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Challenge notices under the terms of the 1990 CAPL Operating procedure

By Nigel Bankes

Cases Considered:

Diaz Resources Ltd v Penn West Petroleum Ltd., 2010 ABQB 153,

This case will be of interest to the oil and gas bar for two reasons. First, the case provides some guidance as to the quality of the information that a joint operator must provide to support a challenge notice. Second, the case raises (but does not resolve) a question as to whether or not a challenging joint operator also carries the burden of establishing that it is capable of operating the property in a "good and workmanlike manner."

The facts

Diaz issued a Challenge Notice to Penn West (PW) under cl. 203 of the 1990 CAPL (Canadian Association of Petroleum Landmen) operating procedure in relation to three properties held equally as to 50% undivided interests. The Notice stipulated that Diaz would not charge the joint account for any costs attributable to a production office, a field office or to first level supervisors in the field.

PW took the position, in a timely way, that the Notice was deficient in that it did not provide sufficient information to assess whether the proposal was more favourable to the joint account or not, or if Diaz would be able to conduct operations in a safe and good and workmanlike manner. In addition, PW was of the view that Diaz might be in default under the agreement given the magnitude of unresolved receivables as between PW and Diaz.

Diaz commenced this application under Rule 410(e) of the *Alberta Rules of Court*, Alta. Reg. 390/1968, seeking a declaration that since PW had failed to elect either option prescribed by the CAPL form ((1) agree to operate on the proposed terms, or (2) resign) PW must be taken to have resigned leaving Diaz as operator.

The decision

Justice Colleen Kenny denied the application. Diaz failed to support its Notice with the information required by cl. 203 to allow PW "to evaluate the nature of the challenge notice and to measure the effect the revised terms and conditions would have on joint operations." In

particular, Diaz failed to provide as part of its Notice two types of information that it later provided by way of affidavit to support the present application. This later information detailed the specific costs savings but it also provided that Diaz would continue to retain an existing contractor thereby speaking (belatedly) to the ability to operate in safe and workmanlike manner.

Although this was sufficient to dispose of the application Justice Kenny also noted that to the extent that PW put at issue the ability of Diaz to assume the operatorship, that matter would have to proceed by way of statement of claim, discovery and trial.

Discussion

The CAPL operating procedure contemplates a number of ways in which the joint operator(s) can obtain a change in the operatorship: (1) for insolvency or similar reasons or purported assignment of the operatorship, (2) by vote, or (3) by notice of default signed by a majority of parties (other than the operator) and where the default remain unrectified. The case law suggests that a joint operator will face an uphill battle against an incumbent who wishes to retain its position: *Norcen Energy Resources Ltd v. Oakwood Petroleums Ltd* (1988), 63 Alta. L.R. (2d) 361 (QB); *Rimoil Corporation v. Hexagon Gas Ltd*, unreported May 5, 1989 (Alta. QB); *Mutual Oil and Gas Ltd v. DSWK Holdings Ltd* (unreported judgement of Justice Kenny, January 5, 1996, rev'd on appeal [1996] AJ 582) (dealing with the challenge provision under CAPL) and *Kaiser Francis Oil Company of Canada v. Bearspaw Petroleum Ltd.* (1999), 240 AR 59 (QB) (dealing with a pre-CAPL agreement).

In addition to the three ways outlined above there is also the challenge provision in cl. 203 which allows the joint operator to offer to operate the property on more favourable terms. Where that offer is accepted, or the incumbent decides to "renew" on those more favourable terms, the new (or renewed) operator is required to swallow any costs in excess of those set out in the challenge notice. The commentary to the 1990 CAPL is instructive:

> By limiting a challenge to an offer to conduct operations on "more favourable" terms and conditions than the operator, the challenger faces a serious, if not insurmountable obstacle. Since one is unable to quantify qualitative changes, the provision seems limited to financial terms. However, how can a challenger give any more than its best cost estimate when the costs of exploration are a function of such factors as weather conditions, exploration success (testing costs), mechanical difficulties, the demand for equipment and inflation? A challenge on the basis of terms and conditions, therefore, might in practice only be the right to challenge on the basis of overhead rates. Moreover, a challenge on the basis of financial terms ignores the consideration that the basis of a challenge may be the operator's technical rather than cost performance.

The commentary recognizes the difficulty that the challenger faces. Implicit in this is the idea that the incumbent operator is better placed to identify where it might be possible to identify efficiencies. Given these practical difficulties one should perhaps be careful not to be too

demanding of the information that the challenger must adduce in support of its challenge. But in this case the challenger seems to have provided only the barest information. One way to read Justice Kenny's short judgement is to say that the joint operator has a duty to put its best foot forward (just as in an application before a master in chambers!) at the time that it serves the Challenge Notice – and if it can adduce evidence by way of affidavit to support a later application for a declaration that it could just as easily have provided that at that earlier time then not only is that too late but also the challenger should not expect much sympathy.

In the present context it is also of interest to note that the commentary makes no reference to Penn West's suggestion that in addition to offering to serve on more favourable terms the challenger also bears the burden of establishing that it has the capacity to be a competent operator who will take charge of and conduct operations for the joint account in a good and workmanlike manner. This is of course the standard expected of an operator and in cl. 304 of the agreement the challenger covenants that it can and should be held to that standard if it becomes the operator. The question for present purposes is whether a challenger must provide evidence to support its capacity to meet that standard as part of its Challenge Notice. Justice Kenny seems to have some sympathy for this view ("It is clear under Clause 203 of CAPL that the challenger must be ready, willing and able" to conduct operations (at para 17)) but I think that this goes a step too far if this serves to erect another condition precedent that the challenger must meet before it can even have its proposal taken seriously. This would leave too much to the auto-interpretation of the incumbent operator who would simply say that an inexperienced joint operator could never have the competence to assume the operatorship. If that is the intent in the industry, then that intent needs to be expressed more clearly than the "ready, willing and able" formulation of the 1990 CAPL form. For as the commentary indicates, it is already very difficult for a joint operator to put together a challenge notice that is not a leap into the dark; the idea that there is a further condition precedent would make the challenge provisions little more than a dead letter.

In this context it is perhaps pertinent to note that the "ready, willing and able" language has been dropped from the 2007 CAPL form. The relevant commentary is essentially unchanged.

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