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Section 27 of the Surface Rights Act and the Potential Fallout of Non-Compliance

By: Fenner Stewart

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Section 27 of Alberta's *Surface Rights Act* obliges operators to notify landowners of the opportunity to renegotiate leases, but provides no enforcement measures for operator non-compliance. This post explores the potential fallout.

1. Introduction

Alberta's *Surface Rights Act* helps to encourage the negotiation of surface leases between landowners and operators. Whether granting a producer the right of entry to drill for oil and gas or granting an energy company the right to place a pipeline or power transmission line across one's property, many landowners would not allow such operators access to their land if the force of law did not compel the right of entry. In mining and drilling cases, the common law recognizes an implied right of entry in conjunction with the granting of mineral rights. In pipeline and transmission line cases, the Crown can exercise its power of expropriation to take private property for public use. In these situations, the legal authority for such rights of entry is not dependent on any power granted by the *Surface Rights Act.*

The primary purpose of the *Surface Rights Act* is to avoid litigation when an obstinate landowner rejects all reasonable offers for compensation in exchange for access to their property. When negotiations breakdown, the Surface Rights Board intervenes and establishes the terms, including compensation, of the surface lease. By offering an alternative to a privately negotiated lease, the Act promises to break deadlocks between lessor-landowners and lessee-operators resulting in expedited energy projects. Further, it is hoped that by providing an alternative to the more adversarial judicial system, more amicable relations between landowners and operators will develop even in less than ideal circumstances.

Unfortunately, section 27 of the *Surface Rights Act* appears to be undermining the goal of facilitating amicable relations. Section 27 aspires to initiate the renegotiation of a surface lease every 5 years. Such renegotiations are necessary so that the parties can review the compensation payable in light of variables arising and evolving over the lease term. These variables include: the compensation that other landowners recently received, the per acre value of the land, the actual loss of use, and other adverse effects such as damages. The problem lies in section 27's requirement that obliges the operator to notify the landowner of the opportunity to renegotiate the lease. Predictably, the landowners rely upon this notification requirement. The Act, however, provides no punitive measure for non-compliance; this, in turn, leaves the operator to follow market incentives. Since renegotiating a lease usually costs the operator more through additional compensation payouts, this incentive encourages the operator, as a rational market actor, to ignore the notification requirement. Non-compliance with the requirement frustrates the landowner when he or she discovers they were short changed by the operator; this ultimately undermines the goal of amicable relations. Undermining amicable relations is precisely what the drafters of the *Surface Rights Act* were attempting to avoid. In contemplation of this regulatory failure, this article explores the pitfalls of this legal quagmire for landowners, the Alberta government, and even the operators who appear to be profiting from the situation.

2. Landowners

If the landowner can look past this additional point of contention with the process, he or she may see the advantage in the situation. To start, the landowner can apply to the Surface Rights Board to adjust the compensation and remedy the situation. If the rate of compensation is higher, the operator will be required to back pay the difference, plus interest if appropriate. So the landowner will not miss out on any compensation. Furthermore, if the operator is failing to provide notice as a normal course of business, which appears to be what is happening in some cases, the operator may neglect to notify the landowner even when it is in its own benefit to do so. The landowner is under no obligation to remind the operator of this failure to negotiate if it is not in the landowner's interest to do so. In addition, if the operator overpays, the Board will not require the landowner to reimburse the overpayment. The landowner can enjoy the windfall without fearing adverse consequences down the road.

The only potential pitfall for the landowner is the time limitation for providing his or her notice to the operator; the Act requires landowners to provide notice to the operator of his or her intention to have the Board review the compensation. This notice needs to be given within a reasonable period of time measured from the date the renegotiation ought to have occurred. So the landowner will not be able to reach back indefinitely to claim additional compensation. This is fair; if renegotiation fails to occur, the landowners are not blameless. They ought to read their leases and know their rights. The regulatory requirement that the operator needs to provide notice should be considered a courtesy to the landowner, and it should not be used as a reward to landowners who mismanage their business affairs. The time limitation reflects this balance.

3. The Alberta Government

Systemic non-compliance occurs, most often, when regulators fail to appreciate other normative pressures placed upon those subjected to their regulation. The most obvious of these normative pressures, especially for businesses, are market pressures. All for-profit actors exist in competitive marketplaces; they need to be profitable to survive. On a fundamental level, business decision-makers evaluate potential options for profit in light of the potential risks associated with each option. From this vantage point, a regulation is merely a single risk in the complex spectrum of risks that must be successfully navigated to achieve profit. The bottom line is that if non-compliance is profitable, profitable businesses will not comply. Regulators ignoring this slightly cynical truism, do so at their peril. Section 27 is a perfect example; the regulatory drafters ignored the market incentives for non-compliance and achieved the foreseeable result: non-compliance.

Some might regard section 27's failing as insignificant, considering the landlord's ability to recoup losses, but regulators should never create rules that habitually encourage non-compliance. Those subjected to such regulatory incompetence understandably conclude that regulators are either indifferent to the rule breaking or too inept to notice. This can nurture an unpredictable culture of non-compliance, which impacts the integrity of the entire regulatory field, and can result in much more serious regulatory failures in the future.

Of course, to err is human, but it is less understandable when no effort is made to correct an obvious pattern of perpetual failure. In other words, regulatory shortcomings will occur, but when identified, they ought not be allowed to persist; in fact, they ought to be fixed as soon as reasonably possible. In the case at hand, the regulator should devise an adequate mechanism to inspire compliance, but requiring compliance with full knowledge of systemic non-compliance ought to stop—better to not regulate at all. So, at bare minimum given the present circumstances, the regulator ought to repeal the notice requirement.

4. Operators

At first blush, there appears to be little incentive to comply with the notice requirement. A shrewd operator will appreciate that not all landowners will petition the Board to review the rate of compensation, which saves it money presuming renegotiation increases compensation. Also, an operator may have a significant number of surface leases in Alberta. Managing each of them incurs administrative expenses, including: the cost of ensuring that the landowner receives notice as prescribed, the cost of renegotiating the lease, and potentially the cost of preparing for a review by the Board. The only potential cost of non-compliance is the interest charged upon the back pay, and such interest is only charged when the Board deems it appropriate. Even if interest is charged, a rational market actor will appreciate that the present discounted value of money will mitigate the said interest payment. Accordingly, based solely on the immediate economic considerations outlined above, no operator ought to comply with this requirement.

However, if operators focus solely upon these immediate economic considerations, they may win the battle but lose the war. To appreciate this warning, one needs to step back and adopt a more farsighted cost-benefit analysis. To start, the benefit is marginal to most operators. The savings of non-compliance is minuscule relative to the operating budgets of the relevant players in Alberta. It is fair to say that for the average oil and gas producer, these gains would have no noticeable impact upon their bottom line. Of course, achieving impressive operational efficiency is a details game; every penny counts, but risk-reward needs to be kept in balance. If the reward is a small one, the risk ought to be as well.

The risk analysis starts with section 27. *Prima facie*, there appears to be no cost in non-compliance. The formula is simple: potential cost of interest less the present discounted value of money equals zero—or next to zero. Of course, this assumes that there are no additional costs. This begs two questions. Does this strategy aggravate landowners? If yes, does it matter?

In answering the first question, when the surface owner does not own the subsurface mineral interests, they receive relatively little of the gain and suffer the majority of the inconvenience of drilling and production. In fact, there is generally not a natural market because there is not a willing supply of landowners lining up asking oil and gas producers to start drilling on their land. Anyone who knows the business of upstream oil and gas can appreciate that such production does little to add to the quiet enjoyment and value of one's property. It is safe to say, without engaging in formal empirical research, that most surface owners who do not have a stake in the oil and gas royalties would prefer no development on their land.

One would think that in the United States of America, where freedom is intimately connected to the right of private property, the imposition of the right of entry would be less acceptable than in Alberta; this is not that case. In America, when surface owners buy land with severed mineral interests or choose to sever the mineral interest, they generally accept that they own only a portion of the land. Furthermore, the right of entry is taken into account when negotiating the purchase price of the land. From this perspective, the implied right of access is more palatable. At the most rudimentary level, if the landowners do not like their situation, they should not have bought into the situation in the first place. In other words, the landowner chose this potential inconvenience when they purchased the property with the severed interest or sold such mineral interest to another. The right of entry is just part of the deal.

In Alberta, the provincial Crown owns approximately 81% of subsurface rights—66 million hectares. Generally speaking, Alberta landowners never chose to sever the mineral interest; never chose to purchase land with a split title; and arguably paid a price that was not properly discounted to reflect the implications of these realities. To put differently, they were cut out of the deal from day one. Thus, Alberta landowners, unlike American landowners, are less amicable to drilling and production on their land. Without choice, they do not see themselves as the author of these impositions. Rather, the lack of choice creates the perception, rightly or wrongly, that oil and gas producers and the provincial Crown are imposing themselves upon the landowner and profiting handsomely from doing so. Thus, it is not surprising that the surface lease issue is contentious in Alberta as *Dome Petroleum Ltd* v *Richards,* (1985) 66 AR 245 so clearly demonstrates.

So, does it matter if non-compliance alienates landowners? Yes. The current oil and gas business in Alberta requires polish and a deft touch; operators need all the public support they can muster. For instance, consider the challenge posed by today's environmental activists. Simple industry reform, to many, will not avoid dangerous climate change; they are squarely fighting to have the use of fossil fuels phased out completely. These activists are not only targeting politically embedded carbon producers, like the coal industry, but also soft targets, such as pipelines, hydraulic fracturing, and other non-conventional forms of production. Needless to say, this is not good news for producers of Alberta's crude.

Furthermore, hydraulic fracturing is transforming America, in particular the Midwest, from a customer to a competitor. Alberta crude needed access to new markets even before the "U.S. Shale Gale," but today the Cushing Hub is starting to look less and less like a reliable option to meet Canadian needs. For a case in point, America's Senate shelved Keystone XL, after an icy President Obama declared: "Understand what this project is. It is providing the ability of Canada to pump their oil, send it through our land, down to the Gulf, where it will be sold everywhere else." Obviously, Canadian-American cooperation generated by the politics of peak oil has shifted—at least for now.

Regardless of the future of Keystone XL, Alberta crude still needs at lease one significant pipeline from Alberta to a Canadian coast. This has been complicated by recent events, including the *Tsilhqot'in Nation* case, 2014 SCC 44, coupled with the new pressures placed upon the Assembly of First Nations, the promise of more public demonstrations such as the Burnaby Mountain Protests, and the opposition to an "Alberta" pipeline expressed by Southern Quebec and other such Eastern constituents. Finally, to add insult to injury, crude prices are falling dramatically amidst a shift in the geopolitics of global oil markets that no one—except maybe the Saudis—fully understand. The only thing that appears clear is that there is willingness to allow crude oil prices to remain uncomfortably low, at least for Canadian oil sands producers, for the foreseeable future.

In sum, what's the benefit? Basically, there isn't one: a nominal cash savings. On the other hand, it is the little things, such as this non-compliance, that can swing public support against the industry, and there is not much room to squander goodwill as it is. In light of this, non-compliance with section 27 makes little sense.

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