February 21, 2020

Relationship Between a Farmout Agreement and a Joint Operating Agreement

By: Nigel Bankes

Case Commented On: *Apache North Sea Ltd v Euroil Exploration Ltd* [2019] EWHC 3241 (Comm) (England and Wales)

Under the terms of a farmout agreement, the farmor, the holder of a working interest in an oil and gas property (i.e. a lease, licence, concession or other form of agreement), affords the farmee an opportunity to earn a share of that working interest in return for performing a work obligation - typically the drilling of a well. In some cases (sometimes termed a farmout and participation agreement) the farmee earns an interest by contributing a share of the costs of a drilling operation to be conducted by the farmor itself rather than the farmee. It is standard practice in either case to attach a joint operating agreement (JOA) to the farmout agreement to address the legal relationship between the farmor and farmee (and perhaps other parties) once the farmee has earned its interest. It is crucial to do this since, once the farmee has earned, the farmor and farmee will then be co-owners of the lease or licence etc, i.e. they will be holders of an undivided interest in that property as tenants in common. But until the farmee earns, the parties are not co-owners. One issue that the parties need to address as clearly as possible in these arrangements is the applicability of the JOA *before* the farmee has earned. Perhaps a working hypothesis might be that the JOA is of no application until the point of earning since the JOA is fundamentally concerned with co-ownership. However, there is frequently a lot of detail in the JOA that the parties may want to incorporate or make reference to during earning and this may be especially the case where the farmout is better characterized as a farmout and participation agreement rather than a pure farmout where the earning well is drilled at the sole cost, risk and expense of the farmee.

This question, the relationship between a farmout and a JOA, was the nub of the issue in this recent decision of the High Court (Commercial Division, England and Wales). The agreement in question was what I would call a farmout and participation agreement. Apache was the farmor and EEL was the farmee. EEL was to earn an interest by contributing to the costs of a well to be drilled by Apache with certain options to acquire a larger interest by contributing a larger share of the costs.

For Alberta cases dealing with the interrelationship between agreements, see for example *IFP Technologies (Canada) Inc v EnCana Midstream and Marketing*, 2017 ABCA 157 (CanLII) and my post here and the earlier decision in *Morrison Petroleums Ltd. v Phoenix Canada Oil Company Ltd.*, 1998 ABQB 624 (CanLII).

In the case under comment here, Apache had a drilling rig under contract with a third party and used that rig for the farmout operation. The principal issue was that the fees payable under

Apache's contract exceeded the market rate for an equivalent rig. Apache relied on the language of the farmout agreement and the concept of "total costs" in the farmout agreement to charge EEL with its share of these costs. EEL resisted on the basis that the farmout agreement did not define a mechanism for defining total costs and that therefore reference should be had to the attached JOA and in turn its attached accounting procedure, Section 3.2.4 of the accounting procedure stipulated 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. (at para 10)

Judge Pelling QC sitting as a judge of the High Court found in favour of EEL principally on the basis that absent reference to the JOA there was no basis on which to ascertain total costs:

> The reality is that if both agreements are read together as was plainly intended by the inclusion of the VJOA as an appendix to the FOA [farmout agreement] … then together they work as a cohesive whole. Treating the FOA as an independent agreement in the way contended for by [Apache] would create anomalies … . None of those arise if the approach set out above is adopted. In particular if EEL is correct then there is a comprehensive machinery for ascertaining what has to be paid and when, whereas, if [Apache] is correct there is no such machinery and disputes were likely to be the result. In my judgment it is inconceivable that either party's expert and specialist lawyers would have wished to expose the parties to such an outcome. (at para 33)

The Court also addressed two other points that may be of more general interest. The first was Apache's argument that the farmout agreement afforded it considerable discretion to drill as it saw fit. Judge Pelling conceded that but deemed it irrelevant:

> How the work is done does not impact on how the costs of doing that work is to be assessed. There is nothing within [the FOA] … that lead to the conclusion that ANSL was free to charge otherwise than as provided by the VJOA. (at para 34)

A second issue that arose related to the question of when a defaulting party became liable for payment of interest at the rate stipulated in the farmout agreement (i.e. LIBOR + 4%) (at paras 35 – 42). The relevant provision in the farmout agreement stipulated that:

> if any amount payable pursuant to this Agreement is not paid when due, the defaulting Party shall pay interest on such amount from the due date of payment (after as well as before judgment) at the Default Rate (on an (*sic*) compounded basis)

EEL seems to have the taken the view that "when due" referred to the time when the present dispute was resolved on the basis that it could not determine what sum was due until then, or at least until sometime after it had assessed the invoice. Not surprisingly the Court rejected that proposition noting that there were provisions in the Accounting Procedure to allow for payment under protest while questioning the correctness of any amount included in an invoice. EEL ought to have paid the full amount or at least the element of the invoice not in dispute in order to avoid a greater liability for outstanding interest.

This post may be cited as: Nigel Bankes, "Relationship Between a Farmout Agreement and a Joint Operating Agreement" (February 21, 2020), online: ABlawg, http://ablawg.ca/wp-content/uploads/2020/02/Blog_NB_Apache.pdf

To subscribe to ABlawg by email or RSS feed, please go to http://ablawg.ca

Follow us on Twitter @ABlawg