OIL & GAS CONTRACT ADMINISTRATION FOR THE 80's AND 90's -- NEGOTIATING THE LEGAL AND REGULATORY MAZE

Presented to Employees of
OXY CITIES SERVICE NGL INC.

23 March 1988
Tulsa, Oklahoma

by

David E. Pierce
Associate Director
National Energy Law & Policy Institute
Visiting Associate Professor of Law
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I. PROGRAM DESCRIPTION AND SCHEDULE

A. Program Description

1. This four-hour program is designed for attorneys, accountants, and contract administrators, who must work with contracts used to facilitate the exploration, development, production, processing, and marketing of oil and gas.

2. The development process is studied chronologically, examining each player in the development process and the common types of contracts encountered.

3. After studying the development process, the oil and gas lease, and conveyances by the lessor and assignments by the lessee, are examined more closely to identify common problems which confront persons representing a gas processing plant operator.

4. After identifying these common problems, various agreements designed to resolve a problem, or leverage the risk of a problem, are examined.

5. Discussion of current issues of special interest to persons representing a gas processing plant operator.

6. Study of federal regulation of the production, processing, marketing, and transportation of natural gas.

7. Discussion of possible trends in the industry and the effect they may have on the gas processing plant operator.

B. Program Schedule

1. 9:30 AM to 10:20 AM
   Introduction to Oil and Gas Contracts
   The Development Process
   The Oil and Gas Lease

2. 10:20 AM to 10:30 AM
   Break

3. 10:30 AM to 11:30 AM
   Joint Operations
   Production Sales

4. 11:30 AM to 1:00 PM
Break for Lunch

5. 1:00 PM to 1:50 PM
Current Gas Processing Issues

6. 2:00 PM to 3:00 PM
FERC And Your Daily Operations
Future Industry Developments

7. 3:00 PM
Open Forum For Questions And Discussion

II. INTRODUCTION TO OIL AND GAS CONTRACTS

A. Nature Of The Industry

Oil and gas industry, like many others, is built on contracts. Every aspect of the exploration, development, and production process requires special contractual attention. The oil and gas industry is contract-intensive because it is capital- and risk-intensive.

1. Complex ownership and development relationships further complicate matters.

2. Contract practices also tend to cause problems:

    a. Time - lack of it.

    b. People - the "letter agreement syndrome."

    c. Forms - tradition, misuse, and abuse.

    d. Change - abundance of it.

B. The Enforceable Agreement

1. To have an enforceable agreement, must have the following:

    a. Mutual Assent. The parties must agree. Expressed by an "offer" and "acceptance."

    b. Consideration. Something exchanged between the parties to support the bargain created by the offer and acceptance.

    c. Capacity. Parties to the agreement have the legal capacity to enter into the agreement.

d. Legal Subject Matter. The agreement cannot violate the law or public policy.

e. Definite Enough To Enforce. The agreement must have sufficient detail to permit a court to ascertain the rights and obligations of the parties.

f. Formalities. Certain agreements must be in writing and meet other formal requirements.

2. Common Misperceptions

a. FICTION: I can't create a contract unless I intend to be bound.

FACT: Mutual assent, the process of offer and acceptance, is governed by your objective (outward) expressions, not your subjective (unexpressed) intentions. It is not a matter of what <u>you</u> <u>meant</u> but rather what a <u>reasonable person</u> <u>perceived</u> you meant.

b. FICTION: "Letter agreements" are not binding.

FICTION: We can't have a contract until my attorney drafts a formal agreement.

FICTION: I can't create a contract until my department manager approves it.

FICTION: Contracts can only be written on legal sized paper.

FICTION: This can't be a contract because it doesn't have "legal language."

FACT: An enforceable agreement can be formed when the necessary elements are present. Usually this will require an offer, an acceptance, consideration (which is usually your promise, on behalf of the company, to do something), a writing signed by the parties, and you have the capacity to sign.

NOTE: Can create an agency relationship through express or implied contract, or by intentionally or negligently leading others to believe the person has the authority to act for the company. An act of an agent within the <u>apparent</u> scope of his authority is binding on the corporation.

c. FICTION: I can bind the other party to a contract without binding myself.

FACT: Generally, there must be "mutuality of consideration (obligation)" between the parties to have an enforceable agreement. If consideration for the agreement is a promise by one of the parties to do something, and performance of the promise is optional, or will not constitute a legal detriment to the party, the contract is "illusory" and therefore void.

NOTE: Managers often want more time to decide whether to accept an offer, but they don't want the other side shopping around while a decision is being made. Practical way to address this problem: Option Contract. You enter into a separate contract to give you a specified amount of time to decide whether you want to accept or reject an offer.

C. Controlling Contract Formation

1. Offer

a. Clearly distinguish in your correspondence whether you are making an offer or merely inviting an offer from the other party.

b. Ideally, should be able to examine a transaction at any stage and clearly identify if you have made any offers or are merely engaged in preliminary negotiations.

c. Language and labels are not necessarily determinative.

d. Example - Preliminary Negotiations:

"These are my preliminary thoughts on the matter; this letter is not intended to create any sort of an offer to contract. However, if you wish to make an offer based upon the terms stated in this letter, please sign and date a copy of this letter and return it to my attention. I will then present it to my management for their consideration."

e. Example - Present Offer:

"As a result of our negotiations, I am prepared to make the following offer: [specify terms of the deal]. To evidence your acceptance of this offer, please sign and date a copy of this letter and return it to my attention. The terms of this letter will constitute our contract."

NOTE: This language will be effective if the other terms of the letter coincide with the intent to create a present contract.

For Example: If the "offer" expressly requires management approval before it can be binding on the party making the offer, it is really only an invitation for offers from the other party (preliminary negotiations).

If the letter indicates it will not become effective until a formal contract is drafted and approved by the parties, no binding agreement will be created until the formal contract is prepared and approved.

CAUTION: A mere reference in the letter, such as "Subject to preparation of a formal agreement," may not be sufficient to keep the letter from becoming a present offer (and contract after acceptance). In such cases courts may find the parties intended to presently enter into a binding contract and then attempt to formalize it later. Unless the formal agreement is expressly stated as a condition to formation of the contract, a contract may, unwittingly, be formed.

2. Acceptance

a. Once an offer is made, it creates in the party to which the offer is directed, a "power of acceptance."

Until the offer is accepted, there is no contract.

Evaluate whether a party has accepted an offer by the same objective standard used to determine whether an offer has been made. For Example: Would a reasonable person, observing the actions of the person with the power of acceptance, conclude they intended to accept the offer.

b. The person making the offer can specify what the other party must do to accept the offer. This is important because it allows you to look at the transaction and determine whether you are subject to a contract.

c. Anytime prior to acceptance of the offer, the person making the offer can change their mind. They can "revoke" the offer.

d. May want to structure acceptance so you know when you are still free to revoke an offer - so you can make offers to other persons.

e. The "power of acceptance" can be destroyed by:

(1) "Rejection" of the offer. "I don't accept."

(2) "Counter-offer." "I accept all the terms of your offer except the price will be \$2.10/MMBTU instead of \$2.09/MMBTU."

(3) "Lapse." The offer required a response by 23 March 1988 at 4:00PM. Or, if no time is specified, the offer will lapse after a reasonable time has passed. "Reasonable time" varies according to the circumstances of the parties and the subject matter.

(4) "Revocation." Person making the offer revoked it prior to acceptance. This assumes the person making the offer did not <u>contract</u> to hold the offer open for a specified period of time.

(5) Death or Incapacity. If the person making the offer, or the person to whom it is made, dies or becomes legally incapacitated, the offer will terminate. NOTE: Different rule if there is an option contract.

D. Administering The Contract

1. The contract is a "living" instrument.

Carefully negotiated and drafted rights and obligations in the contract can be lost through poor administration.

NOTE: This is something attorneys, particularly tax attorneys, should consider when drafting agreements or requiring relations to be structured in a particular way.

Can the proposed agreement be efficiently administered once it takes effect?

Does your client have the capacity to function under the contract?

2. Read the contract periodically and audit its operation.

   For Example: May need to request a deliverability test to determine the "average daily quantity" of gas used to calculate take-or-pay obligations.

3. Diligently pursue any failure to adhere to the express terms of the contract to avoid later claims of "waiver" and "estoppel."

   Determine what your course of action can (and should) be for any deviation from contract terms. Notify the other party how you plan to treat present, and future, deviations.

4. Each contract, even with the same party, has a separate existence.

   CAUTION! Avoid settling disputes under one contract through nonperformance of other contracts. For Example: Gas Purchaser (<u>GP</u>) buys gas from <u>X</u> under three different contracts. <u>GP</u> believes <u>X</u> has tampered with the meters to wells under contract #1, resulting in an overpayment to <u>X</u>. <u>GP</u> withholds payment for gas under contracts #1, 2, and 3 until the overpayment is recovered. <u>GP</u> has breached contracts #2 and 3 unless they specifically authorize <u>GP</u> to withhold payment under these circumstances.

5. If you have a potential breach of contract (whether you are the breaching party or the other party commits the breach), obtain legal assistance.

   If you are the breaching party, there may be ways to cure the default, minimize damages, and maintain the contract in effect.

   If you believe the other party has breached the agreement, proceed with caution. A wrong move, a moment of overreaction, or a poorly phrased declaration, could make you the breaching party.

III. THE DEVELOPMENT PROCESS

A. The Landowner

1. Owner of land owns all minerals that may be found within the surface boundaries (extended downward) of their land. However, since oil and gas can migrate within a defined rock structure (reservoir), must produce the oil and gas to perfect ownership.

2. Rule of Capture. Oil and gas produced from a properly operated well, bottomed within the landowner's surface boundaries, belongs to the person capturing it - even if it has been drained from under neighboring lands outside the landowner's surface boundaries. Edwards v. Lachman, 534 P.2d 670 (Okla. 1974).

3. Conservation Regulation. State places limits on how close to another person's property you can drill a well - spacing regulation. State also regulates the rate at which you can produce a well - production regulation (prorationing). State laws establish the minimum rules for how the Rule of Capture can be exercised.

4. Rights to the minerals can be owned separate from the right to occupy and use the surface of the land.

   a. For Example: A owns the land. A can convey the oil in the land to B, the gas to C, and retain the balance of the minerals - and the right to occupy and use the surface.

      B would have the right to the "oil" and the right to enter and reasonably use the surface of the land to develop it for oil.

      C would have the right to develop the "gas" in the land and make similar use of the surface.

      A would own all rights to minerals other than "oil" and "gas" and would have the right to occupy and use the surface subject, however, to the surface rights of B and C.

b. A could also create a severance by conveying the land and excepting from the conveyance the "oil and gas."

c. Rights to the surface often referred to as the "Surface Estate." Rights to minerals referred to as the "Mineral Estate." Problem, however, because usually the Surface Estate also includes some minerals not otherwise conveyed away by the surface owner.

5. Developer's major problem is trying to identify everyone who has the right to develop the target minerals (e.g. oil and gas). Must identify all these "mineral interest" owners so they can be approached by the developer.

   Mineral interest often fragmented and held by numerous individuals and entities.

6. Often have interpretive problems. For example:

   a. Does this person own the rights to "oil and gas?"

   b. Does my "oil and gas" lease include helium?

   c. Does the document creating the interest give the person the right to develop the minerals or only the right to participate in the income from mineral development?

      More commonly referred to as the mineral/royalty problem. Does the document convey a "mineral" interest (which includes the right to develop) or a "royalty" interest (which does not confer development rights but merely a right to participate in a share of production).

7. Rights in the minerals can be transferred in two general ways:

   a. Voluntary Transfers -

      Mineral Conveyances through documents commonly titled "Mineral Deeds."

      Rights to participate only in a share of production (royalty) through documents commonly titled "Royalty Deeds."

b. Involuntary Transfers -

Death - when a person dies owning minerals (or land where the minerals have not all been severed), their interests will either pass by the terms of their will (if they have one) or pursuant to state law (if they don't have a will - or if they do and the will doesn't dispose of their mineral property).

Three situations where the will would not dispose of the property: (1) The property is not subject to the will - such as minerals held in joint tenancy with the right of survivorship, or held in trust. (2) The will fails to mention the property - in which case it would pass through the state's intestacy law. (3) The will purports to convey the property but some or all of it is subject to a spouse's election - under homestead laws and dower.

c. Judicial Action - Title to the property becomes subject to a court and is transferred by court decree. For example: Divorce, Foreclosure, Quiet Title, Partition, Condemnation, Bankruptcy.

8. Goal is to trace an unbroken chain of title to the minerals from the person you are dealing with back to the issuance of the federal patent to the land.

Chain for voluntary transfers created by deeds and mineral deeds.

Chain for involuntary transfers created by the documents of the judicial proceedings causing the change in title. Must examine enough of the court proceeding to ensure it had jurisdiction over the property and all necessary parties, that all proceedings were properly conducted, and that the final order of the court places title to the interest in your chain of title.

B. The Developer

1. Developers in the United States overwhelmingly use an "Oil and Gas Lease" to obtain the right to develop minerals.

2. Lease has aspects of a conveyance and a contract.

3. Developer's interest created by the Oil and Gas

Lease commonly referred to as a "Leasehold Interest" or a "Working Interest." Called a working interest because the lessee is given the right to enter the leased land and "work" it for the granted minerals.

4. Lessee can create various non-working interests in the leasehold estate by conveying (assigning) rights to receive income from production which lack any right to exercise the right to work the leased land. Common forms of non-working interests created by lessees include:

   a. Overriding Royalty. A right to a share of oil and gas from the leased land free of the cost of production. Payable out of the working interest from which it is carved; will terminate (as is the case with all non-working interests) when the lease terminates.

   b. Production Payment. A right to a share of oil and gas from the leased land free of the cost of production but limited to a specified quantity or value of production.

   c. Net Profits Interest. A right to a share of oil and gas from the leased land free of the cost of production but payable only if and when the lessee earns a net profit from its operations. Difficulty is defining what costs will be deducted from revenues to determine whether a net profit has been realized.

   d. Convertible Interests. A non-working interest, such as an overriding royalty, which may be converted to a working interest after the occurrence of a specified event, such as recovery of costs from a well. Commonly used in farmout transactions.

5. Working interests and non-working interests, like mineral interests, can be transferred by voluntary action - conveyance by the owner (usually through a document called an "Assignment"), or by involuntary action.

6. Anyone purchasing production from property must ascertain everyone having the right to produce and sell the specified mineral.

   a. Must identify mineral owners - to ensure the people developing the land obtained their lease from the proper parties.

b. Must identify royalty owners - to ensure you account for everyone entitled to a share of production carved out of the mineral interest by the mineral owner.

c. Must identify working interest owners that obtained mineral owners' development rights.

d. Must identify non-working interest owners - to ensure you account for any rights to a share of production carved out of the working interest.

C. Terminable Interests

1. Many oil and gas interests are for a limited duration. Upon the occurrence of a specified event, ownership terminates in the present owner.

2. The interest may terminate completely - such as with a production payment that has been satisfied (paid). Consider the Oil and Gas Lease.

3. The interest may change - such as with a farmout agreement where upon payout of a well an overriding royalty can be converted to a working interest.

4. The interest may revert - such as with term interests and defeasible term interest.

Term Mineral Interest. A conveys to B all the oil and gas in Section 30 for a term of 10 years.

Defeasible Term Mineral Interest. A conveys to B all the oil and gas in Section 30 for a term of 10 years and so long as oil or gas is produced from Section 30.

5. The interest may shift to another person - The Life Estate. X grants the oil and gas in Section 30 for life with the remainder to A.

6. "NGL shall not be responsible for recognizing any change of ownership in the absence of actual notice and proof thereof satisfactory to NGL. NGL is hereby relieved of any responsiblity for determining when any money or other payments, payable from any interest herein set forth, has been satisfied or discharged . . . ."

D. Simple Leasehold Development

LANDOWNER
Mineral Interest Conveyances
"Deeds" and "Mineral Deeds"

OIL & GAS LEASE

DEVELOPER
Leasehold Conveyances
"Assignments"
"Farmouts" and "Support Agreements"

GAS SALES CONTRACT

DIVISION ORDERS

GAS PURCHASER
Traditionally a Pipeline or Processor

E. Leasehold Development - Multiple Developers

LANDOWNER

OIL & GAS LEASE

POOLING AGREEMENT OR ORDER

DEVELOPER A
DEVELOPER B
DEVELOPER C
DEVELOPER D

Multiple Ownership of the Leasehold Interest
Due to Assignments, Farmouts, Pooling Agreements or Order

OPERATING AGREEMENT

Creates the "Operator" [Developer C]

GAS SALES CONTRACT

DIVISION ORDERS

GAS PURCHASER

F. Leasehold Development - Gas Processor

LANDOWNER

OIL & GAS LEASE

DEVELOPERS A, B, C, & D
OPERATING AGREEMENT
OPERATOR C

GAS PROCESSING AGREEMENT

RESIDUE GAS SALES CONTRACT

DIVISION ORDERS

GAS PROCESSOR

RESIDUE GAS PURCHASER

LIQUIDS CONTRACTS

LIQUIDS PURCHASERS

G. Leasehold Development - Gas Marketer

LANDOWNER

OIL & GAS LEASE

DEVELOPERS A, B, C, & D
OPERATING AGREEMENT
OPERATOR C

[GAS MARKETER]
MARKETING AGREEMENT

GAS PROCESSING AGREEMENT

GAS PROCESSOR

[GAS MARKETER]
TRANSPORTATION AGREEMENT

GAS SALES CONTRACT
[MERCHANT OR END USER]

PIPELINE

H. Leasehold Development - Common Creditors

LANDOWNER

OIL & GAS LEASE

DEVELOPERS A, B, C, & D
OPERATING AGREEMENT
OPERATOR C.

OPERATOR C

DRILLING CONTRACT
OTHER SUPPLY & SERVICE CONTRACTS

DRILLING CONTRACTOR
SUPPLY & SERVICE CONTRACTORS

MORTGAGE AGREEMENTS
SECURITY AGREEMENTS

PRIVATE & COMMERCIAL LENDERS

IV. THE OIL AND GAS LEASE

A. Preliminary Considerations

1. Basic transaction for developing oil and gas in America is for the landowner to "lease" the minerals, and associated surface easements, to a developer.

2. Generally, the relationship created by the oil and gas lease is not governed by landlord/tenant law.

   a. Special rules have been developed by the courts to govern the oil and gas lessor/lessee relationship.

   b. There has also been some statutory intervention governing the relationship.

3. No standard "form" of oil and gas lease. _Fagg v. Texas Co._, 57 S.W.2d 87 (Tex.Com.App. 1933) ("the character of printed matter contained in any designated class of oil and gas lease form depends on what matter various designers of such forms may deem appropriate - and may vary accordingly.").

4. Although there is no standard _form_ of oil and gas lease, oil and gas leases create a standard _relationship_. See Pierce, "Rethinking the Oil and Gas Lease," 22 _Tulsa Law Journal_ 445 (1987); See generally M. Merrill, _Covenants Implied in Oil and Gas Leases_ §§220-223 (2d ed. 1940); Polston, "Recent Developments in Oil and Gas Law," 6 _Eastern Min. L. Inst._ 19-1, 19-2 (1985).

   a. The relationships created by varying oil and gas lease forms are typically identical in structure.

   b. Courts and legislatures have fashioned rules to respond to the relationship, not necessarily the terms of a particular lease form.

5. The basic structure of the standard relationship consists of the following:

   a. Lessee given option to conduct operations on the leased land for a specified term.

   b. Lessee must pay a "rental" if development is not immediately pursued. This is an interim fee to maintain the option in effect.

c. If lessee discovers oil or gas during the option period, the grant is extended until it is no longer profitable for the lessee to produce existing wells.

d. Lessee pays all the costs and keeps all the revenue, subject to an obligation to pay or deliver a cost-free share of production to lessor.

B. Basic Structure of the Oil and Gas Lease

1. The basic structure of the oil and gas lease, like the relationship it creates, has become standardized, consisting of the following clauses:

   a. Granting Clause

   b. Habendum (Term) Clause

   c. Drilling/Delay Rental Clause

   d. Royalty Clause

2. Granting Clause - defines the scope of the rights conferred upon lessee.

   a. Land encompassed by the grant. Surface and subsurface extent.

   b. Purpose of the grant.

   c. Substances encompassed by the grant.

   d. Easement burdening the surface estate necessary to exercise the grant.

3. Habendum (Term) Clause - defines the duration of the grant.

   a. Primary Term - the period of time, specified in the lease, during which it will remain in effect. (Subject to the operation of other clauses which may extend or reduce the specified term.)

      For Example: "This lease is for a term of three years from the effective date."

      Also known as the "term" clause.

   b. Secondary Term - a contingency which extends the lease beyond the primary term.

For Example: "This lease is for a term of three years from the effective date <u>and so long thereafter as oil or gas, or either of them, is produced from the leased land</u>."

Also known as the "thereafter" clause.

4. Drilling/Delay Rental Clause - limits the duration of the lease unless the lessee develops the leased land or pays a "rental" to delay development.

    a. Limitation on the primary term of the lease.

    b. Lessee has the option to either drill or pay delay rental. Unless the lessee drills or pays rental, the lease terminates.

5. Royalty Clause - specifies the lessor's share of production, substances subject to the royalty obligation, costs chargeable to lessor's share, how it will be valued and paid, and when it is payable.

6. Miscellaneous Express Clauses - most of the remaining clauses found in the typical lease are designed to expand or qualify the operation of the four basic clauses. For example:

    a. Pooling Clause provides a mechanism to expand the scope of the habendum clause and modify the drilling/delay rental and royalty clauses.

    b. Completion, dry hole, cessation, shut-in royalty, and force majeure clauses are designed to expand the duration of the lease under the habendum clause.

7. Judicially-Defined Implied Obligations - express lease clauses are affected by judicial attempts to balance the relative positions of the lessor and lessee under the standard relationship created by the oil and gas lease.

C. Keeping the Lease Alive

1. Habendum clause establishes duration of the lease.

    a. Other clauses, such as the drilling/delay rental clause, may limit the duration of the lease.

    b. Other clauses may extend the lease.

2. Habendum clause creates a "special limitation" on the grant.

   a. This is an area where the lease "contract" is treated more like a conveyance.

   b. If the requirements of the habendum clause are not met, the lease terminates. The terms of the habendum clause limits the duration of the leasehold grant.

3. Production Requirement.

   a. Typical habendum clause extends the grant "for so long as oil or gas is produced."

   b. Kansas - Must be actual production at the end of the primary term.

      Substance must be produced <u>and marketed</u> on the date the primary term ends or the lease terminates. <u>Baldwin</u> <u>v.</u> <u>Oil Company</u>, 106 Kan. 848, 850, 189 P. 920, 921 (1920).

      Similar rule applied to defeasible term mineral interests. <u>Home Royalty Ass'n</u> <u>v.</u> <u>Stone</u>, 199 F.2d 650, 653 (10th Cir. 1952).

   c. Oklahoma - Discovery of production satisfies the habendum clause. A reasonable time is allowed to initiate marketing of production. <u>McVicker</u> <u>v.</u> <u>Horn, Robinson & Nathan</u>, 322 P.2d 410 (Okla. 1958) (contrasts the Kansas position).

   d. Texas - Follows the Kansas rule. Production requires marketing.

   e. Well not completed by end of primary term - Lessees responded with express lease provisions allowing lessee to "complete" a well which was "commenced."

   f. Well completed but unable to market production by end of primary term - Lessees responded with shut-in royalty clause to avoid situations like <u>Elliott v. Oil Co.</u>, 106 Kan. 248, 187 P. 692 (1920), where lessee had, during the primary term, completed several productive gas wells on the land but was unable to get it hooked up to a pipeline prior to the end of the primary term. Held: lease terminated.

g. Even though the lease is producing when the primary term ends, lease remains in effect only so long as production continues.

h. Lease forms often expand the habendum clause by specifying events which will extend the lease without actual production or discovery of production. For example, gas storage, pooling, unitization, shut-in royalty, commencement of a well, operations, completion of a dry hole.

4. Paying Quantities

a. Phrase "so long as oil or gas is produced" means produced in paying quantities.

b. When used in habendum clause of lease or defeasible term mineral interest, it requires "production of quantities of oil or gas sufficient to yield a profit to the lessee over operating expenses, even though the drilling costs, or equipping costs, are never recovered, and even though the undertaking as a whole may result in a loss to the lessee." Reese Enterprises, Inc. v. Lawson, 220 Kan. 300, 311, 553 P.2d 885, 895-96 (1976).

c. Texas Approach - Clifton v. Koontz, 160 Tex. 82, 325 S.W.2d 684 (1959):

"In the case of a marginal well, . . . the standard by which paying quantities is determined is whether or not under all the relevant circumstances a reasonably prudent operator would, for the purpose of making a profit and not merely for speculation, continue to operate a well in the manner in which the well in question was operated."

Whether there is a reasonable basis for the expectation of profitable returns from the well is the test."

d. Two major problems in determining profitability:

(1) What items to charge as expenses and include as income; and

(2) The period of time over which profitability should be considered.

D. The Royalty Clause

1. The terms of the royalty clause should identify the lessor's share of production, the substances it is payable on, how it will be valued and paid, the costs which can be deducted from lessor's share, and when it is payable.

   a. In most cases the royalty clause will be silent or ambiguous on many of these matters.

   b. Same type of problems when attempting to determine what non-working interest owners should be paid under overriding royalty, production payment, and net profits assignments.

2. Common form of royalty clause:

   "The royalties to be paid by lessee are: (a) on oil, and other liquid hydrocarbons saved at the well, one-eighth of that produced and saved from said land, same to be delivered free of cost at the wells or to the credit of lessor in the pipe line to which the wells may be connected;

   (b) on gas, including casinghead gas and all gaseous substances, produced from said land and sold or used off the premises or in the manufacture of gasoline or other products therefrom, the market value at the mouth of the well of one-eighth of the gas so sold or used, provided that on gas sold at the wells the royalty shall be one-eighth of the amount realized from such sale.

   This clause is from an oil and gas lease form distributed by the Kansas Blue Print Co. Inc. titled: "Form 88--(Producers) Kan., Okla. & Colo. 1962 Rev. BW."

3. Lessor's Share of Production

   a. Royalty clause usually states lessor's right to royalty as a fractional share of:
   (1) Production, (2) Value of production, or
   (3) Proceeds from a sale of production.

   b. Most royalty clauses provide for a share of production when the substance is oil or other liquid hydrocarbons (the right to "take in kind").

If the substance is gas, most clauses provide for a share of the proceeds or market value.

c. If the lessor has the right to take their royalty in kind, lessor retains title to a share of the substance until it is sold by lessor.

   If the lessor has a right to payment of the proceeds or market value of production, title to the substance is in the lessee when produced, subject to lessor's contractual claim for payment of proceeds or value.

d. If lessor fails to sell or otherwise dispose of their in-kind production, the lessee is generally regarded as having the right to sell the lessor's share of production and pay the proceeds to lessor.

   However, the lessee, or purchaser, will usually obtain the lessor's written permission to make the sale by having the lessor sign a "division order."

4. Valuation of Lessor's Share of Production

a. What is the production from the well worth? What is the market value of the production?

   With oil, this has seldom been an issue because it is typically sold under short-term contracts in a market which readily reflects a value for the commodity.

   Gas, however, is more difficult to value. Long-term contracts, inability to freely transport to a market, or alternative markets, and federal regulation each make it difficult to ascertain a market price for gas.

b. ILLUSTRATION:

   Assume a mineral owner has entered into an oil and gas lease providing for a 1/8th royalty. If gas is being sold under a long-term contract [entered into in 1960 when $0.80/MCF was a good price for gas] for $0.80/MCF, will the lessor's royalty be calculated using the $0.80/MCF value?

   Assume the current price being paid for

similar gas in the area is $8.00/MCF. Should lessor's royalty be calculated using the $8.00/MCF value?

What if federal regulation establishes the maximum lawful price for this particular gas at $4.00/MCF. Should the $4.00 figure be used to calculate lessor's royalty?

NOTE: If the value of the gas is anything other than $0.80/MCF, the lessee's inability to realize the higher market prices (due to the long-term contract) will result in the lessee perhaps paying a greater royalty on the gas than it receives for sale of the gas.

5. This "market value" problem generally will not arise unless the lease requires calculation of royalty based upon the "market value" of production. Courts have taken varying approaches to this issue:

   a. Oklahoma - Oklahoma courts, recognizing lessees generally must enter into long-term contracts to market gas, equate market value to the amount received by the lessee under the long-term gas sales contract. In our Illustration, the Oklahoma lessee will pay royalty using the $0.80/MCF value. However, lessee must have entered the gas contract in good faith and obtained the best price available at the time the contract was entered. <u>Tara Petroleum Corp.</u> <u>v.</u> <u>Hughey</u>, 630 P.2d 1269 (Okla. 1981).

   b. Texas - Texas courts look to current market value of the gas but consider its legal characteristics. The Texas lessee will pay royalty using the $4.00/MCF value. <u>First National Bank of Weatherford v. Exxon Corp.</u>, 622 S.W.2d 80 (Tex. 1981).

   c. Kansas - Kansas courts look to current market value without considering the legal characteristics of the gas. The Kansas lessee will pay royalty using the $8.00/MCF value. <u>Holmes</u> <u>v.</u> <u>Kewanee Oil Co.</u>, 233 Kan. 544, 664 P.2d 1335 (1983).

6. What are "proceeds?"

   Difficult to determine the extent of proceeds because the lessee obtains a number of benefits under the gas sales contract.

For Example: Is the right to have the gas redelivered at some point after the initial sale (which generated the "proceeds"), so the producer can process it, a "proceed" from the sale of the gas?

Is the obligation to make payments for gas even though it is never taken a "proceed?"

7. <u>When</u> do we determine market value or the proceeds?

Often this is tied to a particular point in time by the royalty clause - such as "market value at the well" or proceeds from the sale "at the well."

However, still have the questions: What is market value? and What are proceeds?

8. Costs Charged Against the Royalty Owner's Share

Once the market value/proceeds issue is resolved, still must determine what costs can be deducted from this gross amount to arrive at the lessor's net royalty share of production.

Royalty generally defined as a cost-free share of production. The lessee (working interest owners) must pay for all development (and thereby incur the risk), the lessor receives a share of production without having to contribute toward the cost of drilling, completing, equipping, and producing wells on the leased land.

a. Lessee's commonly charge royalty owner with their proprotionate share of "post-production" expenses. The problem is separating the production function from the post-production function. Difficult when lessee has an implied obligation to market production under the oil and gas lease.

b. Most courts have allowed lessee to deduct costs required to market production before calculating royalty. See, e.g., <u>Johnson v. Jernigan</u>, 475 P.2d 396 (Okla. 1970) (transportation charges to access a market).

Other courts view the marketing function as part of the production process contemplated by the lease and deny deduction of post-production expenses. See, e.g., <u>West v.</u>

Alpar Resources, Inc., 298 N.W.2d 484 (N.D. 1980).

c. The battle is raging in Oklahoma. Lessees have won at the Corporation Commission level. Lessors have taken the battle to the Oklahoma Legislature.

d. A carefully worded royalty clause would eliminate the dispute.

NOTE: The terms of the oil and gas lease will control this issue unless it is unclear or amended by some other document - like a division order.

E. Other Lease Clauses Affecting Royalty Calculation

1. The typical form of oil and gas lease will contain clauses which affect how delay rental, shut-in royalty, and royalty will be calculated. These clauses may significantly reduce the amount due under the clause authorizing the payment. The three most common of such lease clauses are: the proportionate reduction clause, pooling clause, and entirety clause.

2. Proportionate Reduction Clause - also called a "lesser interest" clause.

"If said lessor owns a less interest in the above described land than the entire and undivided fee simple estate therein, then the royalties and rentals herein provided shall be paid the lessor only in the proportion which his interest bears to the whole and undivided fee."

a. Regardless of the lessor's actual mineral ownership in the leased land, the oil and gas lease typically states the lessor owns, and leases, 100% of the mineral interest in the leased land.

b. Lessor's right to lease benefits is then reduced to reflect their actual ownership of minerals in the leased land.

c. Protects lessee's net revenue interest in the lease by ensuring lessee does not contract to pay more than the specified royalty (e.g. 1/8th) to gain control of all the minerals encompassed by the lease.

d. For Example: Using the proportionate reduction clause in paragraph IV.E.2., _A_ grants _X_ an oil and gas lease which purports to cover all the mineral interest in Section 30. Assume _A_ owns 50% of the mineral interest in Section 30.

Although the lease, on its face, indicates _A_ will receive $640 in delay rental and shut-in royalty, and a one-eighth royalty on production, the proportionate reduction clause will reduce each item ("royalties and rentals") to "the proportion which his [A's] interest [50%] bears to the whole undivided fee [100%]."

Therefore, the lease entitles _A_ to only $320 in delay rental and shut-in royalty (50/100 x $640) and a one-sixteenth royalty on production (50/100 x 1/8).

3. Pooling Clause

a. Many times oil and gas leases contain a pooling clause which authorizes the lessee to combine the leased land with adjacent lands to permit development in accordance with state spacing and prorationing laws.

b. The effect of a pooling clause is to combine leased acreage in a designated area to form a "pooled" unit. Mineral owners contributing acreage to the pooled unit will share in production from the unit. Each mineral owner's share of production, however, will generally be proportionate to their share of the acreage included in the pooled unit. See generally _Tiller v. Fields_, 301 S.W.2d 185 (Tex. Civ. App. 1957).

c. For Example: _A_ owns the minerals in the Southwest Quarter of the Southwest Quarter of Section 30 (40 acres). Lessee _X_, pursuant to pooling clauses in _X_'s leases with _A_, _B_, and _C_, declares a pooled unit consisting of Section 30 (640 acres). _B_ owns the minerals in the East Half of the Southwest Quarter (80 acres) and _C_ owns the remainder of the minerals in Section 30 (520 acres).

A well is completed on the Southwest Quarter of the Southwest Quarter of Section 30. Assuming each lease provides for a lessor's royalty of one-eighth, the typical form of pooling clause will adjust each lessor's royalty as follows:

<u>A</u>: 1/8 x 1/16 (40/640 acres) = 1/128
<u>B</u>: 1/8 x 2/16 (80/640 acres) = 2/128
<u>C</u>: 1/8 x 13/16 (520/640 acres) = 13/128

This assumes, as is typically the case, each party's participation will be determined according to the surface acreage they contribute to the pooled unit.

4. Nonapportionment and the Entirety Clause

a. Leases sometimes contain an "entirety clause" which provides that if ownership of the leased minerals is divided into separate tracts, after the lease is entered into, the lease benefits, including royalty, will be apportioned among the various tract owners on a surface acreage basis.

b. For Example: <u>A</u>, owner of the minerals in Section 30, leases to <u>X</u> on 1 January 1988. On 2 January 1988 <u>A</u> conveys the minerals in the Southwest Quarter of Section 30 to <u>B</u>. On 1 February 1988 a producing well is completed on the Southwest Quarter of Section 30.

If the lease did not contain an entirety clause, most state courts have held that royalty in this situation will not be apportioned, <u>B</u> would receive all the royalty since production is from the Southwest Quarter. See generally <u>Central Pipe Line Co. v. Hutson</u>, 401 Ill. 447, 82 N.E.2d 624 (1948) (discussing the states that apply apportionment and nonapportionment).

However, assume the lease contains the following form of entirety clause:

"If the leased premises are hereafter owned in severalty or in separate tracts, the premises, nevertheless, shall be developed and operated as an entirety, and royalties shall be paid to each separate owner in the proportion that the acreage owned by him bears to the entire leased acreage." See <u>Gypsy Oil Co. v. Schonwald</u>, 107 Okla. 253, 254, 231 P. 864, 865 (1924).

c. Under our example, _A_ will recieve three-fourths (_A_ owns minerals under 480 surface acres comprising the 640 leased acres--480/640 = 3/4) of the royalty and _B_ will receive one-fourth (_B_ owns minerals under 160 surface acres comprising the 640 leased acres--160/640 = 1/4). See _Brubaker v. Branine_, 237 Kan. 488, 701 P.2d 929 (1985).

In states applying the nonapportionment rule, if the lease did not contain an entirety clause _A_ would not receive any of the royalty, but _A_'s mineral interest would continue to be subject to the terms of the lease. See generally _Japhet v. McRae_, 276 S.W. 669 (Tex. Com. App. 1925).

V. JOINT OPERATIONS

A. Division Of The Leasehold Interest

1. Can have a multiple working interest owner situation created in numerous ways:

a. Various owners of undivided mineral interests lease to different developers. For Example: _A_ owned the minerals in Section 30 at his death. Under _A_'s will, the mineral interest passed to _A_'s daughters, _B_ and _C_, in equal shares. _B_ leased to _X_; _C_ leased to _Y_. _X_ and _Y_ each own the nonexclusive right to develop the minerals in Section 30.

b. _A_ leased the minerals in the North Half of Section 30; _B_ leased the minerals in the South Half. By order, or agreement, the North and South Halves of Section 30 are combined to form a 640 acre drilling unit.

c. _A_ owns all the working interest in Sections 29 and 30. _B_ proposes to drill a well on Section 29 if _A_ will assign 100% of the working interest in Section 29, and 50% of the working interest in Section 30, conditioned upon _B_ completing the well as a commercial producer. _A_ retains an overriding royalty in Section 29, convertible at payout of _B_'s well to a 50% working interest.

If _B_ drills the required well, _A_ and _B_ will each have the nonexclusive right to develop Section 30. If the well on Section 29 "pays out," A and B may again each have the nonexclusive right to develop Section 29.

2. Anytime you have multiple ownership of the working interest, or the potential for multiple ownership, the parties owning the working interest will normally enter into a contract to coordinate development of the leased land.

   a. Called an "Operating Agreement" or "Joint Operating Agreement."

   b. NOTE: Sometimes the owners of the working interest will contract with a third party, who is not a working interest owner, merely to operate the well.

3. Operating Agreement designates one party as the "Operator," who will be responsible for daily lease operations.

   a. Operator is generally the person who contracts directly with the drilling contractor, other supply and service companies, gas processors, and production purchasers. See drawing at Page 18.

   b. Must ascertain operator's authority to dispose of production from the leased land.

B. Operator's Authority Under the Operating Agreement

1. For our purposes, primarily concerned with the operator's authority to market production attributable to the other working interest owners.

2. Typical form authorizes each working interest owner to separately market their proportionate share of gas production.

   A.A.P.L. Form 610 Model Form Operating Agreement: Each working interest owner has the right "to take in kind or separately dispose of its proportionate share" of gas produced from the contract area.

   Art. VI.C. (1982 & 1977 Model Forms); § 13 (1956 Model Form)

3. What happens if the nonoperators fail to make any arrangement to take gas in kind?

   a. OPERATOR BUYS THE GAS. Operator may purchase the nonoperators' gas after providing the nonoperators with advance notice. If they do not enter into a gas sales contract, operating agreement permits a sale for period of time not to exceed 1 year - but nonoperator can exercise right to take in kind "at any time." Price must be "at the best price obtainable in the area for such production." Art. VI.C., p. 7 ('77); Art. VI.C., p. 8 alternate ('82).

b. OPERATOR ACTS AS AGENT. The operator can act as the nonoperator's agent in selling nonoperator's share of the gas. Must give notice of intent to sell as agent, must get best price, cannot contract to sell in excess of 1 year, and must account for all profits as a fiduciary.

c. OPERATOR SELLS GAS FOR ITS OWN ACCOUNT. Operator might market all the gas for his own benefit with the obligation to account for the nonoperator's gas through some form of gas balancing arrangement.

Cross-conveyance and co-tenancy problems - is each molecule of gas owned proportionately by each working interest owner?

Operating agreement, with the right of each party to take in kind, dispells the co-tenancy argument and the express terms of the 77 and 82 forms disclaim any sort of cross-conveyance.

Problem in absence of a Gas Balancing Agreement - what are the rights of the parties?

C. Effect Of Operating Agreement On Lessors And Non-Working Interest Owners

1. The lessor is not a party to the operating agreement; nor are non-working interest owners.

2. Lessee's obligations to lessor specified in the oil and gas lease and cannot be altered by other agreements to which the lessor is not a party.

3. Non-working interest owner's rights governed by the assignment between the non-working interest owner and the working interest owner. Non-working interest owner rights cannot be altered by agreements to which they are not a party.

VI. PRODUCTION SALES

A. The Division Order

1. Defined: A contract between the owner of production (or their agent) and a purchaser of production.

   Terms authorize the purchaser to take custody of production and pay the parties in the proportions indicated in the division order.

2. Function: To protect the purchaser from adverse claims in the event of an improper distribution of production proceeds.

   a. Relieves the purchaser from trying to interpret documents which may have varying meanings.

   b. Purchaser's attorney will examine title to the production and identify all potential interest owners. If there are any defects in title, the attorney will identify these in the division order title opinion and state the requirements that must be satisfied before production proceeds can be distributed.

   c. Once title requirements are satisfied, division order section will prepare the division orders and send them to each interest owner.

   d. When the division orders are signed, production proceeds are disbursed in accordance with the division order.

      Even though the division of interest may be inaccurate, the purchaser will be protected in relying on the division order until purchaser receives notice of the problem.

   e. Division orders have obtained a "bad name" among royalty owners because lessees have often used them to, in effect, amend the oil and gas lease on significant payment issues such as: calculation of how production will be valued for royalty purposes, costs deductible from royalty, warranty of title, indemnity provisions, interest on suspended accounts. Often they purport to ratify the lease.

See the 1988 NARO Special Report: "Division Orders: Sign, Sue or Stall?" Also see the "Uniform Division of Interest Form" prepared for NARO members.

3. Common Provisions

a. Warranty - Provide purchaser with a remedy against the signing party (royalty owner, working interest owner, non-working interest owner) in the event purchaser pays the signing party and they do not own the represented interest.

b. Description of the Lease and Land - Establishes the premises from which production can be taken. Serves as the basis for other provisions in the division order; e.g. warranty, indemnity, etc.

c. Effective Date and Time - Must know, at all times, how payment is to be made.

d. Term - Often revocable at will. Many gas division orders are tied to the term of a particular gas sales contract.

"NGL is authorized to receive gas therefrom during the term of the Contract/Agreement referenced below . . . ." [NGL Gas Division Order]

"This Division Order may be cancelled by either party giving thirty (30) days prior written notice." [NGL Indemnifying Division Order]

e. Direct How Payments Should be Made - Specify the fraction or decimal share of production purchaser has allocated to the interest.

f. Change of Ownership - Purchaser will follow payment directions in the division order until notified of a change.

Not required to keep track of terminable interests. Must receive notice of the changed circumstances.

g. Authority to Receive Production - Passing of title from interest owner to purchaser.

NGL Gas Division Order, Paragraph SECOND: "The word 'GAS' . . . [includes] . . . all other substances contained in the gas stream such as . . . sulfur, helium and nitrogen."

GAS also defined to include gas, casinghead gas, and "all liquid hydrocarbons contained in the gaseous substances . . . ."

h. Price - Oil usually market or posted price. Gas, may refer to gas sales contract.

NGL Indemnifying Division Order - Payment tied to Gas Processing Agreement.

NGL Gas Division Order - Payment tied to Gas Processing Agreement?

i. Payment Procedures - Time period for making settlement and sending payment.

Right to accumulate small amounts.

Authorization to pay by mail and check.

j. Measurement - Methods for determining quantity of production and deductions for quality problems.

k. Taxes - Authority of purchaser to deduct taxes. Effect on lease? May merely permit purchaser to pay; may not be a reallocation of the tax burden.

NGL Gas Division Order, Paragraph FIRST: "less any taxes required by law to be deducted . . . ."

l. Evidence of Title - Obligation to provide purchaser with proof of title. Effect of a title dispute - power to suspend payment.

NGL Gas Division Order, Paragraph THIRD: "NGL may withhold payment without interest until any defect, dispute or question of title is corrected or removed to the satisfaction of NGL."

See, however, Maddox v. Gulf Oil Corporation, 222 Kan. 733, 567 P.2d 1326 (1977) cert. denied, 434 U.S. 1065 (1978) (court refuses to honor division order to relieve lessee from payment of interest on royalties held in suspense).

Kansas takes a dim view of lessees using division orders to try and adjust their obligations under the oil and gas lease. See Holmes v. Kewanee Oil Co., 233 Kan. 544, 664 P.2d 1335 (1983) (division order requiring payment of royalty based on proceeds ineffective when oil and gas lease required payment of the market value).

m. Miscellaneous Provisions - Compliance with applicable law.

B. Transfer Orders

1. Defined: An authorization to the purchaser to pay another person for all or part of a share of production covered by purchaser's division order.

   Often contains terms similar to those contained in a division order; or incorporates terms of the division order it amends.

2. Function: Usually the evidence required by the purchaser to effect a change of distribution under a division order.

   a. NGL Gas Division Order, Paragraph THIRD: "NGL shall not be responsible for recognizing any change of ownership in the absence of actual notice and proof thereof satisfactory to NGL."

   b. The Transfer Order is the "proof thereof" required by the purchaser (NGL).

   c. Unless the underlying division order is revocable, will need to effect a change of ownership through a transfer order - unless the parties agree to revoke the divsion order and execute a new division order with the transferee of the interest.

      A new division order may be used when the entire interest is being transferred.

C. "Letters In Lieu Of" Transfer Orders

1. Defined: A letter executed by the owner of the interest (shown in the division order) and their transferee, directing the purchaser to pay production proceeds to the transferee as of a

specified date and time.

2. Function: When an owner sells all or a large part of their interest in a field, a letter may be used to authorize the purchaser to make payment to the new owner in lieu of executing individual transfer orders.

   a. Parties to the sale can use one letter, listing all the interests being sold, and then state terms similar to those contained in the production purchaser's standard division order.

   b. Designed to speed up the change of ownership process so the new owner gets paid as soon as possible.

   c. In many cases, if there has been a sale of all the owner's interests, the production purchaser will want the new owner to execute new division orders anyway.

D. Indemnity

1. Division orders, transfer orders, letters in lieu of transfer orders, and just about every sort of contract you find in the oil and gas business, will contain some form of "indemnity" clause.

2. Defined: A contract provision which shifts the burden (risk) of liability for an event from one party to another.

   Does <u>not</u> exempt the party from potential liability. Party is still responsible to third parties for their acts. However, if they have to pay something to third parties, then the contract provides someone will reimburse the paying party.

3. Function: Participants in the oil and gas industry leverage risk in many ways. They often leverage risk by sharing it in joint operations. Also, within a joint operation, certain risks will be allocated among the parties. The indemnity clause is used to allocate such risks as: loss of title, lack of title, and accidents.

4. [Seller] "agrees to indemnify NGL . . . against all claims of any one claiming any title to or interest in gas delivered hereunder, or the proceeds thereof, and against all loss, damage and expense, (including court costs and reasonable

attorneys' fees) incurred or suffered by NGL . . . by reason of any such claims . . . ." NGL Indemniying Division Order.

E. Gas Sales Contracts

1. Function: To pass title of gas (and other defined substances) from the producer to the gas purchaser. Specifies the terms of the sale and how the sale will be effected. E.g., construction of gathering lines, delivery point, custody transfer.

2. No standard form of gas contract. However, gas contracts do tend to uniformly address certain essential matters:

   a. Identity of the Parties - Buyer and Seller.

   b. Recitations - Consideration and purpose of the contract.

   c. Representations - Title to the gas, authority to sell (or have it processed).

   d. Commitment - What gas (leases, formations, etc.) is being committed to the contract?

   e. Reservations - What rights to the gas are retained by the seller?

      Right to control operations, use gas for operations, prior commitments of gas (free gas clause in oil and gas lease), ability to remove liquids prior to delivery of gas - or at some later time pursuant to a redelivery right for processing.

   f. Price - How will the current and future sales prices be determined?

      Definite Price Escalators - precise schedule of periodic price increases.

      Indefinite Price Escalators - an event triggers a price increase; the price is calculated by reference to events outside the contract. Two traditional forms:

      (1) Area Rate Clause - price raised to the highest price permitted by applicable regulation.

(2) Favored Nations Clause - price raised to the level paid to another seller in the area.

Two newer forms:

(1) Index Pricing - price raised (or lowered) based upon reference to the price of a competing energy resource such as No. 2 Fuel Oil, No. 6 Fuel Oil, wholesale electric rates, coal, etc. The assumption is the indexed fuel will represent the current market value of the competing fuel (natural gas).

(2) Net-Back Pricing - price raised (or lowered) based upon reference to the price purchaser is able to resell the gas or gas and products. [This form of pricing has traditionally been used in Gas Processing Agreements and is now becoming more common in gas sales - especially where the gas is purchaser by a marketer for resale.]

Another common form: Renegotiate (arbitrate).

Price Limitations - Market out, FERC out, Economic out provisions. Provides the purchaser with a mechanism to reduce the price paid when it is unable to resell the gas at the price being paid (market out), unable to recover the purchased cost of gas through its rates (FERC out), or it would be uneconomic for purchaser to continue purchasing under the current contract price (economic out).

g. Price-Related Matters - Tax reimbursement by purchaser to producer; Reimbursement for NGPA § 110 "production related costs" such as compression and gathering allowances.

h. Quantity - Although gas from a certain lease is "committed" to the contract, how much must the seller deliver and the buyer purchase?

Casinghead Gas - Purchaser's refusal to take casinghead gas may mean it will be flared in order to produce the associated oil. Many state conservation commissions prohibit or limit the quantity of gas that can be flared or vented; this means oil production will be shut in when the purchaser refuses to take casinghead gas.

Take-<u>and</u>-Pay Clause - requires the purchaser to take the gas; no option to refuse to take the gas (by paying the producer money).

Gas Processor has similar concerns when it sells residue gas at the tailgate of their processing plant. If the purchaser will not take the gas, processor may not be able to operate the plant.

Take-or-Pay Clause - requires the purchaser to take a stated percentage of the seller's gas deliverability or, instead of taking the gas, pay for it as though it was taken. Typically the purchaser has 5 years to make up the gas they paid for but did not take.

Other Take Formulas - Ratable take, best efforts, no express obligation to take.

Gas Processor Formulas - Limit take obligation to capacity of plant, right to allocate capacity, economic operation.

Connection Obligations - When must purchaser connect new wells onto the system?

Producer Delivery Obligations - Up to allowable assigned to wells; warrant to provide a specific quantity.

i. Quality Standards - Limit impurities, heat content (Btu) limitations.

j. Delivery Point - Point where custody and liability for the gas will pass.

NOTE: Today it is becoming more likely that gas produced in Oklahoma (and other producing states) will have a delivery point far removed from the lease - such as a GM Plant in Michigan.

This may change basic rights under the oil and gas lease - with the gas being sold "off the leased premises" royalty may have to be calculated using a "market value" formula instead of a "proceeds" formula. Even if a "proceeds" formula is used, where does the sale to generate the proceeds take place? In Michigan? Can the transportation and other marketing costs (gas marketer fees) be deducted?

k. Delivery Pressure - pressure requirements to deliver gas into the purchaser's pipeline.

l. Compression - obligation or right of seller to compress gas to meet a delivery pressure.

m. Term - life of lease, life of reserves, stated duration. Right to terminate after notice.

"Evergreen" provisions - continues in effect for a specified period of time unless party gives notice of termination within e.g. 30 days prior to the contract anniversary date. A type of "successor to an existing contract" under § 2 (14) of the Natural Gas Policy Act of 1978.

"Rollover" Contract - term of art used in § 2 (12) of the Natural Gas Policy Act of 1978. A contract entered into after an existing fixed term contract has expired.

Regardless of the stated term in many "old gas" contracts, a sale subject to federal jurisdiction under the Natural Gas Act of 1938 is commencement of a "service" that cannot be abandoned unless FERC finds abandonment is in the "public interest." FERC is making it much easier to abandon - See FERC Order 451 and Order 490.

n. Deliveries of Gas - how will the gas be delivered from seller to purchaser? Dispatching coordination.

o. Measurement - how will the gas, and other components be measured? Type of meters, maintenance and operation of meters.

p. Tests - how will tests required by the contract be conducted? Meter tests, deliverability tests, quality tests.

q. Title - Proof of ownership or right to sell (or process).

r. Payment Procedures - Reading meters, applying contract terms, calculating amount due, and sending the check.

Will payment for all interests be made to the seller or will purchaser distribute payments to all persons having an interest in the gas?

s. Rights of Way - Purchaser usually given the right to use whatever easement rights lessee has under the oil and gas lease. See Delhi Gas Pipeline Corp. v. Dixon, 737 S.W.2d 96 (Tex. App. - Eastland 1987).

t. Force Majeure - Excuse for nonperformance due to specified events which relieve performance. God and government problems.

u. Notice - Contact person for each party to receive oral and written notices.

v. Disputes - Rights of parties, arbitration.

w. Choice of Law - What state's law will be used to interpret the contract?

x. Binding Effect - Contract binds the parties and their "successors and assigns."

y. Regulations - Contract subject to applicable state, federal, and local law.

z. Date - Date the agreement is executed. Typically not the date for calculating events under the contract.

aa. Signatures - Signed by authorized individuals for each party.

3. Parties Bound by the Gas Sales Contract

a. Only the named producer, purchaser, and their successors and assigns are bound by the contract.

Typically the operator of the well will enter into the gas sales contract relying upon the terms of the operating agreement. However, the typical form of operating agreement does not grant the operator the right to bind the other working interest owners to a long term contract. Each has the right to take their gas in kind. See discussion at pages 32-33.

b. Gas contracts usually contain a representation by the gas seller that: "Seller owns or has the right to sell the gas." Form #2 - Garrett Replacement, Page 1, Whereas Paragraph #1.

c. To the extent seller does not actually have the right to sell the gas, the gas will not be subject to the gas sales contract. However, the seller may be liable to the purchaser under the contract warranty provision.

"Seller warrants the title to the Gas and that Seller has the right to sign this Contract on behalf of one hundred percent (100%) of the working interest owners in the well(s) under the lease(s) covered by this Contract." Form #2 - Garrett Replacement, Page 4, Paragraph 7.

d. Royalty owner's share of gas is probably subject to the contract unless royalty owner retains the right to take in kind. However, since the royalty owner is not a party to the contract, the provisions of the contract do not necessarily determine the lessor's rights against the lessee. For example, payment by the gas purchaser to the lessee may, in some situations, not be the basis for calculating lessee's royalty obligations under the oil and gas lease.

e. Although the royalty owner is not a party to the gas sales contract, they might be able to enforce the terms of the gas contract as a "third party beneficiary."

If the lessee entered into the contract in part to discharge an obligation to its lessor (e.g. obligation to market production), the lessor may be able to assert rights under the contract as a third party beneficiary.

Other working interest owners, and non-working interet owners, might also be able to assert third party rights.

F. Gas Processing Agreements

1. Function: To acquire custody of gas suitable for removing liquid hydrocarbons, remove the liquids, and return the residue gas to the producer's gas purchaser.

2. Contain many of the same terms found in Gas Sales

Contract.

3. Major difference is they require a number of additional calculations to allocate products and residue gas back to each producer delivering gas into the system.

   a. Agreement provides for the measurement of the inlet gas to determine its "theoretical" liquid content and then provides for the allocation of liquids and residue gas among each producer delivering gas into the plant.

   b. Requires additional testing and metering at each stage where the streams are comingled.

   c. Common to have a provision allowing the plant operator to allocate its capacity among various producers delivering gas into the plant.

   d. Assurance that residue gas and liquids are marketed to permit the plant to continue operating.

   e. Requires coordination with ultimate gas purchaser when processor is not buiying the residue gas.

4. Gas Processing Basics

   a. Natural gas consists of: methane, ethane, propane, iso-butane, normal butane, isopentane, normal pentane, hexane, heptane, octane, nonane, and decane.

   b. Processing recovers hydrocarbon liquids (products) from natural gas.

      Remove liquids as a bulk product called "propane-plus."

      Can sell the propane-plus as a product or process it further to recover propane, butane, and natural gasoline through a process called "fractionation."

      When there is a market, processor may also be able to fractionate ethane as a separate product.

   c. Processing may also treat the gas to remove water (dehydration), carbon dioxide, hydrogen sulfide, and other impurities.

d. Shrinkage - Processing gas lowers the Btu content and volume of the gas entering the plant. This is called "shrinkage" and occurs when the liquid hydrocarbons are removed from the gas.

e. Plant Fuel - The processor will use some of the gas to run the processing operation.

f. Residue Gas - The gas remaining after processing is called the "residue gas."

g. Measurements - Gas is measured by volume (thousand cubic feet - "MCF") and heating value (million British thermal units - "MMBTU"). The liquid hydrocarbon concentration of the gas is expressed in "gallons per MCF" ("GPM").

5. Common Processing Arrangements

a. Processor purchases the gas. Form - Bluitt/Lehman Casinghead Gas Contract; Form #2 - Garrett Replacement Gas Purchase Contract.

b. Processor agrees to process gas and purchases liquids. Form - Chico Type II Gas Processing Agreement.

c. Processor performs the processing as a service for a fee. Liquids and residue gas redelivered to producer.

d. Where the processor does not own the gas being processed, it may be delivered by the producer or by the producer's purchaser (pursuant to redelivery and processing rights retained by the producer in the gas sales contract).

G. Transportation Agreements

1. Function: To move gas from delivery point to a redelivery point. No transfer of title. Pipeline merely functions as a bailee for a fee (typically regulated).

2. Common Concerns:

a. Measuring the gas entering the system;

measuring the gas exiting the system. Quality of the gas, payment, etc. These are matters similar to those addressed in the Gas Sales Contract.

b. Transportation rates. Look at pipeline's applicable tariff.

c. Dispatching Problems. Controlling what goes in and what comes out at the other end. Pipelines often charge a fee (penalty) for failure to deliver and take the specified quantity of gas for which transportation has been contracted.

d. Firm or Interruptable Service. What if there isn't capacity on the line to transport all gas tendered? How will existing capacity be allocated?

H. End User Agreements

1. Same as a Gas Sales Contract except you are not dealing with a pipeline.

2. Unique problems - the end user typically needs to have the gas at certain volumes at varying times.

3. Need to carefully coordinate production capabilities, existing contract restrictions, access to transportation, and customer's needs to determine whether the sale will be workable.

I. Other Marketing Agreements

1. Exchange Agreements. Trade gas in one location for gas at another location. Require quality adjustments so you are trading gas for gas. May be transportation obligations to meet the terms of the exchange.

2. Brokerage Agreements. What services are being provided? How will compensation to the broker be paid?

J. Application of the Uniform Commercial Code

1. The Uniform Commercial Code, as the name implies, is a codification of rules designed to provide uniformity in dealing with commercial transaction contracts. Article 2, the Sales Article, has been adopted by all states except Louisiana.

2. Article 2 applies to transactions in "goods," including the sale of natural gas and oil.

   a. A processing agreement, to the extent there is no sale of the gas or liquids, is a service agreement governed by general contract law instead of the UCC.

   b. A sale of oil or gas while in the ground is not governed by the UCC.

   c. A transportation agreement is a service agreement and not governed by the UCC.

3. Significance of the UCC's application - special rules apply in interpreting the agreement and in its performance and nonperformance.

VII. CURRENT GAS PROCESSING ISSUES

A. Ownership/Title Issues

1. So long as mineral conveyances, oil and gas leases, and lease assignments continue to employ imprecise language, there will be ownership and title problems. The long term nature of most oil and gas transactions often means you may be operating with a flawed document for as long as there is production from the property to fight over.

2. "Innovative jurisprudence" is another matter we must contend with. Courts have a tendency to change the rules or interpret them out of (or into) existence to accomplish a particular goal - such as protecting a landowner from undue surprise.

3. Judicial proceedings will continue to be flawed on occasion - e.g. improper notice or failure to make a required finding. This will require cleanup work the next time the property is dealt with.

B. Gas Balancing Problems

1. Assume <u>A</u> and <u>B</u> each own an undivided 50% interest in an oil and gas lease covering Section 30. <u>A</u> has a market for his gas but <u>B</u> does not. Their operating agreement is silent regarding gas imbalances. Can <u>A</u> sell the full gas stream to its gas purchaser? Can <u>A</u> tender the full stream to its gas processor?

a. What if B objects to the sale by A but makes no arrangments to take his share of the gas?

b. Does B owe any royalty to his lessor?

2. In Oklahoma these matters have been somewhat mitigated by statute and judicial decisions interpreting certain statutes.

a. Non-selling Working Interest Owners - See 52 Okla. Stat. §§ 541-547 (Supp. 1987): Non-selling working interest owner can elect to share in the proceeds of a gas sales contract negotiated by another working interest owner. Requires the operator to offer to market each working interest owner's share of the gas. See Seal v. Corp. Comm'n, 725 P.2d 278 (Okla. 1986) cert. denied 107 S.Ct. 1265 (1986).

b. Royalty Owners - Whichever working interest owner sells gas must pay all royalty owners within the gas pooling unit. The "Blanchard" "weighted average" approach. See Shell Oil Co. v. Oklahoma Corp. Comm'n, 389 P.2d 951 (1964). 52 Okla. Stat. § 87.1 (Supp. 1987).

52 Okla. Stat. § 87.1 provides, in part:

"In the event a producing well or wells are completed upon a unit where there are, or may thereafter be, two or more separately owned tracts, the first purchaser or purchasers shall be liable to any royalty owner or group of royalty owners holding the royalty interest under a separately owned tract included in such drilling and spacing unit for the payment of proceeds from the sale of production from the drilling and spacing unit."

"Each royalty interest owner shall share in all production from the well or wells drilled within the unit . . . to the extent of such royalty interest owner's interest in the unit. Each royalty interest owner's interest in the unit shall be defined as the percentage of royalty, including the normal one-eighth (1/8) royalty, overriding royalties or other excess royalties owned in each separate tract by the royalty owner, multiplied by the porportion that the acreage in each separately owned tract or interest bears to the entire acreage of the unit."

"The first purchaser or purchasers shall also be jointly and severally liable for the payment to each royalty interest owner of any production payments or other obligations for the payment of monies contained within the leases covering any lands lying within the drilling and spacing unit."

c. Note, however, this statute does not address the situation posed above - there are not "separately owned tracts" in a unit. Instead we are dealing with co-tenants of undivided interests. Arguably each owns an undivided 1/2 interest in each molecule of gas.

d. The statute does not address non-working interest owners such as overriding royalty, production payment, and net profits owners, who are not "royalty owners."

3. Gas Balancing Agreements -

a. May pose an even greater burden to the working interest owner.

b. Often provide for balancing in kind while producing and cash balancing upon exhaustion of the reservoir.

4. The opportunity for gas imbalances will increase as producers are given more marketing options.

5. Most producers, when processing gas, will pay liquids on a current basis to all other working interest owners and royalty owners - even though they are not marketing the gas.

See 52 Okla. Stat. § 542 (Supp. 1987) A.: "This act [right to participate in working interest owner's gas sales contract proceeds] shall not apply to the natural gas liquids extracted as a result of mechanical processing of the natural gas stream for the removal of liquid components of the methane."

C. Statutory Intervention Into the Payment System

1. Check-stub Laws - many states, including Oklahoma, have enacted legislation specifying accounting information which must be provided to the lessor to allow lessors to audit their lessee's

calculation of royalty payments. See, e.g., 52 Okla. Stat. § 567 to 568 (Supp. 1987).

2. Payment Laws - many states, including Oklahoma, have enacted legislation specifying when royalty must be paid and the effect of late payment. 52 Okla. Stat. § 540 (Supp. 1987) provides:

PAYMENT OF OIL AND GAS PROCEEDS

§ 540. Payment of proceeds from oil and gas production—Interest—Action for recovery

A. The proceeds derived from the sale of oil or gas production from any oil or gas well shall be paid to persons legally entitled thereto, commencing no later than six (6) months after the date of first sale, and thereafter no later than sixty (60) days after the end of the calendar month within which subsequent production is sold. Such payment is to be made to persons entitled thereto by the first purchasers of such production. Provided, such purchasers may remit to the persons entitled to such proceeds from production semiannually for the aggregate of six (6) months' accumulation of monthly proceeds of amounts less than Fifteen Dollars ($15.00). Further provided, that any delay in determining the persons legally entitled to an interest in such proceeds from production caused by unmarketable title to such interest shall not affect payments to persons whose title is marketable. Provided, however, that in those instances where such proceeds cannot be paid because the title thereto is not marketable, the purchasers of such production shall cause all proceeds due such interest to earn interest at the rate of six percent (6%) per annum, until such time as the title to such interest has been perfected. Marketability of title shall be determined in accordance with the then current title examination standards of the Oklahoma Bar Association. The first purchaser shall be exempt from the provisions of this subsection and the owner of the right to drill and to produce under an oil and gas lease or force pooling order shall be substituted for the first purchaser therein where the owner and purchaser have entered into arrangements where the proceeds are paid by the purchaser to the owner who assumes the responsibility of paying the proceeds to persons legally entitled thereto.

B. Any said first purchasers or owner of the right to drill and produce substituted for the first purchaser as provided herein that violates this act shall be liable to the persons legally entitled to the proceeds from production for the unpaid amount of such proceeds with interest thereon at the rate of twelve percent (12%) per annum, calculated from date of first sale.

C. The district court for the county in which the oil or gas well is located shall have jurisdiction over all proceedings brought pursuant to this act. The prevailing party in any proceeding brought pursuant to this act shall be entitled to recover any court costs and reasonable attorney's fees.

Added by Laws 1980, c. 205, § 1, eff. July 1, 1980. Amended by Laws 1985, c. 141, § 1.

D. Payment Problems

1. Payment of all the proceeds to the operator. Risk: royalty owner, and other interest owners, are never paid. Although you have an "indemnity" from the operator, an indemnity is only as good as the financial condition of the party obligated to indemnify.

2. Liens. Request by operator to pay proceeds over to them because of a nonoperator's failure to pay their share of costs. Operator's lien.

   a. Effect of operating agreement lien provisions - purchaser normally refuses to pay under it without indemnity or bond. Or the purchaser may require a court decree. Purchaser might suspend payment.

   b. Statutory oil and gas liens. Many states the statute specifically covers proceeds of production (Oklahoma). Other states, the statute is silent on the matter (Kansas).

3. Bankruptcy

   a. Automatic Stay

      Filing of bankruptcy petition stays all proceedings concerning property subject to the bankruptcy.

      Must ask the bankruptcy court for relief from the stay before you can do anything.

      Attempts to create, perfect, or enforce a lien against property subject to the bankruptcy proceeding violates the automatic stay.

   b. Trustee Can "Avoid" Unperfected Security Interests

      As of date bankruptcy petition is filed, trustee (debtor in possession) assumes status of a hypothetical lien creditor.

      "Strong-arm" provision permits trustee to avoid unperfected security interest that would be subordinate to a judicial lien creditor.

c. Trustee Can "Avoid" Unfiled Interests In Real Property

As of date bankruptcy petition is filed, trustee (debtor in possession) assumes status of a bona fide purchaser of the debtor's real estate.

Allows trustee to avoid mortgages, and other interests in real estate, if not properly recorded prior to the filing of the petition.

d. Trustee Can "Avoid" Executory Contracts

Trustee can elect to assume or reject executory contracts.

Is an oil and gas lease an executory contract?

Is a gas sales contract? A processing agreement?

e. Trustee Can "Void" Transfers To Creditors

Trustee can set aside a transfer made by the debtor, to the creditor, to be applied on a preexisting debt.

Trustee can reach transfers occurring within 90 days of filing the petition or within 1 year of filing when the creditor is classified an "insider."

f. Trustee Can Sell And Use Property

Trustee can, under certain circumstances, sell property in the bankruptcy estate and give clear title to the purchaser.

Trustee can deal with bankruptcy estate property when operating the debtor's business and acting in the ordinary course of business.

4. Royalty on Take-or-Pay Payments - Courts Divided:

No production, no sale, no royalty due. See <u>Mesa Petroleum Co. v. U.S. Dept. of Interior</u>, 647 F.Supp. 1350 (W.D. La. 1986), appeal pending in 5th Circuit.

Focus less on express terms of royalty clause and more on the lessor/lessee relationship and industry practices. See Diamond Shamrock Exploration Co. v. Hodel, No. 86-537 (E.D. La. Jan. 23, 1987), appeal pending in 5th Circuit.

Possible Oklahoma Approcah:

Apache Gas Products Corp. v. Oklahoma Tax Com'n, 509 P.2d 109 (Okla. 1973). "Value" of production for purposes of the Oklahoma Gross Production Tax would be calculated using the price producer receives for gas under the gas sales contract.

a. Court notes the "realities of the natural gas industry."

b. Necessity of marketing under long-term contracts.

Tara Petroleum Corp. v. Hughey, 630 P.2d 1269 (Okla. 1981). Gas sales contract, made by lessee in good faith, establishes the limits of lessee's royalty obligation under the oil and gas lease.

a. Court recognizes the necessity of long-term contracts (at that time).

b. Court acknowledges there is a nexus between the oil and gas lease and the gas sales contract created by the lessee's implied obligation to market production.

c. Such a rule is "fair" to producers and not "unfair" to royalty owners - producer not receiving any collateral benefit because they are limited to price set by the gas sales contract.

Proportionality Analysis - how will the benefits and burdens be distributed between lessor and lessee.

a. Is the lessee receiving any benefits which the lessor will be unable to share in proportionately?

b. If the lessor will not share proportionately in any benefits, has lessee traded any of lessor's rights to obtain the disproportionate benefit?

c. How is the price of gas determined in negotiating a gas sales contract? Price tied to quantity? Obligation to take? Do you give up some per MCF value to obtain broad processing rights?

5. Royalty Owner a Third Party Beneficiary?

   Lessors, dissatisfied with their lessee's actions in renegotiating a gas contract, settling a take-or-pay claim, exercising FERC Order 451 GFN rights, or giving "offers of credit" under FERC Order 500, may try to bring everything back to square one asserting the contract cannot be amended without their consent.

   a. Gas sales contracts seldom expressly exclude the lessor as having third party rights in the contract.

   b. Factors to determine whether parties intended to confer a benefit upon the lessor:

      (1) Foreseeable lessor may assert an interest in the contract?

      (2) Will the promisor render any performance directly to the lessor?

      (3) What was the <u>purpose</u> and <u>motive</u> of the lessee and gas purchaser in making the contract?

      (4) Lessor reliance upon the contract?

   c. Ability of purchaser and lessee to alter contract:

      Can amend any time before lessor has knowledge of the contract and relies upon it.

      Varying degrees of acknowledging and relying upon the contract.

      Remember that division order where the lessor was asked to accept payments under the gas sales contract in satisfaction of lessee's royalty obligation?

E. Affiliate Transactions

1. A problem at every turn of the development process.

2. What is an "affiliate?"

An entity related (subject to some measure of control) by stock ownership to another party.

3. Oil and Gas Lease

   a. Perhaps the most volatile area.

   b. Gas producer and processor (purchaser) are affiliates.

      Royalty calculation problems - when is there a sale? Are costs charged allowable? What are the proceeds? Best price? Best terms?

4. Gas Sales Contract

   a. Access to pipeline capacity where the pipeline has a marketing affiliate.

   b. Preferences to affiliates? FERC examining this area.

5. Operating Agreement

   Obtain a sale to an affiliate, is there an obligation to sell for other working interest owners?

VIII. FERC AND YOUR DAILY OPERATIONS

A. The New Gas Market

1. Traditional Market - Producer removes gas and sells it to an intrastate or interstate pipeline. Pipeline performs a merchant function by reselling the gas to the end user at a price adequate to cover the cost of the gas, transportation, plus a regulated profit. Opportunity for sales to end user limited to situations where gas wells are in close proximity to end user.

   a. Natural gas pipelines are not "common carriers." Can refuse to purchase or transport gas unless they have contracted to do otherwise.

   b. Once a sale is made into interstate commerce, the producer has commenced a "service" which continues beyond the life of the gas sales contract. Only FERC can authorize abandonment of the service.

c. Major Philosophical Goals - obtain an adequate supply of gas at the lowest price possible.

d. Pipeline is a "natural monopoly" which requires rate regulation to take the place of competition. Determine pipeline's "cost of service," calculate how much money it will need to operate, and then provide for a reasonable rate of return sufficient to attract investors to capitalize the continuing operation of the pipeline.

e. In 1954 rate regulation was extended to producers selling gas to interstate pipelines. Initiated federal regulation of producer sales of gas - set a rate for how much the producer could sell their gas to an interstate pipeline.

f. In 1978 maximum price legislation applied to all producer sales of gas. However, legislation provides for gradual removal of price regulation on certain categories of gas.

g. Vintaging Concept - Gas priced according to when it was available for sale. Designed to provide lower prices for gas already discovered and in the system; higher "incentive" prices for gas that would not be available (explored for and discovered; or not economic to produce) at the lower prices.

2. The New Gas Market

a. FERC recognizes only the transportation function requires regulation as a natural monopoly. FERC is now proceeding to dismantle 35 years of regulated gas marketing.

b. FERC working to relieve each of the three main bottlenecks in the gas marketing system: (1) Limitations on who the producer can sell to (permit more liberal abandonment of gas from old "service" obligations);
(2) Limitations on producer and end user access to transportation ("open access" to pipeline facilities on a fair basis);
(3) Limitations on who the end user can buy from (permit the end user to purchase gas from entities other than the pipeline).

c. However, the transition has not been smooth. An industry built on long term contracts cannot change without some readjustment of existing contract rights. Contractual relationships, usually long term, have been made by all participants in the marketing process based upon traditional regulatory restrictions and goals.

3. FERC Order 436 - "Open Access"

a. Offer pipelines freedom from traditional regulatory burdens (so they can compete for gas sales and services), if they will open their pipeline facilities so others can ship gas - and compete with the pipeline's traditional gas sales customers.

b. Let the pipeline's traditional gas sales customers change their gas purchase obligations with the pipeline (and change rate structures which tie them to the pipeline) so they can seek out cheaper gas purchase arrangements in competition with pipeline gas.

c. <u>Associated Gas Distributors</u> <u>v.</u> <u>FERC</u>, 824 F.2d 981 (D.C. Cir. 1987). Upholds most of FERC's goals expressed in Order 436 but remands it because the court felt the new gas market was being created at the expense of the pipeline.

Required FERC to provide pipelines with some sort of relief from take-or-pay obligations under existing gas contracts as part of the consideration for pipelines providing open access (which will expose them to greater competition).

4. FERC's Response to <u>Associated Gas</u>: Order 500

a. Retains much of the Order 436 principles but conditions producer access to pipeline transportation on the producer providing take-or-pay credits for any gas shipped on the pipelines.

b. Cross-Crediting: If producer has a take-or-pay (or take-and-pay) contract (executed before June 23, 1987), and they ship gas on an interstate pipeline which owes take-or-pay to the producer, the pipeline can obtain a "credit" against its liability for failure to take the producer's gas. This credit can be applied to any take obligation (back to January 1, 1986) under any contract the pipeline has with the shipping producer.

Each MCF of gas transported by the pipeline earns the pipeline one MCF of take-or-pay credit which it can apply to any contract it has with the producer that owned the gas on June 23, 1987 - (exception for take-and-pay obligations under cansinghead gas contracts).

5. Freeing-Up "Old Gas" - FERC Order 451

   a. Order 451 permits producers with old low-priced gas contracts (NGPA §§ 104 & 106) to force their pipeline purchaser into negotiations (either through voluntary action or through forced "good faith negotiations" (GFN)) to raise the price of the gas to an amount which more nearly represents the current market value of the gas.

      Pipeline has a reciprocal right to bring to the table any high-priced gas which is sold with low-priced gas (sold under the same contract). Pipeline can force the producer to negotiate to reduce the high-priced gas to a price which more nearly represents the current market values.

      If the parties agree on a new price - the contract continues. If they fail to agree - the contract can be terminated by either party and the gas abandoned from the service obligation.

   b. Target Price Used - § 109 (approx. $2.65/MMBtu)

   c. Before producer can use the 451 process, must have a contract containing an area rate clause (clause which permits the contract price to rise to levels established by applicable regulation).

6. Liberalizing Abandonment - FERC Order 490

   a. Traditional Approcah - gas subject to service obligation even though the gas sales contract terminated (or the underlying oil and gas lease terminated). To obtain abandonment of the service obligation, must initiate proceeding under § 7b of the Natural Gas Act and demonstrate the needs of the new (proposed) gas sale customers are greater than the needs of the exisitng customers.

b. New Approach - compare needs of existing customers against the benefits freeing-up the gas would offer the market as a whole. See Consolidated Edison Co. of New York, Inc. v. FERC, 823 F.2d 630 (D.C. Cir. 1987).

c. FERC takes the view that the market benefits will, in most every case, exceed the needs of the existing customers. Generic approach to abandonment.

d. Order 490 - permit party to an expired contract to abandon the service without a §7b proceeding - merely "report" the abandonment to FERC after it occurs.

7. Permitting the End User to Shop Around

a. Order 436 (and now 500) permits end users (Local Distribution Companies - "LDCs", industrial plants) to convert a share of their firm gas purchase obligations to firm transportation rights.

b. In the process of proposing and approving a "blanket certificate" (under § 7 of the NGA) to provide open access transportation, Order 500 places limits on the types of rate structures the pipeline can enforce against end users.

Goal is to ensure the pipeline does not create a rate structure which, in effect, makes it uneconomic for the end user to buy their gas from anyone but the pipeline supplier. Rates for transportation and backup supply can determine whether producers can compete with the pipeline for gas sales customers.

B. A Guide To Take-or-Pay Crediting

1. Qualifying Dates

a. The Contract: Take-or-pay (or take-and-pay) contract executed before June 23, 1987.

b. The Producer: Owner of the gas <u>on June 23, 1987</u>.

c. The Service: Transportation <u>on or after January 1, 1988</u> (of gas "owned" by the Producer) by interstate pipeline having a Contract with the Producer. Remember - gas ownership is determined as of June 23, 1987 - NOT when the gas is shipped.

d. The Credit: One MCF of gas for each MCF of gas transported on or after January 1, 1988. The credit can be applied to any take-or-pay obligation with the Producer accruing <u>after January 1, 1986</u> (so long as the pipeline perfromed open access transportation during some portion of 1986).

2. The "Offer of Credit"

a. If you tender gas for transportation, must provide the transporter with an offer of credit - even though no credit is due.

b. Pipeline must ship the gas even if they dispute the adequacy of the offer of credit.

c. 85% Rule - Before the pipeline is obligated to ship, must have offers of credit covering at least 85% of the working interest owners of the gas to be shipped. Shipper must also provide a list of the working interest owners refusing to provide offers of credit.

The nonconsenting 15% need not offer to credit - but if any gas is ever shipped at their request (or their assignee), and they provide an offer to credit, the prior gas shipped will become subject to credits.

d. Gas Processor Exception to 85% Rule - Offer of credit for residue gas sales need to be signed only by the processing plant operator when the processor <u>purchases</u> gas from behind-the-plant producers under percentage-of-proceeds processing agreements entered into on or before June 23, 1987.

Pipeline can apply credits only against its take-or-pay obligations under pre-June 23, 1987 take-or-pay contracts with the plant operator. See FERC Order 500-C.

e. Change of Gas Ownership - if A owns the gas on June 23, 1987, and assigns its lease to B on September 1, 1987, when the gas from the lease is tendered for transport on January 1, 1988, A and B must provide the pipeline with offers of credit.

3. Crediting Exemptions - the following activities will not generate credits (however, the pipeline may insist upon a signed offer of credit even though no credit will be allowed):

   a. Transportation of "new" gas - gas from wells spudded after June 23, 1987. Use § 102 NGPA 2.5 mile test, 1000 feet below exisitng production test, and new reservoir test. FERC Order 500-C.

   b. Transportation which generates credits for intrastate pipeline pursuant to a release of intrastate system supply gas - subject to certain conditions. FERC Order 500-C.

   c. Gas sold to a processing plant under a percentage-of-proceeds gas processing agreement entered into on or before June 23, 1987. FERC Order 500-C.

   d. Gas sold by producer which doesn't have a pre-June 23, 1987 take-or-pay contract with the transporting pipeline.

   e. Gas previously purchased by the pipeline under a terminated take-or-pay contract.

   f. Gas released from a take-or-pay contract containing a market-out clause which gives the pipeline discretion to terminate the contract.

4. Special Situations

   a. Released Gas - pipeline can elect whether it will follow settlement agreement crediting mechanism or the Order 500 mechanism.

   b. Multiple Pipelines - where credits will be generated for more than one pipeline in a single transportation transaction, if one of the pipelines released the gas, only the releasing pipeline will receive credits.

   If the gas is not released by any of the pipelines, the transaction will generate the same amount of credits but they will be shared between the transporting pipelines. The pipelines will agree how credits will be allocated.

If gas transported and one of the pipelines formerly purchased the gas under a terminated or market-out contract, none of the pipelines are entitled to a credit.

c. Casinghead Gas - Purchaser cannot use a take-or-pay (or take-and-pay) credit to excuse taking casinghead gas under a take-and-pay contract. Purchaser will remain obligated to take the gas and receive a credit. However, the credit must be applied to a non-casinghead gas contract take obligation.

IX. FUTURE INDUSTRY DEVELOPMENTS

A. New Services for Old Monopolies

Pipelines will capitalize on their transportation, dispatching, storage, and backup supply capabilities.

Pipelines will continue to be a major marketer and merchant of gas.

B. Competition

Competition will be a reality.

Access will truly become "open" and meaningful competition will develop.

Consumers will be required to pay for the services they demand.

C. Your Work Will Become More Complex

Instead of dealing with 100 operators selling to 10 purchasers you may be dealing with 1000 working interest owners selling to 10000 purchasers.

Payment disputes will escalate as the marketing process becomes more complex.

Acquiring and disposing of oil and gas properties will become more complex because of the latent liabilties created by cross-crediting.

Oxy Cities Service NGL Inc.
Box 300
Tulsa, Oklahoma 74102

INDEMNIFYING

DIVISION ORDER

____________________, 19___

LEASE NUMBER ________________

The above number will appear on all settlement checks and will be the only lease identification shown. It is important that you retain and record this number and lease description in your records.

The undersigned, and each of them, guarantee and warrant that they are entitled to receive the proceeds in the proportions set out below of the gas rights from the ________________ ________________ lease, described as:

in ____________ County, State of ____________ and commencing at 7 A.M. ____________, subject to the covenants appearing on the reverse side hereof, which same are binding upon the undersigned, their successors, legal representatives and assigns, Oxy Cities Service NGL Inc. (hereinafter referred to as "NGL") is authorized to receive gas therefrom during the term of the ____________ referenced below and to give credit for gas proceeds as directed below. **This Division Order may be cancelled by either party giving thirty (30) days prior written notice.**

CREDIT TO	DIVISION OF INTEREST	P.O. ADDRESS
	100% ____________ taxes	

PAYMENTS DISBURSED UNDER THIS DIVISION ORDER SHALL BE COVERED AND CONTROLLED BY THAT CERTAIN ____________ DATED ____________, AS MAY BE AMENDED AND ANY SUCCESSOR OR REPLACEMENT CONTRACTS RELATING TO THE SAME LANDS, EXECUTED BY ____________, AS PRODUCER/SELLER AND OXY CITIES SERVICE NGL INC., AS PROCESSOR/BUYER. IF ANY PROVISION CONTAINED IN THIS DIVISION ORDER CONFLICTS OR IS AT VARIANCE WITH ANY TERM OR CONDITION OF THE ABOVE REFERENCED AGREEMENT/CONTRACT, THE TERMS OF THE AGREEMENT/CONTRACT SHALL PREVAIL.

In consideration of NGL processing or purchasing the gas hereunder, the undersigned **warrants that it has the right to sell and/or have processed all gas sold and/or processed under this Division Order, and agrees to indemnify NGL**, its successors and assigns, against all claims of any one claiming any title to or interest in gas delivered hereunder, or the proceeds thereof, and against all loss, damage and expense, (including court costs and reasonable attorneys' fees) incurred or suffered by NGL, its successors or assigns, by reason of any such claims, and further agrees to make settlement with all parties in interest.

WITNESSES: SIGN BELOW Social Security or Taxpayer No.

____________ ____________

____________ BY: ____________

____________ ____________

____________ ____________

Be sure you show your correct mailing address and taxpayer identification number. If you are an individual, your SOCIAL SECURITY NUMBER is your identification number, if a company or an estate, please furnish your employer identification number.

Print or type - do not abbreviate

7CN/1265 1
04/08/87

FIRST: The gas shall be measured by a meter in the customary manner. The basis for determining the quantity of gas delivered shall embrace all the factors customarily used in measuring and determining the quantity of gas.

Settlement for gas proceeds, less any taxes required by law to be deducted, will be mailed within sixty (60) days after the last day of the month in which the gas is sold or processed by mailing or delivering to the respective owners as above set out, their assigns or successors in interest, check or draft of NGL. It is agreed that if, at any settlement date, the amount payable to any party hereunder shall be less than $10.00, NGL may withhold payment until the amount payable to such party equals or exceeds the sum of $10.00, after which time payment shall be made at the next regular settlement date. Upon termination of this division order, payment shall be made to the respective owners entitled thereto regardless of the amount or amounts due.

SECOND: The word "GAS" as used herein is hereby declared to include all gaseous substances including oil well gas (casinghead gas) processed or purchased hereunder. It shall also include all liquid hydrocarbons contained in the gaseous substances.

THIRD: Satisfactory evidence of title shall be furnished to NGL at any time on demand; and the undersigned agree that NGL may withhold payment without interest until any defect, dispute or question of title is corrected or removed to the satisfaction of NGL. NGL shall not be responsible for recognizing any change of ownership in the absence of actual notice and proof thereof satisfactory to NGL. NGL is hereby relieved of any responsibility for determining when any money or other payments, payable from any interest herein set forth, has been satisfied or discharged and the undersigned, whose interests are affected by such money or other payments, agree to give written notice to NGL of the satisfaction or discharge of such money or other payments, and to hold NGL harmless from all loss, cost, expense or damage (including court costs and reasonable attorneys' fees) that may result from any overpayment in the absence of such written notice.

FOURTH: Operators and/or working interest owners, and each of them by execution of this Division Order, hereby warrants that all gas delivered under this Division Order has been and will be produced and handled in compliance with the Fair Labor Standards Act of 1938, and any amendments thereto, the regulations promulgated thereunder, and all other federal, state, and municipal laws, rules and regulations.

OXY CITIES SERVICE NGL INC.
BOX 300
TULSA, OKLAHOMA 74102

NGL GAS
DIVISION ORDER

______________, 19____

LEASE NUMBER ______________

The above number will appear on all settlement checks and will be the only lease identification shown. It is important that you retain and record this number and lease description in your records.

The undersigned, owners of royalty, overriding royalty and working interest hereby guarantee and warrant that they are the legal owners in the proportions set out therein and are entitled to the proceeds of gas sold or processed from the ______________________ ______________________ lease, described as:

in ______________________ County or Parish, State of ______________________

commencing with ______________________, and thereafter until we are furnished an instrument in writing evidencing a change in the ownership different from that set out hereunder. Subject to the Covenants appearing on the reverse side hereof, which same are binding upon the undersigned, their successors, legal representative and assigns, Oxy Cities Service NGL Inc. (hereinafter referred to as "NGL") is authorized to receive gas therefrom during the term of the Contract/Agreement referenced below and to give credit for gas proceeds attributable thereto as shown on the Division of Interest Summary attached.

CREDIT TO	DIVISION OF INTEREST	P.O. ADDRESS

SEE DIVISION OF INTEREST SUMMARY ATTACHED (DO NOT DETACH)

Subject to the Covenants appearing on the reverse side hereof, which same are binding upon the undersigned, their successors, legal representatives and assigns, Oxy Cities Service NGL Inc. (hereinafter referred to as "NGL") is authorized to give credit for gas proceeds as directed on the attached Division of Interest Summary and thereafter until we are furnished with an instrument in writing evidencing a change in the ownership different from that set out hereunder.

FAILURE TO SHOW YOUR ADDRESS MAY DELAY PAYMENTS
(Signatures of owners must be witnessed)

WITNESS OF SIGNATURE		SIGN BELOW	Social Security or Taxpayer No.
	Signature		
	Address		
	Signature		
	Address		

Be sure you show your correct mailing address and taxpayer identification number. If you are an individual, your SOCIAL SECURITY NUMBER is your identification number, if a company or an estate, please furnish your employer identification number.

Print or type - do not abbreviate

7CN/1296 1
08/05/87

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Settlement for gas proceeds, less any taxes required by law to be deducted, will be mailed within sixty (60) days after the last day of the month in which the gas is sold or processed by mailing or delivering to the respective owners as above set out, their assigns or successors in interest, check or draft of NGL. It is agreed that if, at any settlement date, the amount payable to any party hereunder shall be less than $10.00, NGL may withhold payment until the amount payable to such party equals or exceeds the sum of $10.00, after which time payment shall be made at the next regular settlement date. Upon termination of this Division Order, payment shall be made to the respective owners entitled thereto regardless of the amount or amounts due.

SECOND: The word "GAS" as used herein is hereby declared to include all gaseous substances including oil well gas (casinghead gas) purchased and/or processed hereunder. It shall also include all liquid hydrocarbons contained in the gaseous substances, as well as all other substances contained in the gas stream such as but not limited to sulfur, helium and nitrogen.

THIRD: Satisfactory evidence of title shall be furnished to NGL at any time on demand; and the undersigned agrees that NGL may withhold payment without interest until any defect, dispute or question of title is corrected or removed to the satisfaction of NGL. NGL shall not be responsible for recognizing any change of ownership in the absence of actual notice and proof thereof satisfactory to NGL. NGL is hereby relieved of any responsibility for determining when any money or other payments, payable from any interest herein set forth, has been satisfied or discharged and the undersigned, whose interests are affected by such money or other payments, agrees to give written notice to NGL of the satisfaction or discharge of such money or other payments, and to hold NGL harmless from all loss, cost, expense or damage (including court costs and reasonable attorneys' fees) that may result from any overpayment in the absence of such written notice.

FOURTH: Operators and/or working interest owners, and each of them by execution of this Division Order, hereby warrants that all gas delivered under this Division Order has been and will be produced and handled in compliance with the Fair Labor Standards Act of 1938, and any amendments thereto, the regulations promulgated thereunder, and all other federal, state, and municipal laws, rules and regulations.

SAMPLE ECONOMIC DURESS LETTER

January 28, 1987

Mary O. Smith
Contract Analyst
Division Order Administration
Anoil Company
Houston, Texas 77252

Re: Wright No. 1
Property No. 36-20-6395
Section 1-22N-9W
Major County, OK

Dear Ms. Smith:

Your letter of January 20, 1987, states that the Uniform Royalty Division of Interest Form prepared by me covering the above-referenced property is not acceptable to Anoil Company. The Division of Interest form I submitted to you verified my ownership interest, provided my taxpayer identification number, was properly executed and witnessed. There is no legal requirement that I sign your form of Division Order as long as I provide you with the information outlined above. You have already purchased my oil and, although there is no title problem, you have refused to release to me royalties due and payable.

Therefore, I have executed your Division Order which is attached hereto. This Division Order has been executed under economic duress and by so executing, I have not agreed to any terms other than those contained in my lease agreement. Nor have I waived any of my rights to proper payment or to litigate under the lease and the laws of the State of Oklahoma.

Respectfully,

xc: (name of your attorney)

Attachment:
Anoil Company
Oil Division Order dated December 5, 1986