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Court of Appeal (England and Wales) Confirms High Court Decision on the Relationship Between a Farmout Agreement and an Operating Agreement

By: Nigel Bankes

Decision Commented On: *Apache North Sea Limited v Euroil Exploration Limited and Edison SPA*, [\[2020\] EWCA Civ 1397](#)

In this decision, the Court of Appeal of England and Wales confirmed Judge Pelling’s decision in the High Court with respect to the drilling costs Apache was entitled to recover from Euroil under the terms of a farmout agreement (FOA) and its related joint operating agreement (JOA). I commented on Judge Pelling’s decision [here](#) and I refer readers to that earlier post for a more detailed statement of the facts, as well as references to Canadian decisions dealing with the relationship between an FOA and the JOA.

In that earlier post I suggested that the FOA at issue here would likely be denominated as a “farmout and participation agreement” in a Canadian context insofar as the drilling obligation was not a sole risk obligation of the farmee (Euroil) but rather was a shared risk operation for which Euroil was to cover only a percentage of the costs. The farmor, Apache, was to carry out the drilling operation as operator and was also responsible for a percentage of the costs.

The principal issue in the case was whether Apache was entitled to recover Euroil’s percentage share of Apache’s contract cost for the semi-submersible rig that Apache elected to use for the operation, or whether that should be reduced by the amount that the Apache’s contract rate for the rig exceeded prevailing market rates. The answer to this question turned on whether or not a clause in the accounting procedure attached to the JOA applied during the earning phase of the operation. That clause (cl 3.2.4) provided that

... the cost of services, equipment, and/or facilities owned, partly owned, leased or hired by the Operator or its Affiliates and used on behalf of the Joint Account, which shall be charged at rates commensurate with the cost of ownership. The rates shall not exceed rates currently prevailing for like services, equipment and/or facilities if provided by non-affiliated third parties;

Both Judge Pelling and a unanimous panel of the Court of Appeal concluded that this clause applied to all joint account operations and this well was such an operation, with the result that Euroil was only responsible for £1,114,480.68 as its proportionate share of the costs, rather than £3,280,482.46.

The decision confirms that drafters must carefully address the relationship between a JOA and an FOA, especially during the earning phase of the FOA. As Lady Justice Carr observed (at para 2):

Farm-out agreements do not typically exist in a vacuum. Where there is more than one owner, the parties will regulate their relationship in relation to that asset under a joint operating agreement. Farm-out agreements need to take account of and interact appropriately with those joint operating agreements to avoid inconsistencies and minimise the prospect of dispute. This appeal arises out of a dispute relating to the interaction between a farm-out agreement and a joint operating agreement.

Justice Carr was also careful to emphasize at the end of her judgment that the case should not be read as laying down any general propositions as to the relationship between these two types of agreement (JOAs and FOAs) (at para 70):

[T]his conclusion is a contract-specific one. I reject [Apache’s] submission to the effect that it would have any industry-wide impact by setting a general precedent. Neither the FOA nor the [JOA] was on a standard or model form; rather each was bespoke. The proper construction of a farm-out agreement and analysis of its interplay with an associated joint venture agreement will always turn on the precise terms of agreement between the parties.

As earlier Canadian authorities and these quotations confirm, drafters need to reflect carefully on the relationship between the different agreements (bespoke or standard form) commonly used in the upstream oil and gas industry.

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