

**Freehold Owners
Association**

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FUNDING PROPOSAL

IN PURSUIT OF FAIRNESS AND THE
MORE EFFICIENT DEVELOPMENT OF
ALBERTA'S ENERGY RESOURCES

FUNDING PROPOSAL

EXECUTIVE SUMMARY

The Freehold Petroleum & Natural Gas Owners Association ("FHOA" or "The Freehold Owners Association" respectfully requests funding from the Alberta Government in the amount of \$200,000 per annum for a four-year period beginning in January, 2005.

The Freehold Owners Association is a federally-incorporated, not-for-profit corporation which was organized in late 1999 with the assistance of Alberta Energy to: provide information and education to individuals who own freehold mineral rights in the Province of Alberta; research issues of concern to these individual 'freehold owners' or 'freeholders'; and act as their common voice. The activities of FHOA are governed by a 14-member board of directors comprised of ordinary citizens who own freehold mineral rights together with energy industry professionals and members of the legal community who are concerned with maintaining fairness in society while still championing the fundamental principles of free enterprise. Twenty-five hundred freehold owners representing approximately 7,000 individual freeholders have joined the Freehold Owners Association to date. (*See FHOA - Objectives, Governance, Operations and Membership, p. 8; Board of Directors, Attachment One*)

Individual freehold owners hold title to the oil, gas and/or coal beneath farm-sized parcels of land comprising approximately six million acres in Alberta. Most freeholders are the descendants of Alberta's original settlers and continue to have ties to rural Alberta. Their mineral rights are concentrated in southern Alberta where they are 'checker-boarded' with mineral rights owned by the Crown. As individually-owned freehold mineral rights have passed down from generation to generation, the number of individual freeholders has increased and the titles to freehold minerals have become more and more fractionated. Currently, an estimated 50,000 individuals own interests in Alberta freehold mineral rights. (*See Background - Individual Ownership of Mineral Rights in Alberta, p. 3*)

Freehold owners generally have little or no technical oil and gas knowledge or legal experience and find themselves at a tremendous disadvantage in their dealing with the energy companies that lease their mineral rights. Particularly in rural areas of the Province, freeholders' access to competent advice and assistance on oil and gas matters may be limited or non-existent. Even if experts are available, most freehold owners are citizens of ordinary financial means and many are senior citizens living on fixed incomes who cannot afford the retainers that oil and gas lawyers and petroleum geologists or engineers typically charge. Specifically for this reason, FHOA has maintained modest membership fees to ensure everyone can access the needed information. Unfortunately, this merely transfers the cost burden of retaining technical and legal experts to FHOA, thereby limiting FHOA's ability to put in place the permanent infrastructure necessary to provide services to members, to communicate with freeholders, and to grow FHOA's membership. (*See Background - The Contractual Basis for Oil and Gas Exploration and Development, p. 3; The Plight of Freehold Owners in Alberta, p. 4*)

Most energy companies are good corporate citizens who, in their dealings with freeholders, exercise the power that their superior technical, legal and financial resources provide in a responsible manner. Unfortunately, some do not. Over time, the actions of the minority who choose to exploit vulnerable freeholders have given rise to feelings of mistrust and suspicion of the entire energy industry amongst the freehold owner community. These feelings have been exacerbated by the fact that freeholders who have disputes with the energy companies that lease their mineral rights have no effective recourse. (*See Background - The Plight of Freehold Owners in Alberta - Lack of Effective Recourse, p. 8*)

Southern Alberta is part of a mature conventional oil and gas basin and development of the area's remaining conventional reserves and exploitation of the area's unconventional resources such as coal bed methane (CBM) will require innovative approaches and cooperation amongst all stakeholders. A level of trust is essential if these reserves and resources are to be developed efficiently. FHOA is trusted by freeholders and can be effective in helping freeholders adapt to the changes necessitated by the maturation of the western Canadian sedimentary basin. In particular, the adoption of variable royalty rates tied to profitability in both future and existing freehold lease agreements will be essential if the development of CBM is to proceed efficiently on the checker-boarded Crown and freehold mineral rights in southern Alberta. The model form of freehold lease agreement which FHOA is currently developing includes a variable rate royalty. Similarly, the current trend to ever more fractionated freehold mineral titles must be halted and reversed if the remaining reserves and resources of southern Alberta are to be efficiently developed. A properly informed freeholder will not needlessly divide title in passing his or her mineral rights on to succeeding generations. (See – *What FHOA Needs to Do Going Forward - A Freeholder-Friendly Lease Form*, p. 12; *Estate Planning*, p. 14)

Since inception, FHOA has: built a comprehensive web site containing detailed information on freehold leases (www.fhoa.ca); sponsored 14 mineral rights information seminars in various areas of the Province; published 8 detailed newsletters dealing with such matters as estate planning and coal bed methane; provided basic technical information to more than 300 freeholders; answered thousands of telephone and e-mail queries; intervened on behalf of freeholders before the Supreme Court of Canada; and provided representatives to participate in a number of Government and regulatory task forces and studies. All of FHOA's accomplishments to date have been the result of the efforts of volunteer members of the association. (See *FHOA - What FHOA Has Done for Freeholders*, p. 9)

While FHOA's volunteers have established the association as a credible voice for freeholders, volunteers can only do so much and the association faces significant challenges going forward due to its financial constraints. FHOA's volunteers currently do not have time to respond to all of the questions that freehold owners pose, never mind properly researching the answers. Concurrently, the acceptance of FHOA as a legitimate voice for freeholders has placed demands on the time of those FHOA volunteers with technical and legal expertise which cannot reasonably be sustained.

A healthy and profitable energy industry is essential to all Albertans and an active sustainable association representing freehold owners will help facilitate just that. The Government could provide freeholders with the information and education that freeholders need to make the informed decisions which will be necessary to develop southern Alberta's remaining reserves and resources efficiently, but FHOA can do so at far less cost. Researching issues of concern and providing information and education to freehold owners are FHOA's principle goals. Providing FHOA with the modest supplementary financial support we need to continue our efforts on behalf of freeholders and grow our membership to the point of self-sufficiency is also the right thing to do. One of the fundamental roles of government is to represent and protect all members of society. It is also the fair and reasonable thing to do. Last year, the Government of Alberta collected almost \$100,000,000 in Freehold Mineral Tax from mineral rights owned by individual freeholders. This tax is approximately equal to a 6.9% royalty and its effect is to directly reduce the royalty rate which energy companies would otherwise be prepared to pay in freehold leases. The freeholders who directly and indirectly pay this tax receive no direct benefit in return. FHOA is asking the Alberta Government to commit over a four year period to supplement funds raised from the association's members by \$200,000 per annum. This represents approximately 2/1000ths of the amount collected as tax on production from our mineral rights. (See – *Why the Alberta Government Should Support FHOA*, p. 16)

The Freehold Owners Association was organized, in part, because the checks and balances which normally protect the vulnerable from exploitation by the powerful in Canadian society did not appear to be working in the case of freehold owners. FHOA was surprised and dismayed that our prior requests for funding support from the Wild Rose Foundation and the Community Initiatives Program

were rejected. FHOA represents a unique community with unique concerns and the association may not readily fit into any of the categories established by the various Government agencies which provide generous supplemental funding support to other not-for-profits. This does not alter the fact that FHOA represents a large group of vulnerable Albertans with serious, legitimate and long-standing concerns which need to be addressed. FHOA has consistently sought to present the plight of freehold owners in a balanced, non-confrontational, professional manner and to avoid the inflammatory rhetoric which other groups engage in with considerably less justification. FHOA trusts that the Alberta Government will find a way in which to provide FHOA with the supplemental funding the association needs over the next four years to continue to represent freeholders in a professional manner and to grow our membership so as to become self-sufficient.

The proposed funding will be used in 2005 to: complete a 'freeholder friendly' form of freehold lease agreement, to research coal bed methane development and ownership issues, and to establish the permanent administrative infrastructure needed to improve communication with freehold owners. In subsequent years, funding will be applied as deemed necessary to address future priorities while focusing on the necessity of building FHOA's membership to the point where the association is completely self-sufficient.

BACKGROUND

INDIVIDUAL OWNERSHIP OF MINERAL RIGHTS IN ALBERTA

- Individuals whose forefathers purchased farm-sized parcels of land from the Dominion Government, the Hudson's Bay Company (the HBC) or the Canadian Pacific Railway Company (the CPR) in the late 1800's and early 1900's hold title to the subsurface hydrocarbons beneath 6 million acres in Alberta.
- The mineral rights owned by these individual 'freehold owners' or 'freeholders' are concentrated in the southern portion of the Province where they are 'checker-boarded' with the 81% of Alberta mineral rights owned by the Province and the mineral rights owned by the successor corporations to the HBC and the CPR.
- Individually-owned mineral rights are typically passed down from one generation to the next. In result:
 - freeholders tend to be significantly older than the general population;
 - the ownership of the mineral rights has become increasingly fragmented over time and the number of individual freehold owners has constantly increased.
- An estimated 50,000 individuals currently hold ownership interests in subsurface coal, petroleum or natural gas in Alberta.
- Most freeholders are either members of the farm community or have direct ties to rural Alberta.

THE CONTRACTUAL BASIS FOR OIL AND GAS EXPLORATION AND DEVELOPMENT

- Energy companies wishing to explore for and develop subsurface oil and gas must obtain an agreement from the owner of the resource. The necessary rights are typically secured under 'lease' agreements.
- Oil and gas lease agreements are exceedingly complex documents which attempt to address all of the imponderables associated with one party paying to find, produce and market valuable hydrocarbons owned by the other party, when the existence of the resource is not even known. However, all lease agreements provide:
 - for the energy company to pay the owner a sum of money (the bonus) for the sole and exclusive right, but not the obligation, to explore and drill wells for a certain number of years (the primary term);
 - that if the company discovers the leased substances during the primary term, the lease will continue for as long as the leased substances are capable of production; and
 - for the owner to receive a share of production (the royalty), if the leased substances are produced and marketed.
- Leasing mineral rights in Alberta has never been 'hard core business' where two equal parties sit down to negotiate the terms of a business relationship.
- The Province of Alberta and the successor corporations to the HBC and the CPR have always prescribed the form of agreement under which they lease their mineral rights.
- The lease forms prescribed by the HBC and CPR successor corporations are designed to maximize the return to the owner of the resource.
- It is in the Province's best interest to prescribe Crown lease terms which encourage energy industry activity, but ensuring a fair return to the owner of the resource has always been of paramount importance.
- Energy companies either accept the terms of the business relationship prescribed by the Province and the corporate owners of mineral rights or do business elsewhere.
- The shoe is on the other foot with individually-owned freehold mineral rights. Energy companies, not the freeholders who own the resource, have always prescribed the form of agreement used to lease freehold mineral rights in Alberta, and the substance of the business relationship between the parties has never been open for negotiation.
- During the 1950's and 60's, a 10-year primary term and a 12 1/2% royalty rate were standard in freehold leases, and freehold lease 'negotiation' typically consisted of the freeholder filling in a single blank space which determined the cash bonus to be paid.
- In recent years, lease forms developed by the Canadian Association of Petroleum Landmen (the CAPL) have become standard for leasing conventional oil and gas from individual Alberta freeholders. The 'negotiation' of a CAPL lease typically consists of filling in several blank spaces in the lease document. These blank spaces determine the primary term, bonus and royalty rate to be paid by the oil company in the event the pre-determined business relationship is consummated. The substance of the business relationship is set forth in more than 6000 convoluted words drafted by oil and gas industry lawyers for purposes of fully protecting their clients' interests.

THE PLIGHT OF INDIVIDUAL FREEHOLDERS

- Most individual freehold owners are citizens of ordinary financial means with little or no legal or oil and gas technical training. Freeholders find themselves at a tremendous disadvantage in their dealings with energy companies.
- The problems faced by individual freeholders are rooted in the lease agreements they sign. Most freehold owners do not understand:
 - the terms and conditions in freehold leases;
 - the conflicts of interest that can arise between the energy company's obligations to them under a freehold lease agreement and the company's other business interests;
 - that freehold leases contain few of the protections for the owner of the resource that energy companies readily agree to assume in Crown leases;
 - how to monitor the actions of the energy company that has leased their mineral rights; and
 - what is fair and in their own best interests.

Unfair Freehold Royalties:

- According to Alberta Energy, a fair royalty share of the production from the Crown mineral rights which are collectively owned by the citizens of Alberta is 20 - 25% of the net profits made by energy companies.
- Individual freehold owners typically receive less than 1/2 of this 'fair share' because:
 - Crown royalty rates vary based on well productivity (from 5% for wells with low production to 35% for wells with high production);
 - freehold royalty rates are fixed at levels which are:
 - substantially lower than Crown royalty rates for high productivity wells, resulting in windfall profits for energy companies producing high volumes of oil or gas from wells on freehold mineral rights;
 - higher than Crown rates for very low productivity wells, thereby hindering development of freehold mineral rights and resulting in the premature abandonment of wells producing at low rates from freehold mineral rights;
 - Alberta Energy calculates the Crown's royalty share of the production from Crown mineral rights and invoices energy companies on a monthly basis. The calculation is readily verifiable by the company;
 - energy companies calculate the freeholder's royalty share of production from freehold mineral rights. The reports provided to freeholders are often not timely, vary widely in format, and can seldom be understood by freehold mineral rights owners;
 - Alberta Energy determines the price to be used in calculating its royalty share of production based on the weighted average price of all sales in the Province;
 - energy companies determine the price to be used in calculating a freeholder's royalty share of production based on contractual arrangements to which the freeholder is not a party;
 - Alberta Energy allows energy companies to make certain deductions from Crown royalties to compensate for the companies' costs in making the oil or gas 'market ready'. The specifics of these 'GCA' deductions are prescribed by statute and Alberta Energy regularly audits the deductions made;

- energy companies deduct what they consider to be the 'reasonable' costs to make freehold oil or gas market ready. There are no regulations governing what is reasonable;
- The Government of Alberta imposes an approximate 6.9% tax on production from freehold mineral rights. In many cases, this tax is equivalent to more than 1/2 of the royalty the freeholder receives. Alberta Freehold Mineral Tax directly reduces the royalty which energy companies could otherwise pay to the freeholder.

Continuation of Freehold Leases for Speculative Purposes by Energy Companies

- Both Crown and freehold leases may be continued beyond their primary term by the capability of production.
- In the case of Crown leases, Provincial regulations require an energy company wishing to continue its lease to submit an application to Alberta Energy demonstrating the capability of production in paying quantities.
- In the case of freehold leases, there are no regulations and many freehold leases have been continued for decades with payments of \$1 per acre per annum and wells that have never been capable of production in paying quantities.
- By making token annual payments, energy companies preserve for themselves whatever business opportunities may arise in the future respecting the freeholder's mineral rights, and deprive the freeholder of the opportunity to re-lease.

Lack of Deep Rights Reversion in Freehold Leases

- Twenty years ago, the Alberta Government retroactively amended all Crown leases to reclaim for the Province the rights below the deepest zone proven capable of production of oil or gas in paying quantities. At the time, many energy companies complained, at least privately. The industry now acknowledges that the Government's action has had a positive overall effect because it has made available for exploration by the entire industry Crown deep rights which would otherwise have been held by shallow production.
- CAPL leases and earlier freehold lease agreements used in Alberta provide for an energy company that establishes shallow production from freehold mineral rights to hold all geological zones to the centre of the earth.

Lack of Protection from Drainage

- Subsurface oil and gas are 'fugacious' - they are capable of moving about within the subsurface reservoir rocks in which they are confined in response to pressure changes induced by wells penetrating the reservoir.
- Due to the fugacious nature of oil and gas and the fact that these substances typically cannot be traced from their point of production at the surface to their original position in the subsurface, the law treats oil and gas differently than other real property. An owner of subsurface oil and gas owns what he recovers or captures in a well legally drilled on his lands whatever the original source of that oil or gas. Under this 'rule of capture', an owner has no legal recourse against his neighbour or the energy company that has leased his neighbour's mineral rights, if a well is drilled on his neighbour's mineral rights and drains away the owner's oil or gas. The owner's only recourse is to drill his own well.

- When an owner leases oil or gas to an energy company, the owner grants the sole and exclusive right to drill to the energy company and the owner can no longer minimize drainage by drilling. In consequence, all lease agreements contain provisions known as offset obligations which, in their simplest form, require the energy company that has leased an owner's mineral rights to either drill a well on the owner's mineral rights or drop the lease in the event that a well produces from mineral rights offsetting the owner's rights.
- Alberta Energy monitors wells drilled on freehold mineral rights offsetting Crown leases and strictly enforces the offset obligations in Crown leases.
- The CAPL lease forms most commonly used in Alberta (CAPL 88 and CAPL 91) contain an exceedingly convoluted and confusing offset wells clause. Individual freeholders seldom understand that the clause provides them with no protection whatsoever from drainage in the common situation where an old dry hole exists on the section which includes their mineral rights. The offset wells clause in CAPL 88 and 91 leases also provides no protection from drainage through wells drilled diagonally offsetting the freeholder's rights. The more recent CAPL 99 lease form corrects these deficiencies, but energy companies steadfastly refuse to use CAPL 99.

Split Title Mineral Rights - Petroleum v. Natural Gas

- On July 16, 2004, the Supreme Court of Canada released its decision in respect of the ownership of hydrocarbons produced from wells on 'split title' lands. Split title lands arose during the 1905 – 1912 period when the Canadian Pacific Railway Company sold farm-sized portions of its railway land grant to homesteaders reserving for its own account all coal and petroleum which may be found to exist within the lands. Encana Corporation, as successor to the CPR, now holds title to coal and petroleum within these lands and an estimated 10,000 individual freeholders hold title to all other mines and minerals including natural gas. There are approximately one million acres of this type of split title land in Alberta. All parties before the Court agreed that the 1953 decision of the Judicial Committee of the Privy Council in *Borys v. CPR and Imperial Oil Limited* was authority for distinction between the petroleum and natural gas being made based on the phase condition (liquid v. gas) of the hydrocarbons in the ground. In issue was whether Encana's ownership of petroleum vested at the time the land was sold to the settlers or at the time the petroleum was found to exist within the lands.
- FHOA intervened unsuccessfully before the Supreme Court arguing, in part, that ownership determination at the time of the sale was contrary to the express wording of the CPR reservation and gave rise to ownership uncertainty in the common situation where the petroleum in an oil pool has an overlying layer of gas in a gas cap prior to human disturbance.
- The Supreme Court ruled that "the reservation of petroleum divided the ownership interest in oil and gas on the basis of the phase the hydrocarbon was in under initial conditions at the time of the contract for sale of the property".
- The Court recognized that production from an oil pool may cause pool pressure to decline and some of the petroleum to evolve into gas and that "it is impossible to distinguish evolved gas from those hydrocarbons which were originally in a gas phase". But, according to the Court, the "entire industry relies on estimates of what is under the surface, and these estimates have to suffice for dividing up ownership as well".

- The fact that estimates of what is under the surface are made by industry and industry regulators does not resolve the issue of how much gas belonging to an individual freeholder is being produced at any particular time from any particular well on split title lands in an oil pool with a gas cap. The energy industry's historical practice has been to assume that all gas produced from all oil wells on split title land is gas which was initially in solution in petroleum. Royalties on this gas have historically been paid to the CPR and its successors until the involved freehold owner of natural gas proves that gas cap gas is being produced. Most individual freeholders lack the technical and legal expertise necessary to protect themselves in these circumstances.
- Current energy industry practices respecting production from split title mineral rights are without technical merit and unfair to individual freehold owners of natural gas. Now that Canada's highest court has decided the ownership issue in a manner which enshrines ownership uncertainty, it would be appropriate for all involved stakeholders to arrive at some mutually acceptable method of dealing with the situation.

Lack of Effective Recourse

- In the case of mineral rights owned by the Province of Alberta or the corporate successors to the HBC and the CPR, these entities have:
 - the technical expertise required to monitor the performance of the energy companies that have leased their mineral rights; and
 - the legislative authority or financial strength necessary to enforce the terms in their lease agreements when necessary.
- Most individual freehold owners don't have the technical expertise to recognize situations in which the energy company that has leased their mineral rights is not fulfilling its obligations. Those that do recognize a problem can seldom do anything about it.
- Surface owners in Alberta have recourse to the Surface Rights Board in situations of conflict with energy companies. No similar board exists for subsurface rights.
- Surface owners also have recourse to the Alternate Dispute Resolution Program sponsored by the Alberta Energy and Utilities Board (the AEUB). No similar AEUB program exists for subsurface owners. The AEUB takes the position that disputes between individual freehold owners and the oil companies that have leased their mineral resources belong in the courts
- Becoming involved in a law suit is a frightening prospect for most Canadians.
- In the case of freehold owners, oil and gas industry lawyers proudly proclaim that CAPL leases are judicially 'bulletproof' (no matter what an energy company does or doesn't do, the company's CAPL lease agreement cannot be terminated by a court without the company's consent).
- Suing an oil company with vastly superior technical, financial and legal assets that is operating under a CAPL lease agreement makes no economic sense and is simply not an option for individual freeholders.
- The fact that individual freehold owners have no effective recourse against the energy companies that have leased their mineral rights under CAPL leases:
 - encourages some energy companies to take advantage of the situation; and
 - exacerbates the feelings of helplessness, frustration and resentment felt by many freeholders.

THE FREEHOLD OWNERS ASSOCIATION (FHOA)

OBJECTIVES, GOVERNANCE, OPERATION AND MEMBERSHIP

- FHOA was organized in October of 1999 with the assistance of Alberta Energy for purposes of:
 - providing information and education to help individual freehold owners properly deal with their valuable resources;
 - researching issues of concern to freeholders; and
 - promoting fairer treatment for all freehold owners by:
 - acting as their common voice;
 - bringing their legitimate concerns to the attention of oil and gas industry associations, industry regulators, governments and the general public; and
 - advocating reasonable solutions for these concerns.
- FHOA is a federally incorporated not for profit corporation currently registered to operate in Alberta, Saskatchewan and Manitoba.
- A volunteer board of directors governs the activities of the Freehold Owners Association. FHOA members elected the current fourteen-member board at the association's June 14, 2003 annual meeting. The board consists primarily of ordinary citizens who own freehold mineral rights, but also includes members of the legal community and oil and gas industry professionals who are concerned with maintaining fairness in society while still championing the fundamental principles of free enterprise. Mrs. Else Pedersen was elected as President of the association at FHOA's April 20, 2002 annual meeting. (See – *Board of Directors – Attachment One*)
- FHOA has no paid staff and is currently funded entirely by modest fees charged for:
 - membership;
 - providing basic technical information about their mineral rights to members upon request; and
 - attendance at information seminars.
- Twenty-five hundred freeholders have joined the Freehold Owners Association since inception. FHOA's membership has grown without advertising. This growth clearly demonstrates the need for FHOA.
- Statistics gathered in membership application forms indicates that each member represents, on average, 2.8 other family members. FHOA now speaks for approximately 7,000 Alberta freeholders.
- Regrettably, lack of funds for advertising means that many of the individual freeholders who most need the services that FHOA provides (elderly freeholders who have no internet access) remain unaware of the association's existence.

WHAT FHOA HAS DONE FOR FREEHOLDERS

INFORMATION AND EDUCATION:

- To date, FHOA has:
 - built a comprehensive web site providing detailed information to assist freehold owners in dealing with their mineral rights (www.fhoa.ca);
 - sponsored 14 information seminars for freehold mineral rights owners in various areas of the Province;
 - published 8 detailed newsletters discussing issues relevant to freehold mineral ownership including:
 - leasing strategies and how to modify CAPL leases;
 - how to deal with shut-in wells and drainage;
 - deductions from freehold royalties;
 - estate planning for freehold mineral owners;
 - coal bed methane; and
 - freehold mineral tax;
 - provided more than 300 members with basic technical information about their mineral rights. Information provided includes well statuses, historical well production and prices paid at Crown land sales for the area immediately surrounding their rights; and
 - answered thousands of telephone and e-mail queries from freehold owners.

RESEARCH AND A COMMON VOICE FOR FREEHOLDERS:

- Since inception FHOA has:
 - researched class actions and submitted a brief to the Alberta Law Reform Commission in support of the Alberta Government's subsequent introduction of class action legislation;
 - researched the law respecting the ownership of hydrocarbons produced from a well on lands where title is split with individual freeholders owning all mines and minerals except coal and petroleum and the successor corporation to the CPR owning coal and petroleum;
 - sought and received approval from FHOA members to intervene before the Supreme Court of Canada in a hearing of the ownership issue;
 - raised monies from members to fund the Supreme Court intervention and argued the ownership issue before the Court. Although FHOA's intervention was unsuccessful, the collective voice of freeholders was heard for the first time in Canada's highest court;
 - researched the income tax implications of resource allowance and freehold mineral tax and provided members with information regarding the submission of claims for tax refunds in situations where energy companies have failed to properly report resource allowance on T-5 slips;
 - written to the federal Finance Minister respecting the phase out of resource allowance seeking some form of grandfathering for freeholders who have entered into freehold lease agreements based on the assumption that the provisions of the Income Tax Act respecting resource allowance would remain unchanged;
 - opened a dialogue with organizations representing freehold mineral rights owners in American jurisdictions in order to share research into common areas of concern;
 - polled FHOA members and identified the following areas of concern:
 - incomprehensible freehold lease agreements which should be written in plain English;
 - royalty statements which cannot be understood by a layman;
 - late or irregular royalty payments;
 - excessive deductions from natural gas royalties;

- continuation of freehold leases for decades with uneconomic shut-in wells;
 - failure to remove caveats in a timely manner after a freehold lease expires; and
 - inadequate communication from energy companies;
- set forth the concerns of freeholders respecting the lack of standards governing the deductions from freehold gas royalties in a letter to all M.L.A.'s and in meetings with a number of individual M.L.A.'s;
- sought the involvement of industry production accounting associations in respect of developing uniform industry reporting standards for freehold royalties;
- opened a dialogue with the Canadian Association of Petroleum Producers (CAPP) in an attempt to address the legitimate concerns of individual freehold owners in a cooperative manner.
- opened a dialogue with the AEUB and succeeded in having the AEUB recognize FHOA as a stakeholder to be contacted with respect to future changes to AEUB policies and procedures;
- submitted comments in respect of the AEUB's review of the enforcement of industry production reporting requirements;
- provided representatives to sit on Alberta Energy's Coal Bed Methane / Natural Gas from Coal Multi-Stakeholder Advisory Committee and a number of associated sub-committees.
- provided representatives to participate in Alberta Energy's stakeholder review of the administration of freehold mineral tax;
- opened a dialogue with the Canadian Society of Unconventional Gas Task Force and committed to providing representatives to participate in a committee addressing the ownership of coal bed methane in situations where individual freeholders hold title to all mines and minerals except coal and the successor corporations to the CPR own coal;
- built a database containing several hundred freehold leases and royalty statements submitted by FHOA members; and
- researched the structure of freehold leases and initiated the development of a form of freehold lease agreement intended to more fairly balance the interests of individual freehold owners and the energy industry.

WHAT FHOA NEEDS TO DO GOING FORWARD

ENHANCED INFORMATION AND EDUCATION:

- The internet represents a cost-effective, user-friendly method of providing information and education but the information on FHOA's web site (www.fhoa.ca) is now more than 3 years old and the site requires updating to include:
 - information provided in newsletters but not otherwise accessible on the site including:
 - estate planning for freehold mineral rights;
 - freehold mineral tax and resource allowance issues; and
 - coal bed methane issues;
 - information to help freeholders understand their royalty statements;
 - information on gross royalty trust agreements;
 - information on the recent Supreme Court split title ownership decision;
 - a frequently asked questions page;
 - a glossary of commonly used energy industry terms;
 - an on line membership subscription and technical service request facility;
 - more audio-visual aids to assist freeholders in understanding complex issues;
 - a page for freeholders to post their mineral rights available for lease;

- a chat room for freeholders to share information;
 - links to experts who can provide competent technical and legal assistance to freeholders; and
 - a search engine.
- Individual freeholders tend to be significantly older than the general population and many cannot afford a computer or are not computer literate. Based on information provided in membership renewal forms, less than 50% of FHOA's members currently have internet access.
 - Individual freeholders without internet access need alternative sources of education and information such as:
 - frequent newsletters;
 - brochures which explain in simple terms the complexities of leasing;
 - video cassettes dealing with complex issues on an audio-visual basis; and
 - frequent mineral rights information seminars at which freeholders can ask questions.
 - The Alberta Office of the Farmers' Advocate publishes a brochure entitled "Leasing Mineral Rights". The format of this brochure is excellent but the information it contains is out of date. An updated brochure addressing current problems and lease forms is needed.
 - FHOA has video-taped a mineral rights information seminar for freeholders conducted during 2003. The tape needs to be edited and published in VCR and CD ROM format.

RESEARCH, POLICY DEVELOPMENT AND A COMMON VOICE:

A 'Freeholder-Friendly' Lease Form:

- The problems faced by freeholders are rooted in the form of lease agreement which has historically been prescribed by the energy companies that lease freehold mineral rights. Freehold owners need their own form of freehold lease agreement which is written in plain English that they can understand.
- FHOA has partially completed the drafting of a freehold lease agreement which addresses the concerns of freehold owners while still protecting the interests of energy companies. FHOA needs to complete research on certain aspects of this lease form, have it reviewed by competent outside legal counsel, and make it available to freehold owners.

Coal Bed Methane Issues:

- Southern Alberta has immense resources of coal bed methane and FHOA currently provides representatives to sit on the Alberta Government's Coalbed Methane/Natural Gas in Coal Multi-Stakeholder Advisory Committee (MAC) and various subcommittees. This task force is primarily concerned with Crown lease issues and the regulatory environment for coal bed methane (CBM) development.
- An energy company's initial capital requirements to develop CBM are typically much higher than for an equivalent recoverable volume of conventional natural gas. The historical production profile for CBM is also different. Whereas conventional natural gas production typically declines fairly rapidly over time as the pressure in the subsurface pool containing the gas declines, CBM wells tend to produce at low but constant rates over many years.

- Over the past half century, the Alberta Government has developed a complex Crown lease royalty regime with royalty rates varying with:
 - when the oil or gas was discovered;
 - how much the product is sold for; and
 - the well production rate.

- The Alberta Government's royalty regime is a model of fairness and good business sense. A royalty rate as low as 5% is charged on newly-discovered, low-productivity oil and gas so as to encourage the energy industry to produce less profitable resources, but the Crown achieves an overall 20 - 25% royalty share of the oil and gas industry's net operating profit by charging royalty rates as high as 35% on established high-productivity oil and gas production. The variable royalty rates in existing Crown lease agreements encourage the development of low productivity CBM from Crown lands.

- Some of the freehold mineral rights in the most prospective areas for CBM are held by conventional production under existing freehold lease agreements. These existing leases typically have fixed royalty rates. Leases negotiated before 1970 typically have a fixed 12 ½% royalty rate. During the 1980's, fixed royalty rates as high as 18% were common. More recent freehold leases typically have fixed royalty rates of 15 or 16%.

- These fixed royalty rates discourage the development of CBM on freehold land.

- The energy industry is currently aggressively leasing open coal bed methane rights throughout southern Alberta. Many CBM developers and some small conventional energy firms have recently introduced addendums to CAPL lease forms which have the effect of reducing the royalty paid to freehold owners on a sliding scale basis tied to well productivity. These proposed sliding scale royalties are being met with concern and suspicion by most freehold owners primarily because the companies seek a 'one way street'. Freeholders are being asked to 'share the pain' by reducing royalty rates on low productivity wells as in Crown leases, but the involved energy companies are not prepared to 'share the gain' with higher royalty rates for high productivity wells as in Crown leases.

- FHOA needs to develop policies to deal with freeholder queries respecting future CBM lease strategies and the re-negotiation of existing freehold leases to deal with CBM development.

- The July 16, 2004 ruling by the Supreme Court of Canada decides the ownership of oil and gas produced from wells on the one million acres of land in Alberta where title to coal and petroleum is held by Encana and title to all other mines and minerals is held by individual freeholders. The Supreme Court ruling may impact the ownership of CBM produced from these split title lands, but it does not decide the issue. Furthermore, mineral title is split on a great many more acres of land in Alberta with the successor corporations to the CPR holding title to coal and individuals who are the descendant of settlers who purchased land from the CPR in the 1902 -1905 period holding title to all other mines and minerals, including petroleum and natural gas. The uncertainty respecting ownership of CBM produced from these lands hinders, and may prevent, the development of the resource on freehold lands where title is split.

- FHOA needs to research the law respecting ownership of CBM, develop policies to address the CBM ownership issue on split title lands, and work with all involved stakeholders to either resolve the ownership issue on a mutually agreeable basis or promote an early judicial determination of the issue.

Estate Planning:

- For most of the first half of the 20th century, the potential value of the subsurface minerals acquired by Alberta's original settlers in the late 1800's and early 1900's was not recognized. Typically, parents passed down title to the family farm by will or some form of sale to the son who intended to carry on operating the family farm. Typically, a single title to the farm property existed which included the surface and whatever subsurface minerals had been acquired by the original settlers. In result, subsurface mineral titles tended to remain whole. This changed when Leduc was discovered in 1947.
- The natural tendency of parents is to divide their assets equally amongst their children in their wills. Following Leduc, the separation of title to the surface and subsurface mineral rights became commonplace. Parents could now leave the surface title to the son who intended to carry on with the family farm and divide the mineral title equally amongst their other children. Many did just that.
- There are advantages to having title to a single tract of subsurface minerals held separately by several family members. Having several separate titles to the same tract minimizes the impact of Freehold Mineral Tax because a \$1600 exemption is granted to each mineral title owner. More critically, having several title holders in the same family often enhances the family's bargaining power in leasing negotiations with the land agents who are retained by energy companies. However, the advantages of title fractionation not only disappear but become extreme disadvantages as the number of separate title holders to the same tract increases.
- The cost to the energy industry of conducting operations on a particular tract of freehold minerals grows as the number of title holders to the tract increases. Negotiating a freehold lease with two or three title holders on the same quarter section tract of mineral rights is clearly more difficult and costly than dealing with a single owner, but the cost may be justifiable. Similarly, paying royalties to three parties rather than one and responding to the queries of each of them adds to an energy company's administrative costs, but these additional costs may be justifiable depending on the technical circumstances. There are very few technical circumstances where the cost of acquiring and administering leases from ten or more owners of the same tract of freehold mineral rights can be justified by an energy company.
- Allowing freehold mineral rights to become unduly fractionated:
 - destroys the value of the rights to the owners of the minerals because it is uneconomic for energy companies to deal with multiple owners; and
 - negatively impacts the efficient development of the Province's remaining reserves and resources because freehold rights are checker-boarded with Crown and other privately owned mineral rights throughout southern Alberta.
- Since the Leduc discovery, freehold mineral rights have passed through at least three generations. Left unchecked, the number of freehold mineral titles will grow exponentially as succeeding parents pass their share of the whole title down to their children.
- The fractionation problem has become acute. FHOA's membership statistics indicate that each of our members now represents 2.8 other family members.
- Many freehold owners do not understand the consequences of leaving their mineral rights in equal portions to their children. Many of the professionals to whom freeholders turn for estate planning advice are also uninformed. FHOA needs to develop policies

which will allow it to make estate planning information more widely available to all freehold owners and their advisors.

- There are incremental costs involved in structuring and administering the family corporations or trusts needed to prevent title fractionation. FHOA also needs to interface with professional estate planners to develop programs which will minimize these costs and encourage freeholders to stop and reverse the trend to fractionation in this generation so as to preserve the value of their family's freehold mineral ownership and allow for the efficient development of Alberta's remaining reserves and resources.

Royalty Reporting:

- Freeholders cannot understand the royalty statements which are provided to them. In many instances, the information reported cannot be understood by industry professionals. A lack of understanding breeds suspicion and freeholders who cannot understand how the royalty check which is provided to them has been calculated may assume that they are being cheated.
- FHOA needs to draft an appropriate royalty reporting format and interface with industry production accounting associations to find a way to modify existing industry joint venture reporting systems to accommodate a standard freehold reporting format.

Communications:

- Information and education are only useful to freeholders if they are aware of the existence of this information and education.
- FHOA needs to develop policies which will allow more freehold owners to become aware of the association and access the information and education which FHOA provides.

Common Voice:

- FHOA currently provides representatives to sit on the Alberta Government's Coalbed Methane/Natural Gas in Coal Multi-Stakeholder Advisory Committee (MAC) and various subcommittees. FHOA has also committed to sitting on a recently formed Alberta Energy Task Force studying freehold mineral tax and to providing representatives to sit on a committee established by the Canadian Society for Unconventional Gas to research CBM ownership issues in situations where coal is owned in fee simple by one party and natural gas by another.
- The opportunity to represent a group of stakeholders which has heretofore had no voice in various committees and task forces studying energy issues brings with it the responsibility to properly research the issues under consideration, and insure that the positions presented by FHOA are understood and supported by FHOA's membership.
- Regulatory authorities are in some cases unfamiliar with the problems faced by freeholders. FHOA has concerns with some current Alberta Energy and Utilities Board (AEUB) policies and procedures including the waiver of off-target penalties for the first well in a pool and the approval of holdings which reduce well spacing in only parts of producing pools. Senior AEUB staff have asked FHOA to make representations to the AEUB respecting these concerns and FHOA needs to do so.

FHOA'S CHALLENGE GOING FORWARD

- All of FHOA's accomplishments to date are the result of volunteer efforts.
- Most freeholders who have joined the association are willing to volunteer their time to help in achieving FHOA's goals. Volunteer members organize local information seminars and provide assistance with FHOA mailings. Unfortunately, most of these volunteers have no technical or legal training and are not in a position to provide others with help in understanding the complex issues which confront them.
- To date, a small core of industry and legal professionals has volunteered time to advance the association's goals by answering freeholder telephone and e-mail queries, drafting information for inclusion in FHOA's web site and newsletters, speaking at information seminars throughout the Province, and representing FHOA on various task forces and panels.
- Membership growth has resulted in a situation where FHOA volunteers do not have time to answer all of the questions posed by freeholders, never mind properly researching these answers. Increasingly, the technical services we offer to members cannot be provided in a timely manner due to growing demand.
- Concurrently, the acceptance of the Freehold Owners Association as a legitimate voice for freeholders has placed demands on the time and energy of those FHOA volunteers with technical and legal expertise which cannot reasonably be sustained. The interests of freehold owners cannot be properly served on committees which are addressing technically and legally complex issues by volunteers taking time off from their day jobs.
- FHOA's directors have prevailed upon friends and associates in the energy industry who are concerned with the plight of freeholders to provide the association with furnished office space, administrative and accounting assistance, legal services, internet services, access to an oil and gas technical database, access to a legal database, and the use of computers and other technical equipment at prices significantly below market rates or at no cost.
- The generosity of friends and associates and the efforts of volunteers have established an organization capable of addressing the many legitimate concerns of freehold owners, but volunteers can only do so much and FHOA needs access to additional funding.
- The association's current fee structure allows FHOA to publish two newsletters annually; to hold several mineral rights information seminars each year; and to pay for the required annual audit of the association's books. FHOA has no funds available to:
 - retain the technical and legal experts necessary to:
 - complete a 'freeholder-friendly' lease form;
 - research CBM leasing and ownership issues;
 - draft and cause to be implemented a standard form for freehold royalty reporting;
 - update FHOA's web site;
 - draft and publish brochures for freeholders who are unable to access information on FHOA's web site;
 - edit and publish in CD ROM or VHS format information provided in mineral rights information seminars for freeholders unable to attend seminars;
 - establish permanent operations, communications and delivery of services.

- Some freeholders could afford to pay more for membership in FHOA and for the services which FHOA provides, but many could not.
- FHOA does not want to increase the fees it charges for membership or basic technical services as this would defeat the very purpose of the association – elderly freeholders living on fixed income are the freeholders most vulnerable and are also the freeholders least able to pay increased fees.
- FHOA was organized to provide the information, education and representation that freehold owners clearly need. Our volunteers and the generosity of concerned industry friends and associates means that FHOA does not need the level of funding required by energy industry associations such as CAPP, SEPAC, etc. in order to be effective.
- In five short years, FHOA has accomplished a great deal. We believe that we can achieve self-sufficiency by growing our membership and making minor changes to the way we conduct our affairs going forward. However we need access to a modest amount of outside funding for a limited period of time in order to become self-sufficient.
- FHOA seeks a commitment from the Alberta Government for funding in the amount of \$200,000 per annum for a five-year period commencing in January, 2005.

APPLICATION OF PROPOSED FUNDING

- In 2005, outside funding would be primarily dedicated to:
 - retaining the technical and legal experts necessary to:
 - complete a 'freeholder-friendly' lease form;
 - research CBM leasing and ownership issues;
 - establishing permanent administrative infrastructure so as to improve member communication and build FHOA's membership.
- Application of funding in future years would depend on FHOA's assessment of the priorities of its membership at the time.
- FHOA would welcome Government representation at either the board level or at the level of the board's budget advisory group.

WHY THE ALBERTA GOVERNMENT SHOULD SUPPORT FHOA

- FHOA submits that it is appropriate for the Government of Alberta to provide a modest amount of funding to the Freehold Owners Association for the limited period of time the association considers necessary for it to become self-sufficient because:
 - the role of government is, in part, to support those members of society who are vulnerable;
 - the Alberta Government collected almost \$100,000,000 in Freehold Mineral Tax from mineral rights owned by individual freehold owners last year. FHOA's request for 2/1000th of this tax to be dedicated to providing education, information and representation to these owners is fair and reasonable;
 - it is in the business best interests of both the Government of Alberta and the energy industry to support FHOA.

Business Considerations:

- The plains of southern Alberta are part of a mature conventional oil and gas exploration basin. Alberta's conventional oil production peaked in 1975 and remaining reserves of conventional oil are now 1/3rd of what they were 25 years ago. Alberta's gas production peaked in 2001 and is forecast to decline continuously going forward. Remaining reserves of conventional gas have declined by 50% since 1982.
- Significant reserves of conventional oil and gas remain to be discovered in southern Alberta but most of these reserves will be found in small, relatively low productivity pools.
- Most of Alberta's CBM resources are located in the plains of southern Alberta. Although the size of the resource is immense, CBM production rates are relatively low and large upfront capital investment is required to develop the resource.
- Over the past half century, the Alberta Government has developed a complex Crown lease royalty regime with royalty rates varying with:
 - when the oil or gas was discovered;
 - how much the product is sold for; and
 - the well production rate.
- The Alberta Government's royalty regime is a model of fairness and good business sense. A royalty rate as low as 5% is charged on newly-discovered, low-productivity oil and gas so as to encourage development by the energy industry, but the Crown achieves an overall 20 - 25% royalty share of the oil and gas industry's net operating profit by charging royalty rates as high as 35% on established high-productivity oil and gas production.
- Most existing freehold leases signed before 1970 have a fixed 12 ½% royalty rate. During the 1980's, fixed royalty rates as high as 18% were common. More recent freehold leases typically have fixed royalty rates of 15 or 16%.
- The fixed royalty rates in existing freehold leases discourage the development of low productivity conventional oil and gas reserves or CBM from freehold mineral rights.
- CBM developers typically seek to acquire large acreage holdings prior to initiating development and the combination of checker-boarding of Crown and freehold mineral rights throughout southern Alberta and existing freehold leases with fixed royalty rates discourages the development of both Crown and freehold resources
- The development of the remaining conventional oil and gas reserves and the unconventional coal bed methane resources of southern Alberta cannot be efficiently accomplished without compromise and cooperation between all stakeholders.
- Compromise and cooperation require a level of trust.
- For more than 1/2 a century, the energy industry has 'had its way' with freehold owners. Most energy companies are cognizant of the technical, legal and financial imbalance between themselves and the freehold owner community and exercise the powers provided to them in the freehold lease agreements they have drafted in a responsible manner. Others do not. Some energy companies:
 - make excessive deductions for gathering and processing natural gas produced from freehold mineral rights thereby minimizing freeholder royalties;

- manipulate gas contracts to assign low priced gas to freehold mineral rights thereby minimizing their overall corporate royalty obligation and freeholder royalties;
 - continue freehold lease agreements for decades for speculative purposes with shut-in wells which are incapable of commercial production;
 - intentionally drain the freehold owners who have granted them leases;
 - fail to pay royalties on time or at all;
 - provide indecipherable royalty statements to freeholders;
 - fail to remove caveats in a timely manner; and
 - do not respond to legitimate queries from freeholders.
- In 2000, energy industry associations approved the CAPL 99 lease form. This lease addresses some of the unfair drainage and lease continuation practices permitted under CAPL 91 and CAPL 88 lease forms. However energy companies almost uniformly refuse to use the CAPL 99 lease form. In fact, some lease agents are currently presenting freehold owners with CAPL 88 leases - this lease form allows energy companies to make deductions from freehold royalties that actually exceed the royalties themselves. Former Alberta Energy Minister Ric Orman advised the energy industry to stop using CAPL 88 almost 15 years ago.
 - Leading energy industry associations have done nothing to curb the improper practices of some of their member companies, encourage the use of CAPL 99, or encourage a code of conduct for lease agents in their dealings with freehold owners.
 - The unscrupulous practices of a minority of energy companies and the seeming indifference of leading industry associations to these practices has given rise to suspicion and distrust of the oil and gas industry amongst freehold owners.
 - In a 2003 Ipsos Reid survey of which industries Canadians trust the most, the oil and gas industry ranked second last, slightly ahead of the tobacco industry. Only 17% of Canadians found the energy industry to be trustworthy. A survey of freeholders would not be so kind.
 - FHOA is trusted by freehold owners. FHOA has the credibility needed to convince individual freehold owners to make the royalty rate concessions necessary to reflect the maturation of the western Canadian sedimentary basin and promote the efficient development of Alberta's remaining conventional reserves and unconventional resources.
 - FHOA also has the expertise necessary to interface with energy industry associations and negotiate reasonable concessions from the energy industry in return for the concessions of freeholders.
 - Similarly, the efficient development of southern Alberta's remaining reserves and resources requires that the current trend to ever more fractionated freehold mineral titles be halted and reversed. Most freeholders are not knowledgeable in estate planning. Many do not understand the consequences of leaving their mineral rights in equal portions to their children. Often even professional estate planners don't realize that dividing the title to freehold minerals increases the energy industry's cost of doing business with freehold owners and may ultimately destroy the value of the mineral rights.
 - Freeholders, and in many cases the professionals they consult, need information and education in order to make informed decisions. An informed freeholder will not divide his or her mineral title unnecessarily.

- The Government of Alberta could provide the information and education that freeholders need to make informed decisions respecting estate planning and other issues, but FHOA can provide it at far less cost. Providing information and education to freehold owners is FHOA's principle goal.

The Role of Government:

- No reasonable energy industry executive or informed observer would deny the vulnerability of freehold owners in their dealings with the energy industry.
- Likewise, no informed observer would deny that some energy companies have taken advantage of their superior technical, legal and financial position to exploit freehold owners over the past half century, and some companies continue to do so.
- The Freehold Owners Association was organized, in part, to promote fairer treatment for freehold owners because the checks and balances which Albertans assume are in place to protect the vulnerable from exploitation by the powerful in Canadian society did not appear to be working in the case of freehold owners.
- Throughout its existence, FHOA has sought to present the plight of freehold owners in a reasonable and balanced manner, to interface with industry associations, regulators and government in a professional and respectful manner, and to avoid the type of inflammatory rhetoric which other groups engage in with considerably less justification.
- FHOA represents a large community of vulnerable Albertans and we have been surprised and dismayed that our prior requests for funding have been rejected by the Wild Rose Foundation and the Community Initiatives Program.

Fundamental Fairness Considerations:

- In the year which ended on March 31, 2004, the Government of Alberta collected \$288 million in Freehold Mineral Tax. This tax is based on the value of oil and gas produced from Alberta freehold mineral rights. Almost \$100,000,000 of the tax collected last year was from mineral rights owned by the individual freeholder owners that FHOA represents.
- The imposition of Freehold Mineral Tax, which is essentially equivalent to a 6.9% royalty, reduces the royalty rate which energy companies would otherwise be prepared to pay to freehold owners.
- In many cases where individual freeholders remain bound by the 12.5% royalty rates in old freehold leases, the Alberta Government's is taking $6.9/12.5 = \$0.55$ from the freeholder's property for every \$1.00 the freeholder receives. In fact, because the Alberta Government calculates Freehold Mineral Tax and energy companies calculate freehold royalties, in situations where unscrupulous energy companies manipulate gas prices or charge excessive gathering or processing fees, the Alberta Government's take may equal that of the individual who owns the property.
- FHOA and the freeholders we represent do not object in principle to the collection of a tax on production from our mineral rights by the Provincial Government. However we submit that it would be fair and reasonable for the Alberta Government to return a tiny fraction of the tax collected to an association dedicated to providing freeholders with the information and education they need to protect their valuable resources.

