

PRIVATE ROYALTY ISSUES: A CANADIAN VIEWPOINT

Nigel Bankes
Faculty of Law
The University of Calgary
ndbankes@ucalgary.ca
February 2003

1.0 PURPOSE OF THE PAPER AND AN OUTLINE

This paper discusses some of the key private royalty issues that have engaged the Canadian courts over the last number of years. Some of these issues will no doubt seem parochial to an American audience. It may appear in some cases that Canadian oil and gas lawyers are captured in a time-warp from which our American colleagues escaped decades ago. Others of these issues will doubtless resonate with American readers more directly.

The first matter for discussion is the legal characterization of the royalty. The principal issue here is whether or not the royalty in question may be characterized as an interest in land that will bind subsequent purchasers of the property. This continues to be an important issue in Canada because of the restrictive rules that we have for the running of covenants and especially the burden of positive promises.¹ The second matter for discussion deals with the approach of the Canadian courts to the question of the implied duties that the working interest owner may owe to the royalty payee, whether that payee is the holder of a lessor's royalty or the holder of a GOR. Third, I shall deal with the case law pertaining to the measures that royalty owners may take to protect their interests through the negotiation of reassignment and surrender clauses and the like. Fourth, the paper looks at a range of interpretive questions that have drawn the attention of Canadian courts. Key among these are those cases that deal with the deductions that the royalty payor is entitled to make for post-production charges such as transportation, compression and processing but I shall also consider a range of other miscellaneous interpretive matters as well. The paper closes with some conclusions.

The paper does not deal with Crown royalties and neither does it deal with some of the interesting litigation that has been occurring over the last number of years in the context of Indian oil and gas leases.² One of

¹See generally Bruce Ziff, "Positive Covenants Running With Land: A Castaway on Ocean Island?" (1989), 27 Alta. L. Rev. 354.

²I have commented on some of this litigation in Bankes and Rae, "Recent Cases on the Calculation of Royalties on First Nations Lands" (2000), 38 Alta. L. Rev. 258.

the surprises that one encounters in surveying the Canadian case law is that there is really no case law relating to the private lease and gross overriding royalties that deals with the valuation of production for royalty purposes. Thus, while we have case law on the legitimacy of deductions for processing and transportation none of that private case law deals with the meaning of market price. While the absence of such litigation during the period of regulated pricing in Canada from the mid-1970s to the mid-1980s should be anticipated, the fact that we have not seen such litigation emerge since then, except in the context of Indian oil and gas leases is more surprising.³

Before taking up the issues identified above individually it seems useful to begin with some remarks of a more general nature on the Canadian law of royalties.

1.1 The Classification of Royalties in Canadian Oil and Gas Law

Canadian case law recognizes three principal categories of royalties: a lessor's royalty, a royalty created by the owner of a corporeal estate in fee simple, and a gross overriding royalty (GOR). The lessor's royalty is a royalty that is reserved or granted as a term of an oil and gas lease. It would ordinarily terminate upon the termination of the lease. The second form of royalty is characterized by the fact that it is granted by the owner of the corporeal estate and is not incident to a reversionary interest of the grantor.⁴ It might be granted for a term of years or in perpetuity. Perhaps surprisingly we do not have a particular name for this form of royalty in Canadian law. In American law it is generally known as a perpetual non-participating royalty. The gross overriding royalty is a royalty created by the holder of a working interest in the property.

³For discussion of the period of regulated pricing see *Enchant Resources Ltd. v. Dynex Petroleum* (1991), 123 AR 81 (Q.B.). For discussion of the evolution of the energy market in Canada since that time and especially in the context of natural gas see *Stoney Tribal Council v. PanCanadian Petroleum Ltd.*, [1999] 1 WWR 41 (Alta. Q.B.), varied [2001] 2 WWR 442 Alta. C.A.), Keith Miller, "Energy Regulation and the Role of the Market" (1999), 37 Alta. L. Rev. 419 and National Energy Board, *Producers' Response to Changing Market Conditions*, June 1997, *Natural Gas Market Assessment, Long-Term Canadian Natural Gas Contracts*, January 1997 and August 1992 and *Canadian Natural Gas Market: Dynamics and Pricing: An Energy Market Assessment*, November, 2000. The period of regulated pricing did, surprisingly enough, produce one case on the meaning of "price received": *Norcen International Ltd v. Suncor Inc.*, [1984] 4 WWR 35, var'd [1986] 4 WWR 57 (Alta. CA). Suncor operated a tarsands plant. Norcen claimed a royalty interest in production under a very complex agreement based upon the price received by Suncor. The agreement was negotiated before prices were regulated as were long term sales agreements pursuant to which price was fixed by reference to sales from three conventional fields. With the introduction of price regulation Suncor lobbied to receive world price for its production. It was successful. Was royalty payable on the regulated price plus the petroleum compensation payment (PCP) or just on the regulated price? The trial court gave judgement for Suncor holding that the PCP was not part of price. The court of appeal varied holding that it all depended upon the mechanism chosen to make the payment. According to that court, for one period the mechanism chosen by government entitled Norcen to treat the PCP as part of the price received but not for another period and another delivery mechanism.

⁴For examples see *Bensette and Campbell v. Reece* (1969), 70 WWR 705, rev'd by [1972] 2 WWR 497 and *Vanguard Petroleum Ltd v. Vermont Oil and Gas*, [1977] 2 WWR 66 (Alta. S.C.).

Since it is carved out of the working interest it too will terminate when the working interest terminates.⁵

There is at least one additional category of royalty interest that is something of a hybrid of the first two types of royalty; this is the gross royalty trust agreement (GRTA). A GRTA is an arrangement whereby the owner of the corporeal estate⁶ settles a royalty interest in the petroleum and natural gas on a trustee.⁷ Under the terms of the transfer and trust deed, the trustee creates units in the royalty, each evidenced by a certificate, which units the trustee distributes on the instructions of the settlor. The unit holders have an entitlement to a share of the royalties. Thus far, the GRTA has all the hallmarks of the second form of royalty described above, but most of these GRTAs were actually created when the lands in question were already subject to a lease. Thus, one possible characterization of the arrangement was that it was simply an assignment of a lessor's royalty. GRTAs were very common during the 1950s and 1960s. They permitted lessors to market their royalty entitlements and allowed them to share the risks of production or non-production by trading royalty certificates with neighbours. We have seen extensive litigation on these GRTAs during the last decade and I canvass some of that case law in section 2.2 of the paper.

While the above distinctions remain useful, and while some of the attributes of the different forms of royalty will always differ (e.g. attributes relating to duration), the recent trend of Canadian courts has been away from emphasising the distinctive characteristics of the forms of royalty. Instead, the courts have chosen to emphasise, for example, that the rules pertaining to both the creation and the interpretation of royalty clauses should be the same.

1.2 The Case Law and the Literature: Use of American Authority

There is not a large body of Canadian case law on private royalties and the same may be said of the

⁵GORs may be created in any number of ways and for all sorts of reasons. They may be created in return for the provision of services (e.g. geological services) *Western Oil Consultants v. Great Northern Oils* (1981), 121 DLR (3d) 724 (Alta. Q.B.); they may be created as an incident of a farmout agreement and may or may not be convertible back to a working interest, *Welty Oil and Gas Ltd. v. Opal Energy Inc* [1995] AJ 1085 (Q.B.) (purchase and sale of oil and gas assets subject to a convertible GOR; purchaser entitled to a reduction in purchase price when representations to the effect that GOR holder would not convert turned out to be unfounded); they may be created as part of a sublease, *Suncor Inc. v. Norcen International Ltd* (1988), 89 AR 200 (Q.B.) (here the question was whether the royalty reserved by the sublessor was payable on gross production or net of the Crown's royalty as lessor); they may be created as a way of deferring the payment of the purchase price for an asset or a group of assets over time, *Mesa v. Amoco* (1992), 129 AR 177 (QB), aff'd (1994), 19 Alta. L.R. (3d) 38.

⁶It is conceivable that the holder of a GOR might engage in a similar practice and there is at least one case that attests to this possibility: *Montreal Trust Co. v. Gulf Securities Corp.*, [1978] SCR 708. This seems to be an isolated example.

⁷For more detailed discussion of the structure of the GRTAs see Justice Hunt's judgement at trial in *Scurry-Rainbow Oil Ltd v. Galloway Estate*, [1993] 4 WWR 454, 138 AR 321, (Alta. Q.B.) aff'd [1995] 1 WWR 316, leave to appeal to SCC denied (1995), 26 Alta. L.R. (3rd) 1.

academic commentary.⁸ This has led both counsel and the courts to resort to US case law and commentary, especially when considering any question that has not already been subject to consideration by Canadian courts. That said, it is rare for such considerations to be conclusive if only because there seems to be such a varied range of opinion in state courts on most issues of oil and gas law. But royalty cases in particular seem to encourage broad research and the marshaling of relevant US authority. Here are some examples:

- C In *Vanguard v. Vermont*⁹ Justice Moore of the Alberta Supreme Court referred generally to US authority for the somewhat commonplace proposition that, after many years debate on the meaning of the word royalty, “The American courts have held that it is necessary to examine the language under particular sets of circumstances to determine the nature of a royalty.”
- C In *Telstar Resources v. Coseka Resources*¹⁰ the Alberta Court of Appeal, while emphasising that it was the wording of each agreement that would, if clear, “govern at all times”, relied on US authority to support the proposition that a GOR is carved out of the lessee’s working interest.
- C In *Resman Holdings Ltd v. Huntex*¹¹ the Alberta Court of Queen’s Bench relied upon US authority (an academic article and a decision of the Fifth US Circuit Court of Appeals) for the proposition that the calculation of value at the wellhead for royalty purposes implies that one can deduct processing charges on a proportionate basis from the point of sale back to the wellhead.
- C In *Mesa Operating Agreement Ltd. v. Amoco Canada Resources Ltd*¹² Justice Shannon of the Alberta Court of Queen’s Bench relied on a US decision for the proposition that a working interest

⁸For a short commentary see Hunt and Lucas, *Oil and Gas Law in Canada*, 1990 pp. 156 - 158. For commentary on the royalty clause of the oil and gas lease see Ballem, *The Oil and Gas Lease in Canada*, 3rd ed, 1999, esp. chapter 8, Rae, “Royalty Clauses in Oil and Gas Leases” (1965-1966), 4 Alta. L. Rev. 323. For commentary on the characterization of royalties see: Davies “The Legal Characterization of Overriding Royalty Interests in Oil and Gas” (1972), 10 Alta. L. Rev. 232, Ellis, “Property Status of Royalties in Canadian Oil and Gas” (1984), 22 Alta. L. Rev. 1, Kuntz, *Classifying Non-Operating Interests in Oil and Gas*, Working Paper, Canadian Institute of Resources Law, 1988, Evans, Newman, Smith, “Overriding Royalties and Subleases as Interests in Land” in Papers Presented at the Mid-Winter Meeting of the Alberta Branch, Canadian Bar Association, Calgary, 1988, Quesnel, “Modernizing the Property Laws that Bind Us: challenging traditional property law concepts unsuited to the realities of the oil and gas industry” (2003) Alta. L. Rev (forthcoming) (considering both the characterization of gross overriding royalties and the rule against perpetuities).

⁹*Supra*, note 4: the issue was the characterization of a royalty obligation as an interest in land rather than a mere promise to pay.

¹⁰(1980), 12 Alta. L. R. (2d) 187 (C.A.).

¹¹[1984] 1 WWR 693 at 697.

¹²*Supra*, note 5.

owner would only breach its duty to the royalty owner in the event that it allowed the lands to surrender, if there were evidence of fraud or collusion between the lessor and the working interest owner.

- C In *Prudential Trust Company Limited v. National Trust Company Limited*¹³ the court used US authority to show that the problems of apportioning royalties were universal.
- C In *Western Oil Consultants Limited v. Bankeno Resources*¹⁴ the court relied on US commentary and case law for the proposition that reassignment clauses were developed to protect the royalty owner because of the clear understanding that the payor of the royalty owed no duty to the GOR holder, except possibly a duty of good faith, and has no fiduciary relationship with the GOR holder.
- C In *Scurry-Rainbow Oil Ltd v. Galloway Estate*¹⁵ (hereafter the *GRTA Test Cases*), a case on the characterization of the royalty, Justice Hunt urged that while US decisions may be of assistance “they must be used cautiously because of the fact that different American jurisdictions have adopted varied approaches to basic concepts of oil and gas law ...”. Her comments were approved by the Court of Appeal but that court added the qualifications that “it would be ... erroneous to rely to heavily on U.S. decisions” and that “American cases are persuasive when not in conflict with authoritative Canadian decisions.”¹⁶

With the exception of the case law on the GRTA, the bulk of Canadian case law deals with GORs rather than with the lessor’s royalty. This should not be taken as a reflection of the fact that all is well with the lessor’s royalty interest but rather a reflection of the fact that in Canada we do not have a tradition of freehold owners organizing to vindicate their rights.¹⁷ An individual freehold lessor will ordinarily lack the legal, technical and financial resources to challenge, for example, the lessee’s view of deductions.

¹³50 WWR 29, rev’d but not on this point by (1965), 56 WWR 37 (Alta. App. Div.).

¹⁴(1995), 28 Alta. L.R.(3d) 395 (Q.B.). A Saskatchewan Court took a similar approach in the earlier case of *Masai Minerals Ltd et al v. Heritage Resources Ltd et al* (1979), 95 DLR (3d) 488 (Sask. Q.B.), aff’d (1981), 119 DLR (3d) 393 (Sask. C.A.), leave to appeal to the SCC denied, 119 DLR (3d) 393n.

¹⁵*GRTA Test Cases*, *supra*, note 7 at 329 (AR), para. 16.

¹⁶[1995] 1 WWR 316 at 321 and see also *Bank of Montreal v. Dynex Petroleum Ltd*, [2002] 2 WWR 693 (Alta. CA), aff’d [2002] SCC 7. The Supreme Court of Canada made no reference to US authority in affirming the Court of Appeal’s decision. To the same effect see *Paddon Hughes Development Co. v. Pancontinental Oil Ltd*. [1998] AJ 1120 at para. 50, [1999] 5 WWR 726 (Alta. C.A.), leave to appeal to the SCC dismissed, [1998] SCCA 600 (a case dealing not with a royalty but the manner of payment clause of the lease).

¹⁷There is at least one active association of freeholders in Alberta, the Freehold Owners Association: www.fhoa.ca. The FHOA was formed in 1999. Other reasons that may inform the absence of lessor royalty litigation might include, the Canadian rules on costs (the winner is usually entitled to require the loser to pay its costs) and the reluctance of Canadian courts to develop a doctrine of implied covenants to protect the interests of the lessor.

2.0 THE CHARACTERIZATION OF THE ROYALTY

The most significant doctrinal issue to come before the Canadian courts in the royalty context has been the capacity of the royalty entitlement to bind third parties, that is to say, an assignee of the property out of which the royalty is carved, and who was not a party to the original contractual or other arrangements that gave rise to the royalty. This issue has arisen in two particular contexts, the GRTA and the GOR.

The issue has arisen in the context of the GRTA on these stylized facts:¹⁸

L, the owner of the corporeal fee simple estate in the oil and gas, grants an oil and gas lease to T1. The lease reserves or grants a royalty to L. L subsequently, by way of a GRTA, assigns the royalty reserved by the lease, or a more extensive interest, to a trustee, TT, which undertakes to create units in the royalty interest and to market those units on the instructions of L. The GRTA also imposes on L, in some manner, the obligation to reserve and assign the like royalty on any lease subsequently granted in relation to the lands. TT files a caveat to protect the interest created the GRTA. T1's lease expires. L sells the land to L2 and L2 registers the transfer in the Land Titles Office. L2 enters into a new lease with T2 reserving a royalty. Who is entitled to the royalty on the T2 lease, L2 or TT?

In resolving this type of question the courts have identified two sub-issues which we may state as follows: (1) did the GRTA provide that the assignment of royalty (and any associated obligations) was to survive the termination of the lease in place? (2) is the lessor's royalty an interest in land and is its assignment an interest in land, or, alternatively did the interest granted by the GRTA, if different from the lessor's royalty, create an interest in land that would bind successors in title to L and T1?

The issue has also arisen in the context of the gross overriding royalty. Here the stylized facts might be depicted as follows:¹⁹

TZ the holder of a Crown lease, or a freehold lease, or an interest in such a lease, grants G1 a gross overriding royalty in production from the lands. TZ sells its interest to TY. TY or a successor in interest to TY (such a trustee in bankruptcy), takes the view that it is not bound by the royalty obligation.

¹⁸There are obvious variations on these facts. For example, (1) there might have been no lease in force at the time the GRTA was executed, (see, for example, the scenarios discussed in the *GRTA Test Cases*, *supra*, note 7 at 316, paras 148 - 157 (AR) (QB)); (2) L2 might not be a purchaser but simply a volunteer taking under the terms of a will or by way of an *inter vivos* gift (see, for example, the facts of *Guaranty Trust Co. v. Hetherington*, (1987), 50 Alta. L.R.(2d) 193, varied 67 Alta. L.R.(2d) 290, leave to appeal to the SCC refused, 103 AR 240n). I commented on the trial judgement in *Hetherington* at (1987), 50 Alta. L.R.(2d) at 350.

¹⁹Again, the possible variations are legion: (1) TZ might create the GOR before it has earned or otherwise acquired its interest in the lease (see for example the facts of *Saskatchewan Minerals v. Keyes*, [1972] 2 WWR 108 (SCC), *Vandergrift v. Coseka* (1989), 67 Alta. L.R. (2d) 19 (Q.B.)), (2) the GOR might be created as part of an asset sale, as part of a farmout or for other reasons, see, *supra*, note 5, (3) the GOR holder might have the right to take in kind or not and the right to convert to a working interest or not.

This issue too may be dis-aggregated: (1) is TZ, as a matter of law, able to grant a royalty interest to G1 which is entitled to the status of an interest in land? (2) did TZ and G1 intend to create an interest in land? and (3) even if G1's royalty is not an interest in land, is there any other doctrinal basis upon which the royalty obligation might bind a subsequent purchaser of TZ's interest?

2.1 An Overview

Before analyzing these issues and sub-issues in some detail I think it will be useful if I provide an overview the case law on both of these main questions.

2.1.1 An overview of the GOR Issue

The legal characterization of the royalty interest first arose in a serious way in the context of GORs in the early 1970s. The early case law suggested that the person claiming the royalty interest faced two primary obstacles. The first was that a royalty framed simply in terms of an entitlement to a share of the proceeds of production, especially a net share of such proceeds, was little more than a promise to pay contingent upon production and did not, on its face, look much like an interest in land. The second obstacle was more formidable. In its shorthand version this was the doctrinal objection that there could be “no rent upon a rent”. A more meaningful summary of the objection relies upon the following linked propositions. (1) An oil and gas lease does not give the grantee of the lease a corporeal interest but only an incorporeal hereditament in the form of a *profit à prendre*. (2) As a matter of common law, it was not possible to reserve a rent out of an incorporeal hereditament because it would not be possible to levy distress to enforce the payment of rent. (3) A royalty is a rent or analogous to a rent and therefore the holder of a *profit* could not reserve a royalty that was entitled to the proprietary status of a rent. (4) *Ergo*, it was not possible, as a matter of law, for an oil and gas lessee to create a royalty interest that amounted to an interest in land.

From the 1970s to the end of the century, provincial superior courts in Canada could offer no coherent and consistent position on either of these two principal objections. On the second question (the question of law), the Supreme Court of Canada seemed to be divided on the issue.²⁰ The problem was not resolved until 2001 when the Supreme Court of Canada in its ground-breaking decision in *Dynex*²¹ decided that there was no good reason to adhere to the old doctrinal stance of the common law captured by the “no-rent-upon-a-rent” mantra, and that there were good and sufficient reasons for concluding that, as a matter of law, it should be possible for an oil and gas lessee to create a royalty with the status of an interest in land. Whether the parties *had* created such an interest would depend upon the answers to two further inquiries: (1) the did the party creating the royalty have an interest which itself amounted to an interest in land, and (2) did the parties intend to create a royalty with that status?

²⁰The key case is *Saskatchewan Minerals v. Keyes*, *id*.

²¹*Supra*, note 16.

Dynex settles and clarifies the law on a go-forward basis. It would be entirely prudent for any parties to any future agreement creating a royalty to express the matter of intention explicitly.²² The court went on to provide some limited guidance as to how to divine the intentions of the parties with respect to existing agreements and we shall return to that question. Determining the intentions of the parties in relation to older agreements will likely continue to prove to be difficult since the *pre-Dynex* law was unsatisfactory and the additional guidance offered by the Court is limited on this point.

2.1.2 An overview of the GRTA issue

Although GRTAs were created in Alberta from at least as early as the beginning of the 1950s, the characterization issue was not raised in litigation until the 1980s²³ before being resolved by the Alberta Court of Appeal in a series of decisions during the 1990s.²⁴ There is no decision of the Supreme Court of Canada on point, but that court may be taken to have endorsed the position of the Alberta Court of Appeal by its refusal to grant leave to appeal for the two main Court of Appeal GRTA decisions, *Hetherington* and the *GRTA Test Cases*. Consequently, short of the Court of Appeal of another province taking an entirely different view of the matter, (which seems unlikely) the characterization of the GRTA may be taken to be equally as settled as the characterization of the GOR. What then is the position?

The case law confirmed that the trustee faces the two distinct problems outlined above in enforcing its entitlement. The first problem relates to the duration of the royalty interest and the second relates to its legal character.

As to the first problem, the courts have confirmed that there were some GRTAs that were defectively drafted. For those GRTAs all obligations will be held to have terminated when the lease in force at the time the GRTA was created comes to an end. This issue is simply as a matter of interpretation. It does not involve a rule of law. As to the second problem, and, notwithstanding large differences in the drafting of lease royalty clauses, and the equally large differences in the granting clauses of the GRTAs themselves, the royalty clause of the lease has been uniformly treated as creating an interest in land, as has the GRTA granting clause. The result may best be characterized by saying that there is a very strong presumption in

²²The more explicit the better: “The parties to this agreement intend that the royalty created/reserved by clause x shall be/not be an interest in land.” [strike out the relevant clause]. For an example of a clause where the parties apparently disclaimed an intention to create a GOR that was an interest in land see *Montreal Trust Co v. Gulf Securities Corporation Ltd*, [1973] 2 WWR 617. The point is considered by the trial judge but not by the Supreme Court at [1978] SCR 708.

²³The first case was *Hetherington*, (1987), 50 Alta. L.R.(2d) 193, varied 67 Alta. L.R.(2d) 290, leave to appeal to the SCC refused, 103 AR 240n.

²⁴In addition to *Hetherington* the key cases are the *GRTA Test Cases*, *supra* note 7, *Barrett v. Krebs*, [1995] 5 WWR 23, aff’d [1996] 5 WWR 529 (Alta. C.A.) and *Scurry Rainbow Oil Ltd v. Kasha* (1996), 135 DLR (4th) 1 (Alta. C.A.).

favour of interpreting the lessor's royalty and the GRTA as having created an interest in land. The presumption may not be irrefutable but thus far no case has come along in which that presumption has successfully been rebutted.

There is ongoing GRTA litigation in Alberta and the other prairie provinces but it seems no longer to be raising the fundamental characterization issue. It is instead concerned with the more detailed questions that arise as the parties endeavour to implement the series of decisions, the effect of which is described in the previous paragraphs.²⁵

I shall now review the case law in some greater detail.

2.2 The GRTA Issues

2.2.1 Did the GRTA survive the death of the lease in place?

This issue first came to the fore in *Guaranty Trust Co. v. Hetherington*.²⁶ The trial court had held that the GRTA in question (hereafter referred to as the PTC-1 form or the *Hetherington-form*) only gave rise to contractual rights and did not create an interest in land. The Court of Appeal ducked that point and found that the GRTA entitlements did not survive the death of the lease in force at the time the GRTA was negotiated. The court's reasoning turned on the language of the recital to the GRTA and two of the operative clauses, the granting clause for the GRTA, and the covenant with respect to future leases. So far as relevant these clauses read as follows:

WHEREAS ... the Owner has leased to the said Lessee all Petroleum and Natural Gas and related Hydrocarbons, within, upon and under the said lands; and

WHEREAS the said Rio Bravo Oil Company is obligated to pay to the Owner under the Covenants and Conditions contained in the said Lease a Gross Royalty of Twelve and One-Half (12 ½%) Percent of all production from any well or wells that may be drilled upon the said lands, or any part thereof, and;

WHEREAS the Owner herein is desirous of constituting Gross Royalty Certificates to cover all the said Twelve and One-Half (12 ½%) percentum gross royalty, and has requested the Trustee hereunder

²⁵The cases include: *549029 Alberta Ltd. v. First City Trust Co.*, [2002] AJ 950 (QB) this was an attempt to secure an order declaring a *Hetherington-form* trust invalid - the application was denied on the basis that the successors in title of the fee owners had executed a waiver agreement declaring *inter alia* that the GRTA was to apply to subsequently granted leases; *Guaranty Trust Co. of Canada v. Clark* [1990] AJ 154 (Q.B.) dealing with the form and registration of *post-Hetherington* interpleader orders in the Land Titles Office; *Astl v. Montreal Trust Co. of Canada* [200] AJ 1700 (C.A.) giving directions as to the procedure to be followed to "collapse" *Hetherington-form* GRTAs; *National Trust Co. v. Johnson*, [2002] MJ 189, (1) a caveat that protects the transfer of an undivided interest in land pursuant to a GRTA will not also protect an assignment of a gross royalty which claim is not disclosed by the caveat, and (2) where the GRTA assigns a royalty in the leased substances but the lease cannot be located, the grant of the royalty by the GRTA will be void for uncertainty.

²⁶*Supra*, note 23.

to act as Trustee for the issuance of such Gross Royalty Certificates, and;

WHEREAS the Trustee has agreed to act as such Trustee with respect to the said Twelve and One-Half (12 ½%) percentum gross royalty and to receive and distribute such gross royalty if, as and when the same is received, subject to the Owner herein assigning, on his own behalf and on behalf of any person to whom he may have assigned any part thereof, all of the said percentum gross royalty to the Trustee;

2. The Owner herein doth hereby grant, bargain, sell, assign, transfer and set over unto the Trustee, its successors and assigns: forever, all the estate, right, title, interest, claim and demand whatsoever, both at law and in equity of the Owner in and to the above mentioned Twelve and One-Half (12 ½%) percentum gross royalty or share of production from any well or wells that may be drilled upon the said lands or any part thereof (hereinafter referred to as "the Gross Royalty") TO HAVE AND TO HOLD the same with all and every benefit that may or can be derived from the same unto the Trustee, its successors and assigns forever, subject only to the terms of this Trust Agreement.

25. The Owner hereby covenants and agrees with the Trustee that, in the event that any lease that may be in existence as at the date of this Agreement is cancelled for any reason or in any event that no lease is in existence as at the date of this Trust Agreement, he shall and will in negotiating any lease or other instrument for developing the said lands reserve unto the Trustee the full 12 1/2% Gross Royalty hereby assigned to the Trustee."

The Court of Appeal contemplated two possible grounds upon which the trustee might argue that it was entitled to royalties reserved by subsequent leases. One possibility was that the granting clause effected a transfer of a royalty interest forever, in much the same manner as a rent charge for the equivalent of an estate in fee. The second possibility was that the trustee was entitled to a royalty as a result of the cl. 25 covenant. The trial judge had effectively merged the two grounds and found that cl. 2, when informed by the "hereby assigned" language of cl. 25, must be interpreted as expressing the intention of the parties that the GRTA was to survive the death of the lease extant at its time of creation.²⁷

The Court of Appeal severed these arguments and that court found that cl. 2 was limited to an assignment of the royalty reserved by the extant lease.²⁸ By the same token, cl.25 could only protect the trustee to the extent that it was able to bring itself within the terms of the clause and it could not do so in this case because the lease was never "cancelled" within the meaning of the clause. Instead, it simply "expired through effluxion of the primary term of the lease."²⁹

²⁷*Id.*, at 215 (trial).

²⁸*Id.*, at 298 (CA): "[W]e agree that the royalty assigned by cl. 2 is the royalty payable from the recited Rio Bravo lease".

²⁹*Id.*, at 298. In the later case of *Barrett v. Krebs*, [1995] 5 WWR 23 at 46, Justice Hunt at trial offers an extended commentary on this question. The plaintiffs in *Barrett*, confronted with a GRTA with identical cl. 25 language, were endeavouring to distinguish *Hetherington* and adduced a variety of arguments to support the claim that, notwithstanding the language of cl. 25, the parties intended that the GRTA survive the lease in place. When the rectification argument failed (as well as arguments based on estoppel and breach of fiduciary duty- the court held that there was no duty owed by the settlor to the beneficiaries of the GRTA), the plaintiffs argued, in effect, that the

The defect in drafting noted by the Court of Appeal was not apparent in all of the GRTA forms in use in Alberta and in other cases the Courts have found that the trustee can claim an interest or entitlement that extends beyond the original lease. The leading case is *Scurry Rainbow Oil Ltd. v. Kasha*.³⁰ The Montreal Trust GRTA form (hereafter MT form) in use in that case followed the PTC-1 form insofar as it began by reciting the terms of the lease and the royalty obligation of the lease. It also followed the PTC-1 form insofar as the first part of the granting clause, while framed in large terms of grant, limited the subject matter of the grant to the “above mentioned royalty”. This could only be interpreted as a reference to the royalty reserved by the lease and described in the recitals to the agreement. The key difference was that the granting clause then went on to fulfill the office of the *Hetherington* PTC-1 cl. 25, but in much broader terms:

In the event that the lease hereinbefore mentioned [the California Standard lease] is cancelled, terminated or in any manner whatsoever brought to an end, the Owner agrees that the petroleum, natural gas and related hydrocarbons or any or all of them in and under the said lands shall continue to be subject to a twelve and a half (12 ½) percentum gross royalty and the said twelve and a half (12 ½) percentum gross royalty shall be subject in all respects to the trust herein created and it is further agreed that any Owner's royalty payable under any future lease of petroleum, natural gas or related hydrocarbons or any or all of them under the said lands shall be subject to the trust herein created and the owner further agrees that he will not in future lease petroleum, natural gas or related hydro-carbons or any or all of them under the said lands without expressly providing for the payment of a twelve and a half (12 ½) percentum owners gross royalty of the leased substances free and clear of all charges, restrictions or covenants of any kind whatsoever.

This clause is broader than the PTC-1 form in at least two ways. First, the clause clearly expresses the intention of the parties that the royalty is to continue beyond the term of the original lease. The language used is more consistent with a modification of the granting clause than it is consistent with a mere promise to reserve a like royalty when subsequently granting leases to the property. Second, the MT form contemplates a broader range of scenarios that will trigger the continuing obligation than simply the “termination” of the lease. Justice O’Leary in giving judgement for the Court of Appeal distinguished *Hetherington* and

word “cancelled” should be accorded a different meaning in this case than the court had accorded the word in *Hetherington*. The claim was supported by the fact that in *Hetherington* the lease form was not before the court whereas the lease was before the court in *Barrett* and the form did not use the word “cancelled” at all. Justice Hunt confessed herself to be puzzled as to what the term cancelled might mean but concluded that whatever it meant she was bound by *Hetherington* to conclude that it could not mean expiration “due to non-production at the end of the primary term ...”. The Court of Appeal reaffirmed its conclusion in *Hetherington* on two occasions in the *Barrett* litigation, first as part of an application for leave to have the court reconsider its earlier views [1995] AJ 753, 32 Alta. L.R.(3d) 224, and, when that application was denied, upon regular appeal to the court, [1996] AJ 167, [1996] 5 WWR 529, where the court observed (at para. 6) that “we would simply reaffirm this Court’s conclusion in *Hetherington* that cancellation of a lease and expiry due to non-production are not the same.” An argument that the court should rectify a GOR so as to make it grant an interest that was clearly an interest in land rather than a mere contractual claim also failed in *Nova Scotia Business Capital Corp. v. Coxheath Gold Holding Ltd.*, [1994] NSJ 480 (NSCA).

³⁰(1996), 135 DLR (4th) 1 (Alta. C.A.). But see also the *GRTA Test Cases*, *supra*, note 7, at paras 146 *et seq* (AR) dealing with the non-PTC-1 forms of GRTA and concluding that they were intended to survive beyond the duration of any extant lease.

concluded as follows:³¹

In my view, the wording of the second segment of [the granting clause] in the context of the agreement as a whole, clearly expresses the intention of the parties that the royalty interest assigned to the trustee was not limited in time to the life of the California Standard lease but was to remain effective and attached to the lands after its end whether or not a further petroleum and natural gas lease existed.

2.2.2 Does the GRTA create an interest in land capable of supporting a caveat?

While *Hetherington* established that some GRTAs were doomed to terminate along with the lease in place, the Court of Appeal in that case had said nothing about the interest in land issue.³² By contrast, the trial judge, Justice O’Leary had decided the case on this issue and had determined that the GRTA in question had *not* created an interest in land. O’Leary reached this conclusion primarily on the basis that the GRTA did not reveal an intention to create an interest in land but revealed simply “an intention to assign to [the trustee] the benefit of the lessee’s covenant to pay [the lessor] an amount calculated as a percentage of the oil and gas produced from the lands and subsequently sold.”³³ Consequently, the assignment of the royalty to the trustee was not binding on subsequent purchasers for value of the fee simple estate of the original lessor. It followed that the registered owners were entitled to have the caveats discharged and entitled to an order that the entire royalties from subsequently granted leases should be paid to them.³⁴ Justice O’Leary

³¹*Id.*, at 16.

³²There were earlier cases in which the courts had concluded that the owner of a fee simple estate in the minerals *could* carve out a royalty interest that amounted to an interest in land: see *Bensette and Campbell v. Reece* (1969), 70 WWR 705 (Sask. QB), aff’d on this point [1973] 2 WWR 497 at 498 - 500. Here the grantor, the owner of an estate in fee purported “give, grant, bargain, sell and assign and transfer ... a six per cent (6%) royalty in all the oil, gas, petroleum and mineral oils, mines and minerals ... which may be found in, under or upon the said lands.” *Bensette* did not involve a GRTA.

³³(1987), 50 Alta. L.R. (2d) 193. It is clear that Justice O’Leary did not decide against the trustee on the basis of a proposition of law but on the basis of the intentions of the parties. At 216 O’Leary contemplates the following possibilities: (1) that a fee simple owner of minerals subject to a lease can convey an undivided fractional interest in the minerals. Such a conveyance could be coupled with an assignment of the royalty, and (2) “I am prepared to assume, without deciding, that a lessor may also assign a royalty interest in his mines and minerals in gross, that is unaccompanied by a conveyance of fractional interest in his fee simple title, in such a manner as to create an interest in land in the assignee.”

³⁴The subsequently granted leases had actually reserved incremental royalties and the difference had always been paid to the new lessors. In one of the fact scenarios under consideration in *Hetherington* there was no transferee for value only a transfer to the executrix of the estate of the original grantor. On that fact pattern, Justice O’Leary held that the estate was bound by the obligation to assign any royalty to which the estate became entitled as a result of granting any subsequent lease (*id.*, at 215). Although the Court does not address the issue explicitly it must have been of the view that there was no other basis, other than the interest in land argument, for making the burden of a positive promise run with the transfer of the fee simple estate. In my view this is correct: see *Rhone v. Stephens*, [1994] 2 All E.R. 65 (Eng. H.L.) as applied in *Canada Southern Petroleum Ltd. v. Amoco Canada*

did not examine the language of the original leases in reaching this conclusion since the executed leases were not available.³⁵

While the result in *Hetherington* was that the trust's interest terminated, either on the basis that it did not survive the original lease (the Court of Appeal's view), or on the basis that it could not bind a purchaser for value (Justice O'Leary's view) (but would bind volunteers), *Hetherington* had done little to lay down general propositions that might serve to clarify the law. In particular, the Court of Appeal's refusal to deal with the proprietary characterization issue effectively invited further litigation.

That litigation was not long in coming and the Court decided to case manage it by selecting a number of test cases that were principally designed to test the characterization issue in the context of differently worded leases and differently worded GRTAs. The result was the *GRTA Test Cases*.³⁶

At trial, Justice Hunt recognized that there were at least two distinct ways in which one could conclude that the GRTA created a caveatable interest in land. The first approach focuses on the lessor's royalty interest. If that were an interest in land, and it was that interest that had been assigned to the trustee (i.e. made the subject of the granting clause), then one might conclude that the assignment of that interest was the assignment of an interest in land. The second approach focuses on the fact that regardless of whether or not the lessor's royalty amounted to an interest in land, the lessor's reversionary interest in the minerals allowed it to create a royalty which might be an interest in land.³⁷ This approach focuses attention on the granting clause of the GRTA and asks whether, on a stand alone basis, it was capable of creating an interest in land.

The lessor's royalty

Petroleum Co. [2001] AJ 1222 (a case dealing with the of a positive promise to develop and market oil and gas found on the premises). The binding effect of a GRTA on a successor in title who is a volunteer was confirmed in *Kasha*, *supra*, note 24, at 8. In that case the Court went on to consider the interest in land argument in any event because the successors in title had raised a question as to the validity of the trustee's caveat.

³⁵That said, the Court of Appeal in *Krebs*, *supra*, note 24, suggests that the parties had introduced a copy of what must have been Rio Bravo's standard form lease and Justice Hunt herself acknowledges this at trial in the *GRTA Test Cases*, *supra*, note 7 at 138 (AR), para. 20.

³⁶*Supra*, note 7.

³⁷*Id.*, at 337 para. 47 (AR). "So long as it is clear that it was intended that the GRTA would apply to future leases or to circumstances where there was no lease in place ...". To describe the lessor's interest as merely a reversionary interest seems misconceived. If the lease creates a *profit* then it follows that the lessor must have a present corporeal interest in the mines and minerals. The focus on the lessor's reversionary interest seems to arise from the particular ademption issue that arose in *Berkheiser v. Berkheiser*, [1957] SCR 387 the *locus classicus* on the status of the lease in Canadian law.

In Justice Hunt's view there are three distinct grounds on which it might theoretically be possible to conclude that a lessor's royalty constitutes an interest in land: (1) a royalty may be a species of rent, (2) a royalty may be a *profit à prendre*³⁸, and (3) a royalty may be an interest in land "akin to a rent". Notwithstanding significant differences in the language of the three leases³⁹ that were in force for the test case lands at the time the GRTA was executed, Justice Hunt felt able to conclude that in each case the lessor's royalty amounted to an interest in land on each of these three theories and thus there was no impediment to it being "assigned as such" under the GRTA. In taking such a robust view, Justice Hunt downplayed the significance of the particular words used and looked to the substance of the transaction⁴⁰ in which royalty is part of the compensation for granting the lessee the right to use the land.

The granting clauses of the GRTAs

Justice Hunt took an equally robust view of the alternative argument based upon the language of the GRTAs themselves. Two of the agreements, a Security Trust form and a Guaranty Trust form should have presented no difficulty whatsoever. In each case the granting clause contemplated that the trustee was to receive an "undivided interest" in the lands⁴¹ and each contemplated that the settlor would reserve a royalty on subsequently granted leases and assign that royalty or pay any royalty received to the trustee.

The third form should have been more problematic since it was the same PTC-1 form that Justice O'Leary had considered in *Hetherington*. But Justice Hunt chose to reject O'Leary's conclusion. She emphasised instead the large words of grant contained in the granting clause of the GRTA, and she downplayed the significance of the line of decisions which suggested that claims to the proceeds of production rather than an in situ interest in the minerals are inconsistent with a proprietary claim.⁴² Another line of cases which

³⁸*Id.*, AR at 333, para. 31. The idea that a royalty interest is a species of *profit* seems to me to be entirely misconceived. A *profit*, by its nature gives the right to work. It gives the holder the right to go on land of another and take something of profit from that land. A royalty interest typically does not give any right to work. *Accord* see *Bensette and Campbell v. Reece*, *supra* note, 4 per Disberry J. at 711; the point was not dealt with in *Reece* on appeal. *Contra*, see the discussion of *Kasha*, *infra*.

³⁹For example, the Burden lease used the language of reservation and in the case of oil gave the lessee the right to purchase the lessor's royalty share; the Fletcher lease did not use the language of reservation and simply contemplated that the lessee "pay or deliver" to the Lessor its royalty share of the substances; the Noble lease simply obliged the lessee to pay a percentage of the market value of produced substances.

⁴⁰*Supra*, note 7, at 351 (AR) *et seq.*

⁴¹The "magic" of the "undivided interest" language is simply that the grantee must become a tenant in common of the fee simple corporeal estate - it is much more than interest in somebody else's property.

⁴²*Supra*, note 7, at 337 (AR), para. 34. "There is in my view an unreality about placing too heavy an emphasis upon fine distinctions as the selection of words such as 'in' rather than 'on'". See *infra*, part 2.3.1 of this paper.

suggested that an assignment of rents⁴³ could not give rise to an interest in land was similarly disposed of by emphasising that it was the analogy with the law of rents that was persuasive, not all the details of that body of law.⁴⁴

The Court of Appeal affirmed Justice Hunt's decision and in doing so chose to emphasise the GRTA granting clause part of her analysis rather than her analysis of the lessor's royalty.⁴⁵ What was critical for the Court of Appeal was that following the grant of a lease, the lessor continues to have two significant interests in the oil and gas, a fee simple interest in the minerals in situ, and a reversionary interest in the subject minerals with respect to the lessee's *profit à prendre*. Both are clearly interests in land and in each of the three test cases the lessor/settlor granted the trustee an interest in land by virtue of the terms of the GRTA.

Post GRTA Test Cases Litigation

The Court of Appeal confirmed and refined its approach to the characterization issue in the subsequent case of *Scurry Rainbow Oil Ltd. v. Kasha*.⁴⁶ In *Kasha*, Justice O'Leary, now speaking as a Justice of the Court of Appeal, endorsed what he described as the two-step approach⁴⁷ of the *GRTA Test Cases*. Step one was the characterization of the lessor's royalty, and step two the characterization of the interest granted by the GRTA.

It seems fair to say that if one conceives of a spectrum of instruments with, at one end of the spectrum a royalty clause and GRTA granting language that undoubtedly intend to create proprietary interests⁴⁸ and

⁴³*Canada Trustco Mortgage Company v. Skoretz* [1983] 4 WWR 618 (Alta. Q.B.), *Northland Bank v. Van de Geer* (1986), 34 DLR (4th) 156 (Alta. C.A.); the Alberta legislature has reversed this particular rule and now deems an assignment of rents to create an equitable interest in land: *Law of Property Act*, RSA 2000, c. L-7, s. 63.

⁴⁴*Supra*, note 7, at 353 - 354 (AR).

⁴⁵As to this, the court (Alta. C.A.) simply said [1995] 1 WWR 316 at 320, "We have concluded that we need not decide on that basis to answer the questions before us."

⁴⁶*Supra*, note 15.

⁴⁷*Id.*, at 9. I think that this is an inaccurate label since the cases actually suggest that the trustee may receive a interest in land under a GRTA either through the lessor's royalty or through the granting clause of the GRTA. O'Leary himself recognizes this when he says at 12 that "Unless the royalty was an interest in land, the owner could not assign an interest in land, *unless* he conveyed a portion of the reversion." (Emphasis added.)

⁴⁸For example, the royalty clause might use the language of reservation and the GRTA granting clause might transfer an undivided interest and oblige the settlor to assign the benefit of any future lease royalties to the trustee.

other end of the spectrum much weaker language, the instruments in question in *Kasha* fell into the latter category. The royalty clause of the *Kasha* lease was little more than a promise to pay with no right to take in kind. The granting clause of the GRTA was largely confined to the grant of the “said royalty” (i.e. the royalty provided for by the first lease) although the second part of the clause did go on to emphasise that the lands would still be subject to the royalty, and the royalty subject to the trust, even if the existing lease came to an end.

This time, the Court went out of its way to endorse the first part of Justice Hunt’s analysis in the *GRTA Test Cases*. Thus Justice O’Leary expressly agrees with the alternative contentions that the lessor’s royalty may be an interest in land because it may be characterized as a *profit*, as a rent and as akin to a rent.⁴⁹ In sum, there is apparently a presumption in favour of the proprietary analysis:⁵⁰

... barring very specific language manifesting a contrary intention, a royalty retained by a freehold mineral owner on the granting of a petroleum and natural gas lease is an interest in land.

And if the royalty reserved by the lease were an interest in land then it was clear from the granting clause of the GRTA that this entire interest had been assigned to the trustee even though this was not a case where it was (or could be) contended that “*Kasha* intended to convey to the trustee an undivided fractional interest in the lands, that is a portion of his reversionary fee simple interest ...”⁵¹.

2.3 THE GOR CASES

Prior to the *Dynex* litigation,⁵² Canadian courts were badly divided on the characterization of the GOR. Three lines of cases are significant: (1) the case law on the intention to create an interest in land, (2) the case law on the no-rent-on-a-rent problem, and (3) the case law that explores other avenues for making the royalty obligation run with assignments.

2.3.1 The case law on the intention to create an interest in land

The first line of cases proceeded on the assumption that it was possible for a working interest owner to

⁴⁹*Id.*, at 12 - 14.

⁵⁰*Id.*, at 14. O’Leary goes on to prefer the *profit* analysis. The presumption in favour of the proprietary analysis was applied in the case of an oil and gas lease on Indian reserve lands in *Stoney Tribal Council*, *supra*, note 3.

⁵¹*Id.*, at 14.

⁵²*Supra*, note 16.

create a GOR that granted an interest in land provided that the intentions of the parties were clear. But within this line of cases there was little agreement as to the relevant indicia of that intention and the decisions seemed to turn on some very fine distinctions. A few examples will make this point.

In *Emerald Resources Ltd v. Sterling Oil Properties Management*⁵³, Emerald alleged that it was entitled to a part of Sterling's own GOR agreement with a third party "of all petroleum, natural gas and related hydrocarbons produced, saved and sold from each property" subsequently acquired. Sterling resisted the claim pleading the Statute of Frauds, but Justice Allen for the Court of Appeal indicated that he thought that it was doubtful that the language used could give rise to an interest in land. In Justice Allen's view the text "clearly indicates that the royalty is to be calculated and payable only upon the products mentioned after they have been taken from the ground and severed from the realty. It may follow from this that the royalty share of production which accrues to Sterling is personalty and not land or an interest therein."⁵⁴

A second example is *Vandergrift*⁵⁵ where the GOR provided that "The Grantor does hereby grant and

⁵³[1969] AJ 2, (1969), 3 DLR (3d) 630 (Alta. App. Div.), aff'd (1971), 15 DLR (3d) 256 (SCC) without further reasons. Another case often considered in this context is *St. Lawrence Petroleum Ltd et al v. Bailey Selburn Oil and Gas Ltd et al* [1963] SCR 482, 45 WWR 26. In my view this case has equally frequently been misunderstood; see, for example, the Alberta Court of Appeal's judgement in *Dynex, supra*, note 16 at 703, para. 32. The plaintiffs in that case claimed under a net profits interest arising by way of a participation agreement. The relevant agreements related to Crown lands and the plaintiff sought to argue that it was entitled to a registerable interest in the Crown leases. This contention was rejected by all levels of court. The Supreme Court's judgement is particularly instructive because it draws attention to the fact that under the Crown registry system in force then (and now) the plaintiff would have to establish not just that it had an equitable interest in the leases but also that its interest amounted to an *undivided* interest in the leases. The Court held (at 45 WWR 34) that the plaintiffs did not have such a specified undivided interest but that is all that the court decided. At trial (36 WWR 167 at 173) Justice Milvain had held that the plaintiffs had "some intangible equitable interest in the lands". The court of appeal (41 WWR 210 at 215) seemed prepared to accept this proposition and Justice Martland does not appear to have dissented from this view. Thus it is surprising that the case is often cited as authority for the proposition that an interest in the net proceeds of production either is not, or cannot be, an interest in land. If anything it recognizes the NPI as an equitable interest in land.

⁵⁴*Id.*, at 640; in fact the court never finally decided the point, noting that many of the properties were in Montana and that it had no evidence as to the legal character of oil and gas leases in that jurisdiction.

⁵⁵(1989), 67 Alta. L.R.(2d) 17 (Q.B.). See also the Saskatchewan Court of Appeal's decision in *Bensette, supra* note 4. This decision, it will be recalled, dealt with a royalty interest created by the fee simple owner but it seems to be the origin of much of the almost bizarre emphasis on prepositions in the construction of the royalty clause (at 500): "The words 'royalty in' connote an interest of some kind 'in' the minerals. If it were 'royalty on' the minerals some kind of a commission would be readily inferable." A similar case is *Vanguard Petroleum Ltd. v. Vermont Oil and Gas Ltd., Westersund et al*, [1977] 2 WWR 66 (Alta. S.C.) where the fee simple owner granted Vanguard a 7% gross royalty on the "proceeds of sale of the petroleum substances that may be produced, saved and marketed out of the said lands". The agreement expressly contemplated that Vanguard would be able to file a caveat. Justice Moore held that the agreement created a promise to pay a sum of money out of the proceeds of sale. It did not give an interest in situ and the payment did not amount to rent. Notwithstanding his apparent

assign to the Royalty Owners a Three (3%) percent gross overriding royalty out of the 94.4% interest of the Grantor in all petroleum substances found within, upon or under the lands ...". Justice Virtue's analysis proceeds as follows:⁵⁶

In reading the agreement one is struck by the fact that the first reference to the nature of the interest to be conveyed uses the expression "royalty on all petroleum substances recovered from the lands", not petroleum within, upon and under the lands, but, those substances "recovered" from the lands. The next reference, in para. 2, is to a royalty on "petroleum substances found". Again, the reference is not to petroleum substances within, upon or under the lands, but to substances "found" within, upon or under the lands. The other references in agreement are to royalty in terms of "a share of production", "petroleum substances sold", "petroleum substances produced". Taken as a whole, I am of the view that the agreement conveys a contractual right to the payment of a royalty on petroleum substances produced from the lands, that is, a share of the petroleum after it has been removed, rather than on interest in land.

But Justice Virtue seems to set the bar for the royalty owner at an unattainably high level:⁵⁷

One of the incidents of an interest in land one would expect to find in a royalty agreement intended to create an interest in land, would be the right, to the royalty holder, to enter upon the lands to explore for and extract the minerals. A mere entitlement to an overriding royalty, without more, does not, in my view, carry with it the right to explore for oil and gas. In this case, the Royalty Agreement specifically provides that "nothing herein shall be construed as requiring Suffolk to conduct exploratory operations or to drill a well on the lands." Thus the Royalty holders could not themselves extract the oil and gas, nor could they require the grantor to drill a well for that purpose.

These cases may be criticized on various grounds. Some seem to be premised on the unsustainable idea that a royalty claim can only give rise to an interest in land if it accords an *in situ* interest in the minerals in place,⁵⁸ while *Vandegrift* seems to want to turn the royalty owner's passive interest into a working interest.

acknowledgment of the importance of the intention of the parties in resolving the question Justice Moore was not persuaded by the caveat clause but his reasoning on this point seems mistaken. While it is true, as he says, that a caveat cannot create an interest in land, the clause here was being used as evidence of intention.

⁵⁶*Id.*, at 28. Justice Virtue completely ignored other language that supported the interest in land argument and in particular an enurement clause which provided that "All the terms and conditions of this Agreement shall run with and be binding upon the lands."

⁵⁷*Id.* Justice Virtue went on to hold that the proprietary claim was doomed to failure in any event since the interest out of which the royalty was carved (a Crown natural gas licence) did not itself convey an interest in land. This conclusion also seems contestable given that the licence apparently conveyed the classic rights associated with a *profit*: "A licence conveys the right to drill a well or wells for natural gas that is the property of the Crown ... and the right to produce the same ...". Justice Virtue seems (at 30) to have been unduly influenced by the title "licence" and as a result failed to examine the rights actually granted in light of the hallmarks of a *profit*. See the Court of Appeal's judgement in *Bailey Selburn*, supra note 53, (1962), 41 WWR 210 at 215. For another case denying a royalty proprietary status on the basis that the interest out of which it was carved lacked such status see *Coxheath Gold*, supra note 29.

⁵⁸In my view this line of argument is unsustainable because it simply goes too far. The oil and gas lease itself does not give the lessee *in situ* ownership of the petroleum and natural gas in place but only a set of rights in relation to the substances. The absurdity of the claim was recognized by Matheson J in *Canco Oil and Gas Ltd v. Saskatchewan*, [1991] 4 WWR 316 (Sask. Q.B.) and Justice Hunt was similarly sceptical in the *GRTA Test Cases*.

But, criticisms aside, what these cases are clear evidence of is the historic reluctance of Canadian courts to recognize the proprietary status of GORs.

2.3.2 The no-rent-on-a-rent case law

Another line of *pre-Dynex* cases raised the theoretical obstacle of the no-rent-upon-a-rent rule but generally found a way not to apply it. Justice Laskin's judgement in *Saskatchewan Minerals v. Keyes*⁵⁹ is the best example of this line of cases. In *Keyes*, Keyes sought to enforce its royalty interest against a successor in title of its grantor. The royalty in question, expressed to be part of the consideration for an assignment of rights, referred to "a royalty of 25 cents per ton on all anhydrous salt produced and sold from the said leasehold property."

The majority of the Supreme Court of Canada took the view that this agreement was unenforceable as it had never received the requisite ministerial consent but the majority also doubted whether the agreement could have granted an interest in land, not on the basis of a proposition of law but on the familiar grounds that the words used merely entitled Keyes to a contractual claim to a payment in relation to salt produced and sold.⁶⁰ Justice Laskin however, in a very influential dissent, took on the issue of principle. Laskin, while aware of the common law rule that rent could not issue out of incorporeal interest,⁶¹ took the view that the distinction between corporeal and incorporeal interest was not very helpful and that a mineral lessee "should be able to grant or submit to an overriding royalty in respect of that interest to take effect as itself an interest in the lessee's holding."⁶² That said, whether or not any particular royalty clause created an interest in land was a matter of the intention of the parties.

The fact that the royalty was framed as an entitlement to the proceeds of production could not alone

Much of the confusion on this point can be traced back to the Saskatchewan Court of Appeal's decision in *Bensette*, *supra* note 4. The court there concluded (at 501) that the language used "connotes a conveyance of an interest in the minerals themselves in situ and hence an interest in the land which could properly be the subject of a caveat."

⁵⁹[1972] 2 WWR 108 (SCC). The point is also discussed in the *GRTA Test Cases*, *supra*, note 7 at AR 333, para. 32 *et seq.*, although there the issue was not germane as the court was not dealing with a royalty carved out by the working interest holder.

⁶⁰*Id.*, at 111 per Martland J: "If the clause had used the word 'payment' instead of 'royalty' I would doubt whether the respondent's position would be arguable. Does the use of the word 'royalty' imply an intention by Astral to create an interest in land in the respondent? I would doubt that it does."

⁶¹*Id.*, at 121.

⁶²*Id.*, at 122.

establish the royalty as giving rise to a mere contractual interest, for if that were the case, a rent could never be an interest in land. In effect, Justice Laskin seemed to be saying that absent any language that tended to personalize the royalty obligation, it should be treated as having created an interest in land.⁶³ There was no such language here and in fact there was language exhibiting a contrary intention insofar as the agreement provided that it was to “enure to the benefit of and binding upon the parties hereto, their heirs, executors, administrators, successors and assigns”.⁶⁴

2.3.3 Other avenues for making the royalty bind successors in interest

Although the first line of cases referred to above shows considerable reluctance on the part of the courts to embrace a proprietary analysis, in other cases, perhaps where the court was of the view that a purchaser with notice should not be able to avoid its obligations, the courts took a different tack. In these cases the courts explored alternative conceptual grounds for concluding that a successor in title might be bound by the terms of the GOR even if it was not an interest in land. A remarkable example of this line of cases is the trial judgement in *Harris v. Nugent*.⁶⁵ In that case the GOR holder apparently put forward four arguments in support of its efforts to bind a subsequent working interest holder: (1) novation implied by conduct, (2) the GOR as an interest in land, (3) a general equitable argument,⁶⁶ and (4) unjust enrichment. Justice MacLeod rejected the first two arguments⁶⁷ but accepted arguments (3) and (4). In my view, his conclusions

⁶³*Id.*, at 124.

⁶⁴*Id.*, at 116 and 124.

⁶⁵(1995), 32 Alta. L.R. (3d) 126, rev'd on other grounds (1996), 141 D.L.R. (4th) 410 (Alta. C.A.). In addition to *Harris* the *Dynex* case itself provides another example. In that case, Justice Rooke at trial [1997] A.J. 341 went to considerable effort to reach the conclusion that the Bank, as a secured creditor, was still effectively bound by the terms of the GOR/NPI interests through the subordination clauses of its own security instruments. The Court of Appeal and SCC found it unnecessary to deal with this issue.

⁶⁶The argument here was simply that the defendant took with notice and therefore should be obliged to perform. The authorities cited for this proposition including *Canadian Long Island Petroleum Ltd v. Irving Wire Products* [1975] 2 SCR 715 deal with negative covenants and are entirely unpersuasive in the context of positive obligations. Justice MacLeod himself has seemingly acknowledged this problem in his much more recent (and more persuasive) decision in *Canada Southern Petroleum Ltd.*, *supra* note 34. In that case the plaintiffs explored three ways of making the burden of a positive promise run (the obligation to develop and market production from the lands) in the absence of privity of estate or contract: (1) absent novation, by assignment and the theory that she who takes the benefit must also take the burden, (2) by incorporation by reference, and (3) by virtue of an implied obligation. Justice MacLeod rejected all three grounds.

⁶⁷There was no implied novation (*supra*, note 65 at para. 27) since there was no complete assumption of all liabilities by the defendant as required by *National Trust v. Mead*, [1990] 5 WWR 459 (SCC). The interest in land argument failed since (at para. 28) “there is insufficient positive authority to support a finding ... under this head.”

on grounds three and four cannot withstand scrutiny⁶⁸ but his approach does demonstrate the extent to which counsel are driven to convoluted and doctrinally suspect arguments in the event that the courts deny proprietary status to GORs but still wish to make the GOR run with assignments.

2.3.4 *Dynex*

Matters were brought to a head by Justice Rooke's judgement at trial on a preliminary motion in *Bank of Montreal v. Dynex*.⁶⁹ Over the course of its operations over a number of years, Dynex had acquired oil and gas interests some of which were encumbered by a variety of gross overriding royalty interests and net profits interests.⁷⁰ Subsequent thereto, Dynex gave security in its oil and gas properties to the Bank of Montreal. The security took various forms including debenture security. Dynex defaulted and the Bank placed Dynex in receivership. Subsequently, Dynex was forced into bankruptcy. The trustee wanted to sell Dynex's assets and one issue was whether or not the properties should be sold free and clear of the rights of the GOR and net profits interest holders. On a preliminary motion, Justice Rooke held that he was bound by authority to rule that "as a matter of law, a lessee of an oil and gas lease (which is a *profit à prendre*), which is in itself an interest in land, obtained from a lessor (whether the Crown or freehold), cannot in law pass on an interest in land to a third party." For Justice Rooke the intentions of the parties were irrelevant.⁷¹

The Court of Appeal reversed and its decision was upheld by the Supreme Court of Canada. The Court of Appeal gave three main reasons for its conclusion. First, it accepted that there were compelling practical and commercial reasons for according GORs a proprietary status rather than just a contractual status.⁷² Second, recent decisions such as the *GRTA Test Cases* had affirmed that lessors' royalties could be interests in land and there was really no practical difference between GORs and lessors' royalties: "royalties,

⁶⁸The doctrine of unjust enrichment cannot be used to unravel basic doctrines of contract (e.g. privity) and property (e.g. the rules on the running of covenants).

⁶⁹[1995] AJ 1279.

⁷⁰Examples of the circumstances under which these interests were acquired is given in the Court of Appeal's judgment [1999] AJ 1463 at paras 8 - 17.

⁷¹*Supra*, note 69, "I stop to say that intention is irrelevant in my findings to this moment because even if we had the most perfectly drafted document to create such an intention, and evidence to support the intention of wanting to have an interest in land, I am convinced that is not the law, and that there cannot be an interest in land at law downstream from a *profit à prendre*." (at para 6).

⁷²*Supra*, note 70, the reasons include: (1) expectations within the industry, (2) protection against insolvency, (3) protection against double conveyancing, innocent or otherwise. Royalties themselves are acknowledged to be important vehicles for spreading and allocating risk and for financing. The court makes it clear (at para. 33) that its analysis of GORs is equally applicable to NPIs.

whatever their origin, should be subject to the same set of rules.”⁷³ Third, the reasons given in those cases for not taking an overly restrictive view of the law were equally persuasive here and the courts should not treat the longstanding dichotomy between corporeal and incorporeal rights as an obstacle to recognizing GORs as interests in land.⁷⁴

Thus, for the Court of Appeal, the question of law was answered but that still left the intention of the parties. Given that the issue had come before it on the pure question of law, the Court reached no final conclusion on this point but did offer some guidance. For example, the Court seems to have approved of those cases that approach this question by considering the document as a whole along with evidence of surrounding circumstances “as opposed to searching for some magic words.”⁷⁵ The court would thus seem to have disapproved of the old line of cases discussed in section 2.3.1 above. In addition the court offered the following indicia:⁷⁶

1. The underlying interest is an interest in land (corporeal or incorporeal);
2. The intentions of the parties, as evidenced by the language of the grant and any admissible evidence of surrounding circumstances or behaviour, indicate that it was understood that an interest in land was created/conveyed.
3. The interest is capable of lasting for the duration of the underlying estate.

While these indicia are not free from difficulty (for example, why should it be necessary that the royalty has the same duration as the underlying interest?⁷⁷) the search for workable criteria is a useful one.

The Supreme Court adopted the same approach as the Court of Appeal confirming that “the prohibition of the creation of an interest in land from an incorporeal hereditament is inapplicable. A royalty which is an interest in land may be created from an incorporeal hereditament such as a working interest or a *profit à*

⁷³*Id.*, at para 50.

⁷⁴Other reasons were also offered: an overwhelming majority of US jurisdictions took the view that GORs can be interests in land; in fact no Canadian case had ever decided that the no-rent-on-a-rent rule was an obstacle and in any event the rent seek was a form of rent that was not associated with the right of distress. Here of course the court was very much echoing Justice Laskin’s views in *Keyes*, *supra* note 20.

⁷⁵*Supra*, note 70, at para 73.

⁷⁶*Id.*, at para. 84. The Court also seemed to refer with approval to three additional indicia: (1) where the farmor reserves to itself an interest in the petroleum substances in the working interest to be earned by the farmee, (2) where the farmee is the agent for the farmor for the farmor’s share of royalty production, and (3) where the farmor/royalty holder retains a lien remedy against the farmee. These criteria were developed by Evans, Newman and Smith, *supra* note 8.

⁷⁷This would clearly be problematic for those royalties that terminate when the payee has received a specific agreed sum.

prendre, if that is the intention of the parties.”⁷⁸ The court offered little further guidance in divining that intention⁷⁹ but did chose to endorse a passage from Justice Virtue’s judgement in *Vandergrift* to the effect that a GOR may be an interest in land if:

1. The language used in describing the interest is sufficiently precise to show that the parties intended the royalty to be a grant of an interest in land, rather than a contractual right to a portion of the oil and gas substances recovered from the land; and
2. The interest out of which the royalty is carved, is itself an interest in land.

While this two step approach seems useful (although one might logically reverse the steps) I do not think that the Court should be taken to have endorsed either the particular approach taken by Justice Virtue or the actual result that he arrived at in that case.⁸⁰

In resolving at least the first part of the GOR characterization issue, and in developing guidance on the second issue the Court is clearly seeking to harmonize the rules pertaining to lessor’s royalties and GORs. At the beginning of its judgement, and having defined the two types of royalties, the Court observes that “The rights and obligations of the two types of royalties are identical. The only difference is to whom the royalty is initially granted.”⁸¹

2.4 Conclusions

Taken together, the Alberta Court of Appeal decisions in *Hetherington*, *GRTA Test Cases*, *Kasha* and *Barrett* have clarified years of uncertainty and provide a firm foundation for resolving all of the outstanding GRTA issues. The decision of the Supreme Court of Canada in *Dynex* will provide a similar foundation for GOR cases. This does not mean that characterization issues will disappear for the Court has not changed the rules on the running of covenants. The characterization question will remain important for Canadian law. However, it does mean that the focus must now always be on the intentions of the parties as expressed in the words used in the relevant documents. We can only hope that, in answering these questions, the courts will not revert to the past practice of haggling over prepositions in order to divine intention.

⁷⁸[2002] SCC 7, at para. 21.

⁷⁹The court seems to refer with approval (*id.*, at para. 16) to the suggestion that the parties may be taken to have evinced an intention to create a GOR as an interest in land if the instrument is caveated in the land titles office. With respect this hardly seems conclusive. Unless the agreement specifically contemplates that GOR holder will caveat, the unilateral act of caveating is nothing more than the expression of an intention by one party. In any event, the caveating option will not be available for Crown lands.

⁸⁰For my criticisms of *Vandergrift* see note 55, *supra*.

⁸¹*Supra*, note 78, at para. 2.

3.0 THE IMPLIED OBLIGATIONS OF THE WORKING INTEREST OWNER

Commentators are agreed that Canadian courts are extremely reluctant to imply additional obligations to the written terms of commercial contracts. The courts have seen no reason to depart from the traditional test of “business efficacy” in relation to royalty contracts and obligations, whether those obligations arise pursuant to a lease or some other form of oil and gas industry contract.⁸² The courts are similarly reluctant to impose fiduciary duties in commercial contracts including oil and gas contracts.⁸³ In one case, *Western Oil Consultants v. Bankeno Resources*,⁸⁴ the plaintiff GOR owners, and in the context of a reassignment clause, alleged in their pleadings a breach of a common law duty of care. The issue was not pressed in written argument and the court simply found that the claim on this head failed.

That said, the courts have not been completely insensitive to the vulnerable position of the royalty owner.

⁸²See, for example, *Ballem*, *supra*, note 8, at 260 - 266. The common practice of using “entire agreement” clauses simply makes it that much more difficult to make the case for additional implied terms. See also the *Canada Southern case*, *supra*, note 34. That case dealt with a carried interest owner rather than a GOR owner. It also involved an express covenant to develop and market the lands. However, in order to try to get around the running of covenants problem there was some suggestion (at para. 161) that there might be an implied obligation covering the same ground as the express obligation. Justice MacLeod at para. 164 concluded that “I am unable to conclude from the evidence that there is an implied obligation to market generally, or specifically, in this case.”

⁸³Characteristic is *Luscar Ltd. and Norcen Energy Resources Ltd. v. Pembina Resources Ltd.*, [1995] 2 WWR 152 (Alta. C.A.). In the context of royalties see the *Bankeno Resources* case, *supra* note 14, at para. 13 and *Mesa*, *supra* note 12. However, the door is not completely closed. See, for example, *Norcen International Ltd. v. Suncor Inc.*, [1986] 4 WWR 57 (Alta. C.A.). In that case the GOR holder argued that the working interest owner owed it a fiduciary duty. In general terms this was alleged to mean that the working interest owner in dealing with the lease (at 67) “was duty bound not to do anything which might result in its acquiring a benefit or profit to the detriment of the” royalty owner. There are two ironies here. First, the GOR owner was not a poor, helpless landowner/lessor but a sophisticated corporation. Second, the argument was premised on the supposed control exercised by the working interest owner over the lands. But the particular allegation put the lie to this since the argument was that the working interest owner had lobbied for a change in the regulations that affected the calculation of “price received” within the meaning of the royalty agreement. Presumably the royalty owner was far from handicapped from engaging in similar lobbying. Rather than simply rejecting the legal basis of the argument Justice Belzil for the court rejected it on other grounds. Indeed, and perhaps unwittingly, the court seems to have offered some support for the fiduciary argument at least in limited circumstances: “While I might agree with the appellant that the lessor-lessee relationship was capable of giving rise to a fiduciary duty which might render the lessee liable as, for instance, if it had entered into a contract for the sale of its production at less than the obtainable price in return for some side benefit to it alone ...” that was not this case. It is hard to imagine why a royalty owner would ever need to rely upon a fiduciary duty on the hypothetical facts offered rather than the express language of the contract, at least if the contract refers to market price or value. See also *Ballem*, *supra*, note 8, who (at 227 - 228) hypothesizes that a lessee may owe a lessor/royalty owner a fiduciary duty when entering into a unitization agreement and negotiating the tract participation factor. In the *Stoney Tribal Council* case, *supra* note 3, the court (at para. 71) rejected the argument that a lessee of oil and gas rights owed a fiduciary duty to the Indians.

⁸⁴*Supra* note 14, at para 14.

In one case in particular, *Mesa v. Amoco*,⁸⁵ both the trial court and the court of appeal made creative use of the duty of good faith and the concept of custom in the industry to protect the royalty owner's interest on a set of facts which was particularly compelling.⁸⁶ It bears emphasising that the case in question raised a GOR set of facts between sophisticated commercial operators; the courts have not taken the position that a freehold lessor, simply by virtue of that status, is particularly vulnerable and particularly in need of protection.

This part of the paper considers three issues: (1) does the working interest owner owe a royalty owner a duty not to discriminate against the royalty lands in the manner in which it produces those lands vis-a-vis its other properties, (2) what duty does the working interest owner owe the royalty owner when entering into a pooling agreement, and (3) what duty, if any, does the royalty owner owe to the working interest owner?

3.1 Does a working interest owner owe the GOR owner an implied duty of non-discrimination?

The question of whether a working interest owner owes the GOR owner a duty of non-discrimination in the way in which it produces royalty lands, by comparison with its other lands, has been raised indirectly in a number of cases. But the arguments never seem to have been presented clearly and on the basis of a favourable set of facts. Perhaps for those reasons they have never been successful.

Indicative of the lack of clarity on the issue is the *Vandergrift v. Coseka Resources* decision⁸⁷. Vandergrift claimed an undivided interest in a 3% gross overriding royalty that the grantor had purported to carve out of a Crown petroleum and gas licence. The licence covered some seven sections of land known as the Suffolk lands. There was but a single gas well on the lands, the 4-23 well. Adjacent to this property, but owned by the same working interest owners, was another block of eight sections, the TransAlta lands, on which there were five producing wells. All of the lands were included within a "gas block order" granted by the conservation board. Essentially, the gas block order permitted the relaxation of ordinary conservation rules such as target area requirements.

When first drilled, the 4-23 well was capable of production from both the Devonian and Mississippian formations but was originally produced only from the Devonian formation "which was quite productive and

⁸⁵*Supra*, note 5, and discussed extensively, *infra*.

⁸⁶In other cases the courts have acted under the cover of their interpretive role to effectively imply terms although this is as likely to be for the benefit of the lessee as the lessor: see, *Pancontinental*, *supra* note 16, especially at paras 26 and 42 - 46.

⁸⁷(1989), 67 Alta. L.. (2d) 17 (Q.B.).

easier to get and handle than the Mississippian zone.” Later, as a result of a drilling accident, production was blocked off from the Devonian formation and subsequently the well only produced from the Mississippian formation.⁸⁸ The balance of the wells produced solely from the Devonian formation.

Vandergrift alleged that Coseka had acted “unfairly” in preferring production from the TransAlta lands rather than the royalty lands.⁸⁹ The claim seems to have been based in the alternative upon an alleged duty to protect the lands from drainage and a duty not to discriminate in production practices. The court rejected both arguments and seems to have done so on both the evidence and as a matter of law. As to the evidence the court simply concluded that there was no drainage from the Devonian formation and that Coseka had not preferentially produced from the TransAlta lands. In fact, the evidence suggested that Coseka had incentives to produce from the royalty lands because the total royalty burden on those lands was lower and because the gas stream from the Mississippian formation was richer.⁹⁰

As to the law, it is not entirely clear whether Justice Virtue felt that the plaintiffs had been able to establish the existence of the duty. On the one hand, one might say that this was a necessary implication of deciding that the plaintiffs failed on the evidence. But, on the other hand, the several broad statements that Justice Virtue offers at the end of his judgement (apparently in the context of a deemed unitization argument) suggest that he also thought that the plaintiffs had failed to establish the existence of the obligation.⁹¹

⁸⁸There is a hint in Justice Virtue’s recitation of these facts that there might have been another cause of action here based upon a possible duty of restoring production, but the matter does not seem to have been pursued in that way (*id.*, at 23):

Since that time [the drilling accident], 4-23 has produced only from the Mississippian level. No claim is advanced based on this drilling accident, but the 4-23 well does not have the same productive capacity as it did before the accident, and, as the plaintiffs’ royalty under the Royalty Agreement, is based on actual production, their potential royalty income is affected.

⁸⁹There was another allegation to the effect that the block order effected a unitization and that therefore royalty should be payable on some proportion of the entirety of the production from the block lands. This argument also failed. The claim that the block order somehow prejudiced the royalty owner’s position was also largely disposed of factual grounds with no elucidation of the precise duty alleged. Thus Justice Virtue finds that the Block order was in the plaintiffs’ best interest for without it there would have been a production penalty assessed against the royalty well that would have shut it in for two years. Furthermore, the Court finds that following the issuance of the order the operator did not in fact change the way in which production was allocated to the various wells in the field.

⁹⁰*Id.*, at 24.

⁹¹*Id.*, at 32. But see *Trilogy Resources Corp v. Dome Petroleum Ltd*, [1992] 1 WWR 716 (Alta. C.A.) where the court held an investment partnership, joint venturing with a managing operator, is entitled to expect that its managing operator will produce wells in which it has an interest so as to get a “fair share of total production”. Knowing that its managing operator held a variety of other interests “it had the right to expect no more and no less than a fair measure of production from its well. It had no right to share in the profits from the production from other

One of the fundamental difficulties which the plaintiffs face, is that they are unable to show that they have any right, contractual or otherwise, to control the manner in which the owners of the lease arrange the production of natural gas from their lands. The Royalty Agreement makes no provision for such production controls, and states specifically that the royalty holders do not have the right to require Suffolk to explore or to drill wells on the land, nor is there any provision for shut in royalties, delay rentals or a minimum guaranteed royalty. It is not the function of the court to modify a bargain which has been reached, or to impose one which has not been achieved.

In sum, I think that this case offers no real support for those who seek to argue that a working interest owner may owe implied duties that go beyond the terms of the contract. Scarcely more supportive is the court's decision in *Enchant Resources Ltd. v. Dynex Petroleum Ltd.*⁹² In that case, the plaintiffs claimed a GOR on gas produced from two areas, the Channel Lake and Drowning Ford areas. Following deregulation of gas prices, Dynex, the royalty payor, sold gas from these two areas primarily to TransCanada PipeLines, the historic purchaser, but also to a variety of industrial parties through direct sales. The price payable by the industrial purchasers was generally higher than that payable by TCPL but TCPL assumed transportation costs on its sales and netting back from the direct sales ultimately resulted in a lower wellhead price for the industrial sales.

Dynex allocated gas sales *within* each of the two areas on a pro rata basis to TCPL and to the industrial sales contracts, but the amount that TCPL took from *each* of the two areas was determined by the deliverability rules under the relevant contracts. As a result, TCPL took over 80% of the gas that the Channel Lake reserves were capable of producing but only about 55% of the gas the Drowning Ford area was capable of producing. Consequently, more of the Drowning Ford production was allocated to the lower priced industrial sales. Enchant held a higher GOR on the Drowning Ford production and argued that on "just and equitable grounds" royalties should be calculated on the average price received by Dynex on all sales from both areas rather than on the price actually received.

The court rejected this argument for a number of reasons. First, there was no evidence that Dynex had deliberately or arbitrarily assigned a higher proportion of TCPL sales to the Channel lake area. Second, Dynex could not require TCPL to take more gas from the Drowning Ford area. While Dynex could have required TCPL to re-assess its obligations to take from the Channel Lake area under the deliverability rules of the contract, the result would have been a downward reassessment that would have benefitted nobody. Finally, and perhaps most importantly:⁹³

wells. Its right was a right to production, not to profit." Just as in *Vandergrift*, the Court found that in determining what might be a fair measure of production the court would need to take account of technical limitations include low pressure problems. There was no evidence of breach.

⁹²(1991), 123 AR 81 (QB).

⁹³*Id.*, para. 19, at 99. The plaintiff seems to have argued its case on the basis of "just and equitable" grounds but that is hardly a sound foundation for a cause of action which needs to be firmly rooted in the contractual agreement between the parties.

The royalty agreements between Dynex and Enchant do not require or contemplate any blending or averaging of the prices received by Dynex from lands covered by different purchase agreements.

Taken together these cases, while not conclusive against the royalty owners' claim of a duty (insofar as the facts did not support the allegations of unfair production practices), do suggest that GOR owners face an uphill battle in arguing that they are entitled to the benefit of an implied duty. This suggests that it would be prudent for a royalty owner to contract for specific protection. The standard form Farmout and Royalty Procedure of the Canadian Association of Petroleum Landmen⁹⁴ (CAPL) includes the following language:

5.07 Royalty Wells To Be Produced Equitably

The Royalty Payor will not discriminate against ... the Royalty Lands in ... production and marketing because [that production is] subject to the Overriding Royalty. The Royalty Payor will use reasonable efforts to produce ... from a Royalty Well equitably with production from any diagonally or laterally offsetting well producing from the same pool ... insofar as the Royalty Payor, or its Affiliate, has an interest in that offsetting well.

The clause deals with two scenarios. The first part of the clause simply recognizes a duty not to discriminate in producing these lands versus other lands in which the payor has an interest. The second part of the clause deals with the situation of drainage and imposes a positive duty of "equitable" production.

Canadian lease forms address the issue of drainage through offset wells clauses but rarely deal with the duty not to discriminate in production.⁹⁵

3.2 What obligation, if any, does the working interest owner owe the royalty owner when entering into pooling arrangements?

The typical Canadian lease form authorizes the lessee to enter into a pooling agreement to form a spacing unit. The clause will then go on to provide that production for royalty purposes shall always be allocated on an acreage basis.⁹⁶ GOR agreements may be less specific and that led to the royalty owner's complaints in *Mesa v. Amoco*⁹⁷ that Amoco\Dome (Amoco was the successor in interest to Dome) had artificially reduced the royalty liability by including the royalty lands in a pooling arrangement that was concluded on an acreage rather than a reserves basis.

⁹⁴Adopted in 1997. CAPL standard form agreements are available from CAPL: <http://www.landman.ca/>.

⁹⁵One exception is the PanCanadian lease form (a lessor's form). That form (cl.9) obliges the lessee to use best efforts to produce the leased lands rateably with other lands in the pool in which the lessee has an interest and imposes the more general duty not to discriminate. The offset wells clauses of standard form leases do not typically deal with a duty to produce. See, for example, CAPL 91, cl. 8, and CAPL 99, cl. 6.

⁹⁶See generally, Bankes, "Pooling Agreements in Canadian Oil and Gas Law" (1995), 33 Alta. L. Rev. 945.

⁹⁷*Supra*, note 5.

The facts, so far as relevant, were that the Mesa royalty encumbered the south half of section 4. Dome also had an interest in the north half pursuant to a different Crown lease title. The well was drilled on the south half and Dome\Amoco effected an “internal” pooling of the lands. The court concluded on the facts that Amoco\Dome must be taken to have known at the relevant time⁹⁸ that the reservoir from which the gas was produced was entirely or substantially under the south half of the lands. The royalty agreement⁹⁹ accorded Dome\Amoco a broad discretion to pool or unitize the lands, but:¹⁰⁰

That clause does not purport to dictate to Dome the method of pooling to be employed or the allocation of the revenues resulting therefrom. Therefore, in my view, Dome has the discretion to proceed as it sees fit but it is not an unfettered discretion, because it is obliged to act in good faith vis-a-vis the royalty holder. Such a term exists by implication.

The court went on to reject Mesa’s claim that Dome\Amoco owed Mesa a fiduciary duty and briefly canvassed Mesa’s alternative claim that Dome\Amoco owed Mesa a reasonable prudent operator standard in entering into the pooling agreement before concluding that it was unnecessary to make the distinction between the good faith standard and the prudent operator standard.¹⁰¹ The trial court held that the duty to perform the contract in good faith would be breached “when a party acts in a manner that substantially nullifies the contractual objectives or causes significant harm to the other, contrary to the original purposes or expectations of the parties.”¹⁰² It was not necessary that the plaintiff show fraud or intentional bad faith. That duty had been breached here, but what did breach entail?¹⁰³

I find that the knowledge that [Dome’s geologists] possessed at the time of pooling as to the most likely reservoir dimensions and geographical markers should have alerted them to their good faith obligation to consult with Mesa. Only then would Mesa have had an opportunity to reach an equitable agreement with Dome, or alternately, urge that an application be made to the ERCB to resolve the matter.

Justice Kerans for the Court of Appeal appeared to agree with this approach but then went on to express to express some discomfort with the use of the term “duty of good faith” which some find to be “too vague a term”.¹⁰⁴ Justice Kerans’ preferred approach seems to rely upon evidence as to the existence of a custom

⁹⁸There is an interesting question here as to what was the relevant time. The well turned into a prolific producer from the Basal Quartz G sand but that was not the primary target of the well. The target was another gas zone on identical one section spacing.

⁹⁹“The Vendor grants the Purchaser the right to pool or unitize any portion of the [royalty lands] with any other lands and the Royalty in respect thereof shall be calculated on the production of petroleum substances allocated to the [royalty lands] included in such pool or unit.”

¹⁰⁰*Supra*, note 5, at 55 (Q.B.).

¹⁰¹*Id.*, at 214, para. 72.

¹⁰²*Id.*, at 217, para. 76.

¹⁰³*Id.*, at 218, para. 80.

¹⁰⁴(1994), 19 Alta. L.R. (3d) 38 at 44, para. 18 (C.A.).

or practice in the industry which informs the expectations of the parties and therefore the interpretation of the agreement.¹⁰⁵

In my view, as a matter of fact, this contract created certain expectations between the parties about its meaning, and about performance standards. If those expectations are reasonable, they should be enforced because that is what the parties had in mind. They are reasonable if they were shared. Of course, those expectations must also, to be reasonable, be consistent with the express terms agreed upon. This contract should be performed in accordance with the reasonable expectations created by it.

The assessment of those expectations should include regard to the commercial context. That context, of course, here included the traditions and practices of the oil and gas exploration and development industry. One of those practices, well established in the evidence, is that an operator pools on a reserves basis if the geographical data clearly shows the boundaries of the reservoir, and those boundaries are significantly at variance with the size of the corresponding surface parcels. Indeed, that practice is reflected in the law of Alberta ... [The reference is to the compulsory pooling provisions of the conservation statute.]

I therefore conclude that, at a minimum, the reasonable expectation of Mesa and Dome/Amoco, at the time they made their agreement, was that Amoco would consider both areal and reserves-based pooling, and follow whichever route the facts justified. That expectation might also have been that the operator would advise the holder of the gross royalty of all the facts of the matter in a case where the decision was anything but completely straightforward and, as here, there happened to be a conflict of interest.

The rule that governs here can, therefore, be expressed much more narrowly than to speak of good faith, although I suspect it is in reality the sort of thing some judges have in mind when they speak of good faith. As the trial judge said, a party cannot exercise a power granted in a contract in a way that "substantially nullifies the contractual objectives or causes significant harm to the other contrary to the original purposes or expectations of the parties."

Mr. O'Brien also argued that an industry practice of reserves pooling was not yet well established in 1981 ... While the judge made no explicit finding on this point, it was implicit in his approach to the case. In any event, were I wrong in that, I would make that finding on the basis of my own assessment of the evidence of the Amoco employees. Both the landman and the geologist involved were aware of the practice, although they said they understood that reserves-based pooling was rare. What happened here is that the landman said he thought it was up to the geologist to warn him if the facts warranted any special consideration, and the geologist said he did not consider the question what form of pooling should occur. Between them, they simply failed to consider the matter. That was a breach of contract.

That breach would be a trifling matter if the facts did not warrant serious attention to at least the possibility of reserves pooling. Mr. O'Brien argued that the geologist testified he had no sense of certitude at the time about the boundaries of the reservoir. With respect, that is not the point. He, by his own admission, at the time knew that there was a good chance that the reservoir boundary did not extend into the north half. That knowledge imposed upon him a duty to take further steps, and he did not do anything. That was the point made by the learned trial judge, and he was right.

I have quoted this decision at such length because I think that it is indicative of a very careful, incremental

¹⁰⁵*Id.*, at 44 - 46, para. 19 *et seq.*

approach by the court. In the end, the court protected the royalty holder, but not on the broad ground of the duty of good faith proposed by the trial court but, on what I think is the narrower ground, industry custom. While there is room to argue whether custom in the Alberta industry had solidified to the extent suggested by Justice Kerans, the real importance of the case lies in the methodology that it proposes be followed before judicial intervention is justified. This suggests that it will be difficult to apply the case outside its very specific context. Finally, the references to industry custom notwithstanding, it is important to emphasise that Justice Kerans tries to cloak his reasons in the guise of interpretation rather than under the guise of implying terms into the contract.¹⁰⁶

3.3 Does the royalty holder owe any duty to the working interest owner?

While it may be far-fetched to think that a royalty owner may owe duties to the working interest owner, this issue was at least raised in *Alminex Limited, Home Oil Company Limited and Kern County Land Company v. Berkley Oil and Gas Ltd.*¹⁰⁷ In that case the holder of the working interest alleged that although the farmout agreement creating the royalty clearly accorded it the right to pool and unitize the lands, the royalty owner had delayed unitization by its “systematic campaign of obstruction”.¹⁰⁸ The working interest owner claimed damages based on the difference between the costs of unitized operations versus the costs of independent operations. Unfortunately, the court found that this claim could not be maintained on the facts¹⁰⁹ and thus offers no guidance as to the point of principle as to whether or not there was a duty here that would have supported the cause of action.

3.4 Conclusions

The Canadian courts have always taken a restrictive approach to the adoption of implied terms in commercial contracts. It is therefore hardly surprising that Canadian oil and gas law does not have a well

¹⁰⁶This argument (that it will be hard to apply the decision more broadly in support of creating an extensive set of implied obligations for the working interest owner) is amply supported by the reasons given by Kerans JA for rejecting Mesa’s argument that it was entitled to a royalty on penalty production from the lands when Amoco went non-consent on particular wells. These sections of Kerans’ judgement are discussed *infra* in section 5.1.1 of this paper.

¹⁰⁷[1971] 4 WWR 401, aff’d [1972] 6 WWR 412, (Alata. App. Div.), aff’d [1974] 1 WWR 288 (SCC); the issue is discussed in the trial judgement at 412, it was not discussed further on appeal.

¹⁰⁸While it is the practice in the Canadian industry for the working interest owners to execute pooling agreements and for there to be no requirement of execution by the royalty owner, unitization agreements will ordinarily be executed by both working interest owners and royalty owners.

¹⁰⁹*Supra*, note 107.

worked out doctrine of implied terms designed to protect the vulnerable position of the lessor. The general response of Canadian courts will be that a royalty owner (whether a lessor or a GOR owner) who seeks specific protections should contract for them. Hence, a case like *Mesa* should be regarded as unusual. It was a case that compelled intervention, but the Court of Appeal's reasoning suggests that it was not contemplating a broad application of its own decision and it remains an isolated example of judicial intervention in this area.

4.0 PROTECTING THE GOR OWNER THROUGH REASSIGNMENT CLAUSES

The previous section dealt with two aspects of the vulnerability of the royalty owner - vulnerability to the development and production practices of the working interest owner, and vulnerability to the subsequent contracting practices of the working interest owner. This section deals with another well-known vulnerability of the royalty owner (and especially the GOR owner); the vulnerability to surrenders by the working interest owner. I have already touched upon one aspect of this problem in section 2.1.1 of the paper which deals with the termination of some *Hetherington-type* GRTAs upon the expiry of the extant lease. This section however focuses particularly upon the GOR owner and one technique, the reassignment clause, typically used to protect the GOR.

4.1 The elements of the reassignment clause

The vulnerability of the GOR owner to the surrender or other termination of the working interest arises from the fact that, as a carved out interest, the GOR will terminate along with the lease. Given this vulnerability it is conventional for the GOR holder to attempt to protect its interest through the negotiation of a reassignment clause. The wording of the relevant clause in *Western Oil Consultants Ltd. v. Bankeno Resources Ltd.*¹¹⁰ is fairly typical:¹¹¹

¹¹⁰[1995] 6 WWR 449; see also *Mesa Operating Ltd v. Amoco Canada Resources*, *supra* note 5, in which a similar issue arose. The language of the agreement was very similar except that it expressly provided for the scenario in which "continuance is not possible" but once again the trigger for the notice clause was the "desire" of the working interest owner to surrender, allow to expire (except where continuance is not possible)....". Dome had a well drilled on the lands and did apply for continuance but its application was rejected with respect to part of the lands in question. Justice Shannon while referring for support to US authority which suggested that the relevant test for liability was fraud or collusion concluded that "On the preponderance of the evidence this court is persuaded that Dome did not '... desire to surrender' etc. in accordance with the terms of the contract." The issue was not dealt with on appeal.

¹¹¹Somewhat less typical was the clause considered in *Western Oil Consultants v. Great Northern Oils* (1981), 121 DLR (3d) 724 (Alta. Q.B.) which failed to require written notice. However, that did not prevent Justice Patterson concluding as follows (at 730): "In view of the general practice of the industry and specifically the following words as they appear [in the agreement] 'setting forth the lands to be surrendered' and 'lands set forth in

7.1 No interest subject to this agreement shall be surrendered, let expire, abandoned or released by the Grantor in whole or in part unless each Grantee consents thereto in writing or unless such surrender, expiration, abandonment or release is made and carried out in the manner hereinafter provided.

7.2 If the Grantor desires to surrender, let expire, abandon or release all or any part of its rights or interests in the said leases, it shall give written notice ('a surrender notice') thereof to each Grantee at least 30 days in advance of the due date for any payment or the performance of any act, the non-performance of which will result in lapse, termination, forfeiture or cancellation of the said leases and offer to assign to each Grantee, Grantee's pro rata share of the Grantor's rights or interests in the said leases. A surrender notice shall specify the rights and interests which the Grantor desires to surrender, let expire, abandon or

The Canadian cases on the reassignment clause have focused on two issues: (1) what actions of the working interest owner will constitute a breach, and (2) the question of appropriate remedies in the event of breach.

4.2 What constitute a breach?

Given the language of the typical reassignment clause the inquiry will ordinarily focus on the question of what constitutes a "desire" to surrender or let expire?

The facts in *Masai Minerals Ltd. v. Heritage Resources Ltd*¹¹² were somewhat unusual. Heritage had granted Masai a GOR as recompense for its geological services and then farmed out the lands to Tipco. Just before Tipco was about to drill on the lands it discovered that Heritage had surrendered the Crown lease. Subsequently Heritage bid the lands in again at the next Crown sale, and, in related litigation commenced by Tipco, Heritage was ordered to transfer the lands to Tipco.¹¹³ In this case however Heritage sought to argue that it was entitled to the lands rather than Tipco on the grounds that it was entitled to be offered the property prior to surrender and had it been offered the lease it would have taken an assignment.

The case is primarily significant on the remedies issue and I shall deal with it in more detail below on that point, but Tipco sought to argue by way of defence that Heritage never "desired" to surrender the property. Here the facts showed that Heritage sent one letter to the Crown surrendering two properties, including the GOR property. Perhaps apprehending a mistake in the letter, Heritage then asked for it to be returned unopened. The Crown complied but then, inexplicably, Heritage re-sent the same letter some days later. Thereafter, Heritage sought to have the Crown reverse the resulting lease cancellation but when the Crown

the surrender notice', I find that it was never contemplated by either party that anything less than written notice was acceptable and that [the agreement] required notice to be written."

¹¹²*Masai Minerals Ltd et al v. Heritage Resources Ltd et al* (1979), 95 DLR (3d) 488, aff'd (1981), 119 DLR (3d) 393 (Sask. C.A.).

¹¹³This is discussed *id.*, at 490 - 491 (Q.B.).

refused Heritage bid the property in again at the next Crown sale. Tipco sought to argue on these facts that the cancellation resulted from a clerical error and was not intentional. The court rejected that argument. The court took the view that a party was deemed to intend (desire) the natural consequences of its acts and that therefore sending the letter surrendering the property gave rise to a rebuttable presumption that this was indeed Heritage's intention. Tipco had not been able to rebut this presumption. While the first letter might have fallen within the ambit of "clerical error", it was hard to reach this conclusion when the same letter had been sent twice.¹¹⁴

In *Western Oil Consultants Ltd. v. Bankeno Resources Ltd*¹¹⁵ the question of the "desire" to surrender or let expire arose in the context of the continuance provisions of Crown leasing legislation. The properties in question were included within two Alberta Crown leases. In case A, the property the subject of the GOR constituted working interests in parts of two sections of land that were included in an Alberta Crown lease covering more than 3 sections of land. The lease was set to expire under its own terms in November 1983. In Case B there was an acknowledged breach and I therefore deal with that case under the next heading of remedies.

Under then prevailing Alberta disposition legislation, a lease expired at the end of its primary term except to the extent that it was continued pursuant to ministerial decision under the authority of the relevant provisions of the *Mines and Minerals Act*. While the details of continuance do not concern us here, the key concepts in the legislation were as follows. First, in the absence of an application from the authorized representative of the lessee, a lease will only be continued as to the spacing unit of a productive well. Second, if the lessee applies, within the time prescribed by the *Act* and regulations, along with supporting documentation and data, the Minister may grant continuance for any part of the property held under the lease to the extent that the Minister considers the land capable of producing petroleum or natural gas. Third, and again where supported by an application, the Minister may grant the lessee a temporary reprieve from termination at the end of the primary term, on terms (e.g. the drilling of well secured by the posting of bond) where the Minister considers the land to be potentially productive of hydrocarbons. Under this arrangement the lessee will have one year to prove up the property before re-commencing the continuance procedure.

In case A, Bankeno decided that it wanted to try and retain the land at the end of the primary term and, to that end, and some 4 months before the expiry of the primary term, applied to the Minister for continuance of the *entire* lease area by virtue of a single well (the 11-18 well) and other technical materials. The 11-18 gas well had been completed at the time but did not commence production until several days later. Bankeno did not request a one year extension for any part of the lands for potentially productive lands. The Minister

¹¹⁴*Id.*, at 492 (QB). Of course, it is not clear that Heritage\Tipco should have been able to avoid liability even had they been able to establish that the surrender occurred through clerical error.

¹¹⁵[1995] 6 WWR 449.

granted the application for some of the lands, offered an extension for one year for others of the lands, but denied the application with respect to that part of the lease area that happened to be encumbered by the GOR. Accordingly, the lease expired in accordance with its own terms with respect to these lands. Did these facts trigger the surrender provisions designed to protect the GOR?¹¹⁶

The Court held that the clause was not triggered since Bankeno did not have the relevant desire: “In fact, they wished to continue the lease as shown by the application made.”¹¹⁷

4.3 Remedies for breach of the reassignment clause

Given that the usual result of a breach of the reassignment clause will be the surrender of the lands, the usual remedy sought will be damages calculated in accordance with the relevant rules for breach of contract. But what if the working interest owner, or somebody who stands in the shoes of that person, has reacquired the interest?

These were essentially the facts of *Masai Minerals* recited in the previous section. In that case the court interpreted Masai’s claim as a claim for specific performance of the reassignment clause. The court held that Masai has established that the property should have been offered to it before surrender and that had it been so offered it would have taken the re-assignment. In passing the court noted that had Masai obtained knowledge of the proposed surrender from another source it would have been able to obtain an injunction to prevent the surrender. But, since the surrender had occurred and then the property re-acquired, could it obtain an order for specific performance? Both the Saskatchewan Court of Queen’s Bench and the Court of Appeal refused to make the order and gave somewhat different grounds for their conclusions. Fundamental to the reasoning of both courts however was Tipco’s acknowledgment that it held the re-acquired property subject to the terms of Masai’s GOR.¹¹⁸

Justice MacPherson at trial held that in these circumstances it would be inappropriate to grant the discretionary remedy of specific performance when the common law remedy of damages was adequate. MacPherson was clearly impressed with the idea that the purpose of the clause was to protect the royalty.

¹¹⁶The clause is quoted in the text to note 111, *supra*.

¹¹⁷*Supra*, note 115, at 474, para. 27.

¹¹⁸Tipco had originally resisted this claim but then amended its pleadings to acknowledge liability. Clearly one must be careful about extending the conclusion of liability in this case beyond the very unusual facts. Tipco’s liability depends upon more than just knowledge of Masai’s GOR but must also depend upon the particular circumstances in which Heritage reacquired the interest and was then forced to transfer it to Tipco.

Since the royalty was now payable again Masai had been made whole. The Court of Appeal, however, took the view that once the property was reacquired (presumably with the acknowledgment that it was still subject to the royalty) Masai's cause of action for Heritage's "failure to offer" disappeared: "The respondents have remedied that particular breach by placing themselves in a position to now carry out their obligation to offer before surrender."¹¹⁹

The question of how to calculate damages in the event of a breach of reassignment clause was first considered in *Western Oil Consultants v. Great Northern Oils Ltd.*¹²⁰ In that case a subsequent owner (i.e. an owner under a new lease) had drilled on the lands and obtained oil production from some of the LSDs (but not all of the LSDs) on the section of land. Based on expert evidence as to estimated production from the lands, and allowing for capital expenses and operating costs and subject to a discount factor, the court awarded damages of close to \$1 million. This was said to be the estimated value of the lands to a well-informed person. Importantly, the court also decided that damages should be calculated as of the date of trial rather than the date of breach. This was important not just because of fluctuating prices but also presumably because at the date of breach, the value of the land (prior to the discovery of production) would have much more speculative. The use of the date of trial was justified on the basis that this was a case in which the court would have ordered specific performance had the remedy been available.

The plaintiff was less fortunate in *Bankeno # 2*¹²¹ with respect to the Block B lands. In the case of these lands no drilling had ever been attempted and there was no continuation application made. In this case the defendant's admitted liability i.e. that they desired to let part of their interest expire and yet failed to give written notice to Western. The lands were subsequently re-leased by the Crown and the Crown received a bonus payment of \$51,000 for them. There was subsequent drilling on the lands but the lands never proved profitable. The court held that damages should be assessed as of the date of the breach but "with consideration of subsequent events which will allow for a true assessment of the value of the interest in the

¹¹⁹*Supra*, note 112, at 396 (CA). The Court also noted (at 398) that the reassignment clause did not give Masai an interest in land. The court made no comment on the proprietary status of the royalty. To the same effect is *Western Oil Consultants v. Great Northern Oils*, *supra*, note 5, at 733. The issue was important in this latter case because of a limitations issue. Both cases rely on *Canadian Long Island* *supra*, note 66 for this proposition. The weight of this authority is limited in Alberta by the amendment to the *Law of Property Act* deeming rights of refusal to be interests in land, see now RSA 2000, c. L-7, s. 63.

¹²⁰*Supra*, note 5, commencing at 734. See also the judgement at trial in *Luscar Ltd. v. Pembina Resources Ltd.* (1991), 85 Alta. L.R. (2d) 46 (Q.B.). The trial judge found a breach of an AMI clause and sought to calculate damages on that basis. This was fairly straightforward, the court simply (at 95 para. 168) ordered Pembina to pay the relevant percentage of revenues net of Crown royalty to the plaintiffs to whom the AMI duty was owed. The court of appeal reversed and accordingly did not have to deal with the damages issue on appeal: [1995] 2 WWR 153 (Alta. C.A.).

¹²¹There is a separate judgement on this matter (*Bankeno # 2*) at [1995] 6 WWR 475.

lands”.¹²² Consequently, the court awarded only nominal damages which it fixed at \$1,000.

4.4 Obligations upon re-assignment

When the GOR holder exercises the right to take an assignment or reassignment of the working interest, the assignor will obviously expect the GOR holder to assume responsibility for lessor royalties etc. One would ordinarily expect that the GOR itself would merge with the reassignment. But the facts were somewhat complicated in *Montreal Trust Co v. Gulf Securities Corp.*¹²³ There Gulf had assigned certain GORs to Montreal Trust through a royalty trust agreement. The GOR arose from an earlier farmout agreement with Tidewater in which Gulf had taken the usual steps to protect itself through a reassignment clause. The Tidewater agreement also provided that if Tidewater chose to assign any properties then the assignment should be subject to the “assumption by [that party] ... of all rights and obligations of the Assignee [Tidewater] under said lands and under this agreement”.

The granting clause of the trust agreement provided for an assignment of “all royalty payments which may by the terms of the Tidewater Agreement become hereafter payable by Tidewater, or its successor or assigns, to Gulf.” Sometime later, Tidewater determined to surrender some of the properties and gave notice to Gulf. Gulf elected to exercise its entitlement but chose to do so by having Imperial take the transfer. By separate agreement Imperial undertook to pay Gulf a GOR on the lands. Imperial obtained production from the lands and paid the royalty to Gulf whereupon Montreal Trust argued, as against Gulf and Tidewater, that it was entitled to receive the royalties.

The trial court in Saskatchewan had held for Montreal as against Gulf but the Court of Appeal had dismissed the claim as against both Gulf and Tidewater concluding that the royalty entitlement under the Tidewater agreement ended when Gulf took the reassignment through Imperial and that this also served to remove the lands from the ambit of the royalty trust agreement. The Supreme Court took a different view of the transactions. It accepted that the transactions triggered the reassignment provision of the Tidewater agreement rather than the part of the clause dealing with assignments to third parties but it did not accept that this must mean that the royalty obligation came to an end. Why was that? Here the court focused on the particular language of both the assignment clause of the Tidewater agreement and the granting clause of the trust agreement. The Tidewater agreement provided that any exercise by Gulf of its right to reassignment was subject to the same conditions relating to the assumption of obligations as those of a third party transferee. Such a transferee was obliged to take the lands “subject to the assumption ... of all of the rights and obligations of [Tidewater] under said lands and under this agreement.” One of those obligations was

¹²²*Id.*, at para. 22.

¹²³[1978] SCR 708.

the obligation to make a royalty payment to Gulf. That obligation had in turn been assigned to Montreal Trust under the terms of the assignment clause of the royalty trust agreement.¹²⁴

Perhaps another way of explaining this case is to say that while the exercise of the right of reassignment will ordinarily effect a merger of the GOR obligation, the courts will not find a merger where the entitlements of third parties may be prejudiced.

4.5 Conclusions

The limited Canadian case law on reassignment clauses suggests that while they may be useful in protecting a GOR owner's interests, any effort to enforce the clause will face two significant difficulties. First, it may be difficult to establish a breach. Where the lease is a Crown lease and the working interest owner has applied for continuance *Bankeno Resources* suggests that that will be the conclusive of the matter since the lessee cannot be said to have a "desire" to let the lands expire. Second, where the GOR owner can establish a breach it may still face a significant hurdle in claiming more than nominal damages in the absence of actual production on the lands.

5.0 INTERPRETATION ISSUES

Many royalty cases involve little more than difficult problems of interpretation. There is scarcely a royalty case decided in which the Court does not spend considerable time considering questions such as: is the agreement so ambiguous as to permit the introduction of evidence as to earlier drafts of the final agreement,¹²⁵ what evidence should be admissible as to the commercial circumstances surrounding the negotiation of the agreement?¹²⁶ I do not propose to canvass those issues here for there seems to be little, if anything, that is peculiar to oil and gas agreements in general or to royalty agreements in particular. Indeed, Canadian courts approach the construction of royalty agreements in much the same manner as they approach the construction of any commercial arrangement and eschew the adoption of any unique rules of

¹²⁴The unstated premise of this conclusion must be that the royalty obligation was an interest in land. A minority of the court would also have found Tidewater liable to Montreal Trust. The interest in land point was not taken by the court at all and it is not clear why. The trial court did consider the point, [1973] 2 WWR 617, and had held that this was a case in which the parties had expressly disclaimed an intention to create an interest in land.

¹²⁵See for example *Resman Holdings*, *supra* note 11.

¹²⁶See for example the discussions in the *GRTA Test Cases*, *supra* note 7, and in *Barrett v. Krebs*, *supra* note 24. *Alpine Resources Ltd. v. Bowtex Resources Ltd.*, [1989] AJ 163 (Q.B.). Interpretive principles applied in the context of the interpretation of a GOR payout account and cautioning against the use of other agreements to aid in the interpretation of the subject agreement.

construction.¹²⁷ Thus, the leading rule is undoubtedly that “...the actual wording of the agreement itself, if clear must, of course, govern at all times ...”.¹²⁸

This part of the paper seeks to do two things. First, it describes how Canadian courts have dealt with the interpretation of those provisions of royalty agreements and royalty clauses that deal with admissible deductions. The focus is on those deductions that are claimed downstream of production for such things as processing, compressing, transportation, etc. but I also deal with two “pre-production” issues. Second, this section offers some comment on a range of other interpretive issues that are best collected under the heading of “miscellaneous interpretive matters”.

5.1 Pre-Production Deductions

As one would expect, most of the Canadian case law on deductions focuses on the costs incurred post-production. After all, a royalty interest is not a working interest and there is surely a shared premise that costs incurred prior to production will always be for the account of the working interest owner. But what if the working interest owner avoids incurring costs by going non-consent on a well? Or what if the working interest owner is in default under the terms of an operating agreement and the result is that production revenues are not received by the working interest owner because of set-offs available to the operator of the property? The first issue was dealt with in *Mesa v. Amoco*¹²⁹ and the second issue has been dealt with as one stage in some very complex litigation known as the Hamilton Brothers Royalty litigation.¹³⁰

5.1.1 Non-consent wells

¹²⁷See for example *Western Oil Consultants*, *supra* note 5, at 729 confirming that since the GOR agreement had been prepared by the GOR holder it should not be construed in his favour to the extent that there is doubt about its interpretation.

¹²⁸*Telstar v. Coseka*, *supra* note 10 at 190.

¹²⁹*Supra*, note 5.

¹³⁰The litigation saga includes the following: (1) *Hamilton Brothers Corp v. Royal Trust Corp. of Canada*, [1987] AJ 706 (QB), aff'd [1988] AJ 618 (CA), (hereafter *Hamilton # 1, (PGRT)*), (2) *Hamilton Brothers Corp. v. Royal Trust Corp. of Canada*, [1988] AJ 1060 (hereafter *Hamilton # 1A (PGRT accounting)*), (3) *Hamilton Brothers Corp. v. Carter Oil and Gas Ltd*, [1988] AJ 1054 (QB) (hereafter *Hamilton # 2 (Nipisi)*); (4) *Hamilton Brothers Corp. v. Royal Trust Corp. v. Royal Trust Corp. of Canada* [1991] 4 WWR 44 (Alta. Q.B.) aff'd (1991), 83 Alta. L.R. (2d) 119 (hereafter *Hamilton # 3, enforcement of judgement*) (I refer to this judgement to complete the record, I shall not further discuss it here as it does not deal with any royalty issues), (5) *574095 Alberta Ltd. v. Hamilton Brothers Exploration Co*, [2002] AJ 317 (QB), aff'd [2003] AJ 113 (hereafter *Hamilton # 4, processing and marketing costs*).

In *Mesa v. Amoco* Dome\Amoco had gone non-consent on a number of wells and as a result was in a penalty position under the terms of the various operating agreements all of which (except one) had been in effect at the time of the original conveyance of the properties to Dome. Dome did not make royalty payments on this production. Mesa argued that Dome\Amoco was obliged to pay royalty on the production that would have been attributable to its interest had it not gone non-consent. In the alternative, Mesa argued that the penalty provisions of the operating agreements effectively worked an assignment of Dome\Amoco's interest. This in turn triggered Dome's obligation under the agreement to require any assignee to enter into an agreement with Mesa under which the assignee would agree to be bound by the terms of the royalty obligation.¹³¹

The royalty clause in question provided that the royalty was to be calculated on the "gross proceeds of all Petroleum Substances" and "gross proceeds" was defined to mean "... the proceeds received by [Dome] at the point of sale of the Petroleum Substances". Justice Shannon at trial basically adopted Dome's position. Dome argued that the royalty clause should be given a literal and plain meaning and since the result of going non-consent was to afford the participating parties the rights to the well and to production from the well until the penalty was worked off, Dome *received* no production or proceeds of production and therefore had no royalty obligation.¹³² The court supported this conclusion by noting that while Dome had committed under the agreement to incur or cause to be incurred exploration expenses on the non-producing properties of at least \$70 million dollars over a prescribed period, this obligation had been discharged and there was no other covenant to develop the properties.¹³³

The Court of Appeal agreed with Justice Shannon's conclusions at trial but not his reasons. In particular, the Court took the view that Shannon had taken too literal an approach to the interpretation of the word "received". In the Court of Appeal's view, an interpretation that demanded physical receipt by Dome would lead to an absurdity because it would allow Dome to avoid the royalty obligation by the simple expedient of using an agent or by assigning production revenues to a creditor. At a minimum, the term must embrace "receipt *for* as well as *by* a recipient"¹³⁴ but the court still rejected Mesa's argument principally on the ground that the agreement did not oblige Amoco¹³⁵

¹³¹The clause read as follows: "[Dome] may assign any legal or equitable interest [in the properties or any portion thereof]; provided that ... [Dome] will cause its assignees to enter into an agreement with [Mesa], their respective successors or assigns, whereby such assignees shall agree to assume and be bound by all of the terms and provisions hereof insofar as the same relate to the interest so assigned." *Supra*, note 5 at 193 - 194 (AR) (Q.B.).

¹³²*Id.*, at 222.

¹³³*Id.*, at 223, para. 92.

¹³⁴*Id.*, at 50, para 41 (C.A.), emphasis supplied.

¹³⁵*Id.*, at 51, para 46.

... to work the interest. And it leaves the choice whether to go non-consent with Amoco exclusively. Whether Mesa gets a penny from even the most promising property depends on the decision of Amoco, wholly independent from Mesa, whether to make the huge and uncertain investment that is the hallmark of the industry. If Amoco decides not to participate, Mesa then is in the hands of a similarly independent investment decision by strangers to the contract. I adopt this argument for Amoco:

An overriding royalty is carved out of the working interest. Thus the fortunes of that royalty holder track those of the working interest holder. If Dome chooses not to expend funds for drilling costs on a non-producing property, there will be no production and Mesa receives no royalty. Similarly if Dome chooses to go non-consent there will be no proceeds from the working interest until such time as the penalty period is over. ...

Justice Kerans went on to say that “The non-consent clause, in turn, can be seen as a sort of rental of the working interest accompanied by a right of first refusal.”

That led Justice Kerans to consider Mesa’s alternative argument. This was the argument to the effect that, at least in the case of those forms of the operating agreement that adopted the language of assignment to describe the interest obtained by the consenting parties, then Dome\Amoco must be in breach of the covenant in the royalty agreement to ensure that assignees covenanted to observe the royalty obligation. Not so said Justice Kerans.¹³⁶

The answer is that another covenant in the royalty agreement permits that sort of thing, and is necessarily paramount. I refer to the term permitting Amoco to decide not to participate in development. That implies, in the light of all that I have just said, that it may also execute operating agreements that provide that, in doing so, it will lose any claim to any sort of interest in revenue during the penalty period.

I therefore agree that, while "proceeds received" in the royalty agreement means proceeds received for as well as by Amoco, both the royalty agreement and the other agreements mean to say that production revenue during a penalty period are not received for, let alone by, Amoco.

5.1.2 The set-off scenario

The question here is whether a working interest owner can reduce its royalty obligation by going into default under various operating agreements with the predictable consequence that the operator exercises its right of set-off, thereby reducing the amount of monies actually received as proceeds of production by the royalty payor or its agent. One would think that this should be a situation in which merely articulating the argument in such bald terms is enough to answer it but it took the Alberta Court of Queen’s Bench to confirm that such a strategy would not succeed.

¹³⁶*Id.*, at 52, para. 50.

The issue arose in *Hamilton # 2 Nipisi*¹³⁷. Hamilton acquired working and royalty interests in various petroleum producing properties during the 1960s before selling them to Carter Oil and Gas Ltd in 1979 for a purchase price of \$32 million as well as a vendor's royalty. The vendor's royalty was in effect a mechanism by which the purchaser could defer payment for the assets over a period of time. Thus the royalty rate of payment was fixed at between 62.5% and 70% of production revenue net of certain defined burdens. Thus, although labelled a royalty by the parties, the term net profits interest might have been more apt. The royalty was to terminate when total royalty payments reached \$490.5 million. "Burdens" were defined as follows:

"burdens" means all deductions, taxes (excluding income taxes) charges and payments payable to the Crown in the right of Canada or any of its provinces in respect of the ownership, production or sale of petroleum substances and shall include all rentals and royalties payable pursuant to the said leases, freehold mineral taxes, and any overriding royalties that exist at the Closing Date as shown on Schedule "A" to the said Agreement, but shall not include overriding royalties, production payments or similar interests created on or after the Closing Date.

Consequently, the more charges that fell to be classified as burdens, the lower would be the royalty payments.

Given the structure of the agreement for deferred payment of the acquisition of the assets, it is hardly surprising that Hamilton took considerable care to protect its position in the drafting of the Petroleum, Natural Gas and General Rights Conveyance and Royalty Reservation (the conveyance agreement) designed to give effect to an earlier letter agreement. First, while the agreement permitted further assignments of legal and equitable interests in the properties, Carter was required to obtain a covenant from any assignees to agree to be bound by the relevant agreement and "Notwithstanding any assignment hereunder [Hamilton] may continue to look to [Carter] for performance of all rights and obligations hereunder." Second, Carter made certain covenants as to the prudent operation of the lands:

11. COVENANTS OF PURCHASER

a. subject to paragraph 12, Purchaser shall, so long as the Vendor's Royalty is in force and effect, as a prudent operator or working interest owner:

- (i) act in operating or insofar as it is able to cause to be operated the said lands in good and workmanlike manner in accordance with sound field practices;
- (ii) perform all obligations of operating agreements, gas contracts, gas plant contracts and other contracts affecting said lands;
- (iii) comply with all applicable laws, rules and regulations;
- (iv) punctually pay all rentals and burdens pertaining to said lands and other payments required by contracts affecting said lands;

¹³⁷*Supra*, note 130, [1988] AJ 1054 (Q.B.).

- (v) pay all taxes affecting said lands;
- (vi) carry insurance against hazards customarily insured against by prudent operators in operating similar properties and to use proceeds of such insurance to repair any damage insured against;
- (vii) provide Vendor with timely monthly reports showing all production and sales data pertaining to said lands and such other operational information, that Purchaser receives from various operators of said lands, as Vendor may reasonably request;
- (viii) except with respect to transfers covered by paragraph 24 of the said Agreement, continue to act as agent for any party to whom Purchaser may assign an interest in said lands and to remain liable for it successors' and assigns, performance of obligations hereunder unless Vendor consents otherwise.

It is understood that Purchaser will be an operator of a portion of said lands and a non-operator as to others. The manner in and the extent to which Purchaser complies with the foregoing covenants in a prudent manner shall be governed by whether it is an operator or non-operator.

(b) Subject to paragraph 12, Purchaser will not, without consent of Vendor (not to be unreasonably withheld) in writing:

- (i) amend or modify any of said leases, gas contracts, operating agreements or other contracts of a material nature affecting said lands;
- (ii) elect to go 'non-consent' or 'sole risk' on any development well or completion operation or workover operation proposed pursuant to an operating agreement affecting said lands.

12. ABSENCE OF OBLIGATION TO DEVELOP OR PRODUCE

Notwithstanding any provision herein contained, Purchaser shall be under no obligation to Vendor to develop the said lands or any part thereof or to produce the petroleum substances which may be within, upon or under the said lands or, subject to paragraph 5 hereof, to keep or maintain the said leases in good standing.

Hamilton further secured its position through an additional agreement, a Disbursing Agents Agreement, pursuant to which the gross proceeds of sale of all production were paid to the Royal Trust with monthly disbursing instructions by a Hamilton affiliated company on behalf of Hamilton and Carter. If Carter did not agree with the instructions monies were not distributed until agreement could be reached.

Carter did take advantage of the opportunity to assign, and, shortly after the initial agreement entered into an agreement with a group of ten companies (the Tencos). Under the terms of the assignment agreement between Carter, the Tencos and Hamilton, and the Royal Trust as third parties, the Tencos provided the requisite covenant to observe the original agreement and accepted joint and several liability for the performance of these obligations.

One of the Hamilton properties that was included in the original 1979 sale was the Nipisi property. Amoco was the operator of that field and had, in accordance with the terms of relevant operating agreements, instituted enhanced recovery operations for the field which dramatically increased the costs of production from the field to the point that, in the judgement of Justice Waite, “those development and production costs ... have so increased as to make it uneconomic for the purchaser to pay the limited overriding royalty to the vendor from production revenues.”¹³⁸ The Tencos had dealt with these increased costs by going into default under the terms of the operating agreements with the result that Amoco set-off the Tencos liabilities against production revenues that would otherwise have been payable to the disbursing agent. Reduced revenues to the disbursing agent translated into lower royalties payable to Hamilton. The Tencos had, by their actions, effectively created a new form of deduction or burden and the question for the court was whether those costs could be treated as burdens so as to reduce the royalty otherwise payable.

Justice Waite had little difficulty in reaching the conclusion that they did not fall within the definition of burdens in part because of the judgments at trial and in the court of appeal in *Hamilton # 1* which made at least some of the issues *res judicata*, but even independently of that.¹³⁹

It is apparent from [*Hamilton # 1*] that by the plain meaning of the “burdens” clause it extends only to “deductions, taxes ... charges and payments” taken in their tax or royalty aspects as opposed to operating or development costs.

In other words, the defendants cannot reduce the size of the net revenues against which the vendor’s royalty is computed by expanding the definition of burdens to include operating and development costs.

But even if the issue were not *res judicata*, the same result would follow since it is abundantly clear from the agreement ... that it was the purchaser and not the vendor who was to be responsible for the payment of the production and development costs in issue.

This conclusion was justified by reference to clauses 11 and 12 quoted *supra*. In the course of reaching that conclusion, the court also rejected the argument that the covenants of clause 11 had been made subservient to the provision of clause 12 which affirmed that Carter was under no obligation “to develop” the lands. In fact, it was really not necessary for the court to deal with the interrelationship of these two clauses since at the time of the conveyance these lands “were in fact developed and producing” and therefore there was no conflict. The court put the point this way:¹⁴⁰

But there is no such subservience. Nor is there any conflict between the two clauses. Clause 12 does not impose on the purchaser any obligation to the vendor to develop or produce any of the lands conveyed. Nor does the vendor seek in these proceedings to hold the purchaser responsible for any such failure to develop or produce. The clause is simply not applicable to the facts of this case. At the time of the conveyance to the purchaser of the vendor's interest in the lands, the lands were in fact developed and producing. By the conveyancing documents, and particularly Clause 11, the Purchaser

¹³⁸*Id.*, at 7 (QL).

¹³⁹*Id.*, at 5 (QL). *Hamilton # 1 (PGRT)*, is discussed *infra* in s.5.3.3 of this paper.

¹⁴⁰*Id.*, at 7 (QL).

undertook to honour the existing operating agreements and contracts relating to the development and production of those lands. Those agreements and contracts, predating the sale herein, were assumed by the defendants and required them to be responsible for development and production costs. Those costs include the Nipisi costs. It is that responsibility which the purchasers now seek to shirk. But that responsibility of the purchasers is not an "obligation to vendor" (emphasis added) under clause 12 but an obligation to third parties (principally the operator Amoco) arising under the agreements assumed by clause 11(a), and principally (ii) thereof. To hold otherwise would be to rewrite the agreement to benefit the purchasers.

The Court also rejected the Carter/Tencos argument to the effect that the Hamilton interests could only make a claim against monies actually received by the disbursing agent. Justice Waite framed the argument as follows:¹⁴¹

The first trial and appeal decided that issue against the defendants. As previously noted, the Court of Appeal characterized the claim as an "action for the balance owing on account of the reserved royalty". In other words, the claim for the unpaid royalty was a simple action in debt and not a claim that could only be exerted against a particular fund.

Furthermore, and in any event, there is nothing in any of the applicable contract documents which restricts the defendants' liability to a particular fund. If it was intended to harness the liability of the purchaser to the net revenue fund, that could have been done in the simplest possible terms. There are no such terms, simple or otherwise, in any of the contract documents.

5.1.2 Conclusions on pre-production costs as permissible deductions

The *Mesa* and *Nipisi* cases confirm what one would expect, namely, that in the absence of clear language to the contrary the court will not readily reach the conclusion that pre-productions costs are admissible deductions. It is hardly surprising that both Justice Prowse in *Nipisi* and Justice Kerans in *Mesa* resoundingly rejected technical arguments that depended upon whether or not revenues were subject to the royalty if they were not actually and physically received. Both cases involved some consideration of the interaction between different clauses of the relevant agreements. The specific interaction issue in *Nipisi* was fairly easy to resolve, the *Mesa* issue more difficult but Justice Kerans was surely correct in concluding that if the working interest owner is responsible for the development of the properties, and if the GOR owner gives the working interest owner the right to decide whether or not participate, then it must have the right to do so on terms that are current in the industry. If the GOR owner seeks additional entitlements it must contract for them.

5.2 Deductions for activities downstream of production

While the general rule is no deductions whatsoever for pre-production costs, the picture is very different for those costs incurred downstream of production. This is true for both GORs and lessor royalties. The royalty clause of Canadian oil and gas leases contemplates that the lessee will be able to deduct some or all

¹⁴¹*Id.*, at 4 (QL).

transportation, compression, separation and processing charges for oil, natural gas and liquids notwithstanding that the royalty is typically described as a gross royalty. This conclusion is generally achieved not by express language but through the technique of specifying that the royalty is calculated on the basis of the market value on the leased lands or at the wellhead. Where the point of sale is downstream from the leased lands the practice has been to allow the lessee to deduct a proportionate share of the costs associated with transportation and processing as part of the procedure for arriving at a market value on the leased lands. The rationale for this is simply that the royalty owner should not get a free ride beyond the point of production, which is the point for calculating royalty, insofar as steps beyond that add value. The limited case law confirms this practice in the context of both oil and natural gas.

The following would be a fairly typical traditional clause:¹⁴²

Royalties

The Lessor does hereby reserve unto himself a gross royalty of Twelve and one-half per cent (12 1/2%) of the leased substances produced and marketed from the said lands. Any sale by the Lessee of any crude oil, crude naphtha, or gas produced from the said lands shall include the royalty share thereof reserved to the Lessor, and the Lessee shall account to the Lessor for his said royalty share in accordance with the following provisions namely:

The Lessee shall remit to the Lessor, on or before the 28th day of each month, (a) an amount equal to the current market value on the said lands of Twelve and one-half per cent (12 1/2%) of the crude oil and crude naphtha produced, saved and marketed from the said lands during the preceding month, and (b) an amount equal to the current market value on the said lands of Twelve and one-half per cent (12 1/2%) of all gas produced and marketed from the said lands during said preceding month.

Notwithstanding anything to the contrary herein contained or implied, the Lessee shall be entitled to use such part of the production of the leased substances from the said lands as may be required and used by the Lessee in its operations hereunder, and the Lessor shall not be entitled to any royalty with respect to said leased substances.

I have also included in the appendix the royalty clauses from the two most recent CAPL lease forms and I shall offer some commentary on those clauses below.

5.2.1 Decisions relating to oil royalties under the lease: gathering, treatment and storage costs

¹⁴²This clause is actually an early PanCanadian form and is reproduced in the *GRTA Test Cases*, *supra* note 7, at para. 55. In many respects it is a fairly simple clause. It provides for the same royalty rate for the different substances.

The leading case on the lessor's royalty is *Acanthus Resources Ltd et al v. Cunningham and Sullivan*.¹⁴³ In *Acanthus*, a gross royalty was payable on "the current market value" at the wellhead. There were multiple oil wells on the land which were connected by way of gathering lines to a central battery where the oil was treated by removal of the water. The water was re-injected into the reservoir through a water injection well. The treated oil was stored in tankage at the central battery before being trucked to a sales point at a nearby pipeline terminal. Predecessors in title to the current lessee had paid royalty on the amount received on sales at the terminal with a deduction being made solely for the costs of trucking. There had been no deduction for treatment costs. In confining deductions to transportation costs, *Acanthus'* predecessors in title were acting consistently with oilfield practice in Alberta which has been acknowledged to be less aggressive than actually contemplated by the lease terms.¹⁴⁴

Acanthus now sought to make a deduction for gathering, treating and storing costs. The court held that the lessee was entitled to make these deductions.¹⁴⁵

I interpret the royalty provision in the Leases to mean that the royalty is to be determined at the wellhead and that in so doing costs properly incurred downstream of the wellhead to the point of sale must be borne proportionally between the Lessors and the Lessee. Since this is a 17% royalty this same percentage of such costs are for the account of the Lessors. These costs, of course, specifically include the treating costs which are directly at issue as well as the trucking costs to which no objection is taken by the Lessors.

The court did not distinguish between these three categories of costs and there is no suggestion from the report of the case that it was invited to do so. Similarly, the court did not specifically deal with the costs of operating the re-injection well.

5.2.2 The position in relation to gas royalties

¹⁴³(1998), 57 Alta. L.R.(3d) 9 (Q.B.). See also *Skyland Oils Ltd. v. Great Northern Oil Ltd* [1976] 5 WWR 370. The case is discussed further infra where the text of the first part of the royalty clause is reproduced. The clause went on to provide, mirroring standard terms of freehold leases, that "Such gross overriding royalty shall be based upon the current market value at the time and place of production of the petroleum substances produced, saved and marketed from the lands in which Liberty has an interest in the P. & N.G. rights." Although the GOR holder took issue with the treatment of Crown and other royalties it took no issue with transportation charges (at 378): "Since the royalty is based upon the current market value at the time and pace of production ... counsel for the plaintiff concedes that the cost of transportation of those substances to refinery or gas plant, as the case may be, is properly deductible from the gross proceeds before calculation of the 2 per cent gross overriding royalty."

¹⁴⁴See Ballem, *supra*, note 8 at 167: "The general practice in computing royalty on oil has been to ignore any treating and surface storage costs and to pay royalty computed on the actual selling price of the crude."

¹⁴⁵*Supra*, note 143 at para. 23

The position is much the same in relation to processing charges for natural gas. The general proposition in Alberta is that natural gas will not be purchased at the wellhead but that the first market transaction will occur downstream of a processing plant, either at the plant outlet or at a point further downstream such as by a direct purchaser. The processing plant will produce gas that meets the specifications of the pipeline companies and may also be used to strip additional liquids and other products out of the gas stream. These liquids and other products will also generally be sold downstream of the plant either at the plant gate or some further downstream point. In all cases the language of the lease that calls for royalty to be calculated at the point of production or at the wellhead or on the leased or said lands has been taken to authorize the lessee to netback from the point of sale to the point of production and in the course of doing so to deduct a pro rata share of the processing and transportation costs incurred.

Given that the facilities involved may be extensive and require significant capital investment, the real question is what methodology should be adopted by lessees, and ultimately the courts, in determining what are appropriate deductions? There is general agreement in Alberta that these costs should be calculated in accordance with something called the Jumping Pound Formula.¹⁴⁶ This leads to two questions: (1) what is that formula, and (2) what fora are available in the event that a party takes issue with those deductions?

The Jumping Pound Formula

The so-called Jumping Pound Formula was established by the then Alberta Public Utilities Commission on an application by Shell Oil in the 1950s.¹⁴⁷ The then *Public Utilities Act* allowed the Board to fix and just and reasonable charges for gathering, treating and processing gas for the purposes of establishing the value of production at the wellhead. Shell was then in the process of developing the Jumping Pound gas field west of Calgary and constructing associated processing facilities. To that end, it had entered into a sales agreement with the local utility company, Canadian Western Natural Gas, with the price fixed at the plant gate. Shell evidently wanted to be assured that it would be able to deduct processing costs prior to calculating its royalty liability to lessors and other royalty interests. The Commission confirmed that it could, and, in a series of two decisions in 1954 and 1959, approved the proposed fees for compression, gathering and processing (an absorption plant). Fees were based on typical rate making principles and included amounts for a return on the capital invested in the plant (with a deemed capital structure of 50% debt and 50% equity), depreciation, interest charges etc.

¹⁴⁶There are references to the Jumping Pound Formula in the following cases: *Resman v. Huntex*, *supra*, note 11, *Canada Southern*, *supra* note 34, *Acanthus*, *supra* note 143, and *Mitchell Energy Corp. v. Canterra Energy*, [1986] AJ 1149 (principles of the Jumping Pound Formula to govern a contract between the parties implied by their conduct and allowing the use of interim billings followed by final adjustments.)

¹⁴⁷The original decision of the PUC is reproduced in its entirety in Bankes and Bennett Jones, *Canadian Oil and Gas*, volume 1, Digest 70. The later review decision of the PUC is reproduced in (1959), 31 PUR (3d) 503. There is further commentary on the decision in Ballem, *supra* note 8, at 168 and in Rae, *supra* note 8, at 339 - 350.

Since then the Jumping Pound formula has also informed the practice of the Crown in allowing Crown lessees to make deductions for processing and transportation costs (the so-called gas cost allowance of Alberta)¹⁴⁸ and has been held to have the status of a custom in the industry in various royalty disputes.¹⁴⁹

Modifications to the Jumping Pound Formula

In the late 1980s it became apparent that there was growing discontent with the issue of processing fees in the province of Alberta.¹⁵⁰ This discontent manifested itself through complaints presented to the Alberta Public Utilities Board (PUB), the Alberta Energy Minister and the Office of the Farmers' Advocate.¹⁵¹ The Minister of Energy took the matter up and wrote to the various industry organizations raising a series of concerns.¹⁵² First, the Minister alleged that high custom processing fees were resulting in a proliferation of gas processing plants and compromising efforts to recover and process solution gas. Second, the Minister suggested that high processing fees were having negative effects on freeholder royalty returns and for Crown royalty revenue.¹⁵³ The letter concluded by suggesting that the matter of custom processing fees might be considered by the PUB but intimating that an industry-led solution might be preferable to regulatory intervention from the perspective of all concerned. The industry took the hint and convened a joint task force to consider the matter. The result was a report known as the JP-90 Report or, in its longer form, as Gas Processing Fee

¹⁴⁸Note that in some cases the parties will simply agree that royalty gas shall be subject to the same deductions as the Crown accepts for Crown owned production. See, for example, the royalty clauses discussed in *Home v. Page* [1976] 4 WWR 598 (Q.B.): "the royalty share ... shall be treated in the same manner and liable, to the same deductions as Crown Royalty, reserved under a Crown Petroleum and Natural Gas Lease ..." and to the same effect *Emerald Resources Ltd. v. Sterling Oil Properties Management Ltd.* [1969] AJ 2 the royalty "to be calculated in the same manner as the lessor's royalty payable to the Crown ...".

¹⁴⁹See for example, *Resman v. Huntex*, *supra*, note 11 and discussed in more detail below..

¹⁵⁰The following account is drawn from the joint task force report, *Gas Processing Fee Guidelines, Jumping Pound 1990*. The task force was composed of representatives of the Canadian Petroleum Association, the Independent Petroleum Association of Canada and the Small Explorers and Producers Association of Canada. The report is available for a fee through the website of the Petroleum Joint Venture Association at <http://www.pjva.ca/>.

¹⁵¹The province created the office of the Farmers' Advocate in 1973. For more information see http://www.agric.gov.ab.ca/ministry/farmers_advocate/about.html

¹⁵²The letter of August 4, 1989 is reproduced in the Task Force Report, *supra*, note 148, as Appendix A. The industry's account of what triggered the concerns of the later 1980s is provided *id* at 20. The account focuses on plummeting natural gas and crude oil prices beginning in 1986. Prior to that time the report suggests that "Producers in many cases were content not to exercise their contractual right to charge the royalty holder with the proportionate share of gathering, compressing and processing costs." This relaxed attitude changed as producers sought to economize.

¹⁵³The letter, *id.*, noted that in some cases royalty owners had received no revenue but had actually been billed for processing costs.

Guidelines Jumping Pound 1990. An extensive supplement to this report was prepared as JP-95 to provide further guidance to the relevant parties.¹⁵⁴

Much of the 1990 report is directed at the relationship between plant owners and potential custom processors,¹⁵⁵ rather than those royalty owners who have no right to take in kind or who elect not to do so. However, the report also contained sections dealing with dispute settlement and suggestions for royalty clauses for future leases. Here the task force offered a number of suggestions including: negotiating a lower gross royalty but with no cost deductions; a cost deduction cap expressed as a percentage of royalty revenue; and a fixed fee per unit of volume, perhaps subject to adjustment through an economic indicator such as the consumer price index. With respect to existing leases the task force recommended that the royalty owner communicate its concerns to the lessee, that the parties might resort to mediation and arbitration, litigation, and “as a last resort” reference of the dispute to the Public Utilities Board “through the Minister of Energy”. This last suggestion is a reference to PUB’s historic jurisdiction to determine the just and reasonable rates of processing facilities.¹⁵⁶ While the jurisdiction has occasionally been used and indeed a predecessor section was the basis of the original Jumping Pound formula, it is clear that the industry has been and is anxious to avoid intervention by the PUB and its successor the Energy and Utilities Board (EUB).

5.2.3 Changes in the CAPL Form of Lease

Before considering the case law on the treatment of gas processing charges it seems useful to comment on how the drafting of the royalty clause of one commonly used lease form might have evolved in response to some of these comments and concerns. The form is the CAPL form and I shall comment on the 1991 and 1999 iterations of the form. The relevant clauses are reproduced in the appendix. In choosing what to focus on, I am inferentially drawing some comparisons with the more traditional form reproduced above immediately under the heading of s.5.2.¹⁵⁷

¹⁵⁴This report, Joint Industry Task Force Report on Processing Fees, JP-95, April 15, 1996 is also available from the PJVA, *supra* note 150.

¹⁵⁵The goal here was to develop a “fee structure guideline” to promote the negotiation of custom processing arrangements that are “fair and reasonable” to facility owners and custom users.

¹⁵⁶The current source of this jurisdiction is s.5 of the *Gas Utilities Act*, RSA 2000, c. G-5. In addition s.6 makes it clear that an Order in Council is required to trigger an EUB hearing on such a matter.

¹⁵⁷There are considerably more complex processing provisions (and alternates) in the CAPL Farmout and Royalty Procedure, 1997. Among other things, the agreement’s definition of facility fees incorporates by reference the PJVA Jumping Pound-95 methodology. A more detailed exploration of these clause would require a separate paper.

Key features of the 1991 form include the following:

- C the royalty is framed as a promise to pay and not as a reservation; the lessee is assumed to own all of the production by the act of severance;
- C as with the traditional form, royalty is payable on current market value at the wellhead;
- C principally (presumably) in the interests of transparency, the 1991 form makes it explicit that the lessee may deduct reasonable expenses for “separating, treating, processing, compressing and transporting” between the wellhead and the point of sale and included in such reasonable expenses is “a reasonable rate of return on investment”;
- C the form provides that the claim of reasonable expenses shall not reduce the royalty that would otherwise be payable below a floor to be fixed through negotiation;¹⁵⁸
- C current market value is not defined but is deemed never to be in excess of the value actually received by the lessee pursuant to a bona fide arm’s length transaction.

The key changes made in the 1999 form include:

- C the explicit inclusion of the costs of water disposal as a legitimate deduction;
- C the addition of a more comprehensive clause dealing with ascertaining market value; this is deemed to be the price agreed to as a result of an arm’s length sale or transaction, failing which it shall be the average market price for the substances produced from the area where the lands are located. In practice this would likely be determined by using a quoted hub price minus the permitted deductions from the hub back to the wellhead.

5.2.4 The case law on processing and related charges for natural gas

The Canadian case law on permissible deductions for gas processing charges has developed not in the context of the lease but instead in the context of the GOR. The two most important decisions are *Resman*

¹⁵⁸Parties to a gross overriding royalty may stipulate for a royalty of a minimum value, regardless of the price actually received and regardless of processing costs. Such seems to be the case for example in the farmout and royalty agreement discussed in *Novalta v. Ortynsky* [1994] 6 WWR 484 (Alta. Q.B.). The relevant agreement is reproduced as appendix A to the case report at 532. The royalty clause is not the subject of comment in the case but the clause provides that the royalty shall be payable on market value at the wellhead. For gas the royalty is fixed at 15% provided that the royalty shall not be less than \$5.32 per 1,000 m³.

*v. Huntex*¹⁵⁹ and *Amerada Minerals Corp. of Canada Ltd v. Mesa Petroleum (NA) Co.*¹⁶⁰ The *Resman* case is far from satisfactory since the court's conclusion seems to be informed more by an understanding of what might be the general position in the industry rather than by an analysis of the specific language before it in that case.

In *Resman* the agreement provided that the royalty:

shall be two and one half (2 ½%) per cent of the actual market value of the well head of all petroleum and associate substances on all production produced, and on natural gas two and one half (2 ½%) per cent payable at the outlet valve to the pipeline, produced, saved and sold from the said lands ...

Thus the clause provided two different points of calculation- one for petroleum and the other for natural gas. However the court never even refers to this distinctive treatment of the two substances preferring instead to cite US authorities dealing with determination of value *at the wellhead* and then evidence as to the practice or custom in the industry. That custom was to the effect that the industry followed Crown practice and allowed deductions for what is known as gas cost allowance which in turn is based upon the Jumping Pound Formula. Having recited that practice and, with no further discussion, Justice Power simply agreed with the working interest owner that processing deductions were permissible.¹⁶¹

Justice Moshansky in the later *Amerada* case suggests that *Resman* “seems to stand for the proposition that

¹⁵⁹*Supra*, note 11.

¹⁶⁰[1985] 4 WWR 607 (Alta. Q.B.), aff'd [1987] 1 WWR 107 (Alta. C.A.). In addition see the most recent round of the Hamilton royalty litigation, *supra*, note 130 in which one of the successors in title of the Tencos is seeking to argue that it has overpaid royalty to the Hamilton interests on the grounds that certain processing and marketing costs should have been deducted *prior to* allocating amounts to the royalty account. The argument turns on the definition of “value” contained in the original agreement. The plaintiffs do not contend that these costs amount to “burdens” but instead argue that before one can consider the definition of burdens one firstly has to determine “value” at the point of sale. More specifically, this potentially gives rise to the following questions: (1) are the gas processing costs part of operation and development costs? (2) Are the processing costs covered by Clause 11 of the agreement? (3) Does the agreement allow *only* “burdens” to be deducted? The Hamilton interests responded by seeking to have the statement of claim struck on the grounds of issue estoppel and cause of action estoppel and have maintained that the very issue that the plaintiffs seek to raise had either been determined in one of the earlier rounds of litigation or could have been and should have been. Thus far the court has rejected the motion to strike and has accepted the plaintiff's contention that these questions had not been put to the court in the earlier *PGRT* and *Nipisi* cases.

¹⁶¹Ballem, *supra*, note 8, at 167 n.20 frames his criticism of the case more gently commenting that “the court seems to have treated ‘outlet value to the pipeline’ as being the same as ‘at the well.’ Presumably, if the agreement had referred to ‘plant outlet valve’ the result would have been different.”

if there is a vagueness in a royalty provision, the standard industry custom may be resorted to.”¹⁶² This is ironic insofar as Justice Power in *Resman* (in denying an argument that an earlier letter agreement could be resorted to in order to elucidate the meaning of the clause) had explicitly ruled that the agreement was not ambiguous.¹⁶³

In *Amerada Minerals Corp. of Canada Ltd v. Mesa Petroleum (NA) Co*¹⁶⁴ the royalty clause provided that the royalty should be payable as follows:

(b) on all petroleum substances that are produced, saved and marketed from the ... joint lands:

(i) Altair shall pay to Amerada, free and clear of any deductions whatsoever, a gross overriding royalty in cash of ten percent (10%) of the current market value at the time and place of production of all petroleum substances produced in liquid form, saved and marketed from the ... joint lands. For petroleum substances other than those produced in liquid form, the overriding royalty is to be computed at the plant outlet free and clear of all processing charges.

It bears emphasising that for non-liquid petroleum substances the agreement explicitly contemplated computation of royalty at the plant outlet free and clear of all processing charges. The pool in question was initially produced for oil. Associated gas production was flared until 1974 when the conservation authority required that gas conservation measures be instituted. At that point temporary facilities (the so-called Phase II facilities) were put in place to provide limited processing for the associated gas in order to meet the specification of the gas purchase contract. Further facilities were put in place in 1975. These facilities were designed to remove natural gas liquids for separate sale. Mesa, the payor of the royalty, routinely deducted processing charges prior to calculating the royalty obligation and Amerada sought to question this practice.

The court framed the issue as being that of *where* production occurred. The plaintiff argued that it occurred downstream of the processing plant and the defendant urged that production occurred where “gross separation” occurs, which was at the wellhead. After considering evidence as to the commercial context of the contract, Justice Moshansky concluded as follows:¹⁶⁵

The case law appears to coincide with the evidence of the plaintiff’s expert to the effect that in the context of the Alberta oil and gas industry the word “produced” envisages the point at which the

¹⁶² *Supra*, note 160 at 627 (Q.B.)

¹⁶³ *Resman*, *supra* note 11, at 696.

¹⁶⁴ *Supra*, note 160.

¹⁶⁵ *Id.*, at 625 (WWR) (Q.B.).

product can be measured, where its value can be tested and where it can be effectively stored and used. That point is at the downstream plant outlet. I therefore hold that “production” occurs where the plaintiff says it occurs, i.e., downstream of the [separator]¹⁶⁶ outlet.

But that finding gave rise to a second question which was whether the term “plant outlet” referred to the Phase I, II or III plant?

In answering this question Justice Moshansky distinguished between the processing that was necessary to make the gas marketable, and the processing that was desirable in order to add value to the gas stream. The court held that the royalty owner was entitled to have the gas treated “to the extent that the residue gas is acceptable to the market in general and that it meets all standard industry expectations” but was not entitled to the further processing that enhanced the value of the natural gas. The phase II plant produced a gas stream that met the specification of at least two major purchasers in the gas market but did not satisfy the “dewpoint standard” in the industry. In the court’s view this required at least some elements of the phase III plant which the court fixed at approximately 21% of the total plant. Consequently, the court held that the defendants could deduct 79% of the costs attributable to processing in the Phase III plant but that otherwise the royalty owner was entitled to its royalty free and clear of processing.

Somewhat surprisingly the court seemed to suggest that this conclusion was supported by the practice in the industry. The court took the view that it was entitled to look at the practice on the grounds that the royalty provision was vague (it did not refer to natural gas directly but to petroleum substances other than those produced in liquid form) and that the practice showed that it was permissible to make deductions for the cost of processing raw natural gas. However, the court seems to have used this practice solely for the purpose of restricting the possible interpretation of the term “plant outlet” and not to deny the royalty owner’s claim that it was entitled to at least some free processing.

To this extent the case is inconsistent with (but to be preferred to) the earlier decision of Justice Power in *Resman Holdings Ltd v. Huntex*¹⁶⁷ in which the court relied on the custom of the industry to such an extent that it seems to have ignored the actual language of the agreement.

5.2.5 Conclusions on post-production deductions

¹⁶⁶The trial judge actually used the word “plant” here but all parties on appeal were agreed that the judgement should have read “i.e. downstream of the separator outlet”.

¹⁶⁷[1984] 1 WWR 693.

The basic structure of Canadian oil and gas law on permissible deductions for post-production expenses seems fairly clear: absent clear language precluding deductions, deductions will be allowed for those activities that add value between the point and production and the point of sale. To this point there is very little case law that seeks to question the permissibility of different *types* of deductions within this overall framework. Where such litigation has occurred (e.g. *Amerada*) the arguments have been based on the particular language of the agreements.

The courts in this area seem to accord extraordinary weight to what they understand to be “the custom in the industry”. The existence of the Jumping Pound formula sanctioned by the PUB and endorsed by the practice of the Crown has no doubt helped this process. In at least one influential case however (*Resman*), I would argue that the court was unduly influenced by the custom in the industry at the expense of the particular language chosen by the parties.

5.3 Other forms of deductions

In this section I shall briefly canvass the law on other forms of deductions that have been considered by the courts: (1) the treatment of take or pay financing charges as transportation costs, (2) fuel gas costs, and (3) government taxes.

5.3.1 Take or pay carrying charges as transportation costs

The discussion above tells us that if the royalty is payable on well-head value but the point of determining market value is at some point downstream, then the royalty payor will be entitled to deduct a pro rata share of transportation costs as part of the netting back process to determine market value at the wellhead. But what can legitimately be included under the rubric of transportation costs?

In *Enchant v. Dynex*¹⁶⁸ the GOR clause provided that the GOR was payable on “the proceeds (subject to the deductions hereinafter referred to) received by the Grantor on the sales of all petroleum substances produced, saved and marketed from the said lands.” The permissible deductions included: “The costs of transporting petroleum substances to a plant for processing and/or to the delivery point for the buyer thereof.” The principal question in *Enchant* was whether or not Enchant, the royalty payor, was entitled to deduct for an amount that was fixed by the relevant regulator (the Alberta Petroleum Marketing Commission) as part of the Alberta cost of service for common carrier pipeline service but which was ultimately attributable to the take-or-pay liabilities of TransCanada PipeLines, the principal purchaser of gas

¹⁶⁸(1991), 123 AR 81 (QB).

in Alberta.

The royalty agreement had been entered in January 1975 at which time the lands in question were subject to 25-year deliverability based contracts with TCPL at a fixed price subject to annual price redetermination at the option of either party. The contract included a take or pay clause. Under the contract TCPL took delivery at the contract price at the outlet valve of the Enchant processing plant and consequently TCPL assumed the costs of transporting the gas to market on the TCPL system.

Price regulation was introduced in Canada by November 1975. The regulatory scheme was based on a fixed price at the Toronto City gate with field prices determined by netting back TCPL's cost of service to the Alberta border (regulated by the National Energy Board) and then deducting the Alberta cost of service (ACOS) determined by the Alberta Petroleum Marketing Commission, Alberta's regulator for these matters. While the ACOS was primarily based upon the actual cost of service of NOVA (the intra provincial pipeline operator), from 1982 onwards the APMC agreed to include in ACOS amounts associated with interest charges that related to the so-called TOPGAS Agreement. The TOPGAS agreement was an agreement between producers and TCPL pursuant to which the parties settled TCPL's take or pay obligations under its long term contracts.

Dynex received payments under the terms of the TOPGAS agreements¹⁶⁹ but the implications of including TOPGAS carrying charges in ACOS were to reduce the regulated price payable to Dynex. And, since Dynex took the view that ACOS charges were legitimate transportation costs, they could be deducted prior to the determination of Dynex's royalty liability to Enchant. Enchant sought to question this assumption. Following deregulation (effective November 1, 1986), TOPGAS payments continued to be recovered from producers pursuant to the terms of provincial legislation the *Take or Pay Costs Sharing Act*.

Enchant took the view that while the royalty agreement permitted the deduction of some transportation costs, it limited those transportation costs to the buyer's delivery point which in this case was the Dynex gas plant gates. The court rejected that argument. The court held that while the royalty agreement was negotiated in the pre-regulated price environment, the substance of the agreement was that royalty was to be calculated on the basis of the actual cash received by Dynex "regardless of the formula used to arrive at such a price."¹⁷⁰

The introduction of regulated pricing simply established methods by which the price paid to producers

¹⁶⁹The case makes it clear that Dynex never shared these payments with Enchant and that Enchant had made no claim to any share of those payments.

¹⁷⁰*Id.*, at 97, para. 13.

like Dynex was to be calculated. Therefore Enchant's claim that the entire ACOS must be added back to the regulated field price before its royalties are calculated is not consistent with ... the royalty contracts.¹⁷¹

The court went on to say that the regulated price superceded any contract price and that ACOS was an essential element of determining the regulated price and that TOPGAS financing charges were included in ACOS. This was a complete answer to Enchant's claim.¹⁷²

5.3.2 Fuel gas

Royalty agreements and the royalty clauses of leases frequently provided that no royalty shall be payable on gas used in the operations of the royalty payor. But what if the agreement is silent on the matter? And how extensive is the claim to royalty-free gas?

The relevant clause of the contract was silent on the treatment of fuel gas in *Amerada Minerals v. Mesa* but the clause did provide that royalty was only paid on those substances that were "produced, saved and marketed". The court gave two reasons for finding that Mesa was not obliged to pay royalty on gas used as fuel gas in the processing operation. First, to pay royalty on such gas would be inconsistent with the practice in the industry.¹⁷³ Second, this conclusion followed from the very terms of the agreement since gas that was consumed as fuel gas was gas that was not in fact marketed. On appeal, counsel for Amerada, the royalty owner, contended that the trial judge had relied solely upon the custom in the industry and had given no consideration to the plain meaning of the agreement and "that the production of the fuel gas used at the plant should be considered as a processing charge equivalent to marketing and that the appellant should not be deprived of royalty with respect to the fuel gas". The court rejected that contention and agreed with the

¹⁷¹*Id.*, at 97 para. 14. The court was more willing to second guess the classification of costs as transportation costs in a case involving Indian lands. See the *Stoney Nation* case, *supra*, note 3.

¹⁷²The court also held (*id.*, at 97) that this was not unfair or inequitable even though Enchant had made no claim on the benefit received by Dynex on the form of Dynex's TOPGAS payments. In fact Enchant was an indirect beneficiary since the TOPGAS scheme probably saved TCPL from bankruptcy. The court suggested at 98 that "It was open to Enchant to bargain for a share of any take or pay payments but it did not."

¹⁷³*Amerada Minerals*, *supra*, note 160, at 382 - 383 and specifically at 383: "It is safe to say that the evidence here established beyond argument that the custom of not paying royalties on fuel gas is so notorious and widely acquiesced in so as to readily meet the criteria of the Supreme Court of Canada" in *Georgia Construction v. Pacific Great Eastern Ry Co* [1929] SCR 630 "it must be reasonably certain and so notorious as so generally acquiesced in that it may be presumed to form an ingredient of the contract ...".

trial judge.¹⁷⁴

While this conclusion may be justified on the language of this particular case, much must depend on the actual language of the royalty clause. Many lease forms in common use in western Canada, including the CAPL lease forms reproduced in the appendix, confine the royalty free use of gas to those operations actually conducted on the lease premises.

5.3.3 Government taxes

The treatment of government taxes arose in the first of the *Hamilton Brother Royalty Cases*.¹⁷⁵ This case had its roots shortly after the original agreement was executed when the federal government, as part of the National Energy Program, introduced a new tax, the *Petroleum Gas Revenue Tax* (PGRT). The tax was structured so that both Hamilton as a royalty owner and Carter\Tencos as a working interest owner assumed part of the tax liability. Both parties were agreed that their respective tax liabilities constituted burdens within the meaning of the conveyance agreement but in this first case Hamilton alleged that Carter\Tencos had unduly inflated the burden insofar as Carter\Tencos charged its full PGRT liability to the burden account without reducing it by an amount for two credits or allowances that Carter\Tencos was entitled to claim and did in fact claim. Hamilton's position was that the charge to the burden account should simply reflect the amount of tax actually paid.

Both the trial court and Alberta's Court of Appeal agreed with Hamilton's contention. Carter\Tencos advanced two arguments to support their position and a further argument designed to reduce their liability. The more general of the two claims was that the parties had not agreed that only *net* taxes would fall within the embrace of the definition of burdens.¹⁷⁶ On this point Justice Prowse, relying on long-standing authority¹⁷⁷ conceded that while there might be a presumption to the effect that parties are to be taken as having contracted with reference to the law as it existed at the time of the contract they might, by apt words,

¹⁷⁴"In my view the agreement provides that there must be marketing before there is any royalty due. I do not equate processing with marketing. Here the fuel gas was used by the operator and not sold or transferred to a third party." *id.*, at 118, (C.A.)

¹⁷⁵*Supra*, note 140, [1987] AJ 706, *Hamilton # 1*, (PGRT).

¹⁷⁶This was clearly a difficult argument for the Carter\Tencos interests to manage since they clearly wanted the tax liability itself to constitute a burden and this indeed was confirmed by the agreement and practice of the parties.

¹⁷⁷*Mayor of Berwick v. Oswald* 10 ER 1139, *Atlantic Richfield Company v. Petro-Canada*, (1983), 49 AR 109.

express a contrary intention and bind themselves to the law as it evolved. In this case:¹⁷⁸

the intent of the parties ... to have subsequent legislation changes included in the interpretation of the burdens definition may be inferred by the general word used in the definition. The parties could have enumerated the specific taxes, allowances, etc., that were to be treated as burdens. The uncontradicted evidence of [Hamilton's witness Miller was that] Specific taxes, charges and payments were not enumerated in the agreement because the parties wished to have a broad, all-encompassing document which would provide for future contingencies that might arise during the term of the agreement.

The more specific of Carter\Tencos arguments was to the effect that “payable” within the meaning of the PGRT tax meant the gross liability not the amount actually paid following deductions for available credits etc. Having considered the text of the statute¹⁷⁹ the court ruled that taxes payable referred to net taxes.

5.4 Miscellaneous interpretive questions

5.4.1 The percentage of production on which the royalty is payable

Arguments sometimes arise as to whether the royalty clause reserved a royalty on 100% of production from the relevant lands or from some lesser amount. The issue may arise when the working interest grantor of the royalty has less than a 100% undivided interest in the property. Did the parties intend to make the royalty apply to 100% of production attributable to the property or only that share of production in which the grantor had an interest? One would think that it would be an unusual situation in which any grantor would purport to make its royalty obligation extend beyond its own entitlement to production but that has not prevented parties from litigating the point. One example is *Telstar Resources Ltd. v. Coseka Resources Ltd.*¹⁸⁰

¹⁷⁸[1987] AJ 706 at 5 (QL).

¹⁷⁹The statute made a distinction between taxes payable before deduction and referred to these as “the tax otherwise payable”.

¹⁸⁰*Supra*, note 10. See also *Scurry-Rainbow Oil Ltd. v. Kasha* (1996), 135 DLR (4th) 1 (Alta. C.A.). Under the Kasha-California Standard lease the lessee committed to pay a 12 ½ % royalty (the royalty was not “reserved”). Kasha, the lessor, subsequently entered into a royalty trust agreement the preamble to which recited the royalty and then provided that: “Whereas the Owner is desirous of assigning to the Trustee all right, title and interest to a twelve & a half (12 ½ %) percentum of such gross royalty”. I have dealt above with the key issues before the court (1) the proprietary status of the lease, and (2) the question of whether or not the royalty assignment survived the termination of the CS lease, but there was also a preliminary interpretation issue. Did the quoted preambular phrase evince an intention merely to assign a 12 1/2% interest in the 12 1/2% royalty? Notwithstanding the plausibility of the claim given the actual words used the court had little difficulty disposing of the argument (at 6):

Suffolk, the original grantor of the royalty in question, held an undivided 94.4% interest in a Crown Reserve Natural Gas Licence. The recitals to the royalty agreement began by referring to this but a subsequent clause of the recital went on to say that the grantor “has agreed to grant to the Royalty Owners a Three (3%) percent gross overriding royalty on all petroleum substances recovered from the lands” and the final recital noted that the agreement was being entered into “to set forth full particulars of the payment of the gross overriding royalty.” However, while the preamble might have introduced some measure of ambiguity, it would be hard to fault the drafting of the operative clause which stipulated that:¹⁸¹

The Grantor does hereby grant and assign to the Royalty Owners a Three (3%) percent gross overriding royalty out of the 94.4% interest of the Grantor in all petroleum substances found within, upon or under the lands, during the currency of the Licence and any extension or renewal thereof and any leases issued thereunder.

The Court of Appeal had little difficulty in concluding that the practice that had been followed, that of calculating the royalty obligation on 94.4% of production, was the correct one and that “To suggest that [the] 94.4% interest was merely a possible source from which the 3% royalty could be paid makes little sense.”¹⁸² In reaching this conclusion the Court was fortified by its understanding of the label gross overriding royalty which, following a recital of US jurisprudence, it understood to mean a royalty carved out of the working interest and therefore, by its nature, not extending beyond the working interest that the grantor might have had at the time.

A somewhat different issue arose in *Skyeland Oils Ltd. v. Great Northern Oil Ltd.*¹⁸³ There a GOR provided that Liberty would pay to Skyeland “out of the proceeds of production a gross overriding royalty of two (2%) per cent of Liberty’s interest in all P & N.G. rights which Liberty acquires as the result of Skyeland’s sole efforts.” Skyeland argued that GNOL was not entitled to deduct royalties payable to the

Kasha’s real intention was obviously to assign a royalty interest in a percentage equivalent to the percentage stated in the CS lease, that is, the full royalty to which he was entitled. There is nothing in the Royalty Trust Agreement or in the circumstances surrounding its execution to suggest a different intention.

See also *Imperial Oil Co. v. Placid Oil Co.*, [1963] SCR 333 where the Crown deemed itself by statute to have an ownership interest in all producing pools (in recognition of the Crown’s rights within road allowances). The court held that no royalty was payable by private lessees to their private lessors on the Crown’s deemed interest even with respect to leases that had been granted before the legislation came into effect. The legislation was interpreted as fixing the size of the Crown’s interest rather than making a new ownership claim.

¹⁸¹*Telstar*, *supra*, note 10, at 189.

¹⁸²*Id.*, at 192.

¹⁸³[1976] 5 WWR 370 (Alta. S.C.).

Crown or any other parties before calculating its royalty entitlement. The Court accepted this submission. The court reached a similar conclusion in *Suncor Inc. v. Norcen International Inc.*¹⁸⁴

Together these case perhaps suggest that while there may be a presumption (*Telstar*) that a GOR will ordinarily only be payable on the production attributable to the payor's working interest, there is no similar presumption to the effect that other royalty payments should be deducted before the GOR obligation is calculated. Here the presumption may work the other way and the royalty will be payable on gross production, with no deduction for lessor and other royalty payments.

5.4.2 Royalty calculated by reference to individual tracts or combined tracts?

Where the royalty reserved by an agreement is a sliding scale royalty varying by volume of production, questions may arise as to how to allocate production for the purpose of determining what level of royalty applies. The point is illustrated by *Alminex Limited, Home Oil Company Limited and Kern County Land Company v. Berkley Oil and Gas Ltd.*¹⁸⁵ The royalty in question arose by way of a letter farmout agreement between Home as farmor and Berkley as farmee with the latter preparing the documentation.¹⁸⁶ The agreement contemplated that Berkley would earn a 100% undivided interest in two sets of identified lands as a result of drilling the test well and an option well. In each case the agreement contemplated that the lands earned would constitute multiple quarter sections. The lands (along with others) were all included within a single Crown lease. The royalty clause provided as follows:

... reserving unto you an overriding royalty on all Petroleum and Natural Gas and related hydrocarbons as follows:

(a) As to oil: a percentage of the oil produced, saved and old from the said lands computed by dividing the number of barrels of oil so produced, saved and sold each month by 150 with a minimum such overriding royalty of 5% and a maximum such overriding royalty of 15%.

Berkley earned its interests and subsequently, upon application to the Oil and Gas Conservation Board, included the lands within a production spacing unit presumably for the purposes of obtaining relaxations of certain conservation rules such as spacing rules. Its efforts in this regard were the subject of an agreement between Berkley and Home. Later still, the lands were included in a unitization agreement executed by all

¹⁸⁴ (1988), 89 AR 200 (Q.B.). There the court held, inter alia, that the Crown's royalty was not somehow exempted from the lands granted by the lease. The *Placid Oil* case was therefore distinguishable.

¹⁸⁵ [1971] 4 WWR 401, aff'd [1972] 6 WWR 412, (Alta. App. Div.), aff'd [1974] 1 WWR 288 (SCC).

¹⁸⁶ Accordingly supporting, if necessary, a *contra proferentem* interpretation: *id.*, at 411.

the parties.¹⁸⁷ Berkley argued that in each case the royalty should be paid on the basis, not of the allocation of production to the entire farmout lands, but on the basis of a deemed allocation of production to each quarter section or drilling spacing unit of the farmout lands. All three levels of court rejected this contention. Justice Lieberman at trial held that the phrase “said lands” in the operative part of the royalty clause referred to the “lands so earned” and that in turn referred collectively to all of the lands earned by the farmee.¹⁸⁸ The court did not find that this interpretation led to an absurd result. After all, the royalty could rise no higher than 15%.

Given that the unitization agreement was executed by all the parties it had the potential to amend the earlier agreement. This argument was not specifically addressed by the trial judge but was by the Court of Appeal. Chief Justice Smith however took the view that “in the absence of specific provisions to the contrary in the contractual arrangements, unitization of oil-producing lands does not modify the terms of an initial or basic document such as an oil lease or a farm-out agreement”. In his view, the terms of the unitization agreement simply confirmed the conclusion that the unitization agreement was not intended to disturb pre-existing royalty obligations.¹⁸⁹

In a related case, *Home Oil Company v. Page*,¹⁹⁰ the parties had developed a formal agreement (drafted by the farmor this time) and the same issue arose. Berkley the farmee had earned its interest in the lands by drilling the test well and a subsequent option well. After earning, two further wells were drilled. Under the terms of the formal agreement, a sliding scale royalty was payable on “value at the wellhead”. The term “value” was defined to mean “the current market value of petroleum substances produced and saved from the farmout lands.” Armed with this definition, Justice Laycraft had little difficulty finding that the same result obtained. The royalty was payable on total production from the farmout lands and not on the basis of production attributable to the several tracts under the terms of the unitization agreement. The fact that

¹⁸⁷*Id.*, App. Div. at 413

¹⁸⁸*Id.*, at 410 - 411.

¹⁸⁹*Id.*, App. Div. at 414. Clause 703 headed calculation of royalty of the unitization agreement provided in its opening words that “The Working Interest Owners of each Tract shall calculate royalty on the aggregate Unitized Substances allocated to the Tract as the applicable rate under the Lease, other agreement or instrument related to the Tract.” Although the point is not completely clear, Chief Justice Smith seemed to be saying that the royalty would still be calculated on production for the entire farmout lands even if each DSU were included as a separate tract within the unitization (which may or may not have been the case on the facts disclosed in the judgements). This would seem to follow from this passage in Smith’s judgement (at 414): “Allocation of distribution of the unitized substances allocated to the tract has no bearing upon and clearly does not affect the royalty payable in my opinion.” This conclusion (as well as the assumption that there was a tract allocation factor for each DSU in the unitization agreement is confirmed by Justice Laycraft’s subsequent decision on a related matter in *Home Oil Company Limited v. Page Petroleum Ltd.*, [1976] 4 WWR 598 (Alta. Q.B.).

¹⁹⁰[1976] 4 WWR 598 (Alta. Q.B.).

production was allocated to tracts under the unitization agreement may have changed the rights of the parties with respect to their entitlement to production from particular tracts, but it “does not, however, change the computation of the sliding scale royalty which is still to be determined by ... the gross overriding royalty procedure.”¹⁹¹

5.4.3 Allocation of responsibility for an existing royalty obligation

Where a party farms in on leased lands the farmor and farmee will need to agree upon the allocation of responsibility for the payment of existing royalty obligations which might include gross overriding royalty obligations in addition to any royalty that might have been reserved by the lessor.

This issue divided the parties in *Keles Production v. Husky Oil Operations Ltd.*¹⁹² In that case Keles took a farmout from each of Husky and United Canso who held a half section of lands each as to an undivided 50% working interest. Husky’s interest (but not United’s) was subject to a 15% GOR in favour of Canadian Superior (CS) “at the point of measurement of all petroleum substances produced and saved from or attributable to the said lands.” Under the terms of the farmout Keles was to earn a 100% working interest in the spacing unit for the test well subject to a convertible sliding scale GOR payable to Husky\United. Keles was to get a 50% undivided interest in the balance of the farmout lands and in the event that Keles decided to drill additional wells Husky\United was to have the option of converting to a nonconvertible GOR for the proposed operation on a DSU by DSU basis.

The existence of the Canadian Superior GOR was fully disclosed during the farmout negotiations and there was some suggestion that Keles believed that it might be able to reduce the size of this royalty through negotiations with CS. The farmout agreement between the parties stipulated as follows:

Encumbrances on Interest

The Farmee hereto recognizes that the Farmout Lands are encumbered by a nonconvertible 15% Gross Overriding Royalty pursuant to an Agreement dated January 2, 1967 between Canadian Superior Oil Ltd. and Husky Oil Operations Ltd. The Farmee acknowledges that it has examined such agreement and related documents and hereby agrees to assume and accept such obligations on behalf and in place and stead of Husky Oil Operations Ltd. on the Farmout Lands. For greater clarity, Farmee is completely responsible for payment of the herein above mentioned override in addition to any override granted to Farmor by the terms of this Agreement.

¹⁹¹*Id.*, at 606.

¹⁹²(1991), 80 Alta. L. R. (2d) 5 (Q.B.).

Notwithstanding the herein above mentioned encumbrances, if the interest of any party in the Farmout Lands is now or hereafter shall become encumbered by any royalty, excess royalty, overriding royalty, production payment or other charge of similar nature, other than the royalties as set forth under the terms of the lease, such additional royalty, excess royalty, overriding royalty, production payment or other charge of similar nature shall be charged to and paid entirely by the party whose interest is or becomes thus encumbered.

Notwithstanding the apparently clear language of this text, Keles sought a declaration to the effect that each of Keles' and Husky's interests were burdened by the CS royalty and that each party must pay one half of it, at least when Husky elected to convert to a working interest position. Justice McBain rejected that submission and in the course of doing so affirmed that the clause was intended to apply forever and not just during the earnings phase of the farmout. He also held that it was not possible to read the attached operating agreement as derogating from the clear language of the title documents so as to make the CS royalty a shared expense of joint operations.

5.4.4 Conclusions on miscellaneous interpretive questions

If there is a broader lesson to be drawn from these cases it must simply be that there are few rules of law in this area and that the key in any dispute must be the actual language of the particular agreement. While there some guides (e.g. royalty is payable on the interest that you had when the royalty was carved out and not on a greater interest) *Keles* is testament to the idea that clear language will and should trump any more general understandings of norms that their might be in the industry.

6.0 CONCLUSIONS

I have tried to provide in this paper an overview of some the private royalty issues that have been brought before the Canadian courts. To a much lesser extent I have provided examples of Canadian drafting practices in this areas of the law. Are there any broad themes that emerge from this survey or does it simply reveal a wilderness of single instances? I think that we can identify some themes.

C The more recent cases reveal a concerted effort to develop royalty law in a way that meets the needs of the industry and to pay somewhat less attention to the formal categories of property law and the binding effect of old rules. I think that this is revealed most clearly in the case law on the categorization of royalty interests. It will be interesting to see how far this trend will carry us. For example, the royalty area is not the only area bedeviled by the perennial interest in land question. It also permeates the case law on the characterization of Crown oil and gas and mineral and other resource interests. Can we expect that the courts will take a similarly pragmatic approach in this area as well? The two issues are not unrelated as the *Vandergrift* case shows and the Supreme Court

has warned us that at least one part of *Vandergrift* survives, namely the idea that a working interest owner must itself have an interest in land before it can create a royalty that will have that status.

- C The more recent cases also reveal the interest of the courts in developing a consistent body of royalty case law that applies to all forms of royalties: lessor's royalties, GORs and GRTAs. There is no suggestion that Canadian courts are particularly solicitous or protective of the interests of lessor royalty owners.
- C The case law does not reveal any new willingness on the part of Canadian courts to develop a body of implied covenants to protect the royalty owner. The *Mesa* case is exceptional. It is more likely that Canadian courts will emphasise their interpretive role and in so doing will reinforce what they regard as the expectations of the industry as understood by them based on evidence of that custom as introduced by the parties.
- C While there is some evidence that parties are developing creative drafting solutions to more clearly allocate responsibility for processing and related costs the background rules are well established. New case law in this area is most likely to be driven by litigation involving Indian leases and perhaps major GOR owners litigating older agreements. The ongoing *Hamilton Brothers* litigation is a case in point.
- C I said at the outset that I am surprised that we have not seen litigation on valuation issues for royalty purposes. If I were to make one prediction in this paper it would be that that will change.

APPENDIX: CAPL LEASE ROYALTY CLAUSES

CAPL 1991

4. Royalties

- (a) The Lessee shall pay the Lessor a royalty in an amount equal to the current market value at the wellhead as and when produced of (.....%) of all the leased substances produced, saved and sold, or used by the Lessee for a purpose other than that described in subclause (b) hereof, from the said lands; provided that in computing the current market value at the wellhead of all the leased substances produced, saved and sold, or used by the Lessee for a purpose other than that described in subclause (b) hereof, the Lessee may deduct any reasonable expense incurred by the Lessee (including a reasonable rate of return on investment) for separating, treating, processing, compressing and transporting the leased substances to the point of sale beyond the wellhead or, if the leased substance are not sold by the Lessee in an arm's length transaction, to the first point where the leased substances are used by the Lessee for a purpose other than that described in subclause (b) hereof; provided further, however, that the royalty payable to the Lessor hereunder shall not be less thanpercent (.....%) of the royalty that would have been payable to the Lessor if no such expenses had been incurred by the Lessee. In no event shall the current market value be deemed to be in excess of the value actually received by the Lessee pursuant to a bona fide, arm's length sale or transaction. The royalty as determined under this clause shall be payable on or before the 15th day of the second month following the month in which the leased substances, with respect to which the royalty is payable, were produced, saved and sold, or used by the Lessee for a purpose other than that described in subclause (b). No royalty shall be payable to the Lessor with respect to any substance injected into and recovered from the said lands other than leased substances originally produced from the said lands for which a royalty has not been paid or payable.
- (b) Notwithstanding anything to the contrary herein contained or implied, the Lessee shall be entitled to use such part of the production of leased substances from the said lands as reasonably may be required and used by the Lessee in its operations hereunder on the said lands, the pooled lands or the unitized lands and the Lessor shall not be entitled to any royalty with respect to leased substances so used.
- (c) The Lessor agrees that the royalty reserved and payable hereunder in respect of the leased substances shall be inclusive of any prior disposition of any royalty or other interest in the leased substances, and agrees to make all payments required by any such disposition out of the royalty received hereunder and to indemnify and save the Lessee harmless from its failure to do so, provided, however, that the Lessee may elect by notice in writing to the Lessor to make such payments on behalf of the Lessor and shall have the right to deduct any such payments made from the royalty, rental and suspended well payments otherwise payable to the Lessor,
- (d) The Lessee shall make available to the Lessor during normal business hours at the Lessee's address for notice, the Lessee's records relating to the leased substances produced from or allocated to the

said lands.

CAPL 1999

4. Royalty

- (a) Subject-to Subclause (c) of this Clause, the Lessee shall pay to the Lessor a royalty (the "Royalty") in an amount equal to the current market value at the wellhead of% of the Leased Substances sold from the Lands, or used by the Lessee for a purpose other than that described in Subclause (d) of this Clause. In computing the current market value at the wellhead, the Lessee may deduct any reasonable expense incurred by the Lessee (including a reasonable rate of return on investment) for water disposal and for separating, treating, processing, compressing and transporting Leased Substances beyond the wellhead, provided that 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.
- (b) The Royalty shall be payable on or before the 15th day of the second month following the month in which the Leased Substances were sold or used by the Lessee for a purpose other than that described in Subclause (d) of this Clause.
- (c) If the Lessor's undivided interest in the Leased Substances is less than the entire and undivided fee simple estate, the Royalty shall be paid to the Lessor only in the proportion which such interest bears to the entire and undivided fee simple estate.
- (d) Notwithstanding anything to the contrary herein contained or implied, the Lessee shall be entitled to use a portion of the production of Leased Substances from the Lands as reasonably may be required by the Lessee in its Operations and the Lessor shall not be entitled to any Royalty with respect to Leased Substances so used.
- (e) If the Lessee sells the Leased Substances pursuant to a bona fide arm's-length sale or transaction, the current market value at the wellhead of such Leased Substances shall be deemed to be the value actually received by the Lessee less all expenses permitted to be deducted hereunder. If the Lessee does not sell the Leased Substances pursuant to a bona fide arm's-length sale or transaction, the current market value at the wellhead of such Leased Substances shall be deemed to be the average market price for Leased Substances as and when produced from the area in which the Lands are located less all expenses permitted to be deducted hereunder.
- (f) The Lessor agrees that the Royalty shall be inclusive of any prior disposition of any other royalty or other interest in the Leased Substances, and further agrees to make all payments required by any such prior disposition out of the Royalty and to indemnify and save the Lessee harmless from its failure to do so; provided, however, that the Lessee may elect by notice in writing to the Lessor to make such payments on behalf of the Lessor and shall have the right to deduct any such payments made from the Shut-in Well Payment or Royalty otherwise payable to the Lessor.
- (g) The Lessee shall make available to the Lessor or its authorized representative during normal business hours at the Lessee's address for notice or principal place of business, the Lessee's production and financial records relating to the Leased Substances produced from or allocated to the Lands.