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The Economics of Farm-Outs (includes associated papers 21635 and 21888) $

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Summary.

This paper addresses key aspects in the negotiation of terms for farm-outs based on an initial valuation. The theory is applicable to "development farm-outs" and "net-profit-interest" transactions. The paper links the expenditure commitment, the interest earned, tax relief, and possible options through the given value of a license interest. The method advocated provides a structured approach that enables each party to a farm-out negotiation to identify factors to which the highest values should be attributed. In this way, it is possible to increase flexibility and to maximize the chance of arriving at mutually acceptable terms. The equations presented are intended as aids to formulating commercial terms during negotiation.

Introduction

This paper considers the rationale for farmouts and their economics from the perspective of the negotiator. In this paper, a farmout is a partial disposal of an interest in a license area by the farm-out party to a party prepared to carry costs on a defined work program on its behalf, the farm-in party. This definition covers what are commonly called development farm-outs" and "netprofit-interest" transactions, and the theory discussed is equally applicable to both. It is assumed that the reader is familiar with the concepts of discounted cash flow analysis and their application to "expected monetary valuation" (EMV) techniques. In the use of these, the algorithms may seem to provide a single definitive answer, but this is rarely the case. An awareness of the accuracy of the assumptions made and hence the margin of error on the answers derived is always important. It is the contention of this paper that the systematic application of the concepts described provides a useful framework for the negotiator and will become increasingly important as the oil industry operates under tighter economic pressures.

Cash Value

Why farm out? Three major motivations for farm-outs exist:

1. to finance heavy expenditure commitments,
2. to manage a company's acreage portfolio, and
3. to benefit from different perspectives of risks and rewards. Most farm-outs traditionally are initiated by a farm-out party who might not wish to meet his expenditure commitments and who looks to the farm-in party to provide risk finance.

In such situations, the common view is that the consideration for a farm-out where the farm-in party carries E percent of C costs to earn an interest of X percent is E × C, or (E × C)/X per percent. While this equation represents the improvement in cash flow to the farm-out party, the immediate cost to the farm-in party is not consistent with an economic valuation based on future cash flows. As a measure of the value of a farm-out, it has two further failings. First, it implies that the farm-out party's only alternative to drilling is to drop out of the license; this of course may be true but is not necessarily so. Second, it overstates the value of the consideration the farm-out party is receiving compared with a possible sale. Increasingly, farm-outs are motivated either by the desire to balance the risk profile of a company's acreage portfolio or by the possibility that a profitable opportunity may result from differences between the perception of the risks of two companies. In these situations, the cash receipt from the above equation provides neither a fair reflection of value to the parties nor a mechanism for comparing terms. @ deficiencies are addressed in the following sections, which are based on an EMV approach to valuing acreage.

Keywords: **farm-in party**, **EMV**, **expenditure**, **higgins**, **negotiation**, **Upstream Oil & Gas**, **Disposal**, **application**, **acreage**, **probability**

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