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A Complex Oil and Gas Accounting Decision

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Case commented on: *IFP Technologies (Canada) Inc v EnCana Midstream and Marketing*, 2022 ABKB 807 (CanLII).

Several years ago, I commented on both the original trial judgment in this case (2014 ABQB 470 (CanLII),following a six-week trial going back to 2011) and the Court of Appeal's decision (2017 ABCA 157 (CanLII)). The posts are here and here. The Court of Appeal ultimately found in favour of IFP and ordered an accounting as the principal remedy but referred certain questions back to a trial judge to be assigned to hear the matter. This is that decision rendered by Justice Charlene Anderson.

The facts are complicated but here's a very brief summary that I hope will suffice to explain this new decision. My post on the original trial decision provides a more detailed account.

PanCanadian Resources (PCR) (now Encana, hence the style of cause) and IFP were party to a number of agreements that the Court of Appeal interpreted as affording IFP a 20% working interest in certain lands (the Eyehill Creek Assets). PCR had operated these assets for primary production of heavy oil for a number of years but there was a common understanding that the property was marginal and would need to convert to thermal recovery if it were to be viable. The agreements between the parties included an Asset Exchange Agreement (AEA) and a CAPL (Canadian Association of Petroleum Landmen) 1990 Operating Procedure, including CAPL's Article 24 which affords each party the opportunity to refuse consent to a disposition (although such consent is not to be unreasonably withheld).

The agreements suggested that IFP was principally interested in future thermal recovery operations, and that IFP would generally have no interest in, or liability for, existing wells (some 222 wells) or the primary production from these lands. Nevertheless, the majority of the Court of Appeal (per Chief Justice Catherine Fraser) affirmed the primacy of the AEA as affording IFP an ownership position as a tenant in common of the Assets:

> In my view, the Contract reveals that PCR agreed to transfer, and did transfer, to IFP 20% of PCR's working interest in all the assets held by PCR in Eyehill Creek, including both Crown oil and gas leases and leases that PCR held freehold. I have further concluded that the JOA did not reduce or limit IFP's working interest. Accordingly, IFP is entitled to an accounting for 20% of the net revenue realized by Wiser [PCR's assignee, see below] through primary production at Eyehill Creek. (ABCA at para 90.)

After the AEA was executed PCR became concerned that, unless immediate measures were taken to obtain or restore production, the existing leases would start to expire triggering

immediate abandonment and reclamation obligations (or ARO). In response, PCR proposed to enter into an "unusual" farmout agreement with Wiser which would see Wiser acquire PCR's interests in return for fulfilling some of PCR's abandonment and reclamation obligations (the agreement is referred to as the ARO agreement) (at para 167). The common premise of the two parties to the ARO was that Wiser would continue to engage in conventional production rather than initiating thermal secondary recovery techniques. In light of this understanding of the ARO, IFP declined to provide its CAPL Article 24 consent to PCR's assignment. That said, PCR and Wiser still went through with the assignment. In the opinion of the majority of the Court of Appeal, PCR thereby breached the AEA as informed by the duty of good faith in the performance of contractual obligations:

> PCR did not have the right to engage in new primary production and certainly not in any manner it saw fit. At a minimum, PCR was under a duty of good faith not to engage in primary production in a manner which would undermine or substantially nullify IFP's ability to pursue a thermal project. Moreover, such a duty also extended to not farming out its interest to a third party who would likely do the same (ABCA at para 203).

It followed from this that IFP had reasonably withheld its consent to the assignment and that Wiser had never been novated into the operating agreement (ABCA at para 204).

As for a remedy, the majority concluded that since IFP had no right to have PCR develop a thermal operation, IFP's remedy must be confined to an accounting of net profits from the primary production that continued to occur, notwithstanding the contractually shared expectations of IFP and PCR.

Since the Court of Appeal was not in a position to conduct that accounting, it remitted this matter to trial in the following terms:

> [This] issue relates to how to calculate the net revenue. In addition to the obvious, there is a question of whether and to what extent, if any, IFP should be responsible for abandonment costs of existing infrastructure. To take a few examples only, there may be wells that were not reactivated at all and have now been formally abandoned. Whether IFP is responsible for what would otherwise be its proportionate share of those costs remains another open issue. Also, there might be certain abandonment costs that were already required to be paid when existing wells were reactivated. In other words, those costs might have been baked in, with or without reactivating them for primary production. Again, is IFP responsible for those costs or only the incremental costs of abandoning the wells associated with their reactivation for primary production? And is it, in any event, open to IFP to opt in to existing wells on an individual basis? Again, we heard no argument on these or related points dealing with how to determine the "net revenue" realized from primary production at Eyehill Creek. (ABCA at para 218)

Further guidance was provided in a decision dealing with the costs of the appeal and settlement of the judgment roll: 2017 ABCA 269 (CanLII).

Less obviously, the Court of Appeal also seems to have concluded that the accounting would have to be based on the common law principles of co-ownership rather than an accounting under the terms of the CAPL Operating Procedure and attached accounting procedure. The rationale for this seems to have been that the parties contemplated that the CAPL procedure and its associated joint operating agreement would apply to future thermal operations and that such arrangements were inapplicable to the continuing primary recovery operations actually conducted by Wiser. While this premise is repeatedly reaffirmed in Justice Anderson's judgment (e.g., at paras 85, 124, 131 & 140), this did not stop the parties, or Justice Anderson, referring to CAPL and PASC (Petroleum Accountants Society of Canada) agreements and procedures as evidence, through their various experts, of what might be reasonable, or a custom or standard practice in the industry.

The Court of Appeal also referred another question to the trial judge. This was the question of whether a limitation on liability provision in the AEA was applicable, and as such, could serve to cap any claim that IPF might make. While the Court of Appeal listed this as its first direction, I will follow Justice Anderson and deal first with the accounting issues. In doing so I also repeat what I said in my original post to the effect that "I don't envy the trial judge who receives this assignment …". The hearing on the accounting issues took up 14 days of court time and the resulting judgment is nearly 40 pages in length.

I review Justice Anderson's judgment under the following headings: (1) co-ownership law, (2) what did the Court of Appeal mean by the term 'net revenue'? (3) when should the accounting begin? (4) should accounting be on a well-by-well basis or across the assets? (5) how might expenses be proven? (6) how to resolve some non-JADE expense issues, (7) the treatment of royalty payments, (8) the treatment of abandonment and reclamation costs, (8) interest, (9) limitation of liability, and (10) conclusions.

Co-ownership Law

Co-ownership is messy. Co-ownership is for parties who get along. If parties don't get along they should seek partition or sale. The default rules of the common law to deal with co-ownership are pretty thin, and they have not been much expanded by statute (in Alberta, see the *Law of Property Act*, RSA 2000, c L- 7, Part 3 (*LPA*)). It is the very thinness of these common law rules that leads parties in a commercial co-ownership situation (common in the resource sectors) to negotiate very lengthy and complex operating procedures. The challenge in this case was that, as noted above, there was no applicable operating procedure.

Justice Anderson's discussion of co-ownership law is actually very limited. Justice Anderson does not mention the *LPA,* and the only Canadian co-ownership case she references is *Rupstash v Zawick* 1956 CanLII 67 (SCC), [1956] SCR 347. *Ruptash* is authority for the proposition that a co-owner who makes an improvement to jointly owned property with the consent of the other owner has no lien by operation of law against the other owner to secure payment of that other owner's share of the costs of the improvement. On the other hand, *Ruptash* also stands for the proposition that in the event of a partition or sale, the value of the improvements conferred by the one owner must be taken into account in apportioning any proceeds of sale – at least to the extent that the improvements have enhanced the value of the property. While *Ruptash* suggests that this

accounting can only be done at the time of partition or sale, in this case the accounting was authorized and required by the Court, presumably based on its inherent jurisdiction.

What Did the Court of Appeal Mean by the Term 'Net Revenue'?

As noted above, the Court of Appeal ordered an accounting of net revenue. But that Court was not entirely consistent in its terminology, and in other places in its judgment it used the term "net revenue realized". Justice Anderson's judgment contains an extensive discussion of the difference between these two terms couched in the context of a debate between accounting experts. As I understand the discussion, "net revenue realized" requires that an allowance be made for the cost of capital associated with producing revenues, whereas net revenue would not. IFP initially contended that the accounting should be based on the concept of net revenue free and clear of capital costs, but then seems to have modified its position to accept that such costs should be included in the accounting (at paras 30 – 36). In sum, the judgment proceeds on the basis that the relevant concept is that of "net revenue realized".)

When Should the Accounting Begin?

Although there had been primary production from Eyehill Creek prior to 1998 when the AEA was signed, and therefore also prior to Wiser's acquisition of PCP's interest, the parties ultimately agreed that the accounting should begin from the date of Wiser's acquisition (2001). (ABKB at paras 37 – 40). This makes sense in light of the Court of Appeal's identification of the rationale for the accounting in favour of IFP.

Accounting on a Well-by-Well Basis or Across the Field?

IFP's position sems to have been that since the accounting was based on a premise of co-ownership, capital investments by one co-owner (PCP or Wiser) should only be taken into account to the extent that those investments actually enhanced the value of the property, absent any other agreement between the parties. After consideration of some American authority, Justice Morrison concluded that IFP could not opt in to only the profitable wells and that "that an accounting of the entire field is the appropriate and equitable (as per *Zawick*) approach" (ABKB at para 83).

I am not sure that this approach is consistent with the *Ruptash v Zawick* decision on which Justice Morrison relies. Yes, an accounting is an equitable remedy, and thus may not be available against the *bona fide* (perhaps) third party purchasers for value who were present in the *Ruptash* case, but that does not mean that accounting is synonymous with what a trial judge, in this case Justice Morrison, considers to be "fair" or "appropriate and equitable": see *Chupryk v Haykowski*, 1980 CanLII 3025 (MB CA), [1980] 4 WWR 534 at 553 per O'Sullivan JA). Furthermore, why is the entire field an appropriate unit of aggregation when the property actually consisted of a series of 24 leases, each of which was held as a separate title unit in a tenancy in common? Justice Morrison also referred to the penalty or independent well provisions of the CAPL agreements but, as she acknowledges, it is hard to see how they might be directly relevant since "there was no agreement here" (at para 85). That said, the absence of such an agreement in a co-tenancy situation if anything confirms that one co-owner should not be able to

foist an unprofitable "improvement" on the other co-owner, unless that co-owner has expressly opted in. In sum, Justice Morrison's "field approach" is premised on a presumption of consent, or even a deemed consent, which seems inconsistent with the common law's recognition of the autonomy of each co-owner.

How Might Expenses be Proven?

Both parties accepted that PCR should have the burden of proof to establish the expenses that could be deducted as part of the accounting for net revenue realized, and that such expenses had to be actual and not just hypothetical. But this was still a challenging exercise given the period of time involved, the state of the accounting records, and the number of wells and transactions. The parties and their experts placed much reliance on a joint venture accounting program known as JADE (Joint Account Data Extract) to establish expenses, but there was also evidence to the effect that, in the case of a wholly owned property, an operator would frequently not bother recording all expenses in JADE, since it did not need to account to a joint venture partner. This was PCR's position here insofar as it had taken the view that IFP had no interest in conventional operations.

Justice Morrison concluded that it would be open to PCR to prove these additional expenses, and seems to have accepted that it could do so by relying on generally accepted accounting standards (at para 94), or CAPL operating procedures and PASC accounting procedures (at para 95), with the following caveat:

> I accept the evidence and explanation as to why certain expenses would not have been included in the JADE for what was thought to be a wholly owned property. I accept the evidence before me that the defendants would have incurred reasonable and necessary expenses but not accounted for them because they believed the property was wholly owned. IFP's concerns are fair and therefore I will ensure that my decision regarding these additional expenses or adjustments … will not give the defendants a major unsubstantiated financial gain …. (at para 100, emphasis added.)

Resolving Some Non-JADE Expense Issues

Several non-JADE expense claims proved to be contentious and thus required a ruling from Justice Morrison. One example was the costs associated with a processing facility. The court ruled that estimated capital costs for the facility were reasonable and much more favourable to IFP than the alternative - third party processing fees established on the basis of the Jumping Pound methodology (at paras 111 – 120). Similarly, the court accepted that PCR should be able to claim for engineering and design costs, production engineering costs, overhead costs, and insurance costs – and in most case supported this (both eligibility and the amount) by reference to expert testimony as to standard practice in the industry as demonstrated by PASC accounting procedures (at paras 121 – 144).

Treatment of Royalty Payments

The Eyehill Creek assets consisted of 24 leases. PanCanadian was the lessor (as the successor to CPR's mineral estates) in the case of seven of the leases; the Crown or a third party was the lessor for the balance. A further complication, however, was that while one of the PanCanadian leases stipulated a royalty rate (20%), the other six provided that the royalty rate was to be negotiated. Wiser was responsible for paying these and other gross overriding royalties during the time that it worked the properties, and PCR argued that all of these payments should be allowable expenses for the purpose of calculating net revenue realized. IFP took exception to including the royalties payable to PCR as an allowable expense on the grounds that, had PCR intended to charge a royalty on IFP's 20% interest in the PanCanadian leases, it would have stipulated for that in the AEA and it had not done so (at para 151). By contrast, and in further support, PCR's ARO Agreement with Wiser provided that Wiser would pay PCR a gross overriding royalty of 16.667%.

In the end, Justice Morison appears to have accepted (correctly I think) the principle that as a 20% working interest owner in the leases, IFP would ordinarily be responsible for its share of any payments reserved by a lessor and thus that such payments should be an allowable expense against production as part of determining net revenue realized. However, in the absence of any evidence as to what PCR and IFP might have agreed on for six of the seven leases, PCR could only include as expenses the royalties payable under the one lease that stipulated a royalty rate:

> The burden of proof rests with PCR. The defendants have the burden to prove on a balance of probabilities that the royalty rate Wiser negotiated with PCR would be the same rate IFP would have negotiated. The defendants have not met their burden. (at para 165.)

Treatment of Abandonment Costs

Given that the AEA contemplated that IFP's principal interest was in thermal production, the AEA provided that IFP would have no responsibility for the abandonment and reclamation costs associated with the existing wells except to the extent that it chose to participate in primary production from these wells. However, in the changed circumstances of the farmout to Wiser, and IFP's attempt to seek an accounting for Wiser's primary production, as well as the directions given by the Court of Appeal, Justice Anderson was of the view that IFP must be taken to be "opting into the existing infrastructure" (at para 173). But that still left open the question of how much of the existing infrastructure IFP was opting into.

In answer to this question, Justice Anderson distinguished the abandonment costs assumed by Wiser under the terms of its ARO Agreement with PCR. This work was undertaken by Wiser as part of its earning obligation under the ARO farmout, and covered the period from the date of execution of that agreement until the end of 2003 (at paras 178, 189). These costs were ineligible for setting off against the revenue stream. Why? "To rule otherwise, would be to rule that IFP is responsible for 20% of Wiser's purchase price of PCR's working interest (to which IFP refused to consent)." (at para 185).

Abandonment costs incurred post-2003, however, were entitled to a different treatment insofar as wells abandoned after the end of 2003 were used to obtain incremental primary production that benefited IFP (at paras 189 – 190).

But what about future abandonment and reclamation costs? Following the Court of Appeal's recent decision in *PricewaterhouseCoopers Inc v Perpetual Energy* 2022 ABCA 111 (CanLII) and the reality that "end-of-life obligations are as inevitable as death and taxes" (at para 201 of Justice Morrison's judgment), Justice Morrison ruled that future abandonment and reclamation costs would have to be included in the accounting. Justice Morrison provided the following guidance:

> … Given that IFP is seeking an accounting of net revenue realized from 2001 and given that the Court of Appeal ruled that Wiser completed its ARO obligations [by the end of 2003] (for which I have ruled IFP is not responsible), the remaining ARO obligations, must be accounted for in an accounting for profit. The obligations would have arisen during the time frame in which IFP seeks an accounting of net revenue realized, either because of activity during that time or new regulatory requirements. These costs are a real liability or obligation: they are inevitable.
>
> Mr. Johnson calculated IFP's 20% proportionate share of future abandonment costs as $4,474,034 and the present value of future costs as $3,576,011. His calculations are set out in Schedule G of his report and contemplate an annual closure spend from 2021 to 2060.
>
> …
>
> I find that IFP is responsible for its proportionate share of the abandonment costs incurred after 2003 up to and including future abandonment costs as calculated by Mr. Johnson. This finding is in accordance with the direction of the Court of Appeal. However, there may be some flexibility in addressing these future costs. I will hear from the parties as to whether IFP's 20% share could be placed in trust, or whether IFP could post a bond until the actual costs are incurred and accounted for. If not, I accept Mr. Johnson's calculation of the present value of IFP's future abandonment costs, $3,576,011 and find that this amount must be included in an accounting of IFP's share of net revenue realized. (at para 202-203, 206)

Interest

Following a lengthy discussion of simple vs compound interest on any amounts that PCR might owe to IFP following the accounting, Justice Morrison ruled that IFP should be limited to the claim set out in its pleadings, namely interest in accordance with the *Judgment Interest Act*, RSA 2000, c J-1 (ABKB at para 220).

Limitation of Liability

Justice Anderson dealt much more summarily with the second issue that the Court of Appeal had referred back to trial, namely the limitation on liability clause in the AEA, which limited each party to a damages claim that could not exceed the value of the assets (deemed by the parties to be $16 million). Relying on the Supreme Court of Canada's decision in *Tercon Contractors Ltd v British Columbia (Minister of Transportation & Highways)* 2010 SCC 4 (CanLII), IFP argued that the exclusion clause could not apply in the circumstances of this case, insofar as the Court of Appeal had concluded that "IFP's expectation was that PCR would not engage in primary production in a manner which substantially nullified the contractual objectives or cause significant harm" (at para 231). Justice Anderson was not convinced that that finding alone was sufficient to render the limitation of liability clause inapplicable. In particular, she reasoned that:

> IFP has not satisfied me on a balance of probabilities that the limitation of liability clause is inapplicable or is unenforceable. It has not satisfied me, for example, that the clause relates only to thermal production or some other specific cause of action. Neither has IFP satisfied me that the clause is ambiguous. The AEA did not arise in a special commercial context such as with the public procurement process. I can see no special circumstance that would support IFP's position that, on the one hand, the AEA provides for its undivided interest in primary production but on the other hand, the limitation of liability clause in the AEA does not apply to primary production (at para 236).

Conclusions

This dispute concerned events that took place in the late 1990s and early 2000s. It proceeded to a lengthy trial in 2011, a delayed Queen's Bench judgment (due to the death of the presiding judge, Justice Stevens, after the hearing) in 2014, and an appeal judgment in 2017, with leave to appeal to the Supreme Court of Canada denied in 2018 (2018 CanLII 28111 (SCC)). And now we have the trial judgment on the accounting matters four years later. My first observation must necessarily be that the wheels of justice move slowly, ever so slowly. This is not a good advertisement for the judicial resolution of complex commercial disputes in Alberta. And it is not only the time taken – the costs of this litigation must be astronomical. After the original 2011 trial, IFP agreed to pay PCR's costs of $1.6 million (ABKB at para 247) and the costs of the appeal were dealt with here: 2017 ABCA 269 (CanLII). There is further discussion of how to apportion the original trial costs in the present judgment (at paras 247 – 268) while the costs of this trial are yet to be resolved (at para 269).

A second and related point is that in an accounting application with respect to net revenues or net revenue realized, once the parties have agreed upon gross revenues (or the court has made that determination), the onus necessarily falls on the defendant to itemize and prove the expenses that allow the determination of net revenue realized. In a case such as this, dealing with operations that cover a number of years and thousands, perhaps hundreds of thousands, of transactions, that is obviously a huge undertaking. Justice Anderson adopted a robust and pragmatic approach to the

problems of proof in this case while respecting the onus of proof and the rule that defendant's claim of expenses cannot be simply hypothetical but must meet a balance of probabilities standard.

Overall, I think that Justice Anderson has done a good job of discharging the unenviable task thrust upon her. That said, I would have preferred to see a more systematic consideration of how to resolve the accounting considerations within the frame of reference of co-ownership law rather than within the framework of industry agreements that are not directly applicable as a matter of contract law. It remains to be seen whether Justice Anderson's judgment will be subject to appellate review. Part of me thinks that this should be the end of a long dispute; part of me thinks that further appellate guidance on this point might be useful even though cases in which there is no applicable operating and accounting procedure will likely be rare.

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