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When does a royalty owner not have to pay for a share of processing costs?

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Cases Considered:

570495 Alberta Ltd. v. Hamilton Brothers Exploration Company, 2008 ABQB 413

When does a royalty owner not have to pay for a share of processing costs? The answer of course should be that the royalty owner does not have to pay unless it is required to do so by the terms of the agreement that created the royalty. And that in fact is exactly what Justice Alan Macleod concludes in this judgement. Just as there is no rule of law that precludes an oil and gas lease from being kept in force beyond the end of its primary term by the mere existence of a shut-in well in "accordance with oil field practice" (see *Kensington Energy Ltd v. B & G Energy Ltd* 2008 ABCA 151 and my post on this decision), so too there is no rule of law that requires a royalty owner to pay a share of post-severance processing costs. This judgement confirms that processing costs are issues of contract between the parties and that the job of the court is to give effect to the terms of the agreement that the parties have negotiated.

The facts

The Hamilton Brothers Exploration Company (HBEC) disposed of all of its oil and gas assets in Alberta in 1979. For tax reasons the sale was structured in such a way that the most significant part of the purchase price was paid by way of a gross overriding royalty reserved by HBEC which terminates only when total receipts equal $490.5 million. Over the years there has been considerable litigation on various aspects of this agreement. I have commented on many aspects of that litigation in Bankes, "Private Royalty Issues: A Canadian Viewpoint", *Private Oil and Gas Royalties*, Paper No. 8, pp. 1- 65, Rocky Mountain Mineral Law Foundation, 2003.

Under the agreement (cl. 2(a)) the royalty is payable on "the value of all petroleum substances produced from and/or allocated to" the Assets and calculated after the deduction of certain defined "burdens" (which all parties agreed did not cover processing costs). Sales of petroleum substances were to include the royalty share and the agreement defined (cl. 2(c)) "value" as "the full price paid by a bona fide purchaser (including any credit taken by such purchaser by virtue of any prior "take or pay" payment) at the point of sale of the petroleum substances produced, saved and marketed from, or allocated to, the wells located on the said lands excepting the amount of the burdens".

In addition to the purchase and sale agreement there were other agreements between the parties including the disbursing agreement which reiterated that the purchaser was to "pay all costs and expenses incurred in connection with the Said Assets covered by the conveyance, excluding payment of the burdens and the payment of the rentals". The disbursing agreement prescribed how certain calculations and allocations were to be made but said nothing on the subject of gas processing costs.

The practice of the parties was not to deduct gas processing costs from the royalty account and the issue was not raised until the mid-1990s. This litigation commenced in 2000 and, pursuant to an order of court, $25,000 per month was withheld from disbursement to HBEC.

The judgement

Justice Alan Macleod dismissed the plaintiff's claim. In his view (at para. 23) "royalty is a creature of contract", the parties are free to enter into any arrangement and the issue is "what does the contract in this case say"? And the crucial issue was to ascertain the point at which value was to be calculated. Was it at the point of sale or the point of severance (id)? And in answering that question the Court was entitled to consider not only the agreements themselves but also the surrounding circumstances and the conduct of the parties in implementing the agreement. Review of all of this material led Justice Macleod to conclude that this was not an ordinary transaction but was unique; Hamilton itself had invested its capital in the construction of a gas processing plant and this plant was included in the sale of the assets. With that as background the words used were clear. The royalty agreement (at para. 32) "calls for the payment of the royalty on the full price paid at the point of sale excepting the amount of the burdens. Other than the burdens [the purchaser] covenants to pay all costs and expenses incurred in connection with the assets which include the oil and gas interests and gas processing and gathering infrastructure." Furthermore (at para 33), had the parties agreed that processing costs were deductible "it is simply not conceivable … that the agreements would not have contained precise instructions as to how that calculations should be made." It was well known within the industry that the point or place that value is to be determined is a crucial feature of any royalty agreement and by defining value in terms of the point of sale the parties "deliberately decided to exclude processing costs upstream from the point of sale" as legitimate deductions.

Assessment

In light of the express language of this agreement one can only assume that the plaintiffs felt the need to litigate this matter because of their mistaken belief that there was some sort of rule of law in Alberta that requires a royalty owner to pay for its share of post-severance costs. This is not the case and hopefully Justice Macleod's judgement will settle this point once and for all. To be sure it is common practice to structure agreements so as to require that royalty liability is to be calculated at the point of severance (i.e. at the wellhead) thereby requiring the royalty owner to pay its share of any costs incurred adding value to the resource (e.g. pipelining and processing costs) from that point forward to the points of sale. And, to be sure, this practice makes commercial sense. After all, why should a royalty owner be entitled to the benefit of the value added by the working interest owner post-production, and why should the royalty vary depending upon whether the first point of sale is downstream of the processing plant in Alberta

or to a co-generation plant in New York? But these are all reasons for careful drafting; they are not reasons for creating a rule of law that should trump the intentions of the parties as revealed in the language of the contract.

If one looks at the existing case law the only decision that really offers much support for the plaintiff's contention is Justice Power's decision in *Resman Holdings Ltd v. Huntex Ltd et al* (1984), 54 A.R. 281 (Q.B.) but I think that that decision is unreliable because the court never really addressed its mind to the crucial question which was: where was the "outlet valve to the pipeline" as those words were used in the agreement?

While Justice Macleod's judgement should settle these issues and the approach to be taken to the construction of royalty agreements, some may read his judgement as having left the door slightly ajar insofar as he emphasises that this transaction was unique (at para 32) and not a "typical" (at para. 29) transaction. And while he concludes (at para 29) that he should not superimpose the features of the typical transaction on this particular transaction, he immediately qualifies this by saying "unless there are compelling reasons to do so". But what would those compelling reasons be?