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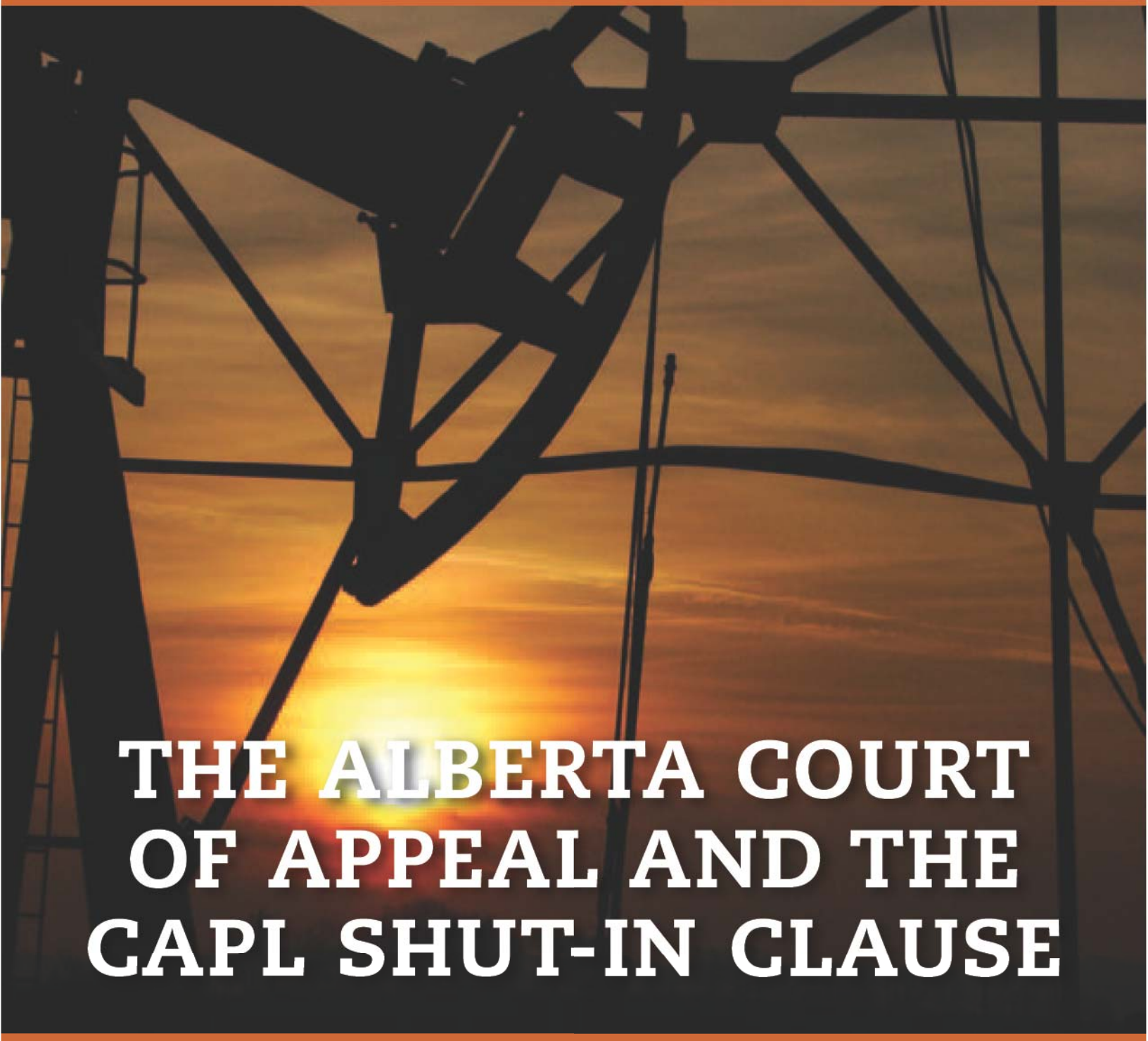

THE ALBERTA COURT OF APPEAL AND THE CAPL SHUT-IN CLAUSE

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OMERS Alberta Court of Appeal Decision and the CAPL Shut-In Clause

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MUNCH, MUNCH, CHEW, CHEW. OH, HELLO THERE, PLEASE EXCUSE ME FOR JUST A MINUTE WHILE I FINISH EATING CROW. Why am I eating crow you ask? Well, because I honestly did not see this decision coming in any way, shape or form. I even said so in writing in *The Negotiator* in December 2009. Feel free to look it up if you wish. Might make for a funny lawyer joke.

The case, however, is not funny. It has changed forever how we interpret CAPL leases in Canada. It is a game changer.

The Oil Company Always Loses

The first lawyer I called to chat about the decision reminded me of a very true statement. In Court, the oil company always loses. Obviously an overstatement, but some very good, general advice that I had forgotten in a moment of euphoria during a string of recent Alberta Court of Appeal oil company verses oil company strict interpretation cases. Lesson learned. It's all about fairness baby, and it is never fair for an oil company to "win".

First a Bit of Background

ERCB Hearings Where All the Cool Kids Hang Out

This case arose from an application to the ERCB by the top lessee under section 39 of the *Energy Resources Conservation Act* on the basis that the freehold lease underlying the well license was not valid and subsisting. In a prior decision, the Court confirmed that the ERCB has the authority to hear such freehold lease validity cases. The ERCB used its authority under section 16 of the *Oil and Gas Conservation Act* to determine that OMERS, as the holder of a well license, was not "…entitled to the right to produce…" because the underlying lease was not valid and subsisting.

So, the first important take away point is that all top-leasing cases in Alberta that involve a well on the lands should probably start with an application to the ERCB to determine lease validity. This would also apply to any fee owner/lessor who wishes to make an application on their own behalf to terminate a lease.

Could be a real growth business. Totally fast and cheap. An ERCB hearing also has the huge hammer that the Board will issue notices to abandon and reclaim if the applicant (top lessor/lessor) is successful. Even crazier is that the applicant (top lessor/landowner) generally has the right to have its costs paid for by the oil company, even if they lose. Nice.

The Habendum and the Shut-In Clause

Next we need to quickly review the lease continuation mechanisms in a CAPL freehold lease. 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 (or pooled or unitized 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. Unless amended, the exact same phrase "capable of producing the leases substances or any of them" appears in every version of the CAPL lease.

The Decision

Facts

No one will deny that the facts for OMERS were tough. The 100/05-4 well was spud during the primary term of the lease and did produce during the primary term. So far so good. However, the well quickly became marginal and was shut-in prior to the expiry of the primary term on February 7, 2006. The Court of Appeal summarized the history of the 100/05-4 well as follows:

> [7] The 100/05-4 Well soon encountered water difficulties and was shut-in on March 28, 2006, when the average daily gas rate had declined due to buildup of produced water in the wellbore. The well remained shut-in until May 9, 2006, when a water clean out was attempted. OMERS' operations to address the water loading issue, however, resulted in little or no gas production and the well depleted in 13 minutes. The well was once more shut-in until November 9, 2006 when clean out and bridge plug operations were performed. This time the well depleted in 3 minutes. (Board Decision 12). After this, the well remained shut-in until January 25, 2008, when it produced for 119 hours at an average rate of 1.1 10^3 M^3/d.
>
> [8] On June 20, 2007, while the well was shut-in, Eva Cymbaluk, successor to Dennis Cymbaluk under the Cymbaluk Lease, entered into a three year Petroleum and Natural Gas Lease with Cavalier Land Ltd. covering the lands described in the Cymbaluk Lease. The respondent, Montane Resources Ltd. (Montane) eventually became the lessee under this agreement.

So we have a very marginal well that could produce at least some leased substances without further actions by the lessee. Tough facts, but really the perfect case to determine what capable of production means. This was the case everyone was waiting for since the CAPLs were drafted.

In a Nutshell

It is not often that I get three paragraphs into a court decision and feel like I was hit by a bus. The sunny August afternoon that I walked over to the court house to pick up an early bird copy of the decision was one of those days. Paragraph 3 reads as follows:

> [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

My view, and the view of many others (whom I bet will no longer admit it), was that the magic words capable of production meant that a lease would continue if the well, in its current configuration and without further action, could produce at least some volume of leased substances. Some people call this the "mere puff" test. Seems like a pretty reasonable interpretation of the words in the contract. We were wrong.

The Court of Appeal could have found that the well simply did not have the "present ability... to produce..." and so was not physically capable of production of the leased substances. There were some possible mechanical difficulties that could have supported this view. That would have been the end of the case using a plain language interpretation of the lease. They didn't. They completely dismissed a merely physically capable test and followed the ERCB's meaningful test.

Capable Means Meaningful (Yuck)

So what does "meaningful production" mean? Beats me. I can do no better that quote the ERCB decision which tries (unsuccessfully) to define this new test. The Board's new test is quoted at paragraph 89 of the Court of Appeal decision as follows:

> [89] The Board found there must be a meaningful quantity of gas to satisfy the phrase "producing the leased substances". It stated at 9 of its decision:
>
> > [T]here must be at least 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 obligation 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.

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 mutual benefit:

> [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.

Game Changer

At the end of the day, the OMERS decision means that the lease validity bar has been raised significantly for all CAPL leases. Any CAPL lease that has gaps in production of greater than 90 consecutive days is at risk. The safe haven of the shut-in clause is no more.

Once you need to rely on the shut-in clause, you must be able to prove to the ERCB (or a Court) that the well was capable of "meaningful" production during all such gaps in production and that your actions were of a nature that respected the intention of the contract to be of mutual benefit to both parties with meaningful steps taken during the period of nonproduction to provide the lessor with the ability to make a profit. If not, your lease is toast.

Pretty tough test. We seem to have come full circle and are getting very close to the good old non-CAPL days where you had to drive out to the field ever three months to turn the valve on for a week. Pretty darn good advice. Too bad some of these leases have been sitting shut-in for years at a time when gas prices were low.