DEVELOPMENTS IN NATURAL GAS PURCHASE CONTRACTS

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This paper examines some of the legal implications resulting from developments in the natural gas industry, with particular emphasis on take-or-pay provisions of gas purchase contracts and the proliferation of discount buyers of natural gas.

I. INTRODUCTION

The past few years have seen some significant changes in natural gas markets. In particular, market demand is down in United States export markets where Canadian gas is priced higher than domestic supplies, and Canadian market demand is relatively flat. Natural gas supply increases have been greater than was expected by gas purchasers. Also, many industrial gas users in Alberta have commenced contracting for their own supply in response to the large volumes of gas available for purchase and the unregulated price for gas used in Alberta. Changes in the business world usually have legal implications, and these market changes are no exception. This paper will examine some of the changes in natural gas purchase contracts and other agreements which will be of concern to oil and gas lawyers.

II. TAKE-OR-PAY

Most gas purchase contracts between gas producers and gas purchasers contain "take-or-pay" provisions which require the gas purchaser to "take and pay for, or nevertheless pay for, if available but not taken" a certain minimum volume of gas during the course of a year. This obligation is usually referred to as the "minimum annual obligation". If the purchaser does not take the minimum annual obligation, it must make a payment equal to all or a portion of the value of gas not taken, and hope to recover that gas at some time in the future. With market demand falling, gas purchasers have been unable to meet their minimum annual obligations and have faced significant prepayment liabilities. Debt financing of these prepayments can be an onerous burden, and even though regulatory authorities have generally permitted interest costs to be included in the purchaser's cost of service, the purchaser's ability to raise equity money in financial markets can be seriously impaired.

Gas purchasers have responded by negotiating with producers to reduce their take-or-pay obligations to a smaller proportion of their minimum annual obligation. Purchasers have been quite successful in these negotiations, as producers have shown some understanding for the purchaser's predicament. TransCanada PipeLines Limited ("TCPL"), the largest gas purchaser in Canada, reduced its yearly prepayment commitments to eighty percent of its previous obligations from November 1, 1977 to October 31, 1982. Alberta & Southern Gas Co. Ltd., another major purchaser, has made arrangements with its producers to reduce its take-or-pay commitments to seventy percent until the end of 1984. Other purchasers have made or are in the course of making similar arrangements.

However, the prospect of a continued slump in market demand, combined with unexpected supply increases and an aggressive gas contracting effort in

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the middle and late seventies resulting in serious oversupply, caused TCPL to propose significant modifications to reduce the prepayment commitments under its gas purchase contracts. TCPL has made arrangements with a consortium of banks (the Canadian Imperial Bank of Commerce, Citibank Canada, Morgan Bank of Canada and the Royal Bank of Canada are the major lenders) who have formed a company called Topgas Holdings Limited. "Topgas" is short for "take-or-pay gas". The agreement among TCPL, Topgas and the producers (the "Topgas Agreement") makes significant modifications to TCPL's 2400 gas purchase contracts. The Topgas Agreement was amended in November, 1983 pursuant to the "Topgas Two Amendment" with the introduction of a new banking company called Topgas Two Inc. In light of the importance of the Topgas Agreement, as amended, in all future dealings with TCPL contracts and lands contracted to TCPL, it is important that oil and gas lawyers be acquainted with the terms of the agreement.

III. THE TOPGAS AGREEMENT

The Topgas Agreement (as it is known) is embodied in a letter from TCPL dated May 20, 1982 and has the effect of amending all gas purchase contracts between TCPL and consenting producers. Basically, the Topgas Agreement reduces TCPL's prepayment obligations to sixty percent of its minimum annual obligation and provides improved terms for the recovery of prepaid gas. In return for granting these benefits to TCPL, producers received take-or-pay payments from Topgas for the 1980/81 and 1981/82 contract years at one hundred percent of TCPL's minimum annual obligation. The Topgas Two Amendment, as set out in the letter dated November 15, 1983 from TCPL, further reduced TCPL's prepayment obligations to fifty percent of its 1980/81 minimum annual obligation for the 1983/84 contract year, and a fluctuating minimum obligation of between fifty and sixty percent thereafter.

More specifically, the provisions of the agreement are that all prepayments made by TCPL before the date of the Topgas Agreement are transferred to Topgas, as though Topgas had made the original payment. Topgas makes further prepayments to the producers for the 1980/81 and 1981/82 contract years at one hundred percent of TCPL's minimum annual obligation. This is the "carrot" offered to the producers to encourage them to enter into the agreement, because the producers had previously agreed to accept prepayments at only eighty percent of TCPL's obligations. However, TCPL wields some "sticks" as well, as will be described later.

The Topgas Agreement, prior to the Topgas Two Amendment, provided that during the period between November 1, 1982 and the date at which all prepaid gas outstanding at December 31, 1982 has been recovered (known as the "allocation period"), TCPL, and not Topgas, will make prepayments to producers only if TCPL fails to take during a contract year the lesser of: (i) 60% of its minimum annual obligation for the 1981/82 contract year, or (ii) 75% of its minimum annual obligation for that contract year.

It was the principal objective of the Topgas arrangement for TCPL to reduce its take-or-pay obligations to a level that would render future prepayments unlikely, or at least less burdensome. However, natural gas markets continued to decline during the 1982/83 contract year, and even the reduced obligations of the Topgas Agreement were too onerous for TCPL. Topgas Two Inc. was created by some of the members of the Topgas banking consortium for the purpose of making the 1982/83 prepayment (at the reduced 60% level described above) to producers pursuant to the Topgas Two Amendment. The Topgas Two Amendment further provided that during the allocation period (now extended to include the time for recovery of 1982/83 prepaid gas), TCPL will make prepayments to producers only if TCPL fails to take in any year the lesser of: (i) the "Take-or-Pay Floor Percentage" multiplied by TCPL's minimum annual obligation for the 1981/82 contract year, or (ii) 75% of TCPL's minimum annual obligation for that contract year. The Take-or-Pay Floor Percentage for the 1983/84 contract year is fifty percent; in subsequent years, it is the lesser of sixty percent and the percentage determined pursuant to the following formula:

$$\text{Take-or-Pay Floor Percentage} = 100 \times \frac{\text{Market}}{\text{Obligation}} \text{ minus } 5$$

Where: "Market" is the average of TCPL's annual market available for allocation for the two preceding contract years; and

"Obligation" is the sum of TCPL's minimum annual obligations for the two preceding contract years under all allocable gas purchase contracts, divided by two,

provided that the Take-or-Pay Floor Percentage may not be less than fifty percent.

In return for the benefit of the reduced take-or-pay obligations agreed to by producers under the Topgas Agreement, TCPL has made certain commitments to producers. Included among these commitments are the following:

(a) Agreement between TCPL and the producer that during the allocation period TCPL will equitably allocate its annual market to its supply available from time to time under its gas purchase contracts. This is known as the "allocation program". TCPL must nominate under each contract a volume of gas which is at least ninety-nine percent of the pro rata share of the available market allocable to such contract.

(b) TCPL agrees not to contract for new supply during the allocation period, except for solution gas contracts or contracts which TCPL is required to enter into by a regulatory authority, or unless deliverability from contracted supply is insufficient to meet market demand.

(c) TCPL limits its rights to redetermine maximum daily quantities and minimum annual obligations under the gas purchase contracts during the allocation period. This is commonly referred to as "max day relief". Reserve redeterminations may only occur when the producer cannot deliver the percentage of the maximum daily quantity which is the sum of 10% and the pro rata share of the available market with respect to the contract for the preceding year, expressed as a percentage of the minimum annual obligation for the contract. The Topgas Two Amendment reduced max day relief by establishing a floor relief level of 65% of the maximum daily quantity for the 1983/84 contract year, and 75% of the maximum daily quantity for subsequent contract years during the allocation period.

(d) During plant turnarounds, TCPL will nominate the minimum daily quantity.

(e) TCPL will attempt to keep nominations high enough so that the minimum operational capabilities of gas processing facilities can be met.

(f) TCPL will not suspend deliveries for high hydrocarbon dew point during the allocation period unless Nova, an Alberta Corporation ("Nova") requires suspension of deliveries.

The Topgas Agreement includes more specific provisions than previously existed for the recovery of prepaid gas. Under TCPL gas purchase contracts the period for the recovery of prepaid gas was limited, often to as little as five years. One of the early agreements that reduced TCPL's take-or-pay obligations increased this recovery period to ten years. The Topgas Agreement contains a specific recovery period program and gives TCPL and Topgas a greater degree of assurance that prepaid gas will actually be recovered. No prepaid gas will be recovered until the 1984/85 contract year. Production during the 1984/85 contract year and each subsequent contract year up to the Annual Quantity for that year constitutes recovery of prepaid gas. The Annual Quantity is a volume of gas equal to ten percent of the outstanding prepaid gas at December 31, 1982 or, under the Topgas Two Amendment, December 31, 1983. The Annual Quantity will increase to as much as twenty percent of outstanding prepaid gas if TCPL can expand its market over the 1981/82 contract year. When prepaid gas is recovered, TCPL will pay to the producer the current Alberta Border Price for the gas less the amount of the prepayment previously given. TCPL refunds the amount of the prepayment to Topgas and Topgas Two.

If TCPL makes a prepayment during the 1982/83 contract year or thereafter (despite the reduction of its take-or-pay commitment as described above), then recovery of such "TransCanada prepaid gas" shall occur after recovery of all other prepaid gas. The period for the recovery of such TransCanada prepaid gas is referred to as the "extended recovery period". Any volumes taken by TCPL in excess of its minimum annual obligation during this extended recovery period constitute recovery of such TransCanada prepaid gas.

Recovery of prepaid gas at a rate of ten percent and up to twenty percent per year commencing the 1984/85 contract year will result in an allocation period that may continue until as late as 1994. If TCPL incurs TransCanada prepaid gas, the extended recovery period may lengthen the allocation period further still. It is likely that a number of gas reserves subject to TCPL contracts will decline during that period and may not be able to produce adequate volumes of gas to recover all prepaid gas. Accordingly, the provisions of the Topgas Agreement dealing with such deficient contracts are particularly important. If either TCPL or the producer is of the opinion that recovery of prepaid gas cannot be achieved under a particular contract, TCPL and the producer shall attempt to agree on the proportion of further deliveries of gas under the contract which will constitute recovery of prepaid gas, so as to ensure that all prepaid gas is recovered prior to November 1, 1994, and that recovery of all TransCanada prepaid gas will be achieved. Failing agreement between TCPL and the producer, the proportions will be determined by arbitration.

If insufficient gas is available under a particular contract to permit recovery of all prepaid gas and TransCanada prepaid gas, all deliveries of the producer's gas under all contracts between TCPL and the producer shall constitute recovery of prepaid gas and TransCanada prepaid gas under the particular contract until such volumes have been recovered in full. If this arrangement is still insufficient to provide for the recovery of prepaid gas, then the producer may provide for the recovery of prepaid gas and TransCanada prepaid gas from any lands from which gas is then available for delivery.

The Topgas Agreement was conditional upon acceptance of its terms by sufficient producers to justify the implementation of the program, and upon TCPL and Topgas receiving sufficient assurances from regulatory authorities that the Topgas interest charges, at a rate of prime plus seven-eighths of one percent, would be included in the calculation of TCPL's Alberta Cost of Service. Both of these requirements were met. Over ninety-nine percent of TCPL's contracted supply is now operated under the Topgas Agreement; only four contracts out of approximately 2,400 are not included in the program. Also, the Alberta Petroleum Marketing Commission (APMC) granted a cost of service determination that permitted the inclusion of Topgas interest costs in TCPL's Cost of Service.[1]

The Topgas Two Amendment was similarly conditional upon sufficient producer acceptance and adequate assurances from the APMC regarding the inclusion of Topgas Two interest charges in TCPL's Alberta Cost of Service. Again, both conditions were met, although the level of producer acceptance was not as high as for the Topgas Agreement. Although the final degree of acceptance is not yet known, contracts representing 81% of TCPL's contracted supply had been amended by the Topgas Two Agreement as of December 31, 1983.

IV. ADVANTAGES AND IMPLICATIONS OF THE TOPGAS AGREEMENT

Why was the Topgas Agreement so widely accepted? There appear to be a number of reasons. One is that TCPL was offering funds to the producers at a time when many welcomed a cash injection. A prepayment can be characterized basically as a loan, with the gas reserves in the ground representing the security for repayment of the principal. Interest on the "loan" is to be paid, as it accrues, by inclusion in TCPL's Cost of Service. It is this interest aspect, however, that made the prepayment a prudent business deal in many cases. The Alberta Cost of Service, which includes the Topgas interest costs, is a deduction from the Alberta Border Price received by producers from TCPL. After deduction of the Alberta Cost of Service, producers are required to pay the federal Petroleum and Gas Revenue Tax and Alberta Crown or freehold royalties. The remainder is revenue to the producers. Since federal taxes and Alberta Crown royalties are so high, a significant portion of the increase in the Alberta Cost of Service resulting from the inclusion of Topgas interest costs is really borne by the federal and provincial governments and only to a lesser degree by the producer. Assuming that the producer is in a taxable position, approximately seventy-five percent of any increase in the Alberta Cost of Service on new gas is borne by the federal and provincial governments. Approximately ninety percent of any increase in the Alberta Cost of Service on old gas is borne by the federal and provincial governments. Therefore, the prepayment can be characterized as a loan at a very low effective interest rate.

Nevertheless, there are some situations where producers felt that they would prefer receiving their production revenue without the deduction for Topgas

1. APMC Determination 82-14 (TCP), dated November 23, 1982.

interest costs. TCPL accommodated these producers by providing a revised Topgas Agreement, known as the Option Agreement, which subjected the producer's contracts to the allocation program and reduced TCPL's prepayment commitment to sixty percent of its minimum annual obligation, but did not require payment by Topgas for additional volumes over eighty percent of minimum annual obligations during 1980/81 and 81/82. APMC Determination 82-14 (TCP) provided for an Alberta Cost of Service without a Topgas interest component for contracts in this category. TCPL has also sought a special category of Alberta Cost of Service for those producers who executed the Topgas Two Amendment and elected to waive the prepayment for the 1982/83 contract year.

Another reason for the wide acceptance of the Topgas Agreement is the power that TCPL has as purchaser to significantly reduce revenue to producers by strict compliance with the terms of its gas purchase contracts. For example, TCPL could make sudden changes in nominations, from zero to maximum daily quantity, on a frequent basis. Since it takes time to bring production up to maximum, it is unlikely that the producer could produce the maximum daily quantity on short notice. TCPL could nominate maximum daily quantity during periods of plant turnaround. It could nominate low during the winter season, when production is high and its Cost of Service is low, then nominate high in the summer months when Cost of Service is higher. TCPL could also put the producer on test and reduce the maximum daily quantity and minimum annual obligation if test results are not satisfactory. In addition it could nominate at a rate that is below the minimum operational capability of the producer's processing facility, and suspend deliveries if the hydrocarbon dew point specification is being exceeded, even though the excess hydrocarbons would probably be taken out at a straddle extraction plant on Nova's pipeline and therefore would not pose a problem for TCPL.

TCPL agreed not to exercise some of these contractual powers against producers who joined the Topgas program.[2] However, TCPL retains a considerable degree of control over a producer's cash flow even after the Topgas Agreement. The Topgas Two Amendment contained few "carrots" for most producers; it was largely TCPL's threatened use of this control that formed the impetus behind the acceptance by producers of the Topgas Two Amendment. Those producers who did not adopt the Topgas Two Amendment may find their cash flow to be less outside of the Topgas program than it would have been if they had adopted it.

Topgas has made the required prepayments to the producers named in each TCPL gas purchase contract in the Topgas program. Where more than one producer is a party to the contract, the payment is made to one producer as agent, and is then distributed to other named producers. However, often there are parties having interests in the lands subject to the contract but who are not named as parties. In these situations, the producer who is named as a party to the contract and through whom the unnamed party claims will have made the proportional prepayment to the unnamed party. Since the named party is the only one having privity with TCPL, however, TCPL will be looking to the named party to satisfy the obligations to deliver prepaid gas. It is hoped that the named party took adequate steps to secure its position before delivering the

2. *Supra* p. 3, points (b) to (f).

prepayments to the unnamed party. Should the unnamed party vanish, the named party may have to fulfill the unnamed party's repayment obligations without compensation. Security agreements dealing with problems of this nature have been circulating in the industry since the first Topgas payment was made in October, 1982.

V. TAX IMPLICATIONS OF TAKE-OR-PAY

For years, sale agreements for oil and gas properties have included a warranty in favour of the purchaser stating that the vendor:

> is not obligated to deliver hydrocarbons from the said lands at some future time without then or thereafter receiving full payment therefor by virtue of any prepayment arrangement under any contract for the sale of hydrocarbons and containing a 'take-or-pay' or similar provision.

Increasingly, vendors have had to add to this clause, "except as previously disclosed in writing to the purchaser." The existence of outstanding take-or-pay obligations upon sale of properties should be a concern to the vendor as well as the purchaser. Prepayments under gas purchase contracts are usually not treated as income in the year received. Instead, the producer will establish a reserve account for the amount of the prepayment under Section 20(1)(m) of the Income Tax Act,[3] since the prepayment is made in respect of goods which will not have to be delivered until after the end of the year. Section 12(1)(e) of the Income Tax Act[4] collapses that reserve each year, but a new reserve may be established each year if the prepaid gas is still to be delivered after the end of that year. Therefore, prepayments need not be recognized as revenue for tax purposes until the obligation to deliver the prepaid gas ceases.

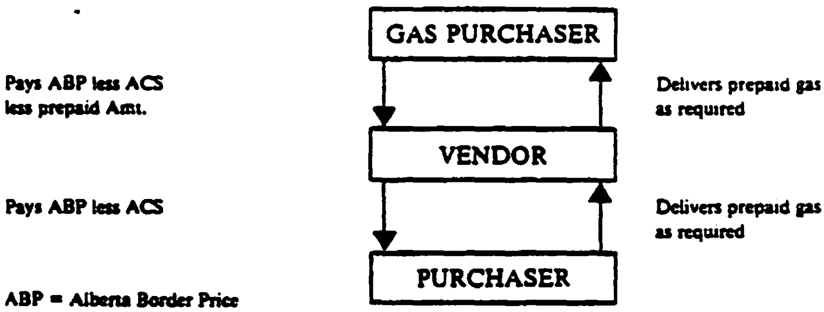
That obligation can cease in several ways, one of which is by recovery of the prepaid gas by the purchaser. As recovery occurs, portions of the prepayment will be recognized as revenue until all prepaid gas has been delivered and the reserve is fully depleted. The other way that the obligation can cease is if the obligation is assumed by another party. This assumption typically takes place upon assignment of properties to a purchaser. On the effective date of the assignment, the vendor will be relieved of all obligations with respect to the lands, and the purchaser will assume them. Accordingly, the vendor may not establish a reserve in the year in which the properties were assigned, and will be required to recognize all outstanding prepayments as revenue in the year of disposition.

This can be an onerous obligation, and if the vendor and purchaser so desire, it may be avoided. It is possible to establish an agreement between vendor and purchaser which would provide that the vendor continues to be liable to deliver the outstanding prepaid gas to the gas purchaser and that such obligation is not assumed by the purchaser. The purchaser would agree to supply gas to the vendor from the contracted lands as and when required in order to satisfy the obligations to deliver prepaid gas. The sale price of the gas is negotiable, but the arrangement would be balanced if the vendor agreed to pay the prevailing contract price (in most cases, the Alberta Border Price) to the purchaser.

3. R.S.C. 1952, c. 148, as am.

4. *Id.*

An example may be of assistance to demonstrate the concept. Suppose the vendor has a gas purchase contract with a gas purchaser. Prepayments have been made at a price of one dollar per Mcf. The current contract price is the Alberta Border Price. Assuming that the prevailing Alberta Border Price less Alberta Cost of Service is two dollars per Mcf, the arrangement for delivery and payment of one Mcf of prepaid gas would be diagrammed as follows:



ABP = Alberta Border Price
ACS = Alberta Cost of Service
ABP minus ACS = $2.00/Mcf.
Prepaid Amt. = $1.00/Mcf.

Gas Purchaser
- Receives Prepaid Gas from Vendor
- Pays ABP less ACS less Prepaid Amt. ($1.00)

Vendor
- Receives Prepaid Gas from Purchaser
- Delivers Prepaid Gas to Gas Purchaser
- Receives ABP less Prepaid Amt. ($1.00)
- Recognizes Prepaid Amt. from Reserve ($1.00)
- Pays ABP less ACS to Purchaser ($2.00)
- Revenue = $2.00 Expenses = $2.00; Income = 0

Purchaser
- Delivers Prepaid Gas to Vendor
- Receives ABP less ACS ($2.00)
- Incurs production expenses

The gas purchaser is unaffected by this arrangement. It will receive the prepaid gas and pay out the incremental price just as if the sale had not occurred. The vendor is in a much more satisfactory position. Instead of incurring a tax liability by recognizing the prepayment as income upon assignment of the property to the purchaser, the vendor delays the recognition of the prepayment and incurs an offsetting expense resulting in zero net income and therefore no tax. However, the vendor must make a payment to the purchaser at the current contract price and in order to do so must obtain from cash flow or other sources the amount of the prepayment. The purchaser should also be satisfied, as it will receive the current price for the gas without any reduction of its cashflow as a result of the prepayments (other than by virtue of the increased cost of service). However, the purchaser would have to be satisfied that the vendor could come up with the prepayments when prepaid gas is recovered in the future.

The agreement between the vendor and the purchaser would provide that the vendor appoints the purchaser as agent of the vendor for the purposes of delivering the prepaid gas to the gas purchaser and receiving payment therefor on behalf of the vendor. The vendor would then have no physical involvement in the transaction.

Acceptance of this arrangement by the gas purchaser is important so that all parties recognize the continuing obligation of the vendor to deliver the prepaid gas. TCPL may be willing to consent to arrangements of this kind, but will require revisions to its standard novation agreement. It is unclear at this time whether other gas purchasers would also consent, but it is suggested that such arrangements should be acceptable since the gas purchaser is not prejudiced by the scheme.

The April 19, 1983 Federal Budget contains a proposed revision to the Income Tax Act[5] which may provide another method for eliminating the tax problems involved in transferring properties from which prepaid gas is to be delivered. Subsection 4(1) of the Draft Amendments[6] to the Income Tax Act provides as follows:

> 4.(1) subsection 20(1) of the said Act is amended by adding thereto, immediately after paragraph (m.1) thereof, the following paragraph:
>
> (m.2) a repayment in the year by the taxpayer of an amount required by paragraph 12(1)(a) to be included in computing his income from a business for the year or a preceding taxation year';

This amendment would allow a taxpayer to make a deduction from income for a refund made by the taxpayer of moneys previously received for goods to be delivered in the future. Under the existing provisions of the Income Tax Act,[7] the elimination of the obligation to deliver goods in the future would result in a collapse of the reserve previously claimed under Section 20(1)(m), and the amount of the reserve would be included in income for that year. The Draft Amendment[8] would permit the taxpayer to make an offsetting deduction for the amount included in income where the taxpayer has refunded moneys previously received. Therefore, if this provision is passed as proposed, it may be possible for a vendor of properties to refund to the gas purchaser the amount of outstanding prepayments and thereby eliminate the vendor's obligation to deliver prepaid gas. The gas purchaser would then make an identical prepayment to the purchaser of the properties, and the purchaser would commit to deliver the prepaid gas. This would, of course, require the approval of the gas purchaser.

There is one final comment on the recent changes we have seen in take-or-pay provisions of gas purchase contracts. For many years, banks and other financial institutions have lent money to producers and pipeline companies on the assumption that future revenue was assured by take-or-pay provisions in gas purchase contracts. The recent market dislocations have proved that assumption to be entirely false, as producers have consented to reduction of their prepayment rights, and foreign gas purchasers have suspended deliveries on the questionable ground that market changes have created a "force majeure" situation. Producers and pipeline companies should expect some skepticism on the part of their bankers the next time they seek a loan on the assurance of take-or-pay commitments in gas purchase contracts.

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5. *Id.*
6. Draft Amendments to the Income Tax Act, to the Income Tax Application Rules, 1971 and to An Act to amend the statute law relating to income tax (No. 2), R.S.C. 1980-81-82-83, c. 140.
7. *Supra* n. 3.
8. *Supra* n. 6.

VI. GROWTH OF DISCOUNT SALES

The exploration thrust of the late 1970's resulted in the discovery of large reserves of natural gas in Alberta. In today's market, much of this gas is shut-in and producers are anxious to sell it, even at reduced prices, to create cash flow. Also, the Alberta government is trying to encourage the consumption of natural gas in Alberta for industrial uses, and has passed legislation providing that gas consumed in Alberta is not subject to a regulated price.[9] These two facts combined have created the scenario which has resulted in an increase in the number of Alberta industrial gas purchasers contracting for discount-priced Alberta gas. This proliferation in the number and volume of industrial gas purchases at significant discounts from the Alberta Border Price has rendered more apparent the problems of split stream sales of gas. Also, many of these new contracts contain dedications of the producer's reserves to the purchaser that can result in conflict with operating agreements among the joint interest holders. This portion of the paper will consider some of the split sales problems that have arisen and offer some suggestions for change.

It is not proposed to thoroughly analyze the common law and statutory law relating to co-ownership of oil and gas properties, as that has been the subject of previous papers published in the Petroleum Law Supplement[10] and in the United States.[11] Briefly, the Alberta law on this matter is established under the Judicature Act[12] by the incorporation of two ancient English statutes[13] of 1285 and 1705. These statutes establish that a co-tenant is liable to his co-tenant for waste, and that one co-tenant may sue for an accounting against another co-tenant for receiving more than his just share or proportion. Although there are no Canadian oil and gas cases on this question, it is submitted that Canadian Courts would follow the rulings of the Courts in the major U.S. oil and gas producing states that hold that production of oil and gas is not waste, and would permit a co-tenant to produce without the consent of his co-tenant, but would entitle the nonconsenting co-tenant to his proportionate share of the proceeds of production.[14]

The Canadian Association of Petroleum Landmen (CAPL) Operating Procedures confirm by agreement this interpretation of the law. Article VI of the 1981 CAPL Operating Procedure reads as follows:

> OWNERSHIP AND DISPOSITION OF PRODUCTION
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> 601 EACH PARTY TO OWN AND TAKE ITS SHARE — Each of the parties shall own its proportionate share of the petroleum substances produced from wells operated for the joint account

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9. Natural Gas Pricing Agreement Act, R.S.A 1980, c. N-4; Natural Gas Price Administration Act, R.S.A. 1980, c. N-3.

10. Muir, "Split Sales of Gas" (1971) 9 *Alta. L. Rev.* 496; Olisa, "Legal Problems Arising Out of Co-ownership of Oil and Gas Leasehold Estate and Facilities" (1970) 8 *Alta. L. Rev.* 177.

11. Fell, "Marketing of Production from Properties Subject to Operating Agreements" (1982) 33 *Inst. on Oil and Gas Law & Tax n* 115; La Grone, "Natural Gas Contracting in the '80's" (1981) 32 *Inst. on Oil and Gas Law & Tax n* 25; Ellis, "The Production of Gas from Joint Interest Properties" (1970) 21 *Inst. on Oil and Gas Law & Tax n* 47; Hillyer, "Problems in Producing and Selling, by Split or Single Stream, Gas Allocable to Diverse Working Interest Ownerships" (1965), 16 *Inst. on Oil and Gas Law & Tax n* 243; Upchurch, "Split Stream Gas Sales and Gas Storage and Balancing Agreement" 24 *Rocky Mtn. Min. L. Inst.* 665.

12. R.S.A. 1980, c. J-1.

13. Statute of Westminster II (1285) 13 Edward I, c. 22; Statute of 4 Anne (An Act for the Amendment of the Law and the better Advancement of Justice) (1705) 4 Anne, c. 16.

14. *Prairie Oil & Gas Co. v. Allen*, (1924) 2F. (2d) 566.

and shall have the right, at its own expense, to take in kind and separately dispose of its proportionate share of production exclusive of the production which may be used by the Operator in developing and producing operations and of production unavoidably lost.

602 FAILURE TO TAKE IN KIND — When and so often as a Joint-Operator shall fail or refuse to take in kind and separately dispose of its proportionate share of any production, the Operator shall have the authority, revocable by the Joint-Operator at will (subject to existing sales contracts), to sell for the account and at the expense of that Joint-Operator its proportionate share of production to others at the same price which the Operator receives for its own share of the production or to purchase the same for its own account at the field price prevailing in the area. All sales made by the Operator of a Joint-Operator's share of production as aforesaid shall be for such periods of time only as are consistent with the minimum needs of the industry under the circumstances but in no event shall any contract for the sale of the Joint-Operator's share of production be made for a period in excess of one (1) year.

603 OPERATOR'S FAILURE TO TAKE IN KIND — If the Operator is the party who fails or refuses to take in kind and separately dispose of its proportionate share of production, the Joint-Operators, or any one or more of them, shall have the same rights, mutatis mutandis, with respect to production, (including the Operator's share thereof), as the Operator has with respect to a Joint-Operator's share of production under the foregoing provisions of this Article; and in that case the Operator shall follow the instructions with respect to production and marketing given by the Joint-Operators who wish to market and/or take in kind their respective shares of production and to market the Operator's and other Joint-Operators' shares of production as aforesaid. Two or more Joint-Operators exercising their rights under this Clause shall do so in proportion to their participating interests.

604 PAYMENT OF LESSOR'S ROYALTY — Each of the parties hereto shall pay or cause to be paid the Lessor's royalty and all other payments required pursuant to the title documents attributable to its proportionate share of petroleum substances.

605 DISTRIBUTION OF PROCEEDS — Subject to the foregoing provisions of this Article, any party that receives income or proceeds from the sale of another party's share of production, shall forthwith distribute such income or proceeds to the party or parties entitled thereto. If a party fails to distribute such income or proceeds within ten (10) days following its receipt, the undistributed amount may, at the option of the party entitled thereto, bear interest (payable by the party holding such income or proceeds for the account of the party entitled thereto) at the rate provided for in Clause 502, from and after the aforesaid ten (10) days until it is paid.

The 1974 CAPL Operating Procedure is identical, but excludes Clause 605. and the 1971 CAPL Operating Procedure is identical but excludes Clauses 604 and 605.

The effect of these provisions is to establish production revenue sharing among the joint operators according to their respective shares. Once again, a chart may display this more clearly. Suppose producers A and B own fifty percent each of a well. A has a gas purchase contract with X, who pays $1.00 per Mcf. B has a gas purchase contract with Y, who pays $1.50 per Mcf. The following chart sets out the operations under the contract for four quarters of a contract year.

EXAMPLE 1

Quarter	Nomination (Mcf)	Volume Produced (Mcf)	Revenue
1	X - 1,000	2,000	A - $1,000
	Y - 1,000		B - $1,500
2	X - 2,000	2,000	A - $1,000
	Y - 0		B - $1,000
3	X - 0	1,000	A - $ 750
	Y - 1,000		B - $ 750
4	X - 0	1,000	A - $ 750
	Y - 1,000		B - $ 750
TOTAL	X - 3,000	6,000	A - $3,500
	Y - 3,000		B - $4,000

At the end of the contract year, A and B have each produced 3,000 Mcf. If purchasers X and Y had nominated the same amount in each quarter of the year, A would have received $3,000 and B would have received $4,500. However, the terms of the Operating Procedure require the Operator to sell the production share of a joint operator who fails or refuses to take his share in kind whenever such failure or refusal occurs. Therefore, a proper accounting is shown above. Although A's contract with X provides for a contract price of $1.00 per Mcf, A should receive $3,500 for the 3,000 Mcf produced during the year. B's contract provides for a $1.50 per Mcf price, but B's 3,000 Mcf of production will earn only $4,000.

Another example will be considered.

EXAMPLE 2

Quarter	Nomination (Mcf)	Volume Produced (Mcf)	Revenue
1	X - 1,000 Y - 1,000	2,000	A - $1.000 B - $1.500
2	X - 2,000 Y - 1,000	3,000	A - $1.500 B - $2,000
3	X - 2,000 Y - 1,000	3,000	A - $1.500 B - $2.000
4	X - 1,000 Y - 2,000	3,000	A - $1,750 B - $2.250
TOTAL	X - 6,000 Y - 5,000	11,000	A - $5,750 B - $7,750

In the second quarter, the total production is 3,000 Mcf, which must be shared 1,500 Mcf for each of A and B. A sells its 1,500 Mcf to X at $1.00 per Mcf, yielding $1,500 in revenue. One thousand Mcf of B's 1,500 Mcf is sold to Y at $1.50 per Mcf, yielding $1,500 in revenue; the remaining 500 Mcf of B's share was sold to X at $1.00 per Mcf, because B failed to take in kind and separately dispose of its proportionate share.

The result of these examples is clear — where joint producers have contracted with different purchasers at different prices, the producer having the higher price contract will share some of its price advantage with the other producer. The industry, however, often accounts for split gas sales differently from the method outlined above. Common practice is to wait until year end, examine the volumes produced to each contract, and compare with each producer's proper share of production. Applying this method to Example 1 above, A would have received $3,000, B would have received $4,500, and no year end compensation payment would be required because A and B produced the same amounts to their contracts. In Example 2 above, A and B produced 5,500 Mcf each; B would receive $7,500 for the 5,000 Mcf sold to Y, A would receive $5,500 for 5,500 Mcf sold to X, and A would make a year end compensation payment of $500 to B for the 500 Mcf of B's gas sold to X.

It is submitted that the foregoing method for revenue splitting is incorrect under the terms of the CAPL Operating Procedure. There is no reason why a period of one year should be chosen for the reconciliation of accounts. In fact, 1981 CAPL Clause 605 requires distribution of proceeds received for another's share of production within 10 days after receipt. However, delayed accounting has certain redeeming features; primarily, it gives the party who has arranged the better contract the benefits of his efforts, and does not distribute them to the producer who is selling at a discount. The revenue sharing method described in the two examples above often does not meet with the intention of the parties.

VII. GAS BALANCING AGREEMENTS

The factual situations described above are bound to occur much more frequently in the future because it is becoming more common for joint owners of lands to dispose of their production to different purchasers, and if the revenue sharing method as described is not acceptable, alternative arrangements should be entered into prior to discovery and contracting of new reserves. In the United States, producers have faced multiple-purchaser, split-sales problems for years because of the larger number of pipeline companies negotiating for the purchase of gas. In response to the problem, gas balancing agreements are often included as an attachment to an operating procedure. A form of gas balancing agreement which might be useful in Canada to overcome split-sales problems attached is set out in the Appendix to this paper.

The gas balancing agreement provides that a joint owner may produce more than its respective share of production from time to time and may receive the revenue for it. The parties who have not produced their respective share do not receive a portion of the production revenue, but they do earn a gas-in-storage "credit" equal to the amount of the underproduction. An underproduced party may then recover its underproduction by taking more than its respective share of production in the future, up to a limit of 50 percent of the proportionate share of production of the overproduced parties. This 50 percent limit is a negotiable figure.

Many United States gas balancing agreements require that each party pay all production and overriding royalties with respect to its proportionate share of production. This requirement often creates difficulties because the underproduced party must pay royalties on production revenue it has not received. Sometimes, the underproduced party does not pay the royalties, and royalty-owners cause problems. The gas balancing agreement set out in the Appendix requires overproducing parties to pay the royalties of the underproduced parties in respect of the portion of production which represents the underproduced parties' share. This may be an accounting headache, but it does solve one of the major problems involved in gas balancing.

The agreement prohibits any party from taking more than its share of the total amount of recoverable gas from any formation. If production is permanently discontinued and there are imbalances in production, then the overproduced parties must pay damages to the underproduced parties representing the revenue received for the overproduction. The overproduction revenue is deemed to be the revenue from the most recent sales by the overproduced party; in other words, at the most recent price received by the overproduced party.

Implementation of a gas balancing agreement would require amendments to CAPL Article VI (or its equivalent in other operating procedures). Clause 601 would stay, but Clauses 602 to 605 would be deleted and replaced by a clause that refers to the "attached" gas balancing agreement, which deals with the rights of the parties to produce and receive revenue from the various formations under the joint lands.

The gas balancing agreement is not the sure-fire solution to split sales problems. Indeed, it may create as many problems as it solves. For example, the lack of cash settlement to underproduced parties, except at the cessation of production, is risky for the underproduced parties. Payment of the cash balance is dependent on the continuing existence and solvency of the overproduced party. Periodic cash settlements might reduce the seriousness of this problem. Also, the underproduced party must pay its proportionate share of operating costs even though it may be receiving little or no production revenue. Accounting for over and underproduction may be complicated and the Operator may have to make difficult decisions relating to the balancing of production among the parties during periods when an underproduced party is recovering its underproduction. Accounting for the payment of royalties for underproduced parties by overproducing parties could become an accountant's nightmare. Nevertheless, the gas balancing agreement can be very useful in resolving problems that arise where one party has a contract to sell its share of gas from a reservoir and other parties have not yet arranged contracts, and in situations involving gas contracted to different purchasers at different prices. As situations of the latter type occur more frequently as appears to be the trend, gas balancing may become a more common arrangement.

Another situation in which a gas balancing agreement may be valuable, or perhaps even necessary, is a situation in which a producer has a gas purchase contract that contains a dedication of lands. A true dedication of lands to a gas purchaser may create a conflict between the terms of the operating agreement and the gas purchase contract. If a producer has dedicated his reserves to a particular purchaser, the dedication is breached if another joint producer produces more than his proportionate share. Many contracts provide for this problem by acknowledging that overproduction might occur and requiring the purchaser to pay overproduction revenues to the parties entitled thereto, or by stating that the contract is subject to co-tenant's rights. A contract that states that performance is subject to all applicable laws and statutes may also resolve the problem, because a co-tenant's right to take gas and to account for revenue received is a matter of law and statute. However, for those contracts that do not contain such terms, a gas balancing arrangement entered into with the acknowledgment of the gas purchaser should resolve the conflict between operating agreement and gas purchase contract.

APPENDIX A

SCHEDULE " "

ATTACHED TO AND MADE A PART OF THE OPERATING PROCEDURE ENTERED INTO ____________________, 19____ BETWEEN

____

GAS BALANCING AGREEMENT

In accordance with the terms of Article VI of the Operating Procedure this agreement shall apply separately to each separately metered formation or group of formations ("Separate Source") in each well covered by the Operating Procedure.

Each party has made (or will make) arrangements to sell or utilize the share of the gas produced from each Separate Source attributable to such party's participating interest in the oil and gas leasehold in such Separate Source (the party's "Gross Share"). It appears, however, that such arrangements of the parties may allow commencing delivery at different times or be limited from time to time; therefore, to permit the parties as much flexibility as possible the parties have agreed as follows:

1. From and after the date of initial delivery of gas from a Separate Source, during any period when a party is taking less than its Gross Share of the gas produced from said Separate Source, any other party may take from said Separate Source all or a part of that portion of the maximum or allowable gas production which is not taken by a party taking less than its Gross Share. The parties hereto at all times shall share in and own the liquid hydrocarbons recovered from such gas in accordance with their respective interests.

2. The over or underproduction of each party shall be determined by comparing:

(a) such party's Gross Share of the total gas produced and saved, less the portion of such gas attributable to the total burden of royalty, overriding royalty and production payments burdening such party's interest,

to

(b) the portion of the total gas produced and save which such party has taken, less the portion of such gas attributable to the total amount of royalty, overriding royalty and production payments paid by such party.

The amount by which any party is underproduced shall be considered gas in storage. Operator will maintain an account of the status of each party's overproduction or underproduction and will furnish each party monthly statements showing the total quantity of gas produced, the total quantity of gas taken by each party, and the monthly and cumulative over and underproduction of each party.

3. After notice to the Operator, any underproduced party may at any time begin taking its Gross Share of gas produced and saved. To allow the recovery of gas in storage and to balance the gas account of the parties in accordance with their respective undivided interests, all underproduced parties taking gas at any time shall be entitled to take, in addition to their Gross Shares, an amount of gas equal to the total of one-half of the Gross Share of gas produced and saved of each overproduced party and all gas produced and saved attributable to the Gross Share of any underproduced party or to the remaining one-half of the Gross Share of any overproduced party, which such party does not wish to take, or such lesser amount of makeup gas as the underproduced parties shall inform Operator they wish to take. Such makeup gas shall be taken by the underproduced parties in the ratio of their respective cumulative underproductions, or as they shall otherwise agree and advise Operator. Should the underproduced parties take a lesser amount of gas than the full amount of makeup gas they are entitled to under this paragraph 3, any portion of such gas which must be taken from the gas attributable to the Gross

Shares of overproduced parties wishing to take more gas than available to them under the terms hereof, shall be taken from the Gross Share of such overproduced parties in the ratio of their undivided interests in the Separate Source.

4. Nothing herein shall be construed to deny any party the right, from time to time, to deliver to a purchaser its Gross Share of the maximum or allowable gas production to meet the deliverability test required by its purchaser. Each party shall, at all times, use its best efforts to regulate its takes and deliveries from said well so that said well will not be shut in for overproducing the allowable assigned thereto by any applicable regulatory authority.

5. Operator shall control gas production and administer the provisions of this agreement. In effecting the provisions of this agreement relating to the balancing of the amount of gas taken by each party, the reasonable and good faith determinations of Operator shall be binding on the parties. Operator shall make reasonable efforts to meet the desires of each party for the amounts and timing of such party's takes but shall not be required to adjust such takes more often than the first of each calendar month.

6. For purposes of determining obligations to pay royalties, overriding royalties and production payments each party taking more than its Gross Share of gas for any month shall be deemed to have taken a portion of the gas not taken by each party taking less than its Gross Share of gas equal to such overtaking parties share of the total overproduction for the month. Other provisions contained in the Operating Agreement notwithstanding, each party taking more than its Gross Share of gas shall be responsible for the payment to each royalty, overriding royalty and production payment owner entitled to a portion of the proceeds received for the gas which such party takes attributable to the interest of a party taking less than its Gross Share, such payment to be based upon the gas produced and the price received. Each party hereto taking less than its Gross Share at any time hereby indemnifies the other parties hereto against the claims, demands and causes of action which have as their basis an alleged entitlement to payment in excess of that received by the party taking the gas, of royalty, overriding royalty and production payment owners to whom such indemnitor is obligated under the applicable leases or other instruments which create such interests.

7. Each party taking gas shall pay any and all production taxes due on such gas.

8. No party shall take gas after such party's cumulative total of gas taken less the portion of such gas attributable to the total amount of royalty, overriding royalty and production payments paid by such party equals such party's Gross Share of the total amount of recoverable gas in the Separate Source, less the portion of such gas attributable to the total burden of royalty, overriding royalty and production payments burdening such party's interest.

9. If upon the permanent discontinuance of production of gas from a Separate Source it is determined that any party has taken gas in violation of the covenant

in paragraph 8, the damages due from and to each party shall be liquidated as follows:

(a) each overproduced party shall pay to a liquidated damage pool the amount received, including tax reimbursement, by such party for the amount of gas by which such party is overproduced less all production taxes attributable to such amount;

(b) for purposes of calculating the amount of damages due pursuant to subparagraph (a) the amount of each overproduced party's overproduction shall be deemed to have been sold by such party after the sale of all gas to which such party was entitled as such party's Gross Share in the Separate Source;

(c) the underproduced parties shall divide the Pool in the ratio of their respective underproductions;

(d) for purposes of calculating the amount of damages due pursuant to subparagraph (a) the amount received by any overproduced party taking gas for its own consumption or delivering or selling such gas to an affiliated party shall be deemed to be the weighted average price received by the other parties selling gas to non-affiliated buyers from the Separate Source at the time of such taking or delivery or the amount received by such overproduced party, whichever is higher; and

(e) if there is no price received by another party selling to a non-affiliated buyer to calculate a price under subparagraph (d), the average price referred to therein shall be the market value of the gas at the time of the sale.

10. Nothing herein shall change or affect each party's obligations to pay its proportionate share of all costs and liabilities incurred, as its share thereof is set forth in the Operating Procedure.

11. This agreement is binding upon the parties to the Operating Procedure and their respective heirs, successors and assigns. It is agreed that this agreement is a covenant running with the oil and gas leases subject to the Operating Procedure. The parties hereto agree to give notice of the existence of this agreement to any successor in interest of such signatory party to any oil and gas lease subject to the terms of this agreement. This agreement shall be and remain in force and effect for a term concurrent with the term of the Operating Procedure between the parties hereto.

APPENDIX B

ALBERTA NORP OIL BLOCK PRICE SCHEDULE

September 1, 1983

Sulphur

Density: kg/m³ ↓ / Sulphur: g/kg →	51 0.0-2.4	52 2.5-4.9	53 5.0-9.9	54 10.0-14.9	55 15.0-19.9	56 20.0-24.9	57 25.0-29.9	58 30.0-34.9	59 35.0 and over
D1 824 and under	240.60	236.40	232.20	228.00	223.80	219.60	215.40	211.20	207.00
D2 825 - 844	236.10	231.90	227.70	223.50	219.30	215.10	210.90	206.70	202.50
D3 845 - 864	231.60	227.40	223.20	219.00	214.80	210.60	206.40	202.20	198.00
D4 865 - 884	227.10	222.90	218.70	214.50	210.30	206.10	201.90	197.70	193.50
D5 885 - 909	222.60	218.40	214.20	210.00	205.80	201.60	197.40	193.20	189.00
D6 910 - 934	218.10	213.90	209.70	205.50	201.30	197.10	192.90	188.70	184.50
D7 935 - 959	213.60	209.40	205.20	201.00	196.80	192.60	188.40	184.20	180.00
D8 960 - 984	209.10	204.90	200.70	196.50	192.30	188.10	183.90	179.70	175.50
D9 985 and over	204.60	200.40	196.20	192.00	187.80	183.60	179.40	175.20	171.00

The price shown is in dollars per cubic metre. One cubic meter is equal to 6.293 barrels.