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What happens when the deep rights you just purchased are being drained by the vendor's shallow rights well?

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Cases Considered:

Nexxtep Resources Ltd. v. Talisman Energy Inc et al, 2007 ABQB 788; aff'd 2008 ABCA 246

What happens when a purchaser obtains the deep rights under certain oil and gas leases (along with a producing horizontal well) and the parties exclude another vertical well on the basis that it is producing from the shallow rights retained by the vendor and later the purchaser forms the view that the well is producing from the deep rights and not the shallow rights? That is the issue on the merits in *Nexxtep* - barring disagreements as to just where the vertical well was producing from. At present the case is reported only on certain preliminary matters, Nexxtep's request for an injunction and Talisman's request for summary judgment.

The facts

Nexxtep purchased certain petroleum and natural gas rights under Crown oil and gas leases from the base of the Mannville through the Rock Creek formation to the base of the Pekisko pursuant to a purchase and sale agreement (PSA) of March 2004 with Talisman. The assets included a horizontal well but not a more prolific vertical well which, at the time of the PSA, both parties assumed to be producing from above the base of the Mannville. Subsequent investigations by Nexxtep established that the vertical well was producing from the Rock Creek formation below the Mannville. When Nexxtep's requests that Talisman shut in the vertical were unsuccessful, Nexxtep commenced this action as well as an application for an injunction requiring Talisman to shut in the vertical well below the Mannville. Talisman sought an order for summary judgment and in the alternative security for costs.

The disposition by the chambers judge

Justice Colleen Kenny denied each of the applications for injunctive relief, summary judgement, and security for costs.

The application for summary judgment was denied because, while the affidavit evidence showed on the balance of probabilities that Nexxtep knew that it did not purchase the vertical well or any

production from that well or pay for that asset, Nexxtep did believe that it was purchasing the Rock Creek formation and did not understand that the vertical well was producing from that formation.

The application for an injunction was denied because while there was a serious issue to be tried what Nexxtep sought was, in effect, a mandatory injunction for which it needed to be able to establish a strong prima facie case; it could not do so. Further there was no irreparable harm here. To the extent that Talisman was producing Nexxtep's gas this might be readily quantified and damages payable. And, to the extent that Nexxtep sought to use the gas resources of the Rock Creek formation to assist in producing Pekisko gas, that was speculative and could not support an argument of irreparable harm. Neither did the balance of convenience support Nexxtep since Talisman's vertical well was more prolific and any enhanced production from Nexxtep horizontal well was speculative at best.

There was no evidence to support an application for security for costs. The only evidence before the court was that Nexxtep had purchased some $4 million of assets from Talisman.

Talisman appealed.

The disposition on appeal

The Court (Justice Constance Hunt, Justice Clifton O'Brien, and Justice Alan McLeod) dismissed the appeal.

Summary judgment will only be granted if it is plain and obvious that there is no genuine issue to be tried and the standard of review is reasonableness as to the decision and correctness as to the legal test. In this case there were factual issues as to whether the well was indeed producing from the Rock Creek formation and the effect of the EUB designation of the well as a Lower Mannville well at the time the PSA was signed. These were not matters that could be resolved on summary judgment and the trial judge applied the correct test.

Similarly, Talisman was not entitled to summary judgment on the basis of a rectification argument so as to have the PSA conform to what Talisman alleged to be the shared intentions of the parties, i.e. that the PSA should exclude the vertical well and its producing zone even if that well were draining hydrocarbons from a formation conveyed to Nexxtep. The evidence on this point was contradictory and the trial judge's decision was therefore not unreasonable.

Analysis and comment

There seems to be nothing very remarkable about the disposition of any of these preliminary matters by either court. Manifestly this was not a case for summary judgment. There will be difficult technical issues here surrounding the classification of deep and shallow rights, the effect of EUB\ERCB zone designations and no doubt the construction of the PSA and the supposed common intention of the parties at the time the agreement was executed.

So the real interest in this case lies in the future disposition on the merits and we wait with bated breath! On the face of it, if Talisman's vertical well is indeed completed in a formation the rights to which were conveyed to Nexxtep, then that well is prima facie a trespassing well. On the other hand, if the well is completed in a formation to which Talisman has retained rights and the well is simply draining from the deeper formation with which it is in communication, then, unless application of the rule of capture is precluded by operation of the contractual documents (*Anderson v. Amoco Canada Oil and Gas*, [2004] 3 SCR 3 at paras 34 and 39), and provided that the well complies with any relevant spacing requirements (*Gulf Canada Resources Ltd v. Ulster Petroleums Ltd*, [1998] 4 WWR 773 (Alta. CA)), Talisman's continued production of that well will fall within the no-liability aspect (*Anderson* at para 37) of the rule of capture.