the strategic issues about deployment and disposal;

- allocates its own employees to the joint activity and supervises them (on a full or part-time basis, depending on specific needs). Some of the employees used by the operator are employed specifically for, and only assigned to, the joint arrangement; and

[1] How a participant's percentage interest is determined in can vary from case to case, depending on the nature of the mineral, activities under the arrangement, etc. In some circumstances it will be based on their respective share of the acreage held and contributed to the geological area. It may also be an equal participation share in risks and benefits. The latter criterion happens in some arrangements which would also include exploration and evaluation activities and when potential reservoir amounts are an unknown parameter. Participants agree to participate equally in the costs of and benefits obtained by the arrangement. They also agree to equally share the risks that one of the mineral rights contributed to the arrangement do not have any economically viable reserves. The criteria ultimately elected will certainly have an impact on the attribution of costs and revenues, but not necessarily in the nature of the arrangement or in the type of direct and indirect interests that arise from it.

- invoices the other participants periodically for their share of expenses and capital expenditures, based on their relative contract's participation.

Other information

The useful life of extraction equipment is designed to be the same as, or less than, as the life of the field; however, some replacement and repair of equipment will occur over the life of the producing area.

Participants separately arrange the borrowings to finance their respective share of the equipment, working capital, and removing and dismantling costs at the end of the production cycle. Each participant is responsible only for its own borrowings.

Analysis

[Remainder part omitted from observer note]

Scenario 2

Basic facts

Two telecom entities (the venturers) have set up a partnership to which each venturer dedicates its share in a cable network. The terms of the arrangement are as follows:

- The cable network has been acquired jointly. The venturers have separately financed their share of the cable network acquisition.

- The strategic operating and financial decisions require the consent of both venturers.

- The joint venture has its own management team. The joint venture's management is in charge of maintaining the cable network and running the daily business operations under the strategic framework agreed upon by the venturers.

- The partnership has its own staff and equipment.

- Even if each venturer generally uses its share in the cable network it is allowed to use the other's share if needed, either because of a breakdown of its own network, an increase of demand, or other reasons. In return, the venturer will pay a compensation fee.

- Two external parties have access of up to 15% global capacity each, with a maximum external access of 30%, under operating lease agreements which are at market terms and can be renewed annually by mutual consent. Cancellation of the contract requires the unanimous consent of both participants. The venturers have no unilateral right to 'call' the network or equipment back, and the eventual residual value obtained at their disposal will be equally apportioned between both venturers.

- The partnership has arranged its own borrowings to finance the equipment and working capital expenditures with joint and several liabilities of the venturers as guarantors.

Analysis

[Remainder part omitted from observer note]

Scenario 3

Basic facts

Partnership C is formed by companies A and B specifically to tender for a public contract with state administration X for the construction of a highway between two cities.

A has its niche in the construction of bridges and shall be responsible for the construction of three bridges needed to cross rivers existing along the route.

B is responsible for the preparation and construction of all of the highway's other elements related to the road.

C is responsible for signing the contract with, and delivering the construction to, X. If the parties were to tender individually, each would be required to extend its operations to supply services it does not currently provide. C formalises a contractual arrangement that preserves the respective specialisations of each participant. C then contracts with A and B to complete performance.

Analysis

[Remainder part omitted from observer note]