FINANCIAL POST

April 30, 2014

Encana's PrairieSky Royalty deal moves heaven and earth

By Drew Hasselback

Encana's proposed spin off of PrairieSky Royalty involves a very special real estate deal involving one of the most unique land packages in Canada

Encana Corp.'s proposed spin off of PrairieSky Royalty Ltd. is no conventional real estate initial public offering. It involves a very special real estate deal involving one of the most unusual land packages in the country.

In fact, it's so intriguing that it's worth taking a moment to pop the hood, and take a look at the legal mechanics that make the proposed transaction so special.

Canadian real estate ownership usually comes with an asterisk. While you might think you own your property lock, stock and barrel, in most instances, what you actually have is limited to a right to live on the surface of your land. It's typical for the crown to retain the ownership of any of the minerals or resources that might be found deep underneath your lot.

So, if it turns out your house is sitting on a gold mine or an oil well, those riches actually belong to Her Majesty Queen Elizabeth II, not you. That's why companies usually have to pay a "royalty" to the crown on the commodities they extract from the ground.

The Encana land package is different. It's one of the rare bits of Canadian real estate in which the landowner also has full title to the subsurface rights. Whatever lies beneath the soil belongs to Encana, and post closing, will belong to PrairieSky. "They're valuable to Encana because they're free of government royalties because the government isn't the owner of the mineral rights," says Chrysten Perry, a senior partner with Norton Rose Fulbright Canada LLP in Calgary.

The situation results from the story of Canada's most famous infrastructure project, the Canadian Pacific Railway. As part of the construction price, the young Dominion government gave CP Rail about 25 million acres of land across the Prairies in 1881. The feds sweetened the deal by giving CP full grants in fee simple or "freehold" lots without any restrictions or "reserves." In other words, the crown didn't keep any mines or mineral rights for itself. As the latin legal phrase goes, CP received the land and all the rights that run with it "usque ad coelum et ad inferos" - up to Heaven, and down to Hell.

The basic land package called for CPR to receive a checkerboard-like allotment of properties stretching 24 miles on each side of the proposed rail line. As the line reached Alberta, CPR was able to take a large contiguous land package just east of modern-day Calgary. This land would become immensely valuable after oil was discovered in Alberta. CP held the land through an oil subsidiary for many years. That subsidiary was spun-off, and ultimately became Encana in 2002. When Encana transfers the land to PrairieSky, the company will literally be moving heaven and earth.

Encana and its predecessor companies weren't the only ones to acquire freehold land in the Canadian West. Similar grants were extended to early Prairie pioneers to encourage them to settle in the West, but those individual grants are minuscule in comparison to the land package that would pass to CP. According to the PrairieSky prospectus, about 81% of fee simple mineral title land in Alberta is held by the provincial government and 9% is held by the feds. Public and private corporations hold another 9%, while individual landowners hold about 1%.

Fee simple is a common law concept that dates back to medieval times - the word "fee" itself comes from the old English word fief. The crown would grant estates to individuals, subject only to the right of the crown to expropriate it or take it back. This one limitation was designed to prevent the nobles who took the land from turning around and establishing their own sovereign realms.

"Fee simple title is an estate in property, and it's often called the greatest estate known to law," says Paul Negenman, a partner in the Calgary office of Lawson Lundell LLP. "That's a fantastic estate."

Encana and its predecessors chose not to extract oil and gas from the land. Instead, they adopted a royalty model that will continue with PrairieSky after the spin off. The idea is to lease rights to other companies. These lessees pay an upfront amount that grants them the right to explore the property for a fixed term. If a lessee finds some oil or gas and starts production, it pays a royalty on this output to the landlord, not the crown. The land returns to the landlord once the lease expires.

"There's absolutely no royalty paid to the crown because they don't own the resource," says David Cuschieri, an associate in the Calgary office of Torys LLP.

Greg Southam, a commercial real estate lawyer with Davies Ward Phillips & Vineberg LLP in Toronto, says the advantage of freehold land is the landlord's ability to negotiate custom deals with the lessees. Leases can be as unique as the parties like. For example, it's possible for the landlord to grant leases on "stratas" or layers of the subsurface soil, just like urban land developers do when they sell fee simple slices of air for the various units stacked up in high-rise condos.

For Encana, and eventually PrairieSky, the model allows the landlord and its investors to take current and future benefits from the land without putting the company's balance sheet at risk.

"It's a purely negotiated deal," Mr. Southam says. "To me, it's the highest and best use of the property."

Financial Post

National Post
