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When, if at all, does a pooling agreement trigger an area of mutual interest obligation?

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Cases Considered:

Hunt Oil Company of Canada Inc v. Shell Canada Limited, 2009 ABQB 627

In a 1994 decision, *Luscar v Pembina Resources Ltd* (1994), 162 AR 34, the Alberta Court of Appeal cast doubt on the proposition that Y, a lessee of a tract within a drilling spacing unit (DSU), who enters into a cross conveyance pooling agreement with Z, a lessee of a different tract within the same DSU, will invariably trigger an area of mutual interest (AMI) obligation that Y owes to X with respect to the undivided interest that Y acquired within Z's tract by virtue of the pooling agreement.

In this decision, Justice Alan Macleod has extended that line of reasoning and has decided (subject to the language used in any particular case) that Y will not trigger an AMI obligation, not only in the narrow situation described above but also in the situation where Y and Z, holding adjacent lands, enter into a pooling agreement to improve project economics and not for the purpose of forming a drilling spacing unit.

The facts

Shell as farmor and Hunt as farmee entered into a farmout and participation agreement in relation to certain lands in British Columbia. The parties used the 1997 CAPL Farmout and Royalty Procedure. Hunt participated in a well on the Block A lands and earned an interest. Hunt ultimately declined to exercise its option to participate in a further well on the Block B lands and as a result did not earn an interest in the Block B lands.

In order to improve the economics of operations on the Block B lands, Shell subsequently entered into a non-cross conveyance pooling agreement with Talisman in relation to the Block B lands and adjacent lands held by Talisman. Production was obtained from the Talisman lands and shared with Shell under the terms of the pooling agreement. Hunt argued that the interest that Shell had acquired under the pooling agreement in relation to the Talisman lands triggered the AMI clause of the farmout agreement and that therefore Shell was obliged to offer to share that interest with Hunt.

The decision

Justice Macleod held that the pooling agreement did not trigger the AMI clause (at para. 49); he also held in the course of his reasons that the expert evidence that had been called did not support the claim that there was an industry custom to the effect that entering into a pooling agreement would trigger an AMI (at paras.36 – 39).

In reaching the main conclusion that the pooling agreement did not trigger the AMI obligations, Justice Macleod develops four main reasons (although I should caution the reader that I am, to some extent, imposing this framework on the judgement).

First, (at paras 41- 42) Justice Macleod reasoned that the purpose of an AMI clause is to avoid competition between the parties to acquire interests in adjacent lands. Given that purpose it would be inappropriate to include acquisition by pooling within the scope of an AMI because a party in the position of Hunt could never have acquired an interest in the Talisman lands by means of a pooling since Hunt was not in a position to offer the *quid pro quo* i.e. an interest in the Shell Block B lands. Hunt would have been able to participate in that trade had it elected to participate in the option well and earned an interest in the Block B lands but Hunt had declined to do.

Second, there really was no acquisition here. Shell's overall interest in the pooled lands was no greater after the pooling agreement than before; the pooling "is financially neutral" (at para.43).

Third, even if the pooling agreement afforded Shell an acquisition, not all acquisitions fall within the terms of the AMI clause. In particular, Justice Macleod seems to have proceeded on the basis that the parties all conceded that forced poolings and "poolings in the face of regulatory authority" (at para. 46) (and perhaps also unitizations) did not trigger the AMI obligations and therefore it was not obvious that this sort of voluntary pooling agreement should trigger the AMI obligations either.

Fourth, the AMI clause in the farmout agreement (s.8.04A) contemplates that where the obligation is triggered, the party electing to participate "will pay the corresponding share of the cash consideration of that acquisition" to the other party. Since there is no cash consideration in a typical pooling agreement (just a sharing of rights and obligations on an acreage or reserves basis) this might be taken as evidence that the parties did not intend that the AMI obligation apply to pooling agreements.

Before reaching this conclusion and reasoning as above, Justice Macleod also conceded that it is not possible to establish general rules about the triggering effect of pooling agreements on AMI clauses. Ultimately it must always be a question of interpretation of both the AMI clause (what does the AMI clause say about the trigger?) and the pooling agreement (what new rights does Shell acquire?). Given this acknowledgement, it is perhaps a little surprising that Justice Macleod's judgement does not provide us with the text of the pooling agreement in question. All that we know of the pooling agreement is that: (1) the agreement is described as a non cross-conveyed pooling agreement (para. 13) (and we can perhaps infer from that that Shell did not

acquire an undivided interest in Talisman lands and that Shell's interest was likely simply a contractual interest), (2) the agreement was not entered into for the limited geographical and legal purpose of forming a drilling spacing unit, but to improve the economics of the play, (3) the agreement was a "voluntary exploratory pooling arrangement" (para. 31) (and we can reasonably infer from that that it covered a much larger area than the standard DSU under the B.C. legislation, the *Petroleum and Natural Gas Act*, R.S.B.C. 1996, c.361); and (4) the pooling seems to be based on acreage rather than reserves. We do not know if the pooled area was based on mapping of an underlying reservoir and we do not know if the pooling was confined to a particular formation.

We know much more about the AMI clause since we know that it is the CAPL standard form and Justice Macleod summarizes the effect of the main provisions at paras 22 and 47 of his judgement. The CAPL standard form deals with AMI issues in the definition section ("'Mutual Interest Lands' has the meaning set forth in the head agreement …"), in Article 8 (the standard terms), and in the head agreement (the business variables of the deal which will tell us the area covered by the AMI obligation and the duration of the AMI rights).

Article 8 (8.03) tells us that the AMI obligation is triggered when a Party acquires "Mutual Interest Lands or rights thereto" (here the underlining is mine and I note as well that I have taken this provision from the standard form itself – Justice Macleod does not quote this part of the agreement and I can only assume that the parties had not modified this particular provision) and "if that acquisition is included within the definition of Mutual Interest Lands" then "the acquiring Party will acquire those Mutual Interest Lands or rights subject to the rights of the other Parties under this Article" (emphasis added).

Absent the actual language of the pooling agreement it is very difficult to assess Justice Macleod's conclusions so I shall end this blog post with three observations. The first is that the AMI language of the CAPL Agreement is broad. By inserting the words "or rights thereto" the parties seems to have contemplated that the AMI obligation might be triggered not only through the acquisition of an interest in land (as through a cross conveyance) but also through the acquisition of other rights such as a contractual right to a share of production.

The second is that we might reasonably be cautious in applying *obiter* statements made in the context of a pooling agreement entered into to complete a spacing, to a very different type of pooling arrangement – indeed an arrangement that I would not describe as pooling at all. The pooling that occurred in *Luscar* was a pooling to make up a spacing unit. That, I believe, is the traditional usage of the term "pooling" and it is certainly the way that the term is used in provincial oil and gas conservation legislation in both Alberta (*Oil and Gas Conservation Act*, R.S.A. 2000, c. O-6, s.80) and British Columbia (*Petroleum and Natural Gas Act*, *supra*, s.68). If the term pooling is confined to a DSU this means that any acquisition and dilution of interests that occurs through pooling is geographically quite confined. Furthermore, we can also say that in *Luscar* some form of pooling was legally essential in order to produce the property. That is not the case on this fact pattern. Shell was not legally required to pool in order to produce from the Block B lands. Pooling to make up a drilling spacing unit is not pooling to spread risk or pooling

to improve project economics – both of which seem to have been the drivers as between Shell and Talisman. I think that this should make it harder to conclude that this arrangement did not trigger the AMI. And certainly, calling something a pooling agreement for the purposes of taking the benefit of a dictum cannot make something a pooling agreement.

Third, the golden rule of interpretation is that the interpreter must seek to give effect to the intentions of the parties based on the words that the parties have chosen to use. Justice Macleod's approach here seems very purposive, and, as I have noted above in reading his judgement we must struggle with the fact that as readers we lack access to the words used by the parties in their pooling agreement. But some may think that this puts me on difficult ground. After all, in taking such a purposive approach to the interpretation of the AMI clause Justice Macleod purports to rely (and generously so) on an article on pooling agreements that I wrote some fourteen years ago: Bankes, "Pooling Agreements in Canadian Oil and Gas Law" (1995), 33 Alberta Law Review 493.