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Lease Terminates by Reason of Wells Shut-in for Producing in Excess of the Prescribed Gas to Oil Ratio

By: Nigel Bankes

Case Commented On: *Canadian Natural Resources Limited v Rife Resources Ltd*., 2017 SKQB 307 (CanLII)

Canadian Natural Resources Limited (CNRL) held a petroleum and natural gas lease for section 26 from Rife and Canpar. The habendum, the proviso to the habendum, and the shut-in clause of the lease (article 11) provided as follows:

> TO HAVE AND TO HOLD AND TO ENJOY the same at an annual rental as hereinafter provided for the term of ten (10) years from the date hereof and so long thereafter as the leased substances, or any of them, are produced or are deemed to be produced from the said lands or lands pooled therewith, subject to the sooner termination of the said term as hereinafter provided.
>
> PROVIDED, HOWEVER, that if at any time after the expiration of the said ten (10) year term leased substances are not being produced on the said lands or lands pooled therewith and the Lessee is then engaged in drilling or reworking operations thereon, this Lease shall remain in force so long as such operations are diligently prosecuted, and if they result in the production of leased substances or any of them, so long thereafter as leased substances or any of them are produced from the said lands or lands pooled therewith, provided that if drilling or reworking operations are interrupted or suspended as the result of any cause whatsoever beyond the Lessee's control (except lack of funds), the time of such interruption or suspension shall not be counted against the Lessee, anything hereinbefore contained or implied to the contrary notwithstanding.
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> If at the end of the aforesaid ten (10) year term leased substances are not being produced from the said lands or lands pooled therewith, or if at any time after the expiration of the aforesaid ten (10) year term leased substances cease to be produced from the said lands or lands pooled therewith, but there is then situated on the said lands or lands pooled therewith, a well or wells capable of production of leased substances and such well or wells are shut-in, suspended or otherwise not producing as the result of a lack of or intermittent or uneconomic market, or any cause whatsoever beyond the Lessee's reasonable control, then, for the purposes of continuing the term of this Lease, each such well shall be deemed to be producing leased substances while shut-in, suspended or otherwise not producing as aforesaid.

CNRL had two heavy oil wells on the section which, by 2011, were producing in excess of the prescribed gas to oil ratio (GOR). Provincial conservation laws required CNRL to shut-in the

wells unless it obtained approval for concurrent production. CNRL applied for, but was denied approval "at this time" on the basis of an objection filed by Waseca/Husky on the grounds that the wells interfered with Waseca's planned steam assisted gravity drainage scheme on adjoining lands. Accordingly, CNRL was instructed to shut-in the wells which it did some time after April 3, 2012. Other wells however continued to produce from the lands until February 2014.
In this application Rife and Canpar sought a declaration that the lease expired at that time for lack of production or deemed production. CNRL sought a declaration that the lease was continued by virtue deemed of production as referenced in the habendum and as defined in the shut-in clause.

Justice Grant Currie ruled in favour of Rife and Canpar.

In order to bring itself within the definition of deemed production CNRL needed to show both that one or more of the wells was capable of production, and that such well could not be produced by reason of a cause beyond CNRL's reasonable control. As to the first, Rife and Canpar took the position that the wells could not be produced both because they continued to produce gas in excess of the GOR and because the infrastructure was not in place to capture the gas. Justice Currie rejected that argument. He concluded (at para 35) that

> The requirement that a well be 'capable of production of leased substances' relates to the physical capability of the well, as opposed to an intervening cause. The intervention of provincial regulation relates not to this first requirement, which is concerned with physical capability, but to the next requirement of article 11 – whether the production has been interfered with by an event that is beyond Canadian Natural's reasonable control.

All that was necessary was that one of the wells be capable of producing a leased substance. It need not be able to produce all leased substances.

Justice Currie however concluded that CNRL had not been able to show that the wells were shut-in for a cause beyond its reasonable control. To reach this conclusion Justice Currie effectively read into article 9 a requirement that any shut-in be temporary and not indefinite. Having so interpreted article 9 it became relatively easy to conclude that CNRL could not rely on it since the evidence showed that the wells had already been shut-in for 5 years and would likely remain shut-in until Husky terminated its thermal project (at para 41):

> There is no knowing, however, when Husky will complete its thermal project. This means that the period during which Canadian Natural would have the parties wait for Husky is an indefinite period. Thus the effect of the Ministry's order, the shut-in of the wells, is not temporary. Rather, it is of indefinite duration. That being the case, the Ministry's order is not the kind of intervening cause for which article 11 was intended.

Justice Currie also relied for this conclusion on evidence (at para 42) to the effect that CNRL would likely not return to production on the lease without a change in the terms of the lease.

In any event, having reached the conclusion set out above Justice Currie found it unnecessary to address the question of whether the shut-in occurred for a "cause beyond the lessee's reasonable

control" or as Justice Currie put it (at para 44) "whether Canadian Natural has taken reasonable steps to recover from the Ministry's order."

It seems to me that this is an unreasonable interpretation of the lease. The lease does not distinguish between temporary and indefinite shut-ins. Neither does the case law. Most of the shut-in case law deals with shut-in gas wells. Those wells were shut-in for market conditions. Many wells were shut-in for very long periods because of the absence of a profitable market (see for example, *Freyberg v Fletcher Challenge Oil and Gas Inc.*, 2005 ABCA 46 (CanLII)) and nobody was in a position to predict in advance when those market conditions would improve and permit production. Now it may well be, given the demanding case law on the term "beyond the lessee's reasonable control" (see *Canada-Cities Service Petroleum Corporation v Kininmonth* (1963), 1963 CanLII 525 (AB CA), 44 WWR 392 (Alta CA) (the issue was not addressed on the further appeal to the Supreme Court of Canada, [1964] SCR 439, 1964 CanLII 81 (SCC)) and *Montreal Trust Co v Williston Wildcatters Co.*, 2001 SKQB 360 (CanLII)), that CNRL was not entitled to succeed on that basis but it is clear that Justice Currie never addressed his mind to this question. Instead he answered another question of his own choosing.

Finally, it is worth noting that CNRL's weak estoppel argument was dismissed as was CNRL's claim that the notice served by Rife and Canpar was defective. Any defects were immaterial for the simple reason (at para 49) that "This case … is not about breach by a lessee, and it is not about a lease being terminated by notice. This case is about whether the lease terminated automatically by operation of its provisions, something that was not dependent on either a breach or notice." And with that I entirely agree.

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