NORTH HOUSTON
ASSOCIATION OF PROFESSIONAL LANDMEN

NON-TRADITIONAL UPSTREAM TRANSACTIONS & JOINT VENTURES

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Topics covered

Multi-Well Farmout Agreements

- Key Drivers
- Key Components of Consideration
- Examination of a Typical Current Transaction

Joint Development Agreements

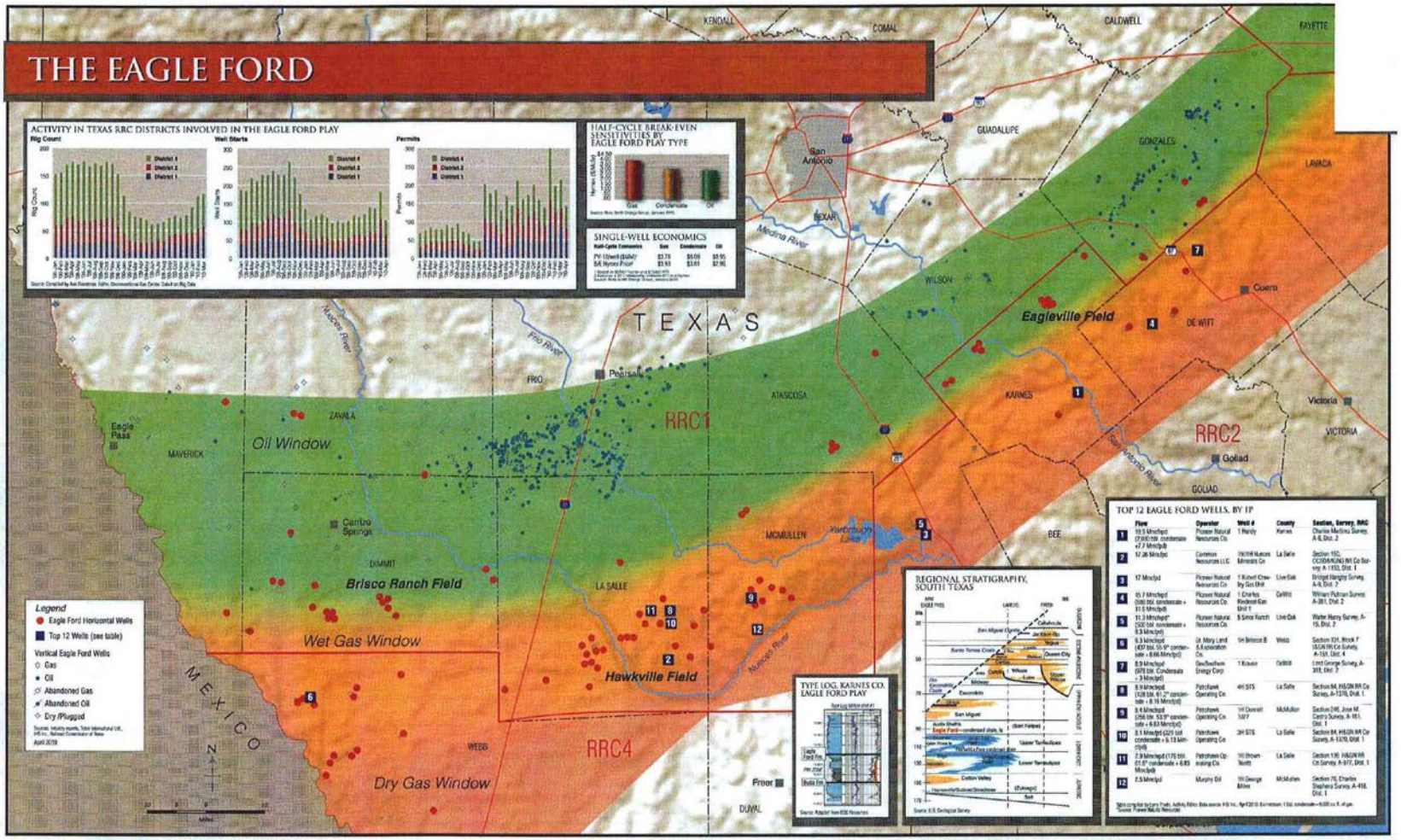
- Typical Transaction Players/Investors
- Key Components of Consideration
- Default and Security Provisions
- Development Plans and Budgets
- Secondment

Current and Emerging Legal Issues

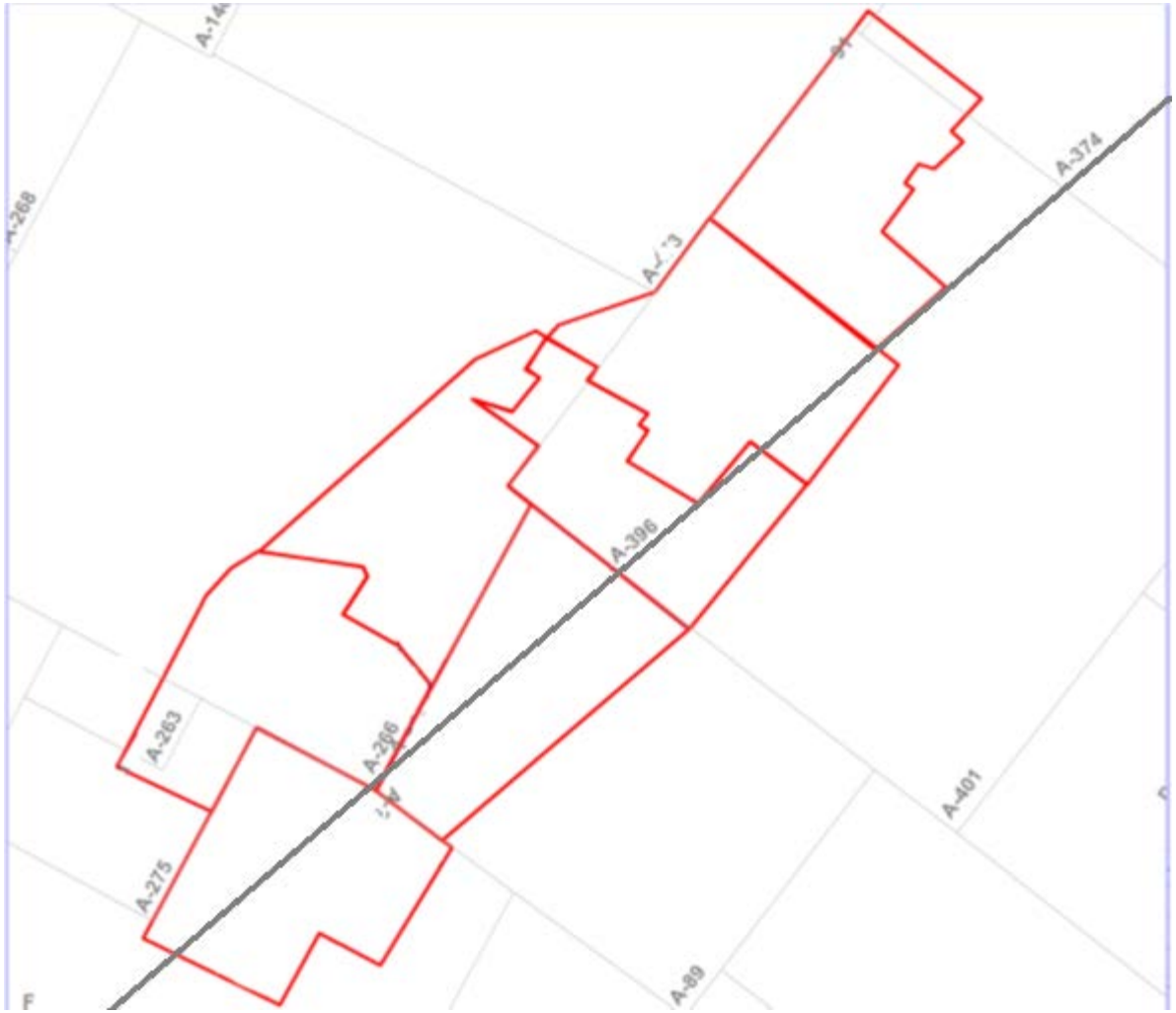
Multi-Well Farmout Agreements

- Key Drivers
  - Cost, financial resources
    - First Eagle Ford Well drilled in a recent matter: Total Drilling, Completion, and Production Facility Costs > $10MM
    - Compare: new Edwards Well total AFE: $1.9MM
  - Technological Expertise – *e.g.*, horizontal drilling, hydraulic fracturing

Eagle Ford Shale

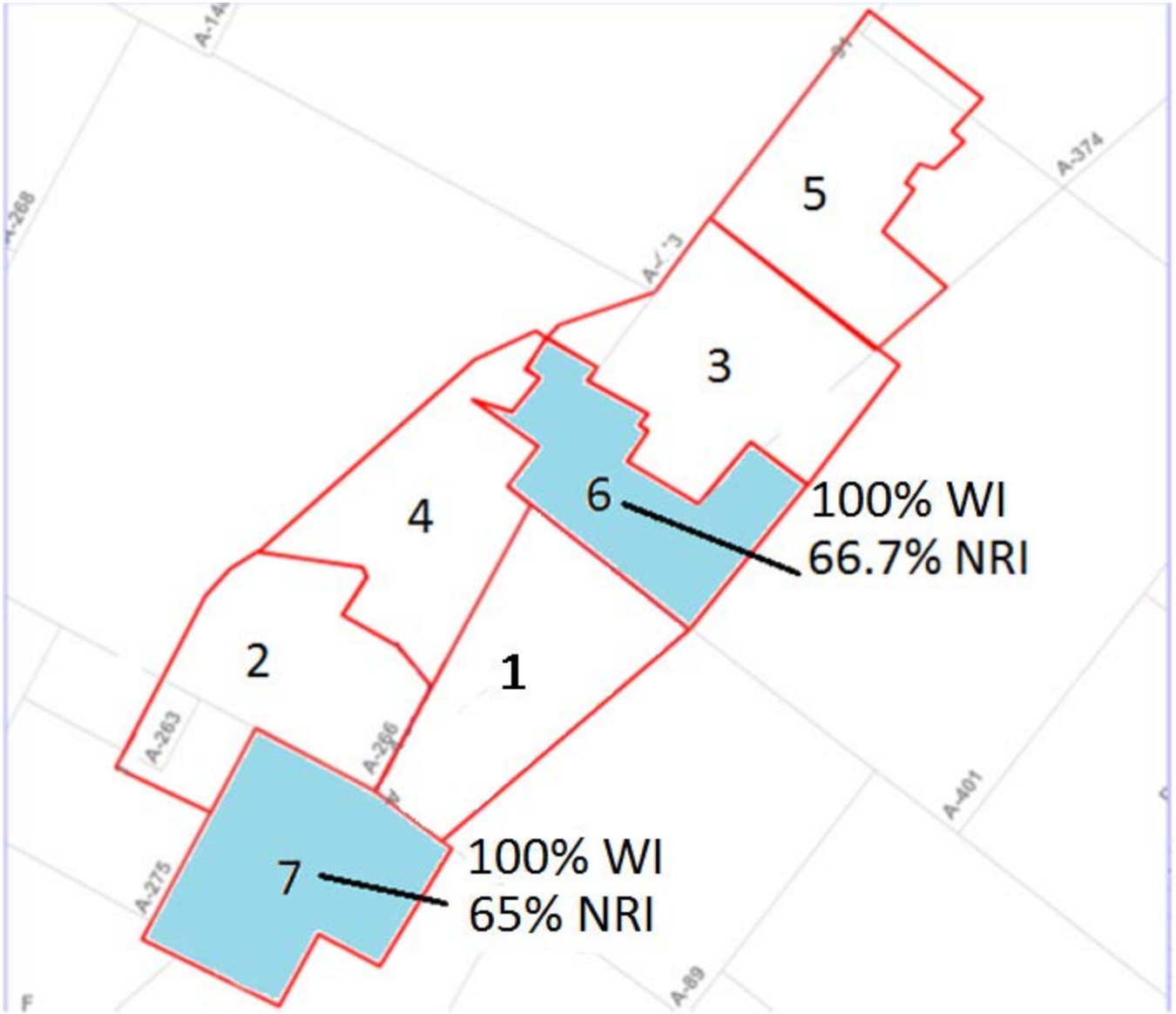


A Common JV Beginning – Existing Conventional Production Below (or above) an Unconventional Play



More Problems

- We had more than 15 WI owners.
- Those owners had Working Interests that differed in proportion between each of the seven Units. (Only 5 had WI in all 7 Units.) Thus, each would have a preference over where the new drilling began.
- Most of the JOA's were over 40 years old, and contained only a 200% nonconsent penalty.
- The gas wells holding all the leases had been producing for decades, and were steadily depleting.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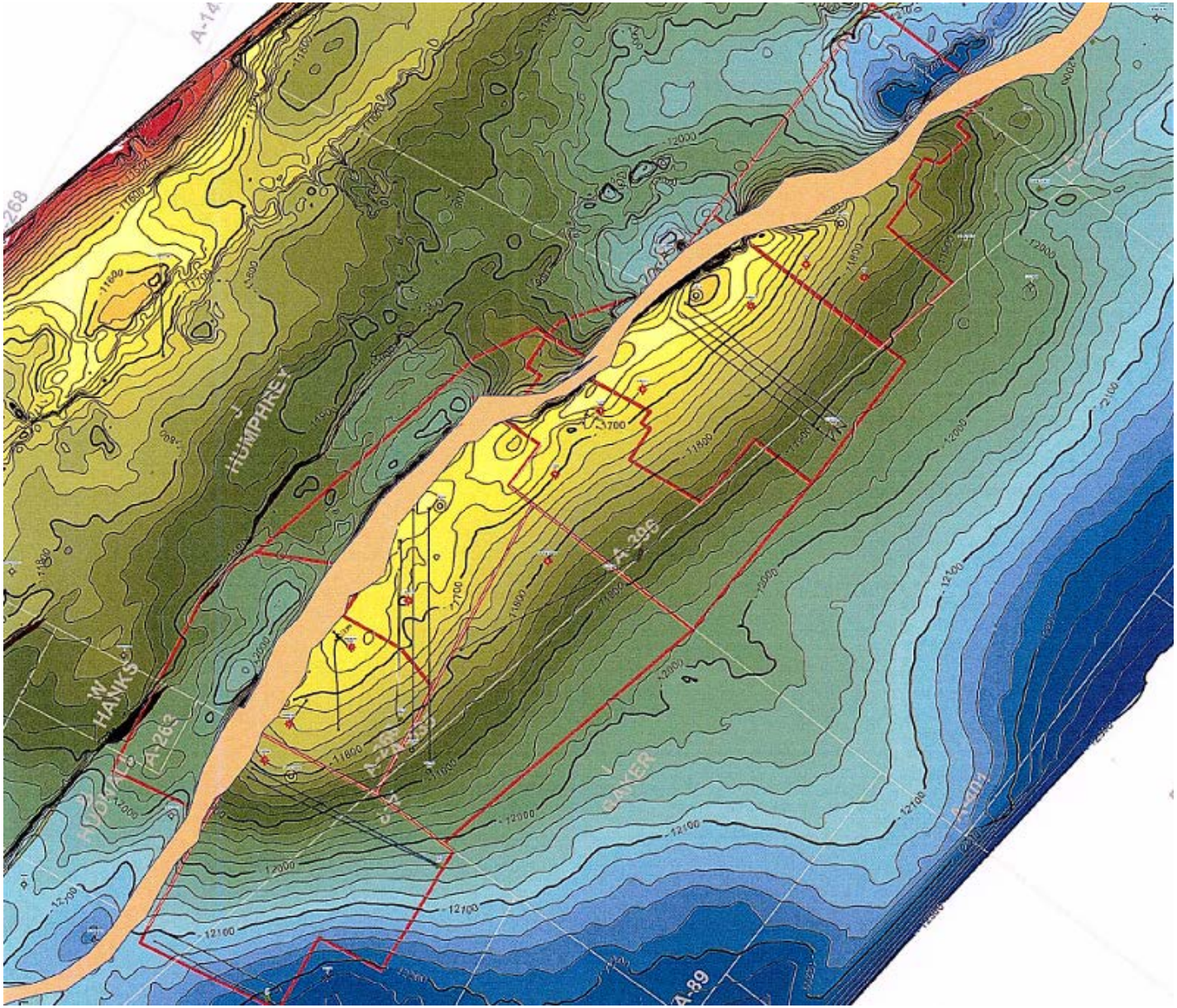
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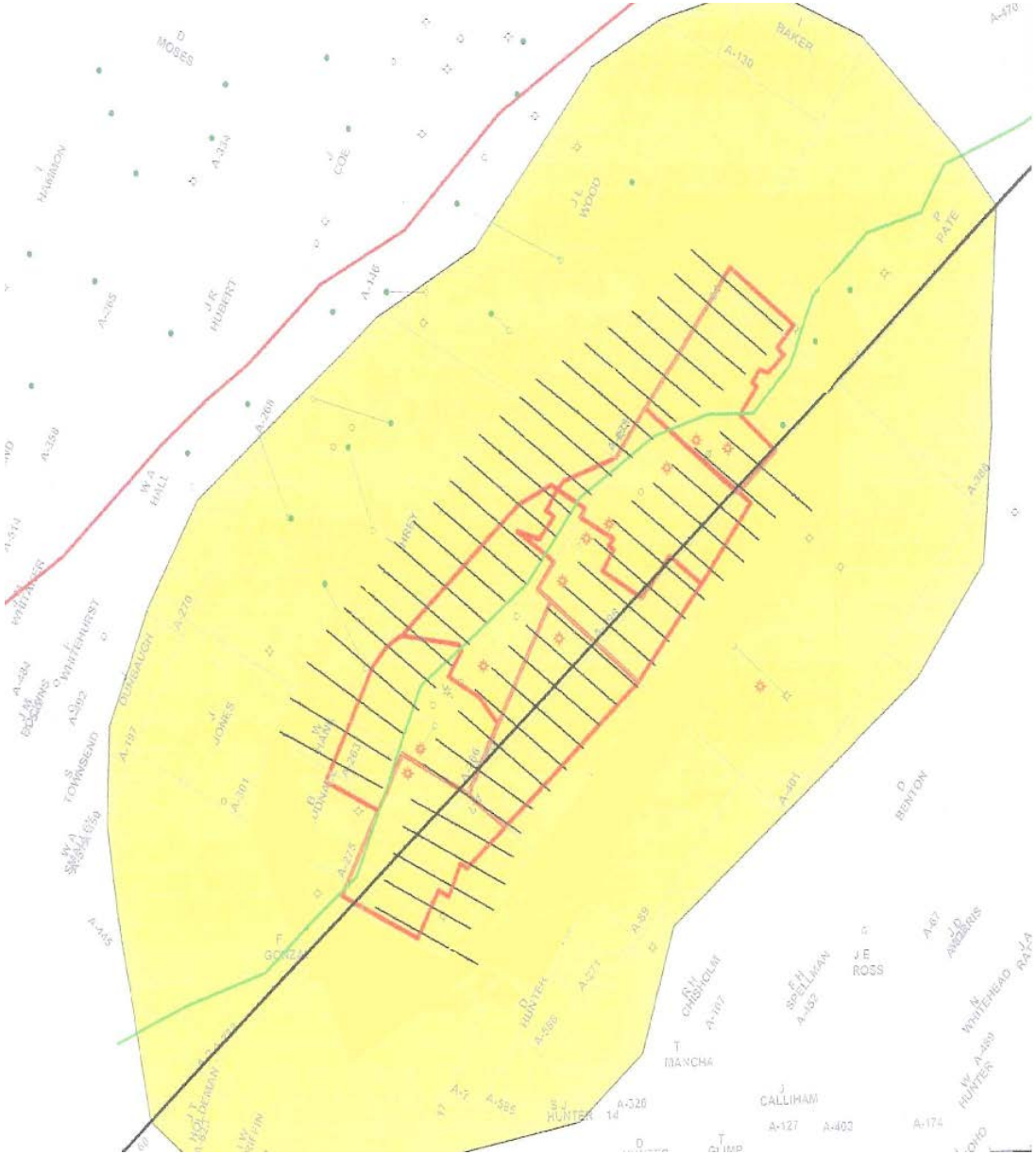
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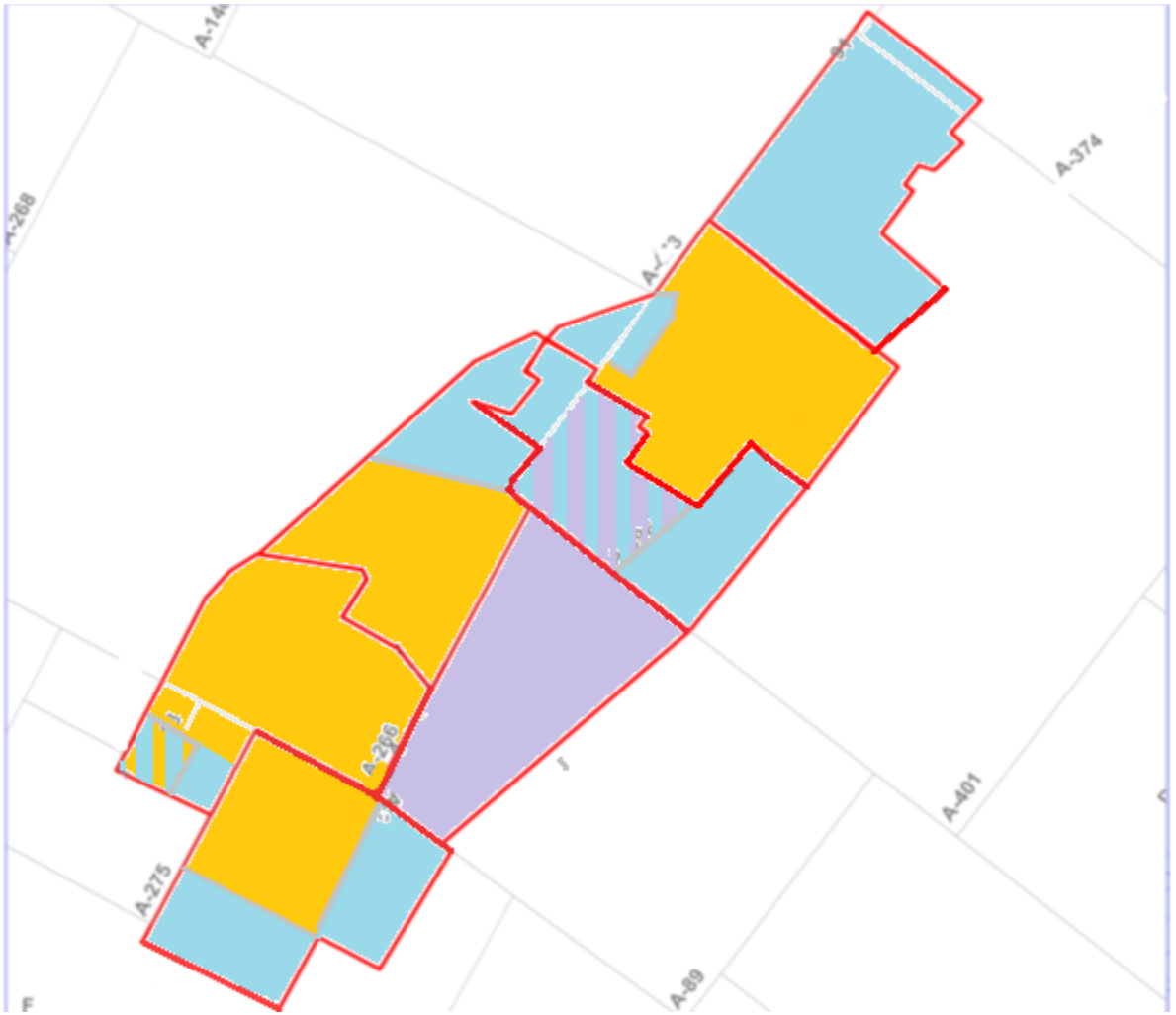


Leases with Gas Pooling Only

Leases with Oil & Gas Pooling

Leases without Oil or Gas Pooling

Key Components of Consideration

- Cash
  - Generally based on total net acres delivered (assuming no production included)
  - May include other consideration such as reimbursement for seismic
- Size of Farmor's Retained Working Interest
- Carried Working Interest
- Continuous Drilling Obligations
- Retained ORRI (BUT: beware of tax consequences)

Tax Implications of Overriding Royalty Reservations

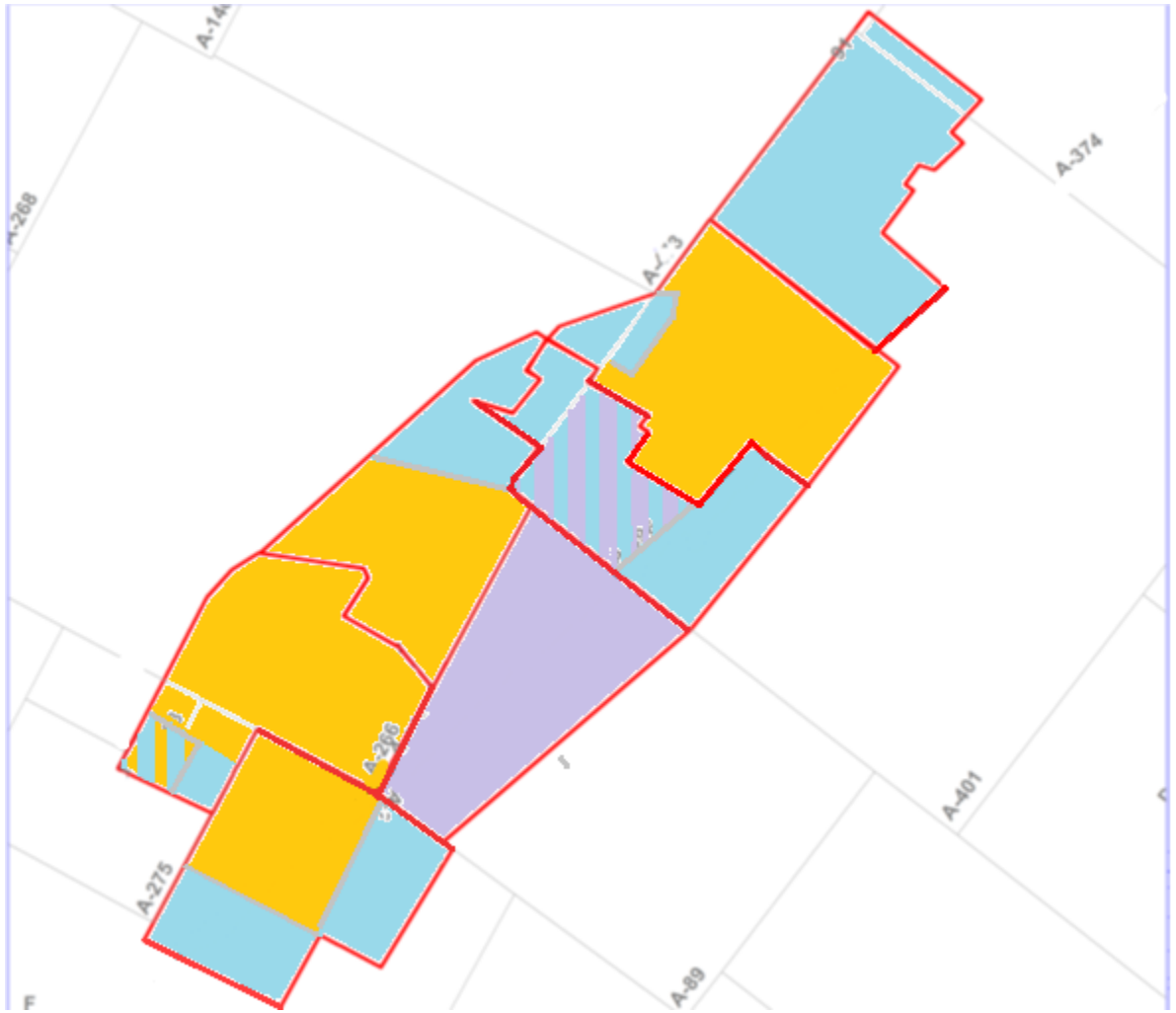
- Transaction is treated as a lease, rather than a sale, for federal income tax purposes:
  - Ordinary income (not capital gains)
  - Sales proceeds are offset only by cost depletion, rather than the seller's entire basis in the transferred lease
  - Seller cannot use the sales proceeds in a tax-advantaged "like-kind exchange"

Terms sought by Yates

- Farmout of the Eagle Ford Formation only
- Keep a significant WI (*e.g.*, 35%)
- Significant cash consideration at Closing, based on a price per net acre
- Commitment to drill an “Earning Well” in each of the 7 existing Units, each of which would earn only the acreage within that particular Unit
- Farmors to have a Carried WI in the 7 Earning Wells
- Continuous Drilling obligations – 120 days between Earning Wells
- Delivery of a 75% NRI
- Reimbursement for the costs of the Seitel 3D survey we’d underwritten; Farmee to have the option to acquire the optional additional license.

Neutralizing the Disproportionate Interests

- We agreed to unitize the Farmors' working interests across the entire Contract Area. We calculated each Farmor's weighted average WI on a surface acreage basis. Each Farmor's working interest under the prospective Eagle Ford Farmout would be equal to that weighted average.
- This required persuading the other Farmors that all units were equally prospective for Eagle Ford production.



Leases with Gas Pooling Only

Leases with Oil & Gas Pooling

Leases without Oil or Gas Pooling

Browning v. Luecke, 38 S.W. 3d 625 (Tex. App. – Austin, 2000)

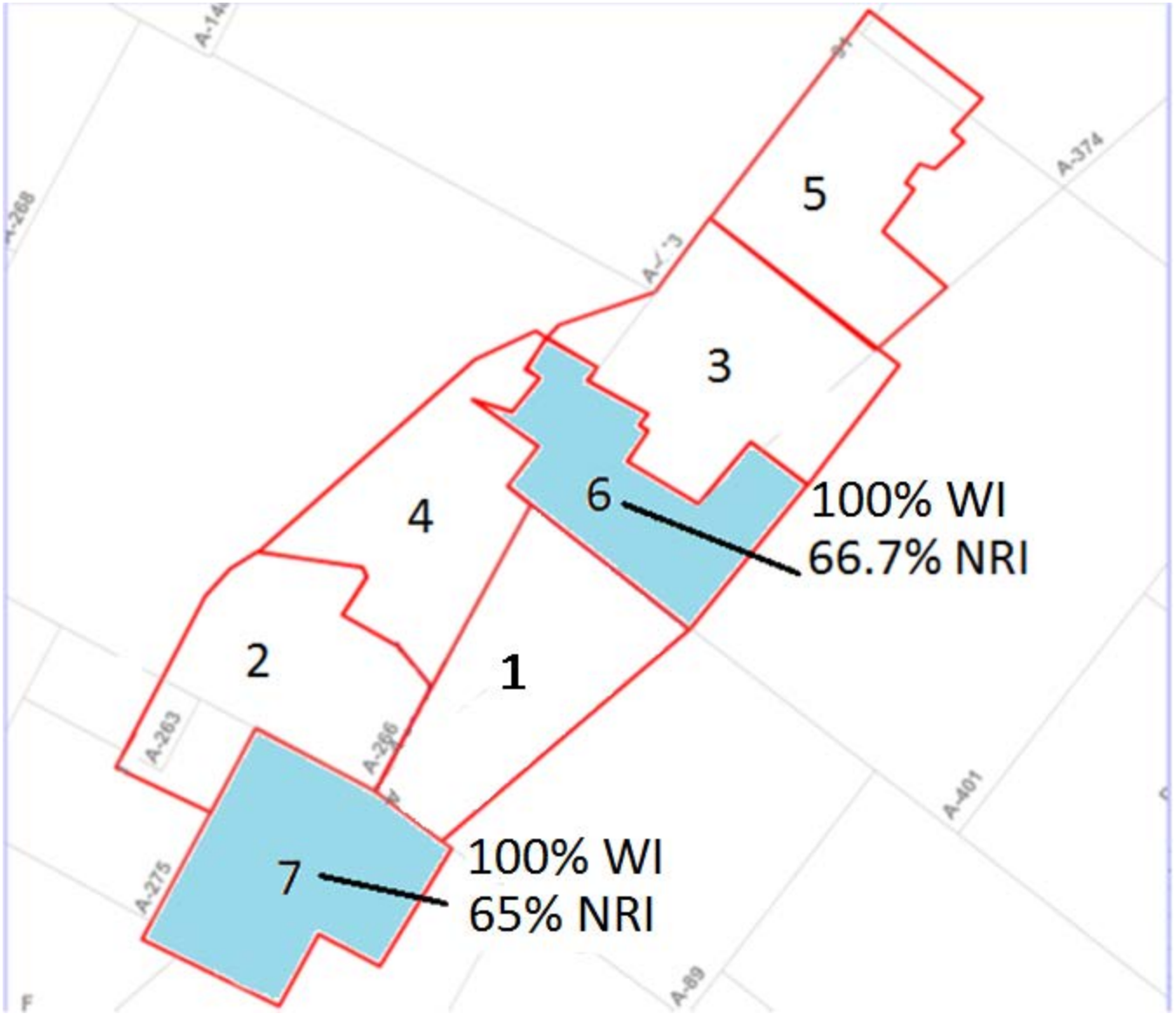
- Lease contained a pooling "anti-dilution" provision restricting the amount of acreage that could be pooled with the lease. Unable to secure an amendment, the lessee formed a pooled unit that exceeded its authority under the lease, and proceeded to drill horizontal wells across the unit.
- The court of appeals acknowledged the rule that a lessee must strictly comply with the pooling provisions in the lease and held that it must account to the lessor for production on an unpooled basis. Rejecting the lessors' argument that the "confusion of goods" doctrine required payment of royalty on all production from the well, the court held that the operator owed damages based upon "a determination of what production can be attributed to their tracts with *reasonable probability.*"
- The Supreme Court of Texas has not addressed what standard governs damages for production from unpooled interests along a horizontal well. Until it does, under *Luecke*, a lessee may allocate production on an unpooled basis, without liability under the confusion of goods theory, provided it can establish with reasonable probability what production originates from the segment or segments of the drainhole within the unpooled lease.

Deal with one EFS operator stalls due to pooling…

- Eagle Ford operator with whom we had a Letter of Intent proposed that the absence of authority to form new pooled units for Eagle Ford horizontal drilling would be a Title Defect, for which downward purchase price adjustments could occur. Further, depending on the amount of acreage without such pooling authority and the failure to significantly cure, that party could terminate the agreement prior to closing.
- We rejected this proposal. We were aware of Devon's recent success obtaining permits to drill allocation wells in the Haynesville. Based on that emerging trend and *Browning v. Luecke*, we attempted to persuade the operator and its outside counsel that this was a risk it would have to assume – and any attempts to amend leases would occur after Closing, at a joint cost, and with approval from the Farmors.
- While at a stalemate on this issue, the prospective farmee signed an agreement whereby it would be acquired by a larger oil company. Discussions were put on hold pending Hart-Scott-Rodino antitrust review.
- We took the opportunity to approach other Eagle Ford operators who we thought would be more willing to drill allocation wells.

New Farmee, new terms

- More upfront cash per net acre (plus reimbursement for 3D)
- Farmout to cover 70% WI, not 65%
- But: Carry in 8 wells to cover the equivalent in net wells to a 35% carry in 7 wells
- But: each Earning Well, regardless of location, will earn 1/8 of the Contract Area
- 180 days between obligation wells, and Farmee could bank days for early drilling of wells
- Farmout to include the Austin Chalk and Buda in addition to the EFS
- No Title Defects for lack of pooling authority to accommodate a horizontal drilling program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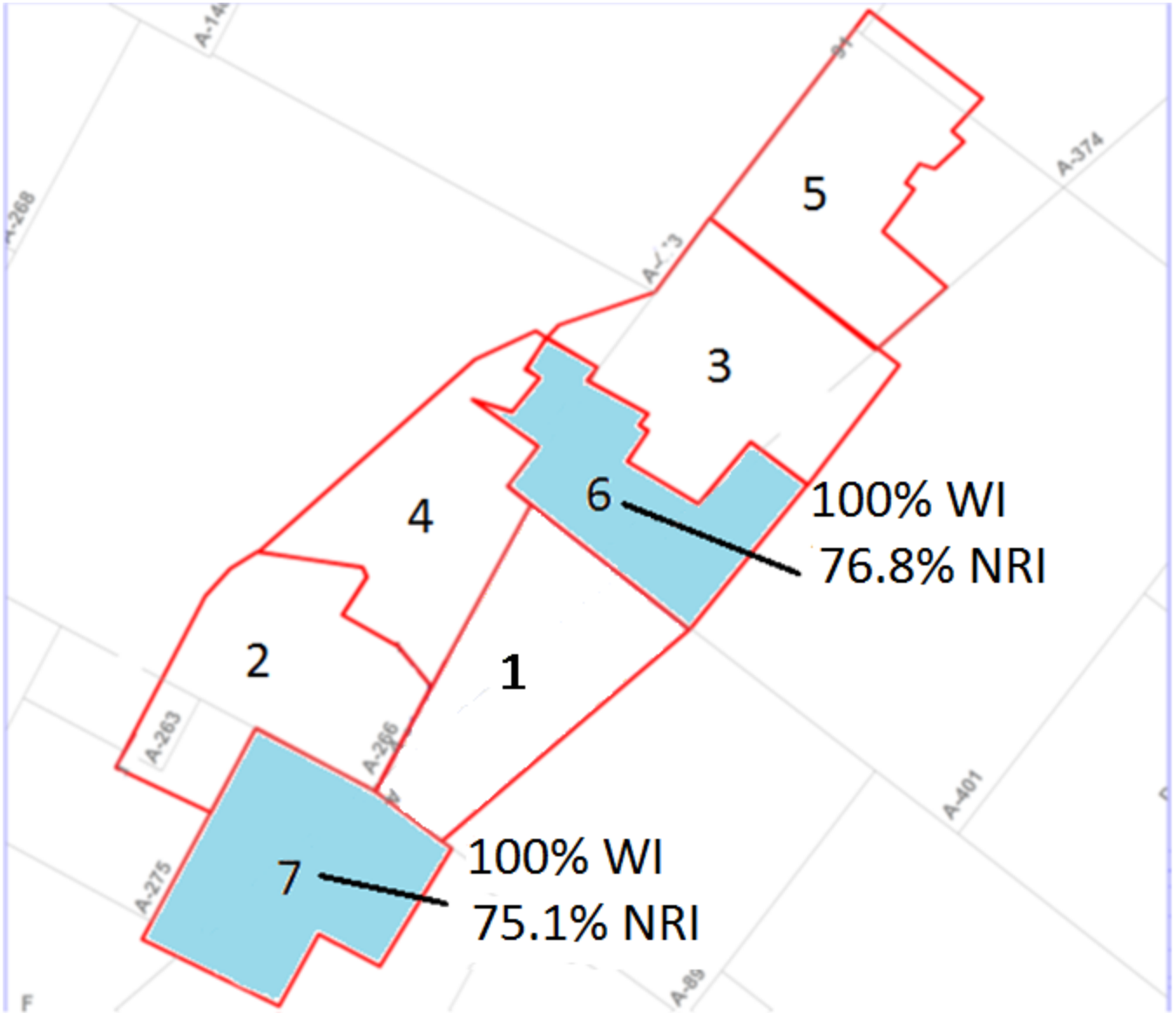
Addressing the 2 Low NRI Units

- At Closing, there would be a downward purchase price adjustment for the failure to deliver 75% NRI in the 2 Units; as well as a proportionate downward adjustment to the Total Carried WI. **However:**
- Farmors would have a post-Closing cure period in which to attempt to increase the NRI.
- Farmors would receive a full refund if the NRI was increased to 75% or more, and a partial refund if the NRI was increased to 72%.

The Cure

- We determined that the low NRI in each Unit was substantially attributable to a 1/8 ORRI which had been retained by Phillips Petroleum, an early Edwards operator.
- Phillips had ultimately exited the play but the assignment it executed when exiting had been limited to the Edwards Formation.
- We determined that the Farmors' weighted-average NRI in the Contract Area was > 75%. Could we trade a portion of our retained ORRI in the other 5 Units to ConocoPhillips in exchange for reducing the ORRI in these 2 Units?
- We approached ConocoPhillips with this concept. During negotiations, production commenced from other lands within the Contract Area.
- After protracted negotiations, the Farmors assigned ConocoPhillips a 1/48 (2.0833%) in the other 5 units, in return for ConocoPhillips assigning us a 5/48 (10.4167%) ORRI in the 2 low NRI units.
- Result:….. (next slide)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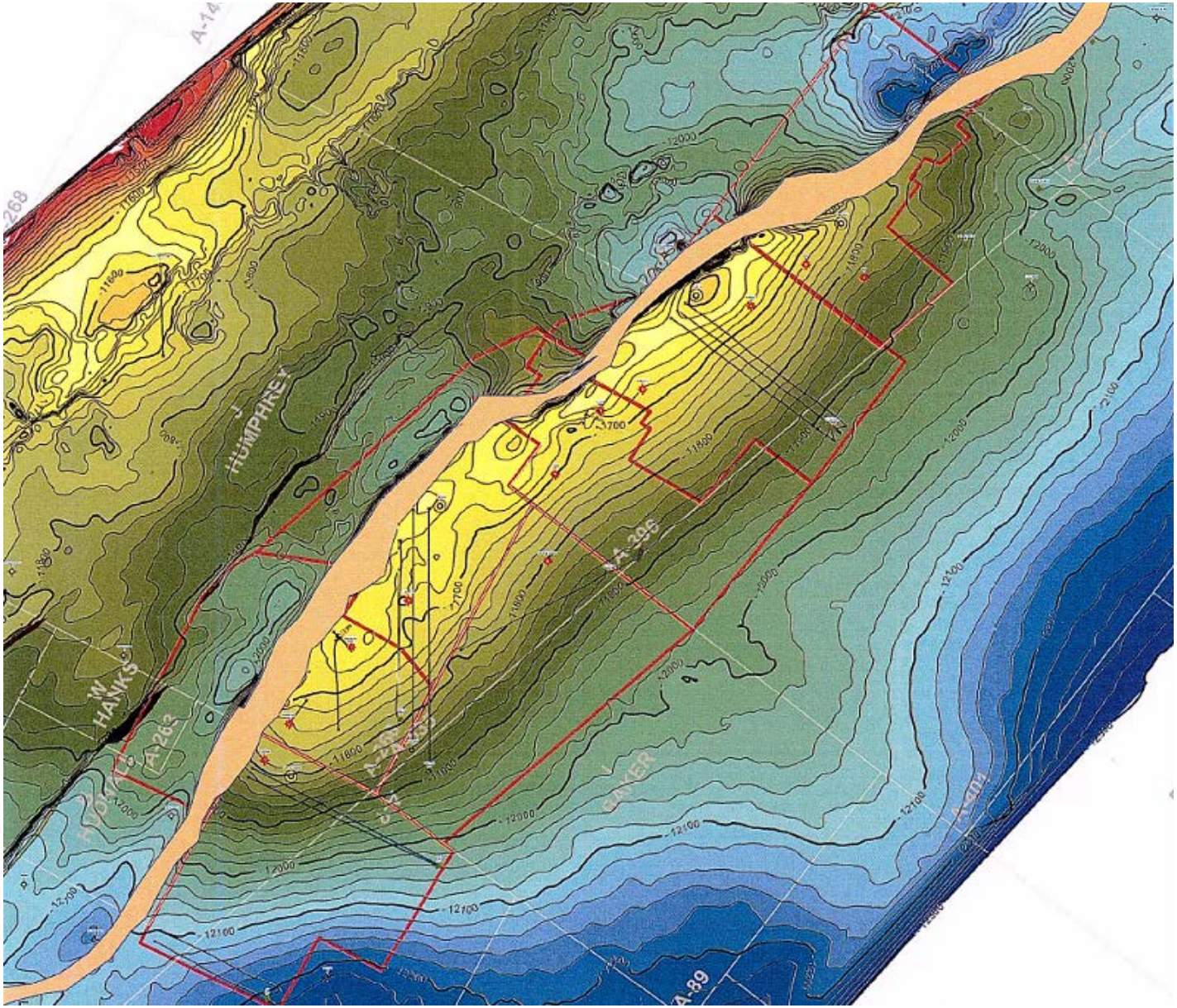
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What about that fault?

- We formed an AMI extending 1/2 mile beyond the Contract Area.
- We introduced a concept, "fully develop the Prospect Lands," meaning to include all of the Prospect Lands in a Production Unit.
- If Farmee owned acreage outside the Contract Area (prior to the AMI) that is not committed to another well and would be necessary to fully develop the Prospect Lands, then Farmee would contribute such lands to a Production Unit including the Prospect Lands.
- Likewise, if Farmors owned such acreage, they would have the option to either (A) contribute such lands to a Production Unit including the Prospect Lands, or (B) farm out such lands to Farmee under the same terms as this Agreement.
- Without prior consent, neither Farmors nor Farmee could commit any of such acreage to any well other than a well drilled under this Agreement.
- Neither Farmors nor Farmee can withhold such consent if the other can show that such acreage would not be necessary to fully develop the Prospect Lands.

What about that fault? (continued)

- If any such outside acreage is contributed to a Production Unit that includes Prospect Lands, then the Contract Area under the Operating Agreement will be deemed expanded to include such contributed acreage.

- If there is any adjacent third party acreage that is not committed to another well and would be necessary or useful to fully develop the Prospect Lands, then Farmee will use commercially reasonable efforts to reach an agreement with the WI owners of such acreage to contribute such acreage to a Production Unit that includes the Prospect Lands. Farmors will cooperate with such efforts.

The Klotzman Case

- EOG applied for a Railroad Commission permit to drill a horizontal oil well across two adjacent, unpooled 40-acre tracts covered by separate oil and gas leases. The underlying leases did not provide for pooling for oil.
- The landowners (the "Klotzmans") disputed the legal sufficiency of EOG's application. They asserted that no allocation agreement or production sharing agreement existed for the proposed well, and that the lack of pooling authority for oil resulted in the lack of a good faith claim to drill the well.
- The Commissioners voted to approve EOG's permit to drill the well. They found that EOG made a reasonably satisfactory showing of a good faith claim of ownership, and that the lack of pooling authority in the underlying leases was inconsequential to issuing the drilling permit.
- The Commissioners reasoned that pooling authority, and methods for allocating production from this type of well, are private contractual matters to be decided by the parties to the transaction, or potentially the courts, and are not within the bounds of the Railroad Commission's jurisdiction.
- EOG and the Klotzmans settled shortly after the RRC ruling.

Was it all worth it?

- 2010 Engineering Study obtained by client projected an EUR per well of 400,000 BOE. The study assumed 160 acre spacing (room for possibly 30-35 wells).
- Two years into the Farmout, 9 wells (including all Earning Wells) have been completed and the parties are conducting heads-up drilling. The Operator is having success drilling multiple laterals from a single pad.
- Early results indicate an EUR of approx. 800,000 BOE per well. The wells are approaching 40-acre spacing.
- If this keeps up:
  - 5000 acres at 40-acre spacing = 125 wells
  - 125 wells x 800,000 BOE = **100 million BOE**

Joint Development Agreements – Case Study Introduction

- Investor ("Asia Gas") is a large gas provider and power producer in a large AP country.
  - It has substantial equity in an approved U.S. LNG export facility ("Asia Gas LNG") along with a liquefaction tolling agreement for the export of over 2 million tons of LNG per year from the U.S. to Asia for 20 years.
  - Ownership of U.S. natural gas interests is essential to ensuring a successful U.S. natural gas export strategy, which is a core component of its LNG value chain integration efforts.
- "American Oil Company" is over weighted on the gas side of its portfolio; wants to monetize some of its gas assets and use the proceeds to acquire and/or further develop liquids.
- American Oil and Asia Gas enter into a joint venture whereby Asia Gas acquires a 50% non-operating share of certain of American's gas assets in a prominent shale gas play. The acquisition is made pursuant to a Purchase and Sale Agreement. At Closing, the parties execute a Joint Development Agreement, which will govern their rights and obligations with respect to the ownership and operation of the applicable properties (including those subsequently acquired under the AMI).
- Parties will often structure these types of joint ventures as a corporate transaction, whereby a "NewCo" is formed, the Operator contributes the applicable assets into NewCo, and the Investor contributes cash. Ownership is then set up through equity in NewCo rather than through record title in and to the assets.

Joint Ventures where the Investor is not the Operator

- These types of joint ventures occur where the Operator already has the land position, but brings in a financial partner ("Investor").

- In addition to Asia Gas, other typical Investors include:
  - Other industry players with no prior foothold in the applicable play
  - Private equity or similar financial institutions looking for high upside
  - Foreign companies looking to invest in the US
  - Foreign companies seeking to acquire first-hand knowledge and experience with unconventional drilling and operations

Key Differences from Multi-Well Farmouts

- Carried Interest: The Operator (i.e., American Oil Company) is now the carried party, not the Non-Operator.

- The parties typically agree on a specific dollar amount for the total consideration and split it out between the “Cash Consideration” and the “Carry Consideration.”

  - Example: $400 Million Total Consideration
    - Cash Consideration = $100 Million
    - Carry Consideration = $300 Million

- The Parties will need to specify all parameters of the Carry.

Case Study: Carry Consideration

- Example – Asia Gas acquires 50% interest, Carry will cover ½ of American Oil Company's 50% Retained Working Interest

  "Asia Gas will fund 50% of American Oil Company's Retained WI share of total Qualified Costs with respect to drilling and other operations relating to the jointly owned acreage constituting the Subject Property and any other jointly owned acreage acquired pursuant to the terms of the AMI until the Drilling Carry is fully utilized."

  "Qualified Costs" will include all costs associated with the development of the jointly owned acreage or well(s) thereon, including any taxes, costs attributable to third-party title review or examination, permitting, drilling, completion, initial production infrastructure and equipment, plugging and abandonment costs and reclamation and related costs.

  Note→ the inclusion of post-production costs (such as transportation costs) in "Qualified Costs" is often a key point of negotiation.

Default and Security Provisions to Secure the Carry

- Since the Investor will usually be getting a present assignment at Closing, the Seller will negotiate for terms that provide security for the Carry Obligation. Alternatives include:
  - Liens and security interests covering the Investor's interest pursuant to a JOA or otherwise (such as the standard Operator's lien)
  - Mortgages on the Investor's interest
  - Re-assignment obligations
  - Letters-of-credit/Performance bond
  - Investor's obligation to make advance payments for estimated development expenditures
  - Parent guaranties
    - May or may not be capped

Development Plan

- Joint Development Agreements will typically contain an initial drilling program (of some specified time), which is intended (at a minimum) to facilitate the full utilization of the Drilling Carry.
- Note that the agreements should be drafted so that there is enough flexibility for the parties to modify Development Plans and corresponding budgets if needed (as they are merely estimates), but also so that the parties can have a reasonable expectation of receiving the benefit of the bargain.
  - Note also that there is often inherent tension between Investors and Operators as to the Development Plan, as each has different economic motivators.
- Some Joint Development Agreements call for an Operating Committee (sometimes called a Management Committee) in which the Investor will have some influence. The Operating Committee will generally be authorized to make modifications to Development Plans as may be necessary.
  - Rarely will the Investor have a controlling vote on the Committee.

Case Study: Development Plan

- Purpose of the Development Plan between Asia Gas and American Oil Company: to optimize the timing and scale of gas production so as to achieve a long-term, stable production profile balanced against the need to hold acreage, secure leases, and American Oil Company's production needs and goals."
  - Asia Gas Motivator- when Asia Gas LNG becomes operational in 2-3 years, there should be a sufficient source of gas supply to meet Asia Gas' export strategy.
  - American Oil Company Motivator- hold acreage and leases with minimum costs during times of depressed gas prices.

Case Study: Development Plan

- Key Components of Development Plan and Budget:
  - American Oil Company to prepare and provide to Asia Gas an initial 60-month budget for approval prior to execution of the JDA
  - Drilling Carry costs that Asia Gas will be required to pay during each of the first three years of the Carry Period will not be less than $75,000,000 (subject, however, to American Oil Company's rights to roll over to subsequent year(s)
  - For year four of the Carry Period, the Drilling Carry costs that Asia Gas will be required to pay will not exceed the amount obtained by taking the remaining Drilling Carry amount at the beginning of such year (taking into account any Rollover Amounts) and dividing that amount by 2
  - During year five of the Carry Period, the Drilling Carry costs that Asia Gas will be required to pay will be any remaining Drilling Carry costs.
- Note: To ensure timely development, Investors will want any unused Carry Consideration to be forfeited at the end of the Carry Period. Operators will want to ensure that all Drilling Carry costs are spent.

Variances from the Budget

- The Operator will want some discretion to deviate from and amend the budget (remember: these budgets are rough estimates). The Parties will negotiate various limits on the Operator's unilateral authority to deviate from the budget.

- Example of limits on Operator's discretion:

  - Operator will consult with Investor with respect to any material changes in the Development Plan and when and if Operator becomes aware that expenditures will be more or less than 10% of the budgeted amount in a given year, Operator will promptly distribute to Investor a supplemented or amended budget that reflects such variance for Investor's prior approval.

- As for operations that are provided for in the Development Plan, or any subsequent approved budgets, the Operator will generally want to provide that the Investor may not go non-consent in any such operations until the Drilling Carry has been spent.

Secondment

- Investors (particularly foreign investors looking to acquire first-hand knowledge and experience with unconventional drilling and operations) often want to enter Secondment Agreements with the Operator so they can send employees to observe and participate in the joint operations.
- The AIPN has a Model Form Secondment Agreement
- If the Parties agree to a secondment, they should address the following issues:
  - Who will pay the Secondee while the Secondee is working with the Operator?
  - What will be the extent and scope of the Secondee's activities while with the Operator?
    - Is the secondment an accommodation to the Investor, or will the Secondee be doing valuable work for the Operator?
  - How many Secondees can the Investor send at one time and can they be replaced?
  - NOTE- the recent trend is moving away from secondments and towards informal training methods (such as scheduled site visits, tutorials, meetings and conference calls)

Case Study: Secondment

- American Oil Company was opposed to providing any type of secondment arrangement. However, it was very important for Asia Gas to obtain first-hand knowledge and experience (and remain involved) with unconventional drilling and operations. Thus, the compromise was for American Oil Company to schedule the following:
  - At least one quarterly in-person meeting/program to be held at American Oil Company's offices principally designed to provide technical and operational training with respect to the Subject Assets to certain Asia Gas representatives
  - At least one monthly conference call to be hosted by American Oil Company so that representatives of the Parties can discuss the status of Development Operations, expenditures under the applicable Annual Plan and Budget, and any operating reports or other data that have been distributed by American Oil Company
  - One weekly, informal conference call hosted by American Oil Company, so that the Parties are able to discuss any follow-up issues relating to the Subject Assets

Emerging Legal Issue

- Back to our case study: American Oil Company and Asia Gas anticipate selling gas directly to Asia Gas LNG for prevailing market prices (estimated between $3 and $5/mcf). Back at home, Asia Gas expects to sell this gas for $20+/mcf.
  - As a landman for American Oil Company, is there anything here that concerns you?

Emerging Legal Issue

- Sample royalty clause:

Lessee covenants and agrees to pay lessor the following royalty: (a) twenty-five percent (25%) of the market value at the well of all oil and other liquid hydrocarbons produced and saved from the Leased Premises as of the day it is produced and stored; and (b) for natural gas, including other gaseous substances produced from the Leased Premises and sold or used on or off the Leased Premises, twenty-five percent (25%) of the price actually received by lessee for such gas . . . . *The royalty reserved herein by Lessor shall be free and clear of all production and post-production costs and expenses, including but not limited to, production, gathering, separating, storing, dehydrating, compressing, transporting, processing, treating, marketing, delivering, or any other costs and expenses incurred between the wellhead and Lessee's point of delivery or sale of such share to a third party.*

Emerging Legal Issue

- In a prior case, the MMS required an Operator to calculate royalty based on the price received in Japan, less certain actual costs. The MMS ruling was upheld by the U.S. Court of Appeals. *Marathon Oil Company v. United States Cook Inlet Region, Inc.*, 807 F.2d 759 (9th Cir. 1986).

- Not just an Asia Gas issue. American Oil Company has joint and several liability for payment of lease royalties. *Sharp v. Beacon Oil & Ref. Co*., 108 S.W.2d 870 (Tex. Civ. App.—Texarkana 1937, writ dism'd).

Other Joint Venture Issues

- A and B are independent E&P companies who are acquiring leases in the same areas.
- The parties commence discussions regarding a potential agreement to jointly acquire leases and develop new gathering lines. These discussions are ultimately abandoned.
- Nevertheless, A and B agree on a Memorandum of Understanding to jointly bid on four leases at upcoming BLM auctions.
  - Under the MOU: (a) only A will bid at the auctions; (b) the parties set a maximum price that A can bid; and (c) if A acquires the leases, B will receive a 50% interest at cost.
- Thereafter, A and B complete their negotiations and enter into a formal agreement to jointly acquire and develop leases and gathering lines within a Contract Area.
- Any problem here?

U.S. v. SG Interests and Gunnison Energy

- The Justice Department Antitrust Division filed a civil suit under the antitrust laws and the False Claims Act.
  - Antitrust: the Justice Department charged that A and B engaged in unlawful bid-rigging.
  - False Claims Act: the Justice Department charged that A and B falsely certified that the bids were "arrived at independently" and "tendered without collusion with any other bidder for the purpose of restricting competition."
  - The MOU was not ancillary to the later JV Agreement.
- A and B signed consent decrees requiring each company to pay $275,000 in penalties.
- The Justice Department brought a civil case, not a *criminal case*, despite the fact that the Justice Department very often pursues criminal charges over bid-rigging in auctions.
- Perhaps this case was civil because the parties were discussing a broad collaboration and apparently eventually entered into one.
- Does this mean that bid-rigging in lease auctions is unlikely to be pursued criminally?

Criminal Case Example - *Michigan v. Encana*

- In March 2014, the Michigan Attorney General filed **criminal bid-rigging charges** against Encana Oil and Gas USA and Chesapeake Energy Corporation.
- The AG alleged that Encana and Chesapeake conspired in 2010 not to bid against each other at public oil and gas lease auctions and in private negotiations for oil and gas leases. The AG alleged that the agreement stopped a "bidding war" and caused lease prices to "plummet."
- Multiple incriminating e-mails were discovered among top executives of the 2 companies, including:
  - "Should we throw in 50/50 together here rather than trying to bash each other's brains out on lease buying?"
  - A note projecting that the two companies could "save billions of dollars in lease competition."
  - An internal e-mail from the CEO to a VP stating that it was "time to smoke a peace pipe" with Encana "if we are bidding each other up."

Criminal Case Example - *Michigan v. Encana (continued)*

- On May 5, 2014, Encana settled, agreeing to pay the State of Michigan a fine of $5 million and to plead no contest to one criminal antitrust violation.
- Chesapeake has not settled and is continuing to fight the criminal antitrust charges.
- On June 5, the Michigan AG filed additional criminal racketeering and fraud charges against Chesapeake, alleging that Chesapeake lied to Northern Michigan landowners to obtain gas leases on their land.
- Northstar Energy has sued Encana and Chesapeake in the Western District of Michigan, alleging violations of both the Sherman Act and state antitrust laws, collusion, civil conspiracy, and various other tort claims.
  - Northstar owned 9,838 acres in Utica/Collingwood shale in Northern Michigan, and had received lease offers from both.
  - Suit claims Encana withdrew its lease offer, and CHK then drastically reduced its offer.
  - On March 10, 2014, the Court denied Encana's and CHK's Motion to Dismiss on the all antitrust counts.

Practical Joint Venture Take-Aways

- Unless the NewCo structure is used, a joint venture is generally not construed to be a partnership from a legal perspective. However, from a practical perspective, **joint ventures are more successful when everyone operates as if the parties truly are partners**.
  - From a drafting perspective, try to make this win-win for all parties involved. Determine what the key motivators are for each party (economic or otherwise) and address them. Any remaining issues are likely to work themselves out without much brain damage.
- Spend time critically analyzing the other party to the JV. Think through whether your company is prepared to become "partners" with them (consider foreign investor and competitor issues). Ultimately, if the comfort level is not there, your company will be better off not entering into the joint venture.
- For both parties, it is often more convenient to avoid formal secondment arrangements. However, ensure that the mutually agreed informal arrangements are fully understood by both parties and clearly set forth in the definitive transaction documents.
- If, as an Operator, you are transacting with a foreign investor owning capacity at a U.S. LNG export facility, and the foreign investor will have a direct ownership interest in the underlying assets or an equity ownership interest in a NewCo that will own the underlying assets, you should note that there are risks regarding potential royalty obligations. If this occurs, **further legal analysis should be conducted**.
- Do not participate in an AMI or other joint lease acquisition program that is based solely on a Memorandum of Understanding, Term Sheet, or other non-binding agreement.

Thank you!

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