

NEWSLETTER

The Freehold Owners Association (“FHOA”)

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LANDMARK RULING FOR FREEHOLD OWNERS

On September 7, 2011, the Alberta Court of Appeal released written reasons for its decision in Omers Energy Inc.’s appeal of the Energy Resources Conservation Board (“ERCB”) ruling on the meaning of the phrase ‘capable of producing the leased substances’. FHOA is exceedingly pleased with the Court’s ruling. This issue of your newsletter focuses on what the Court said and why the ruling is so important to freehold owners. Full text of the ruling may be found on the Court of Appeal website (<http://www.albertacourts.ab.ca/jdb/2003-/ca/civil/2011/2011abca0251.pdf>).

In this issue ...

<i>Omers v. ERCB</i> - Background	1
The Appeal Court Ruling	1
Mutual Benefit	1
Speculative Purposes	1
What does ‘Meaningful’ Mean?	2
Capable	2
Role of the ERCB	2
Implications	2
Acknowledgments	2

Omers v. ERCB - Background

In June of 2008, Montane Resources Ltd. asked the ERCB to review certain well licenses issued to Omers Energy Inc. for wells in the SE/4-5-54-14w4m. The ERCB conducted a 3-day hearing in February of 2009. At issue was whether the CAPL 91 lease held by Omers was a valid and subsisting lease for the purpose of the issuance of well licenses.

Lessees may continue CAPL 91 leases beyond their primary terms with token annual suspended well payments if a shut-in

or suspended well exists on the leased lands (or on lands pooled or unitized with the leased lands) and if the well is “capable of producing the leased substances”. Omers had drilled a well on section 5-54-14w4m which had been shut-in after the expiry of the primary term of Omers’ lease of our member’s mineral rights. The central question before the ERCB was whether this well was ‘capable of producing the leased substances’.

During the hearing, Omers took the position that the phrase ‘capable of producing the leased substances’ should be literally interpreted to mean that any amount of production, no matter how small so long as it was measurable, was sufficient to continue its CAPL 91 lease. FHOA submitted that Omers’ interpretation would allow CAPL 91 leases to be continued indefinitely for speculative purposes without production and that this was contrary to the fundamental purpose of freehold leases - to develop the mineral rights for the benefit of both parties to the lease agreement.

In its May, 2009 decision the ERCB stated that “*the lease established a contractual arrangement to facilitate production of the resource from the lands, with a resulting benefit for both the lessor and lessee.*” The ERCB ruled that the words “*capable of producing the leased substances*” meant that a well must be capable of producing leased substances in “*meaningful quantities*” in its existing configuration and state of completion. The ERCB concluded that the Omers well did not meet this test and that the Omers lease had expired on its own terms. (See Decision 2009-037 - ERCB website under ‘Industry Zone’, ‘Decisions’).

The Alberta Court of Appeal subsequently granted Omers leave to appeal the ERCB decision on the issue of whether the ERCB

erred in its interpretation of the phrase ‘capable of producing the leased substances’. FHOA’s member sought and was granted leave to intervene in this appeal.

The Appeal Court Ruling

In a unanimous ruling written by Madam Justice Carole Conrad, the Court dismissed Omers’ appeal. The decision of the Court addresses a number of issues critical to freehold owners.

Mutual Benefit

The Court stated that “*The lease is a contract through which the lessor and the lessee agreed to develop the leased substances for mutual benefit.*”

The vast majority of freehold leases entered into in western Canada over the past quarter century are either CAPL 91 leases or leases with identical basic structures. Consequently, the Court’s comment with respect to the purpose of Omers CAPL 91 lease is widely applicable.

Speculative Purposes

The Court forcefully denounced the concept of freehold leases being continued for speculative purposes. For example: “*an interpretation suggesting a lessor would agree to tie up its land to a lessee beyond the primary term for speculative purposes only is unreasonable*” and “*It strains common sense to think a lessor would agree to tie up its land past the primary term, and perhaps indefinitely, for a lessee’s speculative purposes only and for a well that lacks commercial viability.*”

While the Court’s comments regarding speculative lease continuation specifically addressed the shut-in wells issue, there are many other situations where lessees continue freehold leases beyond their primary terms for speculative purposes with token payments. For example, the

Crown and sophisticated corporate lessees have for many years prescribed zone-specific leases which provide for the mineral rights above or below the zone proven productive to revert to the lessor at the end of the lease's primary term. In contrast, the vast majority of leases entered into by individual freehold owners allow the lessee to hold all rights from the surface to the centre of the earth with production from a single zone. There are many examples of lessees that produce uneconomic volumes of hydrocarbons from one zone for the sole purpose of retaining the lessor's rights to all other zones for speculative purposes. The Court's condemnation of freehold lease continuation for speculative purposes may have future application to such circumstances.

What Does 'Meaningful' Mean?

Before the ERCB, FHOA argued that 'capable of producing' meant 'capable of producing in paying quantities'. In general, a well is said to be producing in paying quantities if operating revenues exceed operating expenses (capital costs associated with drilling, completing, equipping and tying in the well are not considered). In particular, FHOA cited the paying quantities test set forth in 1959 by the Texas Supreme Court in *Clifton v. Koontz* and followed almost unanimously in other American jurisdictions - would a reasonably prudent operator expecting to make a profit continue to operate the well.

The ERCB was not prepared to imply the term 'paying quantities' in a CAPL 91 lease. It ruled that "*the volume of production needed to be material or meaningful*" and what these terms meant depended "*on the relevant factors in each individual case.*"

Before the Court of Appeal, FHOA's member again argued for the 'paying quantities' test. The Court agreed with the ERCB that this term was not included in CAPL 91 leases and should not be implied. The Court upheld the ERCB's meaningful quantities test.

However, Justice Conrad reviewed in detail the American case law provided by FHOA's member and saw no "significant difference between "meaningful" quantity and "paying" quantity. Her Ladyship

found the paying quantities test set forth in *Clifton* "appealing" and stated "*The tests set out in Clifton relating to marginal wells may prove helpful guides in developing Canadian jurisprudence on this issue. ... some questions a tribunal might ask are: Would a reasonably prudent operator, for the purpose of making a profit and not merely for speculation, continue to operate a well in the manner that it does? Or put simply, "Is there [is] a reasonable expectation of profitable returns from the well?"*"

Capable

The Court agreed with the ERCB's conclusion that 'capable' meant that the well had to produce in its existing state and configuration without requiring further operations to produce.

In many instances wells on freehold lands have been cased based strictly on mechanical well logs without any form of production testing and the lessee has advised the freehold owner-lessor that the lease will be continued beyond the primary term under the Suspended Well clause. Pursuant to the Court's ruling, such leases have terminated on their own terms. Even if a well has been production tested during the primary term, unless the test establishes that the well is capable of producing meaningful volumes (ie. volumes which would give rise to the reasonable expectation of profitable returns), the lease will expire on its own terms at the end of the primary term.

Role of the ERCB

Historically, owners of freehold mineral rights in Alberta who wish to challenge their lessee's right to continue their lease under the Suspended Wells clause have had to either file a Notice to Caveator to Take Proceedings on Caveat or initiate a legal action in the Court of Queen's Bench. Both of these courses of action expose the freeholder to the substantial costs and lengthy delays associated with the Canadian legal system. In result, very few freeholders have historically challenged their lessee.

Section 16(1) of the Oil and Gas Conservation Act states that "*No person shall apply for or hold a license for a well ... unless that person ... is entitled to the right to produce the oil, gas or crude bitumen from the well ...*" It is implicit in the Court's ruling that this section provides the ERCB with the authority to make decisions

regarding the validity of freehold leases.

Implications

In FHOA's view, challenging the validity of a CAPL 88 or 91 freehold lease being continued beyond the primary term under the Suspended Wells clause with a well which is not capable of meaningful production may now be as simple as writing a letter to the lessee setting forth the particulars of the well's production and requesting the removal of the caveat protecting the lease with copies to the ERCB's Compliance Department requesting well license cancellation.

The importance of Justice Conrad's ruling to freehold owners cannot be overemphasized. Following the 2009 ERCB decision, an article published in the *Negotiator* (the magazine of the CAPL) asserted that the decision impacted "*thousands (if not tens of thousands) of leases and wells*" and encouraged Omers to appeal. The Court's affirmation of the ERCB decision clearly benefits a great many freehold owners. It also demonstrates how critical it is for freeholders to be represented in regulatory and judicial hearings dealing with freehold minerals - it was FHOA that introduced American case law and argued that leases were for the mutual benefit of the parties.

Although the decision represents a major step forward in FHOA's quest for greater fairness for freeholders, there are many steps remaining to be taken and interventions are expensive. We urge readers to continue to support FHOA with membership fees and donations.

Acknowledgements

FHOA wishes to publicly thank Mr. Tibor Osvath of Rae and Company for his competent counsel, the many freehold owners who attended the Court hearing and clearly demonstrated that this was not just another case of two oil companies bickering, and, in particular, Mrs. Eva Cymbaluk, the member who allowed us to represent her interests in these matters.

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