A REVIEW OF SOME ASPECTS OF THE ORGANIZATION AND FINANCING OF MINERAL RESOURCE VENTURES

BY ROBERT C. NICHOLLS*

The financing of ventures for the exploration for and development and exploitation of petroleum and other minerals is influenced by such factors as the law relating to the ownership of petroleum and other minerals in situ, *the diverse nature of the operations themselves, the way in which the party or parties wish to structure the venture and the taxation implications that flow from those arrangements. In this article Mr Nicholls provides a succinct review of the relevant Australian and North American law and illustrates the diversity of the factors that must be considered when seeking finance for a mineral venture. Particular attention is drawn to the difficulties associated with securing finance before the stage when the mineral venture appears to be economically feasible. Mr Nicholls describes arrangements that have been developed to account for these difficulties such as overriding royalties, carried interests, net profits interests, production payments and gross revenue interests. Lastly, the author formulates a categorization of these concepts preparatory to examining their income tax implications in a later article to be published in the next issue of this Journal.*

Introduction

The purpose of this article is to review, in the Australian context, certain commercial concepts and arrangements which have their origins in the organization and financing of mineral resource ventures in North America.[1] The taxation implications under Australian law of the adoption of such arrangements in the exploration for and development and exploitation of Australian mineral resources will be examined in a later article to be published (by the same author) in the 1977 issue of this Journal.

> Financing of oil and gas transactions is like the law itself—a seamless web. An evaluation of all criteria is necessary in each instance and the ultimate form of the transaction will require negotiation, with price as only one of several variables. Perspective in all phases of the undertaking is necessary in order that one factor will not be given undue weight. For example, tax considerations to the detriment of ownership interests that may be acquired or retained. Financing is fluid under all circumstances, but when oil and gas is the object of

* LL.M. (Syd.); Solicitor of the Supreme Court of New South Wales; Part-time Lecturer in Law, University of Sydney.

[1] Many of the arrangements discussed in this paper originated in the organization and financing of ventures for the exploration for and development and exploitation of oil and gas. However, the arrangements have also been used to a significant extent in relation to minerals generally: Rocky Mountain Mineral Law Foundation (Ed.), *American Law of Mining* 1960-1975 (publ., Mathew Bender), Vol. 3, Title XVII, Ch. II, R. R. Helmick and J. M. Tippet, "Royalty Interests and Ore Payments"; Vol. 3, Title XVIII, Ch. III, W. J. Schwarz and R. L. Beal, "Operating Agreements"; Vol. 5, Title XXVIII, Ch. V, P. C. Maxfield, "The Income-Taxation of Mining Operations".

> financing, it becomes volatile and all precautionary measures available must be utilized.[2]

Often, the financing of a mineral venture will involve the holder of a mineral concession[3] in disposing of an interest in the concession. The extent of the disposition may range from a disposition of the entire interest in a concession to a disposition of a fraction of the holder's rights in a part of the concession. Equally, the length of time for which an interest is disposed may vary, and the method of disposition may be either an outright grant or a reservation in a sublease or assignment. Numerous legal concepts have been developed to express the nature of the interests which may be disposed of in these financing arrangements. The interests (which are explained later in this article) include overriding royalties, carried interests, net profits interests, production payments and gross revenue interests. For convenience, these interests will be referred to initially as "expectancies". In the North American context it has been said of these arrangements that

> [t]here is great flexibility in the type of interests that may be created. Respective bargaining positions of the seeker and the provider of capital will determine the format of the property interests utilized.[4]

At the outset it might also be remarked that the taxation implications for any mineral venture will vary according to the multiple nature of the expectancies which are employed in the venture. The taxation implications to which I refer are two perennial questions of tax law and are to be examined in a later article:

(a) whether the payments or other considerations made or given under arrangements of the type to be considered in this article constitute assessable income in the hands of the recipient; and

(b) the converse question (which need not have the converse answer—see the *Colonial Mutual* case[5]) of whether such payments or other considerations will constitute expenditures which are deductible for taxation purposes on the part of the party making the payment or giving the other consideration.

1. *The Legal Background*

Before discussing the Australian legislation relating to mining, it is important to acknowledge that both in law and in the organization and financing of mineral ventures, a distinction is recognized between petroleum,[6] which is generally divided into the broad categories of oil and gas, and

---

[2] R. E. Sullivan, "The Financing of Oil and Gas Transactions" (1970) 8 Alta L. Rev. 299-330.

[3] That expression is used in this paper to describe all forms of rights or licenses conferring upon the holder the right to explore for and develop or exploit petroleum or other mineral resources.

[4] Sullivan, note 2 *supra* at 284.

[5] *Colonial Mutual Life Assurance Society Ltd* v. *F.C.T.* (1953) 89 C.L.R. 428, 442.

[6] The word itself has an uncertain meaning; see A. G. Lang, *Manual of the Law and Practice of Mining and Exploration in Australia* (1971) 11, 83.

other minerals. (In this article the term "mineral resources" embraces both.) The distinction[7] is due to the different physical and chemical characteristics of the resources, the most important of which is the migratory nature of petroleum.[8] This division between petroleum and other minerals appears not only in the Australian Income Tax Assessment Act, Part II, Divisions 10AA and 10, but also in Australian legislative provisions relating to the exploration for and development and exploitation of such resources. For example, in all jurisdictions in Australia other than Tasmania the statutory provisions governing onshore exploration for and development and exploitation of petroleum are contained in legislation separate from the legislation governing onshore exploration for and development and exploitation of other minerals. Equally, there is special legislation relating to offshore petroleum.

The common law position with respect to mineral resources is probably best summarized in the opinion of the Privy Council in *Michael Borys* v. *Canadian Pacific Railway Co.*[9] According to the Privy Council, the Crown had a prerogative right to all gold and silver found in mines and this right only passed to an individual if the Crown grant expressly and by precise words conferred such right—see *Case of Mines*[10] and *Woolley* v. *Attorney-General of Victoria.*[11] The rights over other minerals would remain with the individual landowner, unless some or all of the minerals in a parcel of land were reserved in the Crown grant to the Crown or to an individual, or in a subsequent sale of the land the minerals were reserved to the vendor.

Legislation has now removed or limited in the following ways the rights of an individual landowner to control of his land for mining purposes or to grant to others the rights to mine:

1. Certain substances are, by legislation, divested from the individual owner and vested in the State. This applies to petroleum, which is covered by legislation in various States and Territories. Also, the Atomic Energy Act 1953-1973 (Cth) grants to the Commonwealth Government extensive powers to mine and remove prescribed substances "in connection with the production of atomic energy".[12]
2. The Commonwealth Government in exercise of the defence power coupled with the land acquisition power can interfere greatly with private rights.
3. The Mining Acts and Ordinances of the States and Territories severely

[7] For a further explanation of the background to this distinction see D. E. Lewis and A. R. Thompson, *Canadian Oil and Gas* 1971 Vol. 1, Div. A, Pt VI, Section 1 at para. 30; Sullivan, note 2 *supra* at 279-280; H. R. Williams, R. C. Maxwell & C. J. Meyers *Cases and Materials on the Law of Oil and Gas* (1974, 3rd ed.) Ch. 1.

[8] The migratory factor has been properly understood only in the later stages of the development of oil and gas law in the United States and Canada: Lewis and Thompson, note 7 *supra* at para. 30.

[9] [1953] A.C. 217; (1953) 2 D.L.R. 65.

[10] (1567) 1 Plowd. 310, 336; 75 E.R. 472, 510-511.

[11] (1877) 2 App. Cas. 163.

[12] S. 17(5); see generally Pt 2, Div. 11, and Pt 3.

> interfere with private mining rights. In part those enactments deal with the granting of mineral concessions over Crown land, but as well they make provision for rights to be conferred for the exploration for and development and exploitation of minerals which are privately owned (subject to the sharing of royalty and compensation).[13]

A few words need to be said about the legislation relating to offshore mining. First, there is a legislative scheme of co-operative federalism covering the exploration for and development and exploitation of petroleum which is under submerged lands adjacent to the Australian coast in the region of the continental shelf and in the seabed and subsoil outside territorial waters.[14] The legislative scheme consists of complimentary Commonwealth and State legislation relating to the exploration for and development and exploitation of petroleum in an "adjacent area", that is in an area adjacent to a particular State. The legislation in question is the Commonwealth Petroleum (Submerged Lands) Act 1967-1973 and the respective State Petroleum (Submerged Lands) enactments 1967. This scheme of co-operative federalism has been the subject of both legal and political criticism[15] and contrary to popular opinion, is, in my view, inoperative. Under the Seas and Submerged Lands Act 1973 (Cth) the Federal Government either has sovereignty over, or has exclusive power to exercise sovereign rights for the purposes of exploiting natural resources of, all submerged lands offshore continental Australia.[16] In *New South Wales and Others* v. *Commonwealth*[17] the High Court dismissed an application by the States for a declaration that the Act was invalid. The Court held that as the coastal boundaries of the States end at low water mark, the Act dealt with matters external to Australia and was within the external affairs power, section 51(xxix) of the Commonwealth Constitution. Further, as the States do not have any international personality, any rights deriving from international law in respect of the territorial sea and continental shelf attach to Australia as a nation.

Accordingly, in the absence of any Federal legislation governing exploration for and development and exploitation of minerals other than petroleum in offshore waters, no such exploration, development or exploitation can legally occur. Further, it is my view that despite what the legislators believed to be the effect of the Seas and Submerged Lands Act, the State Petroleum (Submerged Lands) legislation may have been

---

13 See generally, Lang, note 6 *supra* at Ch. 4.

14 This scheme does not apply to the Australian Capital Territory, Northern Territory and the Territory of Ashmore and Cartier Islands; instead, the legislation provides for the Commonwealth to have the exclusive right to exercise the sovereign rights recognized by the 1958 Geneva Convention on the Law of the Sea.

15 See the Report from the 1971 Senate Select Committee on Off-shore Petroleum Resources, Vol. 1, Ch. VI; see also A. R. Thompson, "Australia's Off-Shore Petroleum Common Code" (1968) 3 U.B.C. Law Rev. 1.

16 See ss 6 and 11.

17 (1976) 8 A.L.R. 1.

void at least since the enactment of that Commonwealth Act.[18] However, in the absence of legislative amendment or agreement between the Governor-General and the Governors of the various States, the State Ministers responsible for State petroleum legislation continue to be the "Designated Authorities" entrusted with the administration of the Federal legislation.[19]

In addition to the general mining and petroleum legislation referred to above, special legislation relating to particular mineral resource projects has been a feature in Australia over the last decade.[20] This special legislation has arisen from the complexities of modern mineral resource projects, involving as they do for their success the marshalling and mobilization of vast amounts of capital and human resources. In addition, the legislation has often been necessary in order to give a proprietary effect to arrangements which would otherwise rest in contract, with undesirable commercial and taxation implications for the parties involved.

This brief survey of Australian mining legislation is provided as a background to two general propositions. First, the result of this legislative intrusion is that petroleum and (subject to certain minor exceptions[21]) other minerals are now the property of the Crown either in right of one of the States or the Commonwealth. Secondly, exploration and production rights over both classes of minerals are granted through mineral concessions. Exploration concessions do not confer on the holder any right to extract minerals. An exploration concession does, however, generally give some form of preferential treatment to the holder to be granted a production concession entitling him to extract the petroleum or other minerals.[22]

These rights conferred by production concessions are generally rights conferred jointly on the parties to whom they are granted. This fact creates problems for mineral resource projects which are to be conducted by joint ventures (as is not uncommonly the case in Australia) because the parties undertaking such projects are anxious to ensure, first, that there is no joint receipt of income among them (else they would be a partnership for tax purposes[23]), and secondly, that they should each be severally entitled to a particular percentage of the minerals extracted as a result of the joint

---

[18] See the exclusionary effect of s. 16(b) of the Seas and Submerged Lands Act 1973 (Cth). Considered in *Pearce* v. *Florenca* (1976) 9 A.L.R. 289.

[19] Petroleum (Submerged Lands) Act 1967-1973 (Cth) s. 15.

[20] See *e.g.*, the special legislation dealing with iron ore and other mineral projects in Western Australia, the bauxite and nickel projects in Queensland, the special legislation in Victoria dealing with the Barracouta and Marlin oil and gas fields and the recently enacted legislation in South Australia dealing with the South Australian Cooper Basin petroleum reserves.

[21] Lang, note 6 *supra* at 9.

[22] It is important to note that where the holder seeks to reserve or carve out expectancies from a Crown granted mineral concession the legislation generally provides that no interest can be created in a mineral concession without the approval of the relevant governmental authorities; see *e.g.*, ss 78 and 81, Petroleum (Submerged Lands) Act 1967-1973 (Cth); ss 106 and 107, Mining Act 1973 (N.S.W.); s. 37 and reg. 57, Mining Act 1968, as amended (Qld); ss 38U, 75 and 75A Mining Ordinance 1939, as amended (N.T.).

[23] Income Tax Assessment Act 1936-1975 (Cth), definition of "partnership" in s. 6.

venture operations (to ensure that they are regarded for tax purposes as being engaged in mining operations). So as to accomplish those dual objectives, the participants will usually structure their arrangements such that each has an undivided proprietary interest in the mineral concession (or derivative concession, if the participants have gained their rights by assignment, sublease or the like) which corresponds to the percentage of production of the minerals to which they are each entitled under their commercial arrangements. This result is usually achieved either by having the mineral concession granted or assigned to the participants as tenants in common or by having the mineral concession granted to one or more of the parties with a sublease or sublicence to all participants in accordance with their entitlements to production under the joint venture arrangement.[24]

It should be added that the arrangements just discussed are suitable mainly to non-petroleum mineral ventures where either there is only one mineral being extracted or there are several minerals but each participant has the same interest in respect of the production of all minerals. In the case of petroleum projects the arrangements can be much more complex.

Finally, before financing requirements are discussed, a word should be said about the legal background to mineral exploitation ventures in North America, insofar as it is relevant to Australian conditions. The mainspring of the extensive body of law surrounding mineral resource exploitation in North America has been the fact that mineral resource rights have been in private rather than public ownership.[25] Even so, that part of the law that relates to petroleum leases is of particular relevance in Australia, because those leases correspond to Crown granted mineral concessions in Australia.[26] In both cases the holder has simply an incorporeal interest in the land or minerals *in situ*.[27] Thus the holder of a mineral concession in

[24] *E.g.*, Robe River Iron Ore Project joint venture documentation, and cl. 6 of Schedule; and App. "B" of the Schedule to the Cooper Basin (Ratification) Act 1975 (S.A.).

[25] Many of the important discoveries of petroleum and other minerals in the U.S. and Canada have been made on areas where the petroleum and other mineral rights were privately owned. This fact of private ownership of mineral resource rights has resulted in the development of a number of different theories of the nature of mineral resources and the creation of interests therein or relating thereto. See *e.g.*, Williams, Maxwell and Meyers, note 7 *supra* at Ch. 3; Lewis and Thompson, note 7 *supra*; Ballem, *The Oil and Gas Lease in Canada* (1973) Pt 1, Ch. 2; E. A. Brown, *The Law of Oil and Gas Leases* (2nd ed.) Vol. 1, Ch. 1 and Ch. 3 paras 3.02-3.04. See also the discussion on the theories of ownership in the U.S. and Canada in Lewis and Thompson, note 7 *supra* at Vol. 1 Pt II, Section 1, paras 31-31A and the references contained therein and also Vol. 1, Div. A, Pt IV, Section 5, para. 106A.

[26] Lewis and Thompson, note 7 *supra* at Vol. 1, Div. A, Pt II, referred to an oil and gas lease as being equivalent to a Crown lease.

[27] In *Berkheiser* v. *Berkheiser* [1957] S.C.R. 387, (1957) 7 D.L.R. (2nd) 721, it was held that the holder of an oil and gas lease in that particular case had an incorporeal tenement in the nature of a *profit-a-pendre*, but did not have title to the petroleum so long as it remained *in situ*. In *St Lawrence Petroleum Ltd et al* v. *Bailey Selburn Oil and Gas Ltd et al* (1962) 35 D.L.R. (2nd) 574, it was held that the agreement there in question involved a purported assignment of an undivided interest in "petroleum and natural gas and related hydrocarbons within upon or under the said lands" and not an assignment of part of the assignor's interest under the Crown leases. Having regard to the view of the Court as to the nature of the rights of the lessee, it was

Australia does not have a proprietary interest in any such minerals, but only a right to explore for and extract them. Consequently he cannot create a proprietary interest in those minerals in a third party. He may only—

(a) assign his rights as a holder of an interest in the nature of a *profit-a-prendre*;

(b) create by assignment or declaration of trust an undivided interest in such rights as he has in favour of another party; or

(c) create an interest in another party in the nature of a sublease.

If the arrangement in question cannot be analysed as creating a proprietary interest of this nature then any attempt to create interests with respect to the production of minerals from the relevant mineral concession will generally only result, it is submitted, in—

(a) contractual rights to receive such production after it is severed from the ground;

(b) contractual rights to receive the proceeds (either "gross" or "net") of the sale of a share of production;[28] or

(c) proprietary rights to receive income from property (being the sales contracts).

2. *Financing Requirements*

The complex and extensive nature of exploration and development operations in the field of mineral resource exploitation demands special consideration with regard to financing. This was recognized in the Report of the Australian Taxation Review Committee.[29] In the field of petroleum, the types of exploration operation and the order of performance can be summarized as follows:[30]

(a) general survey of a wide area using techniques of photogeology, gravimetry and magnetometry;

(b) seismic (and in the case of onshore work, geological) mapping;

impossible for him to convey an interest in such substances; at best, such interest would only come into existence if the substances were reduced to possession as personal chattels. In *Emerald Resources Ltd* v. *Sterling Oil Properties Management Ltd* (1969) 3 D.L.R. (3rd) 630, the Court held that an agreement granting a gross overriding royalty of 2% in the lessee's share of production created only contractual rights in respect of production and not an interest in land. Lewis and Thompson, note 7 *supra* at Vol. 1, Div. A, Pt IV, Section 9, para. 129 (see also Pt III, para. 32) submit that these cases should mean no more than that the holder of an incorporeal interest in land cannot validly assign a corporeal interest in that land or create a new incorporeal interest in it.

[28] As in *Asamera Oil (Indonesia) Ltd* v. *The Queen* (1973) C.T.C. 305 (Fed. Ct—Trial Div.) discussed by C. A. Rae, "Current Developments in Oil and Gas Income Taxation" (1975) 13 Alta L. Rev. 46, 52 ff.

[29] *Australian Taxation Review Committee (Full Report) 1975*, (Asprey Committee Report); see particularly Ch. 19, paras 19.8-19.12, 19.78. See also the *Industries Assistance Commission Draft Report on the Petroleum and Mining Industries*, 9 March 1976.

[30] *Id.*, at para. 19.78.

(c) exploration by drilling;

(d) if the results of the exploration or wildcat well result in the discovery of a productive hydro-carbon reservoir, stepout wells are drilled to assist in the delineation of the field;

(e) production wells are then drilled to permit a flow of petroleum in profitable volume;

(f) separation equipment to separate the oil or gas from the water and other impurities;

(g) in the case of offshore productions, the installation of a production platform to carry the separation and other recovery equipment; and

(h) transport of petroleum from separation plant to storage facilities, a pipeline or the market.

Differences between the arrangements for financing petroleum ventures and for financing other mineral ventures can, I consider, be readily ascribed to the fact that mineral exploration is usually a slower process than petroleum exploration, in that the former involves many more steps or types of operations. The exploratory work involves the following:[31]

(a) geological, geophysical and geochemical surveys, some of which may be carried out by airborne equipment and others carried out on the ground;

(b) hand sampling—breaking off of rock from outcrops and analysing by visual inspection or laboratory analysis;

(c) stripping—cleaning of overburden down to bedrock usually by bulldozer;

(d) trenching—removing of rock samples by hand or blasting in a regular pattern across a rock face. Usually much larger samples are obtained than by "hand sampling" and analysis is usually by an independent laboratory;

(e) diamond drilling of isolated holes with small or large diameter drills;

(f) diamond drilling on a regular grid pattern;

(g) bulk sampling—by pilot mill; and

(h) independent engineering study of all data to determine feasibility of production.

Once this exploration work has been completed, an assessment has to be made of the likely profitability of any production venture. To quote the Asprey Committee, likely profitability must be determined after examination of a variety of factors, including—

> the suitability of extraction methods, transportation and infrastructure requirements, availability of markets and satisfactory financial accommodation. Contracts for the sale of products must be obtained, and, if the product is to be exported overseas, negotiations may have to be

[31] Quoted from J. R. Mackay, "Considerations in the Search and Exploration for Minerals in British Columbia" (1973) 11 Alta L. Rev. 538, 542.

> conducted in other countries. The costs of discovering and proving whether a prospective deposit will be a viable commercial mining proposition are frequently immense.
>
> If the results appear to justify mining on a full scale and negotiations and applications for mining tenures and royalty payments are consummated, further capital must be employed to engage executive and technical staff and an adequate workforce and to secure and install necessary plant and machinery for the opening up of the mine. Where, as usually happens, the mine site is at a great distance from populated centres, housing, medical care, educational facilities and other suitable amenities may be needed to be provided for the necessary personnel, their wives and children. Water, power and light may have to be provided. Pipelines, roads, railways, port facilities (including dredging of harbours and channel approaches), airstrips, launching pads, fixed wing aircraft and helicopters and other equipment are frequently essential for the transportation of both men and materials.[32]

This brief outline is sufficient to illustrate that the more traditional methods of corporate finance available to industrial companies are not available to companies engaged in mineral exploration. Other methods are needed. Often, the methods used will vary depending upon whether operations have reached the stage where the venture appears to be economically feasible. Once the stage of economic feasibility has been reached, financing is usually effected on the basis of a combination of a debt and equity. The debt is normally secured by charges over the assets of the project: the charges are fixed as to the mineral concession, the sales contracts in respect of the proposed mineral production, and significant items of plant, and (generally) are floating as to the other assets. Where, (as is not uncommonly the case) there is a joint venture involved, financing can be effected either on a "project" basis or separately by each of the participants in the joint venture. Although the securities are complex and contain many provisions common to less exotic security transactions, the principal security of the lenders is the cash flow which is generated from the sales contracts. The rest of the security documentation is basically designed to underpin and protect that cash flow. The use of production payments (described later in this article) to secure loans has, the writer believes, only occurred once in Australia.[33]

As one might expect, financing is more difficult before the stage when economic feasibility has been determined. It is particularly with respect to this preliminary stage that the various types of arrangements with which this article is concerned have been developed. The arrangements (as was

---

[32] See the Asprey Committee Report, paras 19.8 and 19.9. In this area generally see R. E. Sullivan, "Organisation and Financing of Mining Ventures" (1955) 1 Rocky Mountain Mineral Law Institute 451; C. A. Rae, "Oil and Gas Industry Financing" (1969) 7 Alta L. Rev. 465; Sullivan, note 2 *supra*; Mackay, note 31 *supra*; University of Sydney Committee of Postgraduate Studies, Law of Mining Lectures in 1971.

[33] It is believed that the use of such production payments occurred in relation to the financing of the offshore development platforms used in the Esso-B.H.P. operations in Bass Strait. However the documentation of such financing has not been made public.

mentioned in the Introduction to this article) usually involve the holder of a mineral concession disposing of an interest in the concession, with the dispositions varying according to the extent of the interest disposed of, the length of time of the disposition, and the method by which it is made. Speaking of development and operating agreements relating to oil and gas in Canada, Lewis and Thompson comment:

> For convenience they may be classified by patterns running through them and identified by indicating the main characteristics of patterns, but it cannot be said that there are standard forms of agreements.[34]

Following are some of the circumstances in which the holder of a petroleum concession may wish to dispose of or create an interest therein in favour of another party:

1. The original grantee of an exploration concession may have acquired it without any intention of conducting exploration and development operations, but with the hope of disposing of it to another person willing to carry out the operations. The concession holder may wish to dispose of the concession by way of assignment or "sublease", in either case seeking to retain (to use a neutral expression) some "non-operating interest" in the area so that if a commercial discovery[35] is made he.will have some continuing financial interest in the success of the operations carried out by the assignee/sublessee.

2. The holder of an exploration concession may have carried out seismic operations and delineated a drilling target but have insufficient funds to carry out the necessary drilling to test the prospect, or alternatively he may consider that the prospect is such that he wishes to "spread his risk" and conserve his financial resources to participate in other exploration operations. In this situation he would enter into an arrangement (usually referred to as a farm out arrangement) under which the other person (the "farmee") would drill the well either to a certain depth or a certain formation in order to "earn an interest" in the exploration concession. The drilling of the well could be made a condition precedent to the farmee receiving the relevant interest or instead the transfer of the interest could be effected in consideration of the farmee covenanting to drill.

   In the classically simple farm out agreement the farmee would acquire an undivided interest in the exploration concession. There would also

[34] Lewis and Thompson, note 7 *supra* at Vol. 1, Div. A, Pt VI, Section 1. See 5th Petroleum Law Supplement, (1970) 8 Alta L. Rev. for general treatment of the subject. See also J. H. Currie, "Recent Cases and Developments in Oil and Gas Law" (1971) 9 Alta L. Rev. 452, 472-476; W. G. Holt, "Problems Relating to Arctic Farm-out and Joint Operating Agreements" (1972) 10 Alta L. Rev. 450; R. D. Bell, "Taxation of Mining and Petroleum" (1974) 12 Alta L. Rev. 36, 36-38; Rae, note 32 *supra*; D. A. MacWilliam and R. C. Muir, "Off-Shore Operating Agreements" (1973) 11 Alta L. Rev. 503; Mackay, note 31 *supra*; University of Sydney Committee of Postgraduate Studies, Law of Mining Lectures in 1971; Williams, Maxwell and Meyers, note 7 *supra* at Ch. 7; Brown, note 25 *supra* at Vol. 2, Ch. XVIII.

[35] See definitions of "Commercial Deposit" and "Production in Paying Quantities" in Williams and Meyers, *Manual of Oil and Gas Terms* (2nd ed.) 50, 307.

be a provision that after the farmee had "earned his interest" future operations on the concession (from exploration through to production) would be carried out in accordance with the provisions of a joint venture agreement (usually called an operating agreement). An alternative to this simple form of farm out agreement would be an agreement under which the concession holder retained an expectancy in the production from the concession (such as an overriding royalty, a gross revenue interest, or a production payment).

3. The holder of the exploration concession can raise finance by granting an expectancy to a contributor of money or services to the enterprise.
4. After a commercial discovery[36] the holder of a mineral concession or an undivided interest therein may dispose of his interest or part thereof in order to realise his gain or to raise further funds for that or other ventures.
5. Parties holding interests in different petroleum concessions covering a reservoir containing hydrocarbons in commercial quantities or even different reservoirs may "pool" or "unitize" their interests so as to permit joint development of the reservoirs (usually referred to as "unitized zones"). Basically, production from any unitized zone in the unit area is allocated to each petroleum concession on the basis of factors (usually referred to as "tract" or "block" factors) which are agreed upon after the holders have taken into account known and assumed reservoir characteristics and other technical information. Each party holding an interest in one of the concessions is then entitled to a share of the production allocated to his concession in accordance with his working interest in that concession. Unitizing agreements enable greater recovery of petroleum in the most economic fashion and also avoid wastage or reservoir damage that may result if the different parties were to "go it alone" in the development of the reservoir or reservoirs involved.[37]

Although, as the earlier discussion showed, there are differences between petroleum and other minerals both in exploration methods and in the arrangements for financing both types of ventures, there are nevertheless certain common characteristics in the arrangements that are respectively used. The consideration for acquiring an interest in a mineral concession (other than a petroleum concession) can be either a cash payment or the carrying out of some exploration of development operations. Most agreements are in the form of an option with annual cash payments or work commitments spread over a period of years with relatively small amounts

[36] *Ibid.*

[37] Ballem, note 25 *supra* at Ch. 11, p. 211; see also, Williams and Meyers, note 35 *supra* at 425; Williams, Maxwell and Meyers, note 7 *supra* at Ch. 8, "Pooling and Unitisation"; Lewis and Thompson, note 7 *supra* at Vol. 1, Div. A, Pt VI, Section 1, paras 147-148; F. E. Kelly, "Unitization in Oil and Gas Industry" (1961) 4 Can. Bar J. 80. The first example of unitization in Australia will occur in the Cooper Basin region of South Australia. Not only will this be unique to Australia, but almost unique to the world as it will involve multi-field unitization as opposed to unitization of one reservoir or several reservoirs in the one field.

being paid in earlier years. The purpose of this form is obviously to enable the "purchasers" to progressively make their "purchase" commitment concurrently with their evaluation of the property.

It is unusual for the original holder of a mineral concession to want to dispose of the whole of his interest and it is not uncommon for the arrangements to provide for, in effect, the retention of expectancies such as a carried interest or a net profits interest, or an overriding royalty (usually being an overriding royalty in cash) calculated as a percentage of net profits from any mining operation or as a percentage of net smelter or mint returns.[38]

In an arrangement where the consideration for the earning of the expectancy is the performance of work to a certain expenditure level, the total amount to be expended on exploration is usually divided into amounts to be spent annually with the payments for the first few years being relatively small and those for subsequent years progressively increased. Usually there is a firm commitment to expend a certain level in the initial year. Thereafter, the "purchaser" usually has the option from year to year to proceed with work for the next year or stage of exploration. Having been committed to a succeeding year or stage, the "purchaser" is then usually committed to expending whatever is necessary in that period to maintain the concession in good standing under the applicable legislation. The projected level of expenditure for the period is usually much higher than this and it is normal for the "purchaser" to have the right to be relieved in respect of this excess if at any time during the relevant period he comes to the conclusion that he does not wish to proceed any further. In some cases if the "purchaser" does not reach the total expenditure level he "earns" no interest at all in the mineral concession; in other cases provision is made for a scaled down interest to be earned.

The level of interest being earned in the mineral concession depends largely on the stage of exploration or development that was already reached at the time the agreement was made and on the amount of work agreed to be done in order to earn an interest. The question of who is to have the right to decide whether to place the property into commercial production is always the subject of active negotiation. In some cases the "purchaser" has this right but if he exercises it, he is obliged to provide or acquire the necessary funds to carry out the work needed for production

---

[38] The expressions "net smelter returns" and "net mint returns" do not have fixed meanings. Broadly, however, the concept of net smelter returns has at its core the price payable for ore by a smelter or mill which purchases the ore mined from the mineral concession. Obviously special provisions would need to be made where the ore is to be smeltered or milled on a "toll" basis. The concept of net mint returns has at its core the price at which the government acquires gold or other minerals used in currency.

A short definition of "net smelter returns" would be "the gross proceeds received from a smelter, mill or other processor, less all smelter and milling charges, sampling and assaying charges and all transportation charges from the mine to the smelter, mill or other processor."

to commence. In return for this, he would normally seek to become entitled to an increased undivided interest in the mineral concession. In other cases although the production decision remains that of the purchaser, the vendor has the right to provide its proportionate share of the necessary funds and, if provided, the vendor's retained or remaining undivided interest in the mineral concession will not be further reduced. In view of the magnitude of mineral projects, it is obviously critical that all these matters be resolved or fully provided for in agreements before the parties embark on significant expenditures.[39]

3. *Concepts and Arrangements*

The concepts and arrangements discussed in this Part have, hitherto, been subsumed under the term "expectancies". The discussion will firstly describe the concepts and arrangements as they have been formulated and characterized in the United States and Canada. They are then anlysed in an Australian legal context, and a categorization, appropriate to an examination of their Australian income tax implications, is formulated.

(a) *Overriding royalties*

Williams & Meyers, in the *Manual of Oil & Gas Terms* define an "overriding royalty" as

> an interest in oil and gas produced at the surface, free of the expense of production, and in addition to the usual landowner's royalty reserved to the lessor in an oil and gas lease.[40]

That book also refers to the definition offered in *Meeker* v. *Ambassador Oil Co*:

> An overriding royalty is a fractional interest in the gross production of oil and gas under a lease, in addition to the usual royalties paid to the lessor, free of any expense for exploration, development, operating, marketing and other costs incident to the production and sale of oil and gas produced from the lease.[41]

Brown defines an "overriding royalty" interest as

> a given interest severed out of the working interest or lessee's share of the oil, and not charged with any of the cost or expense of development or operation. This is true whether the overriding royalty is created by reservation when the original lessee transfers his interest by assignment or sublease or is created by grant when the original lessee conveys such fractional share to a third person.[42]

In the Canadian context, referring to the royalty provisions of common forms of oil and gas leases granted by persons having the ownership of the petroleum, Ballem says:

---

[39] Mackay, note 31 *supra*. The level of expenditure that is regarded as "significant" for this purpose will vary from case to case.
[40] Note 35 *supra* at 275.
[41] (1962) 308 F. 2d 875, 882; *rev'd*, 375 U.S. 160; rehearing denied, (1964) 375 U.S. 939.
[42] Note 25 *supra* at Vol. 2, para. 17.01.

> There is probably more variation in the royalty provision among the individual lease forms than in any other clause of the Canadian oil and gas lease. In general there are three types of clauses: (a) those under which the lessor *reserves* a share of the production; (b) those which embody the concept of *delivery* to the lessor of a share of the production; and (c) those under which the lessee agrees to *pay* to the lessor a percentage of the value of the substances.[43]

To similar effect, Lewis and Thompson have said that

> royalty clauses exhibit great variation in language and some of the differences are substantial on questions such as what substances are covered, the right to take in kind, and what is the measure of value. Some royalty clauses express the royalty only in money's worth and give rise to the question whether the nature of the royalty interest is different in those cases than in the more common case where the royalty is given in kind. 'The term "royalty" may be used in different senses and with different meanings. It may be used merely to indicate a basis for computing compensation for consideration given, and thus establish a contractual right to recover that compensation. It is commonly used to indicate a reservation by the owner of the land and mineral rights on the granting of a "lease" or right to search for and remove the mineral in question. When so used, the reservation or royalty binds not merely the lessee, but also any assignee of the lessee. It has been referred to as a reservation operating as an exception out of the demise'.[44]

Some writers find that in order to discuss the subject of royalty "a more or less arbitrary definition of the term must be formulated"[45] and consequently have used the expression "royalty" as meaning a share in production. However it is recognized "that an interest in production should more properly be called a royalty interest as opposed to a royalty".[46] Royalty

> is the price paid for the privilege of exercising the right to explore. If the right is granted by a lease or contract, it is the whole or part of the consideration for the lease. If the right is granted or reserved by a sale, it is the consideration in part or whole for the sale.[47]

Although many of the U.S. and Canadian cases on the nature of overriding royalties are concerned with the overriding royalty which is held or disposed of by the party who owns the mineral rights, there has, I consider, been a discernible trend to regard overriding royalties reserved or granted by a lessee (who would correspond in the Australian context to the holder of the mineral concession granted by the Crown) as conferring only contractual rights to receive a share of production as opposed to an interest which may be caveated against the title (or mineral concession).

---

[43] Ballem, note 25 *supra* at 117-118.

[44] Lewis and Thompson, note 7 *supra* at Vol. 1, Div. A, Pt IV, Section 5, para. 106, there citing *Spooner* v. *M.N.R.* [1931] D.L.R. 723, *rev'd* [1931] 3 D.L.R. 136. See also G. J. Davies, "The Legal Categorization of Overriding Royalty Interests in Oil and Gas" (1972) 10 Alta L. Rev. 232.

[45] Helmick and Tippet, note 1 *supra* at 432.

[46] *Id.*, at 433.

[47] *Id.*, at 432, n. 10.

This is particularly so where the royalty is expressed in terms which merely create an obligation to pay a percentage of the value of the relevant substances.[48]

A useful statement of the nature and use of overriding royalties in the United States is that of Helmick and Tippet found in *American Law of Mining*, a publication of the Rocky Mountain Mineral Law Foundation:

> An overriding royalty is an interest in the production of minerals and is usually created out of the working interest in a lease; i.e., the Lessee's interest as distinguished from the landowner's and independent royalty interests. Where the overriding royalty is reserved, it is analogous to the rent reserved by a lessee tenant when he sublets the premises to another. Perhaps the outstanding characteristic of a true overriding royalty, which distinguishes it from other interests created out of the lessee's interest, is that it is not charged with the cost of development or production. It is to be distinguished from an ore payment in that the override is co-terminous with the life of the lease while the ore payment ceases when a stipulated sum has been paid. While usage varies somewhat, especially in the oil and gas industry, any royalty created out of the working interest may be properly considered an overriding royalty. This royalty interest has found its most extensive use and development in oil and gas operations; however, overriding royalties in theory were not unknown to the early English mining operations, and various types of assignments, subleases and other arrangements involving an overriding interest are found in early mining decisions in this country. The overriding royalty interest may be created by either grant or reservation—by reservation when the mineral lessee transfers his operating rights by assignment or sublease, retaining the override, and by grant when the lessee conveys such an interest to a third person. The overiding royalty frequently comes into being as a by-product of the attempt to gain production from the mine. The lessee, who is obligated to pay a production royalty to the mineral fee owners, and perhaps also to an independent royalty holder, may sublease a portion of the mine and retain a royalty over and above the amount going to these other interests; or, if the venture is speculative, and the lessee is without funds for development, he may assign the lease to a party with sufficient capital to explore and develop the mine, retaining a percentage of production which 'overrides' the landowner royalty payments. The range of possible transactions and motives for their existence is obvious.[49]

That statement is useful in the Australian context because I submit that the position of the holder of a mineral concession in Australia corresponds with the position of the lessee's interest under a mineral or oil and gas lease in the United States and Canada. The reference to an "ore payment" is discussed below under the heading "Production Payments".

It is submitted that the appropriate categorization of different types of

[48] Lewis and Thompson, note 7 *supra* at Vol. 1, Div. A, Pt IV, Section 5, para. 106A and the cases there cited.

[49] Helmick and Tippet, note 1 *supra* at 477 (references and citations omitted).

overriding royalties for the purposes of examining the Australian income tax implications is as follows:

(a) overriding royalty interest;

(b) overriding royalty in kind; or

(c) overriding royalty in cash (or gross revenue interest agreement).

Under an overriding royalty interest the holder of the overriding royalty would have the right (arising by reservation, grant, assignment, or sublease[50]) to an undivided interest in the relevant mineral production concession, entitling him to extract the relevant percentage of minerals. He would therefore own such minerals as they were severed from the ground.

In the case of overriding royalty in kind the holder of the overriding royalty would have the right either by reservation or by grant and whether arising as a result of an assignment or sublease, to take a certain percentage of the minerals being produced. He would not however have any corresponding right to exercise any of the rights under the relevant production concession.[51]

An overriding royalty in cash or a gross revenue interest arrangement would confer the right to receive cash calculated by reference either to the value of a percentage of the minerals produced or to the gross proceeds from the sale of the specified percentage of the minerals produced. By "gross proceeds" I mean the gross proceeds without any allocation being made for the costs of exploration, development and production.

(b) *Production payments*

A production payment in relation to petroleum is usually referred to as an "oil payment". This has been defined as

> a promise by the owner of the working interest under an oil and gas lease to deliver a fractional interest of the production of any or all of the minerals covered by the lease to the payee, or to pay him the monetary value thereof, until the payee has realised a certain sum from such deliveries or payments.[52]

It has been further stated that:

> An oil payment has these fundamental characteristics: 'It is payable only out of production and there is no personal liability on the part

[50] The expressions "mining lease" or "mineral lease", in relation to which the word "sublease" would be appropriate, are generally only used in relation to minerals other than petroleum. In relation to petroleum the expressions for exploration and production concessions are usually "permit" and "production licence" respectively. In this article, however, I use the word "sublease" to refer not only to mineral concessions but also to what would more properly be called "sublicences" of petroleum concessions.

[51] Overriding royalties which contemplated payments in cash with the right to take in kind were the subject of discussion before the 1971 Senate Select Committee on Offshore Petroleum Resources. There was strong legal advice given to the Crown that such royalties gave rise to contractual obligations only and did not create any interest in or affecting petroleum concessions—see Report, note 15 *supra* at para. 14.17 ff.

[52] A. W. Walker, Jr, "Oil Payments" (1942) 20 Tex. L. Rev. 259, 262—cited in Brown, note 25 *supra* at para. 17.03.

of the assignor.' The payment is not burdened with any of the operating expenses of the lease.[53]

An example of an oil payment was that discussed in *State* v. *Quintana Petroleum Corp.*[54] where the form of oil payment was the reservation by the lessor of "one fourth of the remainder of any oil, gas or minerals produced from the said land until the proceeds of sale (such sale to be made at no less than the market price) by the grantor of the said one fourth of the remainder shall aggregate $2,000,000, whereupon this reservation of title to said one fourth interest shall terminate and this interest shall vest in the grantee and his assignee". Relying on *Tennant* v. *Dunn*[55] and *State* v. *Quintana Petroleum Corp.*, Williams and Meyers describe an oil payment as being

> a share of the oil produced from the described tract of land, free of the costs of production at the surface, terminating when a specified sum from the sale of such oil has been realised. Oil payments may be reserved by a lessor, by an assignor of a lease or carved out by the owner of a working interest or royalty interest . . . the duty to deliver oil under an oil payment subsists if, as and when the oil is produced; *there is no personal liability to pay the sum specified in the instrument creating the oil payment.*[56]

The prevailing uses of production payments in the United States are by lessors in lieu of large bonuses, premiums or overriding royalty; by assignors of leases in lieu of or in addition to overriding royalty or cash; or they are used by the owner of a working interest to finance his operations by assigning an oil payment to a supply company, drilling contractor or as collateral for a loan. In the past, production payments were also used in both the United States and Canada as a means of tax minimization.[57]

Production payments in the area of other minerals are generally referred to as "ore payments". Helmick and Tippet, in *American Law of Mining*, have described their nature and use in the following way:

> Ore payments, like overriding royalties, are created out of the working interest in a hard mineral lease and are not charged with the cost of production. This interest differs from the overriding royalty in terms of duration: the override continues throughout the life of the lease whereas the ore payment terminates upon payment of a specified sum called for in the agreement. The use of ore payments has been a

[53] Brown, note 25 *supra* at Vol. 2, para. 17.03, there referring to *Anderson* v. *Helvering* (1940) 310 U.S. 404, 60 S.Ct 952, 84 L. Ed. 1277.

[54] (1939) 134 Tex. 179; 133 S.W. 2d 112; 134 S.W. 2d 1016.

[55] (1937) 130 Tex. 285; 110 S.W. 2d 53.

[56] Williams and Meyers, note 35 *supra* at 261.

[57] Williams, Maxwell and Meyers, note 7 *supra* at Ch. 6, Section 1; Ch. 9, Sections 5B and 5C; Maxfield, note 1 *supra* at paras 28.61, 28.67-28.70; Spencer and Rowan, "Acquisition of Oil and Gas Properties through the ABC Transaction" (1965) *Prentice-Hall Oil and Gas Taxes* para. 2011; M. E. Jones and A. Gordon Burton, "The ABC Transaction in Canada" (1965) *Prentice-Hall Oil and Gas Taxes* para. 2029; Rae, note 32 *supra* at 472 ff. Production Payments have been used in the financing of the North Sea Oil Projects—see the *Economist*, 22 July 1972, Vol. 244, No. 6726.

> rather recent development in hard mineral operations but, like its equivalent the oil payment, it is now frequently used as a means of raising cash for mining operations and as a method of reimbursing mining equipment suppliers who provide needed supplies for the mining venture. There is a paucity of judicial authority on the subject of ore payments and writing in the field is limited rather exclusively to the subject of oil payments. The practitioner is well advised to examine controlling oil and gas decisions when working with ore payments and let these be his guide with, of course, consideration given to the inherent differences in hard minerals and fugacious subjects and the different treatments given by the courts.[58]

One of the characteristics which production payments have in common with overriding royalties is that they may be categorized as—

(a) production payments interests;

(b) production payments in kind; or

(c) production payments in cash.

The incidents of each category would be the same as those for the corresponding category in the categorization of overriding royalties, with the important difference that the incidents to a production payment would terminate (provided sufficient production were recovered attributable thereto) prior to the expiration of the mineral concession itself. That earlier expiration would occur when the value of the amount of minerals produced, or proceeds of sale from a share of that production, equalled an amount specified in the production payment arrangement.

(c) *Carried interests and net profits interests*

In the petroleum context, Williams and Meyers describe a carried interest as

> a fractional interest in the oil or gas property, usually a lease, the holder of which has no personal obligation for operating costs, which are to be paid by the owner or owners of the remaining fraction, who reimburse themselves therefor out of production, if any. The person advancing the costs is the carrying party and the other is the carried party.[59]

The details of carried interest arrangements vary considerably, for example, as to whether the operator (the party who is putting up the cost of exploration and development) has control of the oil and the right to sell it, or whether the carried party can sell his part of the oil; whether the carried interest is to be carried for the initial development phase only of the operation or for the life of the lease; whether interest is to be charged and if so, the rate; and as to who would own the plant and equipment if production ceased. As observed by Professor Masterson,

---

[58] Helmick and Tippet, note 1 *supra* at 482.

[59] Williams and Meyers, note 35 *supra* at 42-43. The position in the mineral context is described by Maxfield, note 1 *supra* at para. 28.75.

> the numerous different forms of these interests are given from time to time to make it apparent that the terms 'carried interest' and 'net profits interest' do not define any specific form of agreement and rather merely serve as a guide in preparing and interpreting instruments.[60]

This statement is to be contrasted with the fact that in other quarters the term "carried interest" is said to have a "well-defined meaning in the oil business".[61] However the Court in *Pine Pass Oil & Gas Ltd et al* v. *Pacific Petroleum Ltd et al*[62] came down clearly on the side of Professor Masterson's view. In that case it was held that the

> plain meaning of the carried interest formula was that the carrying party could recoup only 7½% of its costs out of the net proceeds of production before the carried party would begin to receive 7½% share given it by the agreement. The attempt by the carrying party to have the agreement rectified so as to provide for recoupment of 100% of costs before the carried party would begin to share failed on the evidence. Neither did expert evidence establish a standard form of carried interest which would invariably commit 100% recovery of costs before sharing with the carried party, nor did evidence establish that the carried interest formula was a result of mutual mistake.[63]

The major difference between carried interests and net profits interests has been said to be that

> it is customary for a carried interest relationship to cease when all costs as to the carried interest are paid; thereafter the carried and carrying parties jointly (*sic*) own the working interest and share in costs and receipts. The net profits interest, on the other hand, usually continues for the duration of the petroleum concession, one party continuing to bear costs and the other receiving a share of proceeds after payment of such costs.[64]

That distinction corresponds to the distinction between limited and unlimited carried interest arrangements. In a limited carry arrangement the owner is limited to particular specified work or work up to a particular stage, for example, until a feasibility study is undertaken.

In relation to the difference between "overriding royalty" and "carried interest", Brown states that "an 'overriding royalty' is a share of the *gross* production; whereas, a 'carried interest' is a share of the *net* production".[65]

In the Canadian context, Lewis and Thompson, in referring to "carried interest agreements", state:

> These agreements fall into two categories; a carried interest joint ownership agreement and a carried interest profit sharing agreement.

---

60 "Discussion Notes", (1956) *Oil and Gas Review* 396.
61 *Winemiller* v. *Page* (1919) 75 Okla 278, 138 Pac 501.
62 (1968) 70 D.L.R. (2nd) 196 (B.C.S.Ct).
63 Lewis and Thompson, note 7 *supra* at Vol. 1, Div. A, Pt VI, Section 1, para. 144.
64 Williams and Meyers, note 35 *supra* at 43.
65 Brown, note 25 *supra* at Vol. 2, para. 17.01, there referring to Glassmire, *Oil and Gas Leases and Royalties* (2nd ed.) 241.

> In the case of the former, both parties own or earn an interest in the land, wells, equipment and production, while in the latter case one party, as operator, owns or earns all land, wells, equipment and production, and the other party is entitled only to a share in profits, which are defined as the excess of operational receipts over expenditures. In this latter case, it has been held that the carried interest does not exist in the permit or lease documents, or in the lands themselves, but only in a share of profits, with the result that the carried interest owner cannot attach fiduciary obligations to the carrying party with respect to the latter's dealings with the leases or with production of the leased substances. (*Act Oils Ltd* v. *Pacific Petroleums Ltd* (1972) 4 W.W.R. 23, 27 D.L.R. (3rd) 444.)[66]

The authors point out that sometimes the carried party has the option of converting his interest to a joint working interest.

Carried interest transactions in the United States were reviewed by the Fifth Circuit Court in *United States* v. *Cocke*.[67]

> In any carried interest transaction one of the owners of the working interest in property is willing to advance the funds necessary for drilling of wells and development of production of oil or gas and to look only to the other owner's share of production for the other owner's contribution to such costs. The party who puts up the money is called the carrying party because he risks his entire investment against the possibility that there will not be enough production to reimburse him for his costs. The other party is called the carried party because he takes no risks. The carried party agrees to wait until the carrying party has recouped his drilling and development costs out of production before he takes any payments on his share. The carried party is not personally liable for any costs and loses nothing if there is no production.
>
> The courts and the commentators have recognised three types of carried interests. In the Manahan type, the carried party originally owns all of the working interest and assigns the entire interest to the carrying party, who is obligated to drill and develop a well or wells. This assignment is subject to a right or reversion of a portion (typically one half) of the working interest to the carried party if and when the drilling and development costs are recouped by the carrying party. After this reversion income and expenses are shared by carried and carrying parties according to their proportionate shares of the working interests. In the Herndon type, the carried party originally owns all of the working interest to the carrying party, who is obligated to drill and develop. The carried party also assigns to the carrying party an oil production payment covering his retained working interest. This assignment ends only when the carrying party has recouped his drilling and development costs. It has been held that during the period of recoupment the carried party in a Manahan or Herndon carried interest gets no income and no deductions for depletion or depreciation and that all income and deductions go to the carrying party. The third form of carried interest is represented by the *Commissioner*

---

[66] Lewis and Thompson, note 7 *supra* at Vol. 1, Div. A, Pt VI, Section 1, para. 144.
[67] (5th Cir. 1968) 399 F. 2d 433, 436; O. and G.R. 527, *cert. denied*, (1969) 394 U.S. 922; 89 S.Ct 1187; 22 L.Ed 2d 455.

> *of Internal Revenue* v. *J.S. Abercrombie & Co.*[68] In that case the carried party had assigned all but one-sixteenth of its working interest to the carrying party. The carrying party was to drill and operate the wells, to pay all costs and expenses out of production, and to pay the carried party one-sixteenth of 'operating profits (income after the deductions for costs and expenses had been made). We held in Abercrombie that the carried party's retention of one-sixteenth interest in 'operating profits' meant that one-sixteenth of all gross income no matter whether paid out to the carried party or retained and used by the carrying party for drilling or development costs or expenses was income to the carried party. Twelve years later, in *Prater* v. *Commissioner of Internal Revenue*[69] we 'followed Abercrombie to its logical conclusion and allowed the carried party (in an Abercrombie transaction) to deduct his attributive (fractional) . . . share of the costs of development and operation'. *Weinert's Estate* v. *Commissioner of Internal Revenue.*[70]

In *Cocke's* case the Fifth Circuit of the United States Court of Appeals reversed its earlier decision in *Abercrombie* (and therefore as a matter of logical conclusion also its decision in *Prater*) and held that for U.S. tax purposes the carried party in the *Abercrombie* situation received no income and was entitled to no deductions until the "break-even" is reached. Until that time it is the carrying party who is regarded as receiving all the income from sale of production and is entitled to all of the deductions relating to such production. The Court in *Cocke's* case rejected an attempt to uphold the *Abercrombie* decision on the basis that the transaction involved should be characterized as a loan from the carried to the carrying party of one-sixteenth of the funds necessary to develop and operate the wells, such loan being repayable only out of the carried party's share of production. On this basis (that is the loan arrangement) under U.S. law the

> production which went towards repaying any of the loan would be income to the carried party on the familiar theory that the non-donative payment of a debt by a third party is income to the debtor Int. Rev. Code of 1954 S. 61(a)(12).[71]

Although there have been distinctions drawn between carried interests and net profits interests on the basis of their duration,[72] I consider the most useful starting point for my analysis is the distinction referred to in Lewis and Thompson[73] between a joint (*sic*) ownership situation and a profit sharing situation. I would suggest, however, that the distinction there drawn is over-simplistic for our purposes.

There is a case for applying an analysis similar to that which I have applied to the overriding royalty and production payment situations. In

---

[68] (5th Cir. 1947) 162 F. 2d 388.
[69] (5th Cir. 1959) 273 F. 2d 124.
[70] (5th Cir. 1961) 294 F. 2d 750, 758 (citations and footnotes omitted).
[71] *U.S.* v. *Cocke* (5th Cir. 1968) 399 F. 2d 433, 437.
[72] See text to note 64 *supra*.
[73] Note 7 *supra* at Vol. 1, Div. A, Pt VI, Section 1, para. 144.

this area, I submit that one should consider in each case whether the carried and the carrying party respectively during the term of the carry and the payout period[74] had, in respect of the share of production which is attributable to the carried interest—

(a) a proprietary interest—the legal right as the holder of an interest in the mineral concession to extract the attributive share of production;

(b) in kind non-proprietary rights—the right to receive production when severed from the ground; or

(c) the right to receive only a certain amount of the net profits from the sale of the production—as in *Pine Pass Oil & Gas Ltd et al* v. *Pacific Petroleums Ltd et al*[75] and *Act Oils Ltd* v. *Pacific Petroleum Limited & Westcoast Transmission Co Ltd.*[76]

On the basis of this type of analysis the *Abercrombie* type carried interest could be viewed as falling into category (c), which category I consider can best be described as a net profits interest. In *Cocke's* case the U.S. Fifth Circuit Court of Appeals rejected an attempt to analyse the *Abercrombie* type carried interest as one basically involving a loan, repayable only out of the carried party's share of production being the share of production to which the carried party was entitled because he still had an interest in the title. The Fifth Circuit Court said that the loan arrangement was in fact a sharing arrangement as to the proceeds from production. It is important however to recall that the U.S. Fifth Circuit Court of Appeals had under review the question of whether the carried party in an *Abercrombie* type situation had "an economic interest" in the production attributable to its carried interest.[77] The Court had so held in *Abercrombie* and was now, in *Cocke's* case, reversing that decision. The principles relevant to answering the question of whether one has an economic interest do not, under U.S. tax law, depend upon the legal ownership of the minerals.[78] On that basis the *Abercrombie* type arrangement may have to be differently regarded when considered in the light of Australian income tax law.

The problems which are foreseen in relation to the loan approach is that it is a loan of a particular type. It does not put the recipient of the loan

[74] The period of the "carry" is the period during which the carried party is relieved from contributing to costs. The "payout" period is the period during which the carrying party recoups the costs borne by him which were attributable to the carried interest. The period of the "carry" may end before the commencement of the "payout" period or may extend into and overlap the "payout" period.

[75] Note 62 *supra.*

[76] (1972) 4 W.W.R. 23, 27 D.L.R. (3d) 444 (Alta S.Ct).

[77] The ownership of an "economic interest" in petroleum or minerals is an important one under U.S. Tax Law—see Maxfield, note 1 *supra* at para. 28.25, p. 28; Williams, Maxwell and Meyers, note 7 *supra* at Ch. 9, Section 5A.

[78] *U.S.* v. *Cocke*, note 70 *supra* at 444-446. The concept of an "economic interest" as developed by the U.S. Courts does not follow a legal analysis as to the ownership of minerals or mineral concessions, the exercise of which involves production of the minerals. Therefore, while of great interest and assistance in formulating an approach to the problems under review in this and the following article, the U.S. cases are not of direct relevance to Australian legal or taxation considerations.

at any risk in relation to repayment if no production is achieved or if the production which is achieved is insufficient to ensure that the share of production attributable to the carried party's interest is not sufficient to yield proceeds equal to the amount of the carried expenses.[79]

(d) *Independent operations*

Joint venture agreements relating to exploration and development operations in the petroleum context usually provide for independent operations. There are said to be two chief reasons for such provisions:

> First as a result of differences of technical opinion, budgets or for other reasons, there must be mechanics available to the parties to allow a party to take independent action. Secondly, that party which has borne the entire cost of the operation which was designed to enhance the value of or evaluate the joint property, should be provided with a reward commensurate with the risk taken.[80]

Although there are many different types of independent operations provisions, the most common division is between "non-consent" and "sole risk" provisions. In many joint operating agreements there is provision that if parties having a certain percentage voting interest determine to carry out drilling operations all parties are bound to participate in such operations subject to the right of any party to become a non-consent party. A party who elects to become a non-consent party is not obliged to consent to the cost of drilling, completing or equipping the relevant well and is not entitled to participate in any production resulting therefrom until the party carrying out the drilling operations has recovered a specified amount. This amount is referred to as a "penalty" on the non-consent party.

In other cases the joint venture agreement provides that no drilling can be undertaken without unanimous consent of all parties, provided that any one or more parties has the right to undertake drilling operations at their sole risk, cost and expense. If the drilling operations result in production then provisions corresponding to those referred to in relation to the non-consent situation come into operation. It is stressed that independent operations provisions are not restricted solely to drilling. It is quite common, for example, for independent operations provisions to be made with respect to seismic operations.[81]

---

[79] *U.S.* v. *Cocke*, *id.*, at 445-446.

[80] See W. G. Brown, "Independent Operations, Obligatory Operations and Challenge of Operator Provisions in Joint Venture Agreements" (1970) 8 Alta L. Rev. 216 for a general review of typical types of independent operations clauses and the types of penalties and general problems which should be considered in connection therewith; see also Holt, note 34 *supra* at 469 ff.

[81] Also, in relation to drilling operations themselves, there is a broad distinction to be made between exploration wells and development wells, the penalty varying according to the projected risks. Non-participation in independent seismic operations does not, of course, lend itself to the imposition of penalty measured by reference to production, as there can be no production without the drilling of a well. I do not propose in this paper to review the whole range of possible provisions relating to independent operations including the different types of penalties involved and the reasons therefor.

In the case of joint venture agreements relating to mineral exploration there is usually no provision for sole risk operations. Generally, the usual provision is a form of non-consent provision under which the non-consenting party suffers a dilution in his percentage undivided interest in the relevant mineral concession, the degree of dilution being calculated in accordance with a formula based on financial contribution to exploration expenditure either actual or deemed. Usually these non-consent or "diminishing interest" provisions come into play in respect of discrete periods for operational programmes and budgets. At the exploration stage, these periods are usually of twelve months duration. As one moves into the feasibility study stage, where significant expenditures are involved, it is more usual for the diminishing interest provisions to come into operation in respect of functional stages[82] rather than particular periods of time. As to the reasoning behind the differences in approach to independent operations between petroleum and other minerals it has been said that

> [d]ue to the in place nature of hard minerals and the intermittent characteristics and variances in per cent of mineral, an exploration program is ordinarily conducted prior to the sinking of a shaft and the opening of a pit for actual mining even after commercial ore has once been encountered on the lands. The expense of exploration can be quite heavy, depending upon the extent thereof, and it is advisable to provide a method for a party who cannot or does not wish to pay his way to reduce his interest and, in effect, become a carried party. The exploratory program would ordinarily benefit all of the lands and, therefore, the reduction in interest of Non-Operator should extend to all of the lands.[83]

I do not propose in this paper to attempt a review of independent operations provisions. However, the following description of three common methods of arranging for the recoupment of costs by the independent operator and the corresponding "penalty" on the "non-participating party" will serve to indicate that the same type of taxation considerations as I will later be discussing in detail also arise in relation to independent operations provisions. Three common forms are—

1. The non-participating party is deemed to have relinquished to the participating parties, and the participating parties shall own and be entitled to receive in proportion to their respective interests, all of the non-participating party's interest in the well, its undivided interest in the petroleum concession and its share of production, until the proceeds from the sale or market value of such share of production (after deducting production taxes, royalty, overriding royalty and any other interests payable out of or measured by the production of such well accruing with respect to such interest until it reverts) shall equal the recoupment of costs and penalty. When the participating parties

[82] *E.g.*, exploration, feasibility study, mine development.
[83] Schwarz and Beal, note 1 *supra* at 624, 625.

recover the costs and penalty from the production attributable to the non-participating party, relinquished interests of the non-participating party automatically revert to it and from and after such reversion the non-participating party owns the same interest as before, and also an interest in the material and equipment in or pertaining thereto and the production therefrom as the non-participating party would have owned had it participated in drilling and working, etc. the well.[84]

2. Until recoupment of costs and recovery of penalty the participating parties own the well, the equipment pertaining thereto and all production therefrom.[85]

3. Until recoupment of costs and recovery of penalty the proportionate share of the non-participating party in oil and gas produced from the relevant well is sold and the participating parties are obliged to direct the purchaser thereof to pay to the participating parties all the proceeds from the sale after deducting all royalty interest, overriding royalty interest and production payments.[86]

4. *The Taxation Implications*

Although the taxation implications will be examined in detail in an article to be published in this Journal next year, it may be useful at this stage to canvass the factors that must be considered in relation to each concept.

In relation to each of overriding royalty interests, overriding royalties in kind, overriding royalties in cash, production payment interests, production payments in kind and production payments in cash, certain questions have to be considered which affect each party to the relevant arrangement. This consideration needs to be made in the context of both reservation and carve out situations.

By "reservation" I refer to a situation where the holder of the mineral concession either assigns or subleases the concession, reserving an overriding royalty or production payment. In that situation the original holder of the mineral concession would become the holder of the overriding royalty or production payment and the assignee or sublessee of the mineral concession would become the "working interest owner". By "carve out" I refer to the converse situation where the holder of the mineral concession continues as the working interest owner yet grants to another party an overriding royalty or production payment.

There are two relevant stages at which taxation implications have to be considered in the case of overriding royalties and three relevant stages in the case of production payments. The two stages in the case of overriding royalties are—

(a) creation; and

(b) post creation.

---

[84] Brown, note 25 *supra* Vol. 2, para. 18.21, pp. 18-248 to 18-250.
[85] Lewis and Thompson, note 7 *supra* at Vol. 2, Div. C, Form B 4(b), para. 6(h).
[86] Williams, Maxwell and Meyers, note 7 *supra* at App. 9, para. 9.

The three stages for production payments are—

(a) creation;

(b) post creation during the pay-out period;[87] and

(c) the end of the pay-out period.

The questions that must be considered are as follows:

1. Is there assessable income derived either by the holder of the overriding royalty (or production payment) or by the working interest owner or by both?
2. If there is such assessable income, is it income from carrying on mining business for the purposes of Division 10, or assessable income from petroleum for the purposes of Division 10AA?[88]
3. What costs and expenses can be off-set against such income?
4. Does the amount (or the value of the production) paid (or delivered) to the holder of the overriding royalty or production payment constitute assessable income of the working interest owner?
5. If so, what is the nature of that income?
6. If such amount (or value) is included in the assessable income of the working interest owner, can he obtain a deduction equal to the amount of the payment made to the holder of the overriding royalty or production payment (or the value of the share of production to which such holder is entitled)?
7. To what extent can the working interest owner obtain a deduction for expenses of exploration, development and production which are attributable to the share of production represented by the overriding royalty or production payment or to which the overriding royalty or production payment relates?

In the case of carried interest arrangements involving a limited carry, the taxation implications of the arrangements need to be considered at three stages:

(a) the position on the creation of the arrangement;

(b) the position post creation and during the pay-out period; and

(c) the position at the end of the pay-out period.

Of particular interest in regard to such arrangements are the following questions:

1. Are the amounts attributable to the carried interest out of which the carrying party recoups himself for expenditure incurred during the period of the carry included in the assessable income of the carried party as well as the assessable income of the carrying party?
2. If such amounts are so included, what is the nature of that assessable income and what deductions can be off-set against it?

---

[87] "Payout" period in this context is the period which is necessary to enable the holder of the production payment to receive the amount to which he is entitled.

[88] These questions may cease to be of such importance in view of amendments to the Income Tax Assessment Act foreshadowed by the Treasurer's budget speech.

3. To what extent can the carrying party obtain deductions in respect of expenditures which he incurs but which are attributable to the carried interest?

In the case of net profits interests or carried interest arrangements involving an unlimited carry, the taxation position needs to be considered in relation to two stages, namely:

(a) the position on creation of the arrangement; and

(b) the position post creation.

There are two questions of particular importance in this area:

1. Does the carrying party have to include in his assessable income an amount equal to the amount payable to the holder of the net profits interest; and

2. If so, can the carrying party obtain a deduction for the payment made to the holder of the net profits interest?

In a number of cases the questions referred to will not be separately dealt with in relation to each category of arrangements. There are a number of instances in which I consider that the principles relevant to one type of arrangement when examined at a particular stage are the same as those relevant to another type of arrangement at the corresponding stage. For example, I consider that the principles which would govern the taxation position at the stage of the creation of an overriding royalty interest would also be applicable at the stage of the creation of an overriding royalty in kind, an overriding royalty in cash and a net profits interest. The results of the application of such principles at such stage to the different arrangements may not, however, be uniform.