November 29, 2011

Judgment Handed Down in a Complex Petroleum and Natural Gas Lease Case

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Case commented on: *Stewart Estate v TAQA North Ltd*, 2013 ABQB 691

This lengthy (121 page plus appendices) and well-reasoned decision will be essential reading for members of the oil and gas bar in Alberta. Justice Barbara Romaine offers guidance on a number of issues including the importance of having all relevant parties before the Court when seeking a declaration as to lease validity, limitations, the interpretation of the term "lack of or intermittent market" and the term "any cause whatsoever beyond the Lessee's reasonable control", and the measure of damages where a lessee produces on a dead lease. Given the length of the decision (much of which is taken up with a careful review of the testimony of expert witnesses) I will limit this post to the above legal questions. There are, however, a number of other issues discussed in the decision that this post does not deal with (e.g. estoppel, leave and licence, champerty and maintenance, etc).

All the parties interested

One of the preliminary issues that Justice Romaine had to deal with was whether some of the plaintiffs were proper parties to the litigation. This issue arose because there was at least some evidence that some of the parties who purported to hold interests in the leases as lessors had actually assigned their interests. The assignees were not before the Court. Justice Romaine did not resolve the issue of standing definitively but instead held that in this situation the validity of these leases could not be authoritatively determined because not all of the potentially interested parties were before the Court. While there might be an argument that such a rule is designed for the benefit of the applicant (to ensure that any declaration that issues will have practical effect) the rule is also supported by efficiency and justice reasons (at paras 171 – 175).

Limitation issues

An application for a declaration that a petroleum and natural lease has terminated is not subject to any limitation period (see *Limitations Act*, RSA 2000, c. L-12, section 1(i) (definition of remedial order) and at para 186) but any application for a consequential remedial order (e.g. a claim for damages based on a cause of action in conversion, trespass or unjust enrichment for wrongful production on a dead lease) is subject to both the two year rule (s 3(1)(a)) and the 10 year drop dead rule (s 3(1)(b)). Section 3(1)(a) provides that the plaintiff must commence its action within 2 years after the date on which the claimant first knew, or in the circumstances ought to have known, that the injury for which the claimant seeks a remedial order had occurred.

In this case the pooled property (the section 25 lands) began producing during the primary term from the 7-25 well and continued until July 1995 at which time the lessee/operator shut the well in. As a result, the lessees no longer paid the lessors actual royalties; the only payments that were made thereafter until production from another formation re-commenced in 2001 were shut in royalty payments. On those facts Justice Romaine held that the limitations period began to run shortly after the cessation of production:

> [197] In this case, the remaining freeholder Plaintiffs knew or ought to have known that production had ceased under the leases shortly after July 1995. By the end of November 1995, they ought reasonably to have known that production had ceased for more than 90 consecutive days. In the result, they knew or ought to have known by that time all the facts necessary for their claim that the leases had terminated in accordance with their terms. They thus should have known of the "injury" that is the subject of the claims of unjust enrichment, trespass and conversion.

It was immaterial (at para 198) that the lessors would not know at that point that the cessation in production was not for a reason provided for by the third proviso since (at para 200): "Even if the Plaintiffs did not know a fact material to the injury in not knowing the reason for the cessation of production, they were not entitled to ignore the issue until they were notified of the reasons by the Defendants, but they were obliged to exercise due diligence in determining the reasons for the cessation of production …:.".

In so ruling Justice Romaine distinguished the Court of Appeal's decision in *James H. Meek Trust v San Juan Resources Inc*, 2005 ABCA 448 [*Meek Trust*]. In that case the Court held that time did not begin to run where a royalty payor stopped making certain gross overriding royalty payments. Time did not begin to run for the plaintiff since the reduced payment alone would not have put the plaintiff on notice that anything was amiss since the payor's accounting did not connect the payments or reduced payments to any particular property. *Meek Trust* was distinguishable in this case since there was only one possible explanation for why the lessors here were no longer receiving actual production payments.

In sum, the plaintiff lessors ought to have known that they had possible claims by mid-1996 at the latest but the action was not brought until August 2005, roughly nine years later (at para 202). Although it is not entirely clear from her judgement I assume that the net effect of this is that if the plaintiffs did have a good cause of action (i.e. if the leases were dead) they could reach back no more than the two years prior to commencing the action (on the basis that each new act of unlawful production is a new tort – and for the most recent confirmation of that see *Canadian Natural Resources Limited v Jensen Resources Ltd*, 2013 ABCA 399 at para 11 – published after the decision in the instant case, which will be the subject of an ABlawg post next week).

"Lack of or intermittent market"

This litigation involved the secondary terms of a number of leases. The language of the leases was similar but not identical. In particular, the third proviso of each of the leases contained a sub-proviso which, if triggered, carried the implication that the time of any non-production "shall not be counted against the Lessee" (as to which see *Kissinger Petroleums Ltd. v Keith McLean Oil Properties Ltd* (1984), 33 Alta LR (2d) 1 (CA)). In one lease the sub proviso was triggered where the failure to produce was "as the result of a lack of or an intermittent market, or any cause whatsoever beyond the Lessee's reasonable control." A second formulation provided that the exception was triggered where non-production was "as the result of any cause whatsoever beyond the Lessee's reasonable control including, in the case of production operations lack of or an intermittent market" (I put to one side third proviso language that deals with interruptions to drilling or working operations (since neither were at issue here)). The shut-in wells clause in each case tracked the language of the third proviso (at para 512).

The evidence showed that the 7-25 well was shut in because it could not be profitably produced in the deregulated environment and depressed prices of the mid-1990s. The well was not shut in

for *lack* of a market (interpreting that term without the qualifying "economic") (at para 515) since the lessee/operator had a gas sales contract throughout the relevant period. Various factors affected the economics of this particular well. It was a sour gas well; the lessee/operator had no working interest in the gas processing plant where the gas was being processed; there was limited capacity at the plant and the operator/lessee had to pay a custom operating fee; and the well was not as productive as some others. Sour gas from the Crossfield formation produced from the well was processed at Amoco's plant which principally served the East Crossfield D1 unit which did not include the subject lands. Amoco had little incentive to take gas from the section 25 lands and indeed was in a position to drain those lands from its own wells. The 7-25 well was put back on production in 2001 when one of the working interest owners in the well put in an independent operations notice to re-complete the well in another formation. By this time prices had improved dramatically.

The principal legal question was whether the language of "lack of or an intermittent market" should be interpreted as requiring an economic or profitable market i.e. that the lessee should be entitled to invoke the sub-proviso if it could only produce at a loss. In the end, and following consideration of the relevant cases (*549767 Alberta Ltd v Teg Holdings Ltd*, [1997] AJ 321 (QB); *Omers Energy Inc v Alberta (Energy Resources Conservation Board)*, 2011 ABCA 251 (and see my ABlawg post here); *Blair Estate Ltd v Altana Exploration Co*, [1987] AJ 554; *Kensington Energy Ltd v B & G Energy Ltd* 2008 ABCA 151 (and see here); *Lady Freyberg v Fletcher Challenge Oil and Gas Inc*, 2005 ABCA 46) Justice Romaine held that a commercially reasonable interpretation (at paras 529 and 538) required that (at para 542) "the phrase 'lack of or an intermittent market', read in context and with a view to the reasonable intention of parties to a lease to profit from the extraction of leased substances, should be interpreted to mean lack of or an intermittent economical or profitable market."

"Any cause whatsoever beyond the Lessee's reasonable control"

Justice Romaine was also prepared to accept that a drastic down-turn in the price of gas accompanied by high processing costs caused by "external forces" (at para 558) could fall within the phrases "any cause whatsoever beyond the Lessee's reasonable control". In reaching this conclusion Justice Romaine distinguished the Alberta Appellate Division's decision in *Canada-Cities Services Corporartion v Kininmonth* (1963), 42 DLR (2d) 56 (aff'd on other grounds [1964] SCR 439) on the grounds that the downturn in prices and other factors relied upon by the lessees (at para. 558) were not "as inevitable or foreseeable as seasonal road bans". I confess to some difficulty with this particular conclusion. While price fluctuations may not occur annually or predictably on any other periodic basis, dramatic price fluctuations in the resource sector *are* foreseeable and in that sense inevitable.

But in the end Justice Romaine seems to have rolled up together these two potentially separate justifications (lack of or intermittent market, and cause beyond the lessee's reasonable control) for failing to produce into a single ameliorative ground concluding:

> [568] Thus I accept that the 7-25 Well was shut-in in July, 1995 for causes beyond the Lessees' reasonable control, in that it was uneconomical to produce during the shut-in period given the low price of gas and the relatively high costs of production and processing, effectively a lack of an economic market. While the operator did not notify the other working interest owners of the decision to shut-in the well, as that decision was within its authority as operator, the other lessees did not object, implying that they were in agreement with the operator's decision.

The Court also held that the operator/lessees turned the well back on at approximately the right time! While the operator made no formal determination as to a price at which it would have been economical to activate the well (at para 572) the evidence suggested that the operator was acting in accordance with the standard in the industry in continuing to evaluate whether it would be economical to produce this well (at para 578).

The Measure of Damages

In the event that she was found to be in error on the question of lease continuation, Justice Romaine went on to consider the measure of damages. The principal question here was whether the court should follow an emerging line of cases (*Montreal Trust Co v Williston Wildcatters Corp*, 2004 SKCA 116, leave to appeal to the SCC denied [2004] SCCA 474 and the damages award in *Lady Freyberg*, 2007 ABQB 353) which adopts the idea that in the case of production on a dead lease damages should ordinarily be assessed on the basis of the royalty (and any signing bonus) that would typically be payable on that production rather than on a disgorgement or gains-based approach. In considering that question Justice Romaine offers a thorough and nuanced assessment of the relevant literature before suggesting (at para 664) two possible bases for assessing damages based on a restitutionary approach, one based on the idea of the royalty (and bonus) that would otherwise be payable, and the other grounding itself in the idea of disgorgement. In the end Justice Romaine favours the royalty + bonus payment approach (at para 665).

The geography of this case

The leased lands in this case involved section 25 of Township 27, Range 1, W5M which places the lands in the Crossfield area north of Calgary. The well in question produced at different times from the sweet Basal Quartz formation and the very sour Crossfield formation. It never produced from the Elkton formation which was thought to underlie at least some of the subject lands. This section of land is contiguous to the CrossAlta Storage Unit which has made efforts to shut down exploratory drilling in the area as explained in earlier posts dealing with Kallisto Energy here and here. Indeed, we learn in this case (at para 21) that the subject well, the 7-25 well was shut-in again in January 2011 at the instance of CrossAlta on the basis that the well was producing CrossAlta's storage gas and later still (at paras 657 – 659) of some of the elements of the settlement agreement between at least some, if not all, of the parties involved in that litigation.

The leased lands are also close to the Number 2 Highway between Calgary and Edmonton and subject, throughout the period, to increasing urbanization. This had several implications for the way in which the operator/lessees managed the property and especially the sour gas of the Crossfield formation. For example, some production in the area was preferentially nominated to produce on long term gas contracts in order to deplete the reserves as quickly as possible to avoid premature shut-in and abandonment as a result of urban encroachment; new facility applications underwent a high degree of scrutiny; and operators had an incentive not to rock the boat by bringing forward new facility applications – better make do with a sub-optimal transportation and processing arrangement than bring forward a new application for fear of attracting scrutiny and review of existing operations.