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What Zones Were the Subject of a Unitization Agreement?

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Cases Considered:

Signalta Resources Limited v. Dominion Exploration Canada Limited, 2007 ABQB 636

The question of what substances are the subject of a unitization has been before the courts on at least one other occasion in *Prism Petroleum Ltd v. Omega Hydrocarbons Ltd*, [1994] 6 WWR 585 (Alta. C.A.). The issue in that case involved a split petroleum and natural gas title. *Signalta v. Dominion* does not involve a split title in that sense. Rather the issue was whether the title that had been committed to a unitization agreement was confined to the Viking or whether it also included the Glauconite. Put in these terms the issue seems relatively simple but the paper trail was very complex. Combine a complex set of facts with competing expert opinions from well known legal (Ballem and Thackray) and land (O'Byrne) experts and the result is a very lengthy 74 page judgement from Justice A.G. Park in which he concluded that the Glauconite for the relevant tract was never included in the original unitization.

The issue in Signalta came to the fore when in late 2000 Dominion completed and began producing for its own account a well in the Glauconite some 25 years after the effective date (February 1, 1975) of the original unitization agreement. Signalta claimed that the well was producing from the unitized zones; Dominion took the opposite view and, in case it was unsuccessful, argued that Dominion could recover damages from Signalta for negligent misrepresentation.

The lands in issue are variously described as the section 8 lands or the Tract 29 lands of the West Viking Gas Unit # 1. The section 8 lands were originally owned by Hudson's Bay Oil and Gas (HBOG). But by the terms of a 1973 agreement covering various parcels HBOG transferred the mineral title to the section 8 and other lands to Siebens, reserving to HBOG the right to acquire petroleum and natural gas leases to these lands. HBOG then entered into a multi-section farmout agreement with Dyco (the predecessor in title to Dominion) on April 25, 1974. This agreement required Dyco to drill 26 wells on locations of its choice on the Scheduled lands with priority to be accorded to lands that were subject to offsetting drainage. The wells were all to be drilled to "contract depth" and tested and completed or abandoned by July 31, 1975. Contract depth was defined as a "depth sufficient to penetrate One Hundred Feet (100') into the Formation indicated or to the total subsurface depth which appears opposite each Bay parcel [as described in Schedule A] ….." The earnings clause in turn provided that having fulfilled its obligations the

Farmee would be entitled to a sublease "of all of the Farmor's rights and interests "of all of the Farmor's rights and interests in and to …. [the selected lands] … insofar as such rights and interests relate to all formations down to the stratigraphic equivalent of contract depth or depth drilled, whichever is greater, described in Schedule "A" opposite each respective Bay Parcel …". Various passages in the judgement (e.g. paras 245 and 269) suggest that the entry opposite the Section 8 lands must have read "the Viking Formation" or words to that effect. This finding was crucial to the resolution of the case.

Shortly before HBOG entered into the farmout agreement, Voyager, a predecessor in title to Signalta, started to canvass parties with respect to forming the West Viking Unit. HBOG attended the first few meetings but then (December 1974) advised Voyager that all future correspondence should be addressed to Dyco and from thenceforward it was Dyco that attended all the relevant meetings. Fairly early on in the negotiations it emerged that there were two mapable reservoirs that might be the subject of the unitization, the Viking and the Glauconite but the treatment of the Glauconite Formation for Tract 29 was not always dealt with consistently.

The Unit Agreement was finalized in December 1974 and copies sent out for counterpart execution. The Agreement was expressed to have an effective date of February 1, 1975. At the first meeting of the operating committee in January 1975 all titles but for Tract 29 were approved on the recommendation of the Titles Committee. Tract 29 was not approved since Dyco could not as yet show a title to these lands. It was understood that Tract 29 would be qualified for admission (as of the effective date) if Dyco could establish its title by May 1. Dyco and HBOG ultimately entered into two agreements in April 1975, one being an agreement to provide Dyco with a sub-lease and the other being the sub-lease itself which granted all of the leased substances down to the base of the Viking. It did not as Justice Park explained (at para. 50) grant any deeper rights since "Dyco had not drilled on the Section 8 lands and accordingly was entitled only to earned (sic) interests to contract depth set out in the Farmout Agreement, being to the base of the Viking Formation". The sublease was stated to have a date of execution of January 31, 1975. On May 1, 1975 the Operating Committee accepted the recommendation of the title committee to include Tract 29. At about the same time Dyco drafted a letter to HBOG in which Dyco acknowledged that its sub lease did not give it rights to the Mannville and sought to have HBOG amend the sub-lease to include those rights. There was no evidence that the draft letter was ever finalized and sent and received by HBOG and the sublease was never amended.

The Unit Agreement was executed in counterpart as follows: Voyager, December 20, 1974 (as a WIO (Working Interest Owner) and proposed unit operator), Dyco January 13, 1975 (as a WIO), Siebens February 21, 1975 (as a Royalty Interest (RI) owner). HBOG executed it on February 26, 1975 although it was unclear as to whether HBOG executed as a WIO and\or as a RI owner. Between the time that the Agreement was first sent out for execution and May 1 the Agreement was subject to an amendment which related to Tract 29. Thus while the agreement as first sent out showed HBOG as the WIO of Tract 29 and the Glauconite was not included as an excepted zone, revision # 1 (stated to have an effective date of February 1, 1975) showed Dyco as the WIO for Tract 29. But the Agreement still did not list the Glauconite as an excepted zone.

In 1992 Poco as successor in interest to Voyager as the operator issued amendment # 13 to the Unit Agreement in which it inter alia revised exhibit A to include the Glauconite as an excepted zone for Tract 29 (at para. 64). That remained the position until nearly two years after Dominion drilled the 13-8 well when Signalta (the successor in interest to Voyager and Poco) took the position that the Glauconite was within the unit and proposed to reimburse Dominion for the costs of drilling and completing the 13-8 well.

In sum, there was at the very least considerable confusion at the time the original unitization was completed as to whether Tract 29 included the Glauconite or was limited to the Viking.

Given the state of the title it would seem that there were two possible ways in which the Glauconite might have been included in the unitization. First, Dyco might have dedicated the Glauconite to the unit. Certainly the Glauconite was not excluded from the unitization documents when Dyco executed the agreement. But the fatal flaw in this argument was that Dyco never became entitled to the Glauconite under the terms of its farmout agreement with HBOG. Dyco's earning was confined to the Viking zone and the sublease that HBOG executed properly reflected that conclusion. On this analysis the fact that the Glauconite for Tract 29 appeared to be included in the unitization documents was simply a mistake (at para. 280) and a mistake that was ultimately corrected by Poco in 1992 (at paras 247 and 2723 – 276).4 Poco was entitled to do this without obtaining the consent of the parties to the Agreement precisely because it was a "mistake or mechanical error" within the meaning of cl. 203 of the Unit Agreement.

The second possibility was that HBOG might have contributed the Glauconite. After all, if Dyco didn't have rights to the Glauconite HBOG certainly did under the terms of the head lease with Siebens. Furthermore, HBOG did execute the Unit Agreement, and as Signalta pointed out (at para. 223), the unit agreement did contain the typical clause to the effect that if a party owns a WI as well as a royalty interest, its execution of the agreement shall constitute execution in both capacities. But there were weaknesses in this argument as well. Thus, while the original version of the Unit Operating Agreement did refer to HBOG as the owner of the WI in Tract 29 (at para. 229), Dyco became listed as the WIO of Tract 29 by Revision # 1 which had an effective date of February 1, 1975. Furthermore, it appeared that HBOG was never a party to the unit operating agreement or at least (at para. 228) there was no evidence that it had ever executed the operating agreement; HBOG did not execute authorizations for expenditure (AFEs) related to the unitization; HBOG did not sit on the operating committee; and HBOG did not receive revenues as a WIO (at para. 255). In sum there was no evidentiary basis to call clause 1302 in aid.

Justice Park's principal conclusion on all of this was as follows (at para. 234):

> In any event, I do not accept Signalta's argument in this area. Rather it is my view the Glauconite formation in Tract 29 [Section 8] was not committed to the Unit by HBOG or Dyco at the effective date of the Unit, being February 1, 1975. I am of the opinion the Unit's Title Committee misunderstood the title and interest Dyco conveyed to the Unit. This misunderstanding was based on the assumption HBOG was conveying to Dyco all of HBOG's Working Interest ownership as set out in Exhibit "A" in the August, 1974

> draft Unit Agreement. HBOG did not convey all that Working Interest in Tract 29 [Section 8] to Dyco. Rather it only contributed its Working Interest ownership, as defined in the sublease, to Dyco, to the base of the Viking formation.

One of the implications of concluding that the Glauconite for Tract 29 was not included was that the reserves allocation for Tract 29 was overstated since there was general acknowledgement and the court so found (at para. 271) that the tract participation factor for Tract 29 as included in Exhibit A was calculated on the basis of both formations being included. In effect this meant that by mistake (whether of fact or law) the WI and RI parties interested in Tract 29 had received more benefits than they were entitled to over the years. But this, said Justice Park, was another issue and an issue that might perhaps present itself as a claim for unjust enrichment (at para. 272).

One of the intriguing aspects of the case was the battle of the experts. The plaintiffs, perhaps most conventionally, called experts who could testify as to customs in the industry with respect to unitization and related matters. These experts included O'Byrne and Moller. The defendants by contrast called two well-known Calgary lawyers to testify on a number of issues which seem to have elicited their opinions on a variety of legal issues including "the ultimate question". Indeed Justice Park acknowledged that at least three witnesses (Ballem, Thackray and O'Byrne) provided evidence as to the ultimate question before him (at paras 260, 264) but only Ballem's was treated as inadmissible. Ballem's evidence was treated as inadmissible on two separate grounds. First, his expert opinion did not meet the definition of necessity (at para. 201):6

> His opinion on contractual issues, interpretation of legal agreements and documentation is a legal opinion which falls within the ordinary experience of this Court. It is knowledge which is based upon ordinary legal principles of the law. I can apply and determine the law in this area of contractual issues and legal documents as I interpret it based upon the evidence and the arguments of Counsel on the law. I can and will form my own conclusions without the assistance of Ballem. There is a sufficient factual basis present to allow me to deal with these issues.

And, second, his evidence was treated as inadmissible on the basis that the evidence as filed provided only conclusions and not the reasoning behind those conclusions (at paras 202 – 205). While Ballem provided this reasoning in his viva voce evidence this was too late to allow the plaintiffs to adequately prepare their case.

O'Byrne's evidence suffered a different fate. Justice Park noted that O'Byrne was qualified as an expert on the basis of industry practice and custom (at para. 260). Thus, in order for his evidence as to the proper interpretation of a clause in the agreement (in this case the farmout agreement) to be given any weight (or perhaps even regarded as admissible) it must be based upon industry practice and custom. O'Byrne did not buttress his opinion as to how the relevant agreements should be interpreted by referring to industry practice and consequently his evidence was disregarded. It didn't help that Justice Park simply disagreed (at para. 262) with many of the legal interpretations of this non-legally- qualified witness.

A couple of other issues arose that are also perhaps worthy of comment even though not central to the outcome of the case. The first was the applicability of the "failure of title" provisions of the unit agreement. Unit agreements typically provide (as did this agreement, cl. 1103 at para. 277) that where a party's title fails the tract shall be excluded from the unitization agreement unless another Party to the Agreement shall be held to own the title in which case that Party shall be bound by the Agreement in respect of the tract. Justice Park held that these provisions were simply inapplicable (at para. 241). The title to the Glauconite formation could not fail as the title or interest to the Glauconite formation never passed to Dyco as a WIO. For a failure of Dyco's title to the Glauconite formation to occur, Dyco would have to own or possess rights to such a title. It never owned or possessed a right or an interest to the Glauconite formation because it never earned such a right or an interest under the Farmout Agreement (at paras 278 – 279). And similarly, HBOG could not be held to be bound by this clause of the Agreement since again this was not a case of title failure but a case of the lands never having been made a part of the Agreement.

Second, there was also a brief limitations discussion in the case. The question was when the two year period would have started to run. Dominion argued that it should have started to run from November 2000 when it wrote to Signalta trying to get access to the processing plant for production from its 13-8 well. But there was a snag with that argument since at that time Dominion by mistake indicated that the well was producing from the Colony (which was not unitized) formation rather than the Glauconite. Justice Park held that it was reasonable for Signalta to rely upon this representation (that the well was producing from the Colony) and that Signalta did not have a duty to ensure for other unit holders that Dominion was not draining substances from the unit (at para. 297).

Since Dominion was entitled to the production from the 13-8 well it followed that no damages were payable by Dominion for unlawful production. But Justice Park still offered his views on how damages should be calculated. And he concluded, following Montreal Trust Co. v. Williston Wildcatters Corp, [2004] SKCA 116, (leave to appeal to the SCC refused)7 that damages should be based on the mild rule. But what did that mean here in the very different context of competing working interest ownership rather than a dead lease? It would mean that Dominion would have to pay revenues received from the sale of the produced substances minus an amount for drilling and operating costs and any amounts payable as royalty. There was another accounting issue to be settled and that related to Signalta's action against the Crown since the Crown seems to have included (at para. 6) production from the 13-8 well in production from the unit. The Court ordered that Signalta was entitled to an accounting for any such monies paid. 7 I commented on this case at length in (2005), 68 Sask. L. Rev. 23 - 77. Justice Park did not refer to the more recent judgement of Justice Kent in *Freyberg v. Fletcher Challenge Oil and Gas Inc*, [2007] ABQB 353.

Footnotes:

1. Given the outcome it was not necessary to deal with this issue but Justice Park did reject the argument (at para. 305) (as he rejected a related estoppel claim – at para. 288) on the grounds that there was no evidence of any misrepresentation by Signalta on which Dominion might have relied. Dominion relied upon its own understanding in drilling the well.
2. Justice Park comments on several occasions that Dyco had a duty to bring this issue (its lack of title to the Glauconite) to the attention of the unit operating committee but evidently it never did so.
3. If anything the evidence showed (at paras 266 – 267) that there were several grounds on which HBOG might take the view that Dyco had yet to meet all of the requirements of the earnings provisions of the agreement. But that was an issue as between HBOG and Dyco and HBOG was quite within its rights to provide Dyco with a sub-lease before it had fully earned.
4. And there could be no argument that any such error had become irreversible by virtue of actual registration in the Land Titles Office since the only relevant registrations appear to have been those of the fee simple owner (Siebens and its successors). A caveat could not cure this sort of error. See the brief discussion of land titles issues at paras 281 – 283.