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Production in meaningful quantities: commercial realities should inform the interpretation of an oil and gas lease

By Nigel Bankes

Cases Considered:

Omers Energy Inc. v Alberta (Energy Resources Conservation Board), 2011 ABCA 251

In important and rare "reasons for judgement reserved" the Alberta Court of Appeal, in unanimous reasons authored by Justice Carol Conrad, affirmed the decision of the Energy Resources Conservation Board (ERCB) to the effect that a petroleum and natural gas lease had expired in its secondary term in accordance with its own terms when the gas well (the 100/05-4 well) on the lands was unable to produce for more than very short periods of time (minutes or hours) because of large volumes of produced water. The lease in question (the CAPL 91 form) provided for continuation beyond the end of its primary term by "operations"; the term "operations" was defined to include "the production of any leased substances" and was further extended by the language of the shut-in wells clause which defined the existence of a well "capable of producing the leased substances" to serve as "operations" for the purposes of the habendum. Both the Board and the Court concluded that the lease could not be continued. The words "capable of producing" did not mean just any production no matter how miniscule the quantities, and instead must be read to mean "production in meaningful quantities". Since it followed from this that the lease had expired, Omers was not entitled to maintain well licences for two other wells that it had drilled on the leased properties since it could no longer meet the requirements of s 16 of the *Oil and Gas Conservation Act*, RSA 2000, c O-6 to the effect that:

> 16(1) No person shall apply for or hold a licence for a well
> (a) for the recovery of oil, gas or crude bitumen, or
> (b) for any other authorized purpose
> unless that person is a working interest participant and is entitled to the right to produce the oil, gas or crude bitumen from the well or to the right to drill or operate the well for the other authorized purpose, as the case may be.

ERCB Decision 2009-037 is available here.

Five Observations

First, this litigation began before the ERCB when a top lessee, supported by the lessor and the Freehold Owners Association sought to question well licences that Omers had obtained to drill and produce two other wells. Omers' title to do that depended on "operations" on the 100/05-4 well to bridge the gap between the end of the primary term and the commencement of production from these two other wells. This decision (inferentially, since there is no discussion of this issue in Justice Conrad's judgement) confirms that the ERCB can make decisions about lease validity

as part of its well licensing proceedings. This is a sound conclusion and in practical terms perhaps offers an alternative to the notice to take proceedings to justify a caveat which is perhaps the more traditional way for the top lessee to proceed in these situation

Second, the case confirms that the standard of review for ERCB decisions where the point at issue is a point of general law (here the correct interpretation of the habendum of an oil and gas lease) is correctness (at para. 29). This too seems sound as does Justice Conrad's decision to reject the Board's efforts to parse the interpretation\application questions into two different points of law with two different standards of review (at paras. 25 and 31). Sometimes parsing can be justified on the language of a statutory or other provision (see, for example, *Dene Tha' First Nation v Alberta (Energy and Utilities Board)*, 2003 ABCA 372), but in this case the proposed parsing seemed artificial and contrived more of a self-serving effort to protect the "space" reserved to the Board than a realistic deconstruction of the language of the lease.

Third, the parties (Omers, the top lessee (Montane) and the lessor (Cymbaluk) as intervener) offered several different interpretations or glosses on the term "capable of producing". The intervener in particular argued that the Court should follow American law and qualify the term "capable of producing" by insisting on production in paying quantities (production that covers ongoing costs) - not the more stringent test of production in commercial quantities (production that covers ongoing costs plus a return on investment). In the end, the Court rejected the idea of inserting or implying such specific language on the grounds that since variants of these terms (i.e. "quantitative measures") were used elsewhere in the agreement (eg the offset wells clause) "a tribunal [at para. 75 and see also at para. 76] should be slow to assume the parties intended a specific quantitative measurement in another term where none was included." But, that said, the Court very definitely accepted the pragmatic, purposive understanding that underlies the US jurisprudence which Justice Conrad described as follows:

> [77] By making this finding [not to read in the terms "in paying quantities], however, I do not wish to be seen as rejecting the general rationale upon which the term "paying quantities" is based. I agree with the American authorities, and the Board, that the purpose and goal of parties entering into such a lease is to develop the resource for the purpose of making a profit. That purpose provides the rationale for concluding that where production extends the primary term of a lease, the parties would have anticipated production at something more than trivial or minuscule production. Certainly they would not have anticipated that a lessee could hold a lease by shutting in a well that was not capable of producing a meaningful amount, even if not every moment would have been in paying quantities. In my view, although the Board was not prepared to read the words "in paying quantities" into the contract, it adopted the rationale underlying the American cases and was proper in doing so.

In light of this it was fairly easy for the Court to take the alternative step of endorsing as correct the Board's approach which adopted the more open textured language of "production in meaningful quantities" as a more appropriate qualifier. In doing so the Court was quite aware that there was perhaps little to choose between the two approaches – at least in terms of outcome:

> [95] Given the rationale which the Board employed to support its choice of "meaningful", I do not see a significant difference between "meaningful" quantity and "paying" quantity – although in certain circumstances the latter may provide more latitude than the former. While I am not prepared to interpret the Suspended Wells Clause as requiring production in "paying quantities", I note that the reasoning behind the concept of "paying quantities"

> in the American authorities, and that used by the Board for choosing "material" and "meaningful", are very similar. That rationale seeks to support the common objective of the parties to benefit by profit from development of the resource. It strains common sense to think a lessor would agree to tie up its land past the primary term, and perhaps indefinitely, for a lessee's speculative purposes only and for a well that lacks commercial viability: see *Freyberg* at para 50 [*Freyberg v Fletcher Challenge Oil and Gas Inc*, 2005 ABCA 46]. By using the term "meaningful" the direction of the Board appears to be much the same as that of the American courts in choosing "paying quantities". Before a lessee can take advantage of the Habendum Clause and the Suspended Wells Clause to extend or maintain the lease beyond the primary term, there must be a meaningful amount of resource capable of production. It was never intended that the shut-in well clause could allow a lessee to hold a property for purely speculative purposes. There must be some commercial viability to the well. Moreover, if the well requires operations of the type defined in the lease to be capable of producing that meaningful quantity, those operations, must be conducted as required by the lease.

While this might lead to a charge of indeterminacy (at para. 49) Justice Conrad meets that objection with the classical response of the common law i.e. these issues can be resolved in the crucible of concrete cases (at para. 95): "As cases move forward through the Board and the courts, the volumetric test will undoubtedly be refined within the context of the specific cases." Relevant questions might include the following (at para. 96): "Would a reasonably prudent operator, for the purpose of making a profit and not merely for speculation, continue to operate a well in the manner that it does? …"Is there is a reasonable expectation of profitable returns from the well?"

Fourth there is some interesting *obiter* discussion in Justice Conrad's decision as to the scope of the lessee's right to shut in (assuming that there was indeed a well capable of production in meaningful quantities). The CAPL 91 form contains a very open-ended shut-in clause in the sense that it describes the implications of shutting in a well but does not establish the preconditions (eg lack of a market) that must be met before shut-in can occur (other than that the well must be capable of production in (now) meaningful quantities). Having observed this (at paras 44 – 46) Justice Conrad went on to say (at para. 46):

As the issue of entitlement to shut-in is not directly engaged in this appeal, I leave to another day the question of whether the language of this lease, viewed objectively, demonstrates a common intention that a well, even one "capable of producing", can only be shut-in for prudent reasons.

Fifth, and this is perhaps related to the last point, there are several references in the judgement to "speculation" (and derivatives like "speculative" see paras 52, 65, 92, 95, 96 – some drawn from the US case law). "Speculation" is explicitly or implicitly condemned as a basis for holding a property (at least where the price for holding is the minimal fee prescribed by the typical shut-in clause) but we should at least ask why this is the case. In the oil and gas sector the problem of speculative holding of oil and gas rights is often linked to ideas of severance and reversion (deep or shallow rights). The basic question is this: should A, who can produce from horizon A1 be able to maintain the right to produce from formations above (shallow rights) and below (deep rights) horizon A1 by virtue of an A1 well that is "capable of producing" the leased substances. More sophisticated lessors such as the Crown or Encana have opted to deal with this issue over the years by requiring non-producing rights to revert to the lessor at the end of the primary term (or equivalent in the case of Crown leases\licences) beginning with deep rights and now, at least in the case of the Crown, extending to shallow rights.

Sixth, while the case insists that the agreement between the parties should (and rightly so), where possible, be interpreted in a manner that meets the reasonable commercial needs of both parties, the case also acknowledges that ultimately it is all a question of interpretation: the lessor can agree to allow the lessee to shut in for speculative reasons and maintain its rights provided that the lease adopts language that requires such a result (see paras 36 and 86). In other words oil and gas lease continuation problems always present problems of construction and (at para 36), "each lease must be interpreted on its own". See in this context *Kensington Energy Ltd v B & G Energy Ltd*, 2008 ABCA 151 and my post on that decision here.