ERCB

Bearspaw Petroleum Ltd.

Application for Variation of Compulsory Pooling Order
Drumheller Field

and

Sirius Energy Inc.

Application for Variation of Compulsory Pooling Order
Drumheller Field

February 9, 2010

ENERGY RESOURCES CONSERVATION BOARD
Decision 2010-005: Bearspaw Petroleum Ltd., Application for Variation of Compulsory Pooling Order, and Sirius Energy Inc., Application for Variation of Compulsory Pooling Order, Drumheller Field

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Energy Resources Conservation Board
640 – 5 Avenue SW
Calgary, Alberta
T2P 3G4

Telephone: 403-297-8311
Fax: 403-297-7040
E-mail: infoservices@ercb.ca
Web site: www.ercb.ca

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Calgary Alberta

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APPLICATION FOR VARIATION OF
COMPULSORY POOLING ORDER **Decision 2010-005**
DRUMHELLER FIELD **Applications No. 1600660 and 1607631**

1 DECISION

Having carefully considered all of the evidence, the Energy Resources Conservation Board (ERCB/Board) hereby approves Application No. 1607631 and denies Application No. 1600660.

2 INTRODUCTION

2.1 Application No. 1600660

Bearspaw Petroleum Ltd. (Bearspaw) applied, pursuant to Section 82 of the *Oil and Gas Conservation Act* (*OGCA*), for a review and variation of compulsory pooling Order No. P293. The pooling order states that all tracts within Section 11 of Township 29, Range 19, West of the 4th Meridian (Section 11), shall be operated as a unit for gas production from the Medicine Hat Sand, the Second White Speckled Shale, the Viking Formation, and the Upper Mannville Formation through a well to be drilled in Legal Subdivision 10. After the pooling order was issued, gas was produced from the well with the unique identifier of 02/10-11-029-19W4 (10-11 well). Bearspaw's application also requested that the ERCB enforce the pooling order by requiring the operator to provide an accounting relating to the drilling, completion, and production of the 10-11 well, obtain a copy of financial statements from Sirius Energy Inc. (Sirius), and amend the pooling order to name Bearspaw as the operator of the 10-11 well.

2.2 Application No. 1607631

Sirius applied, pursuant to Section 82 of the *OGCA*, to vary the pooling order to designate Sirius as the operator of the 10-11 well.

2.3 Interventions

Bearspaw and Sirius filed interventions in opposition to each other's application.

2.4 Hearing

The Board held a public hearing of the applications in Calgary, Alberta, which commenced and concluded on November 12, 2009, before Board Member M. J. Bruni, Q.C. (Presiding Member)

and Acting Board Members R. J. Willard, P.Eng., and J. G. Gilmour, B.A., LL.B. Those who appeared at the hearing are listed in Appendix 1.

3 BACKGROUND

The pooling order was originally issued on December 5, 2005, to Kaiser Energy Ltd. (Kaiser), following approval of Application No. 1419448. Kaiser was subsequently bought by Petrofund Corp., which amalgamated into Penn West PTF Energy Ltd. on July 19, 2006. It later amalgamated to Penn West Petroleum Ltd. (Penn West) on January 8, 2007. As a result of these amalgamations, Penn West filed Application No. 1580433 on July 23, 2008, seeking an order designating it as the operator under the pooling order. This application was approved and Order No. P293A was issued on October 1, 2008.

The natural gas rights of interest in Section 11 are provided in Table 1 below.

Table 1. Natural gas rights of interest in Section 11

Tract	Lessor	Lessee
Northwest quarter	Crown	Bearspaw (100%)
Northeast quarter	Crown	Sirius (100%)
South half	Crown	Sirius (100%)

The 10-11 well was spud on May 16, 2006, and rig released on May 20, 2006. The Glauconitic Sandstone was completed on May 25, 2006, and fracture-stimulated on June 3, 2006. Subsequently, the Medicine Hat Sand and Second White Speckled Shale (Second White Specks) were completed on June 6, 2006, and fracture-stimulated on June 29, 2006. The 10-11 well commenced segregated production from the Glauconitic Sandstone and Medicine Hat Sand in August 2008 and February 2009 respectively. In March 2009, Sirius self-declared the commingling of gas in the 10-11 well for the Glauconitic Sandstone and Second White Specks. Production began from the Second White Specks in the same month.

4 ISSUES

The Board considers the issues respecting the applications to be

- which zones in Section 11 are pooled under compulsory pooling Order No. P293, and
- whether Bearspaw or Sirius should be the operator named in that order.

In reaching the determinations contained in this decision, the Board has considered all relevant information on 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.

5 CONSIDERATION OF THE APPLICATIONS

5.1 Views of Bearspaw

Bearspaw submitted that numerous breaches of the pooling order by Sirius demonstrated both a lack of competence and a willingness to contravene Board orders and the relevant legislation on Sirius's part. Bearspaw stated that it should be named operator of the pooling order.

Bearspaw submitted that Sirius's predecessor drilled and completed the Medicine Hat Sand and Second White Specks in the 10-11 well after the expiration of the six-month period specified in the pooling order and that therefore these formations were no longer pooled in Section 11. It was Bearspaw's expectation that under the original pooling order, Kaiser would have six months to drill and complete any or all of the four specified formations and at the end of the six months only those formations that had been drilled and completed would be considered pooled. Bearspaw considered that the Glauconitic Sandstone was properly pooled, as it was drilled and completed within the six-month period. Bearspaw stated that Sirius's production of gas from the Medicine Hat Sand and Second White Specks was in contravention of the pooling order, as neither of the two formations was pooled under the pooling order. Bearspaw argued that the failure to complete these two formations within the time specified in the pooling order meant that common ownership of the formations did not exist in Section 11 and thus gas production from them was contrary to the legislation. Bearspaw stated that if the ERCB were to decide that only the Glauconitic was pooled under the pooling order, Sirius should be requested to restore the 10-11 well to a single-zone completion at no cost to Bearspaw.

Bearspaw also stated that Sirius had deliberately withheld Bearspaw's share of the proceeds of production from Section 11. Bearspaw stated that the requirement to remit proceeds of production was clearly set out in the pooling order and in the *OGCA*. It further stated that there was nothing in the pooling order or in the *OGCA* that permitted a right of setoff with respect to alleged debts on other properties unrelated to the pooling order or that the operator may keep another participant's proceeds in trust. Bearspaw acknowledged that proceeds were paid by Sirius on October 2, 2009, which was the day that the parties' initial submissions were due to be filed in this proceeding. It was Bearspaw's belief that Sirius would not have made the payment in the absence of Application No. 1600660 being filed and the resulting hearing being scheduled by the Board. Bearspaw stated that Sirius's actions were an improper and bad faith manipulation of the pooling order and the ERCB's process.

Bearspaw submitted that Sirius refused to allow Bearspaw to take its share of gas production in kind and that this refusal was also a breach of the pooling order.

In regard to Sirius's self-declared commingling of production in the 10-11 well, Bearspaw stated that it was not notified of the self-declared commingling process. Bearspaw argued that under the directive for self-declared commingling, Sirius was required to resolve all outstanding equity issues prior to self-declaring commingling. Bearspaw noted that Sirius was not the operator under the pooling order and, as such, Sirius could not make a decision to commingle gas in the 10-11 wellbore. In addition, Bearspaw submitted that Sirius had improperly commingled gas from a pooled zone with gas from an unpooled zone. It was Bearspaw's position that the commingling should not be permitted.

Bearspaw stated that Sirius had wrongfully deducted amounts from Bearspaw's share of production proceeds by charging costs that it was not authorized to charge under the pooling order. Specifically, given that Bearspaw did not believe the Medicine Hat Sand and Second White Specks were pooled, Bearspaw stated that it should not be required to contribute to the completion costs of these two formations. In addition, Bearspaw stated that Sirius had applied a deduction for a royalty that was not related to Bearspaw's lands and had also improperly made deductions for overhead costs that Sirius alleged were allocated to operations on the pooled lands. Bearspaw requested that the ERCB issue an order requiring Sirius to refund to Bearspaw the amounts improperly deducted. Bearspaw submitted that there was sufficient evidence in this proceeding for the ERCB to determine whether Penn West or Sirius should reimburse Bearspaw, maintaining that it was entitled to a reimbursement in any event.

Bearspaw noted that one of Sirius's main arguments to be named operator was that Sirius was the 75 per cent working interest owner in the 10-11 well. Bearspaw suggested that the ERCB not rely on this argument because Bearspaw believed it was probable that Sirius's interest would be reduced to 37.5 per cent as a consequence of the farmout agreement between Sirius and Blaze Energy Ltd. (Blaze). Bearspaw explained that under the farmout agreement, upon Sirius's payout of the capital costs of the 10-11 well, Blaze would earn half of the interest back from Sirius. Therefore, at some point in the future Sirius's working interest ownership in the 10-11 well would be reduced to 37.5 per cent.

Bearspaw stated that Sirius had demonstrated a disregard for its obligations under the pooling order and that it appeared these actions were considered by Sirius to be an acceptable business strategy. Bearspaw argued that such disregard for the pooling order might continue, given that Sirius had not provided a written statement in its evidence that it would adhere to the provisions of the pooling order in the future. Bearspaw stated that it would comply with the Board's orders, adding that it had far greater experience in terms of the operation of pooling agreements than Sirius and had operated far more wells and facilities than Sirius. Therefore it argued that it should be named operator under the pooling order.

5.2 Views of Sirius

Sirius stated that it was the 75 per cent working interest owner and licensee of the 10-11 well. Sirius also stated that it was responsible for the administration of a payout account to Blaze and was operating the well according to good oilfield practice and the regulations. It argued that it would be unusual in the circumstances for a 25 per cent working interest owner to take over operatorship. Sirius requested that the ERCB confirm Sirius as the operator under the pooling order.

It was Sirius's position that the Glauconitic Sandstone, the Medicine Hat Sand, and the Second White Specks in the 10-11 well were all properly pooled under the pooling order. Sirius submitted that the operational record for the 10-11 well showed that these zones were in fact pooled, given that the original operator (Kaiser) drilled and completed the Glauconitic within the six-month timeframe provided in the pooling order. In addition, Sirius submitted that the Medicine Hat Sand and Second White Specks were completed immediately after the Glauconitic in a continuous operation and that the fracture treatment for these two zones was unavoidably delayed due to rain and poor surface conditions. In regard to the Viking Formation, Sirius stated

that it was not clear whether it could complete the Viking Formation in the 10-11 well at this time and it would seek clarity from the ERCB on this matter.

Sirius stated that it had had difficulty with Bearspaw on a number of fronts in the early part of 2009. Sirius submitted that Bearspaw was not conducting itself in accordance with normal industry practice and was refusing to recognize Sirius or pay Sirius its share of production on certain wells unrelated to the pooling order. As a result, Sirius placed the proceeds owing to Bearspaw for production from the 10-11 well in Sirius's legal counsel's trust account. Sirius indicated that after business with Bearspaw had normalized, it instructed its counsel to pay Bearspaw its share of production from the 10-11 well. Sirius stated that it wanted to demonstrate that it could pay Bearspaw, despite Bearspaw's previous concern regarding Sirius's financial capability as a company. Sirius ultimately acknowledged that Bearspaw should have received its share of the proceeds from the 10-11 well, notwithstanding the disputes that were unrelated to the pooling order.

Sirius submitted that it had not received a take-in-kind request from Bearspaw after Bearspaw had elected to participate in the 10-11 well. Sirius stated that if it had received such a request, it would have been uncomfortable with the request, given that Sirius had not yet been named operator of the 10-11 well. Sirius was concerned that Bearspaw would be receiving its full share of production and that Sirius would have no recourse to get paid for Bearspaw's share of operating costs. It was Sirius's belief that Bearspaw would not recognize Sirius as operator and therefore would refuse to pay operating costs.

With regard to the self-declared commingling of production in the 10-11 well, Sirius indicated that the regulations only required it to notify operators in the eight sections surrounding Section 11. Sirius stated that it did not notify Bearspaw of the commingling because Bearspaw would not recognize Sirius as operator and thus would not agree to the commingling, which in turn would hinder the productivity of the 10-11 well. It was Sirius's position that there were no outstanding equity concerns when it self-declared commingling, given that ownership of the Glauconitic Sandstone and Second White Specks did not vary. In addition, Sirius stated that it was not aware that Bearspaw believed the Second White Specks was not pooled, since Bearspaw did not raise this issue until it filed its reply submission in this proceeding.

Sirius acknowledged that it had mistakenly charged Bearspaw overhead costs for Bearspaw's tract in Section 11 and stated that it was prepared to correct this. With regard to the royalty deduction identified by Bearspaw, Sirius indicated that this deduction was incorrectly charged by Penn West. Sirius stated that since the time that it had taken over the 10-11 well, it had been charging the royalty correctly and was not billing Bearspaw for that royalty. Sirius submitted that Bearspaw should have taken the royalty issue up with Penn West. With respect to the completion costs of the Medicine Hat Sand and Second White Specks, Sirius submitted that these deductions were a result of operations that took place prior to Sirius taking over the 10-11 well and the costs were claimed by and paid to Penn West. Sirius stated that these deductions were set out in Penn West's notice of election to Bearspaw and that Bearspaw paid Penn West without question, even though Bearspaw should have been aware from the authorization for expenditures and tour sheets available to it that the 10-11 well was completed in multiple zones. Sirius again submitted that Bearspaw should have taken this issue up with Penn West.

Sirius stated that it was responsible for the payout account to Blaze, which was many months away from being paid out, based on current production and gas prices. Sirius argued that as the majority interest holder and successor in interest to Kaiser, it properly administered the payout account. In addition, Sirius stated that naming Bearspaw as operator of the 10-11 well would create the unusual situation of the minority interest holder operating the well.

Sirius commented that it currently operated 13 wells in the province, but acknowledged that the 10-11 well was the only well it operated under a pooling order. Sirius argued that Bearspaw had assumed no risk in the drilling and completion of the 10-11 well, that the 10-11 well was located on Sirius's land, and that Bearspaw only owned a 25 per cent interest in the 10-11 well, while Sirius owned 75 per cent. Sirius submitted that Bearspaw had not shown any extraordinary circumstances that would disentitle Sirius, the licensee of the 10-11 well and 75 per cent interest owner of Section 11, from being named operator under the pooling order. Sirius requested that the Board amend the pooling order to name Sirius the operator.

5.3 Findings of the Board

The Board first addresses the question of what zones are pooled under Order P 293. The order states in the first numbered paragraph:

> All tracts within Section 11 of Township 29, Range 19, West of the 4th Meridian, shall be operated as a unit to permit the production of gas from the Medicine Hat Sand, the Second White Speckled Shale, the Viking Formation, and the Upper Mannville Formation, through a well to be drilled in Legal Subdivision 10.

The second numbered paragraph requires that the operator drill and complete "a well in the drilling spacing unit as described in clause 1 hereof" within six months following the date of the order. Bearspaw and Sirius were in agreement that the 10-11 well was drilled and completed in the Glauconitic within the six months that followed the date of the order.

Bearspaw's position that the order be interpreted to require that each zone be completed within the six months specified in the order is not supported by the wording of the order. What is required within six months is that a well be drilled and completed in the drilling spacing unit (DSU) that is defined in paragraph 1 of the order. The defined DSU is "all tracts within Section 11." Bearspaw interpreted the pooling order as though it created a single DSU for each of the zones identified in paragraph 1, effectively creating four distinct DSUs for gas production in Section 11. This interpretation is not supported by the wording of the order, which refers throughout to a single DSU, i.e., "the" unit or "a" unit. An interpretation that the order created multiple DSUs within Section 11 is also inconsistent with the Board's practices and previous decisions relating to compulsory pooling.

Bearspaw's interpretation of the order also presumed that if a well were not completed in the DSU within six months, the pooling established in the order was ended. That is not stated in the order; in fact, the order is silent on the question of what consequences arise if paragraph 2 is not fulfilled. That situation is addressed in the *OGCA* itself. Subsection 82(2)(b) of the *OGCA* provides that the Board may hold a public hearing to consider a variation, amendment, or termination of a pooling order if a well required to be drilled by the order is not drilled within six months of the date of the order. Subsection 82(5) of the *OGCA* allows the Board to terminate a

pooling order without notice or hearing if the order requires a well to be drilled within a specified time and the well is not drilled.

In this case, the requirement to drill and complete a well in the unit was satisfied. The Board therefore confirms that all zones identified in paragraph 1 of Order P 293 are pooled as a unit for the production of gas from Section 11 and have been so pooled since Order P 293 was issued. Given this finding, it is not necessary for the Board to consider Bearspaw's request that the 10-11 well be restored to a single completion producing only from the Glauconitic.

The Board next addresses the competing applications from Bearspaw and Sirius to be named operator of the 10-11 well. In doing so, the Board wishes to provide background for the rationale and policy behind compulsory pooling orders. Section 5.005 of the *Oil and Gas Conservation Regulations* provides that only one well can be produced from each pool in a DSU and that no well shall be produced unless there is common ownership throughout the DSU. The first requirement is intended to ensure good production practices that maximize recovery of the resource. The second requirement addresses an equity issue that may arise as a result of the first requirement. If there are separate tracts within a DSU with different ownership, all owners within the DSU must have an arrangement to share in the costs and revenues associated with drilling and producing the only well that is permitted to produce from that spacing unit. Mineral owners or their lessees are able to negotiate voluntary pooling arrangements in the majority of instances of separate tract ownership. However, if an owner or lessee cannot negotiate a satisfactory pooling arrangement in a reasonable period of time, or a tract owner is missing and untraceable, or there is a dispute as to the ownership of a tract, the owner or lessee that wishes to drill and produce a well may apply to the ERCB for a compulsory pooling order. The order serves the same purpose as a voluntary pooling arrangement by providing for each owner or lessee in the DSU to share appropriately in the costs and revenues associated with a well producing from the DSU. The pooling order offers a regulatory means to resolve problems relating to pooling issues, thereby allowing each owner an opportunity to obtain its share of oil and gas from the DSU.

When the Board issues a pooling order, it is required by Section 80 of the *OGCA* to provide for certain matters relating to the drilling and operation of a well in a DSU and the allocation of production and costs relating to that well. Subsection 80(4)(a) requires the Board to provide in the order for the appointment of an operator to be responsible for the drilling, operation, or abandonment of the well producing from the DSU. Although the Board is not bound by its earlier decisions, the Board notes that in previous decisions it has consistently stated that its normal practice is to name the licensee of the well as operator unless compelling circumstances indicate otherwise. The Board stated in *Examiner Report 2000-5: Nycan Energy Corp. and Diaz Resources Ltd.,* at page 8:

> The licensee of a well is responsible for operations at a well, even if another party is conducting those operations, and the Board holds the licensee accountable for any impacts throughout the life of the well to final abandonment. The examiners believe that it would add an unnecessary complexity to the situation if Nycan were operating the 5-14 well while Rozsa remained the licensee of record.

Sirius is the licensee of the 10-11 well and the owner of 75 per cent of the tracts constituting the DSU. While Bearspaw argued that Sirius's interest would be reduced to 37.5 per cent after the 10-11 well reached payout, the Board notes that Sirius would still hold a larger unit share than would Bearspaw. In any event, as the Board previously indicated in *Decision 2008-080:*

Response Energy Corporation, unit share should not dictate the designation of operatorship in preference to the licensee of the well in the DSU.

Bearspaw argued that its greater experience in operating wells and pools and Sirius's demonstrated disregard for Board orders and requirements constituted sufficient reasons for the Board to make an exception from its normal practice of designating the well licensee as the operator of the pool. The Board acknowledges that Sirius did withhold Bearspaw's share of production from the 10-11 well, even though Sirius was otherwise conducting itself as operator by virtue of being the successor to Penn West's interest in the pool. Evidence in the hearing indicated that Sirius's decisions in this regard were influenced by other disputes with Bearspaw over unrelated properties and a concern that Sirius would not be able to recover Bearspaw's share of operating costs. The Board does not condone or accept Sirius's decision to withhold funds from Bearspaw. However, it does not view Sirius's conduct as demonstrating an intention to disobey Board orders or requirements if it is appointed operator of the 10-11 well.

Bearspaw argued that Sirius had failed to properly deduct royalties and operating costs from Bearspaw's share of production and thereby further demonstrated incompetence and/or an intention not to conduct itself as a responsible operator. Sirius acknowledged that some overhead costs had mistakenly been charged by it against Bearspaw's share and stated that it intended to correct that mistake. Sirius also stated that the royalty and completion cost deductions that Bearspaw complained of were made by Penn West prior to Sirius assuming operatorship and that Bearspaw should approach Penn West about those matters.

While the Board received some evidence concerning unresolved issues of account involving Bearspaw, Penn West, and Sirius, in the Board's view it does not have sufficient information to determine precisely what money is owed by and to whom in relation to past operations at and production from the 10-11 well. Bearspaw's application asked the Board to order a complete accounting of drilling and completion costs. It appears to the Board that Bearspaw's request must include Penn West's accounting to Bearspaw for Penn West's operatorship of the 10-11 well prior to Sirius taking Penn West's interest in the 10-11 well. Penn West did not participate in the hearing, and the extent to which either Bearspaw or Sirius has requested that Penn West become engaged in sorting accounts relating to the 10-11 well is not clear to the Board. In these circumstances, the Board declines to make an order requiring Penn West or Sirius to account further to Bearspaw for their respective operatorship of the 10-11 well. However, the Board expects each of them to be receptive to reasonable requests from Bearspaw to resolve outstanding matters of account. Bearspaw will be at liberty to make a future application or applications to the Board under the dispute resolution provisions of the pooling order if these disputes remain unresolved.

Considering all the evidence, including the findings set out in this decision report, the Board concludes that exceptional circumstances do not exist in this case to indicate that the Board should deviate from its normal practice of appointing the licensee of the well as operator of the pool. Although Sirius did refuse for a time to provide Bearspaw with its share of production from the pool when Sirius was acting as *de facto* operator, Sirius's explanation for its behaviour and its assurances given during the hearing persuade the Board that Sirius intends to act as a responsible operator that has proper regard for its obligations under the pooling order. The Board therefore grants Sirius's application to be named the operator under Order P 293 and dismisses Bearspaw's competing application for operatorship.

Dated in Calgary, Alberta, on February 9, 2010.

ENERGY RESOURCES CONSERVATION BOARD

<original signed by>

M. J. Bruni, Q.C.
Presiding Member

<original signed by>

R. J. Willard, P.Eng.
Acting Board Member

<original signed by>

J. Gilmour, B.A., LL.B.
Acting Board Member

APPENDIX 1 HEARING PARTICIPANTS

Principals and Representatives (Abbreviations used in report)	Witnesses
Bearspaw Petroleum Ltd. J. Gruber	P. Wright, P.Eng.
Sirius Energy Inc. M. Niven	G. McGinitie, P.Eng. R. O'Hara
Energy Resources Conservation Board staff G. Perkins, Board Counsel A. Lung, C.E.T. K. Fisher	