THE NEGOTIATOR

The Magazine of the Canadian Association of Petroleum Landmen
June 2012

2012 CAPL CONFERENCE

VANCOUVER, B.C.
SEPTEMBER 23-26, 2012

2012 CAPL Conference

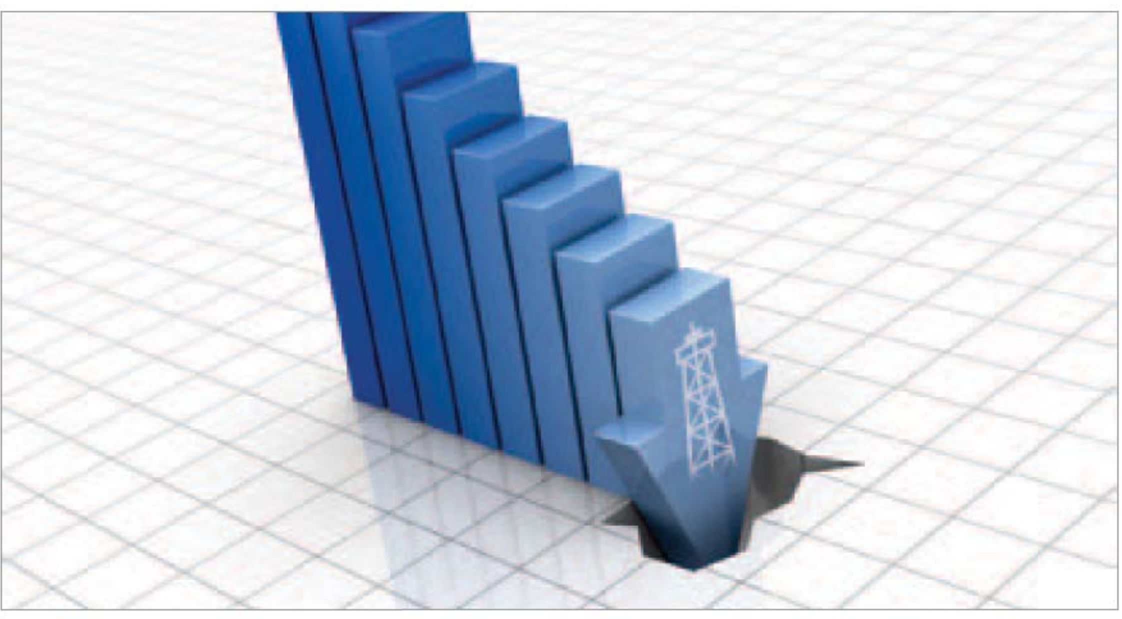
Update on Speakers and Education Courses

When Natural Gas Goes Below $2.00

Impacts of Low Gas Prices on the Land Department

Professionalism

A CAPL Professionalism Committee Update



What the #@$% Happens if Gas Goes Below $2.00?

WRITTEN BY
PAUL NEGENMAN

THE SHORT ANSWER IS THAT THE #$@# HITS THE FAN FOR LOTS OF GAS COMPANIES. But I expect you already know that. Hence, we will not speak today of obvious issues, but rather some landman issues that will arise if the price stays below $2/GJ for any length of time.

Leave it to a lawyer to ignore the big picture and focus on the minutia. It's our special skill.

Freehold Lease Termination Risk

Freehold leases are tender and fragile agreements that grant a limited right to win, take and remove leased substances from the lands of another person. I have spoken of this ad nauseum, but honestly, from what I see day to day, one can never speak of this issue enough.

Unless something changes dramatically from the date of writing this article, the tough meetings about shutting in gas, for at least the summer, are ending and companies are starting to press release and implement cost saving shut-in plans.

Shutting in Non-CAPL Leases

Here is some free advice for non-CAPL freehold leases. Don't shut'em in. Produce at a loss. Honestly, best answer. Take that to management and see how far you get. There are other strategies, but alas they are all second best to just producing. No free lunch on this issue.

If you must shut-in production, you need to read each and every lease and determine your risk. Many of these nifty old leases have straight up "are produced" language which requires production with no cessation of greater than 30/60/90 days. Absent a shut-in provision, these leases will terminate on the 31/61/91 day of consecutive shut-in production.

The next worst class of leases allow you to shut-in production, but only if a set of particular conditions exists. Often, the conditions do not include an inability to make money selling your gas. Seems crazy, but it is not only true in my dysfunctional mind, but affirmed as true by many recent and undeniable Court decisions. Ergo, many shut-in clauses will simply not help you if you are shutting in due to low prices.

Production in Paying Quantities

Most corporate leases and a significant number of other non-CAPL leases contain some version of the requirement of the well to be capable of production in "paying quantities" in order to be shut-in.

First off, remember that if you are producing, you almost certainly never get to this shut-in well clause issue, at least in my view. No real Canadian law, but it seems to me that producing at a loss under a lease's habendum clause should be good enough to continue your lease. God help us if this changes and we start looking at marginally producing wells through the lens of paying quantities (as some US case law does). Anyway, this means that the shut-in issue likely only comes up after you chose to ignore my sage advice and shut-in production.

Once you decide to shut-in, the problem is magnified as you likely have announced to your shareholders that hey, we are shutting in due to the low gas price environment. Hmmm, can you see the problem? I can. Everyone can. We are actually saying out loud that we can't make money selling gas right now. This is suspiciously close to saying you cannot produce in paying quantities from the lease.

If this is true (which it is) then at some point your lease will die. After the press release advising of your shut-in due to low prices, it will be extremely hard, if not impossible, to argue to a Court that the lease was capable of production in paying quantities but you simply chose to not produce.

This issue will be all about the wording of your particular lease and the duration of the shut-in period. The biggest issue is how long prices stay low. US law tells us that "paying quantities" is not an immediately determined concept. You get to look over a somewhat wider time frame to decide if the well could produce in paying quantities. The Court in *OMERs* cites the US test of the "expectation of profitable returns" of a reasonable producer. Fuzzy test, but at least the expectations of a reasonable producer are part of the test which means some period of shutting in due to low prices is okay.

One summer of low prices with future prices on the rise might be okay. A new normal of 2 to 4 dollar gas might mean the death of many non-CAPL leases. If the latter is true, you need to start a serious discussion within your land group and eventually with your lessors to work around this problem. In this rare case, lessors might be motivated to change lease terms or grant a grace period to deal with the fundamental shift in prices. Any such agreements need to be carefully drafted and caveated or you will just be creating other lease problems down the road.

OMERs

Hey, did you notice I mentioned *OMERs* in the last section? Good eye. Not a good thing.

In case you have been living under a rock for the last few years, I will remind you that the *OMERs* Alberta Court of Appeal decision dealt with the meaning of "capable of producing the leased substances or any of them" under the CAPL form of lease. We know that capable now means "meaningful" and meaningful might mean a requirement of production in paying quantities. Ouch.

It is a much bigger problem if we cannot shut-in CAPL leases due to market price. I still cannot get my head around how we have gone from "capable" under a CAPL lease meaning simply a present ability to produce a measurable volume, to where we are today, but alas the risk is there. Complex issue, but it is possible that production in paying quantities must now be read into CAPL leases with all the badness set out above.

Force Majeure

Lastly, a very interesting freehold lease issue will arise where third parties begin to shut-in enough production that entire fields are affected. This will occur when a large producer (or a number of smaller producers) shut-in enough production in a field that it creates a situation where there is simply not enough volume and pressure in the gathering system to move your gas. A variant of this will occur where gas plant or compressor operators simply decide to stop the facility. I guess you could try to truck your gas, but I think the problem is that the trucks float away. Not sure.

Will this scenario create an act of force majeure such that your lease will continue until enough gas comes back on stream or the plant reopens? Perhaps, but we are swinging for the fences with this one. At the very least, you will need to be able to prove that your lease would continue but for the act of force majeure. If your lease has any production in paying quantities language, you may be out of luck.

Even assuming your lease otherwise continues, I am not bullish on force majeure for oil and gas companies. The variable price of gas is one of the most basic aspects of your business. Fluctuations must be accounted for and should be contemplated by other lease

terms. In short, a change in gas price is not an act of force majeure, but is rather simply part of the game. No get out of jail free card.

However, drilling a well at $15 gas and then having the price collapse to $2 might just be enough of an unforeseeable change that it is worth a try to argue force majeure. In most cases I would not bother, but I am not a litigator, so what do I know? Would be a rare win for a lessee.

Corporate LMR and Security Deposits

Next let's chat about falling corporate Liability Management Ratios (LMR) due to falling gas prices, shutting in production and falling throughput in facilities. Wow this is getting kind of depressing. I think you should go drill an oil well to make yourself feel better. Hopefully you have $3 million bucks lying around somewhere.

First a recap of the system. Alberta, through the ERCB, was the first Province to introduce a LMR for the licensed holder of well and facility licenses. Your corporate LMR is essentially the ratio of the ERCB calculated deemed asset value/deemed liability value. The resultant ratio must remain over 1.0 or the licensee is required to pay a security deposit. Failure to pay the security deposit is a noncompliance event and can lead to well/facility closure and ultimately abandonment and reclamation orders. Very similar programs now exist under the BCOGC and SER. I have also spoken on this topic ad nauseum. For example, you can read my January 2009 *Negotiator* article, "The ERCB LLR Trap". In this article, we will reference ERCB rules, however BC and Saskatchewan rules are similar.

Remember, these problems firstly affect the licensee. However, once noncompliance enforcement begins, the issue can quickly become the problem for working interest participants as they are next in line to deal with any well/facility issues under the regulatory schemes. Under any JOA, you are always your brother's LMR keeper.

Let's take a quick look at how this will impact wells and facilities.

Shutting In Wells

Once producers begin shutting in production, the clock for a zero deemed asset value for the well starts to tick. Under Directive 006, a well is considered to be active if it has reported an operation (production or injection) in the last 12 calendar months. After 12 consecutive shut in months, your deemed asset value will fall to zero. That means that every shut-in well will be a pure liability for your corporate LMR after 12 consecutive months of nonproduction. Not long ago it seemed crazy to think of shutting in gas for a year or years at a time. Maybe not so crazy this summer.

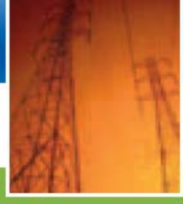
This will likely not be an issue for mixed producers or most large producers. However, if you are a small to midsize gas company trying madly to save operating costs by shutting in wells, you must carefully monitor your corporate LMR (which is updated monthly in the ERCB website) to avoid a nasty ERCB letter demanding a security deposit (to be paid in cash or an irrevocable letter of credit). The security deposit must be received by the Board within a month or so of receiving notice.

I expect if gas prices are low enough that you are shutting in wells for over a year, some companies may be hard pressed to come up with the cash or irrevocable LOC to make the ERCB happy. Not telling small producers what to do, but I would really consider turning the tap on these gas wells once or twice a year to record production and avoid a big drop in your LMR.

Shutting in Facilities

As producers start to shut-in or constrain gas production, this invariably starts to hit the throughput of facilities. Liability rules for compressors and gas plants are based on throughput. If you are unlucky enough to hold the facility license when the throughput falls below the required volumes, you will take a significant hit to your LMR. Facility licenses are generally good until they are bad. Once they are bad, the ERCB imposes a large deemed liability number based upon the recorded size of the facility vs. the throughput. For example, last time I checked, underperforming or shut-in large gas plants attract a one million dollar deemed liability value.

Really crappy. Facilities seem worse to me since the licensee (operator) takes 100% of the hit on its LMR even though they may have a significantly smaller ownership interest in the facility and may be the victim of falling throughput due to shut-in third party gas. So, if you are depending on third party volumes to keep the



• Mineral and Surface Leasing
• Right-of-Way Acquisitions
• Mineral Ownership/Title Curative
• Seismic Permitting
• Mapping/GIS Services
• Abstracts of Title

Elexco Ltd.
Canada: 1.800.603.5263
www.elexco.com
Elexco Land Services, Inc.
New York: 1.866.999.5865
Michigan: 1.800.889.3574
Pennsylvania: 724.745.5600

lights on at your gas facility right now, be careful to watch the fall in throughput as this will also lead to a reduction in your LMR.

LMR Strategies

For larger companies, it might be a good summer student landman job to track your nonoperated shut-in gas wells and see if any of your small joint venture gas partners are in trouble. It might be easier to take over operatorship from some of the smallest guys, just to make sure the wells keep running a bit, and also to avoid the hassle of being the working interest participant the ERCB calls when the current licensed operator is noncompliant. An ounce of prevention, I always say.

For facilities, it is very important to keep your ERCB designated throughput in line with actual throughput. If you are downsizing facilities, be sure to file the proper paperwork at the ERCB to make sure they record the smaller size and throughput. Very simple way to avoid a large LMR shock.

In the long term, if prices stay super low, the rolling 5-year average industry netback price used in determining deemed asset values will fall for all gas wells. This is when the issue may start to impact medium and large gas producers. Hopeful this situation does not arise, however industry would be wise to start crunching some numbers and working with the ERCB and the government to make sure we do not trigger a massive security deposit initiative for the wrong reasons.

Joint Operating Agreement Issues

Lastly, let's touch on a couple of joint operating issues.

Operator Shut-in and the Right to Take in Kind

The CAPL Operating Procedures (and most non-CAPL Operating procedures) are simply not set up to deal with an Operator shutting in gas due to low prices. Under a CAPL, you are certainly not married, so an Operator does not need to act against its own best interests in producing at a loss. It is an interesting question as to whether you could challenge operatorship based upon this Operator decision. Good luck with that. Will take years for someone to get that through Court.

But you say, as a non-operator, I have a right to take in kind. Yes, you do. The problem is that the right to take in kind is premised on everyone agreeing to produce and you simply transporting or selling your own share of production. It gets trickier when the Operator shuts in the well. You have a right to take in kind, but you are taking through a jointly owned wellbore and likely a jointly owned gathering system. Further, if you somehow get to take in kind, your taking will include the Operator's share of production they want to shut-in. It is simply impossible to produce your share of the gas and leave the Operator's share in the ground. Everyone owns an undivided share of the gas produced.

Ultimately, I think a Court would likely find some mechanism for you to produce your share of production and simply account to the Operator (and other non-producing parties) for their share of the production. But again, good luck with that. The Operator is the operator. You simply can't just go to the well and turn the tap back on.

Surrender of Lands

At some point, some companies will simply want to walk away from certain gas wells on joint lands. Under the 1990 CAPL Operating Procudure (for example) this can be done by way of a surrender notice in Article XI. The surrendering party does not want to trigger an immediate abandonment obligation (hence no abandonment notice is issued), but they see no value in the lands and want out. This creates a bit of a game of chicken where the party issuing the surrender notice is hoping at least one other joint venture partner elects to not surrender. The payoff (at least under the 1990 CAPL) is the ability to walk away from normal course abandonment and reclamation obligations.

If you start to see more than a trickle of surrender notices, it will be time to take a real hard look at the economics of some of your gas plays. Might make for an interesting play on gas prices, at least on Crown leases with less tenure issues. Conversely, you might just be increasing your share of abandonment costs for wells that will never pay.

Me, I am just hoping gas prices shoot back up next year. In this business, things always seem to get better just when everyone agrees they never will. Enjoy your summer.