File No. 1620
Board Order # 1620-2

May 31, 2010

MEDIATION AND ARBITRATION BOARD

IN THE MATTER OF THE PETROLEUM AND NATURAL GAS ACT, R.S.B.C., C. 361 AS AMENDED

AND IN THE MATTER OF
SE ¼, Section 17, Township 80, Range 14, W6M, Peace River District
(The "Lands")

BETWEEN:

John Miller and Mary Miller

(APPLICANTS)

AND:

Penn West Petroleum Ltd.

(RESPONDENT)

BOARD ORDER

Heard: April 27, 2010 at Dawson Creek, B.C.
Panel: Simmi K. Sandhu and Bill Oppen
Appearances: Elwin Gowman, for the Applicants
Darron Naffin, for the Respondent

INTRODUCTION

[1] Mary and John Miller lease a portion of their Lands to Penn West Petroleum Ltd. ("Penn West") for a sweet gas well tied-in to a pipeline that is shut in with no future production potential. The leased areas comprise 3.56 acres for the wellsite, with an access road of 3.34 acres, for a total of 6.90 acres (the "Leased Area").

[2] The parties executed a surface lease for the Leased Area on or about November 25, 2003 and the Millers have been receiving $4,500 per year in compensation pursuant to that lease (the "Lease"). The Millers seek a renegotiation of the annual compensation under the Lease pursuant to section 12 of the *Petroleum and Natural Gas Act*, R.S.B.C. 1996, c. 361 (the "Act").

ISSUE

[3] The issue before us is: what is the appropriate compensation to be paid to the Millers by Penn West under the existing Lease?

THE LEGISLATION

[4] Section 21 (1) of the *Act* set out factors the Board may consider in determining an amount to be paid as compensation under this application, including,

(a) the compulsory aspect of the entry, occupation or use,
(b) the value of the land and the owner's loss of a right or profit with respect to the land,
(c) temporary and permanent damage from the entry, occupation or use,
(d) compensation for severance,
(e) compensation for nuisance and disturbance from the entry, occupation or use,
(f) money previously paid to an owner for entry, occupation nor use,
(g) other factors the Board considers applicable, and

(h) other factors or criteria established by regulation.

[5] The factors in section 21(1) do not speak to speculative future loss or damage, and compensation under the *Act* is only intended to compensate for loss or damage that has occurred or is reasonably probable and foreseeable; it is inappropriate to make a speculative award *(Arc Petroleum Inc. v. Piper*, MAB Order 1598-2).

EVIDENCE AND ANALYSIS

[6] The parties take two fundamentally different approaches to determine compensation. The Millers presented a report from Anne Clayton, real estate appraiser, who relied on a method of determining compensation based on a comparison of comparable adjusted lease rates to the comparables' land values to arrive at a factor which is then applied to the subject's land value. Penn West presented a report from Robert Telford, real estate appraiser and land agent, who calculated compensation based only on the specific heads of compensation contained in section 21(1) of the *Act*. Neither party relied upon an analysis of a pattern of dealings for comparable properties and leases in the area.

[7] Ms. Clayton reviewed seven leases dated from 2000 to 2007, as well as the subject, that she "selected" on the basis that the lessors were reasonably well informed and negotiating in their best interests. We were not informed of the specifics of the leases discarded in her analysis.

[8] She then adjusted the lease rates for "compensation in kind" and for time. In terms of the "compensation in kind" adjustment, Ms. Clayton concluded that in certain leases, lessors agreed to a lower annual rental rate because they received other types of compensation, such as supplying water for drilling, or renting tanks and other material to the oil company. For the subject lease, there is a term that the lessee would hire Mrs. Miller's son, Rick Pavlis, to complete lease construction. Therefore, Ms. Clayton determined from Mr. Pavlis the profit from that construction work at $4,243.17 for each of the first five years of the lease, discounted it for present worth over the five year term, and then adjusted the lease rate for this. She also adjusted another lease comparable, which she says is the most similar to the subject, for "compensation in kind". There are no other adjustments for other characteristics, such as size or location. The sizes of the leased areas of the comparables range from 2.82 acres to 6.89 acres. She did not adjust for location because all the leases were located in the rural Dawson Creek area. She did not consider the nature of the land being leased, i.e. whether it was agricultural or used for another purpose, or whether the wellsite was at the outside boundary of the quarter section or in the middle, or whether the wellsite was on a home quarter or not.

[9] After adjustments for time and in kind compensation, the adjusted lease rates range from $1,999 to $623 per acre.

[10] She then determined a land value for the subject and each comparable. She reviewed 12 sales of quarter sections between 2008 and 2009 in the Rolla/Doe River area and concluded that the market value of the subject as of November, 2008 was within the range of $1,150-1,250 per acre based on the sales of properties with a soil rating similar to the subject of CLI2. She concluded the market value for the subject at $1,200 per acre.

[11] For the seven lease comparables, she determined land values for each comparable based on the sales of properties from 2006 to 2009, adjusted for time.

[12] She compared the adjusted lease rates of the seven comparables with the land values she had assigned to each comparable, as well as the subject, and obtained a lease rental to land value ratio, ranging from 3.08 to 1.64 with a median of 2.05. She applied this factor of 2.05 to the land value she assigned the subject of $1,200 per acre and arrived at an appropriate lease rate for the subject of $2,460 per acre, which she says should be the renegotiated lease rate.

[13] There are a number of problems with this analysis. Ms. Clayton did not provide any evidence to show that there is any link between the market value of the land and lease compensation. The lease rate to land value ratio can only be a statistically relevant relationship if each rate represents a common characteristic. For example, in property assessments, an Assessment to Sales Ratio is often used for analysis in which a property's assessment is compared to its selling price. However, both the assessment and the sale price represent a market value for the property and therefore, the ratio becomes a relevant method to analyze whether the assessment is accurate. However, in Ms. Clayton's analysis, the lease rates presumably represent compensation for factors relating to entry onto the land, nuisance, loss of profit or other factors, or a combination of those factors, and the land value represents the market value of the land: two very different concepts. In other words, the market value of the land represents the value of the fee simple interest in the land, while a lease rental rate does not attempt to value the fee simple interest, but is instead compensation for use of the land. Again, they represent two different concepts which, without evidence to the contrary, have no relationship to each other.

[14] Further, we do not have evidence as to how the lease rates for the comparables were negotiated, what each of the comparable lease rates were meant to compensate for, and whether or how those rates took into consideration the value of the land. Ms. Clayton confirmed in her testimony that there are often inducements not captured in the lease documents and side agreements. If so,

what the lease rate compensates for, and the myriad of factors that effect those rates, become more difficult to identify.

[15] Another difficulty with Ms. Clayton's evidence is that she provided insufficient evidence regarding the comparability of the leases relied upon. There were no adjustments made for location of the leased areas compared to the subject, the location of the wellsite within the quarter acre, whether or not the quarter section was a home site, or the use of the property. All of these factors presumably affect the amount of compensation received by a landowner under a lease, but these were not considered in determining comparability with the subject.

[16] Ms. Clayton's ultimate conclusion that the appropriate lease rate as a ratio of the land value should be over twice the market value of the land also undermines the usefulness of the analysis. As stated by the B.C. Supreme Court in *Western Industrial Clay Products Ltd. v. Mediation and Arbitration Board* (20 BCLR (4th) 337 (affd by B.C.C.A. 35 B.C.L.R. (4th) 205), in the absence of special circumstances, the upper limit of compensation is the value of the land. No evidence was provided that there are special factors warranting higher compensation to the Millers than indicated by the market value of the land. Awarding compensation that represents twice the value of the subject, with no evidence of special circumstances surrounding this property, is contrary to existing legal principles of compensation under the *Act* and beyond the jurisdiction of the Board.

[17] Conversely, Mr. Telford, for Penn West, presented a very different analysis to determine compensation, that only considered each of the enumerated factors set out in section 21(1) of the *Act*. He concluded that there should be no compensation for the compulsory aspect of the entry, occupation and use and the land value (section 21(1)(a) and (b)) because the one time lump sum payment that was made with the initial negotiation compensated for these factors. No evidence, however, was provided that the parties, when they negotiated the lump sum payment intended it to compensate for these factors nor does the lease state this.

[18] Mr. Telford determined that there could be compensation for nuisance and disturbance from the occupation and use (section 21(1)(e)), severance (section 21(1)(d)), and loss of a right or profit with respect to the land (section 21(1)(b)). However, he stated that the landowner would need to provide evidence of this loss and that the compensation should be for actual and reasonably foreseeable projected losses of the landowner. He concluded that the subject was being used for production of canola and wheat in 2008 and based on actual yields and a four year crop rotation, the crop loss would total $1,773 per year. As for severance, there is a 0.288 acre area that had been severed from the rest of the property that cannot be farmed due to the location of the wellsite, and he

estimated the crop loss from the severed area at $74.00 per year. As for nuisance, he tried to estimate any additional costs associated with the farming operations due to the wellsite and concluded that the owner would spend an additional day per year dealing with the oil company at $50 per hour, for a total of $400 per year. Therefore, he concluded the Millers were entitled to receive $2,250 per year as compensation under the Lease, less than what they currently receive. Mr. Telford confirmed he looked at four comparable leases of similar sites with shut-in lines and similar location around November, 2008 and determined that there was no pattern of dealings for lease renewals in the area. Evidence of these leases was not provided.

[19] Penn West and Mr. Telford say that in a rent review application under the *Act*, the Board is limited to determining actual or recurring losses sustained by the landowner, i.e. there must be evidence of probable or reasonably foreseeable ongoing losses and damages that can be reasonably quantified (*Arc v. Piper, supra*). They say that Ms. Clayton's evidence fails to do this.

[20] As with Ms. Clayton's evidence, there are difficulties with Mr. Telford's analysis. He ignored the current compensation under the Lease, $4,500 per year, and his conclusion that the compensation should be half of what is currently being paid is simply not reasonable. Section 21(1)(f) states that the Board may consider money previously paid to an owner for entry, occupation or use and section 21(1)(g) also references other factors. The existing compensation is an important factor to consider.

[21] The other factor that Mr. Telford has not adequately presented is the pattern of dealings in the area or the prevailing rates being paid for comparable leases. He stated that he found no pattern of dealings in the area, but did not provide evidence to support this conclusion.

DECISION

[22] There are difficulties with the evidence of both parties, however, we find that Ms. Clayton's analysis cannot be relied upon because she has not shown that a relationship exists between lease rates and land values and concluded a rate of compensation that goes well beyond the market value of the property. Based upon this and other difficulties set out above, we cannot rely upon Ms. Clayton's analysis to determine compensation.

[23] We would have preferred to see better evidence presented by both parties of comparable leases in the area and evidence of whether or not there was a pattern established within those comparable leases. Mr. Telford provided no evidence of this other than his statement that he considered some leases and found no pattern. Ms. Clayton provided seven lease comparables, however, we

have insufficient evidence on the comparability of those leases to the subject. Based on size of leased area, only three (comparables 1, 2 and 5) are close to the size of the subject's leased area, but the leases date from 2003, 2005 and 2007. We do not know precisely the location of these leases and other details to determine if those properties and leases are otherwise similar to the subject. As such, we have insufficient evidence to establish a pattern of dealings upon which we can base compensation for the subject.

[24] Therefore, we are left with Mr. Telford's evidence and his analysis based on the heads of compensation set out in section 21(1) of the *Act*. Although we have concerns with his evidence, we find his evidence is the best evidence that we have before us and we accept his evaluation of the heads of compensation set out in sections 21(1)(a) to (f).

[25] However, as stated by the B.C. Supreme Court in *Scurry Rainbow Oil Ltd. v. Lamoureaux*, 33 L.C.R. 65, having reviewed whether there was a pattern of agreed values and evaluating the various heads of compensation in section 21(1), the Board should then step back from its award and consider whether in its totality, it gives proper compensation in any case because there may be some cases where the sum of the parts exceeds, and some where it falls short of, proper compensation. In our opinion, this is a situation of the latter, particularly, in the circumstances where the sum of the parts falls short of the existing compensation. An analysis of compensation based on the heads of compensation arrives at a figure of $2,250 based on our acceptance of Mr. Telford's evidence. However, the global effect of this calculation results in a 50% reduction of the existing compensation being paid under the Lease.

[26] Having considered the global effect as well as other factors as set out in section 21(1)(g), including the existing compensation being paid, we find that the appropriate compensation should remain $4,500 per year. Added to this figure should be compensation for the severed areas of $74.00 (based on Mr. Telford's calculations), which compensation, both parties agreed, was not included in the existing compensation being paid.

[27] Another factor which has not been adequately considered by either appraiser is section 21(2) of the *Act*, which states that the Board <u>must</u> consider any change in the value of money and of land since the date the surface lease was originally granted. Penn West says that this does not relate to a simple increase in the market value of the land, but where the land use and impact of wellsite has changed since the date of the original lease. However, this interpretation does not reflect the language of section 21(2) which refers to any change in the <u>value</u> of money and of the <u>value</u> of land, not a change in use. The only reliable evidence before us on a change in value is Ms. Clayton's time adjustment of the subject's lease rate of about 9% to November, 2008, which we find is reasonable compared to the change in the value of farm land by way of

Ms. Clayton's paired sales analysis over time. We do not accept that the *Court Order Interest Act* applies in this instance to the statutory requirement set out in section 21(2). We would have preferred to see other evidence as well, including the consumer price index, however, in the absence of better evidence we accept Ms. Clayton's time adjustment analysis on this point. We find the lease rate reflecting change in the value of money and land since the Lease was originally negotiated is $711 per acre or $4,906 per year.

[28] We find the appropriate compensation to be $4,906 per year plus $74 per year for the severed areas, for a total of $4,980 per year, retroactive to November 25, 2008.

ORDER

[29] Pursuant to section 12(2) of the Petroleum and Natural Gas Act, the Board orders that the rental provision under the Lease be varied to $4,980 annually retroactive to November 25, 2008.

DATED May 31, 2010

FOR THE BOARD

Simmi K. Sandhu, Panel Chair

Bill Oppen, Member