Alberta Crude Oil Curtailment: a Q&A. What Operators Need to Know About the Amendments to the Curtailment Rules

By Brendan Downey with the assistance of the BD&P Energy Group

On December 3, 2018, the Lieutenant Governor in Council of Alberta, approved Order in Council O.C. 375/2018, enacting the *Curtailment Rules* commencing January 1, 2019. According to the Government, producers within Alberta currently produce 190,000 more barrels of raw crude oil and crude bitumen per day than the province can export. With nowhere to go, these barrels enter storage at a faster rate than they leave, resulting in an oversupply of crude oil that has, in large part, been responsible for the significant price differential between Western Canadian Select and West Texas Intermediate oil contracts. While many producers in the oil and gas industry support the *Curtailment Rules*, this support has not been universal. A number of industry participants immediately raised concerns with the *Curtailment Rules* and as a result, additional amendments to the *Curtailment Rules* were made before January 2019, the first month in which operators were subject to curtailment.

On December 12, 2018, the Government amended the *Curtailment Rules* to create an 84% "curtailment floor" that ensures no operator will be required to curtail more than 16% of the combined amount of crude oil and crude bitumen it produced in October 2018.[1] On December 31, 2018, the Government further amended the *Curtailment Rules*, changing the manner in which the Minister will calculate each operator's baseline production beginning in February 2019. Instead of calculating an operator's baseline production with reference to the "average number of barrels of crude oil and crude bitumen produced per calendar month by the operator for the 6 calendar months during which the operator's production was greatest in the one-year period commencing November 1, 2017", the Minister will now only refer to the greatest number of barrels of crude oil and crude bitumen the operator produced in any calendar month in the same one year period.[2] Due to this simplified baseline production calculation mechanism, the December 31 amendments also repealed the adjustment formulas for operators that started production after May 1, 2018.[3] However, the *Curtailment Rules* now provide that the baseline production for operators that exceed the 10,000 bbl/day production threshold after October 2018 will be the number of barrels of crude oil and crude bitumen such operators produced during the month in which it first exceeded the threshold.[4]

Finally, the December 31 amendments allow the Minister to amend the combined maximum amount of crude oil and crude bitumen an oil sands operator can produce if the operator: i) operates no more than one oil sands project; and ii) can demonstrate that it cannot both operate the oil sands project safely and comply with a curtailment order.[5] This discretionary amendment of a curtailment order is only available until the end of March 2019.[6]

Curtailment Rules Q&A

While the *Curtailment Rules* themselves do not initially appear complex, they are complex in their

---

[1] *Curtailment Rules*, Alta Reg 214/2018s, s 5.1; *Curtailment Rules Amendment Regulation*, OC 434/2018 (12 December 2018), s 2

[2] *Curtailment Rules*, Schedule 1, s 1(2); *Curtailment Rules Amendment Regulation*, OC 438/2018 (31 December 2018), s 4(a)

[3] *Curtailment Rules Amendment Regulation*, OC 438/2018 (31 December 2018), s 4(b)

[4] *Curtailment Rules Amendment Regulation*, OC 438/2018 (31 December 2018), s 4(c)

[5] *Curtailment Rules*, s 5.2(2); *Curtailment Rules Amendment Regulation*, OC 438/2018 (31 December 2018), s 3

[6] *Curtailment Rules*, s 5.2(1); *Curtailment Rules Amendment Regulation*, OC 438/2018 (31 December 2018), s 3

application. Here we address a number of questions and concerns that have been asked by producers in connection with their review and consideration of the *Curtailment Rules*.

1. **Will a freehold lease terminate if an operator shuts-in production to comply with a curtailment order?**

Whether a freehold lease can survive shut-in due to curtailment depends on a number of factors arising from the contractual language contained in the lease. Operators will need to closely consider the scope of the *habendum* clause to determine the circumstances in which the lease will continue or terminate.

Some freehold leases may entitle the lessee, in its discretion, to shut-in production and maintain the underlying lease by paying the lessor a shut-in royalty. Other forms of lease, such as the 1999 CAPL, go one step further and deem the existence of ongoing operations to preserve the lease. Unfortunately, not all freehold leases are as friendly to lessees. Some may only permit wells to be shut-in to manage an intermittent, uneconomical, or unprofitable market. While the curtailment orders rely on the rulemaking provisions in the *Oil and Gas Conservation Act*[7] and *Oil Sands Conservation Act*[8] that address waste and improvident disposition it is unclear whether the current state of the market can justify continued reliance on such a shut-in clause. Indeed, the price differential between WTI and WCS prices has narrowed significantly since the Government announced the curtailment regime. Other leases may only permit wells to be shut-in for reasons beyond a lessee's reasonable control. Given that operators can choose how they want to apportion the required curtailment of production across their productive asset base, it is unlikely that a decision to curtail production from one or more wells under a particular lease qualifies as an event beyond their control.

In responding to a curtailment order, an operator may be able to declare force majeure and suspend production from one or more wells without being in default of the lease or causing the lease to automatically terminate. While government action (and any necessary operational response) is widely understood to be a force majeure event, its availability will depend entirely on the construction of the clause. In *The Oil and Gas Lease in Canada*, John Ballem provides the following example of a force majeure clause that would apply to save a lease in the face of a curtailment order:

> …The Lessee need not perform any requirement hereunder, the performance of which would violate any reasonable conservation and / or curtailment program or plan of orderly development to which the Lessee may voluntarily or by order of any governmental agency subscribe or observe.[9]

Barring a force majeure clause as explicit as this, the discretion that an operator has in the implementation of a mandatory curtailment order may again bring an operator's decision to shut-in production from particular wells outside of the scope of contractual protection. Finally, the curtailment regime presents a range of *options* to impacted operators. While curtailment orders are mandatory, they do not necessarily oblige operators to shut-in production from a particular well.

[7] *Oil and Gas Conservation Act*, RSA 2000, c O-6 [***OGCA***].
[8] *Oil Sands Conservation Act*, RSA 2000, c O-7 [***OSCA***].
[9] John Bishop Ballem, *The Oil and Gas Lease in Canada*, 4th ed, (Canada: University of Toronto Press, 2008) at 310

Where a termination event flows from an option rather than an obligation, Canadian courts have adopted a narrow approach to the identification of a force majeure event.[10]

The question of whether a freehold lease will terminate if an operator shuts-in production to comply with a curtailment order depends on the nature of the *habendum*, the discretion afforded under the shut-in clause, and scope of the force majeure clause. Answers to this question will therefore vary with each lease.

2. Are there obligations under Joint Operating Agreements relating to the curtailment of jointly operated wells and oil sands mines?

While curtailment orders are issued at the operator level, compliance with an order may have the effect of reducing the production volumes of non-operator Working Interest Participants (WIPs). For example, if an operator has a 60% working interest in production from a well or oil sands mine, reducing the operator's production levels also reduces the production volumes that correspond to the 40% working interests of the WIPs. This may result in disputes among the owners of jointly operated oil wells and oil sands mines.

In most cases, operators of jointly owned assets do not owe fiduciary obligations to their WIPs, but the precise scope of their obligations can vary with the circumstances and is not readily discernable. While the industry standard CAPL joint operating procedures (CAPL JOAs) do not impose a duty on operators to produce, the extent to which operators owe their WIPs any other duties (specifically a duty of care) is a question of fact that must be addressed on a case-by-case basis. A question that WIPs may ask is whether it is good oilfield practice to curtail production in a way that negatively impacts their interests, particularly if the operator's decision was motivated by its own financial interests. While operators must ensure they remain compliant with all applicable laws, the interaction between the mandatory nature of a curtailment order, the Government's apparent preference to target marginal production,[11] and the granting of operator discretion under the *Curtailment Rules* further complicates an analysis of an operator's obligations to WIPs.

Although s. 6 of the *Curtailment Rules* only refers to operators "compris[ing] two or more persons carrying on business as a joint venture or partnership", neither joint ventures nor partnerships can hold licenses or approvals and, therefore, cannot be "operators" as that term is defined in the *Curtailment Rules*. A purposive interpretation suggests that this section can be read more broadly to denote projects that involve multiple persons. Accordingly, the purpose of this section may have been to allow operators and WIPs of jointly owned assets to, in their discretion, enter agreements "respecting the allocation of the combined production of crude oil and crude bitumen among themselves".[12] Such an agreement would unseat the presumption that all WIP is curtailed on a *pro rata* basis and ensure that such production is not impacted by an operator reducing a well's production volumes. Unfortunately, the actual wording of the section is ambiguous and its precise legal effect is not clear.

In any event, and notwithstanding the effect of s. 6, the curtailment regime will likely lead to disputes among operators and WIPs over the operator's right to curtail production in its discretion. Some privately negotiated contracts governing joint operations may provide for mandated curtailment, but

---

[10] Ballem at 311, ref'g to *Canadian Superior Oil of California Ltd v Kanstrup*, [1965] SCR 92 (SCC). For parallel reasoning, see also: *Atcor Ltd v Continental Energy Marketing Ltd*, 25 BLR (2d) 1 at paras 10 – 11, 178 AR 372 (Alta CA) [***Atcor***]

[11] *Curtailment Rules*, s 2

[12] *Curtailment Rules*, s 6

the industry standard CAPL JOAs do not include such contractual solutions. However, operators may be able to claim force majeure to protect themselves, but the availability of force majeure relief will depend on the precise wording of the for majeure provision.

3. How does curtailment impact take-or-pay[13] midstream and oil field service contracts?

As with any contractual agreement between private parties, the precise terms of the contract will determine the consequences of curtailment and which remedies, if any, are available. It may be possible for a party whose production has been curtailed to claim force majeure, or it may be that the curtailed party has no choice but to incur a payment obligation—particularly in light of the discretion operators exercise over the allocation of curtailment and the effect of optionality on force majeure noted above. Importantly, if an operator's decision to curtail production impacts a WIP's ability to meet its contractual obligations, such WIP will likely have a stronger force majeure claim. The decision to curtail was beyond its reasonable control.

Where force majeure impacts a curtailed party's ability to deliver a fixed quantity of a specified product, it may have a common law obligation to apportion its remaining supply in a fair and equitable or commercially reasonable manner among its buyers.[14] If this is the case (the requirement will vary with the terms of the relevant contract and surrounding commercial circumstances), failure to comply with this requirement may preclude the curtailed party from claiming force majeure.

4. What are the penalties for failure to comply with curtailment?

If an operator subject to a curtailment order fails to comply with a curtailment order, the Regulator can assess administrative penalties of up to $5,000 per day. While the quantum of the penalty is small, administrative penalties are treated as judgments of the Court of Queen's Bench.[15] This means that the Regulator can make use of civil enforcement remedies to ensure payment, including the possibility of imprisonment for contempt.

Because the *Curtailment Rules* are enacted pursuant to the rulemaking powers contained in the *OGCA* and the *OSCA* the Regulator has additional tools to address non-compliance. If an operator fails to comply with a curtailment order, it may also be liable for a penalty of up to $50,000 for an individual and $500,000 for a corporation.[16] The Regulator can also make declarations that have the effect of limiting an operator's or working interest participant's participation in the oil and gas industry, including barring license transfers and halting production.

5. Are there any *Competition Act* concerns that arise in connection with arrangements made between producers to allocate or consolidate production?

The *Curtailment Rules* allow: i) two or more persons involved in a joint venture or partnership to enter into an agreement to allocate the combined production of crude oil and crude bitumen among themselves to comply with the curtailment order;[17] and ii) two or more operators, both of whom are subject to curtailment orders, to apply to the Minister for an order permitting consolidation of the

---

[13] These sorts of contracts would also include deliver-or-pay and send-or-pay contracts

[14] *Atcor* at para 23, citing *Intertradex SA v Lesieur-Tourteaux Sarl*, [1978] 2 Lloyd's Rep 509 (CA)

[15] *Curtailment Rules*, s 8; *Responsible Energy General Regulation*, Alta Reg 90/2013

[16] *OGCA*, s 110; *OSCA*, s 26.

[17] *Curtailment Rules*, s 6

maximum amounts, or to apply to the Minister for an order amending the curtailment order to redistribute the amounts fixed under the curtailment orders among those making the request.[18]

While authorized by the *Curtailment Rules*, such arrangements are not mandated by the *Curtailment Rules*. As a result, such arrangements could technically be construed as arrangements between competitors to "fix, maintain, control, prevent, lessen or eliminate the production or supply of a product" contrary to the criminal conspiracy provisions of s. 45 of the *Competition Act*, although prosecution under s. 45 of the *Competition Act* would be highly unlikely.

According to the Competition Bureau's Competitor Collaboration Guidelines, prosecution under s. 45 is reserved for the "most egregious forms of cartel agreements", which these arrangements are clearly not. There are, in addition, two possible defences producers can look to. The first, found in s. 45(4) of the *Competition Act*, is colloquially called the "joint venture defense" as it exempts from prosecution arrangements that are "ancillary to a broader arrangement" (such as a joint operating agreement) that includes the same parties and is "directly related to, and reasonably necessary for giving effect to, the objective of the broader agreement." Outside of the joint venture context, arrangements between operators to consolidate or re-distribute their maximum amounts can likely rely on the second defense, found in s. 45(7), known as the "Regulated Conduct Defence" (RCD). There is little case law in this area; however, the Competition Bureau has prepared a "Regulated Conduct" bulletin in which they note that the Bureau will always consider whether the RCD applies to conduct that may be regulated by provincial law. It will do so by focusing on the question of whether a validly enacted provincial law authorizes (expressly or impliedly) or requires the impugned conduct. The fact that consolidation and redistribution arrangements *between operators* are not permitted unless an order has been issued by the Minister, should give Alberta producers a high level of comfort that they are unlikely to be prosecuted criminally under the Competition Act for arrangements they make among themselves pursuant to the *Curtailment Rules*.

6. Will curtailment negatively impact an operator's LLR and LMR?

Directives 006 and 011 calculate a licensee's LLR with reference to a 36-month trailing industry average netback and the licensee's previous 12 months of production. As a result, any negative impact that the curtailment regime has on an operator's LLR will be softened by these trailing, partially aggregated, figures. Moreover, to the extent that a licensee's LLR constitutes a component of its LMR, the impact of curtailment on LMR and the ability of operators to buy or sell assets may be even less. As an aside, the authors note that the Government's announcement and implementation of the *Curtailment Rules* appears to have narrowed the price differential between WCS and WTI benchmark prices. If this trend continues, it is possible that the curtailment regime, through the industry average netback calculation, will increase the LLRs and thus the LMRs of affected Alberta licensees.

7. Will curtailment have any impact on market activity in Alberta?

It is clear that the *Curtailment Rules* have injected a degree of uncertainty into the Alberta energy market. Given that curtailment has only just taken effect, we have yet to see what its impacts will be and how industry participants will respond. To the extent that this uncertainty could have a chilling effect on the A&D or M&A market, it will likely arise from the fact that: i) the Government continues to amend the *Curtailment Rules*; ii) curtailment orders are determined on a monthly basis and may

[18] *Curtailment Rules*, s 7

vary over time; and iii) the impact that each asset or corporate sale will have on the parties to the transfer.

If two or more operators to whom curtailment orders apply transfer assets amongst themselves, s. 7 of the *Curtailment Rules* appears to provide a mechanism through which they can apply to the Minister to reallocate any curtailment amounts on a monthly basis. Precisely how the Regulator's license transfer approval process will interfere with or delay this curtailment reallocation process remains uncertain, but the current processing timelines for license transfers presents a number of practical challenges and unanswered questions. That said, it is possible that the Minister will reallocate maximum production notwithstanding the fact that the Regulator has not yet approved the license transfer. From the Minister's perspective, there is no change to the aggregate volume of curtailed production, only a reallocation of those volumes between operators. In addition, we expect that the requesting operators will likely be larger producers with LMRs substantially above the 2.0 regulatory threshold, thereby posing a lesser degree of risk to the regulatory regime.

It is less clear how the *Curtailment Rules* will respond to a transfer of production involving a vendor-operator producing above the 10,000 bbl/day threshold (and therefore subject to a curtailment order) and a buyer-operator producing below the 10,000 bbl/day threshold (and therefore not subject to a curtailment order). While the buyer's baseline production, adjusted baseline production, and maximum amount of production will change upon the transfer of the assets,[19] the *Curtailment Rules* do not provide a means to recalculate the baseline production of the vendor. Due to the time parameters set out in the baseline production calculation mechanism,[20] a transfer in these circumstances will increase the province-wide aggregate adjusted baseline production because there is no mechanism to reflect the corresponding decrease to the vendor's production numbers. Section 7 of the *Curtailment Rules* does not address this situation as there is no mechanism to reallocate the "maximum amounts fixed under [a] curtailment order" in a manner that complies with the scheme of the *Curtailment Rules*.

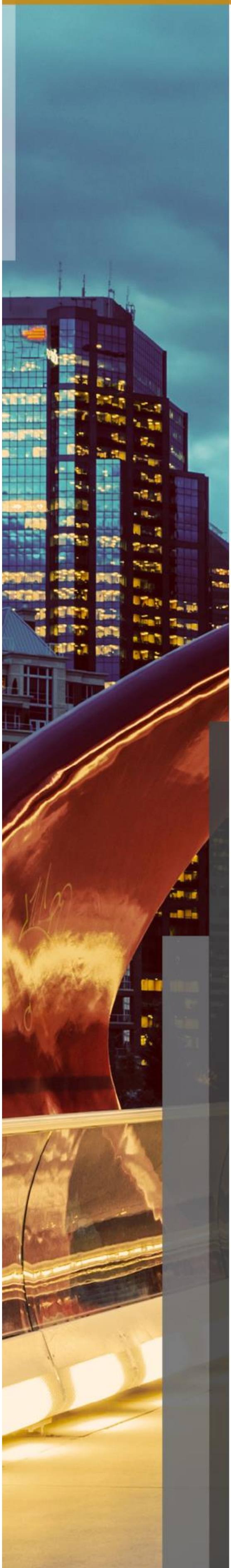
Despite the lack of clear legislative direction, companies are free to negotiate commercial solutions to these uncertainties.[21] Any such solutions may have the effect of dispelling the residual uncertainty highlighted above.

8. **Do the *Curtailment Rules* violate any free trade agreements?**

The North America Free Trade Agreement (NAFTA) is a trade agreement to which Canada, the United States, and Mexico are all party. It will remain the governing trade agreement until the relevant governments ratify a new agreement. Accordingly, and despite the recent negotiation of a new trade deal—the United States-Mexico-Canada Agreement (USMCA)—the initial question to consider here is whether curtailment violates NAFTA.

Curtailment was designed to address the fact that, due to a lack of export infrastructure, Canadian producers were selling oil to American purchasers at a deep discount. Had Canada simply blocked the export of oil to American buyers purchasing at depressed prices, it would have run afoul of Article 605—a proportionality clause within NAFTA—which prevents Canada from implementing policies that limit exports to the United States and Mexico relative to the total supply produced in Canada. But the *Curtailment Rules* apply to production at the wellhead. To the extent that a *consistent*

[19] *Curtailment Rules Amendment Regulation*, OC 438/2018 (31 December 2018), s 4(b)
[20] *Curtailment Rules*, Schedule 1, s 1(2); *Curtailment Rules Amendment Regulation*, OC 438/2018 (31 December 2018), s 4(a)
[21] For example, the parties could agree to limitations on production pending the aforementioned regulatory recognition



proportion of the crude oil and crude bitumen Canada produces remains available to Mexico and the United States, the curtailment regime does not violate NAFTA. Reducing supply in a consistent proportion as outlined in Schedule 1 of the *Rules* simply reduces the required offering on an undifferentiated basis and, as a result, the aggregate volume of crude oil and crude bitumen that Canada sells into the market.

Under the USMCA, a curtailment regime as presently crafted may not be necessary as the proportionality clause has been removed. The United States ceded Article 605 in the USMCA negotiations, likely as a result of bolstered energy security in the United States since 1994, when NAFTA was introduced. The fact that the United States now exports both oil and natural gas to Canada and Mexico when it did not in 1994 may explain why the United States was willing to forego a proportionality clause in the USMCA.