

Is the ERCB the New Court for Freehold Leases?

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- In two recent decisions, the ERCB has taken it upon itself to determine the validity of freehold leases. In each case the Board determined that the lease had terminated and placed closure/suspension and abandonment orders on the relevant wells.

- Traditionally, lease validity issues have been the exclusive jurisdiction of the courts, not the ERCB. This novel use of regulatory jurisdiction may have significant implications on how lessors (or top lessees) attack freehold leases in Alberta.

- For fun and further background on this issue, you can read my May 2009 CAPL article Negotiator, entitled *Is The Board Bored?*
- Available on the CAPL website under Negotiator past issues

ERCB Jurisdiction

- The ERCB has asserted jurisdiction to determine lease validity matters pursuant to Section 16 of the *Oil and Gas Conservation Act*

Section 16 states in part that:

“16(1) No person shall apply for or hold a license for a well... unless that person ... **is entitled to the right to produce** the oil, gas or crude bitumen from the well...”

“16(2) If, after 30 days from the mailing of a notice by the Board to a licensee...**the licensee fails to prove entitlement under subsection 1 to the satisfaction of the Board**, the Board may cancel the license or suspend the license on any terms and conditions that it may specify.”

Entitled to Produce Test

- **16(1) “entitled to the right to produce ”**
test
- Requires that the underlying property right
(i.e. the freehold lease”):
 - Exists
 - Is valid and subsisting in the opinion of the
Board

- Note that the “entitled to the right to produce” test is in no way limited to questions of freehold lease validity.

- Under this test, the ERCB can assert jurisdiction over any property or contract law issue, such as:
 - Farmout earning
 - Ownership through purchase and sale chain
 - CAPL operating procedure disputes (e.g. title forfeiture well)
 - Any other property law or contractual dispute

- Not speculation.
- The ERCB has already asserted jurisdiction over other property rights issues in *Bearspaw Petroleum Ltd.*, *Devon Canada Corporation*, and *Fairborne Energy Ltd.* (ERCB Decision 2007-024)

- In *Bearspaw*, the issue was the ownership and entitlement of CBM in split title cases
- The ERCB comments with respect to Section 16 of the *OGCA* that:

“There is no qualification in section 16 that limits the meaning of ‘entitled to the right to produce’ ... so as to exclude any aspect of entitlement including ownership. This is in keeping with the fact that entitlement disputes may arise from a variety of commercial arrangements. The plain meaning of these words include ownership.”
(Decision 2007-024 page12)

Satisfaction Threshold

- **16(2) – must establish entitlement “to the satisfaction of the Board”**

- The Hammer:
 - Cancel or suspend the licence
 - On any terms and conditions it may specify
 - Including closure orders and abandonment orders

Concurrent Court Case Problem

- This entire hearing process does not replace a court action on property and contract law matters
- Only courts can ultimately determine the rights between parties
- ERCB deals only with right to hold well or facility licenses

As stated by the Board in *Bearspaw*:

“It is important to note that the Board is not making final or conclusive decisions that bind the parties for all purposes when it finds that an applicant is the owner of otherwise entitled to produce the resource. **That ultimate authority belongs to the courts.** The Board is, rather deciding that the applicant has demonstrated entitlement to the Board’s satisfaction for the purpose of issuing a well license ...” (Decision 2007-024 page 27)

- Any subsequent court decision which comes to a different conclusion on matters of law would apply to the ERCB
 - Can occur on appeal of ERCB decision to Alberta Court of Appeal; or
 - Can occur from independent court action.

Two Recent Decisions

- Now you know the background legislative authority and issues
- Lets look at two recent ERCB decisions in which the ERCB decided legal issues of lease validity

Desoto Resources Ltd., Re

(ERCB Decision 2008-047)

- Pan Canadian lease form from 1974-75 (Form 60 PO/LF/5/65)
- No shut-in clause. Continuation based upon habendum wording
- No production on lands for a long, long time
- Wellbores on lands had been cemented
- Lease unitized. No production from Joffre Sand Unit No. 3 since 1998

- Desoto drilled a well in the face of:
 - A notice to take proceeding on caveat
 - Drilled well after it told Board it would wait for hearing process
 - Head lessees (Penn West and Cansearch) had agreed with EnCana that the leases had terminated

- ERCB hearing initiated by **EnCana** as lessor
- Queue scary horror music
- Review of well license pursuant to Section 40 of the *ERCA* - *lessor is a party affected by the issuance of a well license so it can request a hearing*

- At the same time a court action had already been commenced
 - EnCana issued lapse notices on the Desoto caveats on April 19, 2004
 - Desoto had commenced an action in response to lapse

- Board shows no deference to the Court proceeding:

“The Board has its own mandate regarding fair and efficient development and public and environmental safety, separate and apart from the Court’s jurisdiction over civil disputes.”
(Decision 2008-47 paragraph 21)

The Board Decision

- Then the Board jumps in with both feet to determine the legal meaning of “**capable of production in paying quantities**” under the habendum of a PCP form of lease
- Cites two Canadian cases and then sites and appears to follow a Court decision out of the Supreme Court of Texas
- Relatively benign decision since the ERCB talks a bit about “capable of production in paying quantities” but never really decides what the phrase means

- Then the Board brings the hammer:
 - Closure order on well (think padlock)
 - “Abandonment Order will follow in due course” (Decision 2008-047 paragraph 70)

- Aside - the ERCB misses the issue of the unitization of the lease.
 - Unitization amends the lease, such that unit operations and unit production are deemed to be operations and production on the lands
 - In my humble view, this whole case should have been a discussion of a freehold lease amended by unitization and “unit operations” under the unit

The Appeal Decision

- The issue of jurisdiction went to the Alberta Court of Appeal and the Board's jurisdiction was whole heartedly accepted:

“There is no merit to the argument that the Board does not have jurisdiction to deal with the validity of the lease, at least to the extent and only to the extent of establishing entitlement to apply for the well licence” (2008 ABCA 349, paragraph 2)

The Court Decision

- Oh yeah, there is still a Court case going on regarding lease validity
- The Court case is not affected by an ERCB decision
- So, the parties go off and have another hearing. Hooray!

Desoto Resources Ltd. v. EnCana Corp.

(2009 ABQB 337, Masters Decision)

- Master notes the ERCB decision and then promptly ignores it (as he should)
- Does note that “The parties did not raise the issue of *res judicata* in this application”

- This case is fascinating because the judge actually reads the words after “capable in paying quantities” in this form of lease
- Additional words are **“from a well or well on the said lands at the end of the primary term”**

- The Court states:

“Whether or not the Lands are capable of production in paying quantities, the plain terms of the Leases require that the production be **from a well or wells drilled during the primary term**. A well drilled in 2007 cannot operate to satisfy this requirement .” (2009 ABQB 337 paragraph 27)

“The clear words in the habendum clauses of the Leases dictate that absent production or capacity to produce from a well drilled during the primary term, the Leases terminate.” (2009 ABQB 337 paragraph 30)

- I honestly had never really believed a Court could be so anti-lessee as to interpret those words literally

- Silly me

- Aside – beyond the scope of today's talk, but you may want to go take a second look at any old PCP leases with this text in the habendum
 - Leases may only be continued based on wells drilled during the primary term

- Spoke to Don Benson of Desoto on Friday. This Master's decision is being appealed.
- So we have an active appeal of a court decision running in parallel to an ERCB process to force abandonment of the wellbore.

- What happens if the ERCB finds a lease dead but a Court finds a lease alive (or vice versa)? – it makes my head hurt.
- Could the Board actions in the closure order and abandonment order kill the lease even though a court ultimately finds the lease valid and subsisting prior to the ERCB actions?
- Yuck

Omers Energy Inc., Re

(ERCB Decision 2009-037)

- Essentially a CAPL form of lease
- Lease dated February 8, 2001, 5 year term
- Two gas wells on pooled section
- Wells completed and tied in
- Production at end of primary term, but wells shut in in August 2008

- ERCB hearing initiated by Montane Resources Ltd.
- Montane is the top lessee.
- Notice to take proceedings and court case initiated prior to ERCB application
- Section 39 of *ERCA* – Board can rehear and change a decision any old time

- Freehold Owner Association (FHOA) granted intervener status. Appeared at the hearing.
- Queue slightly less scary music.

- First time any “court” in Canada has been asked to interpret the CAPL shut-in well provision wording:

“capable of producing the leased substances or any of them”

- Huge, huge, huge decision that will impact tens of thousands of leases in Alberta
- After *Bearspaw* and *Desoto* the Board does not even consider it necessary to comment on its limited jurisdiction to decide the meaning of the CAPL lease shut-in well provision

The Board Decision

- Decision starts off with all the right words and concepts:
 - Interpret using “plain and ordinary meaning of the words of the lease” (Decision 2009-037 section 5.4)
 - Provisions of lease are “clear and unambiguous”, no need “to resort to extraneous aids or interpretations” (Decision 2009-037 section 5.4)

- Then the Board moves on to consider what “capable of producing the leased substances” means.

- The Board states as follows:

“The Board has concluded that for a shut-in or suspended well to be ‘capable of producing the leased substances’ as that phrase is used in the Cymbaluk lease, the well must have that ability in its existing configuration and state of completion. The *Canadian Oxford Dictionary*, second edition, defines the adjective ‘capable’ as ‘having the ability or fitness or necessary quality for.’ In the Board’s view, the word ‘capable’ means a present or existing ability or fitness of a thing to perform its purpose in the manner intended. Therefore, in the case of the 100/5-4 well, it must have been able to be ‘turned on,’ and if any work were required for the well to attain or maintain the ability to produce the lease substances, in particular work falling within the definition of ‘operations’ under the lease, the well would not be capable of producing the leased substances within the meaning of the suspended wells clause.” (Decision 2009-037 Section 6.4)

- Okie Dokie. So far so good.
- Again, for fun you can read my May 2008 CAPL Negotiator article, entitled *I'm Capable of Anything*

- But then the Board creates a new and novel interpretation of “capable of producing the leased substances”
- **Without any reference to case law or academic authority**

Commercial Realities and Intention of the Parties

“The Board does not accept that any amount of production from the 100/5-4 well, no matter how minuscule, would indicate that the well was capable of producing the leased substances within the meaning of the suspended wells clause. The Board considers such an interpretation to be contrary to the intentions of the parties as expressed in the lease, and also contrary to the commercial realities inherent in the leasing of petroleum and natural gas rights. It is evident from the lease that the parties’ intentions were to strike an agreement that would provide a benefit for both sides.” (Decision 2009-037 Section 6.4)

- Keep in mind no evidence was presented by the either the lessor or the lessee regarding “intentions”
- Me things it must be very difficult to interpret intentions without affidavits and cross examination of parties.

Was it Meaningful for You?

“The Board has concluded that the phrase ‘producing the leased substances’ would not be satisfied by a minuscule or insignificant amount of production. **It is the Board’s view that there must at least be some material, as in a meaningful, volume of production possible for the lessee to rely on the suspended well clause to extend the lease.** An interpretation that would permit a very low or even nonexistent threshold would provide little or no incentive for a lessee to undertake operations to enhance the recovery of leased substances. It would also result in only a nominal return to the lessor for an indeterminate length of time without any obligations on the lessee to rectify the situation. Such an interpretation is, in the Board’s view, contrary to the intention of the parties as expressed throughout the lease as a whole.” (Decision 2009-037 Section 6.4)

- So now, we have an interpretation of “capable of producing the leased substances” from a regulatory tribunal that says that wording requires **“a meaningful, volume of production”**
- I am not so sure that “meaningful production” is a really useful test

What Happened to “or any of them”?

- Text actually reads “capable of producing the leased substances **or any of them**”
- Must give meaning to the full text
- In my humble view “or any of them” suggests a “mere puff” might be enough, but what do I know

- Aside – I am curious as to why the Board did not at least mention the Alberta Court of Appeal decision in *Kensington Energy Ltd. V. B&G Energy Ltd.* (2008 ABCA 151) which came out just a month or so before this decision.
- Case involved a non-CAPL shut-in well clause where well + mere payment = deemed production
- Rare court case that supported a strict interpretation of a lease in favour of a lessee. No fuzzy intention discussion.

- Anyway, the result is that the wells are currently suspended
- Query whether a well that is suspended by the ERCB is “capable of producing the leased substances or any of them”?

Leave to Appeal Granted

- Omers has been granted leave to appeal – *Omers Energy Inc. v. Alberta (Energy Resources Conservation Board)*, 2009 ABCA 273
- No appeal allowed on jurisdiction of Board
- Leave to appeal restricted to Board's interpretation of "capable of producing the leased substances"

- Good news is that standard of review on appeal will be “**correctness**” since the appeal relates to a question of law.

Conclusion

- Unless something dramatic happens, the ERCB is now an alternative and parallel route to the Courts to attack freehold leases
- Quicker, cheaper and bigger impact (suspended wells and/or abandonment orders)

- Added bonus in that you may have to pay the legal costs of non-industry freehold lessors who challenge your license
- Extra special added bonus of possibly having to also deal with Court cases on the same issues, since Courts have not ceded their jurisdiction.