

NEWSLETTER

The Freehold Owners Association (“FHOA”)

1403 -12th Street S.W., Calgary, Alberta, T3C 1B3

Tel: (403) 245-4438; Fax: (403) 245-4420;

E-mail: fhoa@shaw.ca; Web Site: www.fhoa.ca

February 10, 2005

WE EXPECTED BETTER

In the words of the Right Honourable Beverley McLachlin, P.C., Chief Justice of Canada:

“Canadians ... appear to share a profound belief that when other institutions fail, one can count on the fairness of the courts.”

and

“That confidence hinges on the conviction that those who are chosen to sit on the Supreme Court of Canada are the most competent and fiercely independent legal minds that one can find.

and

“Every judge in Canada is committed to performing this important role skilfully and impartially. Canadians should expect no less.”

Supreme Court Website

In April of 2004, the Freehold Owners Association intervened before a five-member panel of the Supreme Court and presented verbal argument in an appeal of an Alberta Court of Appeal ruling impacting tens of thousands of freehold owners. FHOA expected an impartial hearing in which the justices of the Supreme Court would direct challenging questions to both sides of the dispute. FHOA’s expectations were not met.

In July of 2004, the Supreme Court issued a written judgment unanimously upholding the Alberta Court of Appeal

ruling. Based on the tone of the April hearing, FHOA had anticipated an adverse ruling from the Supreme Court. But we also expected the Court to address the issues raised in the appeal in a competent, skilful and impartial manner. Our expectations were not met.



The law is simply expediency wearing a long white dress.

Crisp, Q, Manners from Heaven, 1984

To be clear, the Supreme Court of Canada has no specific obligation to

address any of the arguments advanced by the litigants who appear before it. However in a dispute pitting the property rights of thousands of individual Canadians against those of one of Canada’s largest and most influential corporations, the failure of the Court to rebut any of the legitimate arguments advanced by either the appellants or FHOA is profoundly disturbing and calls into question the impartiality of Canada’s highest court.

This issue of your newsletter focuses on the Supreme Court decision, its implications for individual owners of split title freehold mineral rights and its broader implications for all freeholders and this association.

In this issue ...

THE SUPREME COURT DECISION	2
Lack of Recourse	2
The Economics of Law	2
The Role of the Supreme Court	3
The Origin of Split Titles	3
How the Issue Arose	3
The Nature of Hydrocarbons	4
Borys v. CPR and Imperial Oil Limited	5
Borys Revisited	6
The Alberta Courts’ Rulings	6
FHOA’s Intervention	7
Impartiality	8
Verbal Argument	8
The Supreme Court Ruling	8
Implications for Split Title Owners	10
Broader Implications	10
GOING FORWARD	11
Coming Seminars	11
Coal Bed Methane	11
Funding	12
Membership	12

THE SUPREME COURT DECISION

In medieval times, alchemists attempted to turn base metals such as lead into precious metals like gold.



Today, googling ‘alchemy’ returns hundreds of web sites dedicated to the practice of turning all manner of things one doesn’t like or want into things one does.

FOA has struggled with how to explain the Supreme Court decision in a positive manner to our members. Regrettably, we are not alchemists and we have found no way to sugarcoat the Court’s decision.

For the following reasons, judicial decisions involving freehold mineral rights are important to all freeholders and a Supreme Court decision dealing with the fundamental property rights of freeholders is particularly critical. What follows is not light reading, but your contributions paid for our intervention and you deserve an accounting.

Lack of Recourse

For legal purposes, an owner of freehold mineral rights (a ‘freeholder’) owns ‘land’. The property rights of most Canadian landowners are protected under provincial statute. For instance, the activities of real estate agents, brokers and salespersons are regulated in every province and territory. In Alberta, the operations of the oil and gas industry have given rise to specific legislation protecting landowners. Under the Land Agents Licensing Act, all agents dealing with surface rights are required to be licensed and to abide by strict ethical guidelines in their dealings with surface owners. Under the Surface Rights Act, disputes between surface owners and oil and gas industry operators respecting such matters as compensation for well site access are adjudicated by an independent panel. The Alberta Energy and Utilities Board (the “AEUB”), which regulates all oil and gas industry operations in the Province, has instituted an ‘appropriate dispute resolution’ (“ADR”) mechanism in an attempt to improve landowner/industry relations and resolve disputes through negotiation. Significantly, the AEUB’s ADR initiative **does not apply** to disputes between freeholders and the oil companies who lease their mineral rights and the Land Agents Licensing Act **does not apply** to agents who lease freehold mineral rights.

The land which to freehold mineral rights owners hold title is often far more valuable than the overlying surface rights, yet Alberta freeholders have no protection whatsoever under Provincial statute. A freeholder’s only recourse in disputes with oil and gas industry operators is to the courts. That’s where what’s known as ‘the economics of law’ comes in.

The Economics of Law:

Would you sue the oil company that had leased your mineral rights if you thought the company was overcharging you \$10 a month for gas gathering and processing fees? How about \$100 or \$1,000 per month? Not likely!

Oil and gas litigation is exceedingly expensive and most freeholders simply cannot afford it. Besides, Canada has a ‘loser pays’ judicial system whereby the loser in a law suit pays the winner’s costs. The Canadian courts have not specifically addressed the issue of what deductions are reasonable from freehold royalties. Consequently, if a freeholder of ordinary financial means sued an oil company over gathering and processing deductions and lost, the freeholder could face bankruptcy.

In the United States, freeholders often join together in class actions against oil companies. For example, last year a District Court Judge in Kansas approved a pre-judgment settlement in a class action sponsored by the South West Kansas Royalty Owners Association which alleged improper gas gathering and marketing deductions from freehold royalties. The settlement required BP Amoco to pay forty-nine million dollars to approximately 7,000 freehold owners.

The Alberta Government enacted legislation providing for class actions in Alberta in 2003. The Alberta Class Proceedings Act differs from class action legislation in other provinces and in the United States in that it provides no protection to the member of the class who is named as the representative plaintiff in the event the class action does not succeed and costs are awarded by the court. Due to this deficiency and the magnitude of the cost awards in complex oil and gas litigation, the Class Proceeding Act is of no practical use to Alberta freeholders.

In the absence of Provincial regulations, Alberta freehold owners have no recourse other than the courts in disputes with oil companies, yet the 'economics of law' effectively denies freeholders this recourse in most situations. That's why the decisions of the courts are so important when the courts actually do deal with freehold mineral rights.

The Role of the Supreme Court

Since the Charter of Rights and Freedoms was enacted in 1982, the role of the Supreme Court of Canada has changed. In recent years, most cases heard by the Court have involved Charter or criminal law issues. In civil litigation, only about 7% of leave to appeal applications are granted by the Supreme Court. This means that provincial appellate courts have become the final arbiter of most legal disputes between individuals and corporations.

In September of 2003, the Supreme Court granted a group of freehold owners leave to appeal an Alberta Court of Appeal decision involving the ownership of hundreds of millions of dollars worth of hydrocarbons produced from wells on split title lands. This presented FHOA with an opportunity to circumvent the economics of law. Interventions are relatively inexpensive and an intervener generally does not expose itself to court costs. An intervention by FHOA would allow the collective voice of freehold owners to be heard by Canada's highest court for the first time.

In January of 2004, FHOA applied to the Supreme Court for leave to intervene in the appeal. Leave was granted in March 2004, over the strenuous objections of the involved oil companies.

The Origin of Split Titles

In prior issues of your newsletter (December 29, 2000; February 28,



2002; and November 12, 2003) and on our web site (www.fhoa.ca) we have provided members with considerable background on the 'split title problem'. Interested readers are referred to our website.

Briefly, split title mineral rights arose in the early 1900's when the Canadian Pacific Railway Company (the "CPR") sold farm-sized parcels of its 25 million acre railway land grant to western Canadian settlers. The CPR's 1881 grant included subsurface minerals and initially it was the railway company's policy to sell land to homesteaders in the same form as the land had been received from the Dominion Government. The CPR began to reserve coal rights for its own account in approximately 1904; coal and petroleum rights in approximately 1906; and rights to all mines and minerals in approximately 1912.

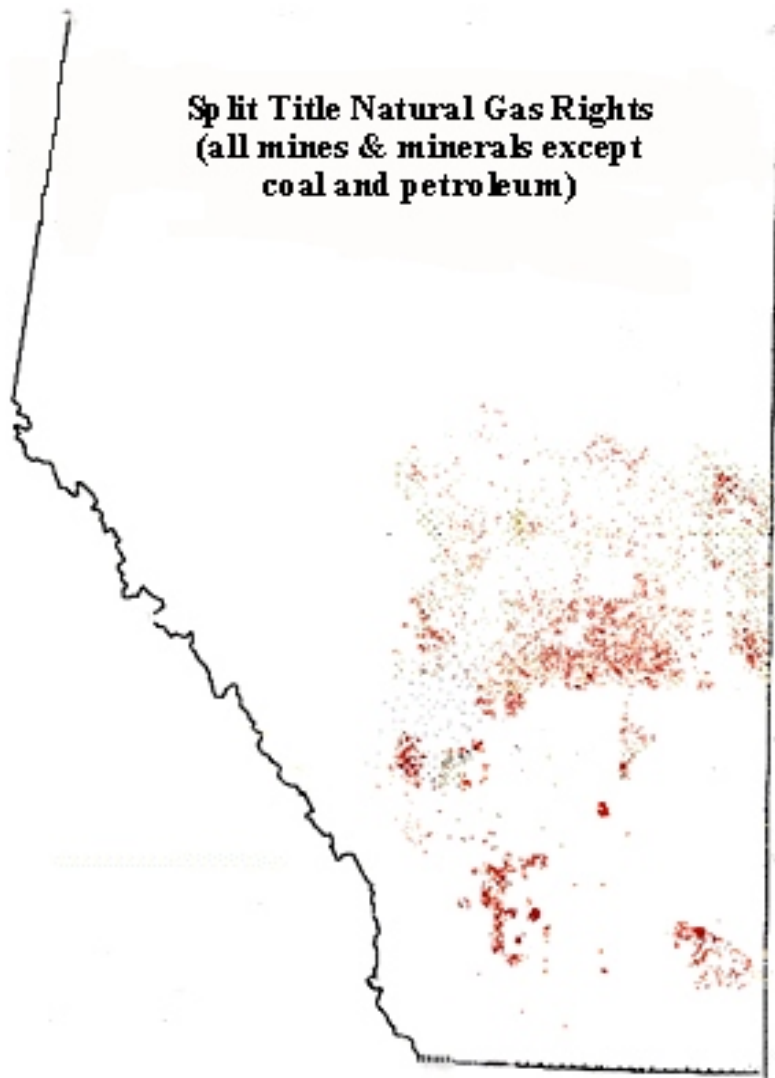
Alberta was the last of the prairie provinces to be settled and most settlement occurred after 1889 when the Dominion Government stopped including subsurface mineral rights in western Canadian land sales and grants. Consequently, most of the freehold mineral rights currently owned by individuals in Alberta were acquired from the CPR.

Settlers purchasing CPR lands during the period prior to 1904 acquired surface rights and rights to all subsurface mines and minerals (including coal, petroleum and natural gas). During the period between 1904 and 1912, the CPR's land settlement policies gave rise to two different types of split title land.

Firstly, settlers who purchased homestead lands from the CPR during the 1904 - 1906 period acquired rights to all mines and minerals beneath the surface except for the coal reserved by the CPR. Secondly, settlers who purchased CPR lands during the 1906 - 1912 period acquired rights to all mines and minerals except for the coal and petroleum which the railway company reserved. The issue before the Supreme Court of Canada specifically involved this second type of split title. The location of the approximately one million acres of land in Alberta where title is split in this manner is shown on the next page.

How the Issue Arose

Natural gas was considered to be a dangerous nuisance in the early 1900's. That perception began to change when a primitive pipeline was completed to carry natural gas from Bow Island to Calgary in



1911. Although legal opinions in the Glenbow Museum CPR files indicate that the railway company's lawyers advised management that the CPR did not own the natural gas beneath split title lands, for petroleum leasing purposes the railway company demanded a royalty on all gas produced and marketed from these lands. Royalite No. 4, the discovery well for the giant Turner Valley field, was drilled on split title lands in 1924. The CPR received all of the royalties from this well - the well produced more than 32 billion cubic feet of natural gas and no petroleum whatsoever.

Almost half a century passed before Michael Borys, a freeholder who owned a quarter section of split title mineral rights near Leduc, challenged

the CPR's position.

In February of 1947, Imperial Oil Limited had discovered the giant Leduc Woodbend D-3 oil pool. This pool is what today's courts refer to as a 'mixed pool'. The porous and permeable ancient reef in which the hydrocarbon accumulation is found initially contained an approximately 200 foot thick gas cap overlying 40 feet of petroleum which, in turn, overlay water. By 1949, Mr. Borys' quarter section was surrounded by producing wells and Imperial had leased all the petroleum which might be found to exist beneath the land from the CPR and spudded a well on the quarter. In the fall of 1949, Mr. Borys initiated a law suit claiming that

petroleum and natural gas were separate substances and that he was the owner of all natural gas within, upon or under his lands.

The Borys courts were faced with a challenging problem due to the peculiar nature of the hydrocarbons (compounds containing hydrogen and carbon) which comprise petroleum and natural gas.

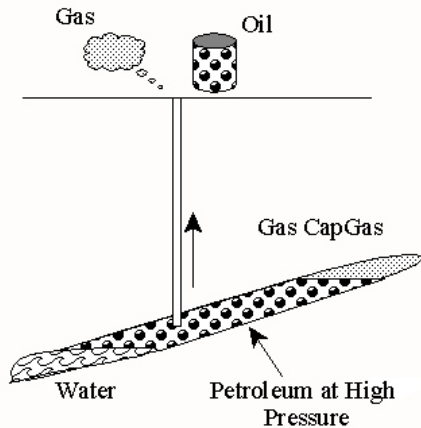
The Nature of Hydrocarbons

There are hundreds of thousands of different hydrocarbon compounds. Those with fewer than four carbon atoms in their molecular structure (methane, ethane, propane and butanes for example) are gaseous under standard surface temperature and pressure conditions. Those with from five to fifteen carbon atoms (pentanes, hexanes, heptanes, etc.) are liquid. In nature, these hydrocarbons seldom exist in isolation. Due to their similar molecular structures, they are generally soluble in each other and are found in nature in the form of highly complex liquid and gaseous solutions. Significantly, the solubility of each component of the solution is dependent on the temperature and pressure under which the solution is confined.

The petroleum beneath Mr. Borys lands was an exceedingly complex solution of normally liquid hydrocarbons containing significant quantities of normally gaseous hydrocarbons dissolved in the liquid solution. The natural gas was a complex gaseous solution containing all of the same hydrocarbons as the petroleum, but in different proportions. The average pressure in the pool in 1947 was 1,910 psi and the average temperature was 150° Fahrenheit.

When petroleum moves from the high pressure of the subsurface to the surface in the production process, the decline in confining pressure causes gas to be released from liquid solution. Similarly when natural gas moves up a

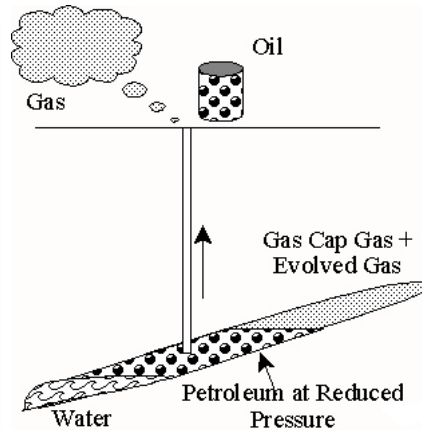
well bore, the decline in confining temperature causes normally liquid hydrocarbons dissolved in the gas to condense from the gaseous solution. The diagram below illustrates what happens in a mixed pool like the Leduc D-3 when the first well to discover the pool begins to produce - a combination of gas and oil is produced at surface from the liquid petroleum recovered at the



bottom of the well bore. Clearly, if petroleum and natural gas are to be distinguished based on their phase condition (liquid or gas), it is critical to specify where the distinction is to be made.

But phase changes also occur over time. Once petroleum begins to be produced from a mixed pool such as the Leduc D-3 pool, the pressure throughout the pool begins to decline. This causes gas to be released from petroleum within the pool. Today's courts refer to this gas as 'evolved gas'. Some of this evolved gas flows to the producing well bores and to surface. This causes the volume of gas produced at surface to increase relative to the volume of oil (the produced gas/oil ratio). The composition of the gas and oil produced at surface also gradually changes, the gas growing richer in valuable natural gas liquids as time passes. The evolved gas which does not flow to the producing well bores remains in the pool and gradually intermingles with and becomes indistinguishable from the pre-existing

gas cap gas. As production continues, the volume of petroleum in the pool continually decreases; the volume of gas continually increases; and the composition of both the gas and petroleum remaining in the pool changes. The diagram below shows the same mixed pool some time after production from the pool has resulted in a significant decline in pool



pressure. As a consequence of the changes in volume and composition which occur over time both at surface and in the subsurface, if petroleum and natural gas are to be distinguished based on their phase condition, it is necessary to specify when the distinction is to be made.

Borys v. CPR and Imperial Oil Ltd.

Mr. Borys case was heard by the Chief Justice of the Trial Division of the Alberta Supreme Court. The CPR and Imperial argued that the word petroleum in their reservation included natural gas. Mr. Borys argued that petroleum and natural gas were separate substances to be distinguished based on their phase condition at surface. He also argued that Imperial could not produce the CPR's petroleum without interfering with and wasting his gas, and sought a permanent injunction preventing this interference. In 1951, Chief Justice Howson ruled in Mr. Borys' favour and granted his injunction.

In 1952, the Appellate Division of the Alberta Supreme Court agreed that petroleum and natural gas were separate substances but ruled that the CPR had reserved petroleum in the earth and that the phase change which occurred when the liquid was brought to surface ought not to affect original ownership.

Legal scholars typically describe the concept of fee simple ownership as the greatest bundle of property rights available under the common law. Paramount within this bundle is the right of an owner to seek the assistance of the state in preventing others from interfering with what he owns. Mr Borys was the registered fee simple owner of his quarter section and everything within it, subject only the CPR's reservation of coal and petroleum. The Appellate Division recognized that Imperial would use and interfere with Mr. Borys' gas in producing its petroleum, but the court vacated the injunction preventing this interference on the basis that:

“gas in the earth may be likened to subterranean waters and they are subject to like principles of law”.

The common law respecting ownership of subterranean waters has been settled for more than a century. A fee simple owner of land owns any subterranean water which he recovers in a well on his lands when he recovers it or reduces it to possession. However, if subterranean waters beneath his land are first recovered by a laterally or vertically adjacent property owner, he has no legal recourse against his neighbour.

In 1953, the Judicial Committee of the Privy Council, then the highest court of appeal in the Commonwealth, ruled that the Appellate Division judgment was right in all respects. With respect to ownership, the Privy Council specifically quoted what is known as

the *ratio* or reason for the decision of the Appellate Division:

The trial Judge found that petroleum and natural gas were, by common usage, two different substances, and that conclusion ought not to be disturbed. I am, however, with respect, unable to agree with him that the reservation 'petroleum' did not include gas in solution in the liquid as it exists in the earth. What was reserved to the railway company was petroleum in the earth and not a substance when it reached the surface. It is true that by change of pressure and temperature, gas is released from solution when the liquid is brought to the surface but such a change out not to affect the original ownership ...

In my opinion, all the petroleum reserved, including all hydrocarbons in solution or contained in the liquid in the ground, is the property of the defendants who are entitled to do as they like with it, subject, of course, to the observance of all relevant statutory provisions and regulations.

So what does all that mean?

In FHOA's opinion, it means that the Privy Council confirmed the Appellate Division's decision to change where not when ownership was to be determined. Instead of determining ownership based on the phase of the hydrocarbons produced at surface, ownership was to be determined based on the phase of the hydrocarbons recovered at the bottom of the well bore. Others have different opinions. What really matters, or should matter, is what the Privy Council understood these words to mean. The Privy Council clearly and concisely summarized the meaning of these words as follows:

“the Court of Appeal adopted a compromise, viz., the condition of the substance as it emerges from time to time from the reservoir.”

Borys Revisited

In the early 1990's, 21 legal actions were initiated by freehold owners in the Court of Queen's Bench of Alberta. In 1997, at the request of the 59 oil companies who were the defendants in these legal actions, the Chief Justice of the Court of Queen's Bench halted these actions and ordered a trial to determine two preliminary issues of law:

- the ownership of hydrocarbons produced from a well on split title lands; and
- the duty of lessees to account for this production.

The Alberta Courts' Rulings

At trial and before the Alberta Court of Appeal, the defendant oil companies argued that the Privy Council decision in *Borys* was applicable and binding authority for ownership of both petroleum and natural gas produced from a well on split title lands to be fixed absolutely at the time of the CPR reservation based on the phase condition of the hydrocarbons as they then existed in the ground. The freehold owners agreed that *Borys* was applicable and binding authority for ownership determination based on the phase of the hydrocarbons in the ground, but argued that the Privy Council decision stood for ownership determination when the substances were recovered at the bottom of a well bore on split title lands.

The freehold owners claimed ownership of any gas recovered irrespective of whether the gas had originally been in solution in petroleum or in 'connate water'. The trial judge defined connate water to be water which lines the pores of hydrocarbon bearing rocks or exists as

a separate layer beneath the hydrocarbon accumulation. Connate water contains small volumes of gas in solution which is released when pool pressure declines. This released gas intermingles with, and becomes indistinguishable from, gas evolved from petroleum and any pre-existing gas cap gas in the pool.

The freehold owners also argued that the defendant oil companies who had leased their natural gas rights were intentionally misinterpreting *Borys* because of their contractual obligations to the CPR and its successors (the "petroleum owner"). Most of the petroleum lease agreements in evidence required these companies to pay royalties to the petroleum owner on natural gas owned by the freehold owners and to indemnify the petroleum owner against any damages a court might award against it.

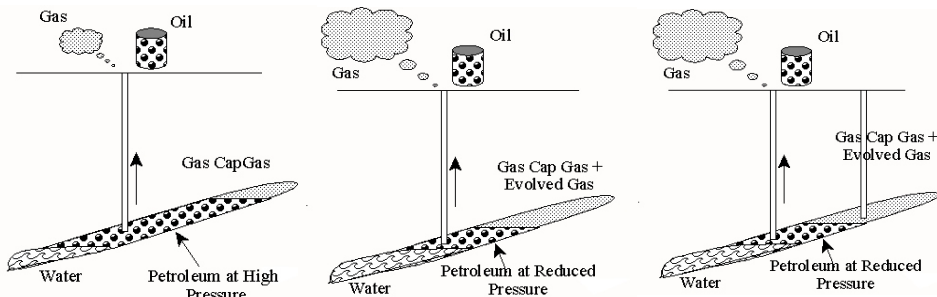
The trial judge ruled that these petroleum leases were "fair" and that *Borys* stood for ownership determination prior to human disturbance at the time of the reservations. According to the trial judge, the Privy Council summary of the Appellate Division decision it upheld was wrong and not binding upon her. The trial judge ordered the freehold owners to immediately pay the oil companies they were suing more than \$600,000 in costs for the 6 ½ day trial.

Costs were paid and the trial judge's ownership and cost decisions were appealed to the Court of Appeal of Alberta. The Appeal Court was in substantial agreement with the trial judge and upheld her rulings except for the portion of her ownership ruling in which she found that the vernacular or everyday meaning of petroleum at the turn of the last century included water. The Appeal Court ruled that gas which evolved from connate water did not belong to the CPR or its successors.

FHOA's Intervention

FHOA chose to seek leave to intervene in the appeal before the Supreme Court for three reasons.

Firstly, we thought the ownership decision of the Alberta Courts was clearly wrong. The CPR reserved all coal and petroleum “which may be found to exist within, upon or under” the lands it sold to our forefathers. Think about these words in the context of the changes which occur in the ground as a pool is produced :



You can't 'find' petroleum without drilling a well. In the far right diagram, a second well has been drilled on split title lands after production has occurred from the mixed pool in our previous example. No petroleum is found. Only gas is found and recovered at the bottom of the well bore. But, according to the Alberta Courts, the CPR's successors own any gas recovered from this well which was originally dissolved in petroleum anywhere in the pool. How could this be when the CPR clearly reserved only the petroleum which might in the future be found to exist beneath the lands and when the Privy Council clearly stated that:

“... the condition of the substance as it emerges from time to time from the reservoir” determines ownership; and “those who make the recovery become owners of the material

which they withdraw from any well which is situated on their property”.

Furthermore, who decides how the gas recovered is to be allocated between the individual freeholder and the petroleum owner? The company that has leased natural gas from the individual freeholder and petroleum from the CPR or its successors decides. And, on what basis is the allocation made? The gas recovered is a combination of initial gas cap gas, evolved gas and gas released from

oil companies they were suing more than \$600,000 for costs of a trial of a preliminary issue of law which did not dispose of any of the law suits underlying the preliminary issue. In our opinion, costs should only have been made payable after the merit of the freeholders' legal actions had been judicially determined. The cost decision was particularly troubling because most of the freeholders were suing to recover royalties on the gas which the Alberta Courts had ruled belonged to them.

Thirdly, the issue being appealed to the Supreme Court was the ownership of hydrocarbons produced from wells on lands sold to the homesteaders by the CPR subject to a reservation of all coal and petroleum. It has been estimated that up to 500 trillion cubic feet of coal bed methane (CBM) exists in subsurface Alberta coal beds. The coal beds most prospective for CBM development lie in the same area of the Province as individually-owned freehold mineral rights. Encana Corporation, as successor to the CPR, claims ownership of CBM beneath lands in which it holds title to coal, including the split title lands in issue as well as those split title lands where the individual freeholders' title is to all mines and minerals except coal. FHOA was concerned that if the Alberta Court ruling was upheld by the Supreme Court, the ownership of CBM would be decided in Encana's favour.

connate water, but there are no labels to identify these components. Is it reasonable to expect the allocation to be made fairly when the company making the allocation has conflicting contractual obligations with a powerful corporation on one side of the conflict and an individual freeholder on the other? Can pigs fly?



Secondly, the Freehold Owners Association was concerned with the practical implications of the cost award. In FHOA's view, it was fundamentally unfair for the Alberta courts to order a group of individuals of ordinary financial means to pay the

Impartiality

According to the Canadian Judicial Council:

“Impartiality is the fundamental qualification of a judge and the core attribute of the judiciary”.

and

“True impartiality does not require that the judge have no sympathies or opinions, it requires that the judge nevertheless be free to entertain and act upon different points of view with an open mind.”

Verbal Argument

The Supreme Court rules provide the appellant with one hour to present oral argument to the Court. During counsel’s for the appellants opening remarks, the following exchange took place:

Counsel:

“And of course there will be a discussion on connate water, which is water in a reservoir.”

Justice Jack Major:

“Connate water, nobody’s.”

Two minutes later:

Counsel:

“Is natural gas capable of being owned absolutely, before recovery, or before it is reduced to possession? That is simply the issue before this court.”

Justice Major:

“*Borys vs. C.P.R. and Imperial Oil Ltd.* case, as I understand it, determined the issue, or that the issue should be determined before commencement of drilling.”

Later still:

Counsel:

“... And I say gas cannot be owned”

Justice Major:

“That’s what you’ve been told you own.”

Counsel:

“Right. That’s what I’ve been told I own by the CPR, that’s true, and the Respondent lessees.”

Justice Major:

“And the Privy Council and every place you’ve been so far.”

Do these exchanges demonstrate a judge with an open mind free to entertain and act upon different points of view or someone who has pre-judged the case?

The Supreme Court Ruling

Justice Major wrote the unanimous decision of the five-member Supreme Court panel. The Supreme Court ruled that the Alberta Courts were correct in finding that *Borys* stood for ownership to be fixed based on the phase condition of the substances at the time of the CPR reservation.

FHOA’s written argument together with the Supreme Court’s ruling (annotated with our comments) have been posted to our web site. Summarized below are a few of the more egregious inconsistencies in the Supreme Court decision.

The freeholders submitted that, pursuant to well-established principles of property law, fugacious substances such as gas, oil and water cannot be owned absolutely before they are recovered or reduced to possession. In *Borys*, the CPR and Imperial had argued before the Privy Council that “gas is even more fugacious than water and must be treated on the same principles”. Both the Privy Council and the Alberta Appellate Division accepted this argument. Ironically, the same companies who convinced the *Borys* courts fifty years ago that gas was like water and consequently Mr. Borys’ ownership of it should not be protected by the state, argued before the Supreme Court of Canada that

Borys was authority for gas to be owned absolutely like a hard mineral. The Court accepted this obvious paradox without question.

The Supreme Court decision makes no reference whatsoever to the reliance placed by the *Borys* courts on the principles of law applicable to percolating water.

The Supreme Court did make reference to oil and gas ownership theory. It was argued that no court had ever before ruled that oil and gas could be owned absolutely before recovery. According to the Supreme Court, ownership theory was not required to determine the appeal because the parties chose to divide their interest by contract.

Think about that! Could you and I divide the fish that may be swimming in the stream on my land today based on a contract? Of course we can’t! We could contract to divide the fish which we might catch in the future, based on some parameter such as the size or colour of the fish when we caught it, but neither you or I know how many fish exist in my stream today and, even if we did, those fish might have grown, changed colour or swum elsewhere tomorrow. The fish in the stream, like



That looks like one of mine!!!

the birds in the sky, and oil and gas in the ground are fugacious or fleeting and have no labels which would allow them to be identified prior to their capture with the certainty that the legal concept of ownership entails.

How could five “fiercely independent legal minds” sign off on this type of legal reasoning?

According to the Supreme Court: “When the substance, which was not in their possession at the time of the contract, is reduced to possession, the date and terms of the contract govern their relative entitlement.”

If the terms of the contract govern, it would presumably be appropriate for the Court to make some reference to these terms. The CPR drafted the transfer agreements which gave rise to split title lands. The wording in the transfer agreements which were before the Supreme Court and the Borys courts is identical. In these agreements, the CPR reserved all coal and petroleum “which may be found to exist within, upon or under” the lands. These are the only words in the contracts which provide the CPR with any interest in the lands, and the words ‘which may be found to exist’ describe and define the petroleum which the CPR reserved.

The principle economic issue before the Supreme Court was the ownership of hydrocarbons which were initially dissolved in liquid petroleum; evolved from petroleum due to pool pressure decline; and were found to exist in the form of gas. In FHOA’s view, evolved gas cannot belong to the CPR and its successors by virtue of the plain meaning of the words in the reservation which the CPR drafted. The CPR reserved only the liquid petroleum which might be found to exist and, according to the Privy Council:

“The substance which is found

in the form of gas in situ is therefore not the subject of reservation and remains the property of the appellant.”

But, according to the Supreme Court:

“For the purposes of these reservations, “petroleum” includes all hydrocarbons in liquid phase under the tract of land prior to any development.”

The Supreme Court has the authority to decide that the word ‘petroleum’ includes ice cream if it wants, but it is hard to rationalize the Supreme Court’s meaning of the word with the Privy Council’s reliance on the vernacular meaning of petroleum:

“In the ground there is a distinction, one is then liquid and the other gaseous and the liquid may naturally be called petroleum and the gaseous gas.”

The distinction drawn by the Privy Council is clearly not time dependent and nowhere in the *Borys* decisions is there any reference to initial reservoir conditions. Further, the pleadings in *Borys* reveal no claim by Imperial or the CPR to the substances as they existed at any time prior to their being found. How could they, the CPR had reserved all petroleum which may be found to exist within, upon or under Mr. Borys’ lands and Imperial had leased from the CPR the petroleum “which may be found within, upon or under” the land.

The CPR could have reserved all petroleum which existed at the time of the reservation. It did not and, in FHOA’s view, it should be bound by the plain meaning of the words it used.

Why is there no reference whatsoever in the Supreme Court decision to the ‘which may be found to exist’ wording used to describe the

petroleum reserved?

According to the Supreme Court, there was no need for the Court to determine who owned the gas evolved from connate water because all of the parties to the appeal agreed that the Province of Alberta owned connate water by statute. The only parties to the appeal that agreed to this were the oil companies.

And what about the Privy Council’s summary of the ownership decision of Appellate Division which it upheld:

“the condition of the substance as it emerges from time to time from the reservoir.”

This summary is entirely consistent with ownership determination based on the principles of law applicable to percolating water which were relied upon by the *Borys* courts; oil and gas ownership theory; and the plain meaning of the CPR reservation.

The trial judge ruled that the Privy Council summary of the decision it upheld was “wrong”. The Alberta Court of Appeal agreed with the trial judge’s reasoning. One of the principal grounds of the freeholders’ appeal to the Supreme Court was that the Alberta courts had usurped the authority of the Privy Council and violated the rules of precedent by substituting their own understanding of the Appellate Division decision in *Borys* for that of a superior court.

The Supreme Court of Canada is not bound to follow Privy Council decisions and could have made new law had it chosen to do so. It did not. The Supreme Court merely confirmed the lower Courts’ finding that *Borys* stood for ownership determination at the time of the CPR reservation.

Why is there no reference whatsoever to the Privy Council’s summary in the Supreme Court decision?

The evidence before the Supreme Court was that production from mixed pools such as the Leduc D-3 causes evolved gas to intermingle with and become indistinguishable from pre-existing gas cap gas. It was argued that this gives rise to an unresolvable uncertainty if ownership is determined at the time of the CPR reservation because it is impossible to determine how much of the gas being produced from a well on split title lands is gas cap gas and how much is evolved gas. It was also argued that the historical effect of the contractual demands of the petroleum owner, as evidenced by the petroleum leases before the Court, had been to resolve all such uncertainties against the freehold owners and to cause royalties on both evolved gas and gas cap gas to be paid to the CPR and its successors.

The Supreme Court ruled that industry estimates would have to suffice for dividing up ownership. Although the uncontested evidence was that there was no uncertainty if ownership was determined based on “the condition of the substance as it emerges from time to time from the reservoir”, as per the Privy Council, the Supreme Court stated that ownership determination on this basis “could be subject to manipulation by a dishonest producer”.

The Supreme Court apparently had no concern with the effect of the petroleum leases prescribed and enforced by the CPR and its successors. During verbal argument, counsel for the petroleum owner attempted to explain why all of the petroleum leases before the Court required the involved oil companies to pay the petroleum owner a royalty on gas which the petroleum owner acknowledged it did not own. This justification of the unjustifiable elicited a queries from only one judge:

Justice Major:

off mike “...Lease he refers to, dated 1960, what was the

value of natural gas then?”

Counsel:

“I can’t tell you that, Justice Major, I don’t know what the value of natural gas was.”

Justice Major:

“I’d be right that it was pennies?”

Counsel:

“It would not be significant, I think that’s correct.”

Is it really appropriate for a justice of the Supreme Court to play ‘straight man’ for one of the parties to a dispute before the Court? Furthermore, the low price of gas 40 years ago may explain why the involved oil company would have agreed at that time to pay royalties to the CPR on gas owned by an individual freeholder; it does not justify the continued receipt of royalties on this gas by the CPR’s successor corporation at the expense of the rightful owner.

The Supreme Court agreed with the trial judge’s cost decision and dismissed the appeal. The freeholders who appealed the rulings of the Alberta courts were ordered to pay the oil companies’ costs of the appeal.

Implications for Split Title Owners

Same old, same old.

The industry (ie. the oil company that has leased the freeholder’s natural gas rights) will continue to decide whether to pay royalties to the individual freehold owner on gas produced from oil wells on lands where the freeholder holds title to all mines and minerals except coal and petroleum. The freeholder’s only recourse if he believes that gas cap gas belonging to him is being produced without proper royalty payment will be to the courts.

The AEUB designates the boundaries of all oil pools in Alberta and determines whether these pools have gas caps. The AEUB operates under the assumption that an oil pool

does not have a gas cap unless what is known as a PVT (pressure - volume - temperature) analysis of the oil proves the existence of a gas cap or a gas cap is penetrated in at least one of the wells in the pool. Less than 20% of oil pools in Alberta have PVT analyses and many single well oil pools have gas caps which the AEUB does not recognize.

Even if the AEUB has determined that a gas cap initially existed in the pool, the freeholder must still prove to the satisfaction of the court that gas cap gas is being produced from the well on his lands. In most instances, this cannot be proven.

Approximately 1% of the gas produced from oil wells on split title land is gas which has evolved from connate water. In some situations this percentage can be significantly higher. Whoever owns this gas it is not the petroleum owner, yet the CPR’s successor corporation will continue to receive royalties on this gas.

The involved oil companies objected to the Freehold Owners Association raising any matters having to do with the ownership of CBM in our intervention, and the Supreme Court ruled that FHOA could not argue the issue. If there is anything positive respecting the Supreme Court decision, it is that FHOA’s intervention resulted in the Supreme Court specifically limiting the appeal to the reservation of petroleum. As a result, the ownership of CBM remains undecided.

Broader Implications

The Supreme Court of Canada has ruled that hundreds of millions of dollars worth of evolved gas production belongs to Canada’s largest independent oil company and not to thousands of individual Canadians. In reaching its decision, Canada’s highest court:

- declined to consider oil and gas ownership theory to the contrary,

ostensibly because the parties had divided their interests by contract; - ignored the plain meaning of the words in the contract; and - did not bother to address a conflicting conclusion of law in the ruling of a court of equivalent stature.

How were the freeholders to know that the Privy Council was wrong when it stated that ownership was to be determined based on “the condition of the substance as it emerges from time to time from the reservoir.” ?

What possible justification can there be for ordering the freeholders who relied on this conclusion of law to pay three quarters of a million dollars in court costs for a trial of a preliminary issue they did not seek before the merit of their individual law suits has even been heard?

The Freehold Owners Association was formed five years ago for purposes of providing information and education to freehold owners and promoting greater fairness for freeholders. The volunteers who direct and manage FHOA’s affairs were under no illusions that correcting the injustices that freeholders have suffered over the years at the hands of the oil and gas industry would be easy. We did however share with other Canadians what Chief Justice McLachlin’s describes as “a profound belief that when other institutions fail, one can count on the fairness of the courts”.

Justice McLachlin, your court has not met our expectations.

GOING FORWARD

In isolation, FHOA’s intervention before the Supreme Court of Canada in 2004 can only be described as an abject failure. We wasted your money and our time.

But it has been said that:

“Success is the ability to go

from one failure to another with no loss of enthusiasm.”

Sir Winston Churchill

Perhaps that attitude explains why Britain won World War II. FHOA’s volunteers have not lost their enthusiasm. The offensive nature of the Supreme Court ruling has actually renewed our determination to seek greater fairness for freehold owners.

Coming Seminars

FHOA’s next mineral rights seminar will be held in the Memorial Arts Building, 5206 - 50th Street, Wetaskiwin, Alberta on February 24, 2005 from 7:00 to 10:00 pm. Topics on the agenda include:

- coal bed methane;
- royalty statements and auditing;
- what to do when the landman comes calling; and
- holdings and reduced spacing applications.

For further information call 780 352-2082 or 780 352-0360.

Coal Bed Methane

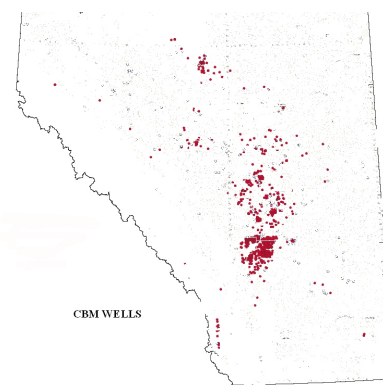
Since the turn of the millenium, the number of wells drilled or re-completed in Alberta for the purpose of producing CBM has grown from 50 to more than 2500. More than 1500 of these wells having been drilled or re-completed in the first 9 months of 2004. Associated with this ever increasing CBM well activity has been an increase in industry leasing of both Crown and freehold mineral rights in areas deemed most prospective for CBM development.

The adjacent map shows the location of CBM wells to September, 2004. It is apparent that the majority of industry CBM well activity corresponds to the area of the Province where the six million acres of mineral rights owned by individual freeholders are checker-boarded with Crown mineral rights.

Since the spring of 2004, FHOA has participated in the Multi-Stakeholder Advisory Committee (MAC) struck to provide recommendations to the Government of Alberta on issues having to do with the development of CBM in the Province. FHOA’s principle concern in participating in the MAC was to ensure that all stakeholders, including freeholders, receive a fair return from the environmentally sound development of CBM. The MAC has now received the final reports of the water, surface/air and tenure working groups and is reviewing their recommendations prior to submitting a final report to the Government. Following release of the final report, FHOA intends to provide its members with a complete review of the MAC recommendations from a freeholder’s perspective.

At this point, we can advise members that many of the issues respecting CBM which FHOA considers particularly important to freeholders were considered to be out of scope and were not addressed in the working groups reports.

FHOA is particularly concerned with the impact of checkerboarding.



In the case of freehold lands which are already leased, the Crown’s sliding scale royalty results in a CBM developer paying a lower royalty on

Crown lands than on adjacent freehold and may result in the preferential development of Crown lands and the sterilization of offsetting freehold.

In the case of open freehold, many CBM developers are offering freeholders lease agreements with sliding scale royalties. Unfortunately, the sliding scale is a 'one way street' - the CBM developer pays 'Crown-type' 6 - 8% royalties if low volume CBM production is encountered but, in the event that conventional high volume production is found, pays the typical 15 - 18% freehold royalty rather than the 'Crown-type' 30%.

The problem could be resolved with a new form of freehold lease and FHOA is acutely aware of the need to finalize the 'freeholder-friendly' lease agreement which we have now been working on for more than a year. FHOA also recognizes that work needs to be done in an attempt to resolve the checkerboarding problem as it relates to existing freehold leases.

Funding

In addition to goals directly related to CBM, FHOA also needs to update our web site to include a frequently asked questions section and information on estate planning, freehold mineral tax, resource allowance, reduced spacing units or holdings, and coal bed methane.

We cannot accomplish these goals without increased funding.

Last fall, FHOA made a proposal to Alberta Energy under which a tiny fraction of the mineral tax which the Province collects annually from individual freeholders would be dedicated to our association over a four-year period during which FHOA would grow its membership to the point of self-sufficiency. We sought \$200,000 in annual funding. With this modest level of funding, FHOA anticipated being able to both

accomplish our many goals and maintain our fees at low levels.

FHOA has asked newly-appointed Energy Minister Greg Melchin for a meeting to discuss our proposal. We are hopeful that the Minister will recognize that our association is not only providing a valuable and desperately needed service to freehold owners, but has the potential to help both government and industry resolve some of the more difficult problems involved in CBM development.

Regrettably, hope doesn't pay the bills.

Membership

Last year, FHOA set a goal of growing its membership to 2,500 freeholders. We are pleased to report that we exceeded our goal and 2,600 freeholders representing more than 8,000 freehold owners have now joined the association.

This year, our goal is to again grow FHOA's membership by at least 25%.

You will note in the attached membership renewal form that we have increased our annual membership fee to \$30.00. We are also increasing our seminar attendance fees to \$20.00 per attendee and our technical service fee to \$75.00 for members and \$150.00 in the case of professionals.

Since inception, FHOA has consciously refrained from raising fees because we recognize that many of the freeholders who most need our services are elderly and live on fixed income. These are the association's first fee increases since inception. Unfortunately, the increases are necessary to ensure FHOA's survival. In the event the Government of Alberta agrees to provide FHOA with the modest financial support we have requested, the board of directors may give consideration to rolling back these increases.

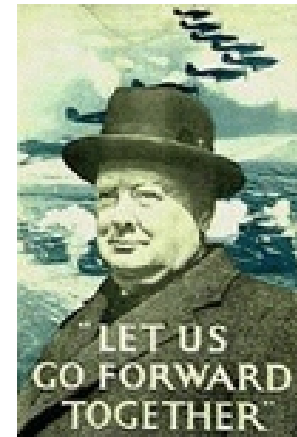
FHOA's board recognizes that increasing membership and other fees will not, in itself, resolve the association's chronic under-funding problem. At our most recent board meeting a number of options were considered and I hope to be in a position to report positively to members in our next newsletter.

It has been said that:

"... beating your head against the wall is more likely to cause a concussion in the head than a hole in the wall"

Sidney J. Harris, 1917 - 1986

We prefer the optimism of Winston Churchill.



Second World War Poster

You be the judge. If you think we are 'beating our head against the wall', don't renew your membership. If you think, as we do, that a large group of concerned citizens can make a difference in a democratic society, renew your membership and convince any family members or friends who own mineral rights to join.

On behalf of the board of directors.

Else Pedersen, President

Canada Post Publication Mail
Agreement No. 40048377

