Navigating joint ventures in oil and gas
Introduction

Today’s joint venture (JV) transactions come in so many shapes and sizes that it can be difficult to decide on the optimal arrangement. For example, private equity partners continue to invest in the sector (with many funds being dedicated to the oil and gas industry), small, independent oil companies are partnering with one or many major oil companies, and public and national oil companies from all over the world have entered the oil and gas market. All offer exciting combinations of resources, assets, capital, expertise and labor. The right JV can optimize these to shape a dynamic growth strategy.

In this paper, we explore the rationale behind utilizing a JV. We look at the JV life cycle and, in particular, what JV partners need to do to ensure that the JV process is a successful one for the partners and for the JV itself.
Why consider a JV?

JVs are a well-established feature of the oil and gas industry. They are typically less risky and are easier to unbundle than full organizational mergers. With the scale of organizations within the oil and gas industry, antitrust concerns and the importance of national energy security, JVs are a useful way of gaining the benefits of collaboration without the economic and political risk associated with a merger or other business combination.

There are a number of drivers behind why JVs are used so extensively within the oil and gas sector:

- **Capital intensive:** upstream projects can be too big for a single company (even a super-major) to finance on its own. Many of the larger liquid natural gas (LNG) and deepwater projects fall into this category.
- **Risk concentration:** the risk profile attached to large-scale exploration and production (E&P) projects is such that no single company may wish to take full exposure.
- **Access to technology:** complex or frontier developments may require proprietary technology that requires the owner to have a stake.
- **Access to resources:** the legal owner of resources may not have the capital or technological ability to develop them to their maximum potential. Entering into a JV may also allow access to complementary assets or reserves.
- **Supply chain optimization:** downstream supply chains may be optimized across disparate geographies by pooling assets. Many of the refining JVs are based upon supply chain and market supply optimization for the various participants.
- **Market positioning and portfolio optimization:** pooling assets may allow the JV to develop a market-leading position in a particular geography (e.g., downstream) or product (e.g., chemicals) and enable a portfolio to be optimized across both asset pools, generating a value uplift from prioritizing larger assets. In an increasingly cost-focused climate, economies of scale are critical to success and partnering may help to achieve this.
- **Regulatory requirement:** some countries require foreign companies to partner with local entities if they are to enter that market.
- **Political sensitivity or energy security:** this means that JVs – as opposed to acquisitions and takeovers – may be more appropriate.
JV types

JVs typically utilized within the oil and gas industry broadly fall into one of three categories:

- The full asset JV
- The full business JV
- The marketing alliance

These types of JVs tend to occur in specific areas within the oil and gas sector. The lined boxes within each JV category highlight the areas that are more prevalent within the three main subsectors, upstream, midstream and downstream. These areas can be summarized in the graphic below.

Full asset JV
A JV entered into with regard to a specific set of existing assets or to develop assets. These have tended to occur around upstream JVs, pipelines, refineries and increasingly now with LNG projects. The upstream/full asset JV is the most commonly occurring type. Many JVs in the upstream subsector take the form of an unincorporated JV.

Full business JV
A JV entered into to combine the resources of entire businesses to create marketing, supply chain, production and scale synergies. These have historically tended to occur with:
- Downstream, chemicals and midstream businesses
- Oilfield services companies within the upstream sector

Marketing alliance
A JV entered into with the intent of jointly marketing product(s), e.g., motor fuels retailers and convenience stores joining forces to combine their consumer offerings.

JV issues and phases

If JVs go wrong, then JV partners may lose money, credibility, proprietary technology, assets and management focus. In the following sections, we look at some of the key areas to focus on at each phase of the JV life cycle to help ensure that the major pitfalls are avoided.

The four key phases in the JV life cycle can be summarized as follows:

- **JV planning** Define the commercial rationale and identify partner(s)
- **JV formation** Build the legal and commercial structure
- **JV operation** Operate and manage the JV on an ongoing basis
- **JV dissolution** Wind up the JV
JV planning

Once a decision has been made that a JV is the appropriate vehicle for a particular project or asset, there are a number of phases and processes that should be gone through.

Define the scope of the JV

The first step is to clearly define the scope of the assets that will be the subject of the JV. Where the asset is upstream acreage or a particular oil/gas field, this step may be relatively straightforward. However, if the assets are a collection of existing businesses that form part of a broader business or supply chain, defining the scope may be more complex. It is, however, critical that the boundaries of the JV arrangement are clearly articulated and are understood by all of the JV partners and contained within the JV agreement. This process should include not only the definition of the physical assets but also the definition of the markets and potential customers that the JV is aiming to serve. This is especially important when a JV could potentially be in competition with the venturing partners’ other business interests.

Perform commercial analysis of the JV

Commercial analysis and modeling of the JV is a key step and should contain a number of scenarios with sensitivity analyses around key variables. These variables can be, in part:

- Financial (i.e., oil price, interest rates, inflation)
- Production/recovery-related (i.e., BPD, throughput)
- Geopolitical (i.e., implications of a change in government, tax regimes)

By thoroughly modeling the financial implications of a range of scenarios, JV partners will understand the possible implications for the JV in terms of net present value and internal rate of return. This will help ensure that all partners are aware of and have considered a range of potential scenarios for the JV and are realistic about their expectations. By considering and discussing upside and downside scenarios in an open and honest manner, partners can anticipate potential difficulties and discuss how they would respond if that scenario should occur. These scenarios and anticipated outcomes can even be built into the legal agreement and can provide protection against future litigation, which may be costly for all sides and damaging to the business.

Define the legal, tax and financial structure

Consideration needs to be given to whether a separate legal entity is required, and if so, the appropriate legal, tax and financial structure that the JV will assume. Prospective JV locations, jurisdictions, legal and tax-efficient operating structures should be evaluated to discover, at an early stage, operational restrictions imposed by applicable laws and regulations. If multiple options are being considered, such due diligence can be utilized to assess the pros and cons of each of the proposed locations and jurisdictions to produce a tabular comparison, with risk-ratings scores and weightings. Part of this process should involve a consideration of the tax implications for both the JV and the venturing partners, where the JV will be domiciled for tax purposes and where its main centers of operation and management will be located. This analysis should also include an assessment of the tax implications of the potential legal structures under consideration.

Define the business strategy and plan

A business strategy and development plan should be prepared for early discussion with potential JV partners. The plan may change over time as a result of discussion and negotiation with JV partners, but it is important that there is a clear, early view of the assets, geographies, markets, outstanding commitments, investment case/ timings and growth targets on which to base discussions with JV partners and potential partners. This plan should also cover areas such as the proposed JV governance model and decision-making processes to get the balance right between allowing JV management enough autonomy to effectively manage the business while allowing the JV partners to maintain control over the operations, and effectively determine the longer-term strategy and commitments of the JV.

Identify and select partners

JVs are often complex, long-term arrangements. Trust, therefore, is critical to the success of the relationship. The early signs of whether your company and its partners are compatible will be evident during the negotiation process. Partner selection is a critical step and one that will determine the success of the JV. When JVs fail, it is often because of a breakdown in the relationship between the JV partners. This can be caused by a lack of trust, differing strategic objectives or unrealistic or nonaligned expectations of what partners can expect from each other. Clarity and thoroughness of planning at this and the JV formation stage can mitigate the risk of disagreement in the JV operation stage. This is especially true when international oil companies are partnering with National Oil Companies (NOCs). Each needs to be aware of the others’ aims and limitations. Shareholders and governments may have very different strategic aims and views on an investment; e.g., NOCs may well have social welfare obligations that may seem alien to an international oil company.

The number of partners in a JV can be a critical determinant of its success. Smaller numbers of partners make it easier to manage the decision-making process and to align objectives and the strategic direction of the JV.

It is important for JV partners to carry out due diligence on each other across a range of areas, including key financials, credit status, technical capabilities, management strength, existing commitments, outstanding litigation and prior JV performance. When a number of partners are being considered, it may be appropriate to have a scoring process covering all of the required partner criteria to assist in the selection process.

Identify and manage third-party risk

While companies often enter into JVs as a means to reduce risk concentration, partnering with another company introduces other risks that must be considered during the planning stage. The exact nature of these risks will vary depending on a company’s role in the venture and the attributes, capabilities, skills and other factors that a potential partner brings to the negotiating table. The following sources of third-party risk introduced by another partner/other parties should be considered during the JV planning stage:

- Financial strength of the partner, which may include pending litigation, environmental clean-up or reclamation obligations, or other contractual obligations
- Indemnities in place that may protect your JV partner but not extend to your company or the JV relationship
- Third-party risk management
- Contractual arrangements governing the JV should be structured in such a way to mitigate or manage these risks to an acceptable level. A company’s due diligence process undertaken when planning the JV should include identifying and understanding any pre-existing obligations and exposures that a potential partner has. JV parties should ensure contractual arrangements include indemnity clauses or other protective mechanisms to minimize exposure to, or appropriately manage, another partner’s obligations. Each party should also consider the financial strength of its partner and whether it is likely to be able to meet cash call requirements and its share of external obligations.

Third-party risk is also influenced by an entity’s role within the JV. In oil and gas arrangements, one party is typically designated as the operator. Frequently, an operator enters into contractual arrangements in its own name on behalf of the venture as a whole, and in the event non-operating parties are unable or unwilling to fund their share of an external obligation, the operator may be liable for the entire amount. Historically, an operator may have also granted to its partners certain contractual indemnities to limit a non-operator’s exposure arising from subcontracting arrangements with external parties. In light of recent industry events, operators should consider whether such clauses afford disproportionate protection to non-operating partners. The contractual terms of an arrangement determine how the associated risks and rewards are shared among partners. Accordingly, the operating partner should consider carefully the degree of proportionality set out in the contract and understand how this might drive the behaviors of its partners. Conversely, a non-operating partner is more likely to be involved in the day-to-day operations of a venture. Decisions made by operators may have unintended consequences to which the other partners are exposed. Given this risk, a non-operating partner should ensure the contract provides the entity with an adequate level of influence in those areas it deems as higher risk.

As part of a JV, companies will be exposed to both pre-existing and ongoing risk from co-venturers. It is therefore crucial that a robust partner risk assessment is completed during the JV planning phase and the contractual arrangement is structured to minimize exposure to appropriately manage these risks.

Don’t overlook the cultural aspects of a JV. Culture isn’t restricted to countries.
JV formation

The JV formation process will see the development, negotiation and finalization of many of the outputs of the JV planning phase.

Detailed location planning
Planning and implementation reports on the chosen, or short-listed, tax and legal environment(s) that will host the JV will need to be completed. Reports should cover aspects such as:

- Required licenses
- Necessary regulatory approvals
- Environmental impact assessment requirements
- Governing law
- Corporate law and compliance requirements of any JV company and any shareholders or stakeholders in a JV
- Local employment law analysis
- Local asset, property and land ownership rights and requirements
- Applicable company law stipulations (such as nationality of general manager, board and shareholder voting and retaining of profits in-country)

Financing of the JV
Details of the JV financing will need to be discussed, agreed upon and finalized. This will include:

- Exact definition of contributions from each partner
- Value of contributions from each partner
- Capital structuring of JV (e.g., use of debt)

The implications of the proposed financing will need to be assessed:

- Does the proposed jurisdiction allow the contemplated form of financing?
- What is the tax treatment of debt financing?
- Does a limited resource project financing model work under the legal system?
- Is leveraged financing possible?
- Does the applicable law allow the free and easy taking of security in certain properties?
- Can security be enforced in theory? In practice?
- Is there a working, transparent, local banking system that a foreign investor can keep working capital in without fearing for it?
- What are expropriation laws, protections and remedies?

All of these questions will need to be considered and addressed.

Financial reporting for the JV
The integration of the JV’s financial reporting with the partners’ statutory reporting requirements will need to be considered.

There may be a need for the JV to provide local generally accepted accounting principles (GAAP) accounts for statutory reporting purposes, International Financial Reporting Standards (IFRS) and/or US or other GAAP, to meet the reporting requirements of the JV partners. JVs can be incorporated or unincorporated. From a US GAAP perspective, in relation to the accounting by the JV partners, the legal form of the venture, proportion of the JV investment and operator responsibilities of each of the venturing partners will determine whether the JV will need to be consolidated within the partners’ accounts, treated as an equity investment or proportionately consolidated. Clearly, the need for consistency with the JV partners’ accounting requirements will be greatest where the accounts need to be fully or partially consolidated. From an IFRS perspective, the accounting is driven by the rights and obligations of each of the parties to the JV. For further information, refer to the IFRS publication, Applying IFRS: Oil & Gas — Impact of the new joint arrangements and consolidation standards (August 2011).

Critical reporting issues, such as oil and gas reserves recognition by the various partners, will need to be discussed and clarified and the principles, if not the quantities, agreed upon.

Critical areas of the JV that are of particular interest to the partners may require additional due diligence to be carried out on behalf of some or all of the partners. One such example is the production management processes and output of a production sharing agreement. Where such issues exist, it may be necessary for partners to consider putting in place additional assurance processes and mechanisms, such as a US Statement of Standards for Attestation Engagements No. 16 (SSAE 16) or the International Standards for Assurance Engagements No. 3402 (ISAE 3402), to provide all JV partners with the appropriate assurance over the JV financial reporting with the appropriate JV partner who “owns” the potential liability and detailed within the JV’s legal agreement.

Use of proprietary technology
Where the JV will use proprietary technology owned by one of the partners or the JV itself, the legal agreement between the partners should cover the usage of this technology. In addition to any patents or trademarks that exist, the agreement should identify the licensed users and the geographies where this technology can be deployed. Suspicions over perceived or real intellectual property theft are a common cause of friction between partners, but by dealing with these issues in a pre-emptive, thorough manner, the risks in this area can be largely mitigated.

Dispute settling mechanism
It is important that a clear dispute escalation and resolution process is understood and agreed to by all of the partners. This agreement also may determine who has ultimate control of the venture and potentially impact the accounting and financial reporting. This may include defining escalation mechanisms in the JV itself, involving the partners as stakeholders and also referencing local and international laws.

Management of legacy risk issues
Where the JV is formed from existing assets, there will need to be a clear mechanism for ring-fencing liability, risk issues and tax contingencies that pre-date the formation. These items may include ongoing litigation, environmental cleanup liabilities and outstanding human resources (HR) liabilities (pension funding, redundancy costs, etc.). These legacy items will need to be attributed to the appropriate JV partner who “owns” the potential liability and detailed within the JV’s legal agreement.

Dissolution options
The JV partners need to be clear about what the JV dissolution strategy and options should be. There is a range of mechanisms that exist to enable partners to buy each other out should the need arise — e.g., “Russian roulette” or “Texas shoot-out” clauses (see page 13). However, other scenarios should be considered and included within the legal framework of the JV. These scenarios could include, in part, the following:

- The inability of one or more of the partners to meet a cash call or unanticipated liabilities
- A number, but not all, of the partners wanting to sell the JV in its entirety
- Putting the JV into liquidation should the need arise

Implementation of a partner review process
As part of the ongoing JV review process, partners should consider the implementation of a regular review process where the performance of the partners is discussed and appraised in the context of the management of the JV. This will enable issues to be discussed, raised and resolved on a timely basis — as opposed to going unused and potentially escalating into larger issues that lead to a breakdown in the working relationship.

The JV partners need to be clear about what the JV dissolution strategy and options should be.
JV operation

Ensuring that the JV is structured and set up correctly is critical to its success. However, it is equally important that the JV performs in line with the partners’ plans and expectations. Many of the problems that occur with JVs stem from performance issues that undermine the initial rationale for creating the JV.

Organization design

Creating the new JV management structure, policies, procedures and culture will be critical to success. Where the JV involves the combination of existing assets and organizations, this will involve decisions regarding whether to harmonize around the partners’ existing policies, procedures and cultures or instead create a completely new set. The organization design needs to be sympathetic to the employees and ensure that they all feel part of the new organization. Change should be managed and communicated proactively. This will be more difficult where there are overlapping or duplicate roles, and a need to simplify and reduce the structure and number of employees engaged in the business. Positioning senior and middle management from all the partners within the new organization is a critical activity. It is important to recognize and understand corporate culture differences within the partners’ organizations. This will help the new leadership team to effectively manage and communicate with the new organization.

Design/harmonize business processes, technology and infrastructure

Where the JV is a combination of existing assets, decisions will need to be made regarding whether there are overlapping assets in terms of office locations, information technology (IT) applications/infrastructure and business processes. The JV businesses will operate relatively discretely from each other, this may be less of an issue – i.e., the combination of a sales and a production organization into a new JV may simply require that interface processes are put in place but the core processes, systems and office locations may remain unchanged. Where there is a need to unite two vertically integrated businesses to realize synergies, certain issues will need to be addressed early in the JV operation phase. The combination of two vertically integrated organizations will result in a potential overlap in a number of areas: functional support (e.g., HR, finance, IT, legal, real estate management, procurement), IT applications/infrastructure, office space, supply chain, suppliers and contractors. Such overlaps will need to be identified and plans put in place to rationalize the new organization and consolidate the overlaps.

Where the JV is a new organization, however, all of these areas will need to be either developed or provided by the partners. Where the partners will be providing services to the new JV, contracts for the provision of these services must be established. The timings of cash calls and distributions will also need to be carefully considered and agreed to in relation to the partners and the JV’s reporting timetable.

Meeting partners’ financial and tax reporting requirements

The JV partners are likely to have different reporting requirements and time frames for fiscal and tax reporting. The JV partners may also have Sarbanes-Oxley, IFRS or other regulatory reporting requirements that, even though they may not be specifically relevant or necessary for the JV itself, will need to be considered. All of these requirements will need to be communicated to both the other JV partners and the JV itself.

As previously mentioned, there may be key areas of the JV’s operation that may need to be subjected to additional assurance. This may take the form of an SSAE 16 or ISAE 3402. JV partner right of audit or annual rolling audits.

A clear program of audit and reporting requirements, formats and timings will need to be agreed to and established. The timings of cash calls and distributions will also need to be carefully considered and agreed to in relation to the partners and the JV’s reporting timetable.

Appropriate involvement of partners in decision-making process

JV partners will need to establish clear rules for maintaining control over the strategic direction of the JV and over key operational decisions that will significantly impact the JV. However, they must allow the JV management enough freedom to manage the organization on a day-to-day basis and not be weighted down by an overly bureaucratic and cumbersome decision-making process. This can be a difficult balance, and there will need to be a clear and well-understood delegation of authority between the JV partners and JV management.

The JV partners need to establish a regular series of governance oversight meetings with both the JV management team and each other to monitor progress, track performance against strategic goals and review and update the agreed-upon strategy.

Partner capital management

Where the JV receives capital funding from the partners in terms of either capital injection or assets, there needs to be a clear plan for the proposed timings and values of the partner capital investment in the JV and proposed timings for capital repayments.

The capital repayment obligations need to be carefully evaluated against the cash flow projections for the JV to ensure that they are realistic and achievable.
JV dissolution

JV dissolution may be a planned milestone event when a certain JV goal has been achieved or it may be a response to circumstances. Either way, it should be an event that has been foreseen, the options considered and provision for it contained within the JV’s legal framework.

There are a number of scenarios or options that the JV partners may have to consider.

Sale to a third party

This is perhaps the most straightforward of the options: the JV partners agree to sell the JV in its entirety to a third party. Where the JV is a stand-alone entity, the impact on the partners will be minimal. Where the JV has significant linkages to one or more of the JV partners’ businesses, it will be more complex. These linkages could involve the provision of certain services (e.g., technical support, research and development, IT) to the JV, or the JV could be integrated into the supply chains of one or more of the partners.

The nature of the business relationships between the JV and the JV partners will need to be carefully assessed and planned for in the sale process to ensure that the sale does not damage either the JV partners’ businesses or the JV itself.

Legal assistance will be needed in the sales process, as there will be a suite of documents to provide for the share sale and purchase, the transfer of obligations, possible renegotiation of the joint operating agreement, possible amendments to the finance agreements and an assignment of guarantees, support documentation, direct agreements, and rights and obligations.

Sale to one of the partners

Sale to one of the partners is a common outcome with many JVs. Often the sale process is governed by a Russian roulette or a Texas shoot-out clause. A Russian roulette clause allows one JV partner to make an offer for another partner’s share of the business, but the partner that has received the offer may then purchase the other partner’s share under the same terms as those that were offered for the purchase of its share. A Texas shoot-out clause initiates a process where JV partners submit written, sealed bids for the purchase of the JV and the highest bidder wins.

Once again, consideration will need to be given to how integrated the JV is with the JV partners’ businesses and how ongoing relationships between them should be governed.

Separation of organization with sharing of assets to partners

Separation of the JV with a return of assets and business to the JV partners is potentially the most complex dissolution. The longer the JV has been operating, the more likely it is that there will have been a “blurring” of the JV partners’ original inputs.

There will need to be discussions and subsequent agreement around which assets (people, technology, licenses and property) go to which partners, valuation of those assets and the appropriate settlement mechanism. These are likely to be complex and time-consuming negotiations. Again, where the businesses are integrated within the partners’ businesses, the process will be more complex, and partners will need to consider the potential impact on their core businesses of reintegrating the JV’s assets back within their organizations.

Consideration of this option should be part of the partner discussions, and provisions for how it would be managed should be contained within the JV agreement if there is more than a remote likelihood that this is a potential dissolution scenario.

Separation of the JV with a return of assets and business to the JV partners is potentially the most complex JV dissolution mechanism.
Summary

JVs are an inherent part of the oil and gas industry and are likely to remain so for the foreseeable future. When managed well, they can deliver real value to all stakeholders. However, when things go wrong, they have the potential to destroy shareholder value, with arbitration and legal proceedings being a costly, time-consuming distraction for the management of both the JV and the partners.

There are a number of critical success factors for JVs:

- Transparency, openness and honesty between the partners
- Thorough financial and tax planning
- Consideration of all potential dissolution scenarios
- A robust legal agreement that contains provisions for all of the above

EY’s JV services

EY has significant experience supporting JVs throughout the JV life cycle. An overview of the services we provide in each of the phases is contained below.

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*Japan’s Sarbanes-Oxley
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<td>Transaction carve-out services</td>
</tr>
</tbody>
</table>
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