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Two New Offset Well Cases

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Cases Commented On: *Canadian Natural Resources Limited v Lisafeld Royalties Ltd*., 2019 SKQB 201 (Can LII); *Whitecap Resources Inc. v Canadian Natural Resources Limited*, 2019 ABQB 698 (Can LII)

This post examines two recent decisions dealing with offset well obligations under petroleum and natural gas leases. An offset well obligation is a clause in a lease that requires the lessee to drill a well on the leased lands where production has been obtained from a contiguous property and there is no similar well on the leased lands producing from the same formation. The purpose of the clause is to protect the lessor from the risk of drainage (i.e. where the well on the neighbouring property is or may be capturing hydrocarbons from under the lessor's lands). While the primary obligation of the lessee is to drill to the target formation, more modern versions of the clause create additional options and allow the lessee instead of drilling to surrender all or some part of the lease, or pay a compensatory royalty to the lessor (i.e. a royalty paid on the production on the offsetting well as if it were occurring on the leased lands). This compound obligation is frequently described as drill, drop or pay obligation.

The first of these two cases, the *Lisafeld* decision, involves an early and simple version of the offset clause originating in a 1949 lease:

> 8. Offset Wells:
>
> In the event of commercial production being obtained from any well drilled on any drilling unit laterally adjoining the said lands and not owned by the Lessor, or, if owned by the Lessor, not under lease to the Lessee, the Lessee shall commence or cause to be commenced within Six (6) months from the date of such well-being placed on production, the drilling of an offset well on the drilling unit of the said lands laterally adjoining the said drilling unit on which petroleum is being so obtained, and thereafter shall drill the same to the horizon in the formation from which production is being obtained from the said adjoining drilling unit; PROVIDED that if such well drilled on land adjoining the said lands has been proved to be productive primarily or only of natural gas, the Lessee shall not be obligated to drill an offset well unless an adequate and commercially profitable market for natural gas which might be produced from the offset well can be previously arranged and provided.

The *Whitecap* case involves the more complex drill, drop or pay form of the clause that is common in more recent leases modelled on the form developed by CAPL, the Canadian Association of

Petroleum Landmen. The clause covers more than two pages in Justice Marilyn Slawinsky's decision.

Both cases involve properties in Saskatchewan although in the *Whitecap* case the parties attorned to the jurisdiction of Alberta (at para 6) and thus that decision is a decision of the Alberta Court of Queen's Bench. Both cases involve Canadian Natural Resources Limited (CNRL): in *Lisafeld* CNRL is the lessee whereas in *Whitecap* CNRL is the lessor. Both cases involve horizontal wells and both cases engage with the challenge of interpreting terms such as spacing units, drilling units, and drainage units within the context of Saskatchewan's oil and gas conservation legislation and with specific reference to horizontal wells.

Lisafeld

As noted above, the lease in this case was originally granted in 1949 with a primary term of ten years. The lease covered the entire east half of section 1. The offsetting well at issue in this case was spudded in on legal subdivision (LSD) 2 (on the leased lands) but completed as a horizontal well under LSD 3 and 4 on the west half of section 1 in the Frobisher zone (i.e. not on the leased lands). The well obtained production on October 16, 2012 and hence, were the well to have triggered an offset obligation, CNRL should have commenced drilling by April 16, 2013. The well produced for a period but was shut in sometime in July 2015 and has not produced since.

Following some correspondence (which seems not to have commenced until 2016) in which Lisafeld demanded a payment of compensatory royalty (there was clearly no basis for that on the terms of the lease), Lisafeld ultimately served a notice of default on CNRL. It appears that CNRL then commenced an action seeking a declaration that there was no breach or default and that the lease was in full force and effect. Lisafeld sought summary judgment and a dismissal of the action. Justice G.A. Chicoine concluded that the case was suitable for summary judgment.

CNRL contended that it was entitled to a declaration on any of three grounds: (1) an offset well obligation did not arise under the lease between the parties, (2) the obligation to drill an offset well was satisfied by a previously drilled well, or (3) a unitization plan superseded the lease (at para 1).

No offset well obligation was triggered

CNRL's first argument under this head was that the horizontal well was not a well that was drilled on a laterally adjoining spacing unit since the well was commenced on the leased lands. Justice Chicoine had little time for that argument – and appropriately so. He concluded:

> I do not consider such an interpretation of these terms to be reasonable. In my opinion, the issue is whether commercial production is being obtained from an oil well drilled into one of the oil producing formations on the adjacent lands. The location of the vertical section of the horizontal well is not relevant. In fact, the vertical section could have been located on the drilling unit to the west of LSDs 3 and 4 of Section 1-5-6 W2M. So long as production is being obtained from LSDs 3 and 4, the offset provision would still apply. (at para 49)

CNRL's second argument was to the effect that in the case of a horizontal well there was no laterally adjoining drilling unit under the applicable Saskatchewan legislation. To understand that argument, it is necessary to review the definitions of drilling units and drainage units as used in the lease and the Saskatchewan legislation and regulations.

The lease defined a drilling unit as:

> a section, legal subdivision or other unit of land representing the minimum area in which any well may be drilled on or in the vicinity of the said lands as defined, described by or under any law of the Province of Saskatchewan now or hereafter in effect governing the spacing of petroleum and/or natural gas wells.

By contrast, Saskatchewan's *Oil and Gas Conservation Act*, RSS 1978, c O-2 has generally used and currently uses the term "drainage unit" defined as:

> … the area allocated to one or more wells for the purpose of drilling for and producing oil or gas, and includes subsurface areas bounded by the vertical planes in which the surface boundaries lie.

The default rules in the legislation prescribe 1 LSD spacing for vertical oil wells but the applicable Ministerial Orders for the Midale and Frobisher Beds specify two LSDs. The *Oil and Gas Conservation Regulations, 2012*, RRS c O-2 Reg 6 also have special rules for horizontal wells. Justice Chicoine summarized these rules at para 28:

> Section 38 of the *Regulations* has specific provisions relating to horizontal wells that do not refer to a "drainage unit" but instead refer to the "productive section of the horizontal well". For example, ss. 38(1)(b)(i) and (ii) state that in the case of a horizontal well, the entire productive horizontal section of a horizontal well must be set back a minimum of 100 metres from a diversely owned lease boundary and the productive horizontal section of a horizontal well must be set back a minimum of 150 metres from a productive vertical well or from the productive horizontal section of another horizontal well. The set-back distances establish the drainage area of the horizontal well.

Counsel for CNRL built on this differing approach for horizontal wells to argue that:

> … because the drainage area of a horizontal well is not defined by sections or legal subdivisions as they are for vertical wells, but instead defined in terms of set-backs (being the area within 100 meters of any productive section of the horizontal well) the "laterally adjoining drilling unit" terminology used in the 1949 Lease is inapplicable when the well on the adjoining lands is a horizontal well. …. [T]here is a 50 metre gap between the drainage area of the Horizontal Well and the Lisafeld lands [and because of this] … there is no production from a drilling unit "laterally adjoining" the Lisafeld lands, the Offset Wells provision in the 1949 Lease does not apply. (at para 51)

While Justice Chicoine found this argument "more cogent" than the first argument he did not find it persuasive:

> A thorough reading of the 1949 Lease leads me to conclude that the proximity of the production from the boundary of the leased lands is not what triggers the Offset Wells provision of the lease. In the context of this particular situation, the provision provides that any well drilled within an 80 acre parcel consisting of two legal subdivisions laterally adjoining any of the west, the south or the east boundaries of LSDs 1 and 2 of Section 1-5-6 W2M would trigger the Offset Wells provision. The distance of the producing section of the well from the boundary of the leased lands is not a factor so long as any commercial production is being obtained from any well drilled in a drilling unit (or drainage unit or spacing unit) laterally adjoining the leased lands. The common sense interpretation of "any well drilled on any drilling unit laterally adjoining the said lands" would include horizontal wells even though the parties would not have contemplated the advent of horizontal well technology in 1949. The purpose of the provision was to induce the lessor to drill an offset well on the leased lands if there was proven commercial production on a laterally adjacent spacing unit. (at para 52)

This seems correct. CNRL's interpretation would have gutted the clause of any meaning with respect to horizontal wells. While nobody would have had a horizontal well in mind in the 1940s it is still a form of well and the parties must be taken to have contemplated technological developments in drilling even if they could not have had in mind horizontal well technology. Justice Chicoine also made the useful observation (at para 50) that the terms "drilling unit", "drainage unit" and "spacing unit" could be treated as synonymous.

The 1956 well

CNRL took the position that a well had been drilled on the leased lands in 1956 on the spacing unit comprised of LSDs 1 and 2, that the well had evaluated the Frobisher formation as not viable for oil production, and that the offset well clause should not be interpreted so as to require it to drill a new well in those circumstances. "Any other interpretation … would be unreasonable and commercially absurd." (at para 54)

In considering this argument, Justice Chicoine was clearly unimpressed by the fact that Lisafeld had waited until *after* the well was shut in to issue its default notice and commence this action. He observed that:

> If notice of default had been given during the period that the Horizontal Well was producing leased substances, then drainage would have been a valid concern. During the period from April 16, 2013, to July of 2015, Lisafeld failed to insist that an offset well be drilled on its lands. By the time that the notice of default was delivered, there was no possibility of any actual drainage from the Lisafeld lands to the Horizontal Well on the adjoining drilling unit. As a consequence, there was no longer any default to be remedied. The only remedy mentioned in Clause 18, the Default clause in the 1949 Lease, for failure to remedy any default "that has not been waived by the Lessor" is termination of the lease. Termination of the lease is a prospective remedy. Termination seems a particularly harsh remedy for failure to drill an offset well if the circumstance that created the breach (a commercially producing well on a laterally adjacent drilling unit) no longer exists when the notice of default is given. (at para 61)

That was perhaps enough to decide the argument with respect to the 1956 well along with the observation that there was no longer any commercial production from the offsetting lands as required by the opening words of the offset well clause. However, Justice Chicoine also concluded that the 1956 well satisfied the offset well requirement and established that the Frobisher formation was unsuitable for commercial production. He also concluded that the fact that the triggering well was a horizontal well did not require the lessee to drill a horizontal well to satisfy a default obligation – a vertical well would suffice. While this second observation seems reasonable (it is perhaps up to the lessee to determine what type of well to drill and where) the first additional conclusion is likely more controversial since it is clear that horizontal drilling and multi-stage fracturing have allowed many formations to be produced that hitherto were considered unproducible.

The effect of the unitization

The leased lands were included in a unitization arrangement in 1961 for the Main Midale Beds. The unitization agreement included a clause (1801, quoted at para 31) which purported to supersede, alter and amend any provision in an underlying lease to the extent that it was inconsistent with the terms of the unitization. In addition, there was a standard clause (203b) to the effect that operations anywhere within the unit area would be deemed to be operations on each tract or lease subject to the unitization. CNRL relied on these provisions, specifically 203b, to argue that this effectively meant that operations were being conducted not just in the Midale Formation but also the Frobisher Formation. Justice Chicoine seems to have accepted this argument:

> … I am of the opinion that the Plan of Unit Operation continues the 1949 Lease in full force and effect as to all lands and formations covered by the lease, including the Midale and Frobisher formations, so long as unitized substances are being produced and royalties are being paid to Lisafeld under the Plan of Unit Operation. If any remedy is to be granted for breach of a term of the 1949 Lease it cannot be termination. (at para 73)

I think that this goes too far. It is one thing to say that this unitization served to extend the lease beyond its primary term as to all formations (see *Voyager Petroleums Ltd. v Vanguard Petroleums Ltd.*, 1982 CanLII 1309 (AB QB) (quoted by Justice Chicoine at para 70)), but it does not follow from this that operations or production are deemed to be occurring in the Frobisher formation or that other provisions of the lease are necessarily inapplicable. Why should unitization of zone A affect a lessor's ability to protect itself from drainage in zone B?

The question of whether lease termination is an available remedy is typically determined by the language of the default clause and it is true that many lease forms include a proviso in that clause to the effect that "PROVIDED that this Lease shall not terminate nor be subject to forfeiture or cancellation if there is located on the said lands or the pooled lands a well capable of producing the leased substances or any of them, and in that event the Lessor's remedy for any default hereunder shall be in damages only." See, for example, the lease at issue in *Freyberg v Fletcher Challenge Oil and Gas Inc.*, 2002 ABQB 692 (CanLII), quoted at para 110 of that decision. But there was no such proviso in this lease (see text of the clause at para 13) and it is hard to see how one can use the referenced provisions of the unitization agreement to read in such a provision.

Neither can I endorse the somewhat offhand remark at the end of this section of the judgment where Justice Chicoine opines that "I do not intend to preclude the possibility that the lessor, in circumstances where there was not a previous well drilled to the formation that is not the unitized zone and that satisfies the offset obligation, *might seek an alternative remedy such as a compensatory royalty or surrender of non-producing formations in lieu of termination*." (at para 74, emphasis added) Any such remedy must be found in the language of the lease. I don't have that lease but there is certainly nothing in the default clause itself (quoted above) to support either of these "possibilities". In particular there is nothing in the judgment to suggest that this was a drill, drop or pay form of the offset wells clause. Consequently, while the loss of a lease in a unitization may be awkward, in order to avoid the conclusion we need to find some language in the contracts that allows us to do so. I am not convinced that Justice Chicoine has got us there. For an example of a unit provision that would offer a suitable "patch" consider the "Extraneous Defaults" clause in the 2003 version of the unitization agreement developed by the Petroleum Joint Venture Association (PJVA):

> 303. Extraneous Defaults
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> If any Lease should at any time during the term of the unitization provided for herein become terminable in whole or in part, whether automatically in accordance with its terms or at the option of the lessor thereunder, as a result of any default in obligations relating to any lands or zones other than the Unitized Zone, such Lease or terminable part thereof shall nonetheless continue in effect insofar as it relates to the Unitized Zone, as though it had been granted only in respect of the Unitized Zone in the Tract or Tracts to which it relates. The provisions of this clause 303 shall not apply with respect to any default in obligations relating in whole or in part to the Unitized Zone.

In sum, Justice Chicoine found in favour of CNRL and offered CNRL a declaration in terms that are both broad and particular:

> In conclusion, the 1949 Lease has not been terminated but remains in full force and effect. CNRL is entitled to a declaration that the drilling and testing of the 1956 Well satisfied any offset well obligation with respect to the Frobisher formation underlying LSDs 1 and 2 of Section 1-5-6 W2M and that the operations conducted under the Plan of Unit Operation continue the lease in full force and effect. The application of Lisafeld for summary dismissal of CNRL's claims in this action is accordingly dismissed. (at para 75)

Whitecap

The *Whitecap* decision involves leases held by Whitecap at the relevant times for three different parcels of land: the SE ¼ of section 21; the west half of section 7 and the entirety of section 33. The leases all contain offset well clauses in the drill, drop or pay form in materially identical terms. All three parcels were in Saskatchewan but, as noted above, the parties attorned to the jurisdiction of Alberta (at para 6). The lessor's interest in these parcels was originally held by Devon but subsequently acquired by CNRL. Upon its acquisition of the lessor's interest CNRL aggressively pursued Whitecap with respect to the alleged non-fulfillment of offset drilling obligations (to drill, drop or pay) arising as a result of horizontal wells drilled on offsetting spacing units. While

Whitecap did not agree that offset obligations had been triggered in most cases, it paid compensatory royalty under the terms of the lease under protest in order to preserve its position and to prevent CNRL from terminating the leases for alleged default. In this action Whitecap sought return of compensatory royalties paid under protest while CNRL sought additional compensatory royalties that it alleged were due. Whitecap was largely successful in its application. Justice Slawinsky was ultimately very critical of CNRL, concluding that:

> … the conduct of CNRL in its dealings with Whitecap was unreasonable, failed to consider the legitimate contractual interests and expectations of Whitecap in the performance of the contracts, and unfairly disregarded Whitecap's legitimate business interests. (at para 125)

Justice Slawinsky's judgment contains a concise statement of issues which I will follow for the purposes of this post.

1. Does the obligation by Whitecap to drill, drop or pay arise when an offset well begins production, independent of any notice by CNRL?
2. Can CNRL enforce the defensive drilling provisions in the leases from January 1, 2014 (date of assignment from Devon) to April 1, 2014 (date of notice of assignment to Whitecap)?
3. Do the defensive drilling provisions in the SE/21 lease apply to the backdated period?
4. Do the defensive drilling provisions in the W/7 lease apply to offset wells drilled on adjacent lands during the Lease Option Agreement period, and if so, for what period of time?
5. Do the defensive drilling provisions in the S/33 lease trigger further obligations when the lease is entirely held by production from a single gas well?
6. Do other offset obligations exist with respect to each lease?
7. Does the offset well clause require multiple wells to respond to one offset well?
8. In the case of horizontal offset wells that span LSDs not adjoining the leased lands, is the entire production used to calculate the compensatory royalty?
9. Does the offset well clause prescribe an unenforceable penalty?
10. Did CNRL's methodology and approach to the offset well dispute breach its duty of good faith, disentitling it to payment of compensatory royalties? (at para 38)

Does the obligation by Whitecap to drill, drop or pay arise when an offset well begins production, independent of any notice by CNRL?

This was perhaps the easiest issue that Justice Slawinsky had to determine. While Whitecap contended that the clock triggering its obligations to drill, drop or pay only arose if and when CNRL served notice of default, that contention was inconsistent with the language of the offset clause which provided that the clock started to run whenever production was obtained from a laterally or diagonally adjoining spacing unit. The fact that there was some evidence of a practice in the industry of the lessor providing notice when it considered that offsetting production was occurring such a practice could not undercut the plain language of the clause.

Can CNRL enforce the defensive drilling provisions in the leases from January 1, 2014 (date of assignment from Devon) to April 1, 2014 (date of notice of assignment to Whitecap)?

The issue here was that Devon assigned the lessor's interest in the lease to CNRL effective January 1, 2014 but notice of the assignment was not given until April 1, 2014. Justice Slawinksy concluded that since the lease was binding on the original parties and their assigns, and since the lease did not contain any restrictions on the lessor's right of assignment, the assignment was effective as of January 1 and CNRL was in a position to enforce the terms of the lease from that time forward.

Do the defensive drilling provisions in the SE/21 lease apply to the backdated period?

Devon had originally leased the SE ¼ to Crocotta and Halo. Those parties had drilled two wells on the lands which produced from the Mannville but the lease expired for non-production. Devon then re-leased the lands to Halo. The new lease was executed in December 2013 but was backdated to October to protect Halo from a possible trespass claim. In addition, Devon agreed to accept the two existing wells as fulfillment of the obligation to drill during the primary term. In the meantime, two offsetting wells had obtained production from the Viking formation in November 2013. Whitecap had acquired Halo's interest in the Viking.

The question for present purposes was whether the two Viking wells triggered an offset obligation on the basis that they began producing *after* the effective date of the new lease or whether they did not trigger on the basis that they began producing *before* the lease was executed. This question engaged the language of clause 8a of the lease (the independent covenant to protect from drainage) which provided that:

> It shall be the duty and obligation of the Lessee, as an independent covenant, to protect the Lands against drainage of the Leased Substances through a well that has production therefrom *at any time subsequent to the date of the Lease* of one or more of the Leased Substances, on any lands laterally or diagonally adjoining the Lands. (emphasis added)

It similarly engaged clause 8b which contemplated that the clock would start to run on the drill, drop or pay provisions of the offset clause

> In addition to the Lessee's general duty to the Lessor to protect the Lands against drainage pursuant to sub-clause [a] in the event of production being obtained from a geological formation,

Principally based on the conduct of the parties and an assessment of commercial efficacy (no one would enter into a lease that would immediately trigger drilling obligations for new and expensive wells in the Viking in order to protect a few hundred dollars of production) Justice Slawinsky concluded that in this case, "date of the lease" must mean the date the lease was executed. Accordingly, there was no breach of the general obligation under clause 8a and no triggering of the drill, drop or pay obligations of clause 8b. Thus the amounts that Whitecap had paid by way of compensatory royalties under protest should be repaid.

Do the defensive drilling provisions in the W/7 lease apply to offset wells drilled on adjacent lands during the Lease Option Agreement period, and if so, for what period of time?

Devon originally leased the petroleum and natural gas rights for the west half of section 7 to Compass in January 2011. The lease had a one-year primary term later extended for six months to July 29, 2012. Whitecap amalgamated with Compass in February 2012. Compass met the drilling obligations for LSDs 12 and 13 and the parties agreed to extend the primary term for the remaining LSDs to December 31, 2013 by means of a Lease Option Agreement (LOA) that included these lands as well as other lands. The LOA required Compass (Whitecap) to drill a total of ten wells at locations of its own choice on the option lands. It also provided that the offset well clauses in the applicable leases would not apply until the termination date of the LOA (December 31, 2013). In fact, Devon agreed in writing to extend the earning period under the LOA to March 1, 2014.

While the parties were agreed that there could be no obligation to drill during the earning period CNRL took the view that defensive drilling obligations recommenced as soon as the tenth well was drilled (rig released January 13, 2014). Furthermore, it argued that the LOA merely suspended the obligation to drill and that therefore the offset obligations applied immediately thereafter to wells that had been drilled on offsetting tracts during the period of the LOA. Justice Slawinsky rejected both of these contentions. In her view the effect of extending the earning period served to extend the period of the non-application of the offset clause until March 1, 2014. Justice Slawinsky concluded that the relevant clause in the LOA was susceptible of different interpretations with respect to the question as to whether or not the offset clause was simply suspended or made inapplicable. Accordingly, she looked to the conduct of the parties noting (at para 67) that Devon did not raise offset obligations and furthermore that Whitecap had itself drilled two of the wells that CNRL alleged gave rise to drill, drop or pay obligations. It is not entirely clear to me why this latter point was relevant but in any event it was Justice Slawinsky's assessment that "The conduct of both Devon and Whitecap suggests that neither party intended for offset obligations to arise for adjacent wells drilled during the time the Lease Option Agreement was in effect." (at para 67). Furthermore:

> The purpose and intent of the Lease Option Agreement further supports this conclusion. Whitecap had committed to drilling ten wells within certain time periods *in locations of its choice* to secure a one-year extension of the primary terms of eight separate leases. In other words, Whitecap had unfettered discretion to drill where it chose to gain

> an additional year to meet the balance of its primary term drilling requirements. While it did so, it had no obligation to defensively drill in response to drilling on adjacent lands. Interpreting the Lease Option Agreement to immediately trigger defensive drilling requirements for wells drilled during the term of the Agreement defeats the purpose and intent of the Lease Option Agreement. Such an interpretation would effectively have required Whitecap to drill its ten required wells defensively in response to offset wells, rather than the specifically stated right to chose its drilling locations. (at para 68; emphasis in original.)

In conclusion, offsetting wells drilled during the period of the LOA did not generate offset well obligations either at the time or upon the expiry of the LOA and any compensatory royalties paid by Whitecap to CNRL should be repaid.

Do the defensive drilling provisions in the S/33 lease trigger further obligations when the lease is entirely held by production from a single gas well?

The section 33 tract raised some distinct issues. The lease in question covered the entire section and granted petroleum and natural gas rights from the surface to the base of the Mannville. Compass (which subsequently amalgamated with Whitecap) drilled a horizontal well through LSDs 4 and 5 which began producing October 2010 from the Viking zone. Compass hoped to find oil but in the end the Saskatchewan regulator classified the well as a gas well because of the high gas\oil ratio (at para 72). The apparent explanation for this was (at para 85) that the Viking formation gains structural elevation in section 33 and that the gas will sit on top of the oil. The lease provided that after the end of the primary term the lease would only be continued "with respect to the Leased Substances in that part of the Lands contained within a Spacing Unit with respect to which Operations are then being conducted…". The judgment records (at para 84) that "Devon confirmed in writing on January 31, 2011 that it deemed the entire lease (consisting of one full section) continued by production to base Viking, based on the production from this single gas well."

Subsequent to the lease, five offsetting oil wells, all apparently producing from the Viking came into production (at para 73 – the judgment does not identify the precise location of these wells). CNRL argued that these wells triggered offset obligations with respect to LSDs 1, 2 and 3.

In responding to this argument Justice Slawinsky began by noting that the offset well clause was triggered by the production of leased substances. The clause does not make separate provision for oil and natural gas. Neither does the drop provision of the clause allow a lessee to drop some substances but not others. What Justice Slawinsky seems to be concluding here is that the obligation to drill, drop or pay cannot be triggered if there is a well on the leased lands that is producing from the same formation as the offsetting well - even if the two wells are producing different leased substances (or are classified by the regulator as producing different substances). This seems to me to be a correct interpretation of the Offset Clause.

It was not however enough to provide a complete answer to CNRL's contentions because it was also necessary to resolve the problem of the spacing unit from which the well on the leased lands was producing. The duty to drill, drop or pay only arises when a well is drilled into a Spacing Unit

that laterally or diagonally adjoins each Spacing Unit of the leased lands from which there is no production of leased substances. Since there was production of leased substances from the leased lands, the question that now needed to be resolved was whether that well was producing from an adjoining spacing. That in turn depended on whether the applicable spacing was a section or something less than a section.

The question would likely have admitted of an easy answer if the well on the leased land were a vertical gas well since in that case the applicable Saskatchewan regulations prescribed one section spacing. If that were the case we might conclude that the well on the leased lands was producing from an adjacent spacing unit from the same formation as the offsetting wells, and thus there would be no obligation to drill.

But the well was drilled as a horizontal well and this necessitated reference to both the terms of the lease and the Saskatchewan conservation legislation much as in the *Lisafeld* case. The lease defined a spacing unit for the purposes of a horizontal well in Saskatchewan (for which there is no established drainage unit) as "that area comprising the minimum set-back distance from all portions of the horizontal section of such well as calculated on an as drilled survey, pursuant to such legislation and regulations." Furthermore, the offset well clause itself provided that in the case of an *offset well* classified as a horizontal well and for which there is no Spacing Unit attributed by regulations "a reference to a Spacing Unit herein shall be deemed to refer to one (1) Legal Subdivision (LSD)." Justice Slawinsky considered that it was at least possible that this meant that it was the nature of the offsetting well that drove the determination of the applicable spacing unit and that (at para 90) "Determination of the correct spacing unit for the S/33 gas well appears to be irrelevant."

So much for the lease. The Saskatchewan *Oil and Gas Conservation Act*, RSS 1978, c O-2 so far as relevant provides that "'drainage unit' means the area allocated to one or more wells for the purpose of drilling for and producing oil or gas, and includes subsurface areas bounded by the vertical planes in which the surface boundaries lie." It further provides in section 22.1 that "Unless otherwise ordered by the minister or authorized by the regulations, there shall be not more than one well capable of producing oil or gas per drainage unit." According to Justice Slawinsky:

> The Saskatchewan *Oil and Gas Conservation Regulations* in both 1985 and 2012 prescribe set-back distances for horizontal gas wells of 100m from a diversely owned lease boundary and 150m from a productive well. While the regulations establish drainage units of one LSD for vertical oil wells and one section for vertical gas wells, they do not establish drainage units for horizontal wells. (at para 80)

It is hard to disentangle this morass. Justice Slawinsky seems to have been of the view that if the well on the leased lands was not a vertical well then it must have a spacing of less than a section (whether determined on the basis of the lease definitions or the regulations) and that therefore Whitecap could not rely on section 22.1 for the proposition that it could not drill any additional wells on section 33 targeting the Viking. Justice Slawinsky put the point this way in her summary to this section of the judgment:

> In the absence of persuasive evidence that further drilling is prohibited on S/33, I find that the offset well clause applies to LSDs 1, 2 and 3 of S/33. As all of the offset wells were producing well before CNRL acquired its interest in the lease, and as the number and location of the wells trigger defensive drilling obligations on all three LSDs, compensatory royalties are payable from January 1, 2014 to August 31, 2015 for each LSD. (at para 96)

As a consequence, in this case Whitecap was obliged to pay a compensatory royalty. There are several reasons why we might want to explore this conclusion further. First, there must be some argument to the effect that CNRL is estopped from taking the position that the well on the leased lands established something other than one section spacing for the Viking formation in that location. Devon evidently accepted the proposition of one section spacing for the purposes of continuing the lease at the end of the primary term. If CNRL is correct about the spacing issue and not bound by Devon's confirmation that the entire lease area is continued, then it would follow that CNRL could take the position that the lease had terminated with respect to that part of the section that was not included in the spacing unit for the well. Second, given that the regulator had already classified Whitecap's existing well as a gas well it seems unlikely that the regulator would licence a second well in the same location as an oil well. And even if the regulator licensed such as well for the purposes of drilling, if the well once completed obtained the same high gas\oil ratios as the existing well then presumably the regulator could also classify it as a gas well an order it shut-in on the basis that one could not have two producing wells from the same drainage unit. Justice Slawinsky's interpretation would seem to encourage the drilling of unnecessary wells.

Do other offset obligations exist with respect to each lease?

The discussion under this heading related to the lease of the SE ¼ of section 21. In this case production was obtained by a well drilled on LSD 9 which was laterally adjacent to LSD 8 and diagonally adjacent to LSD 7 on the leased lands on February 7, 2014. This triggered the 90-day period within which Whitecap was obliged to drill, drop or pay. Whitecap did ultimately drill a horizontal well through LSD 7 and 8 which obtained production on August 11, 2015. This meant that Whitecap was also obliged to pay compensatory royalty for the period between May 8, 2014 and August 31, 2015.

Does the offset well clause require multiple wells to respond to one offset well?

CNRL took the position that a single offsetting well might oblige a lessee to drill as many as three defensive wells where an offset obligation was triggered by both lateral and diagonal offsets. Furthermore, should a lessee fail to drill or drop then it would be liable in such a situation to pay a compensatory royalty three times over. Whitecap suggested that this was a commercially unreasonable interpretation of the offset well clause. In considering this issue Justice Slawinsky emphasized that the lease used the singular "well" rather than "wells". Furthermore, she was persuaded by Whitecap's argument to the effect that the addition of diagonal offsets as a triggering mechanism was designed to capture (at para 106) "wells that were drilled on lands diagonally situated at the corners of the leased lands, and not to create obligations to drill multiple defensive wells in response to a single offset well." That said, she does seem to admit of the possibility that more wells or multiples of compensatory royalties might be payable were there (at para 107) "compelling evidence from CNRL that two or three defensive wells are reasonably required to

protect against drainage from a single well". It is not clear how this interpretation which provides for multiple offset obligations in some cases but not others can be sustained on the basis of the language of the lease.

In the case of horizontal offset wells that span LSDs not adjoining the leased lands, is the entire production used to calculate the compensatory royalty?

All of the wells that triggered offset obligations were horizontal wells that produced from two LSDs. Furthermore, in each case one LSD of each well was not itself diagonally or laterally adjoining to the leased lands. CNRL, emphasising the language of clause b.3 which refers to production "from a well" took the view that compensatory royalty should be payable on the entire production of the well. Whitecap argued that the royalty should be determined only on the basis of production attributable to the adjoining LSD. Justice Slawinsky preferred Whitecap's approach:

> The compensatory royalty clause must be read with the lease as a whole. The clear intent and purpose of the offset well clause is to protect the leased lands from drainage to wells drilled on adjacent spacing units, and to compensate for drainage to adjacent spacing units. CNRL's interpretation does not promote the intent of the clause and yields an absurd or unintentional result. It could not have been the intention of the parties to respond to drainage concerns for a single spacing unit by charging a royalty based on production from multiple spacing units, some of which are not adjacent to the leased lands. CNRL also acknowledged in its evidence that Manitoba and Saskatchewan government practice is to use production only from the adjacent LSD to calculate compensatory royalties. (at para 114)

Accordingly, in any situation in which an offsetting well is producing from multiple LSDs compensatory royalty should be based on the proportion of production attributable to the offsetting LSD. Thus in the case of a well producing from two LSDs (at para 115) "the royalty will be based on one-half of the total production of the offset well." I assume that the premise of this conclusion must be firmly rooted in the provision in the offset well clause to the effect that in the case of an horizontal well for which there is no Spacing Unit attributed by regulations "a reference to a Spacing Unit herein shall be deemed to refer to one (1) Legal Subdivision (LSD)." There can be no other reason to privilege an LSD as the relevant unit of production; in other words, if the applicable spacing unit or drainage unit of the offsetting well comprised two or more LSDs then the compensatory royalty should be calculated by reference to 100% of production from that well. Justice Slawinsky's conclusion only holds because in this case this well had a spacing unit comprised of two LSDs.

Does the offset well clause prescribe an unenforceable penalty?

This point is linked to the last two points dealing with possible multi-well obligations and royalty liabilities extending beyond an adjoining spacing unit. Justice Slawinsky observed (at para 119) that a contractual provision "is a penalty and unenforceable if it sets damages which are "a grossly excessive and punitive response to the problem to which it was addressed" and "disproportionate and unreasonable when compared with the damages sustained or which would be recoverable through an action in the courts for breach of the covenant in question" referring to

H.F. Clarke Limited v Thermidaire Corporation Limited, [1974 CanLII 30 (SCC)](), [1976] 1 SCR 319 at 338. In her view (at para 120) "the purpose of an offset well clause is to protect the lessor against loss of the oil and gas underlying his land through drainage. The traditional industry approach to this problem has been to limit defensive drilling or payment in lieu of drilling to the adjacent spacing unit only."

Accordingly:

> It would be excessive and punitive to require two or three defensive wells in response to a single offset well, royalties equal to double or triple the total production of the offset well, or royalties calculated on production from non-adjacent lands. (at para 120)

Did CNRL's methodology and approach to the offset well dispute breach its duty of good faith, disentitling it to payment of compensatory royalties?

The issue here was whether CNRL's overall approach to the interpretation and application of Whitecap's offset well obligations was such as to disentitle it to compensatory royalties in those scenarios in which it was successful – all on the basis that CNRL had breached its duty of good faith. In the end Justice Slawinsky concluded that while CNRL's behavior (at para 125) "was unreasonable, failed to consider the legitimate contractual interests and expectations of Whitecap in the performance of the contracts, and unfairly disregarded Whitecap's legitimate business interests" it was not such as to "disentitle CNRL to the compensatory royalties awarded in this decision." That must be correct.

However, Justice Slawinsky was not finished. Justice Slawinsky went on to say:

> It is evident, particularly from CNRL's own evidence, that from the time it acquired its lessor interests, CNRL was not interested in achieving the full production value of the lands during the term of the leases. From the outset, CNRL interpreted the leases in a manner designed to maximize the compensatory royalty calculations unreasonably, without regard for commercial context or reasonableness. (at para 126)

She concluded (at para 132) that "CNRL's *misconduct* in this dispute is therefore better addressed in an order for costs." (Emphasis added).

The trouble with these passages is that (apart from the passage referencing the conclusion that CNRL was not disentitled) they create the impression that CNRL has somehow acted improperly in pressing its case as vigorously as it has. I do not think the main reference on which Justice Slawinsksy apparently relies (*Bhasin v Hrynew*, [2014 SCC 71]() (CanLII) provides any real support for that proposition. In *Bhasin*, the unanimous Supreme Court of Canada reached two conclusions. The first was that it should recognize good faith as (at para 63) "an organizing principle … that underlies and manifests itself in various more specific doctrines governing contractual performance." The Court clarified that an organizing principle is not a free standing rule and cautioned that:

> The principle of good faith must be applied in a manner that is consistent with the fundamental commitments of the common law of contract which generally places great weight on the freedom of contracting parties to pursue their individual self-interest. In commerce, a party may sometimes cause loss to another — even intentionally — in the legitimate pursuit of economic self-interest: *A.I. Enterprises Ltd. v. Bram Enterprises Ltd.*, [2014 SCC 12 (CanLII)](), [2014] 1 S.C.R. 177, at para. 31. Doing so is not necessarily contrary to good faith and in some cases has actually been encouraged by the courts on the basis of economic efficiency: *Bank of America Canada v. Mutual Trust Co.*, [2002 SCC 43 (CanLII)](), [2002] 2 S.C.R. 601, at para. 31. The development of the principle of good faith must be clear not to veer into a form of *ad hoc* judicial moralism or "palm tree" justice. In particular, the organizing principle of good faith should not be used as a pretext for scrutinizing the motives of contracting parties. (at para 64)

The Court's second conclusion in *Bhasin* was to recognize (at para 73) "a general duty of honesty in contractual performance." Justice Cromwell was careful to emphasise (at para 89) that he was not adopting a more expansive *duty* of good faith. The defendants in *Bhasin* were in breach of their contractual obligations because they acted dishonestly in their dealings with Bhasin and dishonestly as well with respect to the role of Hrynew as Bhasin's competitor (at para 98).

While it might be the case the case that the duty of good faith effectively rules out certain possible interpretations of contractual provisions, the zealous pursuit of contractual self-interest is not contrary to any organizing principle of contract law and neither can it be characterized as the dishonest performance of a contract. Many of the issues considered in this case were matters of first impression and dealt with complex issues involving contractual interpretation in the context of technological change. CNRL certainly pushed its case strongly but that is hardly enough (on its own) to justify an adverse costs award or any express or implied judicial censure.

In sum, while there is much to applaud in Justice Slawinsky's decision, these final paragraphs run the risk of not heeding Justice Cromwell's warning in *Bhasin* to the effect that "The development of the principle of good faith must be clear not to veer into a form of *ad hoc* judicial moralism."

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