INDEPENDENT OPERATIONS: ARTICLE X OF THE CAPL OPERATING PROCEDURE

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This article discusses independent oil and gas operations on jointly held properties, and in particular considers the application of Article X of the Operating Procedures of the Canadian Association of Petroleum Landmen. It explores the rights and obligations of both the party proposing the independent operation and the non-participating party. Recent judicial consideration of some aspects of the operating procedures is discussed. The article suggests some specific changes parties may wish to incorporate when adapting the operating procedure to their circumstances.

TABLE OF CONTENTS

I. INTRODUCTION

Frequently, the rights to drill for and produce, save and market petroleum and natural gas from a parcel of lands in the Western Canadian provinces are owned by two or more oil companies. Usually, these rights are held by the oil companies under

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petroleum and natural gas leases. In almost all cases, the oil companies are tenants in common. The rights of a tenant in common to use the jointly owned land have been summarized as follows:

> every co-owner is entitled to use and enjoy the common property in a reasonable manner, so long as he does not deny to his co-tenants a similar use and enjoyment. What is reasonable depends upon the nature of the property. The fact that some of the property is consumed, or its value impaired by the use, does not render the use unlawful where such is a natural result of exercising the right of enjoyment. Examples of such uses are the cutting of timber or taking of minerals from lands held in common: *Hersey* v. *Murphy* (1920), 48 N.B.R. 65, at p. 73 per Grimmer J. Indeed, if the position were otherwise, one co-owner would be able to prevent the other from taking the fair profits of the land.[1]

Not only is a tenant in common entitled to use and enjoy the common property, it is prohibited from preventing the other tenants in common from making use of the property and may be required to pay compensation to them if it does.[2] Moreover, a tenant in common may be liable to the other tenants in common for waste which it causes to the common property,[3] although it seems unlikely that producing oil and gas constitutes waste.[4] Generally, a court will have jurisdiction to make an order for partition and sale in order to resolve disputes between tenants in common.[5] Oil companies have developed contractual arrangements to circumvent the difficulties imposed by the common law on the exploitation of petroleum and natural gas rights owned by two or more oil companies as tenants in common.

It has been common practice in the United States for many years for the joint owners of petroleum and natural gas rights to enter into joint operating agreements to govern the exploitation of the jointly owned petroleum and natural gas rights by drilling and production operations. Whether because of the uncertainties respecting the rights and obligations of tenants in common or for other reasons, the Canadian oil and gas industry has adopted this practice, just as it has adopted American practices in other areas of the oil and gas industry.

The most common forms of operating agreement used in Canada are those published by the Canadian Association of Petroleum Landmen, which are referred to in this article as "CAPLs."[6] There are four CAPL versions which were published in 1971, 1974, 1981 and 1990, respectively. As would be expected, each subsequent version contains refinements and expansion of the provisions contained in the preceding versions.

One of the distinctive features of the CAPLs is that they permit one of the joint owners of the petroleum and natural gas rights to undertake an operation to exploit the jointly owned petroleum and natural gas rights regardless of whether the other joint

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1 D. Mendes Do Casta, R.J. Balfour & E.E. Gillese, *Property Law: Cases Text and Materials*, 2d ed. (Toronto: Emond Montgomery Publications Ltd., 1990) at 18:17.

2 *Dennis* v. *McDonald*, [1981] 1 W.L.R. 810 (Fam. D.) at 817.

3 *Statute of Westminster, 1285* (U.K.), 13 Ed. 1, c. 22.

4 *Hersey* v. *Murphy* (1920), 48 N.B.R. 65 (Ch. D.).

5 *Law of Property Act*, R.S.A. 1980, c. L-8, s. 15(2).

6 The Canadian Association of Petroleum Landmen, Calgary, Alberta.

owners wish to undertake the operation. The rules governing operations in which some but not all joint operators participate (which are referred to herein as "independent operations") are set forth in Article X of the CAPLs. This article focuses on drilling of wells as independent operations (referred to herein as "independent drilling operations") under Article X of a CAPL and discusses some of the issues which may arise in connection therewith. However, this article does not purport to itemize all of the rules and exceptions applicable to independent drilling operations under a CAPL.

It should be noted that a CAPL provides for the conduct of other operations by less than all of the joint operators, including completing, deepening, plugging back and whipstocking wells. As well, the 1990 CAPL contemplates the construction of some production facilities (as defined therein) by less than all of the joint operators. This article only deals with certain issues arising in connection with independent drilling operations and does not discuss other independent operations.

It should also be noted that there is no legal requirement for the joint owners to agree to be bound by a CAPL or any other operating procedure. There are many circumstances where joint operators have adopted another form of operating procedure. This will usually occur as a result of the adoption of an operating procedure prior to CAPL versions being generally accepted in the industry. Further, when development of a pool or field reaches the point where unitization is appropriate, unit agreements and unit operating agreements are usually entered into. These will supersede the provisions of the pre-existing CAPL (if there is one) insofar as operational matters relating to the unitized zone are concerned, including independent operations. Unit operating agreements provide that operating decisions, whether for the drilling of wells or otherwise, are determined by a vote, with all joint operators being bound by the results of the voting, so that operations cannot be conducted by less than all of the joint operators. This article does not consider such arrangements.

The CAPLs have been designed to be used in a wide variety of circumstances. They have served the Canadian oil industry very well. The success of the CAPLs is demonstrated by the fact that they are widely used yet there are few judicial decisions in which the provisions of a CAPL have been in issue. Nevertheless, it is to be expected that fact situations will arise which do not precisely fit within the terms of the CAPLs. This article is not meant as a criticism of the CAPLs but rather to discuss some anomalies which can occur from time to time.

II. GENERAL SCHEME OF A CAPL OPERATING PROCEDURE

A CAPL is a form of operating procedure which governs the joint exploitation, by drilling and production operations, of rights to petroleum and natural gas underlying one or more parcels of lands ("joint lands") which are owned by two or more parties, usually oil companies ("joint operators").

A CAPL is designed to permit, to the extent reasonably possible, each joint operator to exploit the joint lands as it sees fit. The CAPL is designed to recognize that the joint operators are conducting separate businesses in competition with each other. In *Mesa*

Operating Partnership v. *Amoco Canada Resources Ltd.*,[7] the Alberta Court of Appeal stated that the independent operations provision of a CAPL "permits each player to establish its own development plans and budgets." While the CAPLs recognize this fact, they also recognize that the joint ownership of the joint lands requires that some limitations be placed on a joint operator's right to exploit the joint lands for its own account. Nevertheless, the thrust of a CAPL is to permit each joint operator to pursue its own business interests to the extent reasonably practicable.

Each CAPL specifically states that the rights, duties, obligations and liabilities of the joint operators shall be several and not joint or collective and that nothing contained in the CAPL "shall be construed as creating a partnership, joint venture or association of any kind or as imposing upon any party hereto any partnership duty, obligations or liability to any other party hereto."[8] It has been held that the operator has fiduciary obligations to the other joint operators in certain circumstances.[9] However, those fiduciary obligations are limited.[10] The Alberta Court of Appeal in *Luscar Ltd.* v. *Pembina Resources Ltd.*,[11] held that the operator was not obligated to share its geological mapping and theories with the other joint operators for purposes of considering an acquisition which was subject to an area of mutual interest clause contained in the operating procedure.

A further general theme of the CAPLs is to encourage the evaluation of the joint lands while neither encouraging nor discouraging independent operations. They attempt to fairly balance the rights of the joint owners who wish to conduct operations with those who do not. The independent operations provisions are intended to fairly reward the joint owner who conducts independent operations while not unfairly penalizing the joint owner who does not participate therein. In almost all cases, except where the operation relates to a well which has already been drilled and which is producing or capable of production in paying quantities, a joint operator will be permitted to undertake an operation on the joint lands even though one or more of the other joint operators does not wish it to do so.

It is submitted that the general scheme of the CAPL must be borne in mind when the independent operations provisions are construed.

III. OBLIGATION TO CONSULT

Subsection 1002(a) of the 1990 CAPL states:

> The parties normally shall consult with respect to decisions to be made for the exploration, development and operation of the joint lands. Whether or not such consultation has occurred or has

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7 (1994), 149 A.R. 187 (C.A.), at 197 [hereinafter *Mesa*].

8 Article XVII of 1971 CAPL or Article XV of the 1974, 1981 or 1990 CAPLs.

9 *Bank of Nova Scotia* v. *Société Général (Canada) et al.* (1988), 87 A.R. 133; 58 Alta. L.R. (2d) 194 (C.A.).

10 (1991), (1994), 162 A.R. 35 (C.A.), rev'g (1991), 85 85 Alta L.R. (2d) 46 (Q.B.) [hereinafter *Pembina*].

11 *Ibid.*

> been requested, a party may at any time become a proposing party and give to other parties an operation notice....

The beginning of clause 1002 of the other CAPLs is virtually identical. The second sentence of this provision clearly states that a notice proposing an independent operation may be given at any time, regardless of whether consultation has occurred or has been requested. It is possible that the provision for consultation in the first sentence of clause 1002(a) is a kind of "motherhood" statement which is not intended to have significant legal consequences. Nevertheless, it seems to impose an obligation to consult with respect to operational decisions, subject to two exceptions, namely circumstances which are not "normal" and the giving of an independent operations notice. It is submitted that the provision for consultation will not necessarily be ignored by the courts.

It may be argued that the statement that the parties will normally consult is reflective of the nature of the relationship of the parties to a CAPL and shows that the parties intend to co-operate and work together in the exploration and development of the joint lands. However, it is clear that there is no requirement to consult before the giving of an operation notice. This is consistent with the general scheme of the CAPL, *i.e.* that each joint operator is at liberty to conduct its own business relative to the joint lands more or less as it sees fit with limited obligations to the other joint operators.

There may be tactical advantages to a joint operator proposing a joint operation. Under a 1990 CAPL, the party proposing an independent operation will be the operator thereof and thus will have control in the manner in which the operation is conducted. Further, proposing an operation may preclude other operations which the proposing joint operator does not want undertaken, whether for engineering, geological, business or other reasons.

There is no restriction on a joint operator proposing an independent operation which provides it with a benefit which is unavailable to the other joint operators. For example, drilling a well may provide information with respect to lands in which it has an interest, but the other joint operators do not, or may result in drainage of neighboring lands owned by one of the other joint owners. Yet, the proposing joint operator is entitled to proceed without regard to the interests of the other joint operators.

It could be argued that joint operators have fiduciary obligations in relation to the proposing of independent operations or, at least, obligations to act in good faith in that regard. In order for there to be a fiduciary obligation, the joint operator to whom the duty is owed must be peculiarly vulnerable to, or at the mercy of, the joint operator which owes the duty.[12] While it could be argued that the vulnerability arises from the proposing party having the power to make the proposal without consulting with the other joint operators, it is unlikely that the vulnerability is of the nature required to create fiduciary obligations. It might also be argued that if there is proprietary geological or seismic information owned by the joint owner, each owes the others a

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[12] *International Corona Resources Ltd.* v. *Lac Minerals Ltd.*, [1989] 2 S.C.R. 574.

fiduciary obligation not to use the proprietary information for its own benefit. It is submitted that by virtue of the independent operations provisions of the CAPLs, the joint owners have agreed that the proposal of an independent operation will not breach such fiduciary obligation. Moreover, the use of the proprietary information in such circumstances benefits all of the joint owners because it results in the development of the joint lands. In almost all cases, the joint operators will be on an equal footing, so that one joint operator doing what the contract expressly permits is unlikely to be construed as having breached a fiduciary obligation.

The decisions in *Opron Construction Co.* v. *Alberta*[13] and *Mesa*[14] illustrate that obligations to act in good faith may be implied in contractual arrangements.[15] It is possible that there is an implied obligation to act in good faith under Article X of the CAPL. The fact that clause 1002 states that the joint operators will normally consult gives credence to this view. If so, it is possible that a joint operator cannot propose independent operations if it would be acting in bad faith to do so. Whether the joint operator will be acting in bad faith will depend on the facts. It has been said that bad faith occurs "when one party, without reasonable justification, acts in relation to the contract in a manner where the result would be to substantially nullify the bargained objective or benefit contracted for by the other, or to cause significant harm to the other, contrary to the original purpose and expectation of the parties."[16] It is submitted that because of the competitive nature of the oil and gas industry and the fact that a CAPL is designed to permit a joint operator to pursue its own business purposes, bad faith will seldom be found in the context of independent drilling operations under a CAPL.

While it is clear that it is not necessary to consult prior to giving an independent operation notice, it is not so clear that consultation is not required, by either the proposing joint operator or a non-proposing joint operator, after the notice is given. In fact, such consultation would seem to be consistent with the statement in clause 1002 that the parties will normally consult, although the consultation requirement would not be consistent with the general scheme of the CAPLs.

If there is an obligation to consult, an issue may arise as to the extent of the consultation that is required. There may be proprietary information, such as seismic or geological theories, relevant to an independent operation. The possessor of the proprietary information, whether the proposing party or one of the other joint operators, may not wish to divulge that information. The Alberta Court of Appeal in *Pembina* found that the operator was not required to share proprietary information with the joint operators in connection with the application of an area of mutual interest clause. It is submitted that the oil and gas industry in Canada would be shocked if the consultation

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13 (1994), 151 A.R. 241 (Q.B.)

14 *Supra* note 7.

15 See also S.K. O'Byrne, "Good Faith in Contractual Performance: Recent Developments" (1995) 74 Can. Bar Rev. 70.

16 *Gateway* v. *Arton Holdings Ltd.* (1991), 106 N.S.R. (2d) 180 at 197, (S.C.); aff'd (1992), 112 N.S.R. (2d) 180 (C.A.).

reference in clause 1002 resulted in a joint operator being required to divulge its proprietary seismic or geological information with the other joint operators.

IV. THE NOTICE OF INDEPENDENT OPERATION

Once a party has identified an operation it wishes to conduct on the joint lands, it may communicate its plans to its partners either by initiating the consultation process described in the first sentence of clause 1002 or it may simply prepare and serve a notice of independent operation. Such notices are typically prepared by oil companies without legal advice. The requirements for such notices are relatively straightforward and at least on their face, free of controversy. Unless a proposing party anticipates a hostile reaction by receiving parties, it is unlikely to have its notice of independent operation reviewed by legal counsel before serving it on receiving parties.

A. VALIDITY OF NOTICE

From time to time, the recipient of a notice of independent operation may challenge the validity of the notice in order to prevent or delay the operation proposed thereunder. It is conceivable that the notice might be challenged to allow the challenger to submit its own notice and thus gain a tactical advantage. The requirements for the notice are specified in clause 1002 of the CAPLs. Clause 1002 of the 1990 CAPL itemizes requirements as follows:

> (i) the nature of the operation;
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> (ii) the proposed location of the operation;
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> (iii) the anticipated time of commencement and estimated duration of the operation;
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> (iv) the classification, if applicable, of the operation as a development well or exploratory well and the application of Clause 1010 thereto, if any; and
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> (v) an Authority for Expenditure, provided that an Authority for Expenditure otherwise submitted hereunder shall not in itself be construed as an operation notice unless it is specifically part of an operation notice served pursuant to this Article X.

In addition to the requirements as described in subclause 1002(a), the definition of "Authority for Expenditure" or "AFE" from subclause 101(e) provides a useful elaboration of the information to be included in a notice of independent operations:

> (e) "Authority for Expenditure" or "AFE" means a written statement of an operation proposed to be conducted pursuant to this Operating Procedure, which statement shall include:
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> (i) the type, purpose and location of such operation, in sufficient detail to enable a party to understand the nature, scope and sequence of such operation, the proposed time frame over which such operation will be conducted and, if such operation is the drilling or deepening of a well, the projected total depth thereof, the proposed

surface coordinates of the well and, if they will differ materially from the surface coordinates of the well, the proposed bottomhole coordinates therefor; and

(ii) the proposing party's estimate of the anticipated costs of such operation, which estimate shall be in sufficient detail to enable a party to identify, in summary form, the anticipated costs of the various identifiable segments of such operation, including, if applicable, those costs which relate to drilling, completing and equipping a well.

Items (i) to (iv) of subclause 1002 would appear to be comparatively free of controversy. All that need be done in respect of them is to ensure that these matters have been properly addressed in the notice of independent operations. Occasionally, the classification of the well as to its status as a development well or exploratory well in item (iv) becomes confusing where the status of the well is divided between exploratory and development portions. Misclassification would seem to result in non-compliance with subclause 1002(a).

The AFE would seem to offer the most fertile ground for sowing the seeds of uncertainty regarding the validity of a notice. The AFE must contain in "sufficient detail" the description of the intended operation and the estimate of the costs of the operation. However, industry practices and the decisions in *Renaissance Resources Ltd.* v. *Metalore Resources Ltd.*[17] and *Passburg* v. *San Antonio Explorations Ltd.*[18] suggest that these tests may not be terribly difficult to satisfy.

B. THE RIGHT TIME TO CONTEST A NOTICE

If a recipient of an independent operations notice has a clear technical concern about the adequacy of the notice or about the technical merit of the operation proposed thereunder, it would seem to be in its interest to raise its objection as soon as possible. Clause 1003 allows a proposing party to commence its operation as soon as it has served its notice and does not require it to wait until the response period set forth in clause 1002 has expired. If the basis of the receiving party's objection is technical in nature, it would seem prudent to raise the alarm as soon as possible to stop the operation totally or at least have it amended to correct the problem. A response of this nature to a notice of independent operations should be copied to all other receiving parties at the same time it is sent to the proposing party.

If a receiving party is simply trying to "buy time" before having to respond to the notice, it does not necessarily care whether the proposing party has commenced the operation. Since the time for responding to an independent operation specified in subclause 1002(b) seems to be predicated on the receiving party having all of the information that is reasonably required to properly assess the proposed operation, it would seem that a request to obtain a missing piece of this necessary information should be made near the end of the applicable response period. At that time, the

[17] [1985] 4 W.W.R. 673 (Alta. C.A.).
[18] [1988] 2 W.W.R. 645 (Alta. Q.B.).

missing information can be provided and the receiving party can start with a "fresh clock" on its response period. To this end, the receiving party must look at the nature of the deficiency which it is going to claim in respect of the notice it has received. If a receiving party is grasping at straws and the alleged deficiency is a trifling matter, the proposing party may simply state that it is not going to provide the particular information and will treat its original notice as valid. Should this occur, the complaining receiving party will have little time to decide whether it should stand on its claim of the notice's invalidity, elect to participate, or seek outside funding or a farmout. Therefore, if a receiving party wants to raise questionable inadequacies in the notice, it may be better to make the objection part way through the response period, leaving enough time to make other arrangements (*i.e.* farmout or sale of its interest) if the proposing party rejects the request for further information and more time to respond.

C. DUELLING NOTICES

An additional tactic which is sometimes used by a receiving party in conjunction with an allegation that it has received an inadequate notice is for such receiving party to serve its own notice of independent operation. This tactic usually relies upon the existence of some deficiency in the original notice. If the original notice is invalid (whether as a result of not containing the information required pursuant to clause 1002 or for other reasons) such notice has no effect and the receiving party will be free to send out its own notice of independent operation in respect of the same operation. This could lead to the confusing situation where there are two inconsistent independent operations notices and it is unclear which is valid.

A CAPL does not address the status of a notice of independent operation which is somehow deficient or the right of a proposing party to correct a deficient notice with more information. Either a notice meets the requirements of clause 1002 or it does not. In the opinion of the writers, once a notice of independent operation has been proposed, the receiving parties have notice of the intention of the proposing party to conduct a particular operation. As such, it does not lie in the hands of such receiving parties to scrutinize the particular notice for the purpose of finding some error or omission therein as would cause it to be inadequate as a notice and therefore open the door to having the same operation proposed by the receiving party. The receiving party may have the right to contest the validity of the notice on the basis of non-compliance with clause 1002, but it would seem unreasonable if the receiving party could then propose the same operation or an inconsistent operation after having received notice of the intent of the proposing party to conduct an operation simply because the original notice did not comply with the notice provisions of clause 1002 because of an irregulatity or technical deficiency.

V. MULTIPLE NOTICES

Subclause 1002(e) of the 1990 CAPL provides as follows:

> A party may become a proposing party with respect to more than one operation at any given time, and

> may serve as many operation notices as it so wishes and proceed to conduct operations pursuant thereto. However, no single operation notice shall relate to more than one well, and the receiving parties shall not be required to respond to an operation notice pertaining to a well unless and until each operation notice previously served by that proposing party respecting a well located within 3.2 kilometres of the proposed well has expired, been withdrawn or the operation proposed thereunder has been completed and the information therefrom has been provided to the receiving parties, to the extent required by Clauses 1018 and 1019. If a party serves more than one (1) operation notice at one time, it shall, subject to the foregoing provisions of this Sub-Clause, state the order in which the operation notices are deemed to be received by the receiving parties, provided that if it fails to specify the order, the operation notices shall be deemed to be received in accordance with Clause 2201.

This provision allows a joint operator to propose a number of operations simultaneously, such as a multi-well drilling program, while ensuring that the other joint operators do not have to commit to participate in an operation without the benefit of the information from the operations which have previously been completed. Since the proposing party is not obligated to implement the operations which it proposes, the proposing party may abandon one or more of the proposed operations if the information from the operations which are previously completed leads it to decide to do so.

The time at which a receiving party must respond to multiple operation notices pursuant to clause 1002 of the 1990 CAPL, and the information to which it is entitled prior to responding, requires the interpretation of subclause 1002(e) and clauses 1003, 1018 and 1019. Clause 1003 provides that,

> The proposing party may begin the operation without waiting for the applicable response period prescribed by Clause 1002 to lapse, provided that the proposing party shall not be obligated to supply any information with respect thereto to a receiving party until such time as it elects to participate in such operation. However, the proposing party shall not commence the operation more than ninety (90) days after the operation notice is deemed to be received by the receiving parties, unless the operation is the construction or installation of a production facility, in which case the operation shall not be commenced more than one hundred and fifty (150) days following such receipt.

Clause 1018 provides for the withholding from non-participating parties to independent operations both access to a wellsite and information in respect of a drilling well. Clause 1019, however, provides that,

> If the participating parties are temporarily withholding well information from a non-participating party pursuant to Clause 1018, no participating party shall propose or conduct any operation pertaining to a well on the joint lands within 3.2 kilometres of such well (except regular production and maintenance operations on producing wells) until it has released such information to the non-participating party.

Clause 1003 provides that a proposing party need not wait for the response period set forth in clause 1002 to lapse before commencing an independent operation either on the first of multiple wells or on any of the subsequent wells. In fact, clause 1003 provides that it must commence such operations no later than ninety days after the deemed receipt of its notices or serve new notices in respect of those operations which have not been commenced. Both clauses 1003 and 1018 allow the proposing party to

withhold information from non-participating parties. It seems clear from the language of clause 1018 that a "non-participating party" includes those parties which have given notice of their non-participation, those which are deemed not to have participated by virtue of the time period in clause 1002 having expired, and those receiving parties which have yet to elect whether they will participate or not during the response period provided by clause 1002. Notwithstanding the fact that a proposing party commences multiple operations prior to the conclusion of the response period provided by clause 1002, subclause 1002(e) assures the receiving party that in respect of operations other than that operation specified in the first notice of the multiple notice package, it can wait for the completion of the operations conducted pursuant to earlier notices and the receipt of all information therefrom before making its election. While an operator can, pursuant to clauses 1003 and 1018, withhold information from a receiving party in respect of the first well in a multiple well program until that receiving party makes its election in respect of that first well, if the proposing party does withhold the information on the first well, clause 1019 precludes the proposing party from either proposing or conducting independent operations for any of the subsequent wells if they are within 3.2 kilometres of the first well. Thus if the proposing party wants to proceed to the drilling of the second well in its program (even before the response period in respect of the first well has lapsed), it must release all information in respect of the first well to the other parties, if the second well is within 3.2 kilometres of the first one. The result is that receiving parties may be able to determine whether or not they wish to participate in the first well *after* they have received all of the drilling and completion information relating to that well.

There are two timing issues arising from subclause 1002(e) relating to multiple notices which are left somewhat vague by the wording of that provision. First, the deemed order of receipt of multiple notices is to be specified by a proposing party "provided that if it fails to specify the order, the operation notices shall be deemed to be received in accordance with clause 2201." Unfortunately, clause 2201 is simply the notice provision which governs the deemed time of receipt for notices served under the operating procedure depending upon whether such notices are delivered personally, by facsimile, or by mail. Assuming all of the multiple notices are sent in a single package and no order of receipt is specified, clause 2201 does nothing to assist receiving parties in determining the order of deemed receipt. Also, subclause 1002(e) provides that where more than one notice has been served at a time, the receiving party is not required to respond "unless and until" certain conditions have been met in respect of operations conducted nearby pursuant to previous notices of independent operations. Once the conditions have been met, however, the time period for the receiving party's response has not been specified. Probably, the receiving party is thereafter entitled to the complete response period provided by clause 1002 as if the notice had been served at such time as the conditions described in subclause 1002(e) were satisfied. However, it could be that the receiving party is only entitled to a "reasonable period of time" to respond once the conditions of subclause 1002(e) have been satisfied if these conditions are satisfied after the end of the response period otherwise provided by clause 1002. Obviously a receiving party will need some time to assimilate information received in respect of a nearby operation. It may not, however, require much time for further consideration of a well if no new information is available, as would be the case in the

event that the notice for a prior nearby well was withdrawn. Thus, what will constitute a "reasonable time" may vary in the circumstances.

There is no doubt that delivery of multiple notices by a proposing party can be used by that party as a means of squeezing out an impecunious partner. At the same time, however, there may be legitimate reasons why a proposing party will want to propose a large number of wells at the same time. The joint lands may be inaccessible to rigs so that once a rig has arrived at the area it is cost effective to have that rig drill a number of wells. Similarly, shallow gas pools are typically developed by drilling very large numbers of wells over short time periods. In these operating contexts, the provisions of Article X seem somewhat onerous from the perspective of the proposing party inasmuch as it is placed in the position of having to either inefficiently drill wells one at a time or disclose information to its partners prior to such partners having to elect regarding whether to participate in the proposed operations. In some cases, the joint owners will modify the CAPL so as to permit an independent operation notice to be given in respect of a multi-well program with the requirement that the recipients of the notice must elect whether to participate in the whole program, rather than electing on a well-by-well basis. Obviously, other permutations could also be agreed upon, as circumstances require.

VI. OPERATORSHIP OF INDEPENDENT OPERATIONS

The 1990 CAPL added two provisions which allow a non-operator to automatically become operator in respect of all or certain operations on the joint lands simply by serving a unilateral notice. Subclause 206(a) provides that:

> a single Joint-Operator holding more than a sixty-six percent (66%) working interest in the joint lands shall have the right, by notice to the other parties, to become the Operator hereunder....

This concept of absolute entitlement to operatorship upon reaching a threshold working interest was an entirely new concept in the 1990 CAPL.

In clause 1004, the drafters of the 1990 CAPL reversed the position that had been taken by the drafters of the 1981 CAPL. In the 1981 CAPL, the first sentence of clause 1004 reads as follows:

> Notwithstanding anything to the contrary contained in this Operating Procedure, if the Operator is a participating party, it shall carry out the operation for the account of the participating parties; provided, if the Operator is not a participating party, the participating parties shall, as and among themselves in accordance with the provisions of Clause 206, *mutatis mutandis*, appoint an Operator for the operation.

In the 1990 CAPL, this provision of clause 1004 was changed to the following:

> Notwithstanding anything to the contrary contained in this Operating Procedure, the proposing party shall be the Operator with respect to any operation proposed as an independent operation, unless the parties otherwise agree or the proposing party would be disqualified from serving as Operator pursuant to Subclause 202(a).

This change in the 1990 CAPL has the effect of allowing independent operations to be used by a non-operator to gain operatorship of a particular operation simply by serving a notice of independent operation in respect of it. Operatorship will be returned to the operator appointed pursuant to Article II upon completion of the particular independent operation. There are differences of opinions as to the merits of the change made in the 1990 CAPL with respect to the operator of an independent operation. On the one hand, it may be argued that the proposing party should be the operator because the original operator may not have the resources to undertake the operation, or because it may not be able to do so within the time constraints or at the cost set forth in the proposal notice, and, in any event, the proposing party should be accountable for the operation. On the other hand, the reasons that the original operator was selected as operator may dictate that it should be the operator in respect of the proposed operation, unless it chooses not to participate therein. The other joint owners should not complain about the initial operator acting as the operator of the joint operations, since they agreed to it being the operator in the first place. However, they should not be forced to accept the proposing party as operator, particularly since the proposing party may not have the expertise to conduct the operation properly. In most cases, it is unlikely that the original operator would not have the resources to implement the independent operation, since it probably would not have been appointed operator if it was likely to not have the resources to implement operations.

Take a theoretical situation in which two parties acquire joint lands for the purpose of developing a shallow gas play. They agree to own and operate the joint lands, with party A holding an undivided 90 percent working interest and party B holding the remaining undivided 10 percent working interest. Not surprisingly, A was appointed operator. In this situation, it would be outside the reasonable expectations of A that B could automatically become operator for the purpose of drilling all of the wells on the joint lands. Imagine A's surprise when B serves 150 separate notices of independent operations for the drilling of wells on the joint lands pursuant to the multiple notice provisions of subclause 1002(e). After having invested 90 percent of the land acquisition costs, A has suddenly lost the right to control any of the drilling operations on the joint lands notwithstanding that it will have 90 percent financial responsibility for such drilling and for all post-drilling operations relating to such wells.

Typically the joint operator with the largest working interest is appointed operator. It is interesting that two provisions of the 1990 CAPL which allow for unilateral notice to seize operatorship have the possibility of affecting large working interest owners in exactly opposite ways. Subclause 206(a) provides that a "supermajority" working interest entitles a party to operatorship, while clause 1004 provides that no matter how much working interest an operator holds, operatorship may be snatched away by any other joint operator. Even the interplay between these two provisions is somewhat vague. The definition of "Operator" in subclause 101(u) refers to "the party appointed by the joint operators to conduct operations hereunder for the joint account, except as provided in Clause 1004." It would seem that the best interpretation of this definition is to say that a party which serves an independent operation notice is entitled to be operator of that operation notwithstanding the fact that there may be another joint operator which has an undivided working interest in excess of 66 percent. On the other

hand, the definition of "Operator" which excludes operations to be conducted under Clause 1004 refers to a party "*appointed* by the joint operators." A party with more than 66 percent working interest does not rely upon the appointment of the joint operators for its authority to become operator. Rather, it becomes operator upon service of its own unilateral notice. Thus in our example involving A (90 percent working interest) and B (10 percent working interest), it would seem clear that B can assume operatorship in respect of specific operations by serving notices of independent operations in respect of them. It is very much less clear whether or not A can turn around and rely on the provisions of subclause 206(a) to snatch operatorship back from B in respect of those same operations.

Under the 1981 operating procedure the party that all of the joint operators had an opportunity to select as operator will operate any independent operation in which it elects to participate regardless of which party proposed that operation. Under the 1990 operating procedure a self-appointed operator (*i.e.* the proposing party) will conduct the independent operation regardless of whether the parties' collective choice as operator participates in that operation. In the *Annotated 1990 Operating Procedure*[19] which is also published by the CAPL, the rationale for the revisions to clause 1004 were described as follows:

> Clause 1004: i) The traditionally accepted Clause provided that the operator would conduct the operation if it elected to participate in the operation. However, the operator may have planned to allocate its personnel to other projects. Moreover, the operator may not be able to conduct the operation under the timing and cost constraints proposed in the notice.
>
> To ensure that a proposing party remains accountable with respect to operations it proposes, the Clause has been structured so that the proposing party would conduct the operation unless the parties otherwise agree or that party would be disqualified by Subclause 202(a). If the operator is a participating party, but not the proposing party, it will succeed the proposing party as operator upon the completion of the operation or that particular phase thereof as the proposing party and the operator may agree.
>
> Remember that the non-operators may not want the operator to conduct the operation anyway if they have confidence that the proposing party can conduct the operation property for the cost set forth in the AFE and they doubt that the operator could conduct the operation for the same cost. That being the case, the provision was not structured to provide the operator with the option to conduct the operation.

The last paragraph of the CAPL commentary cited above suggests that non-operators may not want the operator to conduct the operation if they have confidence that the proposing party can conduct the operation properly. The non-operators (other than the proposing party) would likely have more confidence in the operator they appointed than in a non-operator proposing party who appointed itself (by service of the notice). In any case, the language of clause 1004 provides the parties with no choice or any opportunity to engage in this debate as to whom they may want to operate. The 1981

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[19] CAPL, *Annotated 1990 Operating Procedure* (Calgary: CAPL, 1990).

CAPL may have been flawed in as much as it *required* the operator to conduct a joint operation if it elected to participate in it; but the 1990 CAPL is also flawed in as much as it precludes the operator from electing to operate in instances where it elects to participate in an operation proposed by another joint operator.

VII. NATURE OF INDEPENDENT OPERATIONS PENALTIES AND COMPETING INTERESTS

Clause 1007 of the 1990 CAPL provides that if an independent operation is the drilling of a well which is not a title preserving well[20] and the drilling is successful, the "participating parties shall be entitled to retain possession of the well and all production from such zones through the well until the gross proceeds (calculated at the wellhead) from the sale of such production equal the aggregate of:...." The other CAPLs provide for similar penalties using very similar, though not identical, language. Under the 1990 and 1981 CAPLs, once the gross proceeds from the production retained by the participating parties equals an amount determined by a formula (the "penalty amount"), the operator is required to notify the non-participating parties who have thirty days to elect to participate in the well. If they elect not to participate, they forfeit the "right of participation in and to the well and to the spacing unit of the well." If they elect to have a participation or fail to elect, they will have a participation in the well after the production retained by the participating parties equals the penalty amount. Under the 1971 and 1974 CAPLs, there is no right of election and the well is automatically held for the joint account after the gross proceeds from the retained production equal the penalty amount.

The precise legal characterization of such penalties is not clear. The penalty entitles the participating parties to "retain possession" of two things, the well and the production therefrom, for a certain period of time, namely until the gross proceeds from the retained production equal a penalty amount (the "penalty period"). At first blush, the words "retain possession" do not seem to transfer an ownership interest. If not, the non-participating parties will continue to own their interest in the well and the production during the penalty period and, at the end of the penalty period, possession will be returned to them. While this approach might make some sense insofar as the well is concerned, it leads to an absurd conclusion insofar as the production is concerned. The obvious commercial purpose of the penalty is to permit the participating parties to own the production during the penalty period with the further right to sell the production for their own account. The title preservation provisions of the CAPLs,[21] other than those in the 1990 CAPL, require the non-participating party "to assign" its interest and provide that the assignment includes the non-participating party's interest in the spacing unit of the well. The specific use of those words in the title preservation provisions and not in the penalty provisions suggest that the words in the penalty provisions may not transfer ownership in anything and probably do not transfer ownership of an interest in the joint lands. In any event, it is submitted that the better view is that the penalty entitles the participating parties to possession of the well and

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20 See Part VIII, below for a discussion of title preserving wells.

21 *Ibid.*

to ownership of the production.

In the 1990 CAPL, the right of the non-participating parties to elect not to participate in the well arises "upon recovery of the proceeds prescribed by paragraphs (i) to (iv) of this subclause" and in subclause 1007(b)(ii) of the 1990 CAPL there is reference to "those participating parties receiving the assignment of the production attributable to...," both of which suggest that ownership of the production taken during the penalty period is to be transferred to the participating parties, and not merely possession. Similar references are not found in the other CAPLs.

The legal characterization of the penalty is of little consequence as among the joint operators, since their rights and obligations, *inter se*, are relatively clear. However, the characterization may have consequences on the rights and obligations of third parties. The penalty entitlement (*i.e.* to possession of the well and production) does not seem to extend to petroleum and natural gas rights. However, it is arguable that the penalty results in an assignment and transfer of the petroleum and natural gas rights by the non-participating parties to the participating parties, subject to a requirement to reassign and retransfer them to the non-participating parties when the penalty period has ended unless, in the case of a 1981 or 1990 CAPL, the non-participating parties elect to forfeit their interest. In *Mesa*, the Alberta Court of Appeal said, "[T]he non-consent clause, in turn, can be seen as a sort of rental of the working interest accompanied by a right of first refusal."[22] The reference to the right of first refusal is peculiar to say the least.

Transfer of any interest in the joint lands as a consequence of a production penalty may have unforeseen consequences. For example, the transfer may trigger a right of first refusal contained in another agreement. Furthermore, if the participating party is a restricted corporation for purposes of Alberta Royalty Tax Credits and the non-participating party is not, the transfer of the non-participating party's interest in the joint lands may result in that interest becoming ineligible for Alberta Royalty Tax Credits when the interest is reassigned to the non-participating joint operator if it is not a restricted corporation. This would be a harsh and unexpected result, but would seem to technically follow from the provisions of the *Alberta Corporate Tax Act*[23] which deal with Alberta Royalty Tax Credits. This result may apply even if there is only an assignment of an interest in the well and not in the joint lands.

It may be that in a competition between a third party and the proposing parties, a third party claiming a non-participating party's interest in the joint lands would defeat the participating parties' claim to the production penalty. For example, a mortgagee or purchaser of the non-participating party's interests in the underlying petroleum and natural gas rights may defeat the participating party's claim to the production penalty. If the assignment of the production does not create an interest in land, the rights of the mortgagee or purchaser will probably prevail. It is beyond the scope of this article to discuss whether the assignment of production arising from the production penalty creates an interest in land but there is significant doubt that it does.

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22 *Supra* note 7 at 197.

23 R.S.A. 1980, c. A-17.

Timing and knowledge may be important factors in resolving a competition between the claim of the participating parties to the production penalty and the claims of third parties, such as mortgagees and purchasers, to a non-participating party's working interest in the joint lands. If the penalty is created prior to the creation of the third party interest and the third party has knowledge of the penalty, a court may find that the third party's rights were intended to be subject to the penalty. If the third party's rights are created prior to the penalty arising, a court may nevertheless find that the third party impliedly agreed that its interests would be subject to such penalties. The reasoning for this would be that if the third party had actual knowledge that the petroleum and natural gas rights were governed by a CAPL or was sufficiently knowledgeable that it must have known that a CAPL or similar arrangement would be applicable, then a court may find that the third party agreed that its interests would be subject to penalties arising thereunder.

If a third party's rights defeat the penalty, the non-participating party will almost certainly be in breach of the CAPL and liable to the participating parties for damages. If the third party's rights are expressed to be free and clear of penalties and it has actual knowledge of the existence of such penalties, a court may hold that the third party is nevertheless subject to the penalty, on the basis that the third party has impliedly subordinated its interest to the penalty or induced a breach of contract or on other equitable grounds of some nature. Further, each of the CAPLs contains restrictions on dispositions, such that dispositions are either subject to a right of first refusal or to a requirement that the disposing joint operator obtain the consent of the other joint operators, which is not to be unreasonably withheld. If the third party's interests were created after the CAPL was entered into, it could be argued that the restrictions on disposition result in the third party not obtaining any interest until the restrictions are satisfied. Obviously, it would be reasonable for the proposing parties to withhold consent until their entitlement to the production penalty is recognized. However, it would appear to be generally accepted in the oil and gas industry that failure to obtain consent to a disposition as required by a CAPL results in a claim for damages against the disposing joint operator but does not prevent title from passing.

In considering claims of competing parties, it may be useful to consider the law that would be applicable to the rights of co-tenants, in the absence of different contractual arrangements between them, such as a CAPL. The joint owners are tenants-in-common. Under the common law, one co-tenant cannot exclude the right of the other co-tenant to exploit the jointly owned property. A co-tenant which does exploit the jointly owned property is obligated to account to the other co-tenant for the profits therefrom. Under the law of restitution, the exploiting co-tenant is entitled to recover his costs from the proceeds of the exploitation. Article X of a CAPL is a contractual arrangement whereby the joint owners have agreed that different rules will apply as among them. It would seem inequitable that an assignee of a joint owner should be in a better position than the joint owner and, thus, the rights of the assignee should be governed by the provisions of the CAPL. However, if the assignee acquired its rights prior to the CAPL being entered into, it would seem unfair that the rights of the assignee should be altered by the provisions contained in the CAPL which come into effect after the assignee's rights were created. In any event, when the independent penalty provisions of the CAPL

are viewed from the prospective of the law applicable to the rights of co-tenants, a strong argument can be made that the purpose of the CAPL was to modify those rights, not to transfer property. If this view is correct, then the independent operations penalties should not trigger rights of first refusal or create the problems relating to Alberta royalty tax credits described above.

Royalties create a special concern in regard to independent operations penalties. Article X of each CAPL clearly states that royalties reserved to lessors and royalties that are payable by the joint account are to be deducted in computing the penalty period, with the result that it seems clear that the participating parties will be required to pay those royalties. Usually, those royalties will not be paid by the participating parties, although the 1990 CAPL provides that if the participating parties have previously acknowledged the royalty, they will cause it to be paid and will be entitled to recover 150 percent of the royalty payments through the penalty. If the participating parties have not agreed to pay the royalty, there may be a competition between the royalty owner and the proposing parties concerning the priorities of the royalty interest and the independent operations penalty. If the royalty interest is an interest in land (and that matter is not clear in Alberta) and the independent operations penalty is not, it is arguable that the royalty interest has priority and is binding on the proposing parties, notwithstanding the provisions of the operating procedure. Of course, in that event, the proposing parties would have a claim for damages against the non-proposing parties whose interests were encumbered by the royalty, so that the issue would only be of consequence where the non-proposing party was insolvent.

A second issue which arises in connection with royalties is the liability of the payor of the royalty who has elected not to participate in the independent drilling operation to pay the royalty in respect of production during the penalty period. This issue arose in *Mesa*. Dome Petroleum Limited (the corporate predecessor to the defendant, Amoco Canada Resources Ltd.) had purchased petroleum and natural gas rights from Mesa. In connection with the sale, a gross overriding royalty was reserved to Mesa. Dome elected not to participate in a number of wells drilled on the lands in which it acquired interests from Mesa and took the position that it was not obligated to pay royalties to Mesa on the revenues from those wells which it had not received because of the penalty provisions of the applicable operating procedures. Mesa argued that it was entitled to the royalties on the basis that the royalty agreements provided for a royalty on all production attributable to the interests which it had sold to Dome and the penalty revenues constituted production attributable to those interests. Further, the royalty agreements specifically provided that if Dome assigned its interest in the royalty lands, it would cause its assignee to be bound by and to pay Mesa's royalty. Mesa argued that the independent operations penalty constituted an assignment of Dome's interest in the royalty lands and that Dome had breached the assignment clause requiring it to cause its assignees to agree to pay the royalty.

Both the Alberta Court of Queen's Bench and the Alberta Court of Appeal held that Dome was not liable to pay Mesa the royalty on the penalty production. Because Dome had no further obligation to develop the royalty lands, it must have been intended that Dome would only be required to pay the royalty to the extent that it caused the lands

to be developed and thus the use of the "received" was sensible and did not include revenues attributable to the production penalties. The Court of Appeal stated:

> ...[t]he model agreement of the Canadian Association of Petroleum Landmen ... refers to the non-participating interest as though ownership has changed hands, albeit temporarily.... During the penalty period, the interest of Amoco is deemed to cease, and the interest is held by those who participate. I see nothing suspicious in this.
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> In the case of the agreements that use the assignment terminology, Mesa contended that they cannot be said to assign the right to proceeds in any way that impairs the Mesa claim because, if that were the case, the operating agreements were in breach of the covenant against assignment in the royalty agreement. 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.[24]

The royalty agreement provided that the royalty would be payable on revenues "received" by Dome. Amoco argued that Dome had not received revenues from the production from wells in which it had not participated during the applicable penalty periods because the revenues had been paid to the parties which participated in the wells. Mesa, of course, argued that the revenues had been received by the participating parties for the account of Dome since the revenues were applied to the production penalty and that, accordingly, the revenues should be treated as having been received by Dome for purposes of the royalty agreement. The royalty agreement contained a covenant by Dome to incur a specified dollar amount of exploration and development expenditures on the royalty lands. Dome had satisfied that covenant. The Court found that there was no further obligation on Dome to develop the lands.

VIII. TITLE PRESERVING WELLS

Clause 1011 of the 1971 CAPL and clause 1010 of each of the other CAPLs provide that if a lease or other title document would terminate unless a well is drilled and a joint operator elects not to participate in the drilling of that well, it will forfeit its interest in the title document to the extent that the title document would have terminated if the well had not been drilled. The provisions in the 1971, 1974 and 1981 CAPLs are quite similar. However, the provisions in the 1990 CAPL are much more extensive.

The 1971 and 1974 CAPL provisions apply to a title preserving well commenced within the last forty-five days of the applicable lease or other title document. The 1981 CAPL applies when the title preserving well is drilled during the final one-sixth of the term of the title document or in its final year, whichever is shorter. The 1991 CAPL is structured so that the period is to be selected by the joint operators when the CAPL is adopted.

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[24] *Mesa, supra* note 7 at 198.

The provisions in each of the CAPLs recognize that more than one title preserving well could be drilled. This is unlikely and would probably only occur as a result of a disagreement as to the best location for the well. If either well would preserve the title document, then a party which has participated in at least one of the wells will not forfeit any interest. If the title preserving wells preserve the title to different lands, a party which participates in only one of the wells will forfeit its title to the lands which would not have been preserved if only the well in which it participated had been drilled, but will retain its title to the lands which would have been preserved by the well in which it did participate. The 1990 CAPL is much more explicit in this regard, but it is submitted that the other CAPLs have the same effect.

Subclause 1010(b)(i) of the 1990 CAPL provides that a party which does not participate in a title preserving well will forfeit all of its interest in that well and the corresponding spacing unit to the extent the spacing unit pertains to the preserved lands, even if it participates in another title preserving well which would have preserved title to the spacing unit of the well in which it did not participate. Under the other CAPLs, the joint operator does not forfeit its interest in the title preserving well in which it did not participate, if it participates in another title preserving well which would have preserved title to the spacing unit of the well in which it did not participate. However, in that case, the joint operator's interest in the title preserving well in which it did not participate would be subject to the applicable production penalty under that CAPL.

If there are two title documents applicable to the spacing unit of the title preserving well, one of which will expire within the appropriate period if the title preserving well is not drilled and the other which will not expire for some time thereafter, a party which does not participate in the well will forfeit its interest in the title document which is about to expire (unless a 1971, 1974 or 1981 CAPL is applicable and the party participates in a subsequent title preserving well) and will retain its interest in the other title document. Thus, it will continue to have an interest in the title preserving well because of its interest in the title document which would not have terminated if the well had not been drilled, but that interest will be subject to the applicable production penalty.

One other difference between the provisions in the 1990 CAPL which deals with title preserving wells and those contained in the other CAPLs is that the 1990 CAPL provides for forfeiture of the non-participating party's interest while the other CAPLs require the non-participating party to assign its interest to the participating parties. The writers of this article are not certain why that change was made. It may have been so that the transfer of interest occurs immediately, rather than only upon the non-participating party executing an assignment or to ensure that the assignment took place without the necessity of any action or the execution of any documents by the non-participating party, who might refuse to take such action or execute such documents. The use of the word "forfeiture" suggests a penalty and might give rise to an argument that a court should provide relief from forfeiture or an argument that the penalty is unenforceable since it is not a genuine estimate of liquidated damages. However, it is quite clear that the forfeiture or assignment, whichever the case may be, does not occur as a consequence of a breach of an obligation but rather through the decision of the

non-participating party not to participate in an operation. Since the forfeiture or assignment results from a voluntary act and is not a consequence of a breach of contract, neither relief from forfeiture nor the provisions whereby penalties for a breach of contract are unenforceable if they are not a genuine estimate of liquidated damages will be applicable. It is submitted that there is no practical difference between the use of the word "forfeiture" and the word "assign" in these circumstances.

The case of *APL Oil & Gas Ltd.* v. *Arkoma Production Company of Canada Inc. et al.*,[25] considered whether a well was a title preservating well for purposes of clause 1010 of a 1974 CAPL. Lario Oil & Gas Company, Amoco Canada Resources Ltd. and APL Oil & Gas Ltd. all owned working interests in an Alberta Crown petroleum and natural gas lease. Their interests were subject to a 1974 CAPL. The term of the lease was due to expire on April 12, 1989 but was extended pursuant to s. 96 of the *Mines & Minerals Act*,[26] on the condition that it would terminate on June 18, 1989 unless a well was commenced or an application was made for a further continuance under s. 95 of that *Act*. Section 95 provided that the lease would be continued if "all or part of the spacing unit is considered by the Minister ... to be capable of producing (i) petroleum or natural gas in paying quantity...." Thus, the lease could be continued, either by drilling or by satisfying the Minister that petroleum or natural gas could be produced in paying quantity.

Amoco had entered into a farmout agreement with Arkoma whereby Arkoma had the right to drill a well on the joint lands and, if it did so, it would acquire Amoco's interests therein, subject to an obligation to pay a royalty to Amoco. On May 8, 1989, Lario proposed the drilling of a well on the joint lands as an independent operation, stating that the well would be a title preserving well for purposes of clause 1010 of the operating procedure. APL responded to that notice, in writing, stating that it preferred to make an application to continue the lease under s. 95 of the *Mines & Minerals Act*[27] and that it was confident, from confidential information respecting other wells in the area in which it had interests but the other parties did not, that such an application would be successful. APL further specified that it would not participate in the well and that as a consequence it would be subject to a penalty under clause 1007, but would not forfeit its interest under clause 1010.

After several letters from APL, an application for a continuance was made and on June 13, APL made a presentation to the Department of Energy for the Province of Alberta. On June 16, the Department of Energy advised Lario, by telephone, that the application had been approved. Later that same day, Arkoma spudded the proposed well. On June 19, written confirmation of the continuance was received by Lario from the Department of Energy.

Arkoma nevertheless took the position that the well was a title preserving well and that APL had forfeited its interest under clause 1010 of the operating procedure.

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25 (1993), 16 Alta. L.R. (3d) 95 (Q.B.).

26 R.S.A. 1980, c. M-15.

27 *Ibid.*

The Alberta Court of Queen's Bench held that "the question whether the 13-33 well was drilled as a title preserving well is not so much a question of law as it is a question of fact, depending upon the evidence as to the intention of the parties at the time the well was drilled."[28] The Court found that the parties did not intend to drill the well to preserve title. Lario's primary intention in drilling the well was to prevent drainage from off-setting wells and Arkoma's intention was to satisfy the earning requirements of its farmout agreement with Amoco. Further, the success of the s. 95 application had been communicated to the parties before the well was spudded. Accordingly, the well was not a title preserving well and APL did not forfeit its interest. The Court rejected Arkoma's argument that the well was "commenced" as a result of road preparation, transfer of well license, transfer of surface lease and other matters preparatory to drilling, which took place before the s. 95 application was made. Arkoma also argued that the continuation did not take effect until the lease had expired by virtue of s. 95(4)(a) of the *Mines & Minerals Act*, which provides that "the Minister shall not make his decision ... until after the expiration of the term of the lease." The Court said that, while this point was technically correct, it did not make any difference.

This case suggests that the determination of whether a well is a title preserving well depends upon the intention of the parties at the time that the well is spudded. The implication is that since Lario and Arkoma had other motives for drilling the well, it was not a title preserving well. However, it is obvious that both Lario and Arkoma wanted to continue to lease, since their other motives could not be satisfied if the lease terminated. Further, there is nothing in clause 1010 which suggests that intention is relevant. It is submitted that whether a well is a title preserving well is a matter of fact and not intention. It would have been unfair to APL if they had been correct in determining that the s. 95 application would be successful but the well was held to be a title preserving well because Lario and Arkoma intended to preserve title (even though they were incorrect in thinking that they had to drill the well to do so) or because the well was spudded before the Department of Energy communicated that the application had been successful. The true issue is whether the drilling of the well was "required to preserve title" which is a question of fact. A similar issue could arise with respect to an offset clause under a lease which requires that if there is a well offsetting the leased lands, either a well must be drilled on the leased lands, compensatory royalty must be paid or the lease must be surrendered. Since termination of the lease can be prevented by paying compensatory royalty, it is submitted that a well drilled to satisfy the offset obligation would not be a title preserving well.

IX. HORIZONTAL WELLS

Horizontal drilling is a relatively new drilling procedure which was not widely used when the 1990 CAPL was drafted. It is the understanding of the authors of this article that the drafters of the 1990 CAPL did not consider horizontal wells when it was drafted for this reason. As a result, horizontal wells may require additional considerations which are absent from more conventional independent operations. Subclause 1002(a)(ii) requires that a notice of independent operation include the

[28] *Supra* note 25 at 103.

proposed location of the operation. Subclause 1002(a)(v) makes reference to the AFE that is to be served and the definition of AFE in subclause 101(e) provides that where the proposed surface coordinates of the well differ materially from the proposed bottomhole coordinates, both must be set out in the AFE. It is submitted that in the case of a horizontal well, all directional information in respect of the horizontal leg of the well must be carefully elaborated. In addition to surface coordinates and bottomhole coordinates, the accurate description of any horizontal well should include the total vertical depth of the well, the total horizontal length of the well, the depth at which the horizontal component of the well is to be commenced and the total length of the drilled hole. Presumably, the length of the vertical component and the length of the horizontal component will slightly exceed the total depth of the well since the horizontal component does not commence at a sharp angle but rather as a gradual change in direction. The party receiving the notice in respect of a horizontal well should be able to assess how much of the well is going to penetrate the target pay zone and also assure itself that the change in direction from the vertical component to the horizontal component is sufficiently gradual so as to reduce the likelihood of operational problems later.

Clause 1005 of the 1990 CAPL presupposes that if a well is partly a development well and partly an exploratory well, the exploratory portion of the well will be the portion of the well which is deeper than the depths of wells located nearby (closer than 3.2 kilometres) so that the uphole portion is a development well. While this of course will be true for a vertical well, in the case of a horizontal well it would be possible to drill the vertical portion of a horizontal well at a location which made it an exploratory well and then have the horizontal component of that well directed toward a previously drilled well so as to make the furthest portion of the horizontal component of the well a development well. Clause 1005 provides for the allocation of costs between the development portion of the well and the exploratory portion of the well as follows:

> For the purposes of such allocation of costs, the costs of the development well shall only be those costs which would be anticipated to be incurred if the well were being drilled and, if applicable, completed as a development well only, and all additional costs anticipated to be incurred as a consequence of the well also being drilled as an exploratory well... shall be allocated to that portion of the well which would be an exploratory well.

It is not clear that it would be operationally useful for a party to drill a horizontal well starting from a surface location which would make the well an exploratory well in its vertical portion and then continue with a horizontal leg portion which is, at least in part, a development well. However, if such well was drilled, it would seem that on the basis of clause 1005 the exploration portion of the well would bear no costs.

Subclause 1008(a) provides that "no operation notice for a deepening, plugging back, whipstocking, recompletion or reworking operation may be given with respect to a well producing or capable of producing petroleum substances in paying quantities." While this provision precludes an independent operation on a well that is capable of the production of petroleum substances in paying quantities, it does not preclude the proposal of the drilling of another well which might be able to drain the petroleum

substances that would otherwise be produced by an existing well. With various changes to spacing unit regulations to allow for the drilling of horizontal wells in older pools, it may be possible for a party to propose drilling of a horizontal well which would compete for production of petroleum substances with an existing well. While some production from a horizontal well may be production that might not otherwise have been obtained from the existing well, there exists a real possibility that the benefit of the horizontal well would be to accelerate production rather than to significantly increase the ultimate recoverable reserves of the pool. Thus, by the proposal and drilling of the horizontal well, the proposing party may be able to do indirectly what subclause 1008(a) precludes it from doing directly. Obviously, offsetting wells which are the subject of a notice of independent operation can always have the effect of draining reserves which might otherwise have been produced by an existing joint well. Horizontal drilling, however, poses an additional threat to existing offset wells because of changes to spacing regulations to accommodate horizontal wells and because of the relatively prolific production rates which often accompany horizontal wells when they first commence production.

X. OBLIGATION TO IMPLEMENT AN INDEPENDENT OPERATION

An interesting and unresolved issue in relation to independent drilling operations is whether the joint owner proposing the independent operation has the right not to proceed with it. It is clear that an election by a joint owner to participate in a drilling operation proposed by another joint owner creates a binding obligation of the participating joint owner to pay its share of the costs and liabilities incurred in respect of the independent drilling operation if it is implemented as proposed in the independent operations notice and within the time period required by the CAPL. It is conversely arguable that such election creates an obligation on the part of the proposing party to implement the operation. The non-proposing party who elects to participate in the operation may alter its activities as a result of the operation and may suffer damages as a result of the operation not being implemented. For example, the participating party may forego proposing its own independent drilling operation or may decide to divert capital from other projects to permit it to pay its share of the costs of the proposed operation.

It might be appropriate to specifically provide in the agreement to which the CAPL is attached, that a party who proposes an independent operation is obligated to cause it to be implemented if any other party elects to participate therein unless it obtains the consent from the other participating joint owners or there is a change in circumstances (other than the proposing party's finances) which adversely affects the implementation of the operation. Such a provision would not only ensure certainty but would also discourage improper use of independent operations notices.

It should be noted however, that difficulties arising from the failure of a party who proposes an independent operation to implement it seem to be relatively rare.

XI. DEEP RIGHTS

It is not uncommon for a CAPL to apply to joint lands from the surface to a particular depth and for one of the joint owners to own not only an interest in the joint lands but also to own the rights to petroleum substances within the formations below the joint lands. From time to time, such a joint owner will propose the drilling of a well on joint lands with the view to also drilling the well into its deeper rights, thus evaluating both the joint lands and the deeper rights. Since the CAPL only relates to the joint lands, it is unclear whether the joint owner owning the deep rights is permitted to drill a well to evaluate both the joint lands and the deep rights.

Insofar as the well relates to the joint lands, it is jointly owned by those joint owners who participated in drilling it. It may be improper for one of those joint owners to use the jointly owned well for its own benefit, namely the evaluation of the deep rights. If these circumstances are a possibility, then the agreement to which the CAPL is attached could incorporate provisions respecting the right of the owner of the deep rights to use a joint well for purposes of evaluating or taking production from the deep rights. Such provisions would likely state that the well can only be used in relation to the deeper rights if it is not capable of producing petroleum substances in paying quantities from the joint lands and provide that the owner of the deep rights must compensate the other joint owners for the costs of drilling the well through the joint lands on the basis of an agreed formula.

XII. TAILORING ARTICLE X TO THE SPECIFIC AGREEMENT

Obviously one of the primary advantages of the CAPL is that it is a standard agreement that has been widely adopted throughout the Canadian oil and gas industry. Parties utilizing the CAPL do not have to address their minds to the negotiation of every provision therein each time they enter into a new agreement to which the CAPL is to be attached. Notwithstanding that fact, even as it is currently drafted, the CAPL recognizes that some flexibility is necessary to provide for a series of elections to be made by the parties when they use the CAPL. Within Article X itself elections are already required of the parties in respect of the percentage penalty to be imposed for development wells and exploratory wells in subclause 1007(a)(iv), and also for the minimum number of days prior to title forfeiture that a well may be commenced pursuant to subclause 1010(a)(iv) to be "title preserving well." Some additional changes which parties may want to consider at such times as they enter into their joint operating arrangements are as follows.

A. CLAUSE 1002 RESPONSE PERIODS

In some cases, it may be appropriate to increase the period within which a joint owner must respond to a proposal to drill a well from thirty days to ninety days. In an industry increasingly populated by small and medium size companies, many companies have budgetary constraints which will make it difficult for them to participate in an operation on thirty days' notice. If they lack the funds, they may wish to farmout or sell their interest in the joint lands or seek additional financing to allow for their

participation. Thirty days may be inadequate for this purpose. A period of ninety days might be preferable in some circumstances. Obviously the proposing parties can seek the waiver of the response period and encourage receiving parties to make their elections before the full period has lapsed. If a change to ninety days were made to subclause 1002(b), a consequential amendment which would be required is that the ninety day period following the deemed receipt of a notice during which the proposing party must commence operations (as set forth in clause 1003) would have to be amended to require a proposing party to commence the operation on the earlier of thirty days after all receiving parties have communicated their elections in respect of the operation or thirty days after the ninety day period for their responses has expired. These two changes would have the additional benefit of preventing a party seeking to delay operations from proposing an operation it had no intention of undertaking simply to sit on its notice for ninety days and allow it to expire. Requiring the party to commence operations within thirty days after all receiving parties have made their elections would allow receiving parties to respond immediately and force the operation to be commenced in thirty days rather than the ninety days now specified in clause 1003.

B. OPERATORSHIP OF INDEPENDENT OPERATIONS

Parties adopting a 1990 CAPL may want to consider allowing the operator which they have jointly selected to remain operator of an independent operation in which it elects to participate notwithstanding that another party has proposed the subject operation. To this end, the parties can simply elect to replace clause 1004 from the 1990 CAPL with clause 1004 from the 1981 operating procedure. A somewhat more surgical fix would be to provide that the operator shall have the option but not the obligation to be the operator of any independent operation in which it agrees to participate where such operation has been proposed by another party.

C. CONSENSUAL INDEPENDENT OPERATIONS

Independent operations provide parties with independence on two levels. First it allows them to engage in operations in which other parties to the joint lands have elected not to participate. At the same time, it allows them to conduct such independent operations regardless of whether the non-participating parties desire to see such operations conducted. In unitized operations, there are no independent operations. A party may propose operations and the unit operating committee will determine whether or not such operation is to be conducted. If the proposal receives the required support, the operation will be conducted as a joint operation and funded by those in favour of the operation and those opposed to it. If the vote of the unit operating committee is against the proposed operation it is not open to the proposing party to engage in the operation at its own expense. The operation is simply not conducted. Between the unitized operation model and the notion of independent operations described in the CAPL, there may be some middle ground. The parties may want to consider allowing independent operations which have been consented to by a majority of the working interest owners. For example, it would be possible to provide that no one working interest owner could engage in an independent operation if all other parties in the joint

lands were opposed to this operation being conducted. That is not to say that there would not be circumstances where a high risk well was proposed by a party and other parties were content to not participate but were nevertheless prepared to stand back and let their partner engage in the operation. This notion of consensual independent operations would lend itself to applications where there were three or more joint operators involved in the joint lands, especially if there were some joint operators with comparatively tiny working interests. Just as it might not be reasonable to allow one party to conduct an independent operation which all other parties felt was unreasonable, it would not be reasonable for one party alone to deny an independent operation to proceed. Perhaps the requirement could be that at least two parties having some fixed percentage of working interest agree to the independent operation regardless of whether or not they were participating in it. This notion of consensual independent operations would prevent operation of the joint lands being hijacked by one joint operator. It would not be appropriate for consent to be required for title preserving wells or for operations conducted to evaluate offsetting acreage available at a forthcoming land sale.

D. BONDS TO SUPPORT CLAUSE 1017 INDEMNIFICATION

Clause 1017 provides that the parties engaged in independent operations shall indemnify and hold harmless non-participating parties from any losses or damages relating to independent operations. Where a single party of questionable financial stability proposes a risky independent operation, this indemnity may be of little value to the non-participating parties. To this end, parties entering into a new agreement may wish to provide for a requirement that those parties engaging in an independent operation acquire adequate insurance protection and perhaps even post a bond in respect of insurance deductibles and reasonable abandonment and reclamation costs so as to ensure that non-participating parties get the protection which is notionally theirs in any case pursuant to clause 1017.

E. MULTIPLE WELL PROPOSALS

Where a new agreement to which a CAPL is to be attached relates either to a very remote geographical location or to a property which is to be the subject of shallow gas drilling, it may be reasonable to consider amending subclause 1002(e), which precludes the inclusion of more than one well in a single notice of independent operations. Such operational factors may make it more reasonable to bring in a single rig to conduct a multiple well program. The existing provisions of Article X tend to restrain a proposing party from conducting multiple well drilling programs unless it is prepared to disclose information in respect of those wells drilled early in the program prior to the other joint operators being required to elect whether to participate in those wells. If it is known at the outset that multiple well programs are reasonable for the development of the property, then a single notice of independent operation should be allowed to contain a multiple well drilling program.

F. HORIZONTAL WELLS

If horizontal wells are contemplated, then it would be appropriate to amend the independent operations provisions of the CAPL to stipulate the information required to be contained in a proposal for the drilling of a horizontal well. Moreover, the independent operations penalty applicable to a vertical well may not be appropriate for a horizontal well.