October 25, 2012

Natural gas storage rights in Ontario: questions of jurisdiction and interpretation

Written by Nigel Bankes

Case commented on:

Tribute Resources v 2195002 Ontario Inc, 2012 ONSC 25 (on the jurisdictional issue) and *21955002 Ontario Inc v Tribute Resources Inc* (on the interpretation issues) 2012 ONSC 5412

These two decisions represent one example of the efforts of Ontario landowners who claim ownership of natural gas storage rights by virtue of owning the rights to petroleum and natural gas to assert those rights against working interest owners who claim to have acquired storage rights by various old instruments including petroleum and natural gas leases, unitization arrangements, and, in some cases, specific gas storage leases. The cases are part of a broader litigation strategy in which storage owners are trying to negotiate more favourable economic terms that afford them the right to participate in the value that the storage represents to Ontario utilities and generators.

In this case the landowner, McKinley Farms Ltd, is trying to do this by entering into a storage agreement with a related corporation, Ontario 219. I assume, but I do not know, that the 219 storage agreement incorporates economic terms that are more favourable to the lessor than is typical in the Ontario storage business. I have written about those terms with co-author Julia Gaunce here. Having entered into this agreement, Ontario 219 brought this application questioning whether the old rights claimed by Tribute through earlier agreements with McKinley Farms (specifically an oil and gas lease as modified by a unitization agreement) really does continue to afford Tribute the right to store natural gas. In particular, Ontario 219 sought: (1) a declaration that there are "no gas sands" in, on or under the lands owned by McKinley; (2) a declaration that the Tribute Oil and Gas Lease does not permit Tribute to store gas in or under McKinley lands; and, (3) a declaration that the 219 Ontario Gas Storage Lease permits the injection into, storage under, and withdrawal of, stored gas from beneath the McKinley lands.

This was not the first time around on these issues at least for McKinley and Tribute (see *Tribute Resources v McKinley Farms*, 2010 ONCA 392). I have discussed that earlier litigation in a previous ABlawg post here. The crucial point for present purposes is that the Ontario Court of Appeal in that earlier case held that Tribute's gas storage lease had terminated although the rights that it had under its oil and gas lease (as varied by the unitization agreement) continued.

In the current round, Tribute first raised a jurisdictional objection which had succeeded in another gas storage case: see my previous ABlawg post on *Snopko v Union Gas Ltd*, 2010 ONCA 248 here. Tribute's argument was that all of these issues fell under the exclusive jurisdiction of the Ontario Energy Board (OEB).

This post discusses the preliminary jurisdictional point and then the decision on the merits.

The question of jurisdiction

Timing seems to be everything in thinking about the jurisdictional question and the ratio of the *Snopko* case and thus it is important to appreciate that while Tribute applied to the OEB to have it make an order designating an area including the McKinley farm lands as a designated gas storage area in September 2009 (subsequently withdrawn and renewed in 2011) the OEB stayed these applications pending the determination of both the earlier dispute between McKinley and Tribute and the present matter.

Justice Bryant rejected Tribute's jurisdictional arguments. In Bryant's view Ontario 219's application was simply an application to interpret various leases. The subject matter of this application did not fall within the language of sections 36.1, 38(1), 38(3) or 40(1) of the *Ontario Energy Board Act, 1998* (*OEBA*) (quoted below). Thus the Superior Court has jurisdiction in respect of these matters and these matters are not within the exclusive jurisdiction of the OEB since the Board has not made a relevant storage designation order under the *OEBA*.

Justice Bryant's rejection of the jurisdictional attack paved the way for Ontario 219's main application.

The main application

In its main application Ontario 219 contested the scope of Tribute's extant storage rights. In order to understand this issue it is important to appreciate that Tribute relied on three documents as the potential source of storage rights: (1) its original oil and gas lease (OGL) relating to the property, (2) the amendment of the OGL by a unitization agreement, and (3) a gas storage lease (GSL, but understanding that the Ontario Court of Appeal had already determined in previous proceedings, *supra*, that the GSL was no longer in force).

The documents

The Tribute OGL provided that:

> That the Land Owner…does hereby grant, demise, and lease to Operator …. [the oil and gas rights] …and Land Owner also leases to Operator the exclusive right to drill for, produce, *store*, treat, transport and remove by any method all oil and gas found in or under the said lands, *to store in any gas sands on the premises and withdraw therefrom gas originally produced from other lands…* . [Emphasis added.]
>
> If, at any time prior to the termination of this lease, the Operator should decide to utilize *any underlying productive gas sand as a storage reservoir for gas originally produced from other lands,* Operator agrees to notify Land Owner of such utilization, and thenceforth to pay Land Owner double the herein specified acreage rental amount as full compensation for the storage rights herein granted and in lieu of all delay rental… . [Emphasis added.]

The Tribute OGL was subsequently amended by a unit operation agreement which provided in part as follows:

> 12. If, at any time prior to the termination of this Agreement, the Lessee should decide to utilize *the underlying productive gas sand as a storage reservoir* [emphasis added] for gas originally produced from other lands, the Lessee agrees to notify the Lessor of such utilization, and thenceforth to pay Lessor double the herein specified acreage rental amount as full compensation for the storage rights herein granted and in lieu of all delay rental in event there is a productive well or wells on these lands at the date of said notification *the Lessee shall not commence utilization of the lands as a storage reservoir without first entering into an agreement with the Lessor to settle the value of the Lessor's royalty*… . [Emphasis added.]
>
> 16. Excepting as herein hereby expressly modified or amended, *the said lease shall continue in all respects in full force and effect for so long as therein provided, and the same as so amended or modified is ratified and confirmed*… . [Emphasis added.]

The Tribute GSL (found by the Ontario Court of Appeal to have terminated in *Tribute Resources Inc. v McKinley Farms Ltd*., 2010 ONCA 392 (CanLII), 2010 ONCA 392, [2010] OJ No 2293) provided that:

> The Lessor doth hereby demise and lease unto the Lessee, its successors and assigns all and singular the said lands save and except the surface rights thereto, save as hereinafter provided, (hereinafter called "the demised lands"), to be held by the Lessee, subject to the oil and gas lease, as tenant for a term of Ten (10) years from the date hereof, subject to renewal as hereinafter provided, for the purpose of injecting, storing and withdrawing gas, natural and/or artificial, (hereinafter collectively referred to as "gas") within or from the demised lands:
>
> 16. *Subject to its rights, if any, under the oil and gas lease*, the Lessee shall not inject gas into the demised lands under the provisions hereof unless… . [Emphasis added.]
>
> 21. This Agreement expresses and constitutes the entire agreement between the Parties, and no implied covenant or liability of any kind is created or shall arise by reason of these present or anything herein contained.

The Schedule to the GSL stipulated that "all provisions in this schedule shall be additional and shall be paramount with any of the terms contained in the original agreement." The evidence of Ontario 209 was to the effect that the storage target on the McKinley lands was a Silurian Pinnacle Reef and not a sand. Reefs are composed or carbonates while sands are unconsolidated detrital rock fragments. The pinnacle reef rocks comprise anhydrites and carbonates.

The decision on the main application

Justice Rady concluded that Tribute had no right to store gas under the terms of its OGL. It was not necessary to determine how the term "gas sands" should be interpreted and neither was it necessary to determine whether that term was ambiguous. This was because the parties had a shared intention that the GSL was to replace the rights that had been acquired under the earlier OGL as modified by the unit operating agreement. This intention was revealed by the entire agreement clause in the GSL which must mean that all matters pertaining to storage are

contained in the GSL. This was reinforced by the Schedule which made it clear that the parties intended the storage lease to prevail, at least with respect to those matters dealt with in the Schedule.

The unit agreement also supported this interpretation since it provided that the lessee should not begin using the lands for storage purposes until a further agreement was reached on the lessor's royalty entitlement. That agreement also expressly provided that the oil and gas lease was to remain in full force and effect except as modified by it and there was no similar language in the GSL.

The subsequent conduct of the parties in executing a specific storage lease suggested that they considered that the OGL dealt primarily with drilling and extraction rights and did not adequately provide for storage. The OGL did not provide for issues such as compensation for crop damage while the GSL dealt with that issue and provided a specific right to install compressors, a mechanism for computing and paying for the residual gas in the pool and an additional acreage rental, none of which were dealt with in the OGL. The GSL was more than just a supplement to the earlier OGL and provided strong objective evidence that the parties intended the GSL to provide for all of the contractual rights and obligations governing storage and that it was intended to replace the earlier OGL in relation to storage issues. It was also significant that Tribute wished to have McKinley execute a storage lease before it applied to the Ontario Energy Board for a gas storage designation order. This suggested that Tribute was not confident that it had continuing storage rights pursuant to the OGL.

Commentary

The principal issue in all of these cases is the extent to which old agreements principally directed at oil and gas production rather than storage should continue to govern the economic terms and conditions of storage today. Up until now Ontario gas utilities have been very successful in insisting that these issues are governed by existing contractual arrangements and furthermore that the courts should leave these issues to the experts, in this case the Ontario Energy Board. This is the first decision to open a chink in the armour of *pacta sunt servanda* and the privative clauses protecting the specialized jurisdiction of the OEB. The case will almost certainly be appealed and will be worth watching for a number of reasons including for what it might tell us of the relationship between the ordinary courts and the specialized jurisdiction of energy tribunals (as to which see my presentation to the CBA's Administrative Law sub-section, Alberta (South) in May 2012 here).

Selected Provisions of the Ontario Energy Board Act

Gas storage areas

36.1 (1) The Board may by order,

(a) designate an area as a gas storage area for the purposes of this Act; or

(b) amend or revoke a designation made under clause (a).

Authority to store

38. (1) The Board by order may authorize a person to inject gas into, store gas in and remove gas from a designated gas storage area, and to enter into and upon the land in the area and use the land for that purpose.

Right to compensation

(2) Subject to any agreement with respect thereto, the person authorized by an order under subsection (1),

(a) shall make to the owners of any gas or oil rights or of any right to store gas in the area just and equitable compensation in respect of the gas or oil rights or the right to store gas; and

(b) shall make to the owner of any land in the area just and equitable compensation for any damage necessarily resulting from the exercise of the authority given by the order.

Determination of amount of compensation

(3) No action or other proceeding lies in respect of compensation payable under this section and, failing agreement, the amount shall be determined by the Board.

Appeal

(4) An appeal within the meaning of section 31 of the *Expropriations Act* lies from a determination of the Board under subsection (3) to the Divisional Court, in which case that section applies and section 33 of this Act does not apply.