

# Common Stock Returns around Farmout Announcements in the Oil and Gas Industry

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A farmout occurs where a permit owner or farmor exchanges partial exploration rights or working interests for benefits in the form of exploration activity commitments to be undertaken by the incoming party (farminee). Not surprisingly, farmouts are very popular with smaller, resource constrained oil and gas industry participants who own exploration permits that are expensive or difficult to develop. One of the main factors motivating the use of these cooperative arrangements is the increasing presence of small oil and gas exploration and development firms, a sign of vibrant competition in the upstream oil and gas sector. Industry participants suggest that “without them (farmouts), some oil fields would simply remain undeveloped due to the high risks facing any single operator” (OilNow 2020). Currently, there is only limited descriptive evidence on these important contractual arrangements.

Applying the widely used event study method, we investigate three theories and provide empirical evidence in relation to stock price reactions to farmout announcements. First, resource pooling theory argues that participants conduct alliances to combine complementary resources, which in the oil and gas setting can be either financial or technical in nature. Second, certification theory assumes that characteristics of the farminee conveys quality signals on the prospect or the farmor. Lastly, we test real options theory, which considers investment projects as real options due to their sequential nature. Using a large sample of Australian farmouts, we find that farmout announcements generate a positive cumulative average abnormal return of 3.60% for farmors and 1.90% for farminees over a 3-day event window. Cross-sectional analysis of farmors’ event returns provides results consistent with the resource pooling hypotheses. We also find that farmors’ announcement returns are sensitive to the underlying oil price volatility, consistent with the real options view of farmout arrangements.

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