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Ontario Oil and Gas Case of interest to the Calgary Bar

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Cases Considered:

Tribute Resources Inc v. McKinley Farms Ltd, 2009 CanLII 33043 (ON S.C.)

While most of the country's oil and gas cases are decided in Alberta courts (even if in some cases the property to which the litigation pertains is, for example, in British Columbia – see eg *Canadian Natural Resources Ltd. v. Encana Oil & Gas Partnership*, 2008 ABCA 267 dealing with right of first refusal issues in relation to a property in British Columbia), sometimes the courts in other Canadian jurisdictions do get to add to the body of Canadian oil and gas law.

One such case is *Tribute Resources Inc v. McKinley Farms Ltd* which deals with, amongst other things, the termination of an oil and gas lease during its secondary term; the possible extension of the lease by a unitization agreement; and, to cap it all, a gas storage lease agreement.

The Facts

Tribute's predecessor in title entered into an oil and gas lease 1977 and a unit agreement in 1984, both with McKinley Farms; Tribute and McKinley entered into a gas storage lease agreement (GSLA) in 1998. The oil and gas lease provided for a 10 year primary term continued thereafter by production in paying quantities or by way of storage operations. Production of natural gas continued until 2001 (whether on the leased lands or the unitized lands).

The unit agreement contained a clause that allowed Tribute to continue leased lands not included in the "participating section of the unit area" by payment of $2.50 per acre rental. The agreement went on to provide that:

> And as long as the payments in this clause provided are made or tendered, operations for the production of the leased substances from the unit area shall be deemed to be conducted by the lessee on the said lands under the said lease, and the said lease as hereby amended shall remain in full force and effect as to all of the said lands retained by the lessee under the said lease and/or this agreement. (the emphasis is the court's)

The gas storage agreement (prepared by Tribute) was for a ten year term (with rights of renewal) and contained the following clause:

> This Gas Storage Lease Agreement shall terminate on the tenth anniversary date, if and only if, the lessee or some other person has not applied to the Ontario Energy Board to have the said lands or any part thereof designated as a gas storage area on or before the tenth anniversary date hereof.

No application was made to the Board.

Each party sought declarations as to the validity or otherwise of these agreements.

Decision

Justice T.D. Little decided that the lease terminated in accordance with its terms and was not saved by the terms of the unitization agreement. Justice Little decided that the GSLA also terminated in accordance with its terms.

The oil and gas lease was a profit rather than a true lease. The lease terminated automatically when production ceased. There was no default and therefore Tribute, as lessee, was not entitled to the benefit of the default clause (at paras 14 – 15).

The lease was not saved by the terms of the unit agreement. The deeming clause of the unitization agreement (reproduced above) could not have that effect because it was found "buried"\"camouflaged" in a clause of the unitization agreement dealing with payment rather than duration (paras 20 – 24). Perhaps, more crucially, payment was only effective to deem there to be "production"; but the lease itself required production in paying quantities to continue the lease.

The GSLA terminated in accordance with its own terms since no application was made to the OEB to have the lands designated as a gas storage area.

Finally, Tribute could not rely upon the provisions of Ontario's *Commercial Tenancies Act*, RSO 1990, c. L-7 which allow a Court to relieve against forfeiture. There was no forfeiture here, only an automatic termination of the lease (at para 33).

Comment

There is a lot of activity in Ontario at the moment to enhance available natural gas storage. New projects are being proposed for the approval of the Ontario Energy Board (see, for example, OEB Decision EB-2008-0405, Application by Union Gas Limited for Natural Gas Storage – Heritage Pool Development, May 29, 2009) and operators of existing projects are getting Board approval to increase operating pressures (see, for example, EB-2008-0038, application by Union Gas re operating pressures for the Oil Springs East, Payne and Enniskillen pools). I suspect that operators of old producing reservoirs are looking at their portfolios to see if there are additional depleted reservoirs that can be brought back on stream as storage projects. Perhaps this is one such example.

On the lease point the case is fully consistent with both the approach and the analysis in *Lady Freyberg v Fletcher Challenge Oil and Gas Inc* (2005), 252 DLR (4^{th}) 365 (Alta. CA. Oil and gas leases terminate automatically during the secondary term for want of production or deemed production. There is no default and there is no forfeiture to relieve against. These points are well established in the case law: *East Crest Oil v. Stroschien* (1952), 4 WWR 553 (Alta. App. Div.)

The unitization agreement here seems to have contemplated (at least on one interpretation) that the entire unit area might be continued in force by virtue of some relatively trivial payments made with respect to some "non-participating" property included in the overall unitization. The

concept of “non-participating” is likely a reference in Ontario gas storage parlance to so-called outside acreage (acres within a leased tract which do not fall within the mapped pool boundaries). Including these lands in lease continuations and unitization has the virtue of providing for an orderly transition from production to storage operations, and, at the same time, provides a buffer to protect the actual storage unit. But here the lessee was clearly trying to use a small annual payment to maintain its interest in the property and the Court was not impressed.

The Court gave two reasons for concluding that the lessee’s deeming approach was ineffective and both are I think new points in the lease case law. The first point is that if you are going to adopt a deeming approach then you had better get it right. If a lease is continued by production in paying quantities then you must make sure that you use language to achieve that effect since anything less will be ineffective. The case represents a logical extension of the Supreme Court of Canada’s decision in *Shell Oil Ltd v. Gunderson*, [1960] SCR 424.

The second reason was to the effect that if the deeming effect that you want to achieve is concerned with duration (ie the habendum of the lease) then the deeming language in the unitization agreement should be dealt with in a clause of that agreement dealing with duration and not be buried (as it was here) in a clause dealing with payment. While I have some sympathy with this view (see my blog of *Kensington Energy Ltd v. B & G Energy Ltd* 2008 ABCA 151), if the language is clear the court should give effect to it. Thus, by way of analogy (and as the *Kensington* case shows), it is possible to deal with duration in each of the habendum and the shut-in wells clause of a lease. There is no rule of law that requires parties to stick to the habendum; it is ultimately always a question of construction of the entire agreement between the parties. In sum, the first line of reasoning on the unitization issue is rather more convincing than the second line of reasoning.