THE NEGOTIATOR

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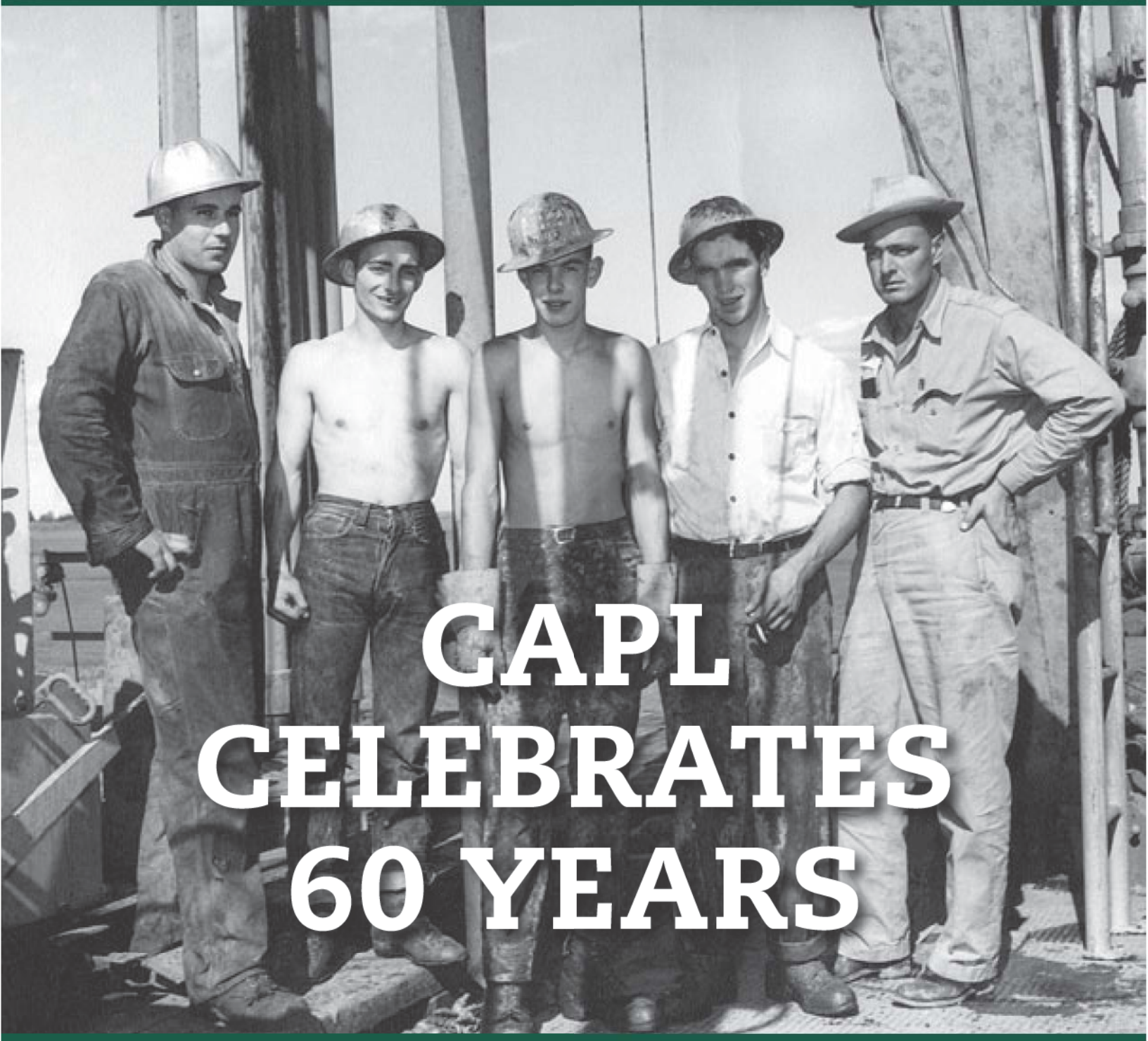

CAPL CELEBRATES 60 YEARS

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I'm Capable of Anything!
The Shut-In Well Clause in the 1991 CAPL Lease

CEAMS
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I'm Capable of Anything

(The Shut-In Well Clause in the 1991 CAPL Lease)

SO HERE IS THE TYPICAL SCENARIO. Your engineer and geologist have identified a great recompletion, or tie-in, or new drill on freehold lands for which your company holds a freehold lease. The lands are in the system and an old well is located on the lands held by the lease. In engineer speak, land in system plus well equals good to go. As a landman they simply want you to give the lease a quick once over and confirm it's okay, preferably by that afternoon. They do not want bad news. They do not want legal involved. They do not want problems.

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Failure to make a timely payment or the inability to prove such payment (on a balance of probabilities) results in the automatic termination of such non-CAPL leases. This type of lease is called an "unless" lease in the case law. Very bad!

Unfortunately, your job as a landman is to confirm that your company holds a valid tenure for the lands prior to the operations occurring. If you do not have a valid tenure, any operations on the lands are a trespass. Ouch!

The question of continuing a 91 CAPL freehold lease by virtue of the clause 3 Shut-In Well provision will arise where the lessee has not conducted "operations" under the habendum of the lease sufficient to continue the lease. If you have been conducting operations, with no cessation for more than 90 consecutive days, you need not look to clause 3. You will know quite quickly if this is the case. Any well not producing for more than three consecutive months will be a candidate for a lack of operations. Absent operations, the lease can only be continued under clause 3.

So now you are looking at clause 3, which says:

> *If, at the expiration of the primary term or at any time or times thereafter, there is any well on the said lands, the pooled lands, or the unitized lands,* ***capable of producing the leased substances or any of them****, and all such wells are shut-in or suspended, this Lease shall, nevertheless, continue in force as though operations were being conducted on the said lands… If no royalties are otherwise payable hereunder during a lease year after the primary term within which such shut-in period or periods occur…then the* ***Lessee shall pay*** *to the Lessor an amount equal to $___ within 90 days after the expiry of such lease year (herein called the "suspended well payment").* [emphasis is mine]

The first non-issue is the suspended well payment. Under non-CAPL leases the suspended well payment is often drafted so that the payment is optional. The lease only continues if the lessee properly makes the payment each year. Failure to make a timely payment or the inability to prove such payment (on a balance of probabilities) results in the automatic termination of such non-CAPL leases. This type of lease is called an "unless" lease in the case law. Very bad!

This is in contrast to the 91 CAPL Lease in which a suspended well payment which is late or is not paid at all is merely a default under the lease, not a failure to exercise an option. The default clause (clause 15) specifically mentions suspended well payments as being a default and the suspended well clause, clause 3, is clear that there is a positive obligation to make the suspended well payment and failure is a default. The payment is incidental and does not affect continuation.

The critical issue under the 91 CAPL is whether the well is "capable of producing the leased substances or any of them". The suspended well clause provides that the mere existence of a well which is capable of producing the leased substances shall continue in force the lease so long as the well is shut-in or suspended. The catch is trying to figure out what "capable of producing the leased substances" means. There is unfortunately no Canadian case law on the 91 CAPL wording. There is significant case law regarding shut in well language in non-CAPL leases. As the wording differs, the cases cannot really be applied to the CAPL. This is likely good news since almost every case finds a way to terminate the lease.

For a court, I believe this would require interpreting "capable" as a present and constant state. To allow for capacity to be sufficient, the lease really turns from a profit a prendre, to almost a fixed lease of the lands.

In my humble opinion, the words "capable of producing" must mean, at a minimum, the present and constant ability for leased substances to be produced from the wellbore without the necessity of any further operation or action by the lessee. I have no judicial authority for this interpretation, but when I prepare drilling opinions for clients this is where I draw the line.

The facts always determine the level of risk. Some examples of high risk wells I have run across are:

(a) a well with an actual cement plug in place because the deeper zone was oozing and leaking stuff. A hole in the ground full of cement is not capable of producing anything;

(b) a well so full of gunk that nothing will flow from the wellbore;

(c) a low flow gas well which will not flow without compression, and the compressor has been stripped;

(d) a well spud but no perforations, fracing or production testing. This is really just a hole in the ground in my view; and,

(e) a variation of (d) where a water well rig is used to punch a bunch of shallow holes on expiring leases so that a spud date shows up on the ERCB data.

It is arguable that "capable" does not require a present and constant ability to produce, but merely the capacity to produce. In which case any of the examples above might be wells capable of production so long as some reserves could be shown to exist that could be produced from the existing wellbore. This is really what the engineers mean by land in system plus well equals good to go. Good luck. To repeat what I have said in a previous article, at the end of the day, lessees must remember that even the 1991 CAPL Lease is still at law only a *profit a prendre*, being a fancy word for the lessee's exclusive right to win, take and remove leased substances from the lessor's lands under the terms and conditions of the lease. The lessee did not buy the lands, nor did they pay for a long term exclusive lease, such as a 25 year primary term. For a court, I believe this would require interpreting "capable" as a present and constant state. To allow for capacity to be sufficient, the lease really turns from a *profit a prendre*, to almost a fixed lease of the lands.

This sentiment is echoed in the decision of Alberta Court of Queen's Bench Justice J LoVecchio in the case of *Kensington Energy Ltd. v. B & G Energy Ltd.* (2005 ABQB 734). The case deals with a non-CAPL shut-in clause and so is not directly applicable to the 91 CAPL. I believe the case may also be under appeal. However, the sentiment of the court regarding the concern that a dry hole could indefinitely continue a lease is a common theme in many judicial decisions (even if unstated). Justice LoVecchio states:

> *...I would be concerned about the result of interpreting the [shut-in well] provision as giving rise to a distinct option [for the lessee to continue the lease by merely paying the suspended well payment]. By so doing, we give control of the future of the lands to the lessee rather than the owner. The lessee has got what the lessee bargained for namely, the right to drill and then to produce until it is exhausted what the lessee has found. When this has happened, why should a lease continue?* [par 87].