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Abandonment Expenses are for the Joint Account

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Case Commented On: *Spyglass Resources Corp v Bonavista Energy Corporation*, 2017 ABQB 504 (CanLII)

In this decision Justice Jones rejected a series of technical arguments raised by the receiver of Spyglass (Ernst and Young) to resist payment of abandonment costs. The receiver had argued that Bonavista had abandoned co-owned assets for its own account rather than the joint account and that Bonavista was not able to set-off revenues attributable to Spyglass's interest against Spyglass's share of abandonment obligations.

Spyglass and Bonavista were co-owners of a number of oil and gas properties and associated pipelines, and some natural gas processing facilities. Operations on the oil and gas properties and associated pipelines were governed by the terms of the CAPL (Canadian Association of Petroleum Landmen (*sic*)) Operating Procedure (either the 1981 or the 1990 form) and PASWC (Petroleum Accountants Society of Western Canada) Accounting Procedure (either the 1983 or the 1988 form). The processing facilities were operated under the terms of an agreement for the construction, ownership and operation (CO & O) of the facilities, the 1996 Model Operating Agreement of the Petroleum Joint Venture Association (PJVA), and the 1996 Accounting Procedure of PASC (Petroleum Accountants Society of Canada). Bonavista was the operator under all of these agreements (collectively the JOAs) and maintained a single joint account for all of these operations and issued monthly joint interest bills (JIB) to Spyglass.

The jointly owned oil and gas properties had been shut-in since May 2011 as a result of orders issued by the Alberta Energy Regulator (AER) (or its predecessor) to protect the recovery of bitumen (see generally Requirements Affecting Gas Production in the Oil Sands Areas). As a result, both Spyglass and Bonavista became eligible to receive gas-over-bitumen royalty credits (GOB credits) under the terms of the *Natural Gas Royalty Regulation, 2009*, Alta Reg 221/2008. These credits were payable to Bonavista as operator for the joint account.

Another consequence of the shut-in was that the natural gas pipelines and gas processing facilities were no longer used thus triggering various decommissioning obligations under either the terms of approval for the facilities or the relevant AER Rules. Bonavista complied with these "requirements". Spyglass resisted paying its share of these obligations. Bonavista obtained an order under s 30 of the *Oil and Gas Conservation Act*, RSA 2000, c O-6 (*OGCA*) to determine the abandonment costs and penalty payable by Spyglass to Bonavista. Bonavista did not enter as a judgment of the Court as permitted by s 30(6) of the *OGCA*. Bonavista had previously noted Spyglass in default under the terms of the various JOAs (June 2015) and began netting amounts received by the joint account (including GOB credits) against costs incurred including abandonment costs.

A receiver was appointed for Spyglass in November 2015 and in January 2016 the receiver took the view that Bonavista was not entitled to retain the GOB credits and demanded payment. In these proceedings the receiver made three main arguments: (1) Bonavista failed to comply with the various JOAs and thus the abandonment costs were for Bonavista's sole account and not for the joint account; (2) by electing to pursue the procedure under s 30 *OGCA* Bonavista was confined to that remedy; and (3) various arguments to preclude Bonavista from exercising a right of set-off.

The Sole Account Arguments

Both the CAPL and the CO & O agreements impose requirements that must be met before the operator can expend funds for the joint account.

The CO & O Agreement requires that the owners must form an operating committee and cl 204 provides that an owner who fails to vote or abstains shall be deemed to have voted in the affirmative. However, cl 208 makes cl 204 inapplicable where there are only two owners of the facilities (the case here) and requires unanimity. Finally, cl 1003 creates an exception to the usual rules when an operation is required by regulation:

> If required by the Regulations or directed by the Operating Committee to salvage the Facility or any Functional Unit or a portion thereof as the case may be, Operator shall, for the Joint Account: …
>
> (b) clean up and restore the site of the Facility, Functional Unit or portion thereof, as the case may be, in accordance with the Regulations and to the satisfaction of any governmental body having jurisdiction with regard thereto and to the reasonable satisfaction of the owner or occupier of the land upon which the Facility is located. (emphasis added by Justice Jones)

In turn the CAPL agreement (1990) provides:

> … the Operator shall not make or commit to an expenditure for the joint account for any single operation, the total estimated cost of which is in excess of twenty five thousand ($25,000) dollars, without an approved Authority for Expenditure from the Joint Owners, unless the expenditure is reasonably considered by the Operator to be necessary by reason of an event endangering life or property or is required by the Regulations and failure to make such expenditure could result in prosecution of the Operator thereunder. If the Operator is required to make such an expenditure, it shall promptly advise the Joint Operators of the nature of such event or requirement and the expenditure anticipated to be associated therewith. (emphasis added by Justice Jones)

The facts seem to have revealed that the parties never created an operating committee under the CO & O Agreement and further that Spyglass never cast an affirmative vote in favour of any of the expenditures; nor did it execute any relevant AFE (Authority for Expenditure). Furthermore, Bonavista resisted attempts by Spyglass to call a meeting to discuss the plant decommissioning issues.

Justice Jones held (at para 18) that Bonavista had breached the procedural requirements of the CO & O agreement but noted that the "consequences of that contravention are ... less clear" and further (at para 23) that while "Bonavista's lack of responsiveness is unfortunate, I find that it does not make what was otherwise a proper expense for the Joint Account Bonavista's sole responsibility." Justice Jones supported this conclusion by interpreting Spyglass's objections as an objection to the lack of an explanation for the expenditures rather than a refusal to pay at all. With respect, these reasons are hardly sufficient to establish that Bonavista's expenditures conformed to the requirements of the two agreements. I think that Justice Jones acknowledged this since he went on to conclude that Bonavista was entitled to make all of the expenditures for the joint account because they were required by law (and not because Spyglass had in some sense agreed to or acquiesced to the payments).

In reaching this conclusion Justice Jones afforded some leeway to the operator in its choice of compliance options and in the timing of those operations (at paras 28-48). Thus, Justice Jones rejected the argument of the receiver to the effect that Bonavista could have further delayed decommissioning the gas plant and he deferred to Bonavista's election to abandon rather than discontinue the pipelines (an option conferred by s 82(3) of the *Pipeline Rules*, Alta Reg 91/2005). The abandonment option was approved by the AER and Justice Jones concluded (at para 48) that "abandonment, as opposed to discontinuance, was considered by the AER to be an acceptable resolution of the lack of corrosion and cathodic protection of the Pipelines." More important perhaps for the guidance of others is Justice Jones' more general observation (at para 46) to the effect that "I am satisfied that, as Operator, Bonavista was entitled, within reason, to decide how best to achieve regulatory compliance. Here, I believe Bonavista acted reasonably. I accept its explanation for proceeding with the abandonment plan." This should give some comfort to operators engaging in at least some facility abandonment operations without the cover of executed AFEs.

Election of Alternative Remedy Arguments

The receiver argued that Bonavista was not entitled to set off the GOB Credits against the abandonment costs because it had elected to recover these costs through the mechanism provided by s 30 of the *OGCA*. Since Bonavista had obtained an order from the AER it needed to register that order as a judgement of the Court and as a consequence claim as an unsecured creditor against Spyglass's assets. Justice Jones summarily dismissed this argument, observing (at para 56) that the AER's abandonment costs order "merely validated and allocated the Abandonment Costs. Obtaining it did not require Bonavista to give up its other remedies."

The Set-Off Arguments

The receiver argued that Bonavista could not set-off GOB Credits against abandonment costs on the basis of either contract, law or equity. It is evident that the receiver needed to succeed with all three arguments in order to preclude Bonavista from netting or setting off the GOB credits against the abandonment costs. It failed on each argument.

Both the CO & O Agreement and the CAPL Operating Procedures provide for a right of set-off. The CAPL set-off right is broader than the CO & O provision since the CAPL provision permits set-off against sums accruing under "this Operating procedure or any other agreement" whereas the CO & O right is confined to sums accruing "pursuant to this agreement." The receiver's

argument must therefore have been that the GOB Credits accrued pursuant to the Crown's natural gas rights which were operated pursuant to the CAPL agreements and therefore could not be set-off against abandonment costs associated with the gas plant which was subject to the CO & O Agreement.

Bonavista seems to have had a number of responses to the contractual set-off argument. The first is that Bonavista was exercising a netting right rather than a set-off right and that netting is inherent in the concept of a joint account. Bonavista maintained a single joint account for all the operations. A second argument seems to have been that so long as some of the agreements provided for a broad right of set-off, that was sufficient when the agreements were read together. In the end it is not entirely clear to me which argument Justice Jones preferred but he clearly sided with Bonavista and he did reject the receiver's argument that Bonavista had to maintain separate joint accounts under each of its agreements. The finding here seems to have been that that was the established practice of the parties and the receiver assumed its responsibilities subject to that practice. In any event, here is what Justice Jones had to say by way of conclusion:

> [79] While I agree that clause 602(b)(iii) of the CO&O purports to limit set-off to amounts due to a defaulting owner from the Operator pursuant to that Agreement, I do not view that clause as prohibiting Bonavista from netting receipts and disbursements arising in connection with the Joint Operations.
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> [80] I believe it would be inimical to the interests of parties whose activities are governed by a number of agreements, but for whom a single joint account is maintained, to deny the Operator the ability to net amounts coming into the joint account under some of those agreements against amounts payable from the joint account under other agreements. In my view, such netting should be permissible when various revenues and expenses, accounted for through the use of the joint account, reflect integrated operations.
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> [81] In this case, some aspects of the Joint Operations are governed by the JOAs and others by the CO&O, but the Joint Operations are directed at a common undertaking. While the unique terms of the various Agreements must be respected, I consider it appropriate to interpret the Agreements in the aggregate as permitting netting the GOB credits against the Abandonment Costs. Such an interpretation, in my view, gives business efficacy to the Agreements.
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> [82] I accept Bonavista's position based on *SemCanada* [*SemCanada Crude Company (Re)*, 2009 ABQB 397, 479 AR 299] that it and Spyglass contracted in the same right under the Agreements. In each case, Bonavista acted as Operator while Spyglass was an owner.

This was presumably enough to decide the case in favour of Bonavista but Justice Jones went on to consider the remaining arguments to the effect that set-off was not available.
With respect to legal set-off, the parties seemed to be in agreement that a legal right of set-off could only exist if:

1. The obligations existing between the two parties must be debts, and they must be debts which are for liquidated sums or money demands which can be ascertained with certainty; and
2. Both debts must be mutual cross-obligations, i.e. cross-claims between the same parties and in the same right.
(*Citibank Canada v Confederation Life Insurance Co (Liquidator of)* (1996), 42 CBR (3d) 288, 1996 CanLII 8269 (ON SC) at para 37)

The receiver's first argument, relying on *Bank of Nova Scotia v Societé General (Canada)*, 87 AR 133, 1988 CanLII 166 (AB CA), and *Brookfield Bridge Lending Fund Inc. v Karl Oil and Gas Ltd*, 2009 ABCA 99 (CanLII) (see earlier post here) and the commingling clauses of both the CAPL and CO & O Agreements, was that the GOB Credits were impressed with a trust and were therefore not available for set-off (and perhaps (see at paras 91-94) an alternative argument that it was a breach of Bonavista's fiduciary obligations to apply these monies to the abandonment costs when it knew that Spyglass was disputing these expenditures). Justice Jones accepted that the monies were impressed with a trust but concluded that the terms of the trust did not preclude using them to discharge Spyglass's obligation. Justice Jones put it this way:

> [95] I agree with the Receiver that Bonavista is in a fiduciary position with respect to receipts and revenues held on behalf of Spyglass as an Owner under the CO&O, in respect of its conduct of Joint Operations and joint accounting. However, I do not accept the Receiver's assertion that the GOB Credits are held under a trust arrangement that prevents them from being treated in a manner similar to other forms of revenue. While clause 603 of the CO&O and clause 507 of the 1990 CAPL Operating Procedure refer to monies accruing to the Joint Account as trust monies, these descriptions do not mean that such revenues can be applied by an Operator only for the benefit of a non-operator. Rather, I find that the reference to such monies as trust monies merely operates to remove them from the Operator's estate and potential confiscation by its creditors. These monies must be applied in accordance with the provisions of the Agreements and the rules of law and equity that govern the parties' relationship.

As to the second branch of the *Citibank* test, the receiver argued that the abandonment costs were not ascertainable until the AER had made its final determination in its abandonment costs order. Since this was after the receiver was appointed the receiver argued that there was no right of set-off because of the terms of the receivership order. The Court rejected that argument (at paras 99-102). Justice Jones concluded that Spyglass had a contractual obligation to settle the monthly JIBs and when it failed to do so within the prescribed time its debt was ascertainable.

The test for equitable set-off is that established in *Holt v Telford*, [1987] 2 SCR 193, 1987 CanLII 18 (SCC) at para 35:

> (a) The party relying on a set-off must show some equitable ground for being protected against his adversary's demands;
> (b) The equitable ground must go to the very root of the plaintiff's claim before a set-off will be allowed;

> (c) A cross-claim must be so clearly connected with the demand of the plaintiff that it would be manifestly unjust to allow the plaintiff to enforce payment without taking into consideration the cross-claim;
> (d) The plaintiff's claim and the cross-claim need not arise out of the same contract; and
> (e) Unliquidated claims are on the same footing as liquidated claims.

The principal issue was the close connection test of para (c). The receiver argued (at para 108) that:

> … the GOB Credits arose pursuant to the JOAs and underlying mineral leases, the Shut-in Order and the applicable Regulations. On the other hand, Bonavista's claim for the Abandonment Costs is based on a regulatory order regarding the decommissioning of specific facilities, issued after the date of the Receivership Order. Alternatively, the Receiver argues, Bonavista's claim for the Abandonment Costs arises pursuant to the CO&O, a separate contract governing lands and facilities different from those under the JOA.

By contrast, Bonavista suggested (at para 112) that GOB Credits and abandonment costs were intimately connected:

> The Abandonment Costs are a direct result of the Gas Over Bitumen Order that required the Wells be shut-in. Shutting-in the Wells led to the GOB Credits. Thus, the same order gave rise to both the requirement to decommission, reclaim and abandon and the GOB Credits.

Justice Jones preferred (at para 115) Bonavista's argument and its characterization of the connection.

Since Justice Jones found throughout for Bonavista he found it unnecessary to deal with Bonavista's limitations argument which would have precluded any recovery of retained GOB payments prior to October 3, 2014, i.e. 2 years before the receiver commenced its application (see *Limitations Act*, RSA 2000, c L – 12, s 3(1)).

Finally, the Court also accepted that the receiver should incur personal liability for Bonavista's costs on the basis that the receiver had acted as a "real litigator". The principal evidence of this was that the receiver was not espousing a claim that Spyglass had already commenced. Indeed (at para 121) "Spyglass had not commenced a claim prior to the receivership and did not challenge netting or set-off of the Joint Account."

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