

# NEWSLETTER

## The Freehold Owners Association ("FHOA")

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## 1500<sup>th</sup> FREEHOLD OWNER JOINS FHOA

The Freehold Petroleum & Natural Gas Owners Association ("FHOA" or the "Freehold Owners Association") is pleased to advise that more than 1500 owners of freehold oil and gas rights have now joined the association.

A large and active membership is essential if FHOA is to succeed in addressing the many concerns of our members and achieving greater fairness for all freeholders.

To date, the vast majority of individuals who have joined our association own freehold minerals rights in the Province of Alberta. The problems faced by owners of Alberta freehold are not unique and are shared by the owners of freehold minerals in Saskatchewan, Manitoba and Ontario. One of the association's goals in 2002 is to expand our membership to include individuals who own oil and gas rights in these other Canadian provinces.

freehold owners can use to protect and maximize the value of their non-renewable resources.

Most consumer contracts are written in plain English. Freehold lease agreements are not. Understanding the terms and conditions in the lease being negotiated is clearly essential to a successful negotiation. Through newsletters, information seminars, our web site ([www.fhoa.ca](http://www.fhoa.ca)), and having someone available to answer freeholders' questions, FHOA is attempting to 'de-mystify' freehold lease agreements.

### ANNUAL MEETING

The Annual Meeting of the Freehold Owners Association will be held in Edmonton, Alberta in the Wildrose Room of the Ramada Hotel and Conference Centre (previously known as the Edmonton Inn), at 1:00 p.m. on Saturday, April 20, 2002. The annual meeting will be followed by an information seminar and workshop from 2:00 to 5:30 p.m. Further information will be provided in conjunction with the Notice of Meeting, Information Circular and Proxy for the annual meeting which will be mailed to members in March.

### Seminars:

FHOA and the Agricultural Societies of Two Hills and Willingdon sponsored an information seminar for freehold owners in Willingdon, Alberta on October 30, 2001. Keith Wilson, an experienced oil and gas lawyer and director of the Freehold Owners Association, was principle speaker. Mr. Wilson spoke on leasing strategies and how freehold owners can protect their interests after entering into a lease agreement. Following a 90 minute presentation, Mr. Wilson and officials of Alberta Energy and the Office of the Farmers Advocate took questions from the 130 freehold owners in attendance.

A similar format was followed at an

### RECENT ACTIVITIES

#### Education and Information

One of the primary objectives of your association is to provide education and information that

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information seminar in Spruceview, Alberta on November 28, 2001. Although inclement weather prevented the attendance of government officials from Edmonton and limited attendance to 90 freehold owners, those in attendance were treated to an informative seminar from Keith Luft, a lawyer experienced in oil and gas matters and a director of the association.

On January 15, 2002, *FHOA* and the Namao Agricultural Society sponsored a third seminar at Namao, Alberta, which was attended by 185 freehold owners. Keith Wilson was principle speaker. Officials of the Alberta Energy Department and the Farmers' Advocates Office attended and participated in the question and answer session which followed Mr. Wilson's presentation.

The Freehold Owners Association wishes to thank member Bev Homeniuk, who organized the Willingdon seminar, director Richard Anderson and member Greg Hillman, who organized the Spruceview seminar, and member Jack Pearse, who organized the Namao seminar. Thanks are also expressed to members of the Namao, Two Hills and Willingdon Agricultural Societies and to *FHOA* members Pat Anderson, Orest and Sharon Berezan, Robert Gorgichuk, Pat Hill, Gail MacGregor, Clarence Miskiw, Violet Safron and Dorothy Ungstead who provided assistance with seminar registration and refreshments. The support of the Alberta Government through the Office of the Farmers' Advocate and the Energy Department is also gratefully acknowledged.

The Freehold Owners Association believes that seminars and workshops represent one of the best methods of providing freehold owners with the

information they need to properly manage their valuable resources. *FHOA* intends to hold further seminars during 2002. The next seminar will be held in conjunction with *FHOA*'s annual general meeting in Edmonton.

If you would like an information seminar to be held in your area of Alberta, don't hesitate to contact either *FHOA*'s office or director Else Pedersen. Mrs. Pedersen has been involved in all of the seminars that the Freehold Owners Association has sponsored to date, has put together a detailed 'check list' of organizational necessities, and would be pleased to advise and assist anyone interested in organizing a seminar.

*FHOA* welcomes suggestions from members for seminar improvements. One suggestion has been to provide speaker notes to attendees and to interested members who are unable to attend the seminars. The association is taking steps to make such notes available for future seminars. *FHOA* is also studying a suggestion that the seminars be video-taped and video cassettes be made available to members at cost.

#### Web Site:

*FHOA*'s web site ([www.fhoa.ca](http://www.fhoa.ca)) has been designed primarily to provide in-depth information to freehold owners in the most cost-effective manner possible. Since being uploaded approximately five months ago, the site has had more than 1600 visitors.

Our web site contains detailed information to help you understand freehold lease agreements. Also included are suggested changes to the wording of certain clauses in the CAPL 91 and CAPL 99 lease

agreements. These changes, which have been designed to more adequately protect your interests, may be downloaded or printed from the web site.

Members who do not own a computer or do not have home access to the internet are reminded that almost every public library in Canada has computers and librarians specifically trained by the federal and provincial governments to provide assistance to individuals in using the internet. If you are approached to lease your mineral rights and you don't have a computer or web access, you can go to your local library and, with the assistance of the librarian, print off information from our web site for review in the comfort of your home.

Members are encouraged to provide us with feedback with respect to our web site. A number of members have asked us to include a copy of the CAPL 91 and CAPL 99 freehold lease forms on the site. Apparently, some lease agents are refusing to even acknowledge the existence of CAPL 99 and continue to present freeholders with discredited CAPL 88 lease forms. *FHOA* has approached the CAPL (the Canadian Association of Petroleum Landmen) for permission to publish CAPL 91 and CAPL 99 on our site, but the CAPL has not yet responded to our request. Members are advised that copies of both lease forms are available for a small fee from the offices of the CAPL (350 - 500 5<sup>th</sup> Ave. S.W., Calgary, AB, T2P 3L5 - 403 237-6635).

#### Calls to *FHOA*'s Office:

Providing someone knowledgeable in freehold issues that you can talk to when you need general information or advice is

an essential part of the service that *FHOA* provides. In recent months, our office has responded to an average of five calls per day from freehold owners.

### Technical Service Requests:

**W**ould you sell your house or farm without first checking recent sale prices for comparable properties? Of course not! You or your realtor would review current listings and recent sale prices for similar properties in your area to determine a fair market value for your property.

A freehold owner's subsurface oil or gas rights may be much more valuable than the freeholder's house or farm. Despite this, freehold owners often lease their mineral interests without making any attempt to determine market value.

One factor which influences the market value of a lease of your minerals is recent prices paid for Crown leases in the area of your mineral rights. Why would you lease your minerals for \$20/acre if Crown lands surrounding your rights had recently been leased for \$1000/acre - you wouldn't unless you didn't know about the Crown lease prices! Similarly, wells licensed to be drilled or drilling in the area of your mineral rights, and the productivity of wells in the vicinity of your rights are other factors which influence the market value of a lease of your minerals.

Historically, one party to a freehold lease negotiation - the oil company - has had access to this type of information; the other party - the freehold owner - has not.

*FHOA* has addressed this problem by acquiring a subscription to a land and

well database, and making basic technical information available to members for a modest fee.

If you wish to acquire technical data respecting your mineral rights, please forward a check for \$50 to *FHOA*. The association will provide you with a map showing all of the wells in the nine sections immediately surrounding the section containing your minerals, a well summary report for all wells licensed, drilling or drilled within the area, a well production report summarizing the production from these wells, and a land map showing Crown and freehold lands within the area. The land map will include bonus prices paid for any Crown leases in the area together with the dates that the particular Crown land was leased.

Although most technical service requests to date have come from members who are involved in leasing negotiations, members who have already leased their mineral rights but are unable to monitor offsetting well activity may also wish to consider making a technical service request. There are many hundreds of unsatisfied freehold offset obligations in western Canada. The principal reason for this is that many freeholders don't realize that it is up to them to monitor the production from spacing units offsetting their mineral rights and to serve notice on their oil company-lessee if the company defaults on its obligations to prevent drainage.

Members who make technical service requests are asked to be patient as the association has no paid staff and it takes time to fill these requests.

## 2002 INITIATIVES

**B**y providing education and information to help freeholders

understand the terms and conditions in freehold lease agreements and by making basic technical information pertinent to an owner's mineral rights available to members for a modest fee, *FHOA* is attempting to 'level the playing field' between you and the oil companies that lease your minerals.

In 2002, your association will undertake a major new initiative designed to further level this playing field and to address the principal concerns of freehold owners.

### Freehold Lease & Royalty Statement Database

**T**he most common concern expressed by freeholders in *FHOA* membership application forms, questionnaires, and calls and letters to our offices is whether they are being treated fairly by the oil and gas industry.

Freehold owners recognize that oil and gas exploration and development is a technically complicated, expensive and risky business and that the oil and gas companies that develop our mineral interests deserve a fair return on their investment. But freeholders also deserve a fair return on the non-renewable resources which form part of our heritage. The question is - what is fair?

In 2002, the Freehold Owners Association intends to establish a database of members' freehold lease agreements and royalty statements in an attempt to answer this question. **All members are asked to provide our offices with a copy of their lease agreement together with representative copies of recent royalty statements.**

One measure of fairness might be to

compare the total return (lease signing bonuses, lease rentals and royalties) received by freehold owners on leases of their mineral interests to the total return received by the Alberta Government on Crown leases.

The oil and gas beneath approximately 81% of Alberta is owned by the Province on behalf of all Albertans. Signing bonuses for leases of this Crown land are determined by the marketplace - industry operators submit bids for Crown leases by sealed tender at public auctions held every two weeks. The annual rental and royalty rates in Crown leases are set by the Alberta Government. Crown rental and royalty rates have been adjusted from time to time by the Government to ensure that the citizens of Alberta, as owners of the resource, receive a fair return, while still maintaining a vibrant oil and gas industry within the Province.

#### Signing Bonuses:

In 2001, the average price paid by oil and gas companies for Crown leases in the plains of southern Alberta was \$206/hectare or \$82/acre. In 2000, the average price was \$248/hectare or \$100/acre.

FHOA receives many calls from freeholders wondering if the \$10 to \$20 per acre they have been offered to sign a lease is fair. Based on this anecdotal evidence, it appears that signing bonuses for freehold leases are substantially lower than those for Crown leases. But perhaps freehold owners who succeed in negotiating higher signing bonuses are not calling our offices for advice. Or perhaps the calls we receive are from freeholders whose mineral rights are in areas of the Province where the industry is paying lower than average bonuses for Crown leases.

A database containing a significant number of freehold leases will allow your association to compare the bonuses paid for freehold and Crown leases in various parts of the Province in order to determine whether a statistically meaningful difference exists and, if so, to quantify the difference.

#### Rentals:

The annual rental in Crown leases is currently \$3.50/hectare or \$1.40/acre. The annual delay rental or shut-in royalty in the vast majority of freehold leases is \$1/acre. In FHOA's view, this 40% payment differential is far less important than the different circumstances to which these payments apply.

The shut-in or suspended well clause in freehold lease agreements became standard at a time when oil was the focus of exploration and development. Markets for natural gas had not yet developed. If a company drilled for oil and found gas on freehold lands, it seemed fair and reasonable for that company to be able to continue its lease by paying its freehold owner-lessee \$1 per acre per year until gas markets developed.

Fifty years ago, most freehold owners farmed the lands overlying their mineral interests. To a farm family struggling to survive, an annual check for \$160 per quarter section was meaningful. Fifty years ago, most oil companies operating in Alberta were subsidiaries of foreign-based majors. The budgets of these subsidiary companies were tightly controlled from south of the border and decisions to pay \$1 per acre per year on non-productive freehold lands were not taken lightly.

Over the past half century, inflation

has ravaged the value of the dollar. Concurrently, natural gas has become society's fuel of choice.

Although natural gas markets have been well established in virtually all areas of Alberta having freehold mineral rights for at least 15 years, many oil company-lessees continue to hold freehold leases with shut in gas wells under suspended well clauses which provide for the lease to be continued if there is a "lack of or intermittent market". In most cases, these wells are not, and have never been, capable of commercial natural gas production. Oil companies continue to make suspended well payments in these circumstances because this represents a very cheap way to maintain an inventory of mineral rights for speculative purposes, or because they want to avoid the costs of well abandonment. In most cases, the companies know their leases would not withstand legal challenge but rely on the fact that freeholders typically don't understand oil and gas law and can't afford the high cost of litigation.

In the past dozen years, CAPL leases have become 'standard' in freehold lease negotiations in western Canada. The suspended well clause in CAPL 88 and CAPL 91 freehold lease agreements exacerbates an already difficult situation for freehold owners. The clause provides for the freehold lease to be continued by payments to the freehold owner-lessee of \$1 per acre per year if there is a shut-in well "capable of producing" on the freeholder's lands. **Every well in Alberta which has not been abandoned is 'capable of producing' some gas.**

The absence of any reference to commercial production in the suspended well clause of CAPL 88

and CAPL 91 provides oil companies with the opportunity to continue freehold leases indefinitely with only token payments to the freehold owner-lessor.

In contrast, it has been Alberta Government policy for many years to require a company seeking to continue a Crown lease with a suspended well to demonstrate to the satisfaction of the Government that the well is capable of producing in paying quantities.

The CAPL and the Canadian Bar Association recognized the "shortcomings" in the suspended well clause of the CAPL 88 and CAPL 91 leases when the CAPL 99 lease was being drafted. The suspended well clause in CAPL 99 increases the annual payment due to the freehold owner-lessor from the token \$1 per acre to an amount equal to the original lease bonus consideration divided by the primary term of the lease.

CAPL 99 was released for use by the industry in the fall of 2000. Subsequent calls to *FHOA*'s offices suggest that very few land agents are using CAPL 99. Some agents apparently claim that their oil company-clients will not do business with a freeholder who insists on using a CAPL 99 lease.

The freehold lease and royalty statement database will allow *FHOA* to monitor the success of freehold owners in forcing land agents to use CAPL 99. In addition, the database will help your association to quantify the magnitude of the suspended well problem.

#### Royalties:

**A**t the time of the 1947 Leduc discovery, the royalty rate in

both Alberta Crown and freehold lease agreements was the same - 12½%. Today, the Government of Alberta charges a royalty of 35% on gas from a pool discovered prior to 1974 and produced through a well on Crown lands at a rate greater than 600 Mcf/d (thousand cubic feet per day). Crown royalties on natural gas liquids recovered from this 'old gas' vary from 30% to 50%. In contrast, gas and natural gas liquids produced from the same pool, at the same rate, but through a well on freehold lands may generate only a 12½% royalty for a freehold owner.

And what about gas from pools discovered after 1974 ('new gas')? Wells producing new gas from Crown lands at rates in excess of 600 Mcf/d currently generate a royalty of 30% to the Government of Alberta. In contrast, calls and letters to *FHOA*'s offices suggest that most land agents are currently offering 15% - 16% royalties in freehold leases and that very few freeholders succeed in negotiating more than a 20% royalty.

Anecdotal evidence suggests that the royalty rates in freehold leases are materially lower than those in Crown leases. But the Freehold Owners Association needs more than anecdotes to address the problem.

Crown gas royalties are both price and productivity sensitive, and an entirely separate royalty regime exists for oil produced from Crown lands. For example, wells producing very low volumes of oil or gas from Crown lands generate royalties of as low as 5% to the Alberta Government. In *FHOA*'s view, these low Crown royalties do not represent 'corporate welfare'. They represent wise stewardship over the Province's resources - higher royalties on

marginally economic, low productivity wells would result in well suspension or abandonment as has occurred in many freehold situations.

The oil and gas industry apparently accepts Alberta Crown royalties as being fair to the industry.

The freehold lease and royalty statement database will provide your association with the information necessary to compare freehold and Crown royalties over a wide range of different oil and gas productivity situations. Quantifying these differences may allow *FHOA* to develop proposals for future freehold royalty rates which are not only fairer to freehold owners but also fairer to the oil and gas industry.

#### Deductions from Royalties:

**M**ost pre-CAPL freehold lease agreements provide for a "gross royalty" to be paid to the freehold owner based on the "current market value of the leased substances at the well head".

But gas is usually not sold at the well head. Gas from the well head gas is typically gathered in pipelines, delivered to a gas plant, and sold at the plant outlet after it has been processed to remove impurities and valuable natural gas liquids. Most industry operators deduct gas gathering and processing costs from the market value of the natural gas at the plant outlet in order to determine 'current market value at the well head'. The problem from a freeholder's perspective is how these deductions from freehold royalties are computed.

In calculating Crown gas royalties, industry operators have historically been allowed to deduct what is known

as 'Gas Cost Allowance' or GCA. The GCA system is based on the Jumping Pound formula which was initially developed almost 60 years ago at a time when facilities for gathering and processing natural gas were few and far between in Alberta. Deductible Crown GCA costs include the direct costs to operate gas gathering and processing facilities, a 10% overhead allowance, depreciation of gathering and processing facilities at a rate of 5% per annum, and a 15% rate of return on average invested capital.

Generous Crown GCA deductions encouraged companies with shut-in gas reserves in Alberta to build facilities to gather, process and market this gas. Companies that built gas facilities frequently allowed non-owners to process gas in their facilities. Non-owning companies were charged custom processing fees which were higher than actual costs because the non-owners had no investment in the facilities. These custom processing fees were deductible by the non-owning company against its Crown royalties. Over time, the GCA system had its desired effect and gas gathering and processing facilities proliferated throughout the Province.

Although the GCA system was specifically developed for application to Crown mineral rights, not freehold rights, it represented a convenient system for industry operators to adopt in calculating 'market value at the wellhead'. Typically, the requirement in most pre-CAPL freehold leases for a "gross royalty" to be paid to the freeholder was ignored (gross means without deduction). The CAPL 88 freehold lease attempts to provide oil company-lessees with contractual authority for historical industry royalty deduction practices. In CAPL 88, the reference to 'gross' is

dropped and the oil company-lessee is provided with specific authority to include a "reasonable rate of return on invested capital" in its computation of current market value at the wellhead. CAPL 91 and CAPL 99 leases contain similar wording.

Most of the gas processing facilities in Alberta were built more than twenty years ago and it might be expected that the depreciation and return on invested capital portions of the GCA calculation would by now have declined substantially resulting in much lower overall gas gathering and processing fees.

In fact, aging gas facilities have spawned an entirely new industry as 'mid-streamers' have purchased fully depreciated gas facilities from former owners effectively 're-starting the GCA clock' for any of their own gas handled in the facilities. These mid-streamers recover their investment through custom processing fees charged to process other companies' gas.

The last time there was a substantial decline in gas prices (the late 1980's), the pricing problem was compounded for both Crown and freehold royalty owners by an increase in custom processing fees associated with mid-stream operations. In the case of freehold owners, the situation became so extreme that some freeholders actually received invoices rather than royalty checks from their oil company-lessees.

In 1989, Alberta's Energy Minister wrote to oil and gas industry associations expressing concern with excessive royalty deductions. The Minister was particularly concerned with custom processing fees and suggested that the industry develop a "system of peer arbitration" which

would resolve the problem without requiring regulatory intervention.

In response, an industry task force recommended guidelines under which custom processing fees charged by new facility owners would be based on a before tax rate of return of from 20% - 23% on average invested capital (including the 10% overhead allowance).

Wouldn't you like to earn a 23% annual return on your investments?

The industry also introduced the CAPL 91 freehold lease which provides for a negotiable cap on the expenses which may be deducted from freehold royalties - the royalty "shall not be less than \_\_\_ percent (\_\_\_%) of the royalty that would have been payable to the lessor if no such expenses had been incurred by the lessee". The CAPL 99 lease contains similar wording.

Freeholders who have entered into CAPL 91 or CAPL 99 leases over the past decade have some measure of protection from excessive gas gathering and processing fees. The freehold lease and royalty statement database will allow your association to estimate the percentage of freeholders who have no such protection because their lease agreements pre-date CAPL 91.

The guidelines recommended in response to the Energy Minister's 1989 letter are just that - guidelines. The industry did not see fit to implement the Minister's suggestion to establish a system of peer arbitration to ensure compliance with these guidelines. Instead, the industry task force concluded that "communication and subsequent negotiation will eliminate the majority of complaints".

Presumably there have been very few complaints from, or communication and negotiations with, individual freehold owners. Freeholders cannot be expected to understand the Jumping Pound formula or GCA calculations - many industry professionals don't understand them.

In the first 10 months of 2001, the weighted average price of all gas sold in Alberta declined more than four-fold from \$11.21 per Gigajoule (GJ) to \$2.40 per GJ. The Alberta Government has audit teams who monitor Crown gas royalties. These auditors can separate the legitimate effects of falling prices from excessive gas gathering and processing deductions, and can disallow excessive deductions when appropriate. Freeholders have no such protection.

Establishing a freehold lease and royalty statement database will provide *FHOA* with the information necessary to monitor deductions from freehold royalties.

### Royalty Statements:

**F***HOA* members are concerned because, in many instances, they cannot understand the royalty statements provided to them by their oil company-lessees.

Some of the royalty statements which the association has reviewed on behalf of members lack even the most basic information respecting the volume of production and the prices received. Many of these statements are meaningless, even to industry professionals. On the other hand, some industry operators provide their freehold owner-lessors with detailed statements which can be understood by any interested layman.

Many of the concerns of freehold owners involve complex technical or legal matters or have significant financial implications for the involved oil company-lessees. This should not be the case with freehold royalty statements.

In recent years, the oil and gas industry has adopted a great many standard formats for inter-company and regulatory reporting purposes. *FHOA* sees no reason why a standard freehold reporting format could not be adopted by the industry.

The freehold lease and royalty statement database will allow your association to review a wide variety of reporting formats with a view to developing proposals for a standard reporting format that can be easily understood by freehold owners.

### Fairness - Let the Market Decide:

**S**ome would argue that comparing the total return to the Crown in terms of lease signing bonuses, rental and royalty payments is not a proper measure of what is fair for freehold owners. Land agents don't physically force freeholders to lease their mineral rights and some would say that freeholders have historically received exactly what their mineral rights are worth in a free marketplace.

If fairness is to be determined by the marketplace, then it is up to us, as freehold owners, to modify the marketplace to create more value for our minerals. One of the most obvious ways to modify the marketplace is to make the terms in our freehold leases agreements public.

All of the terms and conditions in a Crown lease agreement, including the

royalty rate and the length of the primary term of the lease, are matters of public record. When an oil company submits a successful bid for a Crown lease, the price paid by the company becomes a matter of public record.

The effect of making prices paid for Crown leases public is to put upward pressure on future Crown lease prices - companies bidding on Crown leases take past prices paid into account when determining their bid. The effect of making the primary term of Crown leases public is to make all interested oil companies aware of when the Crown lease will expire.

When an oil company leases freehold mineral rights it files a caveat against the freeholder's title with Alberta Land Titles to protect its interest as lessee. After registration, the information on this caveat is available to any individual willing to pay \$6 or \$7 to a registry shop, or to any of the approximately 750 western Canadian oil companies who subscribe to the type of land and well database system to which *FHOA* has subscribed. The problem is that the Land Titles Act does not require a caveator to disclose the bonus price paid for the lease, the primary term of the lease, or the lease royalty rate. Very few caveats contain more than the name of the company claiming the interest and the date the lease was executed.

To whose advantage is this?

It is not in the best interest of the individual freehold owner-lessor to keep lease information confidential. Other oil companies that may be interested cannot readily determine when the freeholder's lease will expire. In many cases, the caveat remains registered against the freeholder's title for years after the

lease has expired and the freeholder wonders why he is not being approached to lease again.

It is also not in the best interest of other freehold owners in the area who are approached to lease their mineral rights. If these other freeholders knew the terms and conditions in freehold leases that had already been entered into, they would seek equivalent or better terms in their own leases. Furthermore, aggressive oil companies would be inclined to better the terms of their competitors.

The owners of surface rights in certain areas of the Province have already demonstrated that sharing information on surface lease bonuses can significantly increase an owner's bargaining power.

Making information regarding bonus prices, royalty rates and primary terms in freehold lease agreements more readily available will create a more transparent and freer marketplace. Over time, all freehold owners will be able to achieve better terms in their negotiations.

*FHOA* intends to make bonus prices, royalty rate, processing cap and primary terms information in the freehold owner database available to members in technical service requests and to oil and gas companies through an industry database.

We need the support of all members to maximize the success of this initiative. Please make copies of your lease agreement and representative royalty statements and forward them to our offices at your earliest convenience.

## RECENT LEGAL MATTERS

### Split Title Ownership:

In September of 2001, the Alberta Court of Appeal heard verbal argument in the appeal of a 1998 Court of Queen's Bench decision on the ownership of hydrocarbons produced from wells on lands where PanCanadian Energy Corporation, as successor to the Canadian Pacific Railway Company, holds title to petroleum, and thousands of individual freeholders hold title to all mines and minerals except coal and petroleum. The ownership dispute before the Court of Appeal on these 'split title' lands arose more than a century ago.

In 1881, when the Dominion Government granted the Canadian Pacific Railway Company 25 million acres of land along the right of way of the proposed transcontinental railroad in return for the CPR's commitment build, operate and maintain the rail line, the railway company had no interest in the hydrocarbon resources it had acquired from the Government. Although the CPR's locomotives were fuelled by coal, almost a quarter century passed before, in 1904, the CPR began to reserve coal for its own account in sales of railway grant lands to settlers. In about 1906, the CPR recognized the potential value of petroleum and began to reserve both coal and petroleum for itself. But natural gas was considered to be a dangerous nuisance in the early 1900's and it wasn't until 1912 that the railway company recognized its potential value and began to reserve all mines and minerals for its own account in land sales to settlers.

As a result of the railway companies land settlement policies, the title to petroleum and natural gas became split on approximately 1 million acres of land in Alberta.

Natural gas is no longer a dangerous nuisance, but a highly valuable commodity. Subject only to potential further appeal to the Supreme Court of Canada, the Alberta Court of Appeal's ruling will decide whether hundreds of millions of dollars worth of past and future conventional natural gas production from wells on split title lands - gas which the CPR had no interest in at the time it sold the lands to settlers - belongs to the CPR's successor PanCanadian or to an estimated 10,000 individual freeholders who are the descendants of these settlers.

The Appeal Court's ruling may also have significant implications for the common law ownership of coal bed methane.

In the United States, coal bed methane production currently accounts for almost 10% of total American gas production and represents a billion dollar industry. In western Canada, the in place reserves of coal bed methane are enormous and a number of pilot production projects are currently underway. On February 27, 2002, PanCanadian announced the first commercial sale of coal bed methane in Canada. As conventional gas reserves continue to decline, it can be anticipated that gas prices will rise and development of coal bed methane will become increasingly important.

Is the owner of coal or the owner of natural gas entitled to coal bed methane?

This issue has been adjudicated in a number of American states, and the U.S. courts have generally found that the natural gas owner is entitled to coal bed methane. In Canada the issue has not been before the courts. PanCanadian and Fording Inc.,

another of the CPR's successor corporations, own most of the privately-owned subsurface coal in southern Alberta. Perhaps not surprisingly, Fording takes the position that it is entitled to any coal bed methane produced from lands in which it hold title to coal.

The judge in the split title ownership trial ruled that ownership of subsurface hydrocarbons is absolute between owners of different hydrocarbons within the same tract of land - in other words ownership of hydrocarbons recovered from a well on split title lands is determined by tracing these hydrocarbons back in time and space to determine their phase condition in the pool prior to human disturbance. The trial judge recognized the fugacious nature of petroleum and natural gas and acknowledged that these substances move about and change phase in the subsurface in response to production-induced pressure changes, but her Ladyship was confident that the oil and gas industry could quantify the respective entitlements of the petroleum owner, PanCanadian, and the individual freehold owners of natural gas. According to the trial judge, "the quantification tail should not wag the ownership dog". In fact, the quantification tail has wagged the ownership dog in oil and gas law ever since subsurface hydrocarbons were first commercially exploited more than a century ago. It is a rule of law in every oil and gas producing jurisdiction, including Alberta, that ownership of oil and gas is not absolute between owners of adjacent tracts. The reason for this rule is that all other courts have recognized that fugacious substances such as petroleum, natural gas and water cannot be traced, not even in space, so as to establish their original ownership. A ruling by the Alberta

Court of Appeal upholding the novel theory of hydrocarbon ownership relied upon by the trial judge would support the coal bed methane ownership position advanced by Fording Inc.

Approximately 20% of Alberta freeholders own split title natural gas rights. Many more hold title to all subsurface hydrocarbons except coal.

The Court of Appeal reserved judgment in September of 2001 and its decision has not yet been released.

### Gross Royalty Trusts:

**I**n January of 2002, the Alberta Appeal Court overturned a November 1999 Court of Queen's Bench decision in Astl et al v. Montreal Trust Company of Canada. The Astl decision dealt with the disposition of royalties paid into court by the trustees of certain gross royalty trust agreements ("GRT's").

In 1989, the Court of Appeal ruled in Guaranty Trust Company v. Hetherington that where a petroleum and natural gas lease referred to in a particular form of GRT which has come to be known as a PTC-1 expired according to its own terms, the GRT itself expired and did not apply to subsequent leases.

Subsequent to the Hetherington decision, freehold mineral owners collapsed hundreds of PTC-1 GRT's through court application. A similar number of GRT's, involving sophisticated, well-financed unitholders who threatened to object to the collapse, were confirmed by agreement.

At the time of the 1999 Queen's Bench decision in Astl, no action had been taken on approximately 100

PTC-1 GRT's and \$2.3 million in royalties were held in court. The Court of Queen's Bench ordered the funds in court to be paid out to the unitholders of the GRT's, if the involved freehold mineral owners took no action to collapse their GRT's within 90 days of receipt of the Court's order.

The Court of Appeal recognized that the Queen's Bench order placed the entire financial burden of collapse on the freehold mineral owner, despite the fact that a preliminary assessment by the trustee suggested that the GRT's were no longer binding by virtue of the Hetherington decision. The Court of Appeal ordered counsel for the freehold mineral owners to bring collapse applications with respect to all unresolved PTC-1 GRT's within 6 months with the costs of these applications to be paid out of monies held in court.

If your mineral rights are encumbered with a PTC-1 GRT and royalties with respect to this GRT are held in court, *FHOA* recommends that you contact either Carscallen Lockwood, counsel for the mineral owners in the Astl decision, or other legal counsel knowledgeable in GRT matters.

On behalf of the board of directors

Richard B. Riggins  
President

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