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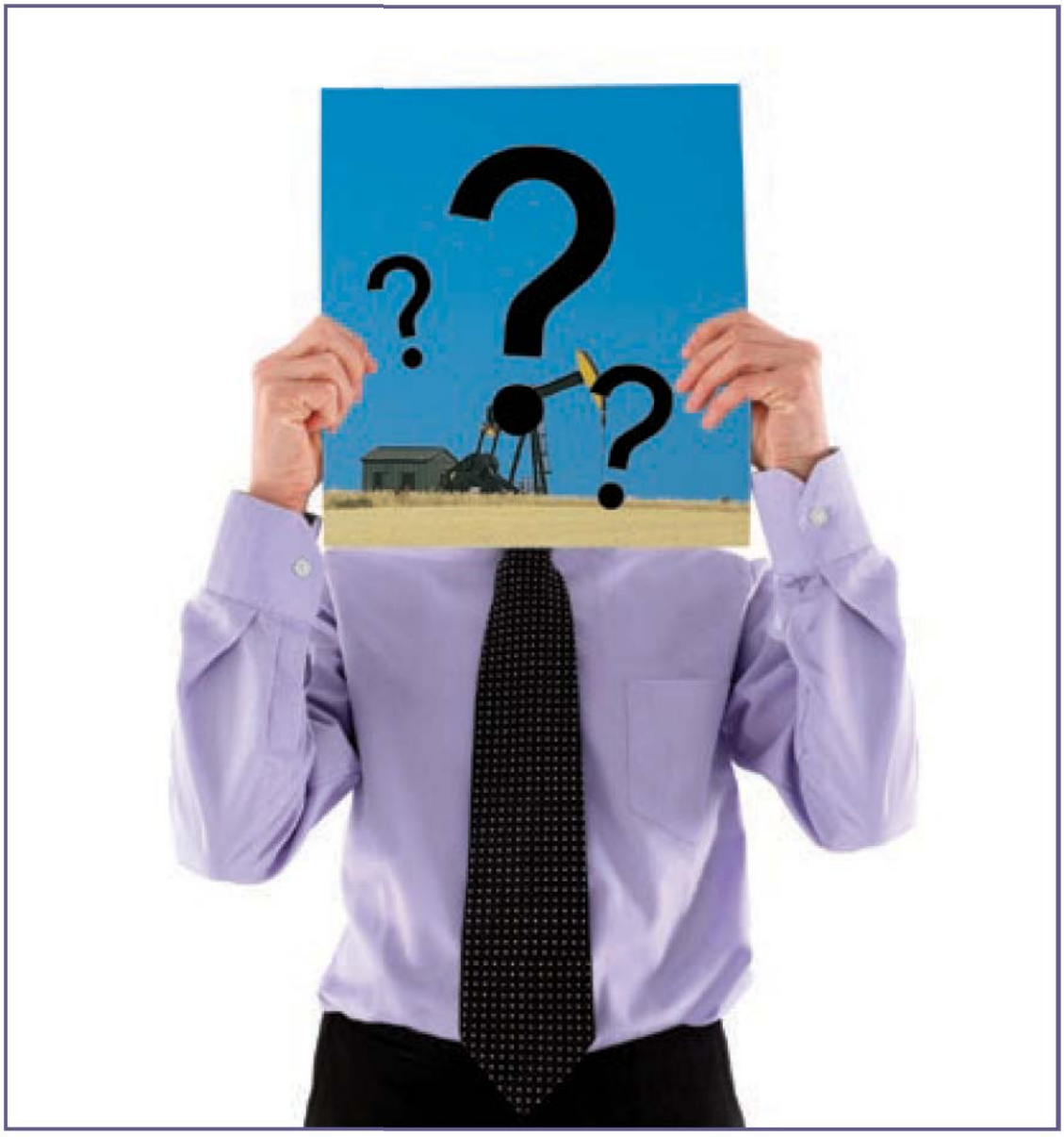

Was It Meaningful For You?

(ERCB Decides what "Capable of Production" Means in the CAPL Form of Lease)

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THE MAGIC WORDS "CAPABLE OF PRODUCING THE LEASED SUBSTANCES OR ANY OF THEM" are at the very heart of lease continuation under every single form of CAPL freehold lease. After the primary term, you can continue a CAPL freehold 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 shutin well "capable of producing the leased substances or any of them".

Therefore, anytime you have a lack of continuous Operations for more than 90 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. This is landman 101. It is the law

Now start to think about how many shutin wells on CAPL freehold leases you own. Wow. Now add in any well that has ever been shut-in for more than 90 consecutive days at any time after the expiry of the primary term. We are talking about thousands (if not tens of thousands) of leases and wells in Alberta alone.

One would think that sometime in the last 20 year or so, a Canadian Court would have been asked to decide what "capable of producing the leased substances or any of them" means. Amazingly it has never happened.

Omers Energy Inc. Re (ERCB Decision 2009037)

So imagine my surprise when the ERCB took it upon itself to help the Courts out and decide what these magic words mean *without reference to any case law or academic authority*. The Board did so in the recent decision of *Omers Energy Inc. Re* (ERCB Decision 2009037). How it did so and the potential impact of this decision on all CAPL freehold leases makes this decision critical to all landmen who work with the CAPL freehold lease.

The Facts

Very straight forward facts. CAPL 91 ALTA form of lease dated February 8, 2001. 5 year term. Two gas wells drilled during the primary term. Production at the expiry of the primary term. Intermittent production and work on the wells over time with last production recorded August 2008. Production testing since shutin showed at least some gas build up behind the valve.

In June 2008 the top lessee requests a section 39 *Energy Resources Conservation Act* review of the two well licences on the basis that the underlying freehold lease was not valid and subsisting.

Plain and Ordinary Meaning

The ERCB 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)

Using this framework the Board moves on to consider the plain and ordinary meaning of the "capable of producing the leased substances":

> "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)

So far so good. In my humble view this should have pretty much been the end of the story. "Capable" is a fairly clearly definable word. The quote above does a good job of establishing the plain and ordinary meaning of the word "capable". Pretty much means that the leased substances or any of them would flow from the

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wellbore if you turned the valve. Some people have referred to this as the "mere puff" of gas threshold.

Intention of the Parties and Commercial Realities

However, the Board does not stop at interpreting the plain meaning of the words in the lease. Rather is chooses to create a new and novel paradigm in which to consider the words "capable of producing the leased substances" as follows:

> "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)

Whenever you see the word "intention" or "commercial realities" in a freehold lease decision, you better get your helmet on. These words almost always mean the big mean oil company is going to get bonked in the head.

The problem for the Board, I think, was that the plain and ordinary meaning of "capable" did not seem very fair. More particularly, is seemed unfair to the lessors. Don't get me started on how subjective and asinine concepts of fairness are. I spent too many years of my youth sitting in university classes being completely dumbfounded by what my professors thought was fair. Just think how quickly the idea of "Our Fair Share" has changed as we try to apply these ideas in the real world. Nuff said.

Anyway, no one should care what I think, I am not a judge. The point is that the ERCB is also not a judge. However the Board has now decided what the intention of the parties to a CAPL lease are and the commercial realities in which such a lease was entered into. This is completely astounding as the Board heard no evidence from the lessor or lessee regarding intention and had no expert evidence on commercial realities in freehold leasing in Alberta.

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Meaningful Production

But wait, it gets better. Next the Board asks itself what does "capable of production" really mean?:

> "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)

Ohhhh, now I get it. "Capable of producing the leased substances or any of them" means a *meaningful* amount of production. Arrggghh. Call it a guy thing, but I am utterly confused and afraid of the word "meaningful". This is because, well, it really doesn't mean anything concrete. I can think of few words more subjective than "meaningful". Sounds nice though. Kinda like "fairness".

The final dagger may be the Boards combination of "intention", "commercial realities" and "meaningful" into the concept of a fair rate of return in order to continue a freehold lease. The Board thinks it is unfair for a lease to continue absent meaningful production as "It would also result in only a nominal return to the lessor for an indeterminate length of time". The lease never promises a specific rate of return for the lessor. Never ever. It kind of says the opposite.

By this point in the ERCB decision we are so far away from considering what words "capable of producing the leased substances or any of them" mean, I am starting to forget if the words even matter. However, as of right now, the decision matrix above may well be the test every well license holder faces when its license is challenged by a lessor or top lessee by virtue of an ERCB hearing. This test is not lessee friendly.

Limited Scope of ERCB Decisions

I am not going to rant again about how I feel about the ERCB (and not the Courts) making the rules with respect to freehold lease validity. Please refer to my lovely article "Is the Board Bored?" in the May 2009 *Negotiator* if you want to hear more about that issue.

What you need to know for today, is that no matter what the Board says about lease validity, it does not make it so. The Board's jurisdiction is limited to issues arising under the *Oil and Gas Conservation Act*. It is not a Court. The problem of course is that their decisions mean wells get shut-in and abandoned, so they really do have a hammer.

In any event, if and when a Court decides on a matter of lease validity, its decision is binding on the Board.

The Necessity of an Appeal

The good news is that:

- Omers appealed this ERCB decision to the Alberta Court of Appeal;
- The Court has agreed to hear the case; and
- The standard of review on appeal will be "correctness" since the appeal relates to a question of law.

I won't even guess at the outcome of the Appeal decision, however I do think that an issue this fundamental to the interpretation of the CAPL forms of freehold lease should be decided by a Court and not by an administrative tribunal.

Hopefully the people at Omers have the energy and desire to see this matter through the costly and time consuming appeal processes.