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When does a "participant" earn under the terms of a farmout and participation agreement?

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Cases Considered:

Solara Exploration Ltd v. Richmount Petroleum Ltd., 2008 ABQB 596

In this decision Justice Sheilah Martin concluded that a participant in a farmout and participation agreement did not earn an interest in the farmout property when it elected to go non-consent on an operation to frac a particular formation, even when that operation was proposed after the parties had already installed a well head, outlet valve and production tubing. However, Justice Martin went on to hold that the farmor was estopped from denying that the participant had earned in the circumstances of the particular case. The decision is an important one for several reasons. It is a first decision on the definition of "completion" in the 1990 CAPL operating procedure, but it also serves to draw attention to the vulnerability of a "participant" in a farmout and participation agreement, especially where the farmor (as here) is wearing multiple hats and serving as both farmor and as operator for the purposes of the test well to which the participant is contributing. The case also highlights some of the difficulties associated with borrowing definitions from other agreements.

Facts

Richmount, Twin Peaks and RMU, who together held a 100% interest in the farmout lands, entered into a farmout and participation (F & P) agreement with Dyno as the predecessor in title to Solara. Attached to the head agreement were the 1997 CAPL farmout and royalty procedure and the 1990 CAPL operating procedure. Under the terms of the F & P agreement, Dyno was to earn a 25% share of Richmount's interest in the farmout lands before payout (BPO) (subject to a gross overriding royalty) diluted to a 17.5% interest after payout. During negotiations towards the agreement Dyno agreed to pay an amount for land equalization costs in return for a larger working interest share.

Under the terms of the farmout agreement Dyno was to earn when the test well was completed, capped or abandoned, but it was Richmount as operator that was to "drill to Contract Depth, test, complete, cap or abandon the Test Well". Drilling proceeded on the basis of an authorization for expenditure (AFE # 1) provided by Richmount. Dyno paid its 25% share of those costs. AFE # 1 called for directional drilling of the test well to a Basal Quartz target along with placement and cementing of production casing and logging. Richmount drilled the well to Contract Depth, logged the well and ran production casing. The rig was released.

Richmount then sent out AFE # 2 describing a completion program to complete and test the Basal Quartz and the Mannville. Richmount described the program as a "Completion/Workover/Re-entry" and assigned tangible costs for Production Tubing and Accessories and Wellhead and Installation and Related Equipment. Dyno paid its share of the expenses and the work was completed. In particular, a wellhead and outlet valve were installed at the well location, the Basal Quartz formation was perforated and production tests run.

As a result of the production tests it was understood that it was not economic to tie-in the well for production, whereupon Richmount proposed a fracing operating and sent out AFE # 3 to that effect. Richmount described the operation variously as a "workover" and a "completion\workover" and proposed fracing the Mannville and installation of further production tubing for that purpose. Dyno communicated its decision not to participate by letter in which it indicated that while the operation was not proposed as an independent operation it was prepared to deem it to be such under cl. 1008 of CAPL. Dyno further noted that it expected to be subject to a 300% penalty for the workover operation and a 200% penalty with respect to equipping costs. Dyno did not send a formal "earning letter" asserting that it had earned its interest and seeking a formal transfer of that interest.

The operation proceeded and the well was ultimately placed on production. While Richmount took the view that the result of Dyno's non-participation was that Dyno had not earned, Richmount did not communicate this understanding to Dyno for some five months. During this time and because of this understanding Richmount failed to offer Dyno the opportunity to participate in a second well that was drilled on the farmout property which well also went into production.

Dyno\Solara argued in this action that: (1) the well was completed on the basis of AFEs # 1 and # 2, and, in the alternative, (2) Dyno was entitled to an interest by virtue of Richmount's breach of the agreement, or (3) Richmount was estopped from denying that the Test Well was completed and that Dyno had earned. The F & P Agreement incorporated various definitions from the CAPL operating procedure including the definition of completion:

> "Completion" means the installation in, on, or with respect to a well of all such production casing, tubing and wellhead equipment and all such other equipment and material necessary for the permanent preparation of the well for the taking of petroleum substances therefrom up to and including the outlet valve on the wellhead and includes, as necessary, the perforating, stimulating, treating, fracing and swabbing of the well and the conduct of such production tests with respect to such well as are reasonably required to establish the initial producibility of the well.

Decision
Justice Sheilah Martin held that Richmount was estopped from denying that Dyno had earned an interest in the test well.

The definition of completion has three aspects: (1) installation of all equipment necessary for taking production on a permanent basis, (2) completion may require fracing etc, and (3) tests necessary to establish initial producibility. Dyno was not able to show, on the balance of probabilities, that all necessary equipment had been installed under the first branch of the definition. With respect to the second aspect of the definition, not all fracing operations are included within the definition of completion; this will depend on the circumstances. Fracing may occur after completion in which case it is sometimes (but not always) referred to as a workover. The evidence here tended to show that in this case fracing was necessary for completion.

Richmount was estopped from denying that Dyno had earned. Richmount was aware of Dyno's position that it had earned; the fact that Dyno did not send a specific "earning letter" was not relevant. In these circumstances (where Richmount was both farmor and operator for the farmee), Richmount's silence amounted to a representation intended to induce a course of conduct. Richmount had a duty to respond to Dyno's assertion and had a duty to communicate clearly as to the categorization of proposed operations. Richmount used different labels (completion and workover) to describe the activities covered by AFE # 3 which invited confusion as to whether the operations covered by the AFE were part of completion or post-completion. In the industry, the term "workover" is generally confined to an operation that occurs post-completion and ordinarily after the well has been placed on production. In these circumstances it would have been better for Richmount to have described AFE # 3 as a "supplementary completion AFE". Dyno relied on the representation in the sense that had it been aware of the fact that Richmount was taking a different position it would have contributed its 25% share of the costs ($40,000) to maintain an interest rather than sacrifice the $200,000 it had already disbursed.

This was not a case (such as *Canadian Superior Oil v. Paddon-Hughes Development Co Ltd* (the *Hambly* case) [1970] SCR 392) where estoppel was being used to revive a terminated agreement. Estoppel cases dealing with the lease were distinguishable. The evidence did not support Richmount's claim that Dyno was being strategic in its drafting of the letter.

On the balance of probabilities Dyno would have participated in the second well and thus it must be taken to have earned an interest in the second well in addition to the test well but must contribute at the penalty rate.

Assessment
I will comment on two aspects of this decision, first the vulnerability of the participant in arrangement of this sort and second, the court's treatment of the plaintiff's claims with respect to the option well.

Participation agreements and the vulnerability of participants

In a pure farmout agreement the allocation of risk is usually fairly straightforward since the agreement will typically provide that the earning operation is to be conducted at the sole cost, risk and expense of the farmee. The farmee also has a duty to indemnify and hold harmless the farmor from any damages or expenses that the farmor might incur as a result of the operation. Similarly, in a pure farmout, the farmee will typically be in a good position to determine whether or not it has earned. The earnings rules will be spelled out in the agreement and ordinarily the farmee will be in charge of the operation. This is exactly what one would expect; a farmee likely does not want to give somebody else control of an operation that is being carried out at the farmee's sole cost, risk and expense. The penalty for failing to complete the earning operation is severe; the farmee will not earn and will thus have nothing to show for the expenditures made. Technically there is no forfeiture since the farmee has nothing until it has earned, but the consequences are similarly penal. Analytically, a farmout agreement is similar to an option and if the option analogy holds (as it certainly does in the context of mining agreements) then it follows that the farmee must comply strictly with all of the earning terms. Where there is only one party farming in there will be no need for an operating agreement until the farmee has earned its interest and there is a co-ownership situation (*Novalta v. Ortynsky* [1994] 6 WWR 484 (Alta. QB)), and for the same reason there will be no need for an authorization for expenditure to authorize and govern the operation.

The rules are also fairly clear when we are dealing with operations solely under the terms of an operating agreement. In such a case, all operations are conducted for the joint risk of the joint account unless they are conducted as an independent operation in which event that operation will be conducted for the sole cost, risk and expense of those parties participating in the independent operation. Operations for the joint account above a certain amount always require an AFE. Subject to some difficulties with the 1981 version of the CAPL agreement (see *Morrison Petroleums Ltd v. Phoenix Canada Oil Co* (1997), 198 AR 81 (QB)), a party who executes an AFE signs on to the full cost of that operation even if the operation exceeds projected costs (*Renaissance Resources Ltd v. Metalore Resources Ltd* [1985] 4 WWR 673 (Alta. C.A.)). But a drilling AFE is only a commitment to participate to the "casing point election". A second AFE is always required to commit the parties to completion and it follows that in a situation where a party elects not to complete at that point it is going non-consent and thus is to be treated as an independent operation with the non-consenting party subject to a penalty. The consequences of failing to execute an AFE or failing to contribute the full costs associated with an AFE are not as severe as are the consequences of failing to earn in a farmout. With the exception of title preserving wells (TPW), a party who fails to sign on to independent operation AFE is consigned to a penalty position; it does not (except in the case of a TPW) suffer forfeiture. A party who fails to pay assessed contributions is simply in breach of the operating agreement and the agreement provides a whole suite of remedies (Article V) to the operator for that eventuality.

If these things are reasonably clear in the context of pure farmout agreements and operations pursuant to an operating agreement, they soon become fuzzy when other elements and concepts are introduced such as the concept of "participation" as in the present case. This is not the first case in which earning has been contentious in the context of a participation agreement: see for example *Hi-Ridge Resources Limited v. Noble Mines and Oils Ltd*, [1978] 5 WWR 552 (B.C.C.A.), *370105 Alberta Ltd. v. Brazos Petroleum Corporation*, [1993] 3 WWR 186 (Alta. Q.B.), and R*oyal Bank of Canada v. Joffre Resources Ltd*, [1995] 5 WWR 75 (Alta. Q.B.).

In this case we have what seems to be an operation for the joint account of the co-owners of the property (Richmount, Twin Peaks and RMU) which is then modified by the desire of one party to share its portion of the risk by bringing in another party (Solara\Dyno), as a participant. Furthermore, since Twin Peaks and RMU were contributing their full share of the costs of the operation, from their perspective this is not an operation for the sole cost, risk and expense of the farmee, but a shared risk operation. The dual nature of the agreements suggests that the parties will see the facts through very different lenses. Take, for example, AFE # 2. On the facts of this case, AFE # 2 would be perceived by Twin Peaks and RMU as the completion AFE as required by Article IX of the Operating Procedure. Presumably, Twin Peaks and RMU actually had an election to make at this point. But from the perspective of Solara\Dyno this was not much of an election; it had to go along with the AFE in order to preserve its chance of earning an interest. While it could also earn its interest through abandonment, abandonment was hardly an option while Richmount as operator was interested in completing the well for production.

The judgment itself demonstrates the competing views of AFE # 3. On the one hand, Solara\Dyno viewed the operation as one that was subject to cl. 1008. On the other hand, at least for Richmount, it was part and parcel of completion, and, as such, Solara\Dyno had to participate in order to earn. The distinction is crucial since if it was a new operation (albeit a re-working or re-completion operation), the AFE would be void unless all parties approved (cl. 701). Solara attempted to address this by purporting to consent to the operation proceeding as an independent operation notwithstanding the absence of an independent operations notice. Richmount in this situation has a huge incentive to prolong completion for as long as possible so as to get as large a share of the costs as possible covered by the participant; and if it can take advantage of a failure to contribute as evidence of non-completion then it also receives a windfall since its interest is no longer diluted to accommodate the participant.

In sum, the participant in a farmout and participation agreement where the farmor is the operator is very vulnerable, since, if the participant fails to complete, it is left with nothing. The facts of this case offered Justice Martin three different options for extending some degree of protection to the participant: (1) a fiduciary duty analysis, (2) a *contra proferentem* analysis (since Brookfield was the originator of the AFEs it was appropriate to insist upon a strict construction of those instruments against the drafter), or (3) an estoppel analysis. Justice Martin touches upon each of these possible characterizations of the facts but in the end opts for the estoppel approach. Within that frame of reference Dyno\Solara's vulnerability as a participant is used to help characterize the legal implications of Richmount's silence when it learned of Dyno\Solara's assessment of AFE # 3. The outcome seems entirely appropriate.

Dyno's position in relation to the second well

Dyno's claim in relation to the second well (it is not completely clear from the facts whether this was a second well on the lands subject to earning under the test well, or whether it was in fact what is more conventionally described as an option well) must be that if it had earned in relation to the test well, then it must also have been entitled to participate in the second well.

In order to pursue that claim Dyno had to prove on the balance of probabilities that it would have participated had it been given the chance. Justice Martin concluded, perhaps surprisingly given the initially disappointing results from the test well, that Dyno would have elected to participate. But what should flow from that?

What should flow is that Dyno should be able to earn an interest on the basis of putting up its share of the costs of the well under the terms of the farmout and participation agreement. Its interest should be encumbered by the BPO royalty subject to the right of conversion as contemplated. Although it is not entirely clear, Justice Martin appears to suggest that Dyno should be required to "pay at the penalty rate for all activities" (paras 162 and 163). While this makes sense for that portion of the costs of the test well that are subject to AFE # 3, it does not make sense with respect to the second well. If as Justice Martin concludes (at para 158), Dyno has been able to show that it "would have taken the opportunity to participate in the 11-2 [second] well, had it been offered" then it should follow that it should simply be required to pay its share of the costs on an ordinary non-penalty basis. Participation on a penalty basis is ordinarily reserved for those who elect to go non-consent.