

Oil, Gas and Salt Resources Act:

Document of Explanation

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This guide is published by the Mining and Lands Tribunal and is intended to give general information only. The information that is conveyed in this guide does not constitute legal advice. For more detailed information or legal reference, please refer to the *Oil, Gas and Salt Resources Act*.

Document of Explanation

This document is an explanation of respective applications, the legislation and the process which is followed concerning matters before the Mining and Lands Tribunal under specific legislation.

Note: This explanation is not a legal document and does not attempt to explain all aspects of oil and gas rights and terms; however it does attempt to explain to the affected parties the processes in connection with an application. This document is designed to be understood by those not normally involved in legal proceedings to provide them with a reasonable level of comfort and understanding in the subject matter.

As will be explained in greater detail below, one of the ways in which unitization may occur requires that all landowners be governed by both a lease and a unit operating agreement.

One item requires clarification at the outset. The term "pooling" means to join all of the various interests in a spacing unit. The term "unitize" means to join all of the various interests in a reservoir or pool. Please be aware of these seemingly contradictory definitions.

Authority

The Mining and Lands Tribunal is a quasi-judicial body. The Tribunal derives authority to make decisions regarding matters which are assigned through appointment by the Ontario Legislature under the *Ministry of Natural Resources Act*. Under the *Mining Act*, the Tribunal has been given the power to call a hearing and require information to be provided. This proceeding resembles a trial. The outcome of the hearing is the issuance of an Order, which is legally binding, deciding the rights of those parties involved.

Under the *Oil, Gas and Salt Resources Act*, the Tribunal is empowered to make decisions after a hearing, including decisions regarding applications for pooling and unitization. Where the resulting Order allows the pooling or unitization, it can be registered on the titles of the effected properties. If the application is disallowed, the resulting Order will not be registered on title and the status of the parties will remain unchanged.

Oil and gas exploration and production in Ontario

Oil and gas resources in Ontario

Oil and gas are found in sedimentary basins in rock formations that were formed under ancient seas. There are four sedimentary basins in Ontario, the Appalachian, Michigan, Hudson Bay and Moose River. Although all of these basins have the potential for oil and gas occurrences, commercial production occurs only in southern Ontario within the Appalachian and Michigan basins. There is no oil or gas contained in the crystalline rocks of the Canadian Shield. Commercial oil and gas mineral occurrences, are found mainly in southern Ontario, south and west of Toronto.

Landowners own minerals

In Ontario, landowners can own the minerals found under or in their property and these minerals include oil and gas. In southern Ontario mineral rights are usually held by the landowner (freehold mineral ownership). As owners of the minerals, landowners are free to enter into agreements, such as petroleum and natural gas leases, to allow for exploration and production of oil and gas.

Leasing of mineral rights

Individuals rarely drill on their own property due to the speculative nature, high cost, and technical complexity of drilling for and producing oil or gas. Resource companies carry out most exploration activities in the province.

To obtain the right to search for oil and gas or other minerals, companies usually lease the mineral rights from the landowner. Most oil and gas companies in Ontario use professional land leasing companies to act on their behalf to secure mineral rights leases. Legal ownership of mineral rights may be determined by searching the title at the local Land Registry Office.

A Petroleum and Natural Gas Lease (P & NG lease) allows for the exploration and production of oil and/or natural gas and provides for the payment of rent to the landowner and production royalties should production of oil or gas occur. Leases are legal agreements between the mineral right owner and the oil and gas company. Landowners may wish to consult with legal counsel that are familiar with oil and gas matters prior to signing a lease.

Well

The term "well" is defined in the *Act* as follows:

"well" means a hole drilled into a geological formation of Cambrian or more recent age for the purpose of,

- a. oil or gas exploration or production
- b. the storage of oil, gas or other hydrocarbons in a geological formation
- c. disposal of oil field fluid in a geological formation
- d. solution mining, or
- e. geological evaluation or testing

Well licence

Before conducting any activity on a well including drilling a well or producing oil and gas, a well licence must be obtained from the Ontario Ministry of Natural Resources and Forestry (MNRF).

Spacing unit

Drilling for oil or gas must take place within the target area of a pooled spacing unit. The following definitions taken from the *Act* and its regulations refer to this requirement:

- "spacing unit" means a surface area and the subsurface beneath the surface area, established for the purpose of drilling for or the producing of oil or gas
- "target area" means the area within a spacing unit that is allocated for drilling a well
- "pooled spacing unit" means a spacing unit in which all the various oil and gas interests have been pooled
- "pooling" means the joining or combining of all the various oil and gas interests within a spacing unit for the purpose of drilling and subsequently producing a well

Spacing units are required and established by regulations under the *Act* and by the Minister on the well licence and by Minister's order for an area as circumstances warrant. The size of a spacing unit and its target area that is required for a well is related to the depth or age of the formation targeted by the drilling and the productive capability of the well and the pool. In general, the deeper the geological target the greater the productive capability of the well and therefore, the larger the spacing unit.

Where the township lot and concession survey fabric of the land is regular, spacing units are comprised of tracts depending on the drilling depth.

Tracts

The word "tract" has two definitions in the regulation:

- a. For the purposes of establishing spacing units, standard 200 acre and 100 acre township lots are divided into rectangles of equal size known as tracts. Each tract is 10.12 hectares (25 acres) in size more or less. Where the township survey is irregular MNR staff devise a similar system of tracts on a case by case basis
- b. For the purposes of applications made to the Mining and Lands Tribunal to pool or unitize lands, tract refers to a particular mineral interest within a spacing unit or proposed unit area (the area proposed for unitization). For example, where landowners located in a spacing unit own the minerals underlying their property the land of each landowner is referred to as a tract

Correlative rights

Correlative rights mean the inherent right of an owner of oil or gas in a pool to his share of the production and reservoir energy and his right to obtain his just and equitable share of production and to be protected from wasteful practices by others in the pool. Where a mineral owner's lands make up part of a spacing unit or unitized pool the mineral owner's royalty is based on the proportion of the mineral owner's part of the spacing unit or unitized pool.

In Ontario, it is common practice for an owner's interest in a spacing unit or unit area to be based on the proportion of his land area to the total area within the spacing unit or unit boundary, however, other calculations are possible. The amount of royalty received will depend on this proportion, the royalty rate stated in the lease or unit agreement and the amount of oil or gas produced.

Protection of correlative rights

The primary means to protect correlative rights provided by the province under the *Oil, Gas and Salt Resources Act* is the requirement placed on operators to drill and produce a well within the target area of a pooled spacing unit.

Modification of spacing units

As stated above, spacing units are established by regulation, on the well license and by Minister's order. These methods can be viewed as a progression or evolution for fine tuning spacing units to the specific geology of the oil or gas pool as new information is acquired by geological and geophysical study and interpretation, drilling, well tests and the well(s) production history.

At the outset of oil and gas exploration, the nature of any subsurface oil or gas resource is unknown. However, correlative rights have to still be protected since drilling and producing a well could have an immediate effect on them. Therefore, standard spacing unit requirements are placed in the regulations. These standard spacing units are somewhat arbitrary and may not reflect the actual production characteristics of a well once it is drilled.

Operators that discover new oil or gas pools are therefore required to apply to the Minister to establish new spacing units based on the information obtained at the time of discovery. This will in turn result in a more accurate protection of correlative rights.

The application to establish spacing units by Minister's order must be accompanied by all available technical data on the pool, the well(s) and must include the probable area of the pool. Once the MNRF reviews this information, then it establishes appropriately sized spacing units over the probable area of the pool by Minister's order and provide protection to the correlative rights within this area.

There is no right in the *Act* for a mineral owner to "opt out" of the spacing units in which their interest is located since this would put the land at risk of being drained without compensation. Spacing unit requirements under the *Act* protect against uncompensated drainage of oil or gas and prohibit individuals from preventing its neighbours within the unit from enjoying the benefits of production from their own lands.

In addition, any person having an oil and gas interest in a pool may apply to the Minister to modify existing spacing units. The application process is the same as applying for spacing units upon discovery of a new pool.

Operator

The *Act* defines "operator" as follows:

"operator" means, in respect of a work,

- a. the person who has the right as lessee, sub-lessee, assignee or owner to operate a work and the person who has the control or management of the operation of the work, or
- b. If there is no person described in clause (a), the owner of the land on which the well or work is situated

This definition includes all persons, companies involved with wells and associated works governed by the *Act* and generally means all leased situations as it is generally understood as meaning the oil and gas companies responsible for oil and gas wells and

works. However, the definition also encompasses landowners on whose land a well is located if no lease to an oil and gas company covers that land.

Pooling

Voluntary pooling

Before MNRFB will issue a well licence, all of the oil and gas interests in the spacing unit must be pooled. When all of the oil and gas mineral interests have been leased to the operator of the proposed well, the spacing unit is pooled and drilling and/or production may commence.

Leases that are issued today usually contain clauses that allow the lessee to unilaterally pool his or her leased interest with other leased interests up to one spacing unit. Older leases that predate spacing legislation will require separate pooling agreement to be executed by each mineral interest owner to accomplish the pooling requirement.

Compulsory pooling

The *Act* provides for means to apply to the Mining and Lands Tribunal for an Order that pools the oil and gas interests within a spacing unit where voluntary efforts to pool have failed. This authority for this order is found in clause 8(1)(a) of the *Act* and is referred to as the compulsory pooling of a spacing unit.

There is no automatic right to a pooling order. A decision will be made after a hearing at which the applicant and the unpooled oil and gas interest owner(s) will present their position(s). Where the unpooled interest owner fails to attend the hearing and make their position and reasons known, the tribunal will proceed with the hearing and make a determination without having their views taken into consideration.

In an application to the tribunal by an operator, those unleased mineral owners will be identified and made parties to the proceeding. In most circumstances, the operator seeks to have a P & NG lease deemed to apply to those unleased parties by Order of the tribunal.

The tribunal at a compulsory pooling hearing will determine whether to apply the lease to the unleased parties by order. Where the tribunal decides to apply the lease to unleased parties then the terms of the lease will also be examined. Compulsory pooling orders are not automatic and unleased or unpooled mineral owners are encouraged to be frank in explaining their position to the tribunal.

Working and royalty interests

In the oil and gas business, the petroleum and natural gas interest is usually composed of a Working Interest and a Royalty Interest. A landowner that leases his oil and gas mineral rights voluntarily or a landowner whose oil and gas mineral rights are pooled by

the imposition of a P & NG lease by Order of the tribunal are referred to as a Royalty Interest.

This terminology, comes from the fact that the landowner retains a royalty interest in exchange for granting the mineral interest to the lessee. The lessee or operator earns the working interest by spending money to explore, discover and develop the resource and by assuming all of the risk of the venture with respect to its success or failure.

Landowner as a working interest

Non-leased landowners may wish to participate as a working interest for the purposes of drilling a well in a spacing unit. Where such a case is brought to the tribunal the landowner would be put in the position of an operator with respect to sharing in the working interest but would also share in the operating costs and risks. If so ordered, the landowner would be required to contribute their proportionate share of the costs of drilling and operating the well(s).

Utilization

Background

Over time an oil and gas company may obtain sufficient information about the pool it has discovered to accurately define its limits and physical characteristics. This information is usually obtained from the wells it has drilled, well testing, the production history of the wells, and geological and geophysical interpretation of the pool. When sufficient information is obtained, the operator may wish to unitize the pool. Essentially this means that they wish to combine all the oil and gas interests in the known pool into a single operation. The mineral interests in a pool are usually more accurately defined in a unitization agreement than the area proportions determined within spacing units.

The benefits of unitization to the operator include streamlined operations, centralized facilities, and a lower economic production limit due to lower operating costs and additional recovery of oil or gas. The benefits of unitization to landowners include a longer production life of the pool (more royalties), less surface production equipment and a guarantee of a share in production regardless of whether a well is located on their land or spacing unit. The latter benefit occurs since all production from a unitized pool is deemed to have come from all interest owners.

Voluntary unitization

Where voluntary or compulsory unitization is implemented one of the operators is chosen to be the initial unit operator. The initial unit operator is usually the operator having the greatest working interest in the pool. A unit operating agreement will govern the manner in which the unit will be managed and the division of royalty and working interests.

At the time of unitization, landowners will fall into different categories depending on how they have handled their mineral rights. There will be those who have signed P & NG leases, those who have not signed a P & NG lease and those that oppose the unitization.

Unitization clause in a P & NG lease

Modern leases usually contain a clause that authorizes the lessee to unilaterally unitize the lessor's lands with other interests within an oil or gas pool. Where no such clause exists in a lease a separate unit agreement must be obtained from the landowner to unitize the oil and gas interest.

Unit agreement

To obtain a fully unitized pool the operator must combine all of the oil and gas interests whether by exercising unitization clauses in the leases or by separate unit agreements. Until such time as unitization is completed, the oil and gas interests in the pool are governed by existing spacing and pooling rules.

Unitization agreements modify leases

Unit agreements modify the terms of existing leases to allow for the unitization of the pool or field including the establishment of the unit area and the unit's expansion or contraction as development continues.

Unitization eliminates the need to drill a well on each spacing unit and allows production royalties to be distributed to all interest owners participating in the unit. There may be different proposals regarding the manner by which royalty shares are determined. They may be based on a landowner's land area relative to the entire unit area or they may be based on a three-dimensional volume calculation of the reservoir. Both may be modified by various tract factors assigned to individual tracts.

Unit participation

Of the leased lands to be included in a unitized area, those that actually cover the underlying pool are characterized as "participating" while those that are outside the pool are termed "non-participating ". Where such a distinction has been made in the unit agreement the production royalty will be paid only to those "participating" interests in the manner described in the unit agreement. In other words, only those parties that actually own the oil or gas interests will be compensated for its production.

Compulsory unitization

Where the various interests cannot agree to unitize or where an interest wishes to otherwise accomplish the unitization of an oil or gas pool, the proponent of a unitization may apply to the tribunal for an Order requiring the joining of the various oil and gas interests in a pool. When the tribunal issues an order to unitize a pool, unleased interests will be deemed to be either a royalty interest or a working interest. Royalty interests will have a P & NG lease applied to them and working interests will be subject to the working interest provisions of the unit operating agreement attached to the order. In addition, the order will direct that all working and royalty interest owners be subject to the unit agreement. The terms of the proposed unit agreement will be examined in detail during the course of the hearing.