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February 10th, 2010

Damages for production on a dead oil and gas lease

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Cases Considered:

Canpar Holdings Ltd v Petrobank Energy and Resources Ltd and Gentry Resources Ltd, unreported transcript of reasons for judgement October 9, 2009 and December 11, 2009, available here.

In this case Justice Miller decided that: (1) a an oil and gas lease that contains a no-deduction form of royalty clause (royalty calculated by reference to sales price and not by reference to value at the wellhead) means just that – no deductions (whatever the industry custom or practice to the contrary), (2) a lessor can terminate a lease by following the default clause of the lease where the lessee has not being paying royalty in accordance with the terms of the lease, and (3) at least in the circumstances of this case, a lessee that produces on a lease that has been terminated by the lessor triggering the default clause may be exposed to an accounting on the basis of sales value of production minus operating costs. Given the importance of each of these issues it is unfortunate that Justice Miller decided to dispose of the matter by way of oral reasons from the bench.

The facts

Canpar Holdings Ltd ("CH") and Canadian Natural Resources Ltd. ("CNRL") granted a petroleum and natural gas lease to Monolith Oil Corp. ("M") in 2000. CNRL assigned its interest in the lease to Petrovera in March 2005 and M's interest became vested in Petrobank. The royalty clause in the lease provided that

> …. the lessor reserves to itself and the lessee shall pay or cause to be paid to the lessor a royalty in cash of 17½ percent of the greater of the actual price received, including payments received from any source whatsoever in respect thereof, or the current market value at the time and place of sale of all these substances produced from the lands, all without deductions, provided that the lessor shall only bear its proportionate share of actual costs of transportation beyond the point of measurement to the point of delivery of crude oil.

In 2005 Canpar formed the opinion that Petrobank was making deductions beyond those authorized by the royalty clause and ultimately issued a notice of default (January 18, 2006), and,

taking the view that the default remained uncured, brought this action seeking: (1) a declaration that the lease had terminated and an order for possession, (2) damages until the time that the default notice became effective based upon a proper calculation of the royalties due and payable, and, (3) an accounting for production from the lands. Petrobank had remained in possession throughout.

The decision

Justice Miller gave judgement for the plaintiff lessor on all grounds.

The lease should be interpreted within the four corners of the document without looking to the past practices of the parties or the prevailing custom in the industry as shown in decided cases. The lease provided that the royalty should be paid on the actual price received or current market value whichever was greater. The fact that Petrobank used its corporate average or pooling price was irrelevant as was the claim that the lessor's position was inconsistent with industry practice. As a result, Petrobank was not entitled to deduct for fuel gas and was not entitled to rely on a proviso that allowed it to use leased substances royalty free for its "operations" on the leased lands. The use of gas for compressors on and off the leased lands did not fall within the definition of "operations". Thus, Canpar as lessor was entitled to royalty without deductions as from September 2003 (presumably when production commenced) but Petrovera could only claim royalty on this basis as of March 2005 when it took an assignment of CNRL's interest (no claim having been made by CNRL).

The lease terminated in March 2006 in accordance with the default clause of the lease. This was not an appropriate case for relief from forfeiture. Relief from forfeiture is rare in the oil and gas industry and it was not appropriate to grant it in this case where the lessee, while not acting in a high-handed way, simply disagreed as to the basis of calculating royalties and as a result underpaid. The lessee could have paid under protest and applied to the court for a declaration as to the proper interpretation of the royalty clause.

Damages for continued production from the date of termination of the lease in accordance with the default clause should be calculated on the basis of an accounting on the basis of the so-called mild rule (see *Freyberg v. Fletcher Challenge Oil and Gas Inc,* 2007 ABQB 353) which in this case was interpreted to mean the proceeds of production minus the costs of severance, production and marketing. Justice Miller rejected a claim for exemplary or punitive damages.

Analysis

Although it is unfortunate that the decision in this case takes the form of a transcript of reasons for decision rather than a reserved judgement with fully articulated reasons, it is still a significant case for at least three reasons.

First, it is one of the very few reported cases in which the courts have given full effect to "no deduction" language in a royalty clause in a lease or a royalty agreement. Another case in which

this happened was *James H. Meek Trust v. San Juan Resources Inc.* 2003 ABQB 1053 at paras 52 – 54) but in at least some cases (see, for example, *Resman Holdings v. Huntex Ltd*, [1984] 1 WWR 693 (Alta. Q,B.)) there is a tendency to assume that the royalty payor should be able to make deductions back from the point of sale to the point of determination of value (at the wellhead). But here the clause was careful to say that the royalty was payable on the basis of market value (the price actually received or market value, whichever was the higher) and not on the basis of wellhead value. The clause also went on to say "all without any deductions".

The discussion of the no deduction language is therefore significant but perhaps more significant was the way in which the clause tied royalty determination to value at the point of sale. The point is not fully discussed here and the judgement does not tell us anything about Petrobank's sales portfolio. It is possible, for example, that it is selling at the wellhead to a midstreamer (see, for example, *Semcams ULC v. Exxonmobil Canada Energy*, 2008 ABQB 469). On the other hand it is possible that it is reserving its own processing and transportation capacity and engaging in direct sales with downstream entities in Ontario or even New York. The point is that with a royalty clause such as this, location matters - the royalty is prima facie payable on the basis of value at the point of the first arms-length sale, wherever that might be. And furthermore the royalty owner will be carried all the way to that first point of sale i.e. there is no opportunity for the lessee to insist that the royalty share of gas (there was a special provision dealing with the transportation of oil) should be responsible for its share of costs incurred downstream of the point of production. The point is not fully developed here because, as I say, we know nothing of where or how Petrobank is selling its gas.

Second, the case is significant as one of the few cases in which a lessee has been able to terminate an oil and gas lease for default in its secondary term. Most of the reported cases deal with termination during the primary term for failure to pay a delay rental or automatic termination during the secondary term for cessation of production or deemed production. In these cases the lease terminates automatically and the lessee does not need to rely on the default clause (see *Lady Freyberg v Fletcher Challenge Oil and Gas Inc,* 2005 ABCA 46 and *Kensington Energy Ltd v. B & G Energy Ltd* 2008 ABCA 151, blogged here). But here the lessee did rely on the default clause and this was accordingly a case of a lessor exercising its right of re-entry for breach of a lessee's covenant. This was therefore also a case in which relief from forfeiture was at least arguable (it is not available at all in a case of automatic termination). The Court seems to have dealt with this issue somewhat summarily and perhaps drew an inappropriate analogy (page 8, lines 40 – 41 of the transcript of reasons for judgement) with cases dealing with the non-payment of a delay rental during the primary term.

Third, the case is significant because it seems to have accepted that accounting is a more appropriate remedy for production on a dead lease than is the remedy of damages calculated by reference to the bonus and royalty payment that a lessor might have expected to receive in negotiating a new lease. In doing so the court effectively distinguished both the decision of the Saskatchewan Court of Appeal in *Montreal Trust Co v. Williston Wildcatters Corp,* 2004 SKCA 116, and the decision of the Alberta Court of Queen's Bench in *Freyberg v. Fletcher Challenge Oil and Gas Inc*., *supra* (notice to appeal was given in this latter case but the matter was settled

before the appeal could be heard). In both of those cases the court was at pains to ensure that the lessor should be confined to a damages claim that was truly compensatory and did not enrich the lessor beyond what it might have received in a typical lease bargain.

I say "seemed" in the above paragraph because Justice Miller's reasoning on the above is extremely sketchy. For example, he does not refer to *Williston Wildcatters* at all, and does not discuss Justice Kent's actual decision in *Lady Freyberg*. As a result, Justice Miller offers no reasons for concluding that the lessor here should be compensated on a more generous basis than in *Lady Freyberg* and in fact such reasons as there are on this point suggest to the contrary: "… the conduct of the defendant is … far less egregious than some of the defendant's in the *Freyberg* case …. The defendants, while mistaken in their interpretation of clause 3 in the lease, were not high handed or abusive. They simply agreed to disagree and appear to have done that in a somewhat reasonable fashion" (page 7-8 of the transcript of reasons for judgement).

But while I am critical of absence of reasons in Justice Miller's judgement I am less critical of the actual result. I wrote an extended case comment on *Williston Wildcatters* some years ago: "Termination of an Oil and Gas Lease, Covenants as to Title, and Assessment of Damages for Wrongful Severance of Natural Resources: A Comment on *Williston Wildcatters*" (2005), 68 Sask. L. Rev. 23 - 77. In that article I argued that an accounting should be the usual remedy for production on a dead lease and that the basis for that accounting should be proceeds of production received by the tortfeasor minus post severance costs actually incurred. That is effectively what Justice Miller has concluded in this decision. There was perhaps one ground on which Justice Miller might have distinguished these earlier cases and that was on the basis of the characteristics of the lessor. In both *Williston* and *Lady Freyberg* the court was at pains to emphasise that neither lessor was capable of operating the well itself. In each case the lessor would have had to have re-leased the property to another oil and gas company, thus justifying an assessment of damages along the line of the bonus and royalty that such a lessor might have received. In this case the plaintiff might have been able to make the argument (I say "might have" since there is nothing in the oral reasons to suggest whether or not such an argument was made) that this lessor was a sophisticated corporate entity that would be able to obtain a contract operator for the well and thus obtain a much better deal than simply a royalty plus bonus.

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