NEWSLETTER

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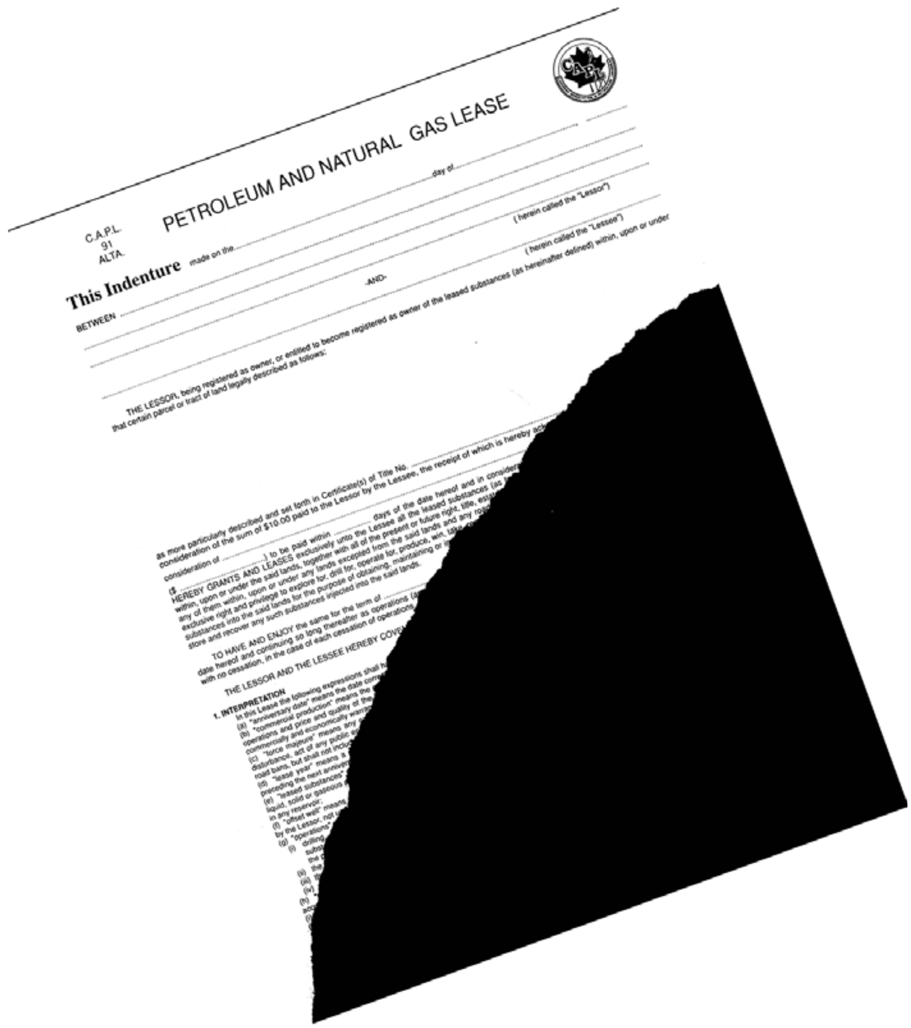
OFFSET OBLIGATIONS - PROMISES MADE TO BE BROKEN

This issue of your newsletter focuses on one of the most misunderstood and widely abused clauses in freehold lease agreements - the 'offset wells' clause. We also update readers on the current status of the coal bed methane ("CBM") ownership dispute.

In this issue ...



The Offset Wells Clause

The purpose of the offset wells clause in a freehold lease is ostensibly to protect freehold owner-lessors against the loss of oil or gas by drainage through wells on adjacent lands. The clause typically requires an energy company-lessee to take some form of action if commercial production is obtained from lands adjacent to its freehold owner-lessor's mineral rights. However, the offset wells clause in the form of freehold lease agreement currently used by most land agents (CAPL 91) provides the freeholder with no protection whatsoever in many technical situations. In other situations, where the clause does impose an obligation on the energy company-lessee, most companies only fulfill their obligation if it is in their business interests to do so or if the freehold owner recognizes that a breach of his lease agreement has occurred and files a notice of default.

Most freeholders no longer live on the land overlying their mineral rights and many are unaware of well production activity adjacent to their rights. Others assume that their energy company-lessee is monitoring the situation and will protect them from drainage. Still others believe that some regulatory agency enforces lease performance by energy company-lessees. No such agency exists.

In consequence, there are many hundreds of situations in western Canada where compensatory royalties are owed to freehold owner-lessors under the offset wells clause in their leases but where these royalties have not been paid. The ongoing split title CBM ownership dispute is making a bad situation worse.

The Alberta Government passed legislation in 2003 effectively stating that coal bed methane was gas, not coal. But the legislation applied only to Crown lands and the estimated 2.5 million acres of 'split title' freehold land in Alberta were left in CBM ownership limbo. The coal rights beneath split title land are owned by EnCana Corporation ("EnCana") and the Carbon Development Partnership ("CDP"). These companies are successors in interest to the Canadian Pacific Railway Company (the "CPR"). The natural gas rights beneath split title lands are owned by tens of thousands of individuals who typically are the descendants of pioneer settlers who bought homestead lands from the CPR in the early 1900's. The coal owners take the position that their ownership includes CBM. They have threatened to sue any energy company that produces CBM from wells on sections of land which include split title freehold unless an agreement to share the CBM has been negotiated between the natural gas owner and the coal owner. Most energy companies that have leased split title natural gas rights from individual freeholders have been reluctant to negotiate CBM sharing agreements with the owners of coal because they consider the coal owners' claims to be without legal merit. However, these companies have also been reluctant to risk being sued by a powerful corporation such as EnCana. In result, the vast majority of the more than 12,000 CBM wells which have been drilled in Alberta over the past seven years have been drilled on Crown lands. Most of these wells have targeted shallow Horseshoe Canyon coals within the 'CBM fairway' between Edmonton and Calgary.

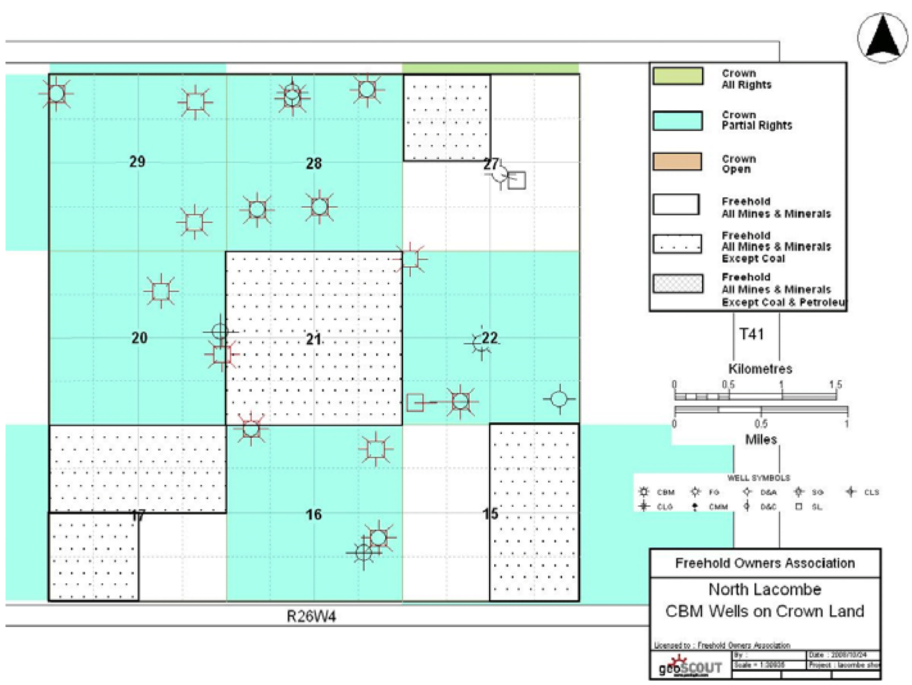
Freehold mineral rights are checker-boarded with Crown lands throughout this fairway. The production of natural gas from CBM wells on Crown lands adjacent to undrilled freehold mineral rights within the CBM fairway gives rise to obvious freehold owner drainage issues. The 2006 decision of the Energy Resources Conservation Board to change well spacing and target areas within most of the CBM fairway has exacerbated the problem. The new rules allow up to four shallow CBM wells per section to be drilled and produced with no requirement for any set back whatsoever along the north and east fence lines of sections.

The map below shows nine sections of land in an area north of Lacombe and illustrates the type of CBM development which has been occurring throughout the CBM fairway - 14 CBM wells producing natural gas on the five sections of Crown (blue) and none on any of the four sections of freehold (white) which include some split title (stippled). The CBM wells on fence lines have obviously been positioned to drain natural gas from both sides of the fence.

And how have the energy companies that have leased the individually-owned freehold mineral rights adjacent to these wells on Crown land responded?

Firstly, by ignoring the offset obligations in their existing leases. Most energy companies operate on the 'catch us if you can' principle when it comes to their relationship with freeholders. In general, offset obligations are not honoured by energy company-lessees unless the freehold owner-lessor realizes that an offset well has been drilled and brought on production adjacent to his or her mineral rights; understands what his or her lessee's obligations are under the offset wells clause; recognizes that a breach of the lease agreement has occurred; and files a proper default notice.

Secondly, energy companies have responded by minimizing or eliminating their obligations to protect their freehold owner-lessors from drainage in new leases. This is being done with subtle changes to the wording of the offset wells clause. These changes transfer the responsibility for monitoring offset well production from the energy company-lessee to the freehold owner-lessor and absolve the energy company-lessee from any obligation to protect the freeholder



from drainage unless the lessee is notified of the offset well by the freehold owner-lessor. Although this represents a fundamental change to the historical lessee/lessor relationship, most land agents neglect to point out the change to unsuspecting freeholders during lease negotiations.

Whether your mineral rights are already leased or you are approached to lease, FHOA recommends that you familiarize yourself with well drilling and production activity in the vicinity of your property. FHOA can help. For a modest fee we can provide members with a 'Technical Service Request' which includes maps and production information for all wells in the eight sections surrounding your mineral rights. FHOA also recommends that you carefully review the definition of offset well and the offset wells clause in your existing lease or any new lease which is presented to you.

The following information is designed to assist you in understanding your rights under the offset wells clause. If you need help in enforcing your rights, FHOA has fostered the formation of Freehold Owner Recovery Services Ltd. ("FORS") for this purpose (403 245-4400).

Background

Oil and gas differ from 'hard' minerals in their ability to move about within the confines of the subsurface 'pool' in which they are trapped in response to production-induced pressure changes. This means that oil or gas beneath your property may be produced through a well drilled on an adjacent property. Drilling a well on one side of a fence line with the intention of producing oil or gas from a neighbour's property on the other side of the fence could be thought of as stealing. But the oil or gas that comes out of the well has no label to identify where it came from in the subsurface and, after more than 150 years of oil and gas production, science has not found any way to accurately measure the magnitude of the drainage or 'theft' suffered by one party when another produces oil or gas from a well on an adjacent property.

Due to the inability of science to quantify drainage, the courts in oil and gas producing jurisdictions have uniformly adopted what is known as the 'Rule of Capture'. Under this rule of non-liability, you own whatever oil or gas you recover or 'capture' in a well legally drilled on your land irrespective of where the oil or gas came from in the subsurface. Similarly, your neighbour owns whatever oil or gas he recovers in a well legally drilled on his lands and you have no legal recourse against your neighbour if he (or his lessee) drills a well close to your mineral rights and produces oil or gas which may have come from your mineral rights. Your only recourse is to drill your own well.

Historically, almost all oil and gas industry operations involving drilling and production have been conducted under lease agreements. Under the granting clause in a freehold oil and gas lease, the freehold owner-lessor grants the sole and exclusive right to drill to the energy company-lessee. Therefore, subsequent to leasing, the freehold owner can no longer drill a well to protect himself from drainage.

The structure of freehold lease agreements was first developed in the United States. Early lease forms were relatively simplistic. Most did not specifically address what actions, if any, the energy company-lessee had to take if oilfield circumstances arose which impacted the freehold owner-lessor's interests. In the absence of specific contractual protection for the freeholder, the Law of Implied Covenants developed in the American courts. Under this law, certain obligations are 'read into' freehold leases. One of the most important of these implied covenants is the lessee's obligation to drill a well to protect the freehold owner-lessor from drainage if it appears that the well would be profitable. There is considerable debate amongst legal scholars in the United States as to whether this covenant is implied 'in fact' or 'in law'. If implied in law, the covenant sets a minimum standard for all energy company-lessees irrespective of the wording of the particular freehold lease. If implied in fact, the implied covenant can be circumvented with wording to the contrary in the lease agreement.

Early forms of the freehold lease agreement used in Canada were also relatively simple. Many contained no offset wells clause. Some of these leases remain binding on current freehold owners.

By the late 1960's, most Canadian freehold leases included an offset wells clause which imposed some form of obligation on the energy company-lessee if production was obtained from a well adjacent to the freehold owner-lessor's mineral rights (an offset well). The production had to be 'commercial' - of sufficient volume to economically justify the drilling of a similar well by a reasonably prudent operator. In some leases the offset well had to be located within a certain distance of the freeholder's mineral rights. In most, the obligation arose if the offset well was in a 'spacing unit' laterally adjoining the freehold owner-lessor's mineral rights. A spacing unit is the area allocated to a well for production purposes by regulatory authorities. The normal spacing unit for gas is one section and for oil it is a quarter section.

Initially, the energy company-lessee 's offset obligation was simply to either drill a well to protect the freehold owner-lessee from drainage or surrender the lease. The lessee had six months from the time the offset well commenced commercial production in which to fulfill its obligation. But if the lessee did not do so, the lease did not automatically terminate.

Virtually all freehold leases contain a default clause. This clause requires the freehold owner-lessor to provide written notice to the energy company-lessee of any breach of the lease agreement, and provides the lessee with a specific period of time (usually 30 or 90 days) in which to begin to remedy the breach. Only if the energy company-lessee fails to do so, does the lease terminate. In circumstances where the freehold lease imposes a simple 'drill or drop' obligation on the energy company, Canadian courts have awarded damages in amounts equal to the royalties which the freehold owner would have received if the energy company had fulfilled its obligations. Unfortunately, it is up to the freeholder to prove what these royalties would have been and this is difficult to do.

As time passed, freehold leases were amended to provide the energy company-lessee with additional choices in fulfilling its offset obligation. The lessee could combine the freehold owner-lessor's undrilled mineral rights with other productive mineral rights by pooling or unitizing, or the lessee could pay the freeholder compensatory royalties as if the offset well was producing from the freehold owner's mineral rights.

This latter amendment was introduced for the benefit of energy company-lessees to address situations in which the company wanted to retain the freeholder's lease but for some reason had not commenced drilling and had not pooled or unitized within the six month period. In fact, this amendment is of considerable benefit to freehold owner-lessors - damages for a lessee's breach of its offset obligation can easily be proven based on the compensatory royalties due to the freeholder.

CAPL Leases

In 1988, the Canadian Association of Petroleum Landmen (the "CAPL") and the Natural Resources Section of the Canadian Bar Association (the "CBA") released what purported to be a standard freehold lease form for western Canada. Under this 'CAPL 88' lease form, if commercial production is obtained from a well drilled in a spacing unit laterally offsetting the freehold owner-lessor's mineral rights, then the energy company-lessee has six months in which to:

a. drill a well on a spacing unit which includes the freeholder's mineral rights to the depth of the productive zone in the offset well;
b. combine the freeholder's mineral rights with other mineral rights productive from the same zone as the offset well with a pooling or unitization agreement such that production royalties accrue to the freeholder;
c. surrender the lease or at least that portion of the leased formations which includes the zone productive in the offset well; or
d. pay compensatory royalties to the freeholder as if the offset well was producing from the freeholder's mineral rights. If there is more than one offset well, the compensatory royalties are based on the average production from all offset wells.

Due to the offensive nature of the royalty clause in CAPL 88, the Alberta Government 'suggested' that the CAPL and CBA draft a new lease form. The CAPL 91 lease form was introduced as a replacement standard in 1991. Over the past twenty years, the vast majority of freehold leases entered into in western Canada have been either CAPL 88 or CAPL 91 leases. The offset wells clause in CAPL 91 is identical to that in CAPL 88 for most intents and purposes.

Perhaps the most convoluted, widely misunderstood and offensive portion of the CAPL 91 and CAPL 88 offset wells clause are the following words which preface the lessee's offset obligation: *"unless (1) a well has been or is being drilled on the spacing unit of the said lands laterally adjoining the spacing unit of the offset well and into the zone or formation from which commercial production is being obtained from the offset well"*.

From the standpoint of offsetting gas wells, this means that if there is an old well on the section of land which includes your mineral rights, irrespective of whether the well is producing, suspended or abandoned, you have no protection from drainage from an offset well if it is producing from a geological zone above the base of the deepest zone penetrated in the old well.

This proviso is particularly damaging to freeholders who own mineral rights within the CBM fairway. In many instances, wells were drilled on their sections in an attempt to establish conventional production from deep geological horizons long before the CBM in the shallow Horseshoe Canyon coals became an object of commerce. For instance, the dry hole on the southeast quarter of section 27 in the map on page 2 is a deep test. Any freehold owner of natural gas in section 27 who entered into an unamended CAPL 91 lease has no protection from drainage by the numerous CBM wells producing natural gas in laterally offsetting sections.

A crude solution to this problem is to amend the offset wells clause by simply striking out "has been or". The proviso then reads "*unless (1) a well is being drilled ...*". A better solution may be found in the CAPL 99 lease or the FHOA lease.

In 2000, the CAPL and CBA released the CAPL 99 lease. This lease form balances the interests of the energy company-lessee and the freehold owner-lessor in a fairer manner than prior CAPL leases. It provides the freehold owner-lessor with protection from drainage through wells drilled after the effective date of the lease in both laterally and diagonally offsetting spacing units. Under CAPL 99, a pre-existing well on the spacing unit which includes the freeholder's mineral rights has no impact on the freehold owner's protection from drainage unless operations are being conducted on the well in the zone productive in the offset well. In addition, if there are multiple offset wells producing from different geological formations, compensatory royalties are calculated based on the average production from each formation.

The CAPL 99 lease form was approved by the Canadian Association of Petroleum Producers ("CAPP"), a group representing 140 companies that produce more than 95% of Canada's oil and gas. According to CAPP, a commitment to "*responsible resource development.*" ... "*is a mandatory requirement of CAPP membership*" (2007 CAPP Stewardship Report, p. 5). Apparently treating freehold owners fairly does not constitute responsible resource development because the members of CAPP uniformly refuse to use the CAPL 99 lease form except in situations where the energy company desperately wants the freeholder to lease and he or she insists on CAPL 99 or in certain technical situations where the particular wording of the lease is advantageous to the energy company.

The FHOA Lease

The FHOA lease provides the freehold owner-lessor with even more protection from drainage than the CAPL 99 lease.

Firstly, an offset well is defined in the FHOA lease as any well completed for production after the effective date of the lease rather than any well drilled after the effective date. This prevents the type of special situation referred to above where an unscrupulous energy company drills a well immediately adjacent to a freeholder's mineral rights, enters into a CAPL 99 lease with the freeholder, then completes the well for production, and then proceeds to drain the freeholder with impunity until the lease expires.

Secondly, the FHOA lease provides more meaningful protection in the event of a partial surrender by the lessee. Most energy company-lessees operating under CAPL leases surrender only the zone or formation which is productive in the offset well and retain their lease interest in all zones above the surrendered zone. This type of surrender is of little practical benefit to the freehold owner-lessor because most energy companies would not consider leasing a single geological zone and having to drill through overlying zones controlled by another company in order to evaluate the leased zone. In the FHOA lease, if the energy company-lessee surrenders a geological zone productive in an offset well then the surrendered zone expands to include all overlying zones except those proven productive or capable of production in paying quantities after a nine month period.

Thirdly, in the case of multiple offset wells, compensatory royalties are calculated in the FHOA lease based on the production from each offset well rather than on the average production from all offset wells as in CAPL 88 and CAPL 91, or the average production from all wells in each productive zone as in CAPL 99. This is a particularly important distinction for freeholders who own mineral rights in the CBM fairway where Crown and freehold mineral rights are checker-boarded and the new ERCB spacing regulations allow up to four CBM wells per section. In the example on page 2, there are 14 CBM wells in spacing units laterally or diagonally offsetting section 21. Paying compensatory royalties on the total production from 14 offset wells clearly creates a greater incentive for an energy company-lessee to drill in a timely manner than does paying compensatory royalties on the average production from these wells.

Not surprisingly, the FHOA lease is even less popular than CAPL 99 amongst land agents. The only energy company prepared to use the FHOA lease is Just Freehold Energy Corp. - the company fostered by FHOA to lead the energy industry by example in treating freeholders fairly.

Recent Changes to CAPL Leases

In May of 2008, FHOA advised those members for whom we had e-mail addresses that land agents acting on behalf of one of the leading developers of CBM in western Canada, Quicksilver Resources Canada Inc., had been using an amended form of CAPL lease under which, according to Quicksilver, its obligation to protect its freehold owner-lessor from drainage did not arise until written notice of an offset well had been received from the freehold owner. As per the amendment, Quicksilver's offset obligation arises:

"*within 6 months from the later of the date of the offset well being placed on commercial production or, if information with respect to the amount of production from the offset well is restricted pursuant to any statute, regulation, order or directive of any government or government agency and such information is unknown to the Lessee, until one month after such information is made public* ***or upon receipt of written notice received by the Lessee from the Lessor***". The bolded phrase is Quicksilver's amendment.

Energy companies subscribe to the same type of digital database as FHOA and have ready access to the technical information needed to monitor production from wells offsetting their freehold leases; individual freehold owners do not. The clear objective of the Quicksilver amendment is to avoid their obligation to protect their freehold owner-lessors from drainage.

In FHOA's view, Quicksilver has not accomplished its objective due to the lack of a comma before the bolded phrase. Quicksilver claims it does not agree but has now changed the offset clause in its current lease form such that its offset obligation arises:

"*provided that the Lessor notifies the Lessee in writing, within 6 months from the later of the date of:*

(i) the offset well being placed on commercial production'

(ii) if information with respect to the amount of production from the offset well is restricted pursuant ot any statute, regulation, order or directive of any government or governmental agency and such information is unknown to the Lessee, until one month after such information is made public, or

(iii) upon receipt of written notice received by the Lessee from the Lessor;"

Freeholders who have entered into freehold lease agreements worded in this manner should constantly monitor well production activity in the vicinity of their mineral rights and provide written notice in respect of each and every offset well as soon as the well commences commercial production.

CBM Ownership Dispute Status

In 2006, at the request of EnCana and the Carbon Development Partnership ("CDP"), the Energy Resources Conservation Board (the "ERCB") called a hearing to determine the legal entitlement to CBM. EnCana and CDP took the position that their ownership of coal beneath split title lands included ownership of CBM and that the ERCB should not issue licenses for wells on split title land to natural gas lessees while the CBM ownership dispute remained outstanding. FHOA intervened in the ERCB hearing in support of the individual freehold owners of natural gas. In March of 2007, the ERCB ruled that EnCana and CDP have no entitlement to CBM and that CBM is gaseous in the ground prior to human disturbance. EnCana and CDP subsequently sought and were granted leave to appeal the ERCB decision to the Court of Appeal of Alberta. FHOA sought and was granted intervener status in the Court of Appeal hearing.

The Court of Appeal hearing was scheduled for November 5th and 6th in Calgary.

On September 29, 2008, Alberta's Minister of Justice and the Attorney General for Alberta ("Alberta") wrote to the parties indicating that Alberta intended to seek leave to intervene in the Court of Appeal hearing. On October 6, 2008, CDP filed a notice of discontinuance and abandoned its appeal. On October 7, 2008, Alberta wrote to the Court of Appeal seeking leave to file a factum and intervene in the hearing. The time period for seeking leave to intervene had expired but Alberta asserted that EnCana had failed to provide Alberta with notice of its challenge to an enactment of the legislature (the Oil and Gas Conservation Act) as required under the Judicare Act. On October 8, 2008, EnCana filed a notice of discontinuance and abandoned its appeal of the ERCB ruling.

In support of FHOA's intervention before the Court of Appeal, FHOA raised approximately $22,000 from its membership. At the time the discontinuances were filed, approximately $10,500 of these funds had been expended. As interveners typically bear their own costs, it is unlikely that FHOA will be able to recover these funds despite the fact that EnCana and CDP have wasted our limited funds and the Courts time.

EnCana has advised the media that the appeal process was slowing down its efforts to pursue legal remedies in the Court of Queen's Bench of Alberta. FHOA understands that EnCana is currently advancing three legal actions under case management. One involves production of CBM from wells on lands where EnCana holds title to all coal and individual freeholders hold title to all mines and minerals except coal. The second involves CBM production from wells on lands where Encana holds title to all coal, petroleum and valuable stone and individual freeholders hold title to all mines and minerals except coal, petroleum and valuable stone. The thrid case involves production of CBM from wells on lands where Encana holds title to all mines and minerals and has leased petroleum and natural gas to an energy company but retained the rights to coal.

As matters now stand, a dispute as to whether the fee simple owners of coal or the fee simple owners of natural gas own billions of dollars worth of CBM beneath split title lands is proceeding through the courts without the tens of thousands of fee simple owners of natural gas being represented. FHOA's board of directors will be meeting to consider what, if anything, can be done to remedy this.

Upcoming Seminar

FHOA's next seminar for freehold mineral rights owners will be held in the Trochu Community Centre, 215 North Field Road, Trochu, Alberta from 7:00 to 10:00 pm on November 13, 2008. Guest speakers will discuss what you need to know about freehold leases before and after you sign and estate planning for freehold mineral owners. A question and answer session will follow the talks.

Mr. Len Webber, MLA for Calgary Foothills and Parliamentary Assistant to Energy Minister Mel Knight has accepted FHOA's invitation to attend this seminar. One of Mr. Webber's roles is to address the issues and concerns of freehold owners. His goal at this seminar is to listen and learn.

On behalf of the board of directors,
Else Pedersen, President

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