IMPERIAL OIL LIMITED (*Plaintiff*) ....APPELLANT;

AND

PLACID OIL COMPANY (*Defendant*) ..RESPONDENT.

1963

*May 22

June 24

ON APPEAL FROM THE COURT OF APPEAL FOR SASKATCHEWAN

Real property—Petroleum and natural gas lease—Farm-out agreement—Production of petroleum—Property interest of Crown in percentage of recoverable oil—Effect on royalty obligations—The Road Allowances Crown Oil Act, 1959, (Sask.), c. 53.

One B, as registered owner, leased to the plaintiff all the petroleum, natural gas and related hydrocarbons within, upon or under certain described lands. He also leased to the plaintiff his right, title, interest and estate in and to the leased substances, or any of them, within, upon or under any lands excepted from, or roadways, lanes, or rights-of-way adjoining, the said lands. The plaintiff agreed to pay a gross royalty on the leased substances produced, saved and marketed from the lands, which royalty, in respect of crude oil, was fixed at 12½ per cent of the current market value of the crude oil produced.

By a farm-out agreement the defendant agreed to drill a well and to pay the plaintiff upon production an overriding royalty of 5 per cent of the value of all crude oil and naphtha produced. The defendant agreed to perform all of the plaintiff's obligations under the lease and to indemnify the plaintiff against all claims and demands which it might sustain, pay or incur consequent upon the failure of the defendant to carry out any of the plaintiff's obligations contained in the lease.

Petroleum production was obtained and the defendant, when paying the royalties to the lessor and to the plaintiff in respect of its production of oil from the lands during the period in question, computed same upon the total production of such oil, less 1.88 per cent thereof, and claimed that it was entitled to make the deduction by reason of *The Road Allowances Crown Oil Act, 1959*. The plaintiff, apparently feeling itself obligated to do so under the terms of the lease, thereupon proceeded to pay to the lessor the difference between a royalty computed on the total production and the amount of the royalty which had been paid to the lessor by the defendant. It then proceeded to sue the defendant for the amount which it had paid to the lessor and also for the difference between the 5 per cent overriding royalty computed on the total production and the amount of royalty which had been paid to the plaintiff by the defendant.

Both the Courts below decided in favour of the defendant and dismissed the plaintiff's action. The plaintiff then appealed to this Court, with leave of the Court of Appeal.

Held: The appeal should be dismissed.

Section 3 of *The Road Allowances Crown Oil Act, 1959*, declared a property interest in the Crown of 1.88 per cent of all the recoverable oil within the whole of a producing reservoir. No matter where the oil migrated

*PRESENT: Cartwright, Martland, Judson, Ritchie and Hall JJ.

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the Crown's interest remained in it and, on production, the property interest still remained. After the Act had provided for the payment to the Crown of 1 per cent of the value of all oil produced, or for the delivery of that percentage in kind in lieu of payment, s. 6 then provided that the owner might retain and dispose of "oil declared by section 3 to be the property of the Crown" to the extent of .88 per cent of the oil produced. This was a clear indication that the declaration contained in s. 3 was as to the ownership of oil produced from a reservoir and that of the 1.88 per cent thereof belonging to the Crown the owner, after paying for or delivering 1 per cent to the Crown, would be free to dispose of the remaining portion of the Crown interest for his own benefit. It followed that the defendant could not be compelled to pay royalty, under the provisions of the lease or the farm-out agreement, upon all the oil produced from the lands, because of that oil, 1.88 per cent was the property of the Crown.

So far as the lease was concerned, the obligation to pay royalty was upon the leased substances owned by the lessor and leased and granted by him to the lessee. The lessee could not be compelled to pay royalty upon oil which did not belong to the lessor. Similarly the defendant could not be obligated to pay royalty to the plaintiff, under the farm-out agreement, on that portion of the oil which it produced, not by virtue of rights conferred upon it by the lease, but pursuant to the provisions of the Act.

APPEAL from a judgment of the Court of Appeal for Saskatchewan[1], affirming a judgment of Brownridge J. Appeal dismissed.

J. Lorn McDougall, Q.C., and *D. E. Lewis, Q.C.*, for the plaintiff, appellant.

L. Harris McDonald, for the defendant, respondent.

The judgment of the Court was delivered by

MARTLAND J.:—The issue in this case involves the determination of the purpose and meaning of *The Road Allowances Crown Oil Act, 1959*, (Sask.), c. 53, which came into force on April 1 of that year and which is hereinafter referred to as "the Act".

The appellant is the lessee under the provisions of a petroleum and natural gas lease, dated April 23, 1949, from Emile Boutin, as lessor, in respect of the North Half of Section 15, Township 6, Range 1, West of the Second Meridian, in the Province of Saskatchewan, hereinafter referred to as "the lands". The lessor, as registered owner, or entitled to become registered owner, of the petroleum,

[1] (1962), 40 W.W.R. 412, 36 D.L.R. (2d) 122.

natural gas and all related hydrocarbons within, upon or under the lands, granted and leased to the appellant all petroleum, natural gas and related hydrocarbons, except coal and valuable stone, which were referred to in the lease as the "leased substances", within, upon or under the lands. He also granted and leased to the appellant his right, title, interest and estate in and to the leased substances, or any of them, within, upon or under any lands excepted from, or roadways, lanes, or rights-of-way adjoining, the lands.

The appellant agreed to pay a gross royalty on the leased substances produced, saved and marketed from the lands, which royalty, in respect of crude oil, was fixed at 12½ per cent of the current market value of the crude oil produced.

Clause 4 of the lease provided as follows:

4. LESSER INTEREST:—

If the Lessor's interest in the leased substances be less than the entire and undivided fee simple estate therein, then the royalties and rentals herein provided shall be paid the Lessor only in the proportion which his interest bears to the whole and undivided fee.

On March 30, 1959, the appellant and the respondent entered into a farm-out agreement, whereby the respondent agreed to drill a well on the lands and would thereby become entitled to earn the right to acquire the appellant's interest under the lease for the term of the lease less the last day thereof. An overriding royalty was provided in favour of the appellant on the production of petroleum substances from the lands, which, in the case of crude oil and naphtha, was 5 per cent of the value thereof produced from the lands. The respondent agreed to perform all of the appellant's obligations under the lease and to indemnify the appellant against all claims and demands which it might sustain, pay or incur consequent upon the failure of the respondent to carry out any of the appellant's obligations contained in the lease. The respondent did drill a well on the lands and obtained therefrom petroleum production.

The relevant provisions of the Act are as follows:

2. In this Act:

* * *

3. "oil" means crude petroleum oil and all other hydrocarbons, regardless of gravity, that are produced at a well in liquid form by ordinary production methods;

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4. "owner" means a person who has a right to drill into an underground reservoir and produce therefrom oil or gas or oil and gas and to appropriate the oil or gas he produces either to himself or others or to himself and others;

* * *

3. In every producing oil reservoir one and eighty-eight one-hundredths per cent of the recoverable oil shall be deemed to be within, upon or under road allowances and shall be the property of the Crown.

4.—(1) Except as provided in section 5, every owner producing oil shall be liable to pay and shall on or before the last day of each month, commencing with the month of May, 1959, pay to the minister one per cent of the value, calculated on the average prevailing well-head price, of the oil produced, free and clear of any deductions, during the preceding month.

Section 5 provided that the Minister of Mineral Resources could elect to take payment in kind instead of the money payment provided for in s. 4.

Section 6 provided as follows:

6. Subject to compliance with section 4 or 5, every owner producing oil may retain and dispose of oil declared by section 3 to be the property of the Crown to the extent of eighty-eight one-hundredths of one per cent of the oil produced, or the proceeds of the sale thereof, for his own use and benefit.

It is conceded that in this case the respondent is the "owner" within the meaning of subs. 4 of s. 2.

The question in issue is as to whether, in the light of the provisions of the Act, the respondent, in paying the royalties to the lessor under the lease and to the appellant under the farm-out agreement, is obligated to pay in respect of all the oil produced by it from the lands, or is obligated only to pay royalty upon (a) that quantity, less 1.88 per cent thereof, or (b) that quantity, less 1 per cent thereof. The respondent, when paying the royalties to the lessor and to the appellant in respect of its production of oil from the lands during the months from and including May 1959 to February 1960, computed the same upon the total production of such oil, less 1.88 per cent thereof. The appellant, apparently feeling itself obligated to do so under the terms of the lease, thereupon proceeded to pay to the lessor the difference between a royalty computed on the total production during the period in question and the amount of the royalty which had been paid to the lessor by the respondent. It then proceeded to sue the respondent for the amount which it had paid to the lessor and also for the difference between the 5 per cent

overriding royalty computed on the total production and the amount of royalty which had been paid to the appellant by the respondent.

Both the Courts below decided in favour of the respondent and dismissed the appellant's action. The appellant has appealed to this Court, with the leave of the Court of Appeal of Saskatchewan.

The appellant's contention may be summarized as follows: Section 3 of the Act does nothing more than to define, in arithmetic terms, the amount of oil, in place in a reservoir, which belongs to the Crown, as being within, upon or under road allowances. The title to such oil, in place, was already in the Crown by virtue of *The Mineral Resources Act, 1931,* (Sask.), c. 16, carried forward into c. 47 of the Revised Saskatchewan Statutes 1953, which was in effect when the Act came into force. That Act provided that mines, minerals and mining rights, in, on or under all public highways and road allowances, should continue to be vested in the Crown and might be leased or otherwise disposed of under the regulations. The Act does not purport to provide that the Crown is the owner of oil when actually produced at a well. Such oil is the property of the producer. Though he is compelled, by s. 4 of the Act, to pay to the Minister of Mineral Resources 1 per cent of the value of the production, this does not alter, in any way, the contractual obligation, imposed by the lease and the farm-out agreement, to pay royalty upon all the oil produced. That is a contractual obligation which is not affected by the provisions of the Act.

I am unable to accept this interpretation of the Act. Section 3 refers to a "*producing* oil reservoir"; *i.e.,* a reservoir from which oil, as defined in subs. 3 of s. 2, is being produced; namely, crude oil and those other hydrocarbons which, regardless of gravity, are produced at a well in liquid form by ordinary production methods. In such a reservoir 1.88 per cent of the oil which is recoverable is declared to be the property of the Crown. In my opinion, the consequence of this provision is that, of the oil which is actually produced

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from a producing reservoir, 1.88 per cent belongs to the Crown.

Counsel for the appellant contends that oil is a fugitive and migratory substance and that the law of capture applies to it. He cites, from the judgment of the Privy Council in *Borys v. Canadian Pacific Railway Company*[1], the following passage:

> The substances were fugacious and were not stable within the container, although they could not escape from it. If any of the three substances was withdrawn from a portion of the property which did not belong to the appellant but lay within the same container, and any oil or gas situated in his property thereby filtered from it to the surrounding lands, admittedly he had no remedy. So, also, if any substance was withdrawn from his property, thereby causing any fugacious matter to enter his land, the surrounding owners had no remedy against him. The only safeguard was to be the first to get to work, in which case those who made the recovery became owners of the material which they withdrew from any well which was situated on their property or from which they had authority to draw.

Lord Porter has here summarized the legal position of a landowner from within whose lands oil has migrated to the land of an adjoining landowner by reason of the operation of a well upon that land. Such, in the absence of s. 3 of the Act, would have been the legal position of the Crown in respect of oil which migrated from beneath a road allowance because of the operation of a well on adjoining land.

Section 3, however, declares a property interest in the Crown of 1.88 per cent of all the recoverable oil within the whole of a producing reservoir. This is a property interest, not in relation to oil situated beneath the surface of specific lands, but in respect of a portion of all the oil in the whole of a reservoir. The result is that, no matter to where the oil in that reservoir migrates, the Crown's interest remains in it and, on production, the property interest still remains.

This view of the effect of s. 3 is reinforced by the wording of s. 6. After the Act has provided for the payment to the Crown of 1 per cent of the value of all oil produced, or for the delivery of that percentage in kind in lieu of payment, s. 6 then goes on to provide that the owner may retain and dispose of "oil declared by section 3 to be the property of

[1] [1953] A.C. 217 at 220.

the Crown" to the extent of .88 per cent of the oil produced. This is a clear indication that the declaration contained in s. 3 was as to the ownership of oil produced from a reservoir and that of the 1.88 per cent thereof belonging to the Crown the owner, after paying for or delivering 1 per cent to the Crown, would be free to dispose of the remaining portion of the Crown interest for his own benefit.

Applying this view of the effect of s. 3 of the Act, it must, I think, follow that the respondent cannot be compelled to pay royalty, under the provisions of the lease or the farm-out agreement, upon all the oil produced from the lands, because, of that oil, 1.88 per cent is the property of the Crown.

In so far as the lease is concerned, the obligation to pay royalty is upon the leased substances owned by the lessor and leased and granted by him to the lessee. The lessee cannot be compelled to pay royalty upon oil which does not belong to the lessor and this conclusion, which, I think, must follow, even apart from the provisions of clause 4 of the lease, is reinforced by the terms of that clause.

Similarly, in my opinion, the respondent cannot be obligated to pay royalty to the appellant, under the farm-out agreement, on that portion of the oil which it produces, not by virtue of rights conferred upon it by the lease, but pursuant to the provisions of the Act.

In my opinion, therefore, the appeal should be dismissed with costs.

Appeal dismissed with costs.

Solicitors for the plaintiff, appellant: McDougall, Ready & Hodges, Regina.

Solicitors for the defendant, respondent: Balfour, MacLeod, McDonald, Laschuk & Kyle, Regina.