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Hibernia Payout Account Dispute

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Case Commented On: *Newfoundland and Labrador v ExxonMobil Canada Properties*, 2017 NLDT(G) 147, 2017 CanLII 56724 (NL SCTD)

This case involves an unsuccessful application by the Government of Newfoundland and Labrador to set aside an arbitral award dealing with the calculation of royalties with respect to the Hibernia project.

Modern Crown royalty regimes are frequently structured in two stages, a small gross royalty that converts to a larger net profits royalty after payout i.e. after the lessee/explorer has recovered allowable costs from production. We can see such regimes in the oil sands of Alberta and in the *Frontier Land Petroleum Royalty Regulations*, SOR/92-26 of the *Canada Petroleum Resources Act*, 1985 c 36 (2d supp) and, in this case, the project-based royalties for the Hibernia Project on the East Coast (although under this regime there is also a third tier supplementary royalty—which has yet to be reached).

The definition of payout and the definition of qualifying expenses is crucial to the operation of the payout account, whether in the context of Crown royalties or in the context of private royalties where payout is the trigger for converting from a gross overriding royalty back to a working interest, or where payout (or a multiple thereof) signals the end of the penalty period in the context of an independent operation under an operating procedure such as Article X of the CAPL Operating Procedure. All other things being equal, a more generous definition of eligible expenses will defer payout to the advantage of the working interest owner.

In the case of private royalties, disputes as to the payout account may be settled in the ordinary courts (or by arbitration if the parties have so provided): see for example, *Keles Production Co. v Husky Oil Operations Ltd*., 80 Alta LR (2d) 5, 1991 CanLII 5842 (AB QB) and *Lateral Resources Ltd. v Karon Resources Inc.*, 22 Alta LR (3d) 265, 1994 CanLII 9017 (AB QB). In the case of Crown royalties disputes are more likely to take the form of a Crown or ministerial decision followed by an application for judicial review or statutory appeal (where provided for). In the case of the Hibernia Project however the Crown royalty is provided for by the Hibernia Project Royalty Agreement (HRA) and the Hibernia Project Allocation Agreement (HPRA). The agreements follow the form of commercial agreements and provide for arbitration in the event of a disagreement with respect to the royalty. Arbitration is to be in accordance with an Arbitration Code based on the *Model Law on International Commercial Arbitrations* as adopted by the United Nations Commission on International Trade Law for June 21, 1985 (*UNCITRAL Model Law on International Commercial Arbitrations*, 1985, U.N. Doc. A/40/17 (1985, Ann. I; the "Model Law")).

In this case the dispute between the parties related to the treatment of the costs of operating insurance acquired by the individual working interest owners in the Hibernia project. In general, the HRA provided that costs would only qualify as Resource Project Eligible Costs (RPECs) if they were directly attributable to the project, were reasonable, <u>and were charged to the joint account</u>. However, the HRA also contained an exception to the joint account rule with respect to insurance. The insurance clause of the working interest owners' internal agreement (the HOUSA) contemplated that while the Operator would ordinarily acquire operating insurance for the joint account (the Operating Insurance Program, OIP), s 18.1.2 of the HOUSA also contemplated that the Executive Committee of the working interest owners (HEC) might direct the working interest owners to "obtain additional operating insurance other than the OIP". In such a case s 29.7 of the HRA contemplated that such premiums would qualify as RPECs:

> **29.7 Insurance Premiums**
>
> Notwithstanding the provisions of clause 29.1(c) [the general rule confining REPC eligibility to joint account expenditures] and subject to the other provisions of this Agreement, premiums for insurance required to be carried by a Project Owner by the third paragraph of clause 18.1.2 of the Ownership Agreement shall be a Resource Project Eligible Cost.

There were two phases to the project from an insurance coverage perspective—the construction and operating phases. For most of the construction period insurance was purchased by the Hibernia Management and Development Corporation (HMDC—the incorporated joint venture of the working interest owners) on behalf of the owners, but in 1997 it became necessary to acquire insurance separately. In subsequent years the HEC made various decisions and issued directions to project owners to acquire individual operating insurance either on a supplementary or primary basis and this was the case for many years. In 2011 the Province took the position (at para 21) that "these Project Owner incurred operating insurance costs did not meet the definition of 'insurance required to be carried by a Project Owner' under clause 29.7 of the HRA and were ineligible to be considered RPECs."

The project owners commenced arbitration on October 2, 2013 and the subsequent Award of the tribunal of December 15, 2015 resolved the dispute in favour of the project owners. The province then commenced this application to set aside the Award pursuant to section 14 of the *Arbitration Act*, [RSNL 1990, c A-14]() on the grounds that: (1) "the award has been improperly procured" in accordance with section 14 of the *Arbitration Act*; and (2) "the award deals with a dispute not contemplated by or falling within the terms of the submission to arbitration, or contains decisions on matters beyond the scope of the submission to arbitration", in accordance with article 34(2)(a)(iii) of the Arbitration Code. Justice Stack rejected the province's application.

While the parties agreed that the arbitration was to be conducted pursuant to the provincial *Arbitration Act* they disagreed as to whether the grounds for setting aside were those prescribed by s 14 of the *Act* or by Article 34(2)(a)(iii) of the Arbitration Code (see above). Section 14 contemplates setting aside "Where an arbitrator or umpire has misconducted himself or herself, or an arbitration or award has been improperly procured" whereas Article 34(2)(a)(iii) contemplates setting aside where "the party making the application furnishes proof that":

> … the award deals with a dispute not contemplated by or not falling within the terms of the submission to arbitration, or contains decisions on matters beyond the

> scope of the submission to arbitration, provided that, if the decisions on matters submitted to arbitration can be separated from those not so submitted, only that part of the award which contains decisions on matters not submitted to arbitration may be set aside.

This difference between the parties raised the question of the extent to which parties to an arbitration agreement might be able to contract out of the provisions of the *Act* (while understanding at para 42 that "The parties agree … that it is impermissible to completely contract out of the Court's inherent jurisdiction to review decisions of inferior tribunals"). Justice Stack was satisfied (at para 50):

> … that the adoption by the parties of article 34 of the Arbitration Code is not contrary to the *Arbitration Act*. The *Arbitration Act* was enacted to provide parameters for the private resolution of disputes. Among its objects is the protection of the Court's inherent jurisdiction to review the decisions of inferior tribunals. Permitting parties to agree to their own scope review for their private dispute resolution in a manner that does not unduly infringe upon the Court's inherent jurisdiction is in keeping with the attainment of the objects of the *Arbitration Act* in accordance with its true meaning. This is especially so for sophisticated entities contracting commercially.

Justice Stack also concluded (at paras 51-65) that the parties must have intended to contract out of the review provisions of the *Arbitration Act* notwithstanding the absence of express contracting out language. Furthermore this limited form of contracting out was not (at paras 67-70) contrary to public policy but was indeed consistent with (at paras 71-76) the principle of party autonomy that underlies the institution of commercial arbitration.

Notwithstanding this conclusion Justice Stack did examine what the result would be if the application to set aside were governed by s 14 of the *Arbitration Act*. That said, Justice Stack was also reluctant to come to any definitive conclusion as to the scope of review permissible under the standards of either "misconduct" or "improperly procured" (see generally at paras 77 – 99 and esp. at para 99). The bottom line however was that Justice Stack was convinced that the Province would fail under both the statutory and contractual tests for judicial intervention.

A principal issue before both the arbitration tribunal and the Court was the question of whether or not the owners acquired the individual insurance in question under s 18.1.2 of the HOUSA or independently thereof. The answer to that turned on whether or not the HEC had so directed. On this point there was some conflicting evidence with the Province choosing to rely on the so-called "Leonard Letter" to support its contention that the insurance was not acquired under a s 18.1.2 direction. However, there was also other evidence (the "DeBoice evidence") to support the owners' contentions and in the end the arbitral tribunal preferred that evidence. Justice Stack concluded that the tribunal's preference for the DeBoice evidence was both permissible and reasonable and that the tribunal gave cogent reasons for concluding (at para 152) that the Leonard Letter had no probative value. It was also reasonable (at para 179) for the tribunal to gain an understanding of s 18.1.2 of the HOUSA in the context of that agreement and industry practice before turning to the question of how that clause was incorporated in s 29 of the HRA.

In conclusion, while the case offers an interesting example of litigation with respect to the calculation of payout, it does not seem to have been a very hard case. Indeed, as both the tribunal and Justice Stack acknowledged (at paras 181, 182), s 29.7 of the HRA was a "complete answer" to the province's arguments. In fact, one wonders why this dispute ever had to go to arbitration let alone why the province thought it stood any chance on a subsequent application to set aside the Award.

Readers of this post who are interested in the arbitration issues and especially the standard of review under Article 34 of the Model Law may also be interested in the recent decision (September 15, 2017) of Justice McCarthy in *SMART Technologies ULC v Electroboard Solutions Pty Ltd*, 2017 ABQB 559 (CanLII).

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