

GAME CHANGER

*The OMERs Alberta Court of Appeal Decision and
the CAPL Shut-In Clause*

CAPL Christmas Dinner
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- The 2011 decision of the Alberta Court of Appeal in *OMERS Energy Inc. v. Alberta (Energy Resources Conservation Board)* 2011 ABCA 251 has fundamentally changed:
 - The process for challenging the validity of freehold leases in Alberta;
 - The interpretation of the CAPL Shut-In Clause; and
 - The manner in which we must interpret the relationship between lessors and lessees under a freehold lease in Canada.

- First a bit of jurisdictional history...

[Please don't fall asleep, this is quite interesting]

- Traditionally, lease validity issues have been the exclusive jurisdiction of the courts, not the ERCB.

- This is because lease interpretation is a legal question and not a regulatory question.
- This is also because the challenge of a lease is typically done by way of a “top lease” and notice to take proceedings on caveat.

- A Court action to determine lease validity is still available.
- However, a much more potent option is now available by way of application to the ERCB.

ERCB Jurisdiction

- Through the *OMERs* decision and other recent cases, the ERCB has established its 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;
 - And, oil company very often must pay the legal and expert costs of the applicant.

- The “Hammer” was first used by the Board in the 2008 decision of *Desoto*.

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.
- Review of well license pursuant to Section 40 of the *ERCB* - *lessor is a party affected by the issuance of a well license so it can request a hearing.*

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 cites and appears to follow a Court decision out of the Supreme Court of Texas.
- **Significant foreshadowing of Board’s approach in *OMERs*** (yet somehow I did not see this when the case came out).

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

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)

Lease Continuation Mechanisms

- End of jurisdictional history lesson...
- Now a quick walk through the CAPL lease continuation mechanisms.

[I know, it just keeps getting better and better, huh]

- After the primary term of a CAPL lease, you can continue the lease in only two ways:
 - by “Operations” under the Habendum clause (with no cessation of Operations for more than 90 consecutive days); or
 - by virtue of a shut-in well **“capable of producing the leases substances or any of them”**.

- Therefore, anytime you have a lack of Operations for more than 90 consecutive days, your lease will terminate unless you have a well capable of producing the leased substances or any of them on the lands.
- The *OMERs* decision does not speak to “Operations” under the habendum, but it does put a dagger through “capable of production” under the shut-in clause.
- Preprinted form, so the exact same phrase “capable of producing the leases substances or any of them” appears in every version of the CAPL lease.

- How can we apply your new knowledge of how a lease works?
- The current case of *OMERs*, of course, where first the ERCB and then the Court of Appeal speak to the meaning of words:

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

Omers Energy Inc., Re

(ERCB Decision 2009-037)

- 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

- 100/5-4 colony gas well. Marginal production. Two work-over attempts in May and November 2006. Cement bond issues

- 102/5-4 well the drilled to same formation. Water issues

- OMERs believed this was a good reservoir but with real production problems
- Even provided the Board with an economic evaluation indicating that economic gas production was possible
- Board focused on water loading problems and the failure to actually produce

- 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 *ERCB* – Board can rehear and change a decision any old time

- Freehold Owner Association (FHOA) granted intervener status. Appeared at the hearing
- Queue 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) (Emphasis mine)

- Okie Dokie. So far so good.

- But then the Board creates a new and novel interpretation of “capable of producing the leased substances”.

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) (Emphasis mine)

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

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.

Leave to Appeal Granted

- OMERS was 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".

- I was pretty sure the Court of Appeal would correct this madness and we could all go along our merry way.

- **I was totally and completely wrong.**

Omers Energy Inc. v. Alberta (ERCB), **2011 ABCA**

- 2011 decision of the ABCA
- Will not be appealed to Supreme Court
- This is the law in Alberta and most likely all of the WSB

- The Court of Appeal fully and completely adopts the ERCB methodology:

[3] The appeal is dismissed. The Board did not err in finding that the phrase "capable of producing the leased substances" means the "demonstrated, present ability of a well on the lands to produce the leased substances in a **meaningful quantity** within the time frames contemplated in the lease." (Board Decision 2009-037 at 9, hereafter Board Decision) **The lease is a contract through which the lessor and lessee agreed to develop the leased substances for mutual benefit.** This purpose would be defeated if the lease were interpreted in a manner that allowed it to continue almost indefinitely at a time when a drilled well is incapable of producing a meaningful quantity of oil or gas in its present state and operations are not being conducted to make it produce. Requiring a "meaningful" volumetric quantity was sufficient to determine this case. Considering each lease and its surrounding circumstances will allow this test to develop in a contextual setting. (emphasis is mine)

- Wow. Let's unpack these words a bit

Capable Does Not Mean Merely Physically Capable

- “Mere puff” interpretation is dead.
- “Demonstrated Present Ability” to produce only the first step, not the whole test.

Capable Means Meaningful (Yuck)

- Court fully adopts the meaningful production test from the ERCB.
- I mean word for word. They quote the Board's decision above.
- Yuck.

Capable Means Meaningful (Yuck)

- As the quoted test is meaningless, what the Court has really decided is that the ERCB will get to decide, on a case by case basis, if your production was meaningful enough to continue your lease. As the Court states in paragraph 96:

[96] As cases move forward through the Board and the courts, the volumetric test will undoubtedly be refined within the context of the specific cases.

- Double Yuck.

Speculation is Evil

- What is most scary to me is the utter misunderstanding of the Court (and the ERCB) of the actual commercial relationship of the parties.
- This would not really matter, except that the decision relies heavily on this implied relationship of the parties to backstop its reasoning.

■ The Court states this view as follows:

[92] These, and other comments throughout its decision, suggest that the Board intended that "meaningful" would reach levels associated with profitability or commercial viability. **Viewed objectively, an owner would not tie up property indefinitely for a quantity of production that would never pay - which is a result that could flow from Omers' interpretation.** Moreover, the Habendum Clause and its 90-day clause would be meaningless once the primary term has passed, unless the lease requires the lessee to be diligent about performing required operations. **Moreover, an interpretation suggesting a lessor would agree to tie up its land to a lessee beyond the primary term for speculative purposes only is unreasonable.** (emphasis is mine)

- Ergo, an oil company paying a lessor a 5 figure bonus payment, then spending millions of dollars drilling wells on the lands, at their sole cost, risk and expense, is quite simply evil speculation. The fact the lessor spends no money and takes no risk in this endeavor is irrelevant. Mere speculation by oil companies is evil and must be punished.

Mutual Benefit is the New Lens of Interpretation

- Even further, the Court has determined that the lens through which we must now view the lessor/lessee relationship is one of mutual benefit. As stated in paragraph 3:

[3] ...**The lease is a contract through which the lessor and lessee agreed to develop the leased substances for mutual benefit.** This purpose would be defeated if the lease were interpreted in a manner that allowed it to continue almost indefinitely at a time when a drilled well is incapable of producing a meaningful quantity of oil or gas in its present state and operations are not being conducted to make it produce.

- This new interpretive lens must now be used in any case involving interpretation of any text in the CAPL lease. This is most concerning for the habendum and shut-in provision, but may have application under the offset clause, royalty clause or any other clause.
- Who knew you entered into a joint venture with the lessor? Too bad you can't send them AFEs.

Capable of Production in Paying Quantities?

- Bottom line for me is that the Court has essentially said that “capable of production” under the CAPL shut-in clause must now meet the test of being “capable of production in paying quantities.”
- It will either be this exact test, or a suspiciously similar test based upon the ERCB “meaningful” wording.

- This of course should not be the case since the words “capable of production in paying quantities” were known to the drafters of the lease and specifically not included.
- Whatever. Need to stop beating a dead horse.

- Here is how the Court sums up some rather convoluted discussions of how to mesh meaningful production and paying quantities:

[77] By making this finding, however, I do not wish to be seen as rejecting the general rationale upon which the term "paying quantities" is based. **I agree with the American authorities, and the Board, that the purpose and goal of parties entering into such a lease is to develop the resource for the purpose of making a profit.** That purpose provides the rationale for concluding that where production extends the primary term of a lease, the parties would have anticipated production at something more than trivial or minuscule production. Certainly they would not have anticipated that a lessee could hold a lease by shutting in a well that was not capable of producing a meaningful amount, even if not every moment would have been in paying quantities. **In my view, although the Board was not prepared to read the words "in paying quantities" into the contract, it adopted the rationale underlying the American cases and was proper in doing so.** (Emphasis mine)

What Does this Mean for Landmen?

- You must review all freehold lease files for gaps in production of greater than 90 days
- If you have over 90 consecutive days of non-production, you may not be able to rely on “Operations” to continue your lease

- Must begin to document in the lease file what “Operations” were occurring during periods of non-production.
- Absent Operations, you must rely on the (now bad) shut-in well provision

- Never drill on such a lease without first reviewing the lease file and production / Operations history
- Determine if well was capable of “meaningful production”
- Title Opinion recommended before all new drilling or expensive work overs on existing leases

- Will not be funny if you spend \$4M on a new horizontal well under a dead freehold lease.
- Remember, new production never, ever saves a dead lease.
- CAPLs are no longer the good leases

Current Lease Negotiations

- As your tenure is now less certain, this should result in:
 - Longer primary terms
 - Lower bonus payments

- Should, but I doubt it will

Towards a New CAPL Lease

- New CAPL 2011 draft lease is just being released for industry comment
- Drafted to keep lease alive so long as there is a non-abandoned wellbore on the lands.

Towards a New CAPL Lease

- \$10/acre shut-in well payment (vs. \$1 acres in the old versions)

- The Current Draft Needs:
 - Slightly tighter language re: abd wellbore
 - Negative statement – re: no obligation to produce

Towards a New CAPL Lease

- The other alternative is to go back to the CAPL 99 concept of a financially significant shut-in well payment
- CAPL 99 shut in is calculated as bonus/primary term