

# NEWSLETTER

## The Freehold Owners Association (“FHOA”)

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## WHAT’S RIGHT FOR ALL ALBERTANS

On December 14, 2006, when Mr. Ed Stelmach was sworn into office as Alberta’s 13th premier, he pledged to do “what’s right for all Albertans”.

In this issue of your newsletter we focus on the coal bed methane (“CBM”) ownership fiasco, the Alberta Energy and Utilities Board (the “EUB”) CBM ownership hearing, the EUB decision, and what you can do to help convince Premier Stelmach to honour his pledge and confirm the EUB decision with legislation.

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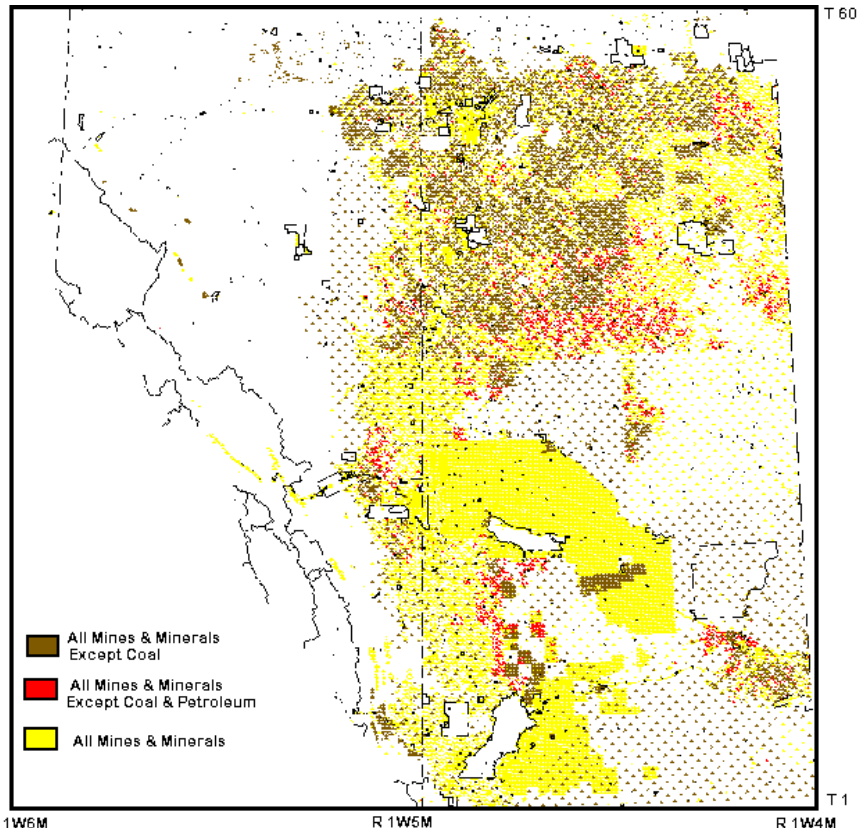


Figure 1 - Mineral Ownership in Southern Alberta

### The CBM Ownership Fiasco

Almost a century ago, the Canadian Pacific Railway Company (the “CPR”) sold farm-sized portions of its 25 million acre railway land grant to the pioneer settlers of western Canada reserving for itself all coal or all coal and petroleum beneath the lands. The railway company did not reserve natural gas because, according to the Alberta Court of Appeal, “it mistakenly believed natural gas was a worthless and noxious substance”.

As a result of the CPR’s mistake, title to coal and natural gas became split beneath more than 3 million acres of land in southern Alberta. The distribution of these ‘split title’ lands is shown above. In red and brown are lands where title to coal is now held by one party and title to petroleum and natural gas (brown) or just natural gas (red) is held by another party. The coal owner is typically Encana Corporation - one of the CPR’s successor corporations. The owner of natural gas

or petroleum and natural gas is typically an individual whose grandfather or great grandfather purchased homestead lands from the CPR in the early 1900’s. In yellow are privately-owned freehold lands where title is not split and all mines and minerals (i.e. coal, petroleum and natural gas) are owned by a single party. Mineral rights owned by the Government of Alberta (“Crown lands”) are shown in white.

In recent years, much has been made of the potential for unconventional natural

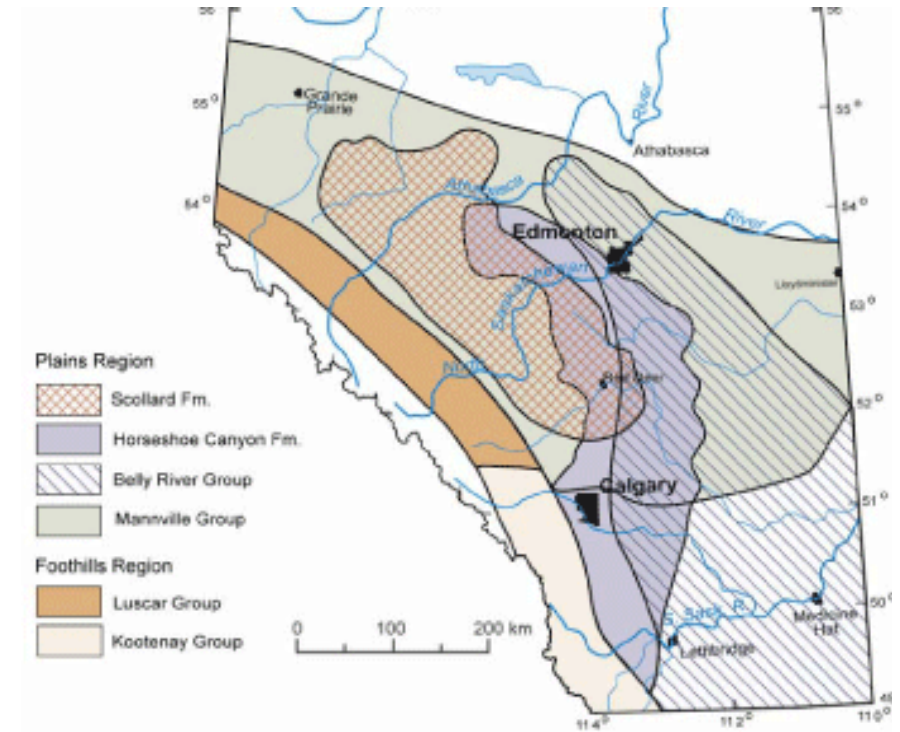
gas such as CBM to replace Alberta's declining conventional natural gas reserves. The map to the right shows the distribution of coals deemed most prospective for CBM development by the Alberta Geological Survey. CBM drilling and production activity to date has been concentrated in the area between Edmonton and Calgary where coals of the Horseshoe Canyon, Belly River and Mannville geological formations overlap in the subsurface (the "CBM fairway").

As seen by a comparison of Figures 1 and 2, privately-owned freehold mineral rights are checker-boarded with Crown mineral rights throughout the CBM fairway. In fact, in many areas of the fairway, freehold comprises more than 50% of the available mineral rights.

CBM wells typically produce at significantly lower rates than conventional gas wells. In addition, because gas does not flow as easily through coal as it does through conventional reservoir rocks, more wells per section are needed to develop the CBM resource. CBM developers typically drill at least 4 wells per section.

Encana is one of western Canada's leading CBM developers. According to Encana, CBM development "requires large contiguous land positions and an almost manufacturing style of well and facility development on the surface." Other leading CBM developers agree - access to large blocks of contiguous acreage improves the economics of CBM development by providing economies of scale and minimizes the impact of CBM development on the environment by providing flexibility in the location of surface facilities.

In our November 4, 2006 newsletter, FHOA detailed the efforts of Encana to reclaim the natural gas that its predecessor, the CPR, had mistakenly sold to western Canada's original settlers in the early 1900's. In particular, we discussed Encana's claim to ownership of the CBM beneath split title lands - a claim which FHOA viewed as lacking in



**Figure 2 - Subsurface Distribution of Coals Prospective for CBM**

legal merit.

Ironically, due to the checker-boarding of Crown and freehold throughout the CBM fairway, the ownership uncertainty and fear of litigation fostered by Encana's claim has prevented CBM developers from accessing the large blocks of contiguous acreage which Encana and other CBM developers deem necessary for the economical and responsible development of the resource.

Encana's claim that its ownership of the coal beneath split title lands includes CBM has caused CBM developers to restrict their efforts to drilling wells and producing CBM from Crown lands surrounding split title freehold mineral rights. The resulting drainage of mineral rights owned by individual freehold owners has been exacerbated by the decision of the EUB to change well spacing and target area regulations so as to allow up to four wells per section to be drilled on fence lines separating Crown and freehold lands.

As a participant since early 2004 in the Multi-Stakeholder Advisory

Committee on CBM Development in Alberta (the "MAC"), FHOA repeatedly attempted to have the split title CBM ownership issue addressed by the MAC. FHOA's efforts were rebuffed. The government of former Premier Ralph Klein effectively took the position that individual freehold owners of natural gas who did not want their non-renewable resources drained away by wells on Crown land could enter into CBM sharing agreements with Encana on terms dictated by Encana. FHOA considered this position to be ill conceived as it essentially aided and abetted Encana's efforts to further its business interests based on a claim to CBM ownership which had no apparent legal merit.

Encana is a \$50 billion corporation and, in FHOA's view, didn't need the help of the Alberta Government to advance its business interests.

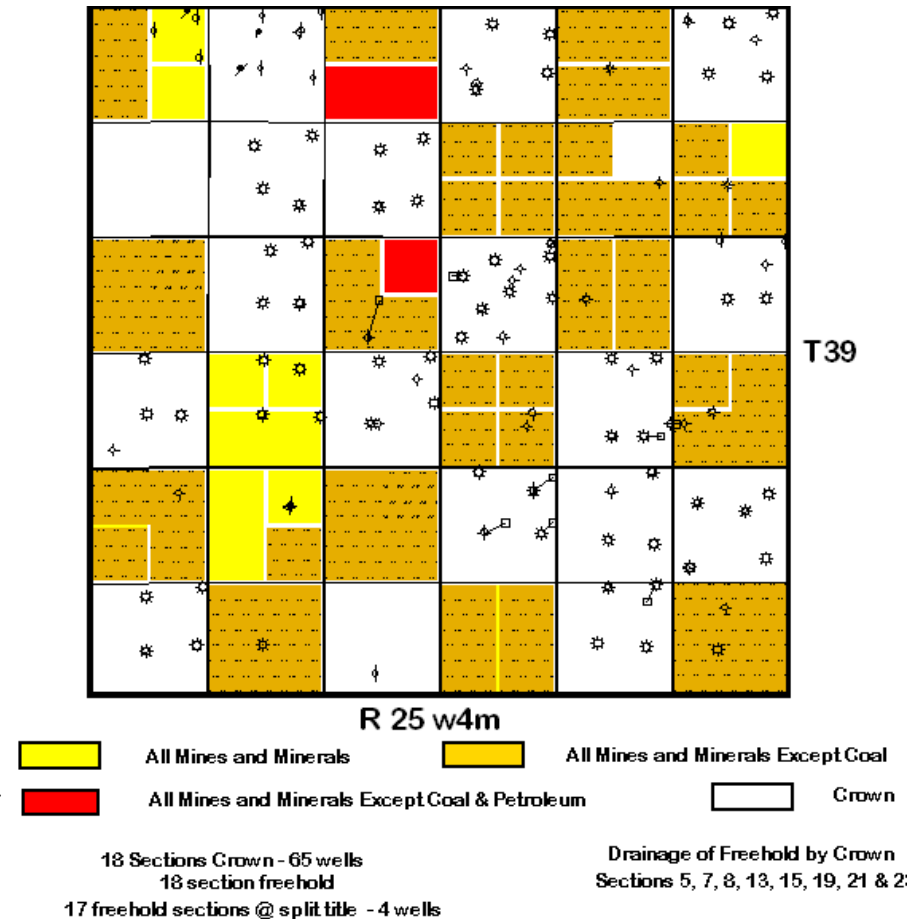
## The CBM Entitlement Hearing

In May of 2006, the EUB responded to Encana's CBM ownership claims by placing a moratorium on all drilling for CBM on sections of land where the entitlement to CBM was in dispute, pending the EUB's ruling in Proceeding 1457147. The EUB called this proceeding to determine the legal entitlement to CBM beneath split title lands.

FHOA sought and was granted permission to intervene in Proceeding 1457147. FHOA argued that CBM was a gas under initial reservoir conditions; that the 1953 decision of the Judicial Committee of the Privy Council in Borys v. CPR and Imperial, as confirmed by the 2004 Supreme Court of Canada decision in Anderson v. Amoco was authority for the "substance which is found in the form of gas in situ" to be the property of the gas owner; that the vernacular meaning of the words in the CPR reservation was determinative of the issue; and that the vernacular meaning of the word 'coal' in the early 1900's was a brown or black rock found in the ground and did not include gas.

FHOA submitted that Encana was using its unsubstantiated claim to CBM ownership to obtain business advantages over the rightful owners of CBM. During the hearing, the EUB heard testimony to the effect that a number of CBM developers had negotiated 'coal certainty agreements' with Encana. Under these agreements Encana allowed these CBM developers to drill and produce CBM on split title lands where the developers had leased natural gas from individual freeholders in return for a share in CBM production. Encana testified that it was "pretty flexible" in these agreements - the only actual agreement referenced required 40% of CBM production to be allocated to Encana. Participants in the hearing included a large number of CBM developers that had refused to capitulate to Encana's demands for coal certainty agreements.

During the EUB proceeding, FHOA



**Figure 3 - Land Ownership & Well Control Twp 39R25W4M -11/06**

presented the above map of a single township of land within the CBM fairway to demonstrate the impact of Encana's unsubstantiated ownership claim on individual freeholders.

Not only have 65 gas wells been drilled to produce CBM from the 18 sections of Crown land within this township as compared to 4 on the 17 sections of freehold land which include some split title freehold, but more than half of the sections of freehold within the township are subject to drainage from wells on Crown lands which are located on, or in close proximity to, the freeholder's fence lines.

FHOA sought an EUB order stating that coal owners have no legal entitlement to the CBM beneath the split title land at issue.

## The EUB's Decision

On March 28, 2007 the EUB released Decision 2007-024. Pursuant to this decision, Bulletin 2006-19 was rescinded. The EUB concluded that subsurface coal is a rock in which CBM is stored and that CBM is a form of gas that is gaseous and distinct from coal at initial *in situ* conditions. The EUB found that the vernacular meaning of coal at all material times was a "solid black or blackish combustible rock and does not include CBM". The EUB also concluded that the CPR's reservation of coal included only hydrocarbons in solid phase; that CBM was transferred to the early settlers by the CPR; and that a valid lease of natural gas from the homesteaders' successors constituted satisfactory evidence of entitlement to produce CBM for the EUB's purposes in granting well licenses, irrespective of the coal owners' objections.

FHOA is exceedingly pleased with the EUB's decision and commends the EUB

for not only ‘doing what’s right for all Albertans’ but also for crafting a decision which addresses the issue of CBM ownership on split title lands throughout the Province from a regulatory standpoint. According to media reports, Encana is “*disappointed but examining options for moving forward*”.

**D**uring the hearing, Encana maintained that the EUB does not have the jurisdiction to determine legal ownership. In Decision 2007-024, the EUB acknowledged that this authority lies with the courts. One option that Encana and the Carbon Development Partnership (“CDP” - the other coal owner involved in the hearing) have is to seek leave to appeal the EUB’s decision to the Alberta Court of Appeal on a question of law or jurisdiction. Other options including initiating litigation in all instances where CBM developers drill on sections of land which include split title lands and produce CBM.

**T**he EUB is a specialized and independent tribunal empowered to determine complex and highly technical oil and gas issues. During Proceeding 1457147, the EUB heard exhaustive testimony from the coal owners’ expert respecting the phase condition of CBM in the ground. The EUB rejected this testimony and ruled that CBM is a form of gas *in situ*. In 2004, the Supreme Court of Canada ruled in Anderson v. Amoco that in split title situations the freehold owner of natural gas “*is entitled to all hydrocarbons which were in gas phase at initial pool conditions ...*”. FHOA considers it unlikely that any Canadian court would vary the EUB’s technical finding and, given the recent Supreme Court decision in Anderson, it is not obvious how Encana or CDP could convince any Canadian court that its ownership of coal includes CBM.

**H**owever in Anderson, Encana and friends managed to convince nine out of the nine Canadian judges who heard the case that the highest court of appeal in the Commonwealth didn’t understand the fundamental issue before it in Borys and really meant to say that ownership of

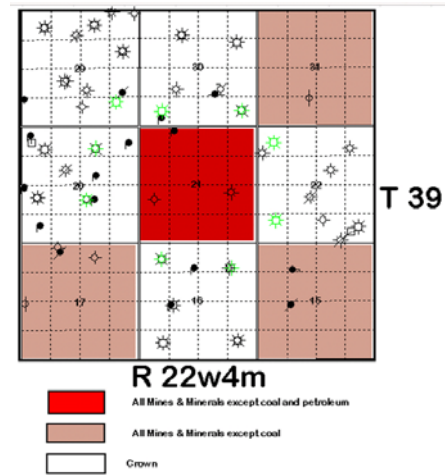
petroleum and natural gas was determined by “the condition of the substance prior to human disturbance” when it said “the condition of the substance as it emerges from the reservoir from time to time”.

**C**onsidering the potential value of the CBM at issue from Encana’s and CDP’s standpoint and the vagaries of the Canadian judicial system, the spectre of litigation may continue to hinder CBM development on split title lands for years to come.

**I**ndividual freeholders cannot afford to wait!

### **FHOA Petition**

**H**ighlighted in green on the map below are nine CBM wells immediately offsetting section 21-39-22w4m. In the 12 month period which ended November 30, 2006, these wells produced 655 million cubic feet of gas worth \$4,600,000. There are no wells producing CBM on section 21 or on the other three sections of split title land shown on the map. The wells offsetting section 21 produce from coals of the Horseshoe Canyon and



Belly River geological formations. Absent Encana’s unsubstantiated claim to CBM ownership, up to eight CBM wells could have been drilled on section 21 (four wells for each formation). Assuming similar productivity to the existing offset wells, reasonable gathering and processing

deductions and a 16% royalty rate, more than \$500,000 in royalties could have accrued to the individual freehold owners of natural gas on section 21 last year. Similar calculations apply to the freehold owners of natural gas beneath sections 15, 17 and 27.

**I**n 2003, the British Columbia legislature passed the Coalbed Act to resolve CBM ownership uncertainty in that province. Under this act, CBM belongs to the gas owner in the case of both Crown and freehold mineral rights.

**A**lberta also passed legislation to resolve CBM ownership uncertainty in 2003. Under the Energy Statutes Amendment Act, CBM belongs to the gas owner - but only in the case of Crown lands.

**T**he nine wells offsetting section 21 are all on Crown lands. Some of the CBM produced from these wells undoubtedly came from section 21. The Alberta Government is obviously profiting from its decision to exclude freehold mineral rights from legislation entitling gas owners to CBM.

**T**he Klein Government justified its decision to exclude freehold mineral rights from legislation entitling gas owners to CBM on the basis that the Alberta Government did not interfere in private ownership issues. This is just not the case!

**T**he moratorium on drilling for CBM on split title lands clearly interfered in private ownership issues.

**E**ven more to the point, in the early 1950’s, a dispute arose in Alberta as to whether the owner of the surface or the owner of all mines and minerals including valuable stone owned gravel.

**I**n February of 1951, the Alberta Supreme Court Trial Division ruled in favour of the mineral owner. Less than 3 months later, the Government of Ernest Manning enacted the Sand and Gravel Act. This act effectively reversed the trial court decision and

vested ownership of sand and gravel in the hands of the surface owner. The act applied to both Crown and freehold.

The following is the preamble to the Sand and Gravel Act read into the legislative record in April of 1951:

*Whereas the ownership of sand and gravel becomes a matter of doubt and uncertainty if it is dependent on whether evidence indicates that it constitutes the ordinary soil or subsoil of the district or that its occurrence is rare and exceptional and on whether it is regarded as a mine, mineral or valuable stone in the vernacular of the mining world, the commercial world and land owners at the time of any disposition in question; and Whereas it appears desirable in the public interest to resolve these doubts and uncertainties and to allay fears: ...*

Encana's unsubstantiated claims to CBM ownership give rise to doubt and uncertainty. Encana's threats to sue all those who produce CBM from split title lands without having entered into CBM sharing agreements with Encana give rise to fear amongst both CBM developers and individual freehold owners of natural gas. This fear has essentially sterilized the vast majority of sections of land within the CBM fairway which include any portion of split title for the past five years.

In 2003, the majority of the members of the Canadian Association of Petroleum Producers (the body which represents companies that produce 95% of Canada's oil and gas) recommended that the Alberta Government enact directive, retroactive legislation applicable to both Crown and freehold mineral rights in Alberta stating that CBM is natural gas.

Premier Klein's Government did nothing in response to CAPP's recommendation or FHOA's repeated pleas for action.

Despite the EUB ruling, doubt, uncertainty and fear will continue to overhang the development of CBM on split title lands for years to come without legislation applicable to freehold lands

stating that CBM is natural gas. Just as in the case of the disputed ownership of gravel, it is in the public interest for the Government of Alberta to take action.

Included with this newsletter is a petition asking Premier Stelmach to honour his pledge to do what is right for all Albertans by confirming the EUB's ruling with legislation.

#### Taxation Issues

Prior to 2003, freeholders who received royalties on oil or gas production from minerals rights in Alberta were eligible for a resource allowance equal to 25% of royalties received because of the fact that freehold mineral tax paid by freeholders to the Alberta Government was a non-deductible Crown charge. During this period, the T-5 slips which Alberta freeholders received should have shown equal amounts in Box 17 (royalties received) and Box 20 (amount eligible for resource allowance).

In 2003, at the request of the oil and gas industry, the Federal Government initiated the phase out of resource allowance and the concurrent phase in of a deduction for Crown charges. The 2006 tax year is the final year of the phase in/phase out period.

This year 35% of the original 25% resource allowance (or 8.75% of royalties received) is deductible. This amount is to be declared on Form T1229 Section III and is claim able on line 224 of your income tax return.

You should also be able to claim 65% of the freehold mineral tax you paid in 2006. Unfortunately, there is no reference to this deduction on the Canada Revenue Agency website, no place on Form T1229 to record this deduction, and no one at the number referenced in Box 20 of the T-5 slips who has any understanding of the issue. The matter has been brought to the attention of the Federal Government at the highest levels. According to Technical Income Tax Inquiries, at this point 'head office' has verbally acknowledged that the deduction is legitimate and that next year Form T1229 will be modified to reflect the

deduction. We have asked the Canada Revenue Agency to post information clarifying this matter on its web site or provide us with written clarification that we could share with our members prior to the income tax filing deadline.

#### Consents and Membership Renewals

We have again enclosed blank consent forms for those members who haven't yet executed these forms. The purpose of these forms is to make freehold owner contact information available to energy companies in a cost effective manner. We urge you to complete a consent form and return it to our offices. If you have questions concerning these forms don't hesitate to call our offices. We have also attached membership renewal forms for those members who have not already paid their 2007 membership dues.

#### Annual Meeting & Seminar

FHOA's annual general meeting will be held on Saturday, April 14, 2007 at 10:00 a.m. in the Crossroads Church, 32<sup>nd</sup> Street West and Highway 2, Red Deer County. The annual meeting will be followed by an information seminar. Topics for discussion include the CBM ownership fiasco; royalty reporting and the 'freeholder-friendly' FHOA lease, Just Freehold Energy - the freeholders' energy company, and services for freeholders. For further information, call our offices or visit our web site.

On behalf of the board of directors.  
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