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Deep rights, shallow rights and the interpretation of a purchase and sale agreement

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Cases commented on:

Nexxtep Resources Ltd v Talisman Energy Inc, 2012 ABQB 62

The oil and gas industry splits petroleum and natural gas rights by substances to create severed estates in gas and petroleum but it also splits rights along the vertical axis into different formations. Split rights may be created along the vertical axis for several reasons. In some cases the Crown or other lessor initiates the severance in order to encourage exploration (e.g. deep and shallow rights reversions - explore non-producing horizons in your lease or lose them). In other cases rights will be severed as part of farmout agreements since farmors will be reluctant to allow the farmee to earn interests in formations that are deeper (and in some cases shallower) than those formations to which the test well is to be drilled. But these vertical splits cannot always be determined with accuracy and in some cases the Energy Resources Conservation (ERCB) may be asked to classify or reclassify whether a pool is part of deeper rights or shallower rights for the purposes of different conservation rules including, spacing rules, first well in the pool rules etc.: see *Oil and Gas Conservation Act*, RSA 2000, c O-6, s 33.

The uncertainties (and changing classifications) associated with vertical splits may also have implications for private agreements such as the purchase and sale agreement (PSA) between Talisman (the vendor) and Nexxtep (the purchaser) at issue in this particular case. In this case Nexxtep argued that Talisman was producing from an asset that Talisman had transferred to Nexxtep and as a result sought damages in trespass.

I have blogged decisions on this fact pattern on two previous occasions. The first blog discusses a decision of Justice Kenny 2007 ABQB 788 (and the appeal 2008 ABCA 246) in which the court refused Nexxtep's application for an injunction to prevent Talisman from producing, and declined as well Talisman's application for summary judgement. The second blog discusses

Nexxtep's successful application to the ERCB to have it redesignate the vertical well that was at issue in this case (ERCB Decision 2009-050) and Talisman's unsuccessful application to obtain leave to appeal that decision: 2010 ABCA 258. The effect of this decision was to shut-in the vertical well pending resolution of the ownership issue – this decision.

This post focuses on Justice Poelman's decision on the merits in relation to a set of preliminary issues that Justice Kenny set down for trial: 2010 ABQB 452. These issues were principally two, first, did Nexxtep acquire any rights to production from the vertical well under the terms of the PSA, as properly interpreted, and second, assuming it did, should the terms of the PSA be rectified to restore these rights to Talisman? As it happens, Justice Poelman dealt with a third issue since he went on to consider Nexxtep's damages claim on the assumption that Nexxtep was entitled to succeed on the first two issues.

Under the terms of the PSA, Talisman agreed to sell to Nexxtep certain "Assets" in the Leedale area of Alberta for $3.95 million. The Assets included petroleum and natural gas (PNG) rights defined as being under a certain surface location and within the "base of Mannville to base of Pekisko" zone plus their associated "Tangibles" (equipment for production, transportation and processing) and "Miscellaneous Interests" (property, contractual rights, records and data relating to the PNG rights and tangibles).

Evidence as to the "genesis of the transaction" showed that Talisman had a number of assets in the area and was only prepared to sell some of them as part of this transaction. Talisman and Nexxtep agreed to divide the assets on the basis of who operated the assets and the related infrastructure (Talisman or Calpine, a co-owner of some of the assets). In particular it was clear that both parties understood that there were two wells producing from below the designated surface location: a vertical well believed by both parties to be producing sweet gas from within the base of the Cardium to the base of the Mannville, and a horizontal well producing sour gas from a formation that was within the lower "base of Mannville to base of Pekisko" (at para 2).

Included in "Tangibles" was Talisman's interest in the horizontal well operated by Calpine but not the vertical well operated by Talisman. The two wells had separate transportation and associated processing infrastructure. Two years after closing, Nexxtep concluded that the vertical well was producing from a pool below the base of the Mannville and within the "base of Mannville to base of Pekisko" zone. After a contested hearing, the ERCB agreed with Nexxtep

and redesignated the pool from which the vertical well was producing as being below the base of the Mannville zone.

Justice Poelman in a well crafted judgement emphasised that the job of the court is (at paras 5 – 6) "to ascertain what the parties objectively intended by their bargain, when they made it. Primacy is given to the parties' words, particularly in a written contract, because it is presumed that the parties chose words that embodied their intentions. However, the objective remains the determination of the parties' intention, not the meaning of words in a document." And in this case, Justice Poelman's examination of the terms of the PSA within a factual matrix in which Nexxtep knew it was buying certain assets in the land but not others allowed him to conclude (at para 59) that Nexxtep was purchasing Talisman's entire interest in the section 16 lands below the base of the Mannville but excluding the pool from which the vertical well produced.

In the alternative, if the contractual intentions of the parties remained unclear after taking into account the factual matrix, the resulting and continuing ambiguity could be resolved by taking into account evidence of subsequent conduct. That conduct included repeated efforts by Nexxtep to purchase the vertical well. This showed (at para 62) that for two years "both parties believed that the rights purchased by Nexxtep did not include any ownership in the vertical well or the pool from which it produced."

In the further alternative, Justice Poelman was of the view that this was one of those rare cases in which the court should order rectification if necessary to make sure that the written agreement conformed to the mutual intentions of the parties (at para 68):

> The findings I made above with respect to the factual matrix and parol evidence resolving ambiguity lead me as well to the conclusion that the mutual contractual intention of Talisman and Nexxtep was to convey Talisman's entire 34.4262% working interest in the petroleum and natural gas rights in Section 16 below the base of the Mannville zone, but excluding the pool from which the vertical well produced. If the principles of contractual interpretation do not permit the PSA to be interpreted at law to achieve that result, then there must be an order in equity rectifying the document in accordance with the aforesaid words.

Justice Poelman also went on to consider what would happen if Talisman did not succeed on either its interpretation or its rectification arguments. In that case the parties seemed agreed that Talisman's continuing production of the vertical well would be tortious and likely trespass - although Justice Poelman hinted that he preferred to characterize the taking as conversion. But how then should damages be measured? Justice Poelman reached the following conclusions. First, damages should be measured on a compensatory rather than a restitutionary basis (at paras 71 – 80). Second, damages should be assessed as of the date of the PSA and not as of the date of the Board re-designation order. This is because the Board's redesignation order might be conclusive in relation to matters covered by the *OGCA* but it is not conclusive with respect to the interpretation of the contract (at para 82). And fault is not a precondition to a successful action in trespass (nor conversion one might add). Third, compensatory damages should be calculated on the basis of net revenues that would have been received minus reasonable deductions for operating costs including reasonable equalization payments for the capital costs of the existing vertical well. It should be noted that the decision to apply the compensatory test of assessing damages (i.e. to put Nexxtep in the same position that it would have been in but for Talisman's tortious act) rather than a restitution approach (disgorge gains minus costs) is not as contentious in this context as it is in the context of a lessee producing on a dead lease. In a lease case the principal competing characterizations are between: (1) damages based upon the royalty that would have been payable had there been a lease (the 'mild' compensatory approach), and (2) the value of production minus operating costs. Where, as here, the contest is between working interest parties with competing ownership claims there will likely be little difference whether damages are calculated on a restitutionary or compensatory basis – although it could be different if Talisman's conduct fell to be characterized as reprehensible (argued by Nexxtep but rejected here) since the argument would then be that in such a situation the tortfeasor should not be able to deduct from its disgorgement its reasonable costs in recovering, processing and selling the production.

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