Desoto Resources Limited

Section 40 Review of Well Licence No. 0365128
Joffre Field

June 17, 2008

Alberta Energy and Utilities Board

ALBERTA ENERGY AND UTILITIES BOARD
Decision 2008-047: Desoto Resources Limited, Section 40 Review of Well Licence No. 0365128, Joffre Field

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Calgary Alberta

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1 DECISION

Having carefully considered all of the evidence and based on the reasons set out below, the Alberta Energy and Utilities Board (EUB/Board) has decided to suspend Well Licence No. 0365128 issued to Desoto Resources Limited (Desoto) and to order the well suspended, with Desoto providing care and custody of the well. The Board will issue an Abandonment Order in due course, according to the Board's usual policy and procedures.

Introduction

1.1 Background

On October 27, 2006, the Board approved routine Application No. 1484517 and issued Well Licence No. 0365128 to Desoto, in accordance with Section 2.020 of the *Oil and Gas Conservation Regulations*, for a single vertical gas well from a surface location at Legal Subdivision (LSD) 11 of Section 13, Township 38, Range 25, West of the 4th Meridian. The purpose of the well was to obtain gas from the Basal Belly River Sands.

On November 2, 2006, the EUB received a letter from EnCana Corporation (EnCana) requesting a review of Well Licence No. 0365128 under Section 40 of the *Energy Resources Conservation Act.* EnCana, as the mineral owner, requested the review on the basis that Desoto was not entitled to the well licence because it did not hold a current and valid lease with EnCana. The Board heard oral argument from both parties and by a decision letter issued May 17, 2007, the Board granted the request for a review hearing and registered the hearing as Proceeding No. 1513307.[1]

The purpose of the hearing, as stated in the Board's May 17, 2007, decision letter, "is to determine whether Desoto has a valid and subsisting lease for the purpose of the issuance of well licence 0365128."

On February 12, 2007, Desoto had written to the Board stating: "We herein confirm that we will not commence drilling of this well until this matter is resolved." In May 2007, the Board denied a request by EnCana for formal suspension of the licence pending the hearing, as EnCana had failed to show irreparable harm. In July 2007, Desoto drilled a well under Licence No. 0365128.

On November 13, 2007, the Board issued a Notice of Hearing commencing a written hearing process to consider this question. Written submissions were filed by both parties on October 12, 2007, followed by written information requests and responses, final argument, and reply

[1] A three-member panel of the Board heard oral argument and made the decision that there should be a review on the merits. A different Board panel conducted the written review hearing and prepared this decision report.

argument.[2] After considering whether it had any questions of clarification for the parties, the Board indicated by letter dated March 25, 2008, that the proceeding was closed.

Although on January 1, 2008, the *Alberta Energy and Utilities Board Act* was repealed, subsection 80(3) of the *Alberta Utilities Commission Act* provided that if a notice of hearing was issued prior to January 1, 2008, the EUB Board would complete the proceeding. In this case, the Notice of Hearing was issued on September 21, 2007; therefore, this hearing was continued as an EUB hearing.

2 ISSUES

Both parties raised the issue of the Board's jurisdiction to determine the validity of the lease, particularly as there was an action before the Court of Queen's Bench considering the same matter**.**

The Board considers the issues respecting the applications to be

- jurisdiction of the Board,
- validity of the mineral lease, and
- relief.

In reaching the determinations in this decision, the Board has considered all relevant materials constituting the record of this proceeding, including the evidence and argument provided by each party. Accordingly, references in this decision to specific parts of the record are intended to assist the reader in understanding the Board's reasoning relating to a particular matter and should not be taken as an indication that the Board did not consider all relevant portions of the record with respect to that matter.

3 JURISDICTION

3.1 Views of Desoto

Desoto submitted that if there were a question as to the jurisdiction of the EUB in this matter, the EUB should defer to the Court of Queen's Bench of Alberta for the purpose of determining Desoto's entitlement to produce under the subject leases.

Desoto also submitted that only the Court of Queen's Bench had the jurisdiction to determine if Desoto's interest in the leases had been properly terminated by EnCana, pursuant to the notices of termination, because such determination involved the interpretation of the leases and a determination of a question of law.

Desoto submitted that its interest in the leases would continue until such time as the Court of Queen's Bench determined that Desoto no longer had an interest in the leases.

[2] The Board notes the procedure in order to clarify that both parties had ample opportunity to submit evidence and to provide argument to support their positions.

3.2 Views of EnCana

EnCana submitted that when entitlement to a licence was contested and the Board was presented with evidence calling into question the validity of rights relied on by Desoto, the Board must cancel or suspend the licence in accordance with Section 16 of the *Oil and Gas Conservation Act (OGCA)*.

EnCana maintained that the EUB lacked jurisdiction to make any determination as to ownership under the leases and that the Board lacked the express or implied jurisdiction to decide complex questions of law under its governing legislation.

EnCana argued, however, that a determination of ownership under the leases was not needed in this case, because Desoto had failed to provide sufficient evidence to prove its claim of entitlement to the licence. It stated that it was Desoto's task to prove entitlement to the satisfaction of the Board and the Board's task to consider whether Desoto had met its onus on the evidentiary record.

3.3 Views of the Board

It is clear to the Board that it has the jurisdiction and in this case must exercise it to determine whether Desoto has entitlement to produce from this well and, if not, what should be done with the well. The well has already been drilled and Desoto appears eager to produce it.[3] EnCana has asked the Board to cancel the licence and suspend operations pending judicial determination of entitlement.[4]

The Board finds that it has jurisdiction to determine whether an applicant under Section 16 of the *OGCA* "is entitled to the right to produce oil, gas or crude bitumen from the well…" for the purpose of granting a licence, notwithstanding that there is a *bona fide* ownership, proprietary, or other legal dispute over an applicant's entitlement.[5]

Section 16 of the *OGCA* reads:

> **Entitlement for well licence**
>
> **16(1)** No person shall apply for or hold a licence for a well
>
> (a) for the recovery of oil, gas or crude bitumen, or
>
> (b) for any other authorized purpose
>
> unless that person is a working interest participant and is entitled to the right to produce the oil, gas or crude bitumen from the well or to the right to drill or operate the well for the other authorized purpose, as the case may be.
>
> **(2)** If, after 30 days from the mailing of a notice by the Board to a licensee at the licensee's last known address, the licensee fails to prove entitlement under subsection (1) to the satisfaction of the

[3] During the course of the written proceeding, Desoto applied for a pipeline licence to tie in this well, but then withdrew it, as it had applied routinely, without notifying the Board of EnCana's objection to the pipeline licence.

[4] Desoto is seeking a declaration from the Court of Queen's Bench as to the validity of Desoto's interests under leases including the Section 13 leases (Action No. 0401-09040, Judicial District of Calgary).

[5] This finding is consistent with that of the Board in EUB *Decision 2007-024: Bearspaw Petroleum Ltd.*, et al., at page 10.

Board, the Board may cancel the licence or suspend the licence on any terms and conditions that it may specify.

(3) Where a licence is cancelled or suspended pursuant to subsection (2),

(a) all rights conveyed by the licence are similarly cancelled or suspended, and

(b) notwithstanding the cancellation or suspension of the licence, the liability of the licensee to complete or abandon the well and reclaim the well site or suspend operations as the Board directs continues after the cancellation or suspension.

RSA 1980 cO-5 s13;2000 c12 s1(8)

Section 16(2) of the *OGCA* clearly contemplates that the Board may find that entitlement does not exist and may take action to suspend or cancel a licence (and order abandonment) accordingly. Even if a Board decision on mineral entitlement under Section 16 of the *OGCA* might not constitute a final and binding determination between parties for all purposes, the Board finds that it must take mineral entitlement into account when deciding on whether a licensee meets the requirements of Section 16 for the purpose of holding a well licence.[6]

Notwithstanding that Desoto is seeking a declaration at the Court of Queen's Bench regarding its interests under the leases, the matter of review of this well licence is properly before the Board. The Board finds that it has specific jurisdiction to determine whether a licensee meets the requirements under Section 16(1) of the *OGCA* for holding a licence, and upon failure to satisfy the Board in that regard, whether the licence should be suspended or cancelled and what should be done with the well. The Board has its own mandate regarding fair and efficient development and public and environmental safety, separate and apart from the Court's jurisdiction over civil disputes.

The standard of proof under Section 16(1), as discussed in *Decision 2007-024*, is satisfaction of the Board. Certainty is not required.[7]

4 VALIDITY OF THE MINERAL LEASE

4.1 Views of Desoto

Desoto submitted that

- by Lease No. P.L. CP-FO-1292-23010, dated June 6, 1975, PanCanadian Petroleum Limited (PanCanadian) leased 50 per cent of its interest to Republic Resources Limited (Republic) in the northwest (NW) quarter of Section 13-38-25-W4M for a primary term of 5 years;
- by Lease No. AB46-900138, dated June 6, 1975, PanCanadian leased 50 per cent of its interest to Beau Canada Exploration Ltd. (Beau Canada) in the NW quarter of Section 13-38-25-W4M for a primary term of 5 years;

[6] The Board relies on and adopts its analysis of jurisdiction under Sections 16 and 94 of the *OGCA* in *Decision 2007-024*, *supra*, at pages 10-15.

[7] Again, the Board relies on and adopts its analysis of the standard of proof required under Section 16 of the *OGCA* in *Decision 2007-024*, *supra*, at page 21, Section 6.3.

- by Lease No. P.L. CP-FO-1292-23009, dated June 6, 1975, PanCanadian leased 50 per cent of its interest to Republic in the northeast (NE) quarter of Section 13-38-25-W4M for a primary term of 5 years;
- by Lease No. AB46-900137, dated June 6, 1975, PanCanadian leased 50 per cent of its interest to Beau Canada in the NE quarter of Section 13-38-25-W4M for a primary term of 5 years;
- by Lease No. P.L. CP-FO-1292-23011, dated June 6, 1975, PanCanadian leased 50 per cent of its interest to Republic in the southeast (SE) quarter of Section 13-38-25-W4M for a primary term of 5 years;
- by Lease No. AB46-900136, dated June 6, 1975, PanCanadian leased 50 per cent of its interest to Beau Canada in the SE quarter of Section 13-38-25-W4M for a primary term of 5 years; and
- by Lease No. P.L. 15492, dated December 19, 1974, PanCanadian leased its interest to Republic in the SW quarter of Section 13-38-25-W4M for a primary term of 3 years.

Desoto explained that EnCana was successor in title to PanCanadian and that by virtue of various assignments and other agreements, Desoto acquired beneficial interests under the leases to Section 13. As a result of bankruptcy proceedings, Jofco Resources Inc. (predecessor to Desoto) agreed to sell its interest in the Viking zone in Section 13 to Numac Energy Ltd. (Numac) and assigned its interest in Section 13 to the base of the Viking Zone to Numac on November 29, 1999. On the same day, Numac signed a unilateral declaration of trust confirming that Jofco retained its interest in the leases and lands above the top of the Viking zone. On March 9, 2000, Numac assigned 50 per cent of its interest in the leases it held in trust to Cansearch Resources Ltd. (Cansearch). Numac and Cansearch then signed a trust agreement confirming Jofco as beneficial owner of 100 per cent interest in all petroleum and natural gas rights in Section 13 down to and excluding the top of the Viking zone and below the Viking zone to the basement.

On January 29, 2002, Penn West Petroleum Inc. (Penn West), successor in interest to Numac, and Cansearch entered into a trust agreement with Desoto (Jofco having now changed its name to Desoto), confirming that they were equally holding legal title to Desoto's beneficial interest in the leases and lands as trustees. The leases were amended as a result of the Joffre Viking Sand Unit No. 3 Unit Agreement. Caveats were registered against the lands by both Penn West (or its predecessor) and Desoto. In April 2002, Penn West confirmed that the leases were in good standing. In March 2003, EnCana confirmed Desoto's intention to drill a well on the Section 13 lands. Then on or about July 16, 2003, EnCana served a notice of lease termination upon Penn West and Cansearch, purporting to terminate the leases, stating that "As the Schedule 'A' lands are not capable of producing in paying quantities, the Petroleum and Natural Gas Leases have terminated by their own terms, effective as of the date of the receipt hereof."

By letter dated September 24, 2003, addressed to Desoto's counsel, Penn West confirmed that Penn West and Cansearch shared the opinion of EnCana that the leases "had terminated by their own terms." EnCana entered into new petroleum leases with Penn West and Cansearch with respect to the Section 13 lands, effective May 22, 2007.

Desoto stated that these leases granted it the right to drill for petroleum, natural gas, and related hydrocarbons so long as there was production or a well capable of production in paying quantities from the said lands. Desoto claimed that there were a number of wells drilled by previous lessees on the Section 5 lands, Section 7 lands, and Section 13 lands, some of which were producing oil or natural gas, and Desoto acquired the interests through its predecessor Jofco.

Desoto stated that wells on the lands were capable of production and, therefore, extended the lease. Desoto explained that these wells had been shut in as a result of an EUB order in June 1998, abandonment notices had been issued in September 1998, and by the end of 1998 none of the wells drilled on the Section 13 lands were in production as the result of an order by the EUB relating to the payment of a well abandonment deposit. Subsequent to the sale of assets by Jofco to Numac, the EUB rescinded all abandonment notices against Jofco.

Desoto argued that the wells in Section 13 were capable of production, based on previous production from Section 13 lands and evidence of production from surrounding lands, namely in Section 18-38-24-W4M. Desoto stated that the Belly River Report prepared by John Harder and Keith Banks in 1998 confirmed the existence of gas with probable reserves in excess of 900 million cubic feet (MMcf) in Section 13 and adjoining lands. Desoto submitted that the oil well in LSD 10-13-38-25W4M was listed as "suspended," confirming that the lands were capable of production. Desoto submitted that 10-13 well was still capable of production, based on six bottomhole pressure surveys. Additionally, testing information obtained by Desoto regarding the LSD 11-13-38-25W4M well was used by Chapman Petroleum Engineering Ltd. to determine that the original gas in place was 1.4 billion cubic feet, of which about 720 MMcf would be recoverable. Accordingly, Desoto argued, there was no question that the lands were capable of producing in paying quantities, as anticipated by the leases.

Desoto submitted that on various occasions EnCana had confirmed the validity of the leases. During the bankruptcy and sale proceedings, Jofco asked PanCanadian to confirm the validity of the leases by signing the assignment agreement, which PanCanadian did on November 29, 1999. Desoto argued that EnCana, as lessor of the Section 13 lands, would have been fully aware that the unit wells ceased production in 1998. Desoto explained that in March 2003, EnCana confirmed Desoto's intention to drill a well on Section 13 and did not purport to terminate the leases until July 2003. Desoto claimed that nothing had transpired between EnCana's affirmation of validity in June 2002 and the notice of termination in July 2003. Desoto suggested that EnCana may be estopped[8] from denying the validity of the leases.

In response to EnCana's argument that Desoto's trustees Penn West and Cansearch surrendered Desoto's interest under the leases, Desoto argued that its interests could not be extinguished arbitrarily by either EnCana's actions to terminate the lease or by the acquiescence of Desoto's trustees to such purported termination.

Desoto submitted that the EUB should not draw any adverse inferences from Desoto's position or give any weight to Penn West's and Cansearch's acquiescence to EnCana's position regarding the validity of the leases. Desoto stated that Penn West and Cansearch had not discharged their

[8] Estoppel: A legal doctrine by which a person is prevented from asserting rights or facts that are inconsistent with a previous position or representation he had made by his act, conduct, or silence.

caveats as a result of the obligations under the trust agreement and had not surrendered their interest in the leases. Alternatively, Desoto claimed that only a Court could determine Desoto's legal status under the trust agreement and that it had initiated steps in the Alberta Court of Queen's Bench to add Penn West and Cansearch as defendants to its action against EnCana.

4.2 Views of EnCana

EnCana claimed that Desoto bore the onus to prove entitlement to the licence in question.

EnCana explained that its predecessor, PanCanadian, granted the Section 13 leases, which were included in the Joffre Viking Sand Unit No. 3. EnCana stated that production from this unit ceased in 1998, at which time Jofco was lessee of the lands. EnCana submitted that the bankruptcy of Jofco resulted in the sale and assignment of the leases to Numac and thereafter to Penn West and Cansearch. EnCana explained that upon these assignments, Numac, Penn West, and Cansearch entered into a trust agreement whereby they purported to hold interests to Section 13 for Desoto. EnCana stated that Desoto had never held leases with EnCana and its beneficial interest was pursuant to a bare trust, with no evidence of agreement with the trustees that Desoto was a working interest owner with an entitlement to drill on the subject lands. EnCana argued that there was no evidence of EnCana's agreement or consent to Desoto's retention of rights under the leases or of any transfer back of lease interests to Desoto. EnCana also questioned whether the interests were in fact retained by or transferred to Desoto after the Jofco bankruptcy.

EnCana claimed that Desoto did not have a valid petroleum and natural gas lease, as the leases under which Desoto claimed a beneficial interest had terminated. EnCana stated that the leases continued for the primary term and so long thereafter as production obtained within the primary term continued or the lessee diligently pursued production immediately upon the expiry of the primary term.

EnCana argued that any evidence of capability of production from other sections around Section 13 had no bearing on the existence and continuation of leases for Section 13. EnCana stated that in the context of a private lease, capability required that a well drilled within the primary term was capable of immediately producing oil and gas upon being turned "on," without the need for additional equipment, utilities, or infrastructure. A well would not be considered capable if pumping, tie-in, or additional infrastructure were required or if the well had been drilled following expiry of the primary term.[9]

EnCana argued that automatic termination for want of production was supported by recognized policy considerations, such as extracting the resource as quickly as possible, decreasing the possibility of minerals being captured by other wells, and the market encouraging production when it was economical and profitable.[10] EnCana referred to a lessee's obligation to pursue production with "reasonable diligence and dispatch" in accordance with good oilfield practices.[11]

[9] Citing Williams and Meyers, *Manual of Oil and Gas Terms*, 12th ed., Martin-Kramer.
[10] Citing *Freyberg v. Fletcher Challenge Oil & Gas Inc.*, 2005 ABCA 46, leave to appeal to SCC refused [2005] SCCA No. 167 (SCC).
[11] Citing *Canadian Superior Oil Limited c. Cull*, [1972] SCR (SCC); quoted in *Canadian Superior Oil Ltd. et al. v.* Crozet *Exploration Ltd.*, [1982] AJ No. 672 (Alta QB) at paras. 28 and 33.

EnCana stated that the evidence showed that the wells drilled within the primary term of the leases for Section 13 ceased producing in 1998. It stated that the primary term expired when the leases stopped producing. No steps were taken to drill a new well in Section 13 following cessation of production in 1998 or to pursue production until Desoto drilled its new well in 2007. EnCana claimed that after production stopped, the lessees, Numac and/or Penn West and Cansearch, took no or inadequate steps to pursue production thereafter. EnCana submitted that at or about January 2003, Desoto applied for and obtained a well licence for Section 13 without notice to EnCana, but no well was drilled pursuant to this licence and it expired.

EnCana stated that it had served a notice of termination on the lessees Penn West and Cansearch on July 16, 2003, and the lessees communicated their acceptance of EnCana's position to Desoto on September 24, 2003. EnCana stated that the notice of termination it issued was a mere formality to confirm its discussion and agreement with its lessees that a lack of production resulted in automatic termination of the leases. It stated that it determined in 2003 that production had ceased and that there were no wells capable of production in Section 13, so the leases had terminated by their own terms.

EnCana claimed that Penn West and Cansearch, as trustees, had surrendered their interest in the leases and Desoto, as a mere trust beneficiary, had no right upon which to base a claim to mineral rights owned by EnCana. EnCana submitted that whether or not Desoto's trustees acted inconsistent with the terms of the trust or in breach of its obligations was a matter between Desoto and its trustees.

EnCana also raised concerns about Desoto's conduct in twice applying for well licences routinely when it was aware of EnCana's dispute over its entitlement to produce.

4.3 Views of the Board

In order for Desoto to be entitled to drill a well at LSD 11-13-38-25W4M, the interests of Beau Canada and Republic under leases regarding the NW quarter of Section 13 must have been acquired by Desoto and these leases must still be valid.

Although EnCana questioned whether the interests at issue were in fact retained by or transferred to Desoto after the Jofco bankruptcy, the Board does not find it necessary to rule on this issue, given the conclusions set out below that the Board reaches regarding the validity of the leases.

The primary term for the NW quarter leases was a period of 5 years starting June 6, 1975. These leases contain provisions that may extend the term of the lease past the primary term. The habendum clause[12] states:

> The Lessor, for the initial consideration paid to the Lessor by the Lessee…DOES HEREBY GRANT AND LEASE…the leased substances…for the primary term and so long thereafter as any of the leased substances is being produced or is capable of production in paying quantities from a well or wells on the said lands at the end of the primary term, but subject to sooner termination as provided in this Lease; provided that if at the expiration of the primary term each well drilled on the said lands by the Lessee is abandoned and the Lessee is then drilling a further well on the said lands for the leased substances, this Lease shall remain in

[12] The habendum clause of an oil and gas lease sets forth the conditions under which the lease continues in force.

> force so long as such drilling is diligently and continuously prosecuted and so long thereafter as any of the leased substances is being produced or is capable of production in paying quantities from the said lands from the well so drilled.

All the Section 13 leases contain the following definitions:

> "leased substances" means petroleum, natural gas and related hydrocarbons except coal.
>
> "production in paying quantities" means the output from a well of such quantity of the leased substances or any of them as can be taken profitably having regard only to the costs of producing such substances and not to the costs of the drilling of such well.

The NW quarter leases contain the following definition:

> "said lands" means the North-west Quarter (NW 1/4) of Section Thirteen (13), Township Thirty-eight (38), Range Twenty-five (25), West of the Fourth (4th) Meridian, containing One Hundred and Sixty (160) acres, more or less.

The habendum clause can be split into two parts. The first part deals with whether the well is producing or capable of production in paying quantities, and the second part deals with whether drilling of a new well has been diligently and continuously prosecuted.

Looking at the first part of the habendum clause, in order for the leases to have been extended past the primary term, there must be a well on the said lands (the NW quarter of Section 13-38-25W4M) that is either producing or capable of production in paying quantities, as so defined, at the end of the primary term.

The current matter before the Board involves the review of a gas well approved in LSD 11-13-38-25W4M (NW quarter). The only preexisting well in the NW quarter of Section 13 was an oil well (Viking zone) at LSD 13-13-38-25W4M licensed to Penn West.[13]

Unless extended under the terms of the lease, the primary term would have ended on June 6, 1980, and from the evidence submitted, production from the unit (which included the said lands) ceased in 1998. Although no production occurred past 1998, Desoto argued that the said lands were still capable of production. Desoto based this argument on

1) the existence of a suspended oil well (Viking zone) in the NE quarter of Section 13 at LSD 10-13-38-25W4M;
2) a Belly River report that concluded there was gas in the NW quarter;
3) testing of the newly drilled 11-13 gas well at issue; and
4) the fact that other lands around the section had producing or suspended wells.

However, under the terms of the leases at issue, the leased substances must be capable of production "in paying quantities" at the end of the primary term in order to extend the leases, not just be "capable of production." "Production in paying quantities" is defined in all of the Section 13 leases as "the output from a well of such quantity of the leased

[13] EnCana submitted a printout entitled "Production for Period Ending 2003/01/31, Well Detail for JOFFRE VIKING SAND UNIT No #3," showing the well status for the 13-13 well as "abandoned oil zone" and last production at January 31, 1985.

substances or any of them as can be taken profitably having regard only to the costs of producing such substances and not to the costs of the drilling of such well."

Notwithstanding the evidence submitted by Desoto of past productive capability of existing wells in Section 13 and potential productive capability of the new 11-13 well, no evidence was submitted regarding the production costs of the wells relative to actual or expected output.[14] Also, no authority was provided to suggest that the interpretation of the first part of the habendum clause is other than that suggested by EnCana.

Canadian and American courts have considered the phrase "capable of production in paying quantities." In *Stevenson v. Westgate*, the Ontario Supreme Court found that the test for "paying quantities" was in reference to the costs of operation, not simply the capital costs.[15] In *Northwestern Utilities v. Peyto Oils Ltd.*, the Alberta Court of Queen's Bench found that "paying quantities" must be defined by looking at the context in which it is used with a view to ascertaining the intention of the parties, which the Court held meant sufficient quantities to yield a return in excess of drilling, development, and operating costs.[16]

In the absence of further Canadian case law on point, it is useful to look to American jurisprudence. In *Hydrocarbon Management Inc. v. Tracker Exploration Inc.*, the Court of Appeals of Texas, Seventh District, determined that the phrase "capable of production in paying quantities" means a well that will produce in paying quantities if the well is turned "on" and it begins flowing without additional equipment or repair.[17] In *Anadarko Petroleum Corp. v. Thompson*, the Supreme Court of Texas held that the completion of a gas well capable of producing in paying quantities but shut in due to a lack of pipeline facilities did not constitute a well "capable of producing in paying quantities."[18]

Desoto's evidence and argument suggest that all that is required to extend the leases under the first part of the habendum clause is to show a capability of production in the sense of actual past production on the lands and/or future potential production based on geological reserve information (or test information). The ordinary meaning of the wording of the leases and Canadian and American judicial interpretation of the same phrase in oil and gas leases indicate otherwise.

The evidence shows that production from the Viking unit agreement, which included the "said lands" (the NW quarter), ceased in 1998. It also notes EnCana's evidence, not disputed by Desoto, that the 13-13 oil well (the only well in the NW quarter prior to the drilling of the 11-13 well at issue) last produced in 1985. Although no evidence was submitted regarding the costs of producing the 13-13 well relative to expected output, even if it had, the evidence shows that the productive zone in the 13-13 well (Viking) was abandoned by 2003, if not before.[19] Even if it could be argued that the 13-13 well's

[14] The Board notes that although both parties discussed production from other wells in Section 13 (the unit wells), Desoto did not argue that the leases were extended past the primary term by virtue of pooling.
[15] *Stevenson v. Westgate*, [1941] 2 D.L.R. 471 (Ont. S.C.).
[16] *Northwestern Utilities v. Peyto Oils Ltd.* (1983), 49 A.R. 1 (Alta QB).
[17] *Hydrocarbon Management, Inc. v. Tracker Exploration, Inc.*, 861 S.W. 2d 427 (Tex. Ct. App. 1993).
[18] *Anadarko Petroleum Corp. v. Thompson*, 94 S.W. 3d 550 (Tex. Sup. Ct. 2003).
[19] The Board also notes that the 13-13 oil well was for the Viking zone, for which Desoto had no rights after November 1999. The evidence shows that the lessees (Penn West and Cansearch), which retained rights to the

production capability may have extended the leases past the end of the primary term, once the productive zone was abandoned, the well could no longer be said to be "capable of production" as that phrase has been judicially considered, in the sense of just turning it "on" without additional operations. Likewise, even if the primary term had somehow been extended up to the time that the new 11-13 gas well had been drilled, evidence of that well's potential output based on reserve analysis and testing information would still appear to fall short of meeting the test of "capable of production," given the Court's views in *Anadarko Petroleum Corp. v. Thompson*, above, as the well has no tie-in to a pipeline.

Having reviewed all of the evidence before it, the Board finds that there is insufficient evidence to support the conclusion that the leased substances in the NW quarter of Section 13-38-25W4M were capable of production in paying quantities at end of the primary term, for the purpose of extending the leases. The Board therefore cannot find that the leases under which Desoto claims its mineral interest in the NW quarter of Section 13-38-25W4M were extended under the first part of the habendum clause.

The second part of the habendum clause reads:

> provided that if at the expiration of the primary term each well drilled on the said lands by the Lessee is abandoned and the Lessee is then drilling a further well on the said lands for the leased substances, this Lease shall remain in force so long as such drilling is diligently and continuously prosecuted and so long thereafter as any of the leased substances is being produced or is capable of production in paying quantities from the said lands from the well so drilled.

Abandonment of existing wells on the said lands at the end of the primary term appears to be a prerequisite to application of the extension provisions of the second part of the habendum clause. The term "abandon" is not defined in the lease, although the clause clearly refers to abandonment of wells and drilling of further wells, as opposed to abandonment of zones within existing wells.[20] The ordinary meaning of this clause suggests to the Board that the abandonment of the Viking zone in the 13-13 well, sometime between 1985 and 2003, is not sufficient to trigger the application of the rest of the provisions in Part 2 of the habendum clause.[21] In case the Board is wrong in that interpretation, it now addresses the possibility of the extension of the leases through drilling a subsequent well.[22]

The parties disagree on the exact date the primary term ended. The parties agree that production ceased from the unit, which included the said lands, in 1998. EnCana argued

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Viking zone while acting as trustees for Desoto for the remaining rights under the leases, had considered the leases to have terminated by their own terms by September 2003. In fact, they entered into new petroleum leases with EnCana for the Section 13 lands effective May 2007.

[20] The Board distinguishes between abandonment of a zone in a well (being the cementing off of a zone in a wellbore to permanently prevent production) from abandonment of the well itself (including the permanent cutting and capping off of a well at surface, following cementing of the wellbore).

[21] The evidence from the parties is silent on the issue of whether or when there was complete abandonment of the 13-13 well, the only existing well on the "said lands." EnCana's production data, referred to in footnote 13, provides a well status of "abandoned oil zone" but no date of such abandonment.

[22] Desoto did not specifically argue this point, but EnCana submitted argument as to the failure of the lessees to diligently prosecute production immediately upon the expiry of the primary term.

that the primary term ended when production stopped from the unit in 1998. Desoto's submissions indicate that at least by 2004, the primary term had expired.[23]

The Board finds that Desoto submitted insufficient evidence that would reasonably fall within the ordinary meaning of "diligent and continuous" prosecution of drilling a new well on the said lands after the expiry of the primary term. There is no evidence of any attempt to pursue drilling a new well on the NW quarter prior to 2003. In 2003, Desoto applied for a well licence for Section 13 but the licence expired and no well was drilled. Desoto stated that it had applied then because EnCana contested its right to drill a well on the lands and it wanted to avoid a dispute with EnCana regarding the leases.[24] Desoto obtained the licence for the 11-13 well at issue in 2006 and then commenced drilling in 2007. Desoto did not offer further evidence regarding its actions in contemplation of drilling during the period between 2004 and 2007. Desoto also provided no authority to contest EnCana's arguments regarding the interpretation of this part of the habendum clause.[25]

The Board finds that there is insufficient evidence to support the conclusion that the lessees (or Desoto) diligently and continuously prosecuted drilling of another well so as to extend the leases, based on the ordinary meaning of that phrase. Years passed between the cessation of production from the 13-13 oil well and the drilling of the 11-13 gas well at issue.

In terms of the evidence, there seems to be uncertainly as to when *exactly* the leases terminated, given EnCana's actions. EnCana states that the primary term of the leases expired when the unit wells ceased producing in 1998. Desoto acknowledges that the primary term had expired by 2004, at the latest. However, exactly when the lease terminated does not appear to be material to the Board's decision, as the facts indicate that it appears to have terminated before Desoto applied for the licence, meaning that Desoto would not have had the right to produce the minerals as required by Section 16 of the *OGCA*. Therefore, the Board does not find it necessary to consider the estoppel argument raised by Desoto (i.e., whether the lease continued beyond 1998 by virtue of EnCana's actions).

Given the Board's findings, the Board also does not find it necessary to examine the trust relationship or adjudicate on the arguments related to the trust agreement. The Board finds that the terms of the leases are clear as to continuation and termination. The Board finds it sufficient that the leases appear on the evidence to have terminated prior to Desoto's application for the 11-13 gas well licence due to expiration of the primary term and failure by the lessees to continue the leases under the terms of the habendum clause. Similarly, the Board does not find it necessary to adjudicate on the surrender argument raised by EnCana.

[23] Desoto states on page 12 of its January 30, 2008, submission: "Notwithstanding expiry of the primary term of the Leases, EnCana did not terminate or purport to terminate the leases until EnCana delivered the Notices to Terminate to Penn West and Can Search (sic) in 2004." Desoto Final Submission, p.12, G-1(a).

[24] Examination for Discovery of Donald Phillip Benson, November 14, 2007, Desoto Resources Limited and EnCana Corporation and Pan Canadian Petroleum Limited, Action No. 0401-09040, p. 26, 12-19.

[25] EnCana referred to a lessee's obligation to prosecute production with reasonable diligence and dispatch in accordance with good oilfield practices.

5 RELIEF

5.1 Views of Desoto

Desoto submitted that the well licence should be neither suspended nor cancelled by the EUB and that the EUB should not suspend the 11-13 well, pending judicial determination of the matter.

5.2 Views of EnCana

EnCana argued that the lack of evidence to support Desoto's claim of entitlement means that the Board must cancel the licence under Section 16 of the *OGCA*. EnCana then submitted that the well be suspended, pending judicial determination of Desoto's interest under the leases.

EnCana submitted that continuation of the well licence would undermine the integrity of the Board's process by enabling parties to seek licences first and only thereafter to procure or establish entitlement by forcing landowners to negotiate in the shadow of an existing well.

5.3 Views of the Board

While the Board is aware that the issue of lease validity is currently before the Court of Queen's Bench, it is of the view that it would not be appropriate for it to defer addressing this situation while awaiting a court determination of that matter.[26] Desoto made application to the EUB for a routine well licence for Section 13 on two occasions when it appears to have been aware of EnCana's views regarding its entitlement (or lack thereof) to the lands at issue. When granted the second licence, Desoto proceeded to drill the well in the face of the dispute, notwithstanding the pending hearing and its earlier commitment made not to drill the well until the matter was resolved. Having found that Desoto has failed to satisfy the Board that it has sufficient entitlement for the purpose of holding the well licence, the Board finds that it must suspend well operations and suspend the well licence. The Board finds that it cannot wait for judicial determination to address this issue.

When the Board finds that a licensee has failed to establish to its satisfaction the right to produce the minerals underlying a well, its usual practice is to suspend or cancel the licence and order the well closed and then abandoned. For administrative purposes, the Board usually cancels the licence if no well has been drilled, but suspends the licence if a well has been drilled, in order to preserve in its record system the particulars of the well and its licensee. This is important, as continuing liability attaches to licensees for matters related to a well, even after the licence is suspended or cancelled and even after a well is abandoned.[27]

[26] The Board commonly directs parties to the Courts for resolution when it is made aware of a dispute over entitlement. If the Court decision materially affects that status of the petroleum and natural gas rights, the Board follows its process under Section 16 and suspends the licence and the well. In this case, EnCana applied to the Board for review and variance of the well licence decision.

[27] See Section 16(3)(b) of the *OGCA*, quoted earlier in this decision. Also, Section 29 of the *OGCA* states: "Abandonment of a well or facility does not relieve the licensee, approval holder or working interest participant from responsibility for the control or further abandonment of the well or facility or from the responsibility for the costs of doing that work."

Accordingly, the Board finds it appropriate to suspend the licence, indicating that no rights under the licence exist, but rather only obligations in terms of care and custody, suspension, and abandonment. The Board also finds it appropriate to suspend operations at the well by way of a Closure Order, which will follow shortly. Desoto is to provide care and custody of the well as licensee in terms of regulatory obligations regarding the well. An Abandonment Order will follow in due course, according to the Board's usual policy and procedures.

Dated in Calgary, Alberta, on June 17, 2008.

ALBERTA ENERGY AND UTILITIES BOARD

<original signed by>

J. D. Dilay, P.Eng.
Presiding Member

<original signed by>

D. A. Larder, Q.C.
Acting Board Member

<original signed by>

C. D. Hill
Acting Board Member

APPENDIX 1 HEARING PARTICIPANTS

Principals and Representatives
(Abbreviations used in report)

Desoto Resources Limited (Desoto)
B. E. Silver,
of Mason Silver, Barristers and Solicitors

EnCana Corporation (EnCana)
C. J. Popowich,
of Code Hunter LLP

Alberta Energy and Utilities Board staff
D. Brezina, Board Counsel
D. Burns, Student-at-Law
K. Clayton
J. Fulford