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M A T T E R S

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Alberta Announces New Royalty Regime

by Ray E. Quesnel

INTRODUCTION

On October 25, 2007, Alberta announced its new policy on oil and gas royalties. The policy is generally consistent with the proposals in the Royalty Review Panel Report issued a month earlier. There are, however, some important differences. The new policy represents the first major overhaul of the provincial royalty regime in over thirty years. A comprehensive policy review at this time should not come as a surprise having regard to the mature if not declining nature of the conventional oil and gas sector in Alberta, the shift in focus to oil sands and a relatively long period of high commodity prices. With some exceptions, industry will see a significant increase in royalty rates. The Province predicts a 20% increase in royalty revenues. The announcement has been met with disappointment by industry and scepticism in some quarters about government estimates of the size of increased royalty revenues. As with taxes, increased royalty rates will not necessarily yield corresponding increases in revenue.

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Highlights

The following are some of the highlights of the new policy:

- the new royalty structure will become effective January 1, 2009;
- the distinction between old and new production is eliminated and there will be no grandfathering for existing projects;
- conventional oil will be subject to a sliding scale royalty that is sensitive to prices and to production volumes with rates ranging from 0% to 50%, with the maximum rate being payable on high volume wells when oil prices reach \$120 per barrel;
- conventional natural gas will be subject to a sliding scale royalty that is sensitive to prices and to production volumes with rates ranging from 5% to 50%, with the maximum rate being payable on high volume wells when gas prices reach \$16.59 per GJ;
- royalties will increase to 40% on NGL and 30% on butanes and propane;
- oil sands will be subject to sliding scale royalties that are price sensitive with gross royalty rates prior to payout ranging from 1% to 9% and net revenue royalties after payout ranging from 25% to 40%, in each case as prices move from \$55 to \$120 per barrel;
- the proposed Oil Sands Severance Tax was rejected;
- the proposed 5% upgrader credit was rejected as ineffective, the government choosing instead to consider other options such as taking in kind its share of bitumen, investing in infrastructure projects and the like to stimulate value added activities within Alberta;
- the Province intends to establish a bitumen valuation methodology (BMO) by June 30, 2008 which will be, in essence, a deemed price for bitumen in the absence of a well functioning and transparent spot market for bitumen; and
- while not a royalty measure *per se*, the province intends to require shallow gas rights reversion similar to the deep rights reversion of the early 1980's. This new initiative might prove even more complicated having regard to its possible effects on already existing deeper rights and facilities.

FAIR SHARE

The new royalty regime is premised on the notion that the provincial government, on behalf of Albertans, should obtain a “fair share” of the value obtained from the exploitation of Crown resources. On its face, this is a reasonable proposition. However, the term “fair share” has no particularly useful commercial, economic or legal meaning. What is meaningful is whether, under a particular fiscal regime, industry can obtain acceptable rates of return on investment. In a global economy, the pursuit of investment capital is very competitive. Admittedly, the design of any fiscal regime is always difficult, never perfect and subject to change. It is all the more difficult in a federal state such as Canada where the total “government take” from resource exploitation is subject to the policies and legislation of two levels of government which do not necessarily have the same policy objectives. As has been observed, there are as many fiscal regimes in the world as there are jurisdictions and making comparisons between the efficacy of fiscal regimes across jurisdictions is extremely difficult having regard to differing operating conditions, cost structures, political risk and so forth. Stability in fiscal regimes is a desired goal and, fortunately, Alberta has benefited in the past from the stability of its royalty regime. Whether the new Alberta policy will be successful remains to be seen. Early indications are that the new policy may result in decreased

investment, resulting in less exploration and development and, ultimately, lower production. Several companies have already announced decreases in capital expenditure budgets in the wake of the new policy. This may be an early warning signal that the new policy may have unintended, adverse consequences for the Alberta economy.

IMPLICATIONS

The new policy will provide royalty relief for older, low productivity wells increasing their longevity. This makes sense in the context of a maturing basin. On the other hand the new policy has been criticized for shifting the royalty burden to new higher risk, higher impact deep gas wells thus creating a disincentive for investment. At the macro level though, the larger shift in royalty burden is in the treatment of oil sands. Here, the government went well beyond the proposal in the Royalty Review Panel Report. That the government chose to do this may not be surprising have regard to the size of the oil sands reserves and the role they will play in the future of the oil and gas sector in Alberta. Again, the approach of the Royalty Review Panel has been criticized for using outdated cost and foreign exchange assumptions. The result may be that the increased royalty burden will be a disincentive to the development of the oil sands sector, yielding less royalty revenue and other economic benefits than anticipated by the new policy.

As noted, there will be no grandfathering for existing projects. The Royalty Review Panel itself stated that changing the rules may not be “best practices” but added that it is definitely not best practice for government to accept something less than its fair share. This, of course, begs the question of what, if anything, “fair share” really means. Clearly, with respect to conventional oil and gas, the Mines and Minerals Act reserves that royalty which may be prescribed by regulation from time to time and the government has the authority to change the regulations. The oil sands generic royalty is embedded in the Mines and Minerals Act itself. Changes to the generic oil sands royalty will require the legislature to enact amendments of the statute. Ultimately, the Province has the legislative authority to change the rules. The manner in which it does so rests on policy and political considerations.

The government recognizes its policy statement is a framework document and, as further work proceeds on the development of the new royalty regime, adjustments may be made to ensure that there are no unintended consequences. Indeed, the Government has already suggested it may be amenable to tweaking its new royalty policy. Hopefully, industry has and will seize the opportunity to influence the shape of the new royalty regime in a meaningful way.

The Implications of UNCLOS for Canadian Offshore Oil and Gas Development*

by Keith F. Miller

INTRODUCTION

Recently, Russia planted its flag encased in a titanium capsule on the ocean floor beneath the North Pole and laid claim to a large swath of seabed territory and resources in the Arctic. These actions have drawn a great deal of media attention to a UN treaty that previously had been the subject of few headlines—the United Nations Convention on the Law of the Sea (UNCLOS). Canada’s then Foreign Affairs Minister, Peter MacKay, tersely dismissed the drama of Russia’s declaration—“Look, this isn’t the 15th century. You can’t go around the world and just plant flags and say ‘We’re claiming this territory.’”

The essence of Mr. MacKay’s evocative rebuke is fundamentally correct. That is because UNCLOS has established the rules governing the rights of coastal nations to exercise authority over seabed territory and resources, and the mere planting of flags is not one of them. Russia’s antic is at best symbolic, but otherwise meaningless under current international law. The validity and areal extent of Russia’s claim will have to be determined under the procedures prescribed by UNCLOS.

THE EMERGENCE OF CONTINENTAL SHELF RIGHTS

The period following the Second World War saw an escalation in the number of conflicting claims regarding sovereign rights over areas and resources of the sea, including rights to exploit and extract resources from the seabed in areas beyond territorial waters. The breadth and

nature of those claims varied widely. What is now sometimes referred to as the “continental shelf regime” emerged from the proclamation of President Truman in 1945 that the United States regarded the natural resources of its contiguous continental shelf to appertain to the United States and to be under its jurisdiction and control.¹ Major developments in the law of the sea followed that proclamation and culminated in the UNCLOS, which was adopted in 1982, entered into force in 1994 and ratified by Canada in 2003.

Simply put, UNCLOS is a comprehensive international framework of enormous magnitude that stipulates the rights and obligations of coastal nations respecting access to and use of the oceans and their resources. Among other matters, it addresses the establishment of specific maritime areas with associated rights and responsibilities, navigation rights, conservation and management of living resources, protection and preservation of the marine environment, scientific research, and the development and transfer of marine technology.

THE IMPLICATIONS FOR OFFSHORE OIL AND GAS DEVELOPMENT

UNCLOS removed uncertainty surrounding differing and sometimes conflicting claims to continental shelf rights. It established four maritime areas for coastal nations that have relevance to offshore oil and gas development—a 12-mile territorial sea, a further 12-mile contiguous zone under which coastal nations can enforce or prevent

contraventions of certain territorial laws, a 200-mile exclusive economic zone, and a continental shelf that overlaps the exclusive economic zone in breadth and can potentially be extended as far as 350 miles seaward.

UNCLOS has many broad ranging implications for resource development in the offshore areas of Canada and other coastal nations. UNCLOS grants coastal nations exclusive sovereign rights to explore for and exploit the natural resources of the continental shelf. They have the exclusive jurisdiction to regulate drilling and the construction and use of artificial islands and oil and gas installations and structures on the shelf. Under that authority, coastal nations can establish regimes for the issuance of exploration and drilling rights; the regulatory process for development project approvals; the regulation of operating practices, and the regulation of environment, health and safety.

Beyond the legal limits of the recognized continental shelf, coastal nations have no rights or jurisdiction. Such areas fall under the authority and administration of a body created under UNCLOS, called the International Seabed Authority.

This article briefly discusses four aspects of UNCLOS that could significantly affect Canadian offshore oil and gas development:

- it establishes the process for coastal nations to claim an extended continental shelf beyond the 200-mile limit;²
- it establishes the process for determining continental shelf boundaries between adjacent or opposite coastal nations;
- it does not explicitly address the development of trans-boundary resources thus resulting in the need for bi-lateral arrangements; and
- it imposes an international tax upon resources produced beyond the 200-mile limit.

EXTENDED CONTINENTAL SHELF

A coastal nation may seek to extend its continental shelf beyond the 200-mile limit by making a submission to the Commission on the Limits of the Continental Shelf. Such submissions must be made within ten years of a coastal nation having ratified UNCLOS and must include supporting scientific and technical data. In order for there to be an extended continental shelf, it must be shown that the area claimed is the natural prolongation of a coastal nation's land territory to the outer edge of the continental margin³ or 350 miles, whichever is greater.

This is the process that needs to be completed before Russia could possibly assert any authority over the extended continental shelf it claims in the Arctic. Indeed, the determination of extended Arctic continental shelf rights will necessarily involve the interests and likely the claims of Canada, the United States (Alaska), Denmark (Greenland) and Norway, each of which has an Arctic coastline. Further, it is important to note that exclusive continental rights, including those that pertain to a claimed shelf extension, are not contingent upon occupation or any express proclamation by a coastal nation.

The principle focus of Russia's assertion is the Lomonosov Ridge, which is a mountain chain that extends for approximately 1,800 kilometres from islands off the coast of Siberia through the Arctic Ocean to an area between northern Ellesmere Island and Greenland. According to the U.S. Geological Survey, approximately 25 percent of the world's undiscovered oil and gas is located in the Arctic region.⁴ It has been suggested that Canada could assert sovereignty over an area larger than Alberta, with the potential for comparable quantities of hydrocarbons.⁵

Russia filed a submission to the Commission in 2001, but it requires further scientific substantiation. Russia has been conducting extensive seabed mapping and surveying of the Ridge over the past few years. The United States, Norway, Canada and Denmark have also undertaken mapping of the Arctic Ocean floor. Canada must file any claim with the Commission within 10 years of ratifying UNCLOS, that being 2013.

DETERMINING CONTINENTAL SHELF BOUNDARIES

UNCLOS provides procedures for the delimitation of continental shelf boundaries between adjacent or opposite coastal nations. First and foremost, and consistent with one of the paramount principles of international law, UNCLOS mandates that coastal nations involved in boundary disputes seek to achieve a negotiated equitable solution. Further, UNCLOS requires the disputing parties to make every reasonable effort to enter into practical provisional arrangements pending a negotiated settlement.

In the event that disputing nations are unable to achieve a settlement, the conflicting claims can be determined under one of three dispute resolution processes—by the International Tribunal for the Law of the Sea, the International Court of Justice (commonly known as the World Court), or a special arbitral tribunal.

Canada shares continental shelf boundaries with Denmark—between the eastern Canadian Arctic and Greenland, with France—in respect of St. Pierre and Miquelon, and with the United States⁶—involving the Gulf of Maine in the Atlantic, the Dixon Entrance and the Strait of Juan de Fuca in the Pacific, and between Alaska and Yukon in the Beaufort Sea.

Canada and Denmark settled their boundary under a 1973 treaty, except for the boundary involving the area of Hans Island. The Gulf of Maine and St. Pierre and Miquelon boundaries were determined through arbitrated decisions in 1984 and 1992, respectively.

BI-LATERAL ARRANGEMENTS TO DEVELOP TRANS-BOUNDARY RESOURCES

Hydrocarbon resources that underlie both sides of a continental shelf boundary raise important issues regarding equity and the avoidance of waste. UNCLOS does not explicitly prescribe resource conservation and equity rules such as well spacing and well density requirements. Nor does it provide potential remedies as available in some jurisdictions that can ameliorate inequitable drainage or potential waste. Such remedies include rateable take orders, common carrier declarations, common processor declarations, compulsory pooling orders and compulsory unitization orders.

To the extent that possible remedies against unfair drainage or waste might be required for transboundary resources, Article 59 of UNCLOS might be of assistance, but only within the 200-mile limit. It would not apply to the area of an extended continental shelf. Article 59 provides:

In cases where this Convention does not attribute rights or jurisdiction to the coastal State or to other States within the exclusive economic zone, and conflict arises between the interests of the coastal State and any other State or States, the conflict should be resolved on the basis of equity and in the light of all the relevant circumstances, taking into account the respective importance of the interests involved to the parties as well as to the international community as a whole.

In the absence of agreement between coastal nations, this provision might permit recourse to third party determination under UNCLOS dispute resolution procedures. However, bi-lateral arrangements for cooperative development can avoid legal uncertainty regarding potential remedies under UNCLOS. Such agreements can be as simple as permitting each country to produce an agreed-to share of the resources through facilities located on its side of the boundary. Alternatively, the arrangements can create more complex relationships through unitizations with an agreed-to regulatory structure or through joint developments under the jurisdiction of the country on whose side of the boundary the development occurs. An agreed-to regulatory structure could involve the creation of a body that exercises authority over the issuance of development permits and approvals, the operational and environmental standards to be applied, the monitoring of operations, and the enforcement of applicable standards and requirements.

Depending upon the nature of the arrangement, cooperative development of transboundary hydrocarbons can provide the opportunity to efficiently utilize capital to the extent that duplication of facilities can be avoided or economies of scale can be achieved. In addition, it can lessen overall environmental impacts, enable each party to obtain its fair share of production or revenues, and achieve optimal recovery of the resource.

The Canada-Denmark (Greenland) Treaty provides that the parties shall seek to reach agreement on the joint exploitation of transboundary petroleum structures or fields or in respect of the part of a structure or field which is located on one side of the dividing line but is exploitable, wholly or in part, from the other side.

On 17 May 2005, Canada and France executed a cooperative development agreement—"Agreement between the Government of Canada and the Government of the French Republic related to the Exploration and Exploitation of Transboundary Hydrocarbon Fields" involving the areas around and adjacent to St. Pierre and Miquelon. As of the date of this article, the nature and structure of the proposed arrangement is not publicly known. The text of the agreement has not been released, as it appears it has not been entered into force.

There is a multitude of precedent arrangements to help guide future cooperative development. These include the 1965 agreement between the United Kingdom and Norway, the 1965 agreement between the

"Hydrocarbon resources that underlie both sides of a continental shelf boundary raise important issues regarding equity and the avoidance of waste."



Netherlands and the United Kingdom, and the 1962 agreement between the Federal Republic of Germany and the Netherlands. More recent examples include the Timor Sea Treaty between East Timor and Australia, and the 2000 treaty between the United States and Mexico involving the Gulf of Mexico.

INTERNATIONAL TAX ON PRODUCTION FROM BEYOND THE 200-MILE LIMIT

UNCLOS imposes an obligation upon coastal nations to make payments or contributions in kind for the exploitation of non-living resources from the continental shelf beyond the 200-mile limit. Such payments are to be made on an annual basis to the International Seabed Authority. The payments are for all production at a site following the first five years of production and calculated on the basis of one per cent of the value or volume of production at the site, which rate will increase by one per cent per year until the twelfth year and then remain at seven per cent per year for each year following.

The International Seabed Authority is required to distribute payments or contributions to disadvantaged nations that are party to UNCLOS on the basis of equitable sharing criteria, taking into account the interests and needs of developing nations, particularly the least developed and the land-locked among them.

The obligations under UNCLOS are state obligations. Therefore payments for production would be the direct obligation of coastal nations and not companies licenced by states to conduct such operations. This raises the questions of whether coastal nations such as Canada would seek to recover from oil and gas producers any taxes paid to the International Seabed Authority and how such recovery might affect then-existing royalty structures. It would seem likely that Canada would not absorb the cost of production payments without obtaining commensurate recovery from the parties that gain the economic benefit of producing oil and gas within the area of an extended continental shelf.

CONCLUDING OBSERVATIONS

Some of the issues related to these four matters may not arise for many years, while others may be more imminent. For example, claims by Canada for an extension of its continental shelf might precede any determination of Canadian shelf boundaries. Canada has until 2013 to prepare and present a claim to the Commission on the Limits of the Continental Shelf. UNCLOS provides that the determination of an extended continental shelf by the Commission is without prejudice to the delimitation of the boundary between opposite or adjacent coastal nations. It is conceivable that the determinations of the Commission could result in overlapping shelves. Therefore, it would be practical to have the limits of the continental shelf determined prior to boundary delimitations between Canada and adjacent coastal nations. This would enable the countries to address the boundary within and beyond the 200-mile limit at the same time.

The timing of development in areas of potential dispute will likely influence the timing of boundary delimitations. Thus far, only Canada's East Coast offshore has had oil and gas projects undertaken. Development in the Arctic and off the West Coast faces timing uncertainties, which, in turn, affect the time by which boundary determinations might be needed. Projects in the Arctic face enormous complexities associated with a hostile marine environment and severe weather. Even with the potential effects of climate change, commercial development in the Arctic would be extremely challenging for technical, environmental, and economic reasons. The offshore area of British Columbia is subject to a 1972 moratorium on all oil and gas activities and its lifting remains uncertain.

The issue of the international tax will arise only when production occurs beyond the 200-mile limit. Therefore, its potential implication to existing royalty structures in areas such as Canada's East Coast will likely remain unknown until such time as there has been an extension of the continental shelf and development is contemplated.

The need for future co-operative development arrangements will arise as and when future boundary delimitations transect oil and gas basins.

Footnotes

* This article is a precis of some of the topics discussed in a paper presented to the 3rd East Coast Seminar in Oil and Gas Law, Canadian Petroleum Law Foundation, St. John's NL, in September 2007. The paper is entitled, *The Implications of UNCLOS to Canada's Regulatory Jurisdiction in the Offshore – The 200 Mile Limit and the Continental Shelf*. It will be published in the *Dalhousie Law Journal*.

¹ U.S., Presidential Proclamation No. 2667, *Policy of the United States with Respect to the Natural Resources of the Subsoil and Sea Bed of the Continental Shelf*, 28 September 1945.

² For the purpose of this article, reference to "mile" means "nautical mile".

³ The "continental margin" consists of the seabed and subsoil of the continental shelf, the slope and the rise. It does not include the deep ocean floor.

⁴ Sruck, Doug, "Russia's Deep-Sea Flag-Planting at North Pole Strikes a Chill in Canada" *Washington Post* (August 7, 2007), online: www.washingtonpost.com/wp-dyn/content/article/2007/08/06/AR2007080601369.html.

⁵ Byers, Michael, "Canada joins with Denmark to map depths of the Arctic" *Globe and Mail* (March 23, 2006), online: www.cfis.ubc.ca/?artid=740.

⁶ Of the three countries with which Canada shares a continental shelf boundary, only the United States has not signed UNCLOS. Ratification of the treaty is presently under consideration in the United States. Under the Constitution of the United States, ratification of treaties requires the two-thirds approval of the Senate. The Senate Committee on Foreign Relations has recommended that UNCLOS be adopted. UNCLOS will now go to the floor of the Senate for consideration. There are many organizations in the United States that have been opposing UNCLOS on the grounds that it would undermine the sovereignty, security and economic interests of the country. Unless and until UNCLOS is ratified by the United States, it will continue to be bound by the limited provisions of the *Convention on the Continental Shelf* and three other law of the sea treaties that were adopted in 1958 as a result of the United Nation's first Convention on the Law of the Sea. The provisions of the *Convention on the Continental Shelf* would not enable the United States to advance a claim for an extended continental shelf.

Damages for the Wrongful Taking of Natural Resources

by Scott Tallman, Summer Research Student

INTRODUCTION

The Alberta courts were recently asked to determine what amount of money a private owner of a mineral interest, and an oil and gas lease relating to that interest, should receive when the natural gas on that lease was removed unlawfully.¹ At issue were the legal principles to be used when determining damages for the tort of conversion (wrongful taking) of natural resources.

BACKGROUND

In 1979 Lady Freyberg, a widow who was living in Surrey, England, inherited a 2/3 interest in the mineral title to lands in Alberta as well as an oil and gas lease on that title. A well had been drilled in 1978 and the results were extremely promising, but nevertheless

the well was shut-in. There was no production, although shut-in royalties were paid every year, until 1999. In 1999 the working interest owners ("Oil Company Defendants") began to extract the natural gas from the well and began making royalty payments to the plaintiff.

In 2001, in the first hearing of *Lady Freyberg v. Fletcher Challenge Oil and Gas*,² Lady Freyberg asked the court to declare the lease had terminated sometime before 1999 on the basis that the lessees had failed to pay the 1993 and 1996 shut-in royalty payments on time. She further submitted that the lease had terminated some time after 1987 because the well was not brought into production when an economic and profitable market existed. The trial judge

concluded that the lessee had met the onus of showing that the shut-in royalty payments had been properly made, resulting in the deemed production of the well for a period of one year notwithstanding an intervening economical and profitable market. The trial judge also held that a clause of the lease itself prevented automatic termination. Furthermore, the failure to produce did not terminate the lease, but rather left Lady Freyberg with a right to damages. However, since Lady Freyberg did not give adequate notice and was unable to show a loss, she was left without a remedy. Lady Freyberg appealed the decision.

The Court of Appeal agreed to hear the appeal³ and to determine whether, based on an interpretation of the terms of the lease in question, the lease had terminated due to there being no production in an economic and profitable market.

The Court of Appeal placed the onus of proving an economic and profitable market on the lessee, the Oil Company Defendants, as the lessee was the one asserting a market did not exist and having particular knowledge of the circumstances. The Court stated that the test to be applied is whether, based on information available at the time, a prudent lessee would have foreseen profitability. A prudent lessee is defined on an objective standard influenced by (1) the character and nature of the lease and (2) the reasonable expectations of the parties.⁴

The Court of Appeal found the defendants did not pass the test. Therefore, there was an economic and profitable market prior to 1999, which led the Court of Appeal to declare the lease in question had terminated sometime before 1999. This meant the Oil Company Defendants in the dispute had been converting Lady Freyberg's gas without a valid lease since 1999.

This finding raised the critical issue of damages. Before the well was shut-in in 2005, the value of the gas that had been extracted was estimated at close to \$5,000,000. While Lady Freyberg had received royalty payments according to the lease, the payments amounted to only 15% of her 2/3 share of the extracted gas. With the decision of the Court of Appeal, how are the damages calculated? Is Lady Freyberg entitled to her 2/3 of the close to \$5,000,000, or something less?

DETERMINING DAMAGES

Damages for conversion in cases involving minerals may be determined using one of two different approaches, *restitution* or *compensation*. The focus of restitution is that a wrongdoer should not profit from his action and this wrongful profit should be given to the party wronged. Compensatory damages, on the other hand, are intended to compensate the wronged party by putting that person in the position she would be in had it not been for the commission of the wrong.

Generally, *restitutionary* damages are awarded where the defendants' conduct is somehow reprehensible and the court can apply either the harsh rule or the mild rule in the calculation of those damages. The harsh rule of restitution applies in cases of trespass or in cases with *mala fides* (dishonesty of belief or purpose) on the part of the party liable for conversion. The amount to be paid to the plaintiff is calculated as the value of the goods taken and the only allowable deduction is the cost of transporting the converted goods to market. Thus, the defendant may pay a significant portion of the business costs involved.

In cases where actions are innocent rather than wilful and there is no *mala fides*, the mild rule is generally used for the damage calculation. The damages are the value of the goods taken minus the costs of extraction. The defendant pays little or no business costs, but is allowed no profit.

In calculating *compensatory* damages, the Court does not focus on stripping the benefit of a trespass away from a wrongdoer, but rather on placing the wronged party back in the position the party would have been in had it not been for the wrongdoing. Compensatory damages are generally calculated along the lines of the mild rule in the restitutionary approach or something less.

The Court in *Lady Freyberg* decided there was no trespass as the Oil Company Defendants had the right to be on the lands due to a surface lease as well as the 1/3 interest held by a party not disputing the lease.

The Court also weighed the actions of the Oil Company Defendants against the possibility of over-compensating the plaintiff. According to Justice Kent, the actions of the defendants must be "sufficiently reprehensible" to justify

the over-compensation of Lady Freyberg. While some of the actions of some members in the dispute were culpable, they were not the actions of the Oil Company Defendants generally. The conduct of the Oil Company Defendants was simply not sufficiently reprehensible in this case to justify the over-compensation.⁵ Hence the most appropriate approach to damages was the compensatory approach.

The Court held one of the options in calculating damages under a compensatory scheme was to take the value of the minerals removed minus the costs of removing the minerals (an award equivalent to the mild rule). However if it is a case where the owner could not have removed the minerals on her own, the amount might be calculated in a different manner such as royalty and bonus payments.

Such was the case in *Livingstone v. The Raywards Coal Company*,⁶ where the Court found that simply applying the mild rule would be inappropriate, as Mr. Livingstone was unable to extract the coal involved in the case himself. Instead, the plaintiff was due only the standard royalty and bonus payment, as that was all the plaintiff would have received were it not for the tort, since he would have required a lease to ever get any value from the coal.

In calculating Lady Freyberg's damages, the question became, what position would Lady Freyberg be in if not for the commission of the tort?

Lady Freyberg had testified that she had intended to produce the gas herself, but the Court found that she was not being truthful when she testified. Despite the creation of Surrey Gas Ltd. by Lady Freyberg in November, 2006, the court found there were simply too many institutional barriers in front of Lady Freyberg for her to ever produce the gas on her own, a key one being the insistence of NV Resources, the owner of the other 1/3 interest, that they would never allow Lady Freyberg to produce.⁷

Without being able to produce, Lady Freyberg would have entered into a lease. Thus, to place her in the position she would have been meant trying to determine the outcome of a lease if the parties involved negotiated in 1999. The decision was therefore to have the parties determine, through negotiation or in

court, what sort of agreement would have been reached. The Court summarized the approach as follows:⁸

In my view the appropriate question to ask is had both sides known conclusively in December, 1999 that the lease was not valid, as reasonable parties and in the case of the Oil Company Defendants who are public companies, under a duty to maximize value for the shareholders, knowing that it was economic to produce the well at that time, what agreement would they reach?

As at that time the well was known to be producing, there was little or no risk and a royalty of 15% to Lady Freyberg would have been too low. Lady Freyberg is entitled to a royalty and bonus more commensurate with someone negotiating a lease for a well that was known to be valuable. However, since Lady Freyberg could not extract the gas herself, the Oil Company Defendants also had some bargaining power; they had the well licence, the surface lease and the support of the other 1/3 rights holder. Also, as the defendants would never knowingly enter a lease expecting to take a loss, they were entitled to some profit as a result of the negotiations.

RESULT

To be continued... The Court told the parties to try to come to agreement or return to Court for a determination of an amount. While no one yet knows exactly how the matter will end, the range of possibilities is now at least reduced, generally to the benefit of the Oil Company Defendants. (Unless, of course, there is another appeal.) All parties know that the defendants will be allowed to keep at least some portion of the profit from the well and that Lady Freyberg will receive more than she received via the previous royalty payments. However, where the number for damages to Lady Freyberg will finally fall remains to be seen.

Footnotes

¹ Freyberg v. Fletcher Challenge Oil and Gas Inc., 2007 ABQB 353

² 2002 ABQB 692

³ 2005 ABCA 46

⁴ Ibid at para. 72

⁵ Supra, Note 1, para. 131

⁶ (1880) 5 App. Cas. 25 (H.L. (S.C.))

⁷ 2007 ABQB 353, para. 138

⁸ Ibid at para. 140



Updates on Alberta Department of Environment Initiatives

by Patrician Quinton Campbell

WATER FOR LIFE STRATEGY

The Alberta Government's response to the growing pressures of maintaining a healthy and sustainable water supply was the development and release, in 2003, of *Water for Life: Alberta's Strategy for Sustainability* (the "Strategy"). The Strategy is a policy document that has three key goals:

1. Safe, secure drinking water supply;
2. Healthy aquatic ecosystems; and
3. Reliable, quality water supplies for a sustainable economy.

It sets out short, medium and long term actions to achieve these goals. It is these three goals which drive the actions being taken by the Alberta Department of Environment ("AENV") and the development by AENV of policies and guidelines for current and future water management.

As it approached the end of the short term (3 year) time frame set for the 10 year implementation plan for the Strategy, the Alberta government, in 2006, sought the assistance of the Rosenberg International Forum on Water Policy¹ to review and make recommendations with respect to the Strategy. The Rosenberg panel was asked:

... first to review the Alberta water strategy, *Water for Life*, and make recommendations as to how it could be strengthened both as a strategic document and in the implementation of various measures that make up that strategy. Second, in recognition of the increasing importance of groundwater in Alberta's water budget, the panel was asked to review the existing arrangements for governing and managing groundwater in the Province and make recommendations about how those arrangements could be further strengthened and improved.²

The final report from the Rosenberg panel was presented in February 2007³ and contains significant discussion concerning each of its recommendations.

Building on the Rosenberg Report, the Alberta Water Council⁴ in June 2007, at the request of the Minister of the Environment, initiated a review of the Strategy. Its mandate is to renew the provincial water strategy to ensure it is effectively managing and sustaining Alberta's water supply. The purpose of the review/renewal is:

- To re-establish at the fundamental level the strategic intent of *Water for Life*; and
- To recommend any changes in direction and focus needed to meet the strategic intent over the next decade.
- The renewal is not a "re-do" of the original strategy; it seeks to adjust and if necessary expand the strategic intent to ensure responsiveness to emerging, current information and the realities faced four years into implementation of a ten-year plan.⁵

As part of that review the Alberta Water council sought comments from Albertans on ideas for renewal of the Strategy. Those comments were to be provided by August 24, 2007, with final recommendations expected from the Alberta Water Council early in 2008.

CUMULATIVE EFFECTS FRAMEWORK

In addition to the review of the Water for Life Strategy, the Alberta Government is developing a framework to address the cumulative effects of development with a view to protecting air, land and water. In furtherance of the proposed framework, AENV has produced a policy paper entitled *Towards Environmental Sustainability: Proposed*

Regulatory Framework for Managing Environmental Cumulative Effect,⁶ which is intended to stimulate discussion on the proposed framework. AENV has noted that:

There are other ongoing initiatives being undertaken by the Government of Alberta that overlap in scope and subject matter. They include the Land-use Framework and renewal of *Water for Life*. This paper should be considered a proposal that can contribute to the progress of those other initiatives.⁷

As part of the proposed cumulative effect framework the government proposes the introduction of new (or amended) legislation to support this new approach. The stated purpose of the legislation is to:

... establish an environmental management system that sets desired objectives for environmental quality for defined parts of the province and ensures human activity is managed to achieve those objectives. The legislation would be sufficiently flexible to support current, successful initiatives embodying some characteristics of the proposed system, while allowing evolution to the intended provincial design.⁸

Comments from industry, non-governmental groups and the public are being requested by November 30, 2007.

ATHABASCA RIVER WATER MANAGEMENT FRAMEWORK

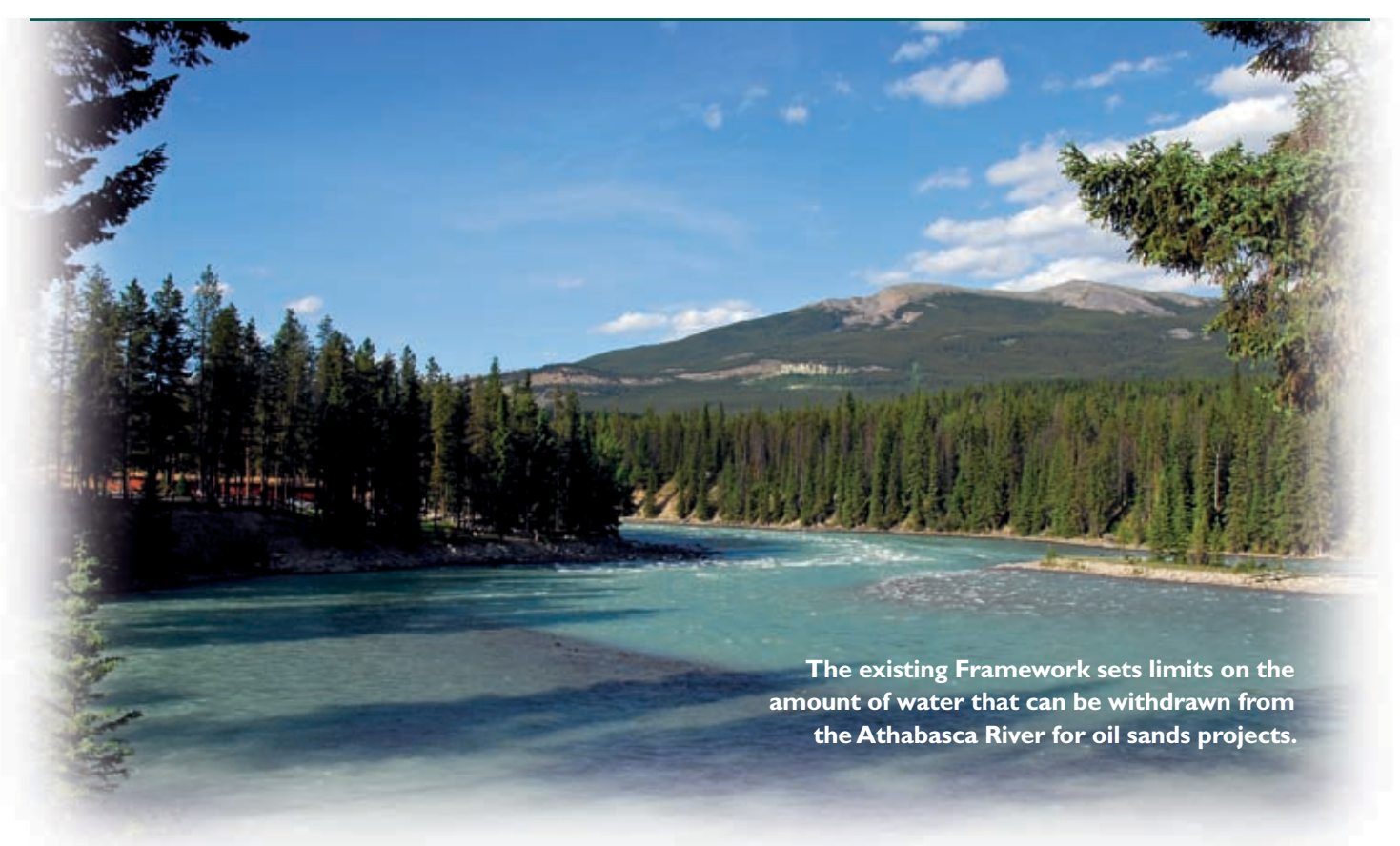
In furtherance of the Water for Life Strategy, AENV released the *Athabasca River Water Management Framework* (the “Framework”), in February 2007. The Framework is the Alberta government’s attempt

to provide protection for the Athabasca River while not stifling development of the oil sands which are dependant on water from that river. The existing Framework sets limits on the amount of water that can be withdrawn from the Athabasca River for oil sands projects.

The Framework is a two phased undertaking with the first phase setting limits in three flow conditions based on current information regarding aquatic habitat requirements, water needs and existing options for reducing withdrawals. The first phase also sets cumulative withdrawal limits industry must meet in each flow category on a weekly basis. The second phase involves the further assessment of future scientific and general knowledge of the Athabasca River to determine if adjustments to the Framework are necessary.

The current water use by the existing oil sands licence holders has been below the limits identified within the Phase 1 Framework. However, the existing licences contain maximum amounts, which could, cumulatively, exceed those Phase 1 limits. In addition, any further project development will add to the cumulative demands and may result in future use, even short of the maximum allowable, which exceeds the Phase 1 limits.

AENV has taken the position that the existing licence holders are subject to the Phase 1 limits, without any apparent reconciliation of the conditions to those licences. AENV and the Department of Fisheries (“DFO”) have, likely in an attempt to avoid any legal confrontations, directed industry to provide a plan in regards to water sharing and meeting the restrictions imposed by the Phase 1 limits. That industry plan is in circulation and it would appear, at this time, that it will garner industry approval. Absent an agreed upon plan, it is questionable



The existing Framework sets limits on the amount of water that can be withdrawn from the Athabasca River for oil sands projects.

whether AENV can impose withdrawal limitations on existing licence holders. Their ability to do so will be dependant on the conditions contained in the existing licences or a change to the legislation, which alters the first in time, first in right principle.

The Framework also specifies water diversion limits designed to minimize the impact on fish habitat. The current In Stream Flow Needs (the "IFN") for the Athabasca River defines the river flows below which diversion could result in impacts to fish habitat and as a result would require authorization under the *Fisheries Act*. As any diversion which results in the harmful alteration, disruption, or destruction of fish habitat is prohibited under the *Fisheries Act*, unless it is authorized by DFO; diversions that reduce, or could reduce flows below the IFN are expected to require authorization.

The Framework recognizes that the existing licences issued to Syncrude and Suncor were issued prior to the authorization requirements of the *Fisheries Act*. However, it notes that any future change operations that result in increased impacts to habitat may require *Fisheries Act* authorization. In addition, the Albian Sands project, which has authorization under the *Fisheries Act*, contains specific conditions dealing with diversion rates. A new *Fisheries Act* authorization or amendment may be necessary if there was an increase in the Albian Sands water withdrawals that exceed the existing authorization when flows are below the IFM. Any new projects will be evaluated against the IFN to determine whether or not *Fisheries Act* authorization is required.

TIER 1 AND TIER 2 SOIL AND GROUNDWATER REMEDIATION GUIDELINES

In June 2007 AENV released new guidelines titled: "Contaminated Sites Management: Tier 1 and 2 Soil and Groundwater Remediation Guidelines" for the remediation of contaminated sites.⁹ The guidelines are designed to provide common updated standards and objectives for the assessment and remediation of soil and groundwater and are intended to apply to all contaminated sites in Alberta.

The guidelines recognize that contaminated site, within a given land use, will fall into a range of sensitivities because of differences in receptors and site conditions. As a result the guidelines provide for three types of management options:

1. Tier 1: The Tier 1 guidelines are a consolidation of updated guidelines from a number of sources and are simply tables of values which are applied to sites with minimal need for site information. They are generic in that they assume that all exposure pathways and receptors relevant to a particular land use are present. As a result the Tier 1 guidelines will apply to the majority of site in Alberta without modification.
2. Tier 2: The Tier 2 guidelines provide for site specific modification of the Tier 1 guidelines and/or removal of exposure pathways based on site specific information. Where site specific information reveals that the site is more sensitive than Tier 1 assumptions the Tier 2 values may be more restrictive than the Tier 1 values. Where the site specific information indicates the site is less sensitive than the Tier 1 assumptions the Tier 2 values are less restrictive. In either case the guidelines are designed to provide the same level of human health and ecological protection because they are site specific.

3. Exposure Control: Exposure control involves risk management through exposure barriers or administrative controls based on site-specific risk assessment

The new guidelines immediately replace:

- *Alberta Tier I Criteria for Contaminated Soil Assessment and Remediation* (AEP, 1994)
- *Alberta Soil and Water Quality Guidelines for Hydrocarbons at Upstream Oil and Gas Sites* (AENV, 2001a); and
- *Risk Management Guidelines for Petroleum Storage Tank Sites* (AENV, 2001b).

While the new guidelines were effective immediately upon announcement, in recognition of the fact that reclamation is an on-going activity, AENV did provide for two transition periods.

1. For Reclamation Certificates relating to sites which are being assessed or remediated to meet the previous guidelines (the *Alberta Soil and Water Quality Guidelines for Hydrocarbons at Upstream Oil and Gas Facilities* (2001 Upstream Guidelines)) the transition period covers activities carried out during the 2007 field season and requires that the laboratory analytical data report(s) from a Phase 2 environmental site assessment or confirmatory sampling event must be dated on or before December 1, 2007 and indicate compliance with the 2001 Upstream Guidelines. Reclamation certificate applications that meet this condition may be submitted at any time in the future
2. For soil monitoring and management programs at approved facilities the transition to the new guidelines will occur as required by the facility operating approval and the Soil Monitoring Directive.

In addition several existing guidelines contain additional information to be used in conjunction with the guidelines and particulars on those guidelines can be provided upon request.

Footnotes

¹ The Rosenberg International Forum on Water Policy is an activity of the University of California. The focus of the Forum is to reduce conflict in the management of water resources through emphasis on the role of science in water management and in the promotion of making of water policy through interaction between scientists and policy makers for the purpose of facilitating the use of science in the making and executing of water policy.

² Report of the Rosenberg International Forum on Water Policy to The Ministry Of Environment, Province Of Alberta, February 2007

³ The Final Report can be found at www.waterforlife.gov.ab.ca

⁴ The Alberta Water Council is the multi-stakeholder group responsible for overseeing the implementation of the *Water for Life Strategy*.

⁵ *Water for Life: Strategy Renewal*, July 2007 Workbook, page 5

⁶ The Cumulative Effects Policy Paper can be found at www.environment.gov.ab.ca/cem/pubs/CEM_Framework.pdf

⁷ Cumulative Effects Policy Paper, page 4

⁸ Cumulative Effects Policy Paper, page 10

⁹ The Tier 1 Guidelines can be found at <http://environment.gov.ab.ca/info/posting.asp?assetid=7751> and the Tier 2 Guidelines can be found at <http://environment.gov.ab.ca/info/posting.asp?assetid=7752>



Newfoundland Announces New Energy Plan

by Ray E. Quesnel

INTRODUCTION

In the run up to the recent provincial election, the Government of Newfoundland and Labrador released its new Energy Plan on September 11, 2007. The Energy Plan deals with the future development of the province's hydro electric potential and its offshore oil and gas resources. With the re-election of the Williams government, one can anticipate efforts by the Province to implement measures contemplated in the Energy Plan. The Energy Plan introduces three key initiatives of interest to the oil and gas industry.

THE THREE KEY INITIATIVES

1. Equity Participation

Firstly, the Energy Plan will require a ten percent government equity participation in all future production projects undertaken in the Newfoundland offshore where such participation fits with the Province's strategic long term interests. The Province's interest will be held through its new Energy Corporation, a crown corporation established as a holding company for its ventures in the energy sector. The Energy Plan contemplates the Province negotiating the terms of payment for such equity participation, both historic and development costs, with project proponents; however is vague as to how such payment will be made. While government participation is not uncommon internationally, it is not favoured by industry and is perceived as adding to the cost, complexity and uncertainty of projects. Previous efforts in Canada in this regard have not been particularly successful. In any event, this initiative will not simplify an already complicated offshore regime. As well, the Province intends to pursue the transfer to it of Canada's equity share of the Hibernia Project.

2. Offshore Natural Gas Royalty

Secondly, the Energy Plan introduces a generic offshore natural gas royalty. Before now, no natural gas royalty regime had been established for the offshore. The royalty will consist of a basic royalty and a net royalty. The basic royalty, payable as of first production, will be a sliding scale royalty of anywhere from 2% to 10% based on realised prices for natural gas. The basic royalty is intended to be price sensitive. The net royalty, payable after payout, is an

“R Factor” type royalty. The net royalty rate will be anywhere between 0% (R Factor less than 1) and 50% (R Factor greater than 4). The R Factor is the ratio of cumulative revenue less cumulative transportation costs and royalties to cumulative project capital and operating costs. The net royalty is intended to be profit sensitive. The Energy Plan also anticipates the introduction of a new generic offshore oil royalty based on the principles and structure of the generic natural gas royalty. While fiscal certainty is a worthwhile policy objective, royalty rates must be economically attractive to meet other government objectives such as increased exploration and development. Underlying these fiscal initiatives is the belief that the existing regime does not yield a fair share of the economic benefits of development to the Province having regard to current prices. Similar sentiments underlie Alberta’s recently announced new royalty regime.

3. Criticism of Existing Offshore Rights Tenure

Thirdly, the Energy Plan attacks certain aspects of the existing offshore rights tenure system as a disincentive to development. In particular, the Energy Plan calls for the elimination of the significant discovery

licence, which form of licence provides for indefinite tenure in respect of acreage constituting a significant discovery. The Province believes that this form of tenure does not provide sufficient incentive to the licence holder either to undertake development activity in a timely manner or to sell to someone who is willing to

The introduction of equity government participation, new royalty terms and new forms of tenure will have a substantial impact on the offshore oil and gas industry in Canada.

undertake such development. Nor does this form of tenure require the relinquishment of acreage to the Crown in the absence of development or further exploration, thus making the acreage available for future licensing rounds. The Province appears to favour a fallow field approach comparable to the one implemented by the UK in respect

of the North Sea, rather than reliance on the drilling and development order powers already available to it under the existing legislation. In any event, elimination of the significant discovery licence will require enactment of legislation by both Canada and the Province, as contemplated by the joint resource management scheme implemented by the Atlantic Accord.

INVOLVEMENT OF INDUSTRY IN NEW REGIME

After twenty years, it is not surprising that the Province has reviewed and intends to change the oil and gas legal and fiscal regime applicable to its offshore. The introduction of equity government participation, new royalty terms and new forms of tenure will have a substantial impact on the offshore oil and gas industry in Canada. Industry will want to take the opportunity to be proactive in shaping the new regime such that its design will be successful from both an industry and government perspective. To put it another way, the regime will not be successful unless it accommodates the objectives of both government and industry.

The Energy Plan can be found at: www.gov.nl.ca/energyplan/EnergyReport.pdf

What We’ve Been Up To

Ray Quesnel and Keith Miller presented papers, “*Fallow Field Initiatives in the UK and their Application to the Canadian East Coast Offshore*” and “*The Implications of UNCLOS to Canada’s Regulatory Jurisdiction in the Offshore – The 200 Mile Limit and the Continental Shelf*”, respectively, at the 3rd East Coast Seminar in Oil & Gas Law, Canadian Petroleum Law Foundation, in St. John’s, Nfld. in September, 2007.

Alicia Quesnel is Past President of the Canadian Petroleum Law Foundation (“CPLF”).

Carolyn Wright is currently a Director of the CPLF, a member of the Organizing Committee for the CPLF Jasper Conference and an executive member of the Canadian Bar Association (“CBA”) Natural Resources Section.

Ray Quesnel is a Director of the CPLF and serves on the Scholarship Committee.

Candice Jones is a Director-at-Large Legal of the Petroleum Joint Venture Association (“PJVA”).

Arnie Olyan is Chair of the Southern Alberta Construction Subsection of the CBA and a member of the Planning Committee for the CBA’s National Construction Subsection Conference to be held in Banff, AB from April 10-12, 2008.

Morella de Castro is Vice Chair of the International Business Law Section of the CBA.

Carolyn Wright teaches a bi-annual course on *Freehold Lessor Estates* to the Canadian Association of Petroleum Land Administration (“CAPLA”).



Energy

BD&P's Energy Team practitioners are recognized and respected leaders in their field, advising on all aspects of domestic and international energy projects and transactions, joint ventures, alliances and mergers and acquisitions.

We represent a diverse range of clients in the petroleum industry including explorers, developers, producers, pipeline and transportation owners and operators, facilities owners and operators, lenders, public and private investors, marketers, aggregators, retailers and traders.

Our Energy Team works closely with other professionals in the firm drawing on the depth of knowledge of lawyers in tax, securities, construction, intellectual property and technology, employment and labour, and oil and natural gas and electricity regulatory law. We are active in a number of professional organizations relevant to the industry including the PJVA, CPLF, SEPAC, CAPL, Natural Resources Subsection of the CBA and the Institute for Energy Law.

The practitioners on BD&P's Energy Team offer strong legal skills, practical and experienced business advice, innovative solutions and timely response to meet the specific needs and objectives of our clients.

SIGNIFICANT AREAS OF SERVICE:

- Development of opportunities in Alberta's oil sands including front-end engineering and design, engineering, procurement, construction management and construction

- Leading edge projects such as coal bed methane projects
- Joint venture, farmout, operating, royalty, participation and transportation agreements
- Acquisitions and dispositions of oil and natural gas properties and facilities
- Share transactions involving both private and public companies
- Natural gas marketing issues and sales agreements
- Construction, financing and operating of petrochemical plants and pipelines
- Corporate reorganizations
- Environmental issues
- Oil and natural gas taxation issues including cross-border transactions
- Oil and natural gas financings
- Co-generation projects
- Onshore and offshore drilling contracts
- International transactions
- Due diligence reviews, including title reviews and opinions
- Surface rights work
- First Nations consultation advice

Energy Litigation

BD&P's Energy Litigation Team has extensive experience in all oil and gas related issues giving rise to litigation. The team compliments and is complimented by the strength of the firm's energy law practice, enabling the litigators to work closely with colleagues in order to provide all the resources key to resolving the client's oil and gas issues.

This Team regularly appears before all level of Alberta's Courts, in courts of other provincial jurisdictions, and before regulatory and administrative tribunals. In addition, the Energy Litigation Team has significant experience in the alternative dispute resolution forums of mediation and arbitration. In order to accomplish our clients' objectives, the BD&P energy litigators are committed to finding practical, efficient and cost-effective solutions for our clients in all contentious oil and gas related matters.

SIGNIFICANT AREAS OF SERVICE:

- Joint Ventures
- Farmout Agreements
- AMIs
- Royalty disputes
- Royalty or title claims by First Nations or by the Federal Crown as their trustee
- Accounting disputes
- Operating disputes
- Fiduciary duties
- Lease interpretations including rights of first refusal and other title questions
- Environmental liabilities
- Oil and gas evaluation disputes

Energy Regulatory

BD&P's Regulatory Team has a wealth of experience involving all aspects of oil & gas and electricity regulatory proceedings, including projects subject to federal and/or provincial environmental assessment legislation. Our lawyers appear regularly before the National Energy Board, the Alberta Energy and Utilities Board, the Alberta Environmental Appeal Board, Environment Canada, the Alberta Surface Rights Board, the Northwest Territories Public Utilities Board, the British Columbia Utilities Commission and other regulatory authorities in other provinces and territories. In addition, BD&P has acted as counsel in regulatory appeals and judicial review applications in the Alberta Court of Queen's Bench, the Alberta Court of Appeal, the Federal Court and the Supreme Court of Canada.

The BD&P Regulatory Team represents oil & gas producers, oil sands producers, owners of intra-provincial, inter-provincial and international transporters of natural gas and crude oil pipelines, owners of NGL extraction plants, petrochemical facilities and refineries, proponents of LNG projects, owners and proponents of generating plants, owners of regulated electricity transmission and distribution facilities, regulated and unregulated retailers of electricity and gas services, buyers and owners under Power Purchase Arrangements, and energy marketers and importers/exporters.

In recent years, BD&P has been on the leading edge of restructuring in Alberta's electricity and natural gas marketplaces.

SIGNIFICANT AREAS OF SERVICE:

Oil & Gas:

- securing facility, environmental and land use planning approvals for oil and gas projects of all scale and scope—oil and gas wells, gas processing facilities, pipelines, oil sands projects, NGL extraction plants, petrochemical plants, refineries and LNG terminal facilities
- representing clients in tolls, tariff and access proceedings for natural gas and crude oil pipelines
- acting for clients in rateable take disputes, common carrier and common processor applications and resource conservation and enhanced recovery schemes
- representing project proponents in land acquisition and compensation proceedings
- providing counsel on regulatory matters involving consultations and disputes with local land owners and non-governmental organizations
- providing counsel on First Nation matters related to oil and projects, including consultation obligations and treaty and traditional land access
- advising market participants on issues arising under affiliate codes of conduct.

Electricity:

- representing clients in rates and tariff proceedings involving electric utilities and the Alberta Electric System Operator
- securing facility, environmental and land use planning approvals for electric transmission lines and co-generation, simple/combined cycle and hydro generating facilities
- advising market participants on issues arising under affiliate codes of conduct, market participation rules and the financial settlement rules of the Alberta Independent System Operator
- representing project proponents in land acquisition and compensation proceedings
- providing counsel on regulatory matters involving consultations and disputes with local land owners and non-governmental organizations
- providing counsel on First Nation matters related to electric facilities, including consultation obligations and treaty and traditional land access

Energy Lawyers

ENERGY

Allford, R. Bruce	rba@bdplaw.com	260-0247
Campbell, Q.C., Harry S.	hsc@bdplaw.com	260-0281
Cuthbertson, John H.	jhc@bdplaw.com	260-0305
De Castro, Morella M.	mmd@bdplaw.com	260-0253
Goetz, John C.	jcg@bdplaw.com	260-0110
Houston, Mark T.	mth@bdplaw.com	260-0375
Johnson, Q.C., Cal D.	cdj@bdplaw.com	260-0203
Jones, Candice J.	cjj@bdplaw.com	260-0109
Lee, Simon J.	sjl@bdplaw.com	260-0868
Money, J. Stuart	jsm@bdplaw.com	260-0312
Nossiter, N. Sarah	snossiter@bdplaw.com	260-0861
Pettie, Alan T.	atp@bdplaw.com	260-0127
Polson, Rory G.	rgp@bdplaw.com	260-0223
Quesnel, Alicia K.	akq@bdplaw.com	260-0233
Taylor, John K.	jkt@bdplaw.com	260-0386
Twa, Q.C., Allan R.	art@bdplaw.com	260-0221
Wivcharuk, Jody L.	jlw@bdplaw.com	260-0129
Wright, Carolyn A.	caw@bdplaw.com	260-5721

Miller, Keith F.	kfm@bdplaw.com	260-0153
Quinton-Campbell, Patricia	pqc@bdplaw.com	260-0308

ENERGY- LITIGATION

Beke, Paul A.	pab@bdplaw.com	260-0216
Crump, Barry R.	brc@bdplaw.com	260-0352
Donaldson, Michael J.	mjd@bdplaw.com	260-0228
Haigh, Q.C., David H.	drh@bdplaw.com	260-0135
McDonald, Q.C., Daniel J.	djm@bdplaw.com	260-5724
McGillivray, Q.C., Douglas A.	dam@bdplaw.com	260-0349
Millard, Robert O.	rom@bdplaw.com	260-5719
Mills, Douglas G.	dgm@bdplaw.com	260-0226
Murphy, James D.	jdm@bdplaw.com	260-0152
Nishimura, Doug S.	dsn@bdplaw.com	260-0269
Novinger Grant, Louise	lng@bdplaw.com	260-0163
Sharpe, Jeff E.	jes@bdplaw.com	260-0176
Strand, David H.	dhs@bdplaw.com	260-0259
Vogeli, L. Grant	lgv@bdplaw.com	260-0171
Wood, Robert D.	rdw@bdplaw.com	260-0125
Wray, Shannon L.	slw@bdplaw.com	260-0245

ENERGY – REGULATORY

Brander, R. Bruce	rbb@bdplaw.com	260-0165
Liteplo, Jonathan M.	jml@bdplaw.com	260-0310
Lowe, John E.	jel@bdplaw.com	260-0257

If you would like any further information on any members of our team, such as a more detailed resume, please feel free to contact the team member or the writer directly. You may also refer to our website at www.bdplaw.com.

o n r e c o r d

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For a complete list of authorities used in drafting these articles please contact the Managing Editor.

Energy Matters, Editors-in-Chief

John H. Cuthbertson, jhc@bdplaw.com..... (403)260-0305
 Alicia K. Quesnel, akq@bdplaw.com (403)260-0233

Energy Matters, Managing Editor

Rhonda G. Wishart, rwishart@bdplaw.com..... (403)260-0268

Contributing Writers and Researchers:

Ray Quesnel, Keith Miller, Patricia Quinton Campbell
 and Scott Tallman.

Contact

For additional copies, address changes, or to suggest articles for future consideration, please contact our Catherine Leitch in our Marketing Department at (403) 260-0345 or at cat@bdplaw.com.

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