# OPERATING PROCEDURE
## ANNOTATED


CANADIAN ASSOCIATION OF PETROLEUM LANDMEN

1990

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# INDEX

**The explanatory notes reflect the observations of the authors and other commentators on the intention and scope of the provisions of the Operating Procedure They have been included only to assist the user in understanding the document, and are not intended to have any legal effect on the interpretation of the provisions of the document**

Heading The Operating Procedure would be attached to a head agreement. That agreement as a minimum would describe the joint lands state the working interests and designate the operator It would also include any special provisions negotiated by the parties pertaining to such matters as an area of mutual interest, lease selections and if applicable the failure to participate in work programs required to maintain any special title documents (i e permits) in good standing

Subclause 101(a) Note the references to the regulations and the restoration of the wellsite Abandonment obligations do not cease with the mere physical plugging of a well

Subclause 101(c) i) Note the exclusion pertaining to security assignments

ii) Some companies are forming partnerships comprised solely of corporations which are affiliates for tax and other business reasons The inclusion of the last proviso ensures that the partnership would be regarded as an affiliate of each partner and its other affiliates If the partnership is comprised of other entities it is probably preferable to include in the head agreement a definition of affiliate which is tailored to the specific fact situation

Subclause 101(e) i) The nature of the financial authority granted by an approved AFE is considered in the notes on Subclause 301(c) However it should be noted that the operation described in the AFE is a condition of the approval While the operator of course does have some latitude to deviate from the described operation this discretion is limited and would probably apply to only minor changes or those which are dictated by necessity during the conduct of the operation It is undoubtedly the more prudent practice for the operator to obtain the consent of the other parties before making other changes Otherwise there is a risk that a party could successfully argue that its previous election was void because the election did not pertain to the operation which was conducted See for example Passburg Petroleums v San Antonio Explorations Ltd and D W Axford & Associates Ltd [1988] 2 W W R 645 (Alta Q B ) Although the court briefly considered the overrun issue and the Renaissance case (See the notes on 301(c)) in the context of the 1981 CAPL Operating Procedure this case turned on the fact that the operator drilled a directionally drilled well after obtaining the approval of the parties to drill what they reasonably believed to be a conventional well On the facts the court determined that the parties did not agree to participate in the directionally drilled well

ii) An AFE must include sufficient detail to enable a party to appreciate the nature and scope of the operation and the estimated costs of its various phases If a party is not provided with the information it reasonably requires to make an informed decision or the provided information is misleading the issuing party faces the risk that a party s election could be voidable That being the case it is the better practice to provide all material information which could reasonably be anticipated to influence a party s decision

iii) Note the requirement to specify the proposed coordinates of a well This alerts the parties to the possibility that the well might be subject to a production penalty under the regulations if the well is being drilled outside a prescribed target area If the parties had used joint seismic to mature the prospect it also enables the parties to tie the location to their seismic data preferably through an additional reference to the applicable shot point

# OPERATING PROCEDURE

Attached to and forming part of the Agreement dated the day of A D 19

BETWEEN/AMONG

## ARTICLE I

## INTERPRETATION

101 DEFINITIONS – In this Operating Procedure the following words and phrases shall have the following respective meanings namely

(a) abandonment" means the proper plugging and abandoning of a well in compliance with the Regulations and the restoration of the well site to the satisfaction of any governmental body having jurisdiction with respect thereto and to the reasonable satisfaction of the owner or occupier of the surface

(b) Accounting Procedure means the schedule entitled Accounting Procedure attached hereto and made a part of this Operating Procedure

(c) Affiliate means with respect to the relationship between corporations that one of them is controlled by the other or that both of them are controlled by the same person corporation or body politic and for this purpose a corporation shall be deemed to be controlled by those persons corporations or bodies politic who own or effectively control other than by way of security only sufficient voting shares of the corporation (whether directly through the ownership of shares of the corporation or indirectly through the ownership of shares of another corporation which owns shares of the corporation) to elect the majority of its board of directors provided that a partnership which is a party and which is comprised solely of corporations which are Affiliates as described above shall be deemed to be an Affiliate of each such corporation and its other Affiliates

(d) Agreement" means the agreement to which this Operating Procedure is attached and made a part

(e) Authority for Expenditure or AFE means a written statement of an operation proposed to be conducted pursuant to this Operating Procedure which statement shall include

(i) the type purpose and location of such operation in sufficient detail to enable a party to understand the nature scope and sequence of such operation the proposed time frame over which such operation will be conducted and if such operation is the drilling or deepening of a well the projected total depth thereof the proposed surface coordinates of the well and if they will differ materially from the surface coordinates of the well the proposed bottomhole coordinates therefor and

(ii) the proposing party s estimate of the anticipated costs of such operation which estimate shall be in sufficient detail to enable a party to identify in summary form the anticipated costs of the various identifiable segments of such operation including if applicable those costs which relate to drilling completing and equipping a well

(f) casing point" means that point in time when a well has been drilled to total depth the authorized logs and tests have been run and a decision must be made by the Joint Operators whether to set production casing and attempt to complete the well

Subclause 101(g) i) The question of whether there is production in commercial quantities or paying quantities (Subclause 101(x)) does not lend itself to a precise determination largely because of the references to anticipated throughout the definitions Although less than an ideal result, there are so many speculative parameters associated with the determination that it is not feasible to replace the reference with the far more onerous probable reference It is implicit, though that there must be a reasonable basis for an objective determination that an item is anticipated as in the case at hand

ii) Note the references to processing and transportation It is difficult to argue that there has been a discovery in commercial quantities if the well cannot be placed on production for five years because of a shortage of suitable facilities or a waiting list for transportation service

iii) Note the reference to burdens payable for the joint account This ensures that the parties are on an equal footing for the determination Otherwise a well could be a discovery in commercial quantities for only some of the parties

Subclause 101(j) i) Note the proviso at the end of the definition If the joint lands only include rights to the base of the Cardium and the sole productive interval within two miles is the Nisku the well is an exploratory well not a development well

Although well information from offsetting producing wells will often reduce the risk of testing a shallower (but non producing) horizons that will not always be the case The well information from an offsetting deep well in fact will often demonstrate that there is an extremely high risk in testing a shallow objective

While many shallow tests will evaluate exploratory objectives it is similarly inappropriate to eliminate the deeming mechanism entirely because of the possibility that data from the offsetting well has significantly reduced the risk The elimination of the deeming mechanism with respect to the shallower horizons would also create serious problems with respect to the dual well case (Clause 1005) since the exploratory portion of the well could overlie the development portion

The proviso is a compromise It attempts to minimize the arbitrariness of the distance test by limiting the examination of productive intervals in offsetting wells to horizons and substances which are also included in the joint lands This mechanism ensures that a party cannot use the shallower exploratory designation when it has the right to exploit the deeper development horizon

ii) Since the status of a well as a development or exploratory well must be clear at the time of the issuance of an operation notice the distance is measured between the coordinates of the existing well and the anticipated coordinates of the proposed well where they penetrate the productive horizon

Although the coordinates of the proposed well could change during the drilling of the well it is important to distinguish between the case in which the deviation is beyond the operator s control and that where it is not If the operator intentionally moved the location the elections of the parties would likely be voidable (See the comments on Clause 1007 )

Subclause 101(k) Note the reference to "the construction of such roadways as are reasonably necessary to gain access to the site of the well The operator has the general obligation to conduct an operation in accordance with good oilfield practice Part of that obligation is the requirement to conduct an operation in a cost effective manner The approval of an AFE respecting a well arguably does not provide an operator with authority to build a road which largely duplicates an existing road or a road which greatly exceeds the specifications which are reasonably appropriate in the circumstances

Subclause 101(s) This definition is applicable to the sale of a party s share of production pursuant to Article VI where that party does not take its share of production in kind and dispose of the same It is designed to ensure that such a party does not receive an unreasonable price for production sold on its behalf

The party selling such production arguably has a fiduciary obligation to the non taking party with respect to the sale However the onus is on the non taking party to demonstrate that the sale price was unreasonable having regard to market conditions at the time of the sale

This mechanism ensures that the party so disposing of production is not required to investigate each opportunity to sell production in an attempt to obtain the highest price available in the marketplace

(g) commercial quantities means with respect to a well the anticipated output of petroleum substances from that well which would reasonably warrant drilling another well in the same area to the formation indicated to be productive by that well having regard to anticipated drilling costs completion costs equipping costs and operating costs the kind and quality of petroleum substances indicated the anticipated availability of facilities for treating and processing such petroleum substances and the anticipated cost of such services the anticipated availability of markets for such petroleum substances the anticipated availability of transportation service for the delivery of such production to market and the anticipated cost of such service the royalties and other burdens payable for the joint account with respect thereto the probable life of the well and the anticipated price to be received for the petroleum substances as and when sold

(h) completion means the installation in on or with respect to a well of all such production casing tubing and wellhead equipment and all such other equipment and material necessary for the permanent preparation of the well for the taking of petroleum substances therefrom up to and including the outlet valve on the wellhead and includes as necessary the perforating stimulating treating fracing and swabbing of the well and the conduct of such production tests with respect to such well as are reasonably required to establish the initial producibility of the well

(i) completion costs means the costs of completing a well

(j) development well means a well insofar as the geological zones penetrated in the drilling thereof (or proposed to be penetrated as provided in the AFE therefor or the operation notice relating thereto) are stratigraphically above the base of the deepest geological zone in which an existing well within 3 2 kilometres thereof (as measured from the coordinates where the other well penetrated and the proposed well is anticipated to penetrate the top of such geological zone) is or has been capable of production of petroleum substances in commercial quantities provided that only geological zones and individual petroleum substances included in the joint lands in the spacing unit for such proposed well shall be considered when making such determination

(k) drilling costs means all moneys expended (exclusive of completion costs and equipping costs) with respect to the drilling of a well including without restricting the generality of the foregoing the cost of obtaining surface access to and for the site of the well the preparation of the site of such well the construction of such roadways as are reasonably necessary to gain access to the site of the well the installation of all surface and intermediate casing respecting the well the logging coring and testing of the well and in the event the well is not completed but is abandoned the cost of such abandonment.

(l) equipping means the installation of such equipment as is required to produce petroleum substances from a completed well including without restricting the generality of the foregoing a pump (or other artificial lift equipment) the installation of the flow lines and production tankage serving the well and if necessary a heater dehydrator or other wellsite facility for the initial treatment of petroleum substances produced from the well to prepare such production for transportation to market but specifically excludes any such equipment installation or facility that is (or is intended to be) a production facility

(m) equipping costs means the costs of equipping a well

(n) exploratory well means a well insofar as it is not a development well

(o) "for the joint account" means for the benefit interest ownership risk cost expense and obligation of the parties in proportion to their respective working interests

(p) joint lands means those lands and interests therein which have been made subject hereto by the Agreement or so much thereof which remains subject hereto and except where the context otherwise requires shall include the petroleum substances within upon or under those lands and interests insofar as those lands and interests are subject to the title documents

(q) joint operation means an operation conducted hereunder for the joint account

(r) Joint Operator" means a party having a working interest in the joint lands including the Operator if it has a working interest in the joint lands

(s) market price means the price at which petroleum substances are to be sold pursuant to Article VI where a party does not take its share of petroleum substances in kind and separately dispose of the same which price is not unreasonable having regard to market conditions applicable to similar production in arm s length transactions at the time of such disposition including without restricting the generality of the foregoing such factors as the volumes available the kind and quality of petroleum substances to be sold the effective date of the sale the term of the sale agreement the point of sale of the petroleum substances and the type of transportation service available for the delivery of the petroleum substances to be sold

Subclause 101(u) Clause 1004 enables a proposing party to operate an independent operation in which the operator elects to participate The rationale for this provision is explained in the comment respecting that Clause

Subclause 101(w) Participating interest has been redefined so that it relates to a party s share of the cost of an operation rather than to its interest in the lands If an operation is conducted for the joint account the participating interest and working interest of a party would be identical

Subclause 101(x) See the comments respecting Subclause 101(g)

Subclause 101(z) i) A production facility is basically a minor facility owned exclusively by all or some of the parties which is intended to serve the joint lands where the parties have decided against the preparation of a separate CO&O agreement If those conditions are not met the facility is beyond the scope of the Operating Procedure (See also the commentary on Article XIV)

ii) Remember that the definition excludes refineries cryrogenic gas plants acid gas or sulphur recovery facilities and sulphur forming loading and remelting facilities

iii) Note that the production facility does not have to be held by the parties in the percentages of their working interests in the joint lands A production facility may be constructed as an independent operation pursuant to Clause 1021 or expanded as an independent operation pursuant to Clause 1022

iv) Remember that a facility which is initially constructed and operated as a production facility might cease to be a production facility

If the parties subsequently enter into a CO&O agreement respecting a facility it will no longer be a production facility for the purposes of the Operating Procedure Even if the parties intend to enter into a separate CO&O agreement the Operating Procedure at least ensures the parties that the facility will be covered by a document until the CO&O agreement is finalized

The facility may also cease to be a production facility if it is subsequently used significantly with respect to outside substances (See Clause 1408)

(t) operating costs means all moneys expended (exclusive of drilling costs completion costs and equipping costs) to operate a well for the recovery of petroleum substances as more particularly set forth in the Accounting Procedure and where applicable all moneys expended to operate a production facility hereunder

(u) Operator" means the party appointed by the Joint-Operators to conduct operations hereunder for the joint account, except as provided in Clause 1004

(v) party means a person corporation partnership or body politic bound by this Operating Procedure

(w) participating interest" means the percentage share of the costs of an operation conducted hereunder (or any respective segment thereof) which a party has agreed to pay or is required to pay pursuant to this Operating Procedure

(x) paying quantities means

(i) in the case of a well which has been drilled but not completed and equipped the anticipated output from the well of that quantity of petroleum substances which would reasonably warrant incurring the completion costs and equipping costs of the well considering the anticipated completion costs equipping costs and operating costs associated therewith the kind and quality of petroleum substances indicated the anticipated availability of facilities for treating and processing such petroleum substances and the anticipated cost of such services the anticipated availability of markets for such petroleum substances the anticipated availability of transportation service for the delivery of such production to market and the anticipated cost of such service the royalties and other burdens payable for the joint account with respect to such production the probable life of the well and the anticipated price to be received for the petroleum substances produced therefrom as and when sold or

(ii) in the case of a well completed for the taking of production the output from the well of that quantity of petroleum substances which would reasonably warrant the taking of production from the well considering the same factors as in paragraph (i) of this Subclause except completion costs

(y) petroleum substances means petroleum natural gas and every other mineral or substance or any of them in which an interest in or the right to explore for is granted or acquired under the title documents

(z) production facility means subject to Article XIII and Clauses 1021 1022 and 1408 any facility serving (or intended to serve) more than one (1) well (including without restricting the generality of the foregoing any battery separator compressor station gas processing plant gathering system pipeline production storage facility or warehouse) which is

(i) constructed or installed for the joint account

(ii) owned exclusively by the parties in accordance with their respective working interests

(iii) initially intended to be utilized exclusively with respect to the production treatment storage or transmission of petroleum substances

(iv) not used for fractionation of petroleum substances sulphur extraction or separation of liquids by refrigeration and

(v) not subject to a separate agreement governing the construction ownership and operation of such facility

and includes all real and personal property of every kind nature and description directly associated therewith excluding petroleum substances the joint lands and the Operator s owned or leased equipment

(aa) proportionate share means with respect to a party a percentage share equal to that party s working interest

(bb) Regulations means all statutes laws rules orders and regulations in effect from time to time and made by governments or governmental boards or agencies having jurisdiction over the joint lands and over the operations to be conducted thereon

Subclause 101(cc) i) Note the addition of the reference to the producing zone at the end of (ii)

There has been a general assumption that the normal Alberta spacing unit respecting a gas well is 640 acres in all zones in which the parties jointly hold the section Since the parties are free to drill and produce a Viking gas well on the same section as is located a Nisku gas well it is clear that a production spacing unit has both an areal and stratigraphic component.

Given the reference in the traditional definition to the three dimensional area allocated to the well pursuant to the regulations for the purpose of producing petroleum substances the definition was certainly accurate as it stood but the subtlety of the definition may not have been appreciated by most users

ii) Remember that a spacing unit is not a static concept. A reduced spacing order subsequently issued under the regulations will change the spacing unit under the Operating Procedure as well

Subclause 103(c) i) This clarifies the timing problems inherent in the use of such terms as "within or at least" when referring to a specific number of days and is based on the comparable provision in the Alberta Rules of Court

ii) Clause 103 of the 1988 PASC Accounting Procedure states that if the due date of a joint account billing falls on a weekend or a statutory holiday the payment will be due on the preceding business day

Clause 105 The inclusion of this provision ensures that terms such as abandon abandoning and abandonment" can be used in the context of the simple definition of abandonment.

Clause 107 The working interests of the parties and the allocation of legal responsibility provided in the Operating Procedure (i e Article IV) shall continue to apply among the parties notwithstanding the registered interests in the documents of title and regulatory provisions respecting legal responsibility for activities conducted hereunder

If the registered interests in the title documents do not correspond to the working interests (as is often the case) the traditional conflicts provision literally states that the working interests of the parties are the registered interests in the title documents because of the inconsistency between the title documents and the Operating Procedure

The liability reference is included because of the degree to which the title documents and the regulations require the lessee or well licencee to assume legal responsibility for losses Although that allocation of responsibility may be in the public interest it is clear that the provisions of the Operating Procedure allocating legal responsibility among the parties should continue to govern the relationship of the parties with respect to the apportionment of responsibility for the loss among the parties

(cc) spacing unit" means

(i) with respect to a well which has not been completed for the production of petroleum substances the area allocated by the Regulations for the drilling of that well provided that in the absence of such allocation or a specific designation in the Agreement, the spacing unit for the well shall be deemed to be the quarter section unit or similar geographical area which includes the bottomhole co-ordinates of the well and

(ii) in every other case the area allocated to the well pursuant to the Regulations for the purpose of producing petroleum substances in each zone from which such petroleum substances are to be produced

(dd) spud means with respect to a well that a drilling rig of adequate capacity to drill that well to the total depth projected in the AFE therefor is rigged-up on location and that a drilling bit has penetrated the surface therefrom

(ee) "title documents means the documents of title by virtue of which the parties are entitled to drill for win take or remove petroleum substances underlying the joint lands and all renewals extensions or continuations thereof or further documents of title issued pursuant thereto

(ff) "working interest" means the percentage of undivided interest held by a party in a production facility or the joint lands or the respective zones portions parcels or parts thereof which percentage is as provided in the Agreement or is as modified subsequently pursuant to the provisions hereof

102 HEADINGS – Article headings and any other headings or captions or indices hereto shall not be used in any way in construing or interpreting any provision hereof

103 REFERENCES – Unless otherwise expressly stated

(a) the references hereunder" herein and hereof" refer to the provisions of this Operating Procedure and references to Articles Clauses Subclauses or paragraphs herein refer to Articles Clauses Subclauses or paragraphs of this Operating Procedure

(b) whenever the singular or masculine or neuter is used in this Operating Procedure the same shall be construed as meaning plural or feminine or body politic or corporate or vice versa as the context so requires and

(c) any reference to days herein is a reference to calendar days and where the phrase "within or at least" is used with reference to a specific number of days herein the day of receipt of the relevant notice or the day of the relevant event as the case may be shall be excluded in determining the relevant time period However in the event the time for doing any act expires on a Saturday Sunday or statutory holiday in either the Province of Alberta or Canada the time for doing such act shall be extended to the next normal business day except as prescribed in the Accounting Procedure with respect to the payment of billings

104 OPTIONAL AND ALTERNATE PROVISIONS – Where alternate or optional provisions are provided for herein and the parties have failed to designate which alternate shall apply or whether a respective optional provision shall be included the first alternate provision in each such case shall apply as if the parties had designated the same and the remaining optional provision shall be deemed not to form a part hereof

105 DERIVATIVES – Where a term is defined herein a derivative of that term shall have a corresponding meaning unless the context otherwise requires

106 USE OF CANADIAN FUNDS – All references to dollars or $ herein shall mean lawful currency of Canada and all payments and receipts shall be made and recorded in lawful currency of Canada

107 CONFLICTS – If any provision contained in the Agreement conflicts with a provision herein the provision in the Agreement shall prevail and if a provision herein conflicts with a provision in an exhibit or schedule attached hereto the provision herein shall prevail In the event of a conflict between any provision in the Agreement or this Operating Procedure and the Regulations or the title documents the Regulations or the title documents as the case may be shall govern except that (i) the working interests shall prevail if there is a difference between the working interests and the registered interests in the title documents and (ii) the allocation of responsibility for losses as provided herein (including without restricting the generality of the foregoing Article IV hereof) shall govern the relationship of the parties If there is a conflict as provided above the Agreement or this Operating Procedure as the case may be shall be modified accordingly to the extent necessary to resolve such conflict and as so modified shall continue in full force and effect

Paragraph 202(a)(i) i) Notwithstanding the clear wording of provisions such as this paragraph there is a major difficulty in attempting to enforce such a provision As evidenced by the case of Norcen Energy Resources Limited and Prairie Oil Royalties Company, Ltd v Oakwood Petroleums Ltd (1988) 92 A R 81 (Alta. Q B) courts may be willing to protect an insolvent operator from the imposition of such a provision even though that party had quite willingly accepted the provision at the time it executed the document.

The case pertained to an interpretation of Section 11 of The Companies Creditors Arrangement Act This act is similar in intent to the concept of Chapter 11 protection in American law in that its purpose is to attempt to allow an insolvent company to continue as a going concern in the hope that it will be able to overcome its major financial difficulties or make an arrangement with its creditors

Norcen was not a creditor of Oakwood in the case and the court interpreted Section 11 as giving it the authority to affect the contractual relations between the insolvent party and a non-creditor It granted a temporary stay which prevented Norcen from assuming operatorship pursuant to Clause 202 of the 1981 document, even though the court recognized that Oakwood had been insolvent for some time The case was not appealed This protection from the application of Clause 202 however would not apply where the operator is making a proposal to creditors under The Bankruptcy Act. See Tri Star Resources Ltd v J C Int Petroleum Ltd [1987] 2W W R 141 (Alta Q B)

The document differs from the 1981 document in that it includes a waiver of relief provision (Clause 2807) through which a party waives certain rights it may have at law or under the regulations However it is questionable whether that provision would apply to this problem

ii) The court also determined in the Norcen case that insolvency was to be given its normal meaning in the interpretation of the 1981 CAPL provision Oakwood had attempted to argue that it was commercially solvent with respect to day to-day matters relating to the specific agreement and that the Operating Procedure provisions contemplated only commercial insolvency Paragraph (i) has been amended to reflect the court s interpretation of the intention of the previous provision However a party would require a great deal of information about the operator s business affairs if the issue of the operator s insolvency were to be considered by a court and would be unlikely to receive any significant cooperation from the operator prior to the commencement of an action It would therefore be difficult to determine both whether or when insolvency had occurred

iii) Note the reference to the appointment of a receiver Following the appointment of a receiver the lender will generally provide the funds required to ensure that the debts are then paid as they become due such that the onus on the non operators to prove insolvency would be more difficult.

iv) There may be circumstances in which the other parties would waive the immediate removal of the operator

Paragraph 202(b)(i) i) This paragraph is much stronger than the generally accepted Clause 203 challenge mechanism since it enables the non operators to remove an operator against its will Given the significant costs potentially associated with the removal of an operator during the development phase the potential for the disruption to operations and the business considerations associated with such a removal the most practical impact of this provision is to reinforce the operator s accountability to the owners for its performance Although quite different from the traditional challenge mechanism it should be remembered that the use of a voting procedure/no cause challenge mechanism is used in conventional unit agreements the CAPL Frontier Operating Procedure and U K. joint operating agreements One might argue that this provision should provide the operator with the right to attempt to rectify its perceived defaults or shortcomings However the problem with that suggestion would be the difficulty one would have in trying to quantify what would usually be a qualitative problem so that one could determine whether the operator had satisfied the performance standard

ii) A non operator holding at least a 66% working interest has the right to assume operatorship by notice to the other parties This reflects the fact that it is paying at least 66% of the cost of joint operations

Paragraph 202(b)(ii) The operator is required not only to commence rectifying the default but also to continue diligently to remedy the default

Clause 203 i) By limiting a challenge to an offer to conduct joint operations on more favourable terms and conditions than the operator the challenger faces a serious if not insurmountable obstacle Since one is unable to quantify qualitative changes the provision seems limited to financial terms However how can a challenger give any more than its best cost estimate when the costs of exploration are a function of such factors as weather conditions exploration success (testing costs) mechanical difficulties the demand for equipment and inflation? A challenge on the basis of terms and conditions therefore might in practice only be the right to challenge on the basis of overhead rates Moreover a challenge on the basis of financial terms and conditions ignores the consideration that the basis of a challenge may be the operator s technical rather than cost performance

## ARTICLE II

## APPOINTMENT AND REPLACEMENT OF OPERATOR

201 ASSUMPTION OF DUTIES OF OPERATOR – The Operator named in the Agreement, or any succeeding Operator appointed hereunder shall assume the duties and obligations of the Operator hereunder and shall have all the rights of the Operator hereunder

202 REPLACEMENT OF OPERATOR –

(a) The Operator shall be replaced immediately and another Operator appointed forthwith pursuant to Clause 206 upon notice to such effect being served by any party to the other parties if

(i) the Operator becomes bankrupt or insolvent, commits or suffers any act of bankruptcy or insolvency is placed in receivership seeks debtor relief protection under applicable legislation (including without restricting the generality of the foregoing the Bankruptcy Act of Canada and the Companies Creditors Arrangement Act of Canada) or permits any judgement to be registered against its working interest and without restricting the generality of the foregoing an Operator shall be deemed insolvent for the purposes of this Clause if it is unable to pay its debts as they fall due in the usual course of business or if it does not have sufficient assets to satisfy its cumulative liabilities in full or

(ii) the Operator assigns or purports or attempts to assign its general powers and responsibilities of supervision and management as Operator hereunder

(b) The Operator shall be replaced and another Operator appointed pursuant to Clause 206 if

(i) the Joint Operators agree by the affirmative vote by notice to the other parties of two (2) or more Joint Operators representing a majority of the working interests to replace the Operator provided that a single Joint Operator holding more than a sixty six percent (66%) working interest in the joint lands shall have the right by notice to the other parties to replace the Operator and to become Operator at the time prescribed by Subclause 206(d) unless it would then be subject to replacement pursuant to paragraph 202(a)(i) or

(ii) the Operator defaults in its duties or obligations or any of them hereunder and within thirty (30) days after written notice from a majority in working interest of the Joint Operators excluding the Operator specifying the default and requiring the Operator to remedy the same it does not commence to rectify the default and thereafter diligently continue to remedy the default

203 CHALLENGE OF OPERATOR – At any time after an Operator has been Operator for at least two (2) years any Joint Operator other than the Operator may give notice ("the challenge notice ) to the other parties that it is ready able and willing to conduct operations for the joint account on more favourable terms and conditions The challenge notice shall contain sufficient detail to enable the receiving parties to evaluate the nature of the challenge notice and to measure the effect the revised terms and conditions would have on joint operations The Operator shall within sixty (60) days after receipt of the challenge notice advise the Joint Operators either that

(a) it is prepared to operate on the terms and conditions set out in the challenge notice whereupon it shall forthwith proceed to do so or

(b) it is not prepared to operate on the terms and conditions set out in the challenge notice and that it will resign as Operator effective not later than ninety (90) days following the sixty (60) day period provided above

Failure by the Operator to advise the Joint Operators of its election within such sixty (60) day period shall be deemed to be an election by the Operator to resign If the Operator resigns a new Operator shall be appointed pursuant to Clause 206 whereupon such new Operator shall operate on the terms and conditions set out in the challenge notice If no other Joint Operator is prepared to act as Operator on the terms and conditions set out in the challenge notice the Joint Operator giving the challenge notice shall become the new Operator and shall thereafter conduct operations pursuant to the undertakings made by it in the challenge notice Any costs in excess of those set out in the challenge notice shall be for the new Operator s sole account Notwithstanding Clause 204 the new Operator shall not resign from the position of Operator until it has acted as Operator for a period of at least two (2) years A Joint Operator may not issue a challenge notice or become Operator pursuant thereto if at the time of issuing the challenge notice or the time it would become Operator pursuant thereto it would be subject to replacement as Operator pursuant to Subclause 202(a) if it were Operator at that time

Although the mechanism may be useful in some circumstances in that it at least enables a party to file a complaint paragraph 202(b)(i) provides the non-operators with far greater protection in practice

ii) Note that the challenge could take almost six months to effect if the relevant events were to occur at the latest times provided in the document.

iii) If the concern of the non-operators is the operator s reluctance to proceed with a work program the non operators could consider assuming a more active role through the utilization of Article X

Clause 206 i) Ignoring the challenge scenario a new operator shall be appointed pursuant to Clause 206 in the event that the operator resigns or is to be replaced

Generally no party may be appointed as operator unless it has given its written consent to the appointment. However if the parties are unable to appoint a successor operator the non-operator having the greatest working interest shall serve as operator pro tem

Under no circumstances though shall a provision of the Clause serve to reappoint as the successor operator a party which had been replaced as operator pursuant to the provisions of Clause 202 without the consent of the parties

ii) Note the proviso at the end of the first sentence of (a) This has been included for consistency with the proviso in paragraph 202(b)(i)

Clause 207 The outgoing operator remains responsible for the unsatisfied duties and obligations which had accrued to it.

Clause 208 The Clause merely specifies that the audit shall be conducted at a certain time The provisions of the Accounting Procedure otherwise apply to the audit including the resolution of discrepancies disclosed by the audit

204 RESIGNATION OF OPERATOR – Subject to Subclause 202(a) and Clauses 203 and 205 the Operator may resign as Operator on giving each of the Joint-Operators ninety (90) days notice of its intention to do so

205 MODIFICATION OF TERMS AND CONDITIONS BY OPERATOR – At any time after an Operator has been the Operator for a continuous period of two (2) years it may give notice ("the Operator s notice ) to the other parties of the revised terms and conditions on which it is prepared to continue to conduct joint operations Within sixty (60) days of receipt of the Operator s notice each Joint-Operator shall advise the Operator whether it agrees to the Operator continuing as Operator and conducting joint operations on the terms and conditions contained in the Operator s notice provided that failure by a Joint Operator to respond within such period shall be deemed to be agreement by that party to the terms and conditions in the Operator s notice If any Joint Operator does not so agree it shall give notice ("counter proposal ) to the other parties of the terms and conditions upon which it would conduct joint operations Any such counter proposal shall be deemed to be a challenge of Operator and shall be subject to all of the terms and conditions of Clause 203 as though such counter proposal was "the challenge notice provided therein except that in determining the merits of the counter proposal it shall be compared to the terms and conditions contained in the Operator s notice rather than to the existing operating terms and conditions

206 APPOINTMENT OF NEW OPERATOR –

(a) If an Operator resigns or is to be replaced a successor Operator shall be appointed by the affirmative vote (by notice to the other parties) of two (2) or more parties representing a majority of the working interests in the joint lands provided that a single Joint Operator holding more than a sixty six percent (66%) working interest in the joint lands shall have the right by notice to the other parties to become the Operator hereunder unless it would then be subject to replacement pursuant to paragraph 202(a)(i) If there are only two (2) Joint Operators and the Operator that resigned or is to be replaced is one of the Joint Operators the other Joint Operator shall have the right to become the Operator

(b) No party shall be appointed as Operator hereunder unless it has given its written consent to the appointment However if the parties fail to appoint a successor Operator or if any appointed Operator fails to carry out its duties hereunder the party having the greatest working interest shall act as Operator pro tem with the right should a similar situation re-occur after a new Operator has been appointed to require the party having the next greatest working interest to act as Operator pro tem and so on as the occasion demands

(c) No provision of this Article shall be construed to re-appoint as next succeeding Operator an Operator who had been replaced under Clause 202 except with the unanimous consent of the parties

(d) Except as provided in Subclause 202(a) every replacement of Operator shall take effect at eight o clock in the morning (0800 hours) on the first (1st) day of the calendar month following the determination to replace the Operator pursuant to Subclause 202(b) or such other date as may be prescribed pursuant to Clause 203 or 204 as the case may be notwithstanding anything contained herein

207 TRANSFER OF PROPERTY ON CHANGE OF OPERATOR – At the effective date of the resignation or replacement of an Operator as provided in this Article II the Operator being replaced shall deliver to the successor Operator possession of

(a) the wells being drilled or operated by the Operator hereunder except any wells in respect of which the succeeding Operator is not entitled to information which shall be operated by a party determined pursuant to Clause 1004 until the successor Operator becomes entitled to such information

(b) all production facilities other facilities and funds held for the joint account together with all production if any which has not been delivered in kind

(c) copies of books of account and records kept for the joint account or pertaining to wells delivered hereunder and

(d) all documents agreements and other papers relating to property transferred hereunder

Upon compliance with such obligation the outgoing Operator shall be released and discharged from and the successor Operator shall assume all duties and obligations of the Operator except those unsatisfied duties and obligations of the outgoing Operator which had accrued prior to the effective date of the change of Operator for which the outgoing Operator shall continue to remain liable

208 AUDIT OF ACCOUNTS ON CHANGE OF OPERATOR – Within ninety (90) days after the successor Operator commences to act as Operator the parties shall cause an audit to be made of the books of account and records kept for the joint account and may cause an inventory of controllable material to be taken The cost of the audit and inventory shall be a charge for the joint account

Clause 209 i) This Clause addresses the assignment of operatorship so that the rights of the non operators are clear As there would be no anticipated impact on joint operations with respect to a transfer from ABC Ltd to its affiliate ABC Resources Inc operatorship may be assigned to an affiliate when the working interest is also being assigned If the non operators were sufficiently troubled with the operator s performance they presumably would have used their other rights to remove the operator If there is a concern that the affiliate is a shell company the parties can easily replace it pursuant to paragraph 202(b)(i) in cases in which the non-operators hold a majority in interest, and they will have immediate access to Clause 203 in all cases

ii) Suppose ABC Ltd assigns to ABC Resources Inc Since ABC Resources Inc is a distinct entity from ABC Ltd and a new operator the two year periods in Clauses 203 and 204 would begin to run from the effective date of the change of operatorship in the absence of the last sentence

Subclause 301(a) One of the fundamental differences between the conventional CAPL Operating Procedure and the CAPL Frontier Operating Procedure is the creation of the management committee and the assignment of certain responsibilities thereto in the frontier document.

Ignoring the independent operations mechanism and of course the expenditure approval process the role of the non operators in setting exploration strategy superficially seems minimal under the provisions of the conventional CAPL Operating Procedure (Subclause 301(a) includes a simple duty to consult, and Clause 504 gives a non-operator the right to require the operator to provide the non-operators with a forecast of the anticipated operations to be conducted for the joint account over the succeeding three to twelve-month period ) However it is not feasible to include a management committee provision in the document. A typical operator will be operating a multitude of blocks with varying partners interests tenures prospectivity maturity and activity It would not be reasonable to impose a management committee procedure on an operator with respect to each block it operates because of the resultant administrative burden Moreover the mechanism would not be workable in many instances anyway because of the likelihood that one party would hold more than a 50% interest or that there would only be two interest holders

It is important to recall that the independent operations provision and the expenditure approval process included in the document in fact provide the non operators with significant control respecting the exploration of the joint lands

Subclause 301(b) i) The $25 000 discretionary authority is included in order to enable an operator to make those minor capital expenditures which in the course of normal day to-day operations are required to maintain production such as the replacement of a minor piece of wellsite equipment. It is not intended to provide the operator with the authority to conduct exploration operations or geological studies

ii) Note that there is no specific requirement for the operator to submit an itemized report of such discretionary expenditures to the parties other than insofar as such information is normally required pursuant to Clause 102 of the Accounting Procedure The only review mechanism as such would be in the case where a non operator were so concerned by the operator s tendency to make such expenditures that it convened a meeting of the parties to discuss the matter

iii) The operator may make additional expenditures without the approval of the joint operators if required by the regulations or if reasonably considered necessary by the operator for the protection of life or property In such event the operator is required to advise the non operators of the nature of that requirement or event and the anticipated expenditure associated therewith

Subclause 301(c) In the absence of a specific provision in an agreement has a party which has agreed to participate in an operation by approving the applicable AFE elected to pay its proportionate share of the cost of that operation or is its participation conditional on the actual cost of such operation corresponding to the estimate? Intuitively operational necessity leads one to the conclusion that the cost estimate included in an AFE is merely the operator s best estimate of the cost of conducting an operation How could it be otherwise when costs are subject to modification because of such factors as mechanical difficulties the presence of hydrocarbons and weather? Moreover one of the consequences of the contrary view would be that a participant had committed to paying the estimated cost if actual costs were lower!

As evidenced by American jurisprudence and the leading Canadian case of Renaissance Resources Ltd v Metalore Resources Ltd [1984] 4 W W R 430 (Alta. Q B ) affirmed [1985] 4 W W R 673 (Alta. C A ) the general legal rule is that the approval of an AFE constitutes the authority of a party for the operator to conduct the operation described in the AFE notwithstanding that the actual cost may differ from the operator s estimate The one major qualification to that general statement is that a party might be entitled to some relief if the operator had been fraudulent or grossly negligent in the preparation of its cost estimate or the operator realized that actual costs would differ significantly from its cost estimate in the period between the issuance of the AFE and the commencement of the operation

It seems likely though that some parties will deviate from the principle in this Subclause with respect to drilling operations in the foothills Given the potential magnitude of cost overruns in that operating environment a pure commitment to the operation mechanism could have a serious financial impact on a party in practice

Clause 303 The usual result of a reference to an operator as an independent contractor would be to require the operator to assume full legal responsibility for its own negligence This general legal principle is overridden by the provisions of the document respecting liability and indemnity (Article IV)

209 ASSIGNMENT OF OPERATORSHIP – In the event the Operator wishes its assignee to replace it as Operator after having disposed of all or a portion of its working interest in the joint lands and any production facilities to such assignee pursuant to Article XXIV such assignee shall have the right to become Operator if it is an Affiliate of the Operator or if it is not an Affiliate of the Operator if the parties agree that it shall become Operator pursuant to Clause 206 Should an assignee which is an Affiliate of the Operator become the Operator pursuant to this Clause the two (2) year time periods described in Clauses 203 and 205 shall be calculated as if the assignment had not occurred and the audit prescribed pursuant to Clause 208 shall not be required

## ARTICLE III

## FUNCTION AND DUTIES OF OPERATOR

301 CONTROL AND MANAGEMENT OF OPERATIONS –

(a) The Operator shall consult with the Joint-Operators from time to time with respect to decisions to be made for the exploration development and operation of the joint lands and the construction installation and operation of any production facilities and the Operator shall keep the Joint-Operators informed with respect to operations planned or conducted for the joint account Subject to the provisions hereof the Operator is hereby delegated the management of the exploration development and operation of the joint lands and the construction installation and operation of any production facilities for the joint account on behalf of the Joint Operators

(b) The Operator shall be entitled to make or commit to such expenditures for the joint account as it considers necessary and prudent in order to conduct a good and workmanlike operation on the joint lands for the joint account However the Operator shall not make or commit to an expenditure for the joint account for any single operation the total estimated cost of which is in excess of twenty five thousand ($25 000) dollars without an approved Authority for Expenditure from the Joint Operators unless the expenditure is reasonably considered by the Operator to be necessary by reason of an event endangering life or property or is required by the Regulations and failure to make such expenditure could result in the prosecution of the Operator thereunder If the Operator is required to make such an expenditure it shall promptly advise the Joint Operators of the nature of such event or requirement and the expenditure anticipated to be associated therewith

(c) Approval of an Authority for Expenditure by a party shall constitute that party s approval of all expenditures necessary to conduct the operation described therein subject to the provisions of Article IX However if the Operator incurs or expects to incur expenditures with respect to a joint operation which would exceed by more than ten percent (10%) the total amount estimated in the AFE therefor the Operator thereupon shall for informational purposes only forthwith advise the Joint Operators of such overexpenditure the Operator s explanation therefor and the Operator s revised estimate of the cost of such operation The Operator thereafter shall provide estimates of current and cumulative costs incurred for the joint account with respect to such operation Such estimates shall be provided on a daily basis where practical but in any event at intervals of not greater than ten (10) days until the operation is completed

302 OPERATOR AS JOINT OPERATOR – The Operator shall have all of the rights and obligations of a Joint Operator with respect to its working interest

303 INDEPENDENT STATUS OF OPERATOR – The Operator is an independent contractor in its operations hereunder The Operator shall supply or cause to be supplied all material labor and services necessary for the exploration development and operation of the joint lands and the operation of any production facilities for the joint account The Operator shall determine the number of employees respecting its operations their selection their hours of labour and their compensation All employees and contractors used in its operations hereunder shall be the employees and contractors of the Operator

304 PROPER PRACTICES IN OPERATIONS – The Operator shall conduct all joint operations diligently in a good and workmanlike manner in accordance with good oilfield practice and the Regulations

305 BOOKS RECORDS AND ACCOUNTS – The Operator shall with respect to all joint operations keep and maintain true and correct books records and accounts with respect to the development and progress made drilling done the conduct of other operations the production of petroleum substances and the disposition thereof in the manner prescribed herein and in the Accounting Procedure The Operator shall upon request of a Joint Operator make available in Alberta and there permit each Joint Operator during normal business hours to inspect such books records and accounts and to make extracts or copies therefrom and thereof and to audit the Operator s books records and accounts as provided in the Accounting Procedure However a Joint Operator shall not have the rights granted under this Clause with respect to a well while not entitled to information with respect to that well

Clause 305 i) Although the provision does not specifically refer to microfiche microfilm and other electronic records the phrase books records and accounts is broad enough to include records in those forms Since auditors would have access to the records in whichever form they are maintained it is inappropriate to specify an operator s record keeping procedures in the document.

ii) See Clause 501 which requires the operator to maintain records respecting operations conducted hereunder separately from those kept by it respecting other operations in accordance with good oilfield practice

Subclause 309(a) Note that the duty to maintain the title documents does not require or permit the operator to drill a well or conduct any operation

Subclause 309(b) The operator is obligated to consult with the other parties with respect to any continuation or grouping applications it proposes to make in order to maintain any of the title documents in good standing and such other matters as offset requirements It is also required to provide copies of related correspondence to the non operators in a timely manner

The provision is a recognition of the fact that the operator has a duty to consult with the non operators with respect to all material matters which pertain to the maintenance of the title documents

Subclause 309(c) i) This simple lease selection mechanism is designed for the situation in which the interests in the affected lands are uniform

Although suitable for a case in which a farmee has earned all of the licence lands for drilling a well which validated less than an entire licence it will often be desirable to include a lease selection provision in the head agreement so that the provision in the head agreement overrides this Subclause

A farmor would likely want to include a special provision if a lease selection is required to be made during the earning phase as could be the case if sufficient work had previously been conducted to enable the parties to make a lease selection on a portion of the licence lands

In addition a special provision would be required if a farmee had both earned and validated less than the entire title document since the process would be much more complicated This is especially the case with respect to British Columbia and Saskatchewan permits where the earned lands may comprise only a small portion of the permit lands

As the provision also assumes that the interests of the parties would be consistent throughout the licence modifications would be required if there were different farmors in distinct portions of the licence or if farmor interests varied

ii) Note the reference to selection units as prescribed by the regulations Basically lease selections in Alberta at this time are required to be in whole sections (where available) However individual spacing units may be selected if the lease earning well is a petroleum discovery (See 11(5) and 11(6) of the P&NG Agreements Regulation)

Subclause 309(d) i) If sufficient work has been conducted with respect to a licence or permit to convert only a portion of the lands contained therein to lease there is a problem determining whether a well is a title preserving well and the applicable preserved lands for the purpose of Clause 1010 unless the lands to be retained for the joint account are designated prior to the issuance of the operation notice

In the event a party were concerned that the lands it regarded as prospective would be returned to the Crown unless an additional well were drilled it would cause the parties to designate their lease selection at an early date for the purposes only of crystallizing the positions of the parties with respect to Clause 1010 If the lands regarded as prospective by that party were to be retained the penalty in Clause 1007 would apply to a well thereon If on the other hand they were not to be retained the penalty in Clause 1010 would apply to a well thereon

ii) Since the lease selection would not be made to the Crown until the date required by the regulations the parties retain the flexibility of changing their selection at a later date should they so agree

306 PROTECTION FROM LIENS – The Operator shall pay or cause to be paid as and when they become due and payable all accounts of contractors and claims for wages and salaries for services rendered or performed and for materials supplied with respect to the joint lands any joint operations and any production facilities The Operator shall keep the joint lands and any production facilities free from liens and encumbrances resulting therefrom unless there be a bona fide dispute with respect thereto

307 JOINT OPERATOR S RIGHTS OF ACCESS – Except as otherwise provided herein the Operator shall permit each Joint Operator or its duly authorized representative at that Joint Operator s sole risk cost and expense full and free access at all reasonable times to inspect and observe all production facilities and all joint operations being conducted upon the joint lands and to the records on location of current operations being conducted thereon

308 SURFACE RIGHTS – The Operator shall acquire and maintain for the joint account all necessary surface rights respecting joint operations

309 MAINTENANCE OF TITLE DOCUMENTS –

(a) Except as otherwise provided herein or in the Agreement, the Operator shall on behalf of the parties and for the joint account, comply with all the terms and conditions of the title documents including (i) the payment of rentals (ii) the payment of any encumbrances agreed to be borne for the joint account and (iii) the performance of all things necessary to maintain the title documents in good standing and in full force and effect However nothing in this Clause shall be construed to require or permit the Operator to drill a well or conduct any joint operation without the approval of the Joint Operators if their approval of an Authority of Expenditure with respect thereto is required pursuant to Clause 301

(b) The Operator shall consult with the parties in a timely manner with respect to any applications it proposes to make under the Regulations to maintain any of the title documents in good standing including without restricting the generality of the foregoing continuation and grouping applications and any other material decisions which are required to be made to maintain any of the title documents in good standing The Operator shall provide the parties in a timely manner with copies of material correspondence pertaining to the maintenance of the title documents

(c) If the joint lands are subject to a particular title document whereby the parties may select some (but not all) of such joint lands for the joint account in a successor title document as a result of work or operations which have been conducted (in this Clause called a lease selection") the following shall apply to the lease selection

(i) the parties having a working interest in such title document shall consult at least ten (10) days prior to the date upon which the lease selection is required to attempt to agree on the lease selection and

(ii) insofar as the parties are unable to agree on the joint lands to be included in the lease selection the Operator shall determine the required number of minimum size geographic units prescribed by the Regulations with respect to a lease selection ("selection units ) to complete the lease selection This number shall be multiplied by each party s working interest to determine the number of selection units which each party may select to complete the lease selection with rounding of such number up or down to the nearest whole integer in the event such calculation would entitle a party to a selection of a partial selection unit. Each party shall be entitled to select for inclusion in leases on a selection unit by selection unit basis that number of selection units determined by such calculation with the order of such selections to be determined by lot

Following the conclusion of the lease selection process the Operator shall submit the application for leases on behalf of the parties in such manner and at such time as are prescribed by the Regulations

(d) If the joint lands are subject to a particular title document pursuant to which the parties may make a lease selection a party may at any time not earlier than one (1) year before the latest date such lease selection may be made pursuant to that title document require the parties to select for the purposes of Clause 1010 only the lands which will be retained for the joint account in the manner prescribed in the Agreement or Subclause (c) of this Clause as the case may be The parties thereupon shall make such lease selection within ten (10) days of the receipt of such notice as if such lease selection was required at such time Unless otherwise agreed by the parties such lease selection shall be binding on the parties for the purposes of determining whether a well is a title preserving well or portions of the lands are preserved lands as those terms are defined in Clause 1010

310 PRODUCTION STATEMENTS AND REPORTS – The Operator shall provide each Joint Operator before the twenty fifth (25th) day of each month with a statement showing production inventories sales and deliveries in kind to the parties of petroleum substances during the preceding month The Operator shall also make all reports relating to joint operations

Clause 311

Alternate A i) Policies must be maintained with reputable insurance companies

ii) Since the policies are maintained "for the benefit of the parties and their respective affiliates directors officers servants consultants agents and employees it is the better practice for the operator to have the policies endorsed to add these persons with respect to the specific work so as to ensure that all of those involved with the operation will have the protection of the policies

iii) Note the reference to agents It is unlikely that a contractor would be regarded as an agent at law To further minimize the possibility a specific reference to contractors has been added to portions of Article IV and Clause 1017

iv) Note that a not less than reference is not used in the paragraphs describing the policies The inclusion of this reference would have provided the operator with total discretion with respect to the selection of the additional coverage to be charged to the joint account.

v) Note that the Alternate does not include a self insurance option whereby the operator may charge to the joint account an amount commensurate with that for which that insurance would have otherwise been obtained in the marketplace The main reason for not including the mechanism is that applicable statutes state that only a licenced insurer is permitted to charge an insurance premium In addition the appropriateness of such a mechanism would depend on the particular fact situation The non operators would consider their past dealings with the operator and their perceptions respecting the operator s continued financial viability They would also require a mechanism whereby the option could be terminated to address their concerns respecting a change in operator or a change in the operator s financial position

Alternate B i) Except for policies required to be maintained pursuant to the regulations and the special allocations of legal responsibility pursuant to Article IV each party is responsible for losses applicable to its working interest

ii) Notwithstanding the general statement in the contract that each party is to be responsible for the losses or claims applicable to its interest the provision may not be effective against third party litigants A court is not obligated by the provisions of the contract. Unless the court apportions legal responsibility among defendants a successful plaintiff can enforce its judgment jointly against those defendants which were held responsible for its loss

Conditions Remember that the conditions in Subclause(a) (g) apply to both Alternates A and B

Subclause 311(a) Without the reference to deductibles the operator could maintain the required coverage but include deductibles which were so large that the coverage would provide only minimal protection

Subclause 311(b) i) The operator is required to advise the other parties in the event that the specified policies or coverages are in the operator s reasonable opinion unavailable or available only at an unreasonable cost If this is the case the parties may wish to redetermine the policies and coverages to be maintained for the joint account

ii) Insurance policies contain items conditions or exclusions which limit the risks covered by the policy or the circumstances under which the insurer would be obligated to pay These provisions should be reasonable and the operator is required to obtain the consent of the parties if it proposes to make such a change after the policy has been acquired

as required by the Regulations and shall upon request of a Joint Operator provide it with a copy of each such report filed by the Operator with any governmental agency

311 INSURANCE – The Operator shall comply with the requirements of all Unemployment Insurance Workers Compensation and Occupational Health and Safety legislation and all similar Regulations with respect to workers employed in joint operations Without in any way limiting the obligations or liabilities of the Operator the Operator shall also comply with the provisions of ALTERNATE _____ below (Specify A or B the ALTERNATE not specified is deemed to be deleted from this Operating Procedure)

ALTERNATE A

The Operator shall prior to the commencement of joint operations hold or cause to be held with a reputable insurance company or companies and thereafter maintain or cause to be maintained for the joint account and benefit of the parties and their respective Affiliates directors officers servants consultants agents and employees the insurance hereinafter set forth and any other insurance which is specifically required to comply with the Regulations The insurance required pursuant to this Subclause shall apply to each separate claim and shall be as follows

(i) Automobile Liability Insurance covering all motor vehicles or snowcraft and all terrain vehicles owned or non-owned operated or licenced by the Operator and used in joint operations (insofar only as they are used in joint operations) with an inclusive bodily injury death and property damage limit of one million dollars ($1 000 000) per accident

(ii) Comprehensive General Liability Insurance with an inclusive bodily injury death and property damage limit of one million dollars ($1 000 000) per occurrence and without restricting the generality of the provisions of this paragraph such coverage shall include but not be limited to Employer s Employer s Contingent Liability Contractual Liability Contractor s Protective Liability Products and Completed Operations Liability and

(iii) Aircraft Liability Insurance covering all aircraft owned or non owned operated or licenced by the Operator and used in joint operations (insofar only as they are used in joint operations) with an inclusive bodily injury death and property damage limit of five million dollars ($5 000 000) per occurrence

OR

ALTERNATE B

The Operator shall prior to the commencement of joint operations hold or cause to be held with a reputable insurance company or companies and thereafter maintain or cause to be maintained for the joint account and benefit of the parties and their respective Affiliates directors officers servants consultants agents and employees only that insurance as is specifically required to comply with the Regulations It is the intention of the parties that except as provided in the previous sentence and in Article IV the cost of any accident loss or any claim of or liability to third parties or to each other for bodily injury death or property damage arising out of any operation conducted hereunder shall be borne individually by the parties participating in the operation proportionate to their respective participating interests in the operation

**The following conditions shall be applicable to the ALTERNATE which is specified**

(a) The amount of the deductible specified for each accident or occurrence in any insurance policy maintained for the joint account shall not exceed the amount set forth in Clause 301 without the prior approval of the Joint Operators

(b) In the event that the policies which the Operator is required to obtain or maintain for the joint account are in the Operator s reasonable opinion unavailable or available only at an unreasonable cost the Operator shall promptly notify the other Joint Operators in order that the parties may redetermine the policies which shall be held for the joint account Subject to the provisions of this Clause policies obtained for the joint account pursuant to this Clause may contain terms conditions or exclusions affecting or limiting the risks covered thereby or the circumstances under which the insurer may be required to indemnify or compensate the parties thereunder provided that such terms conditions or exclusions are in the Operator s reasonable opinion the best available from the marketplace on reasonable terms and ordinary or appropriate However the Operator shall obtain the prior consent of the parties with respect to any such change which is made after the relevant policy or policy renewal has been acquired for the joint account

Subclause 311(c) Payments made by the operator with respect to losses or claims arising out of joint operations are to be charged initially to the joint account if the payment has been authorized by the applicable insurers or is otherwise authorized under the Operating Procedure

There are two points to note about this provision

Firstly it is inappropriate to authorize the operator to settle claims in advance of obtaining insurance proceeds or a settlement agreement from the insurer unless the claim will not be covered by insurance or falls within the deductible limits thereof This action could preclude payment by the insurer if the insurer had not been given proper notice of a potential claim prior to the operator s settlement or if it did not agree with the terms of that settlement.

Secondly losses are initially assumed to be for the joint account. Insofar as it is determined that they are not to be borne for the joint account pursuant to Article IV the accounts of the parties will be adjusted at the time of that determination which is likely to be significantly after the payments have been made Without that reference it is likely that there would be a dispute as to the timing of the adjustment.

The operator shall attempt to process such claims diligently and it shall promptly credit the joint account the amount it ultimately recovers from its insurer(s)

Subclause 311(d) i) Note the reference to primary coverage and exposure to a deductible As many non operators will carry insurance this reference is included to ensure that the insurers of the specific coverage maintained for the joint account will be prevented from claiming that other coverage may be available to share the loss

If a non-operator carries separate coverage to reduce its exposure to a deductible it should ensure that its policy is structured so that it applies only for the deductible portion of the loss and does not duplicate the joint account coverage above the deductible amount

ii) Note that the policies are to survive the default or bankruptcy of the insured for claims arising out of an event prior to the default or bankruptcy The insurer should not be able to deny claims for example simply because the insured may no longer be a legal entity

Subclause 311(e) Note the responsibility of a party to ensure that the policies maintained by it pursuant to this Subclause include waivers of subrogation

Once a claim settlement is made by an insurer it has the right to attempt to recover from the third parties who have contributed to the loss a concept referred to as subrogation By placing a waiver of subrogation in the policy the insurer agrees in advance not to take action against the beneficiaries of the waiver namely the parties and their respective affiliates directors officers servants consultants agents and employees Unless that class is otherwise protected under the policy (i e by being named insureds) members of the class which contribute to the loss are at risk without the waiver The waiver was not included with respect to the policies maintained for the joint account because liability insurance policies do not allow for waivers of subrogation

Subclause 311(g) Operators should not take the responsibilities prescribed by this Subclause lightly In the event that contractors or subcontractors cause a loss in circumstances in which their insurance coverage is inadequate and they do not have the financial resources to withstand the loss the responsibility for the loss may ultimately rest with the parties Also note the responsibility of the operator to ensure that policies to be maintained pursuant to this Subclause include waivers of subrogation

Clause 401 i) Note the notwithstanding reference at the beginning of the provision Clause 303 states that the operator is an independent contractor and Clause 304 imposes a general obligation on the operator to conduct operations in accordance with good oil field practice In the absence of this reference it is possible that the overall standards prescribed by Clauses 303 and 304 could possibly override Clause 401 which basically limits the operator s general liability to gross negligence or willful misconduct This is because the loss may be one which is not addressed by the specific standard of legal responsibility in Clause 401 such that it may be open to argue that the general standard was intended to prevail

Note that the notwithstanding reference is limited to Clauses 303 and 304 A general notwithstanding reference in effect would require the non operators to prove that a loss pertaining to the operator s breach of the contract was due to the operator s gross negligence or wilful misconduct

ii) Note the reference "whether contractual or tortious If the reference to contractual liability is not included there is a possibility that a court may interpret the provision to apply solely to tortious liability See Dominion Bridge Company Limited v Toronto General Insurance Company (1963) 45 W W R 125 (S C C) and Can Indemnity Co v Andrews and George Co [1953] 1 S C R 19 (S C C)

iii) Note the reference "whether negligent or otherwise There is a significant risk that an operator would remain solely responsible for its own negligence unless this exclusion is included As a general rule one has to contract out of responsibility for one s own negligence specifically In the absence of this reference one can only argue that the special gross negligence provisions imply that losses applicable to simple negligence should be borne for the joint account

(c) If the Operator makes any payments with respect to any losses damages claims or liabilities arising out of joint operations which are covered by insurance policies maintained for the joint account hereunder with the approval of the insurers thereof or if the Operator makes any payments authorized hereunder with respect to any other losses damages claims or liabilities arising out of such operations such payments shall be a charge for the joint account However the Operator shall diligently attempt to process its claims under such policies with respect to such losses damages claims or liabilities and shall promptly credit the joint account the amount it ultimately recovers under such policies Insofar as such charge is one which is not to be borne for the joint account pursuant to Article IV the Operator shall adjust the accounts of the parties accordingly at such time as it is determined that the charge is not to be borne for the joint account

(d) The Operator shall use reasonable efforts to ensure that each insurance policy maintained for the joint account pursuant to this Clause includes a provision that coverage is primary to any other coverage carried by the parties (other than coverage maintained by a party to reduce its exposure to a deductible) a provision that such policy shall survive the default or bankruptcy of the insured for claims arising out of an event before such default or bankruptcy and a provision that the insurer shall provide the Operator with sixty (60) days written notice of cancellation of such policy

(e) Each party shall be responsible for insuring its own interest in the joint lands and any production facilities with respect to physical damage to property loss of income Operator s Extra Expense Pollution Liability and any insurance other than that referred to in the Alternate specified in this Clause Each party shall ensure that each policy maintained by it for its own account hereunder shall contain waivers of all rights by subrogation or otherwise against the other parties and their respective Affiliates directors officers servants consultants agents and employees

(f) The Operator shall provide each Joint Operator with written notice of damages or losses incurred hereunder as soon as practicable after the damage or loss has been discovered The Operator shall provide the Joint Operators with such assistance and materials as is required to substantiate such damages or losses for the purposes of the Joint Operators insurance coverages

(g) The Operator shall with respect to joint operations use every reasonable effort to have its contractors and sub-contractors

(i) comply with Unemployment Insurance Workers Compensation and Occupational Health and Safety legislation and all other similar Regulations applicable to workers employed by them and

(ii) carry such insurance in such amounts as the Operator deems necessary provided that such insurance policies shall include waivers of all rights by subrogation or otherwise against the parties and their respective Affiliates directors officers servants consultants agents and employees

312 TAXES – Except as otherwise provided herein or in the Agreement the Operator shall initially pay for the joint account all taxes with respect to property held for the joint account, provided that nothing herein contained shall require or permit the Operator to pay for the joint account income taxes mineral taxes or any other taxes assessments or levies based on reserves on a unit of production or on the value thereof unless required to do so by the Regulations The Operator shall promptly provide each applicable Joint Operator with copies of all tax notices or assessments received by it respecting property held for the joint account and for which payment is not the responsibility of the Operator

## ARTICLE IV

## INDEMNITY AND LIABILITY OF OPERATOR

401 LIMIT OF LEGAL RESPONSIBILITY – Notwithstanding Clauses 303 and 304 the Operator its Affiliates directors officers servants consultants agents and employees shall not be liable to the other Joint Operators or any of them for any loss expense injury death or damage whether contractual or tortious suffered or incurred by the Joint Operators resulting from or in any way attributable to or arising out of any act or omission whether negligent or otherwise of the Operator or its Affiliates directors officers servants consultants agents contractors or employees in conducting or carrying out joint operations except

(a) when and to the extent that such loss expense injury death or damage relates to a risk against which the Operator is required to carry insurance for the joint account as provided in Clause 311 and is within the limits of such required insurance (insofar as such limits exceed the deductible applicable thereto) provided that if the Operator had maintained the required insurance covering such loss expense injury death or damage the Operator shall be released from the responsibility and indemnity otherwise imposed by this Clause to the extent that the insurer thereunder is financially unable to pay all or any portion of a valid claim with respect to such loss expense injury

iv) Note the distinct treatment between liability and indemnity If the distinction between the two is blurred the parties face the risk that the provision could be held to be solely an obligation to indemnify In such event, the non operators would not be able to rely on the clause to provide them with a remedy with respect to direct damage to their property See Mobil Oil Canada, Ltd v Beta Well Service Ltd (1974) 43 D L R (3rd) 745 (Alta. S C App Div)

v) Note the interrelationship in (a) between the requirement to carry insurance for the joint account and Subclause (a) Assume that the operator failed to carry the required insurance and a loss of $1 MM occurred which would have been covered by that insurance In the absence of Subclause (a) that loss could arguably be borne for the joint account unless the non operators could prove that the failure to carry insurance was due to the gross negligence or wilful misconduct of the operator The inclusion of Subclause (a) ensures that the operator is directly responsible for the failure to carry required insurance

vi) Note the reference to the deductible in Subclause (a) Suppose that the operator failed to carry the required $1 MM insurance policy and that a loss of $1 MM occurred which would have been covered thereby As the policy would have included a deductible the amount of the deductible would still have been borne for the joint account such that the operator s responsibility would be $1 MM less the deductible amount.

vii) Most recent judicial considerations of the concept of gross negligence have been in automobile cases where an injured non paying passenger had to demonstrate that the driver s conduct was grossly negligent in order to be successful in a suit against the driver Since the driver s insurance would generally cover a successful claim by the injured passenger courts have tended to minimize the distinction between simple and gross negligence in those cases in order to find for the passenger It is unclear how a court will interpret the term in an oil and gas context.

viii) Note the "when and to the extent" reference at the beginning of Subclause (b) This ensures that a loss which is due to the operator s gross negligence or wilful misconduct and other causes can be apportioned to the applicable causes It also enables the operator to raise the issue of contributory negligence

ix) The exclusion of liability respecting the loss or delay of production is relatively new to North American agreements and has been included in the CAPL Frontier Operating Procedure However the concept has received significant support in Europe where proponents argue that the magnitude of a potential loss of this type is such that the assumption of operatorship would not be viable without such an exemption The most obvious loss resulting from this type of damage of course would be a loss of profits

x) One issue which may arise in the future is the appropriateness of a general exception for consequential or indirect damages The value of such a general provision is questionable though The normal common law rules of remoteness and foreseeability would apply in the absence of such a provision anyway such that one cannot argue that the operator would necessarily assume legal responsibility for those losses without this protection In very simple terms insofar as the operator owes a duty of care to the non operators it would be necessary for the non operators to demonstrate (i) that the operator s actions caused their loss ii) that the loss was reasonably foreseeable in relation to the action iii) the degree of their damages and iv) that the conduct was in fact grossly negligent. Notwithstanding that the general exception for consequential or indirect damages has not been included the inclusion of the loss of profits exemption addresses the major aspect of the concern

xi) There has also been some discussion that there also should be a general exception for exemplary and punitive damages in light of a disturbing trend in some recent U S cases to award them primarily to attempt to deter the conduct causing the loss

Exemplary and punitive damages are similar under Canadian law in that notwithstanding those U S decisions they are designed to penalize a defendant where the defendant s conduct towards the plaintiff and those owed a duty of care has been so high handed oppressive or willfully reckless that the court determines that the plaintiff should recover damages over and above those required to compensate the plaintiff for its loss

The inclusion of such heads of damages within an exclusion in essence would literally provide an operator with a licence to conduct its affairs in such a manner

Clause 402 i) The case of Greenwood Shopping Plaza Ltd v Beattie et al (1980) 111 D L R (3rd) 257 (S C C ) held that a person who is not a party to a contract can neither sue nor rely upon it to protect himself from liability except in case of agency or trust. That being the case there is a likelihood that the obligation to indemnify not only the operator but also its affiliates directors officers servants consultants agents and employees would not be effective Nevertheless the provision accurately reflects the intention of the parties and does not place the operator in a worse position than that in which it would be in the absence of the reference

ii) The inclusion of the reference to directors and officers is included solely because of the tendency of recent suits in the United States to cast a wider liability net Consultants are included because of the common practice of many companies to hire temporary consultants rather than increase the number of employees

iii) Remember that the operator is also a joint operator The indemnification obligation is not borne solely by the non operators

Subclause 503(a) i) The provision reflects two of the operator s concerns security of payment by the non operators and the acquisition of the resources to conduct the operation on an ongoing basis

death or damage or such insurer is determined by a court of competent jurisdiction not to be required to make payment with respect to such loss expense injury death or damage under such policy of insurance and

(b) when and to the extent that such loss expense injury death or damage is a direct result of or is directly attributable to the gross negligence or wilful misconduct of the Operator or its Affiliates directors officers servants consultants agents contractors or employees provided that an act or omission of the Operator or its Affiliates directors officers servants consultants agents contractors or employees shall be deemed not to be gross negligence or wilful misconduct, insofar as such act or omission was done or was omitted to be done in accordance with the instructions of or with the concurrence of the Joint Operators

To the extent that the conditions in Subclauses (a) or (b) of this Clause apply (but subject to the exceptions provided therein) the Operator shall be solely liable for such loss expense injury death or damage and in addition shall indemnify and save harmless each other Joint Operator and its Affiliates directors officers servants consultants agents and employees from and against the same and also from and against all actions causes of action suits claims and demands by any person or persons whomsoever in respect of any such loss expense injury death or damage and any costs and expenses relating thereto However in no event shall the responsibility of the Operator prescribed by this Clause extend to losses suffered by the Joint Operators respecting the loss or delay of production from the joint lands including without restricting the generality of the foregoing loss of profits or other consequential or indirect losses applicable to such loss or delay of production

402 INDEMNIFICATION OF OPERATOR -- Except as otherwise provided in Clause 401 the Joint Operators hereby indemnify and save harmless the Operator its Affiliates directors officers servants consultants agents and employees from and against any and all actions causes of action suits claims demands costs losses and expenses resulting from loss injury death or damage respecting any person which may be brought against or incurred or suffered by the Operator its Affiliates directors officers servants consultants agents or employees or which the Operator its Affiliates directors officers servants consultants agents or employees may sustain pay or incur by reason of or which may be attributable to or arise out of any act or omission of the Operator or its Affiliates directors officers servants consultants agents contractors or employees in conducting joint operations All such liabilities shall be for the joint account and shall be borne by the Joint Operators in the proportions of their respective working interests

## ARTICLE V

## COSTS AND EXPENSES

501 ACCOUNTING PROCEDURE AS BASIS – The Accounting Procedure shall be the basis for all charges and credits for the joint account except to the extent that the Accounting Procedure may be in conflict with the provisions herein or in the Agreement. The accounting and financial records maintained by the Operator with respect to the operations conducted by it hereunder shall be maintained separately from those kept by it with respect to operations which are not conducted hereunder in accordance with established industry accounting practice

502 OPERATOR TO PAY AND RECOVER FROM PARTIES – Subject to the provisions of Clause 503 the Operator shall initially advance and pay all costs and expenses incurred for the joint account. The Operator shall charge to each Joint Operator its proportionate share of such costs and expenses and each respective Joint Operator shall pay the same to the Operator within thirty (30) days after receipt of the Operator s statement thereof

503 ADVANCE OF COSTS --

(a) Upon approval of an Authority for Expenditure by a Joint Operator the Operator may by notice require that individual Joint Operator to secure payment of its proportionate share of all costs to be incurred for the joint account pursuant to such AFE in a manner satisfactory to the Operator If the payment is to be secured by an irrevocable standby letter of credit it shall be established in favour of the Operator by that Joint Operator with a Canadian chartered bank with respect to that Joint Operator s proportionate share of the costs and expenses which are anticipated to be incurred pursuant to such AFE In the event a letter of credit is so established the Operator may draw on the letter of credit in the same manner and at the same time intervals as provided with respect to amounts to be paid by that Joint Operator pursuant to such AFE

(b) The Operator may by notice to the Joint Operators require each Joint Operator to advance its proportionate share of all costs to be incurred for the joint account subject to Subclause (a) of this Clause If the Operator so elects to cash call the Joint Operators it shall not earlier than thirty (30) days prior to the first (1st) day of a calendar month submit to each Joint Operator an itemized written estimate of the costs which are expected to be paid by the Operator for the joint account hereunder in that calendar month together with a request for payment by each Joint Operator of its proportionate share thereof insofar as such amount is not secured by Subclause (a) of this Clause A Joint Operator shall pay its share of such cash call to the Operator (or otherwise secure payment thereo

The Subclause entitles the operator to require an individual party to secure payment of its share of the costs of the operation in a manner satisfactory to the operator The parties might do this by establishing an irrevocable letter of credit in favour of the operator by that party with respect to its share of costs On occasion an operator may convene a meeting of the parties to discuss how a well will be financed before issuing the AFE

Amounts obtained by the operator pursuant to this Subclause or Subclause (b) would be subject to the general trust imposed by Clause 507

ii) Remember that Clause 901 states that approval of a drilling AFE is not the approval of a completion program

Subclause 503(b) Remember that Clause 503 applies to capital advances of costs It does not apply to operating expenses which are covered by Clause 105 of the 1988 PASC Accounting Procedure

Subclause 503(c) The adjustment mechanism is substantially the same as that contained in Clause 104 of the PASC 1988 Accounting Procedure The related billing would be provided to the non-operators in the month next following the month to which the advance pertained as provided in Clause 102 of the 1988 PASC Accounting Procedure

Clause 504 i) This Clause gives a non-operator the right to require the operator to provide the non operators with a forecast of the anticipated operations to be conducted for the joint account over the succeeding three to twelve-month period This provision is seldom used in practice though A prudent operator would tend to discuss the delineation/development of a promising discovery on a technical level with its co-venturers anyway in the absence of the Clause and a non operator would be unlikely to request a forecast respecting an inactive area. However it is a provision which non-operators may consider utilizing if an operator is not advising them of its recommendations for the delineation/development of a discovery

ii) The forecast is for informational purposes This is consistent with the general practice in unit agreements and the CAPL Frontier Operating Procedure

Clause 505 i) The operator s lien provision is included to attempt to secure payment of a non operator s share of costs and expenses by placing a claim or charge on that party s interest in the joint property Note that the lien applies to all costs and expenses incurred for the joint account not only costs incurred in conducting joint operations

ii) The lien under the 1981 provision probably arose when the expenditure was made rather than as of the date of the agreement. Given that a defaulting party has probably created liens floating charges or other security in favour of its creditors it is imperative that one try to provide the operator with the earliest possible claim Therefore the Subclause has been structured so that the operator s claim arises when the Operating Procedure becomes effective rather than as the expenditures are made

The Canada Petroleum Resources Act and comparable legislation resulting from the Newfoundland and Nova Scotia Accords expressly provide the operator with certain advantages in enforcement as regards frontier properties in recognition of the fact that lenders should realize that an operating agreement will probably exist under which the operator would almost certainly have a lien This differs from the conventional situation under the Alberta Mines and Minerals Act for example which provides only that an operator s lien may not be the subject of a security notice such that the actual priority of the operator s lien will be determined by the common law rules on priorities That being the case it is likely that the wording in the provision would not be effective against lenders with registered security notices notwithstanding that those lenders are aware of the probability that an operating procedure is in effect

Subclause 505(b) The rights in this provision are premised on the existence of a default A prudent operator should not resort to the remedies where the parties are disputing an accounting practice or the adequacy of invoice information In such event it may be attractive to deposit the disputed amount into a trust account until resolution of the dispute Interest thereon would accrue for the benefit of the successful party

Paragraph 505(b)(i) Interest should accrue whether or not the operator has given the non operator prior notice of its intention to charge interest. The inclusion of the regardless phrase should eliminate the risk that prior notice is required as was held in Renaissance Resources Ltd v Metalore Resources Ltd [1984] 4 W R R 430 (Alta Q B ) affirmed [1985] 4 W W R 673 (Alta C A )

Paragraph 505(b)(ii) The most obvious use of the suspension of rights would be to withhold the information from joint operations Despite the broadness of the remedy the suspension of other privileges should be considered very carefully in each individual case A denial of a party s right to participate in a well for example might not be effective at law

Paragraph 505(b)(iii) i) While traditionally not found in agreements this remedy is basically the codification of a party s common law right Notwithstanding this general statement there are certain common law restrictions on set off which are beyond the scope of these notes If one planned to appropriate funds using set off as a basis legal advice should be obtained

as provided in Subclause (a) above) on or before the twentieth (20th) day after its receipt of such estimate or by the fifteenth (15th) day of the calendar month to which such estimate relates whichever is the later

(c) The Operator shall adjust each monthly billing to reflect advances received from a Joint Operator hereunder Costs in excess of the advances requested hereunder shall be billed and paid by the Joint Operators pursuant to the Accounting Procedure Amounts advanced by the Joint Operators in excess of actual costs shall be refunded by the Operator with the related billing for the month in which the advance was paid Any such excess amounts not refunded shall at the option of each Joint Operator bear interest (payable by the Operator for the account of that Joint Operator) on the same basis as is provided in paragraph 505(b)(i)

504 FORECAST OF OPERATIONS – The Operator shall from time to time at the request of a Joint Operator provide the Joint Operators with a written forecast outlining all operations which it proposes to conduct for the joint account during the forecast period (which shall be not less than three (3) months and not more than twelve (12) months) together with the estimated costs thereof Such forecasts are for informational purposes only and shall not commit the parties to make the expenditures described therein

505 OPERATOR S LIEN –

(a) Effective from the date of the Agreement the Operator shall have a lien and charge which is first and prior to any other lien charge mortgage or other security interest, with respect to the interest of each Joint Operator in the joint lands the wells and equipment thereon the petroleum substances produced therefrom and any production facilities to secure payment of such Joint Operator s proportionate share of the costs and expenses incurred by the Operator for the joint account.

(b) If a Joint Operator fails to pay or advance any of the costs or expenses incurred for the joint account which are to be paid or advanced by it within the time period prescribed by the Accounting Procedure or Clause 502 or 503 as the case may be the Operator may without limiting the Operator s other rights as contained in this Operating Procedure or otherwise held at law or in equity

(i) charge such Joint Operator compound interest as computed monthly with respect to such unpaid amount from the day such payment is due until the day it is paid at the rate of two percent (2/) per annum higher than the rate designated as the prevailing prime rate for Canadian commercial loans by the principal Canadian chartered bank used by the Operator regardless of whether the Operator has notified such party in advance of its intention to charge interest with respect to such unpaid amount

(ii) withhold from such Joint Operator any further information and privileges with respect to operations conducted hereunder which information and privileges shall be conveyed or restored as the case may be to such Joint Operator upon such default being fully rectified

(iii) set off against the amount unpaid by such defaulting Joint Operator any sums due or accruing to such Joint-Operator from the Operator pursuant to this Operating Procedure or any other agreement between the Operator and such Joint Operator whether executed before or after the effective date of the Agreement

(iv) maintain an action or actions for such unpaid amounts and interest thereon on a continuing basis as such amounts are payable but not paid by such defaulting Joint Operator as if the obligation to pay such amounts and the interest thereon were liquidated demands due and payable on the relevant date such amounts were due to be paid without any right or resort of such Joint Operator to set off or counter claim

(v) treat the default as an immediate and automatic assignment to the Operator of the proceeds of the sale of such Joint Operator s share of petroleum substances produced hereunder Service of a copy of this Operating Procedure upon a purchaser of such petroleum substances from such Joint Operator together with written notice from the Operator shall constitute a written irrevocable direction by the Joint Operator to any such purchaser to pay to the Operator the proceeds from any such sale up to the amount owed to the Operator by such Joint Operator hereunder (including any accrued interest with respect thereto) and such purchaser is authorized by such Joint Operator to rely upon the statement of the Operator as to the amount so owed to it by such Joint Operator and

(vi) enforce the lien referred to in Subclause (a) of this Clause by taking possession of or using free of charge all or any part of the interest of the defaulting Joint Operator in the joint lands in all or any part of the production therefrom and equipment thereon or in any production facilities and all rights powers and privileges of such Joint Operator in connection with such interest until such default is

ii) One question which may arise is whether the seizure of funds accruing to the defaulting party pursuant to another agreement would place the operator in default under that other agreement. Since the right of set off is a common law right anyway and this paragraph states that the timing of the execution of that other document is irrelevant to that right, it is doubtful that this would be the case However the implications of the exercise of this right should be considered in each individual case

Paragraph 505(b)(iv) While traditionally not found in agreements this remedy provides the operator with certain legal procedural advantages because the nature of the claim would be in debt. In essence it provides a short cut in that the operator may be able to avoid having to prove that the work was done and the costs incurred and could simply assert that the amount is a debt to be collected

Paragraph 505(b)(vi) i) Note the duty on the operator to attempt to sell the seized property on reasonable terms having due regard to the potential for the recovery of excess funds for the defaulting party Otherwise the operator has no incentive to attempt to sell the property for greater than the amount owed to it by the defaulting party

ii) Note that a sale is without prejudice to the operator s claim for any amount still owing after the sale

iii) It is likely that a defaulting party s interest would be pledged as security to lenders such that the price to be paid by potential purchasers would probably be heavily discounted A sale would be further complicated if the defaulting party s interest were subject to a gas sales contract.

iv) It is probably advantageous for the operator to have obtained the approval of the other parties to the use of this provision because of the possibility that there may be litigation associated with the exercise of this exceptional remedy

Subclause 505(b) Proviso Note the difference between the less harsh remedies of interest and the withholding of information and the more draconian self help remedy of the seizure of property The latter remedy is only available when the default has continued for at least 30 days following the issuance of a default notice

This variation ensures that the operator cannot immediately resort to the harsher remedies before pursuing other avenues However the 30 day period was chosen to ensure that the operator would have access to the exceptional remedies before the default imposed a serious hardship on the operator

Subclause 505(c) This provision is included because of the provisions of The Interest Act and comparable provincial legislation In effect such legislation operates to merge a judgment of principal and interest Notwithstanding this provision and Clause 2807 there is a significant probability that it may not be effective though

Subclause 505(d) Subject to audit rights the operator s records shall constitute prima facie proof of the existence of any financial default

Subclause 505(e) If the operator is the defaulting party the non-operators may appoint a party to act as their representative to exercise the remedies otherwise available to the operator in the event of default pending the appointment of a new operator

Clause 506 i) Note that the operator has the right to use this mechanism after a party has been in default three months

ii) The non operators are required to reimburse the operator its out of pocket costs associated with the default They are not required to reimburse the operator interest which has accrued on the unpaid principal at the time the operator utilizes the mechanism

iii) This provision would extend to losses incurred for the joint account pursuant to Article IV since those losses would pertain to joint operations In the event the parties were held liable to a third person for a loss suffered by that person as a result of a joint operation the parties would be jointly responsible for the loss unless the court had apportioned responsibility among the defendants in its judgment. It would be a rather odd result if the operator were required to contribute the share of an insolvent party without a corresponding right to have the remaining parties share that burden

Clause 507 Some commentators had argued that agreements should require operators to hold funds in distinct trust accounts because of the view that creditors could otherwise seize funds held for the joint account in the event of an operator s insolvency

However the Alberta Court of Appeal decided in Bank of Nova Scotia v Societe General (Canada) et al [1988] 4 W W R 232 (Alta C A ) (sometimes referred to as the Sorrel decision) that there is a trust relationship imposed when the conventional commingling clause of the 1981 CAPL Operating Procedure is used since the intention that the operator acts for the benefit of the non operators pervaded the entire document. The provision has been expanded to reflect that decision

The case though addressed a fact situation in which the lender was not the same institution as that with which the funds were deposited Usually funds would be on deposit with the lender such that the typical lender may have rights of set off which may prevail over the claims of the non operators unless the lender knew or ought to have known that the funds were held in trust for the joint operators

fully rectified Notwithstanding the provisions of Clauses 601 and 2401 the Operator may sell and dispose of any interest production equipment or production facility of which it has so taken possession either in whole or in part or in separate parcels at public auction or by private tender at a time and on whatever terms it shall arrange having first given at least ten (10) days prior written notice to such Joint Operator of the time and place of the sale provided that the Operator may only sell such interest, production equipment or production facility to such person or persons for such price and on such conditions as the Operator determines are reasonable having due regard inter alia to the possible recovery of funds for such Joint Operator in excess of the amount owed by it hereunder Such sale or other realization shall be without prejudice to the Operator s claim for deficiency and shall be free from any right of redemption on the part of such Joint Operator (which right is hereby waived and released) and such Joint Operator also waives all formalities prescribed by custom or by law with respect to such sale or other realization The proceeds of the sale shall be first applied by the Operator in payment of any amount required to be paid by the defaulting Joint Operator and not paid by it hereunder (including any accrued interest with respect thereto) and any balance remaining shall be paid to the defaulting Joint Operator after deducting reasonable costs of the sale Any sale made as aforesaid shall be a perpetual bar both at law and in equity against the defaulting Joint Operator and its assigns and against all other persons claiming an interest in such property or any portion thereof sold as aforesaid by from through or under the defaulting Joint Operator or its assigns

However the Operator may not exercise the rights granted in paragraphs (iii) (vi) of this Subclause with respect to such default until at least thirty (30) days following the issuance of a notice to such Joint Operator specifying such default and requiring the same to remedied

(c) The obligation to pay interest at the rate specified in Subclause (b) with respect to a default is to apply until such default is rectified and shall not merge into a judgement for principal and interest or either of them The parties waive the application of any Regulations to the contrary insofar as such waiver is permitted by the Regulations

(d) Books and records kept by the Operator for the joint account shall constitute prima facie proof of the existence of any financial default hereunder subject however to the rights of inspection and audit provided for elsewhere in this Operating Procedure

(e) If the Operator is the party which defaults in paying its share of any cost or expense incurred for the joint account the other parties may appoint a party as representative ad hoc of those parties pending the appointment of a new Operator pursuant to Article II Such party thereupon shall be entitled to exercise any of the rights and remedies otherwise available to the Operator pursuant to this Operating Procedure mutatis mutandis in order to rectify such default

506 REIMBURSEMENT OF OPERATOR – If the Operator has not received full payment of a Joint Operator s share of the costs and expenses of joint operations within three (3) months following the date the payment was due each other Joint Operator upon being billed therefor by the Operator shall contribute a fraction of the unpaid amount excluding interest thereon which fraction shall have

(i) as its numerator – the working interest of such Joint Operator and

(ii) as its denominator – the aggregate working interests of all parties except the defaulting Joint Operator

Thereupon each such contributor shall be proportionately subrogated to the Operator s rights pursuant to Clause 505 and to the interest thereafter payable thereunder on the unrecovered portion of its contribution

507 COMMINGLING OF FUNDS – The Operator may commingle with its own funds the moneys which it receives from or for the account of the Joint Operators pursuant to this Operating Procedure Notwithstanding that moneys of a Joint Operator have been commingled with the Operator s funds the moneys of a Joint Operator advanced or paid to the Operator whether for the conduct of operations hereunder or as proceeds from the sale of production under this Operating Procedure shall be deemed to be trust moneys and shall be applied only to their intended use and shall in no way be deemed to be funds belonging to the Operator other than in its capacity as the Joint Operators trustee

Since the scope of that decision is still unclear prudent non-operators should continue to monitor their non operated properties for indications that an operator may have serious financial difficulties It may be attractive to consider replacing such an operator pursuant to Clause 202 or 203 In the alternative it may be desirable to use the leverage provided by those provisions to require the operator to set up a separate trust account for the project or to hold joint account monies at a bank to which the operator is not indebted

Clause 601 i) Each party has the right to take its share of production in kind at the "first point of measurement. In essence this is the point at which royalties are calculated under the title documents/regulations It is not feasible to take production in kind before that point

ii) The provision is silent on the acquisition of transportation service This is an issue which the parties would wish to discuss when considering the development of a gas prospect.

iii) Remember that each party also remains responsible for the costs and expenses applicable to the substances produced in association with the petroleum substances such as associated water

iv) A party shall provide the operator with such information respecting its marketing arrangements as the operator reasonably requires to fulfill its obligations to transfer possession of production

Subclause 602(a) i) If a party fails to take in kind the operator has the right to dispose of that production Without that right or the negotiation of a separate production balancing arrangement (as is contemplated by the AAPL Operating Procedure) the well would have to be shut in

The traditional clause had provided that production so marketed by the operator on behalf of another party was to be sold at the same price which the Operator receives for its own share of the production or purchased "for its own account at the field price prevailing in the area

The provision had seemed satisfactory in the 1970 s and the early 1980 s when markets were readily available for gas production and prices were regulated The problems with the provision quickly became apparent though when there was a surplus of available gas and a large variation in gas prices following deregulation A non operator without a long term full price contract which took in kind was usually forced to sell into the heavily discounted industrial market An operator with a long term full price contract, therefore faced the risk that a non operator without such a contract would prefer to have the operator market its production rather than sell into the industrial market. Assuming that the operator were meeting its deliverability requirements the former provision could require the operator to displace its own production to sell a non operator s share of production under its contract In the alternative the operator could purchase the non operator s production at "the field price prevailing in the area whatever that meant at a time when prices for similar production varied drastically!

The Clause attempts to balance the needs of the operator and the non operators The operator requires the protection that it is never required to displace its share of production to accommodate a non-operator and wants to be compensated for the extra expenses it is forced to incur by marketing another party s share of production A non operator must be protected from unreasonable long term contracts or non arm s length arrangements

The Subclause has been structured so that the operator may (i) sell the non-operator s production under its own contract for the same price it receives (ii) sell that production under another arm s length transaction for a market price (as defined in Subclause 101(s) or (iii) buy the production for a market price

ii) Note that (a)(i) does not require the operator to sell the non taking party s share of production under the operator s contract It only has to sell at the same price as in that contract

iii) Note that there are no restrictions on the references to processing and transportation expenses in (a)(i) and (ii) The inclusion of a provision allowing the taking party to charge the expenses on the same basis as is provided in the regulations would often provide the taking parties with an additional reward Notwithstanding that the document is silent on the magnitude of the deduction there are duties imposed on a taking party at law to ensure that it does not abuse the authority to make those deductions

iv) One issue which arises under (a)(iii) is the possibility that the operator may sell production at a higher price than the market price Remember though that paragraph (a)(iii) does not entitle the selling party to net out direct processing and transportation expenses applicable to the production or to charge a marketing fee as is done in paragraphs (a)(i) and (a)(ii) That being the case there would only by an incentive to purchase production for resale under (a)(iii) if the price at which the production would be sold would be significantly greater than the market price Of course it would be difficult for an operator to argue that the proposed market price was in fact "the market price if the production could easily be sold on the spot market at a significantly higher price The most probable resale case then would be the situation in which the operator has excess capacity under a long term contract which it is unwilling to share

Subclause 602(b) i) Purchases under paragraph 602(a)(iii) may not exceed one month unless the applicable contract entered into by the operator with an affiliate is terminable at any time on notice of not greater than one month If the operator proposes to sell production under 602(a)(i) or (ii) for contracts which either exceed one month or are not terminable at any time on notice of not greater than one month

a) The operator is required to notify the non operator of the intention together with a summary of the material terms

## ARTICLE VI

## OWNERSHIP AND DISPOSITION OF PRODUCTION

601 EACH PARTY TO OWN AND TAKE ITS SHARE -- Each party shall own its proportionate share of the petroleum substances produced from wells operated for the joint account. The Operator shall measure and deliver into the possession of each party as and when produced at the first point of measurement, the proportionate share of petroleum substances owned by that party exclusive of production which has been unavoidably lost and production which may be used by the Operator in producing operations respecting the joint lands Each party shall at its own expense have the right to take in kind and separately dispose of its proportionate share of such production Each Joint Operator shall provide the Operator with such information respecting such Joint Operator s arrangements for the disposition of its share of production as the Operator may reasonably require to fulfil its obligations hereunder

602 PARTIES NOT TAKING IN KIND --

(a) Notwithstanding Clause 601 to the extent that a Joint-Operator does not take in kind and separately dispose of its share of production hereunder or advises the Operator that it will not be fulfilling that obligation the Operator shall have the authority but not the obligation to dispose of such portion of the non-taking party s share of production as the agent of the non taking party pursuant to any of the following options

(i) the Operator may sell such production at the same price which the Operator receives from a third party under an arm s length sale contract for its own share of production and account to the non taking party for the proceeds of the sale applicable to the production sold on its behalf less all direct processing and transportation expenses pertaining thereto and the applicable marketing fee prescribed by Clause 604 or

(ii) the Operator may sell such production at a market price to a third party in an arm s length transaction and account to the non taking party for the proceeds of the sale less all direct processing and transportation expenses pertaining to such production and the applicable marketing fee prescribed by Clause 604 or

(iii) the Operator may purchase such production for the Operator s own account (or the account of an Affiliate) at a market price

Insofar as the Operator disposes of all or a portion of a non taking party s share of production pursuant to this Subclause the Operator shall advise that party of the option pursuant to which the Operator disposed of that party s production within one (1) month of the commencement of that disposition

(b) The Operator may not purchase production pursuant to paragraph (a)(iii) of this Clause under any arrangement which has a term exceeding one (1) month unless such arrangement is terminable at any time on not greater than one (1) month s notice by the non taking party to the Operator without an early termination penalty or other cost. If pursuant to paragraph (a)(i) or (ii) of this Clause the Operator proposes to enter into a sales contract which either has a term greater than one (1) month or is not so terminable at any time on notice of one (1) month or less the following shall apply

(i) the Operator shall notify the non taking party of such intention and provide it with a summary of the terms of the proposed contract in sufficient detail to enable the non taking party to determine whether it wishes that portion of its share of production not being taken in kind and separately disposed of by it sold pursuant to the proposed contract

(ii) the non taking party shall notify the Operator within ten (10) days of the receipt of the Operator s notice whether it consents to having such production sold under such contract provided that failure of the non taking party to notify the Operator of its position within such period shall be deemed to be the consent of the non taking party to the sale of such production pursuant to such contract

(iii) if the non taking party consents to having such production sold under such contract pursuant to the preceding paragraph the Operator shall sell such production under such contract If the non taking party does not consent to having such production sold pursuant to such contract pursuant to the preceding paragraph the non taking party shall state in its notice whether it intends to commence taking such production in kind and separately disposing of the same and if so it shall promptly supply the Operator with the information required by it pursuant to Clause 601 and

b) The non operator shall elect within 10 days of the receipt of that notice whether it wishes its production sold under that contract and

c) If the non-operator does not consent to the contract, it shall advise the operator whether it intends to take in kind or whether it wishes the operator to continue to market the production under short term arrangements in Subclause (a)

ii) Note paragraph (iv) whereby the non-taking party can continue to require the operator to sell its production under short term arrangements in the event it is not prepared to consent to a contract. If that party believes that it can obtain a preferable contract in the next several months it may be unwilling to enter into the operator s proposed contract

iii) The one month restriction may pose problems with respect to the disposition of LPG s There would likely be some difficulty selling the product on the spot market and LPG contracts generally have a one year evergreen term with a window to cancel at the end of a year upon 60 days notice LPG contracts also usually relate to supply sources such as gas plants rather than individual wells Given the limited spot market for LPG s and the nature of LPG contracts it is likely that a party which does not intend to take its share of LPG s in kind for a sustained penod would in practice negotiate a suitable arrangement with the operator in the context of the particular fact situation

iv) Note the 10 day response penod in (b)(ii) Attractive short term contracts are probably only available for a limited period of time A significantly longer election period could result in the loss of a contract.

Subclause 602(c) If the non-operator subsequently wishes to take its production in kind the election will generally be effective at the end of the contract. If though the contract is terminable the election will be effective at the date the agreement is terminated provided the operator has received the election at least 15 days before any specific date upon which it may terminate the arrangement.

Clause 603 i) This provision addresses the possibilities that the operator may be the non taking party and that the operator may only take its own share of production in kind where at least one other party is not taking its share of production in kind (Remember that Clause 601 provides the operator with the right but not the obligation to market a non taking party s share of production ) The operator shall provide the other parties with the information they require to exercise their rights under the Clause These rights shall be shared by the parties in proportion to their working interests unless otherwise agreed by them

ii) Suppose A (operator) and B have not been taking in kind and that C has been selling their share of production pursuant to Clauses 602 and 603 A now begins to take in kind Who will market B s production if B continues to fail to take in kind? If B s share of production is being sold pursuant to a Clause 602 contract C would remain responsible for the production until the termination of that contract At that point and assuming B did not then begin to take in kind A would have the right to sell it under Clause 602 and B would have the right to sell it under Clause 603 if A did not

Clause 604 i) The operator may charge the non-operator a marketing fee with respect to production being sold under the arm s length arrangements in paragraphs 602(a)(i) and (ii) If the parties determine that they would prefer to market through the operator because of the operator s access to gas markets they are certainly free to tailor an arrangement to their fact situation and waive the fee with respect to such dispositions

ii) Note that the marketing fee is not based on the ultimate sale price It is either based on the value of the product at the wellhead or a specified fee Although easier to calculate than a wellhead based fee it is important to remember that a fee based on the gross sale price could be significantly greater depending on the ultimate point of sale and the degree to which the product had been enhanced

The reference calculated at the wellhead in the Clause does not refer to the substances calculated at the wellhead The substances cannot be calculated until the first point of measurement, which will often be after the processing of raw gas

Instead the provision refers to the value of the substance at the wellhead This is determined by subtracting from the sale price all of the costs and expenses associated with product enhancement, such as transportation and processing

iii) While Alternate A may be attractive for its simplicity Alternate B enables the parties to tailor the fee to their particular fact situation

iv) The marketing fee was chosen in lieu of charging the parties the actual cost of marketing The fixed fee was attractive because of its simplicity and certainty Given the subjectivity inherent in the allocation of overhead it would be very difficult both to quantify and audit actual marketing costs

v) Note that the terms petroleum natural gas etc have not been defined Both the terms and the definitions vary from jurisdiction to jurisdiction

(iv) if the non-taking party does not consent to having such production sold under such contract pursuant to this Subclause and does not proceed to take such production in kind and separately dispose of the same the Operator may dispose of such production pursuant to Subclause (a) of this Clause

No contract described in this Subclause however shall have a term exceeding one (1) year without the consent of the non taking party unless that contract may be terminated by the Operator at any time on not greater than one (1) year s notice to the applicable purchaser

(c) If a non taking party proposes to commence to exercise its right to take in kind and separately dispose of its share of production hereunder it shall give notice of such intention to the Operator and shall promptly supply the Operator with the information required by it pursuant to Clause 601 Such notice shall be effective either at the end of the term of any sale agreement pursuant to which such production is being sold by the Operator or at the date such agreement is terminated if terminable by the Operator at an earlier date However such notice shall not be effective with respect to an agreement which is terminable by the Operator unless the Operator has received such notice at least fifteen (15) days prior to any specified date upon which the Operator is required to serve notice to the applicable purchaser to terminate such agreement.

603 OPERATOR NOT TAKING IN KIND – To the extent that the Operator either is the party who does not take in kind and separately dispose of its proportionate share of production or the Operator does not intend to dispose of production not being taken in kind by another Joint Operator pursuant to Clause 602 the Operator shall advise the other Joint Operators in a timely manner of the information required by them to exercise their rights pursuant to this Clause 603 In such event the Joint Operators or any one or more of them shall have the same rights and obligations mutatis mutandis with respect to such share of production as the Operator has with respect to a Joint Operator s share of production under Clause 602 Insofar as the provisions of this Clause are applicable and the Operator requires instructions respecting production and marketing to give effect to this Clause and if applicable Clause 602 the Operator shall follow the instructions which are given by the parties marketing production on behalf of the Operator and if applicable any other party hereunder Two or more Joint Operators exercising their rights under this Clause shall do so in proportion to their working interests and shall attempt to coordinate their plans for the disposition of such production in such a manner that the instructions to be provided to the Operator with respect to such production shall be consistent. For so long as the Operator continues to be a non taking party it shall advise the other parties periodically when and how it proposes to take in kind and separately dispose of its share of production pursuant to Clause 601 If the Operator commences to take its share of production in kind and separately dispose of the same the Operator thereupon shall have the right to sell a non taking party s share of production pursuant to Clause 601 following the termination of any contract entered into on behalf of such non taking party in accordance with Clauses 602 and 603

604 MARKETING FEE – To the extent that a party fails to take in kind and dispose of all or a portion of its share of production and such production is disposed of either by the Operator pursuant to paragraph 602(a)(i) or (ii) or by another Joint Operator pursuant to Clause 603 other than by way of a transaction described in paragraph 602(a)(iii) the party so marketing such production shall be entitled to charge the non taking party the marketing fee in ALTERNATE ____ below (Specify A or B) namely

ALTERNATE A

The party so marketing such production on behalf of a non taking party may charge that party a marketing fee equal to 2 5/ of the sale price of such production calculated at the wellhead

OR

ALTERNATE B

The party so marketing such production on behalf of a non taking party may charge that party a marketing fee which is either a percentage of the sale price of such production calculated at the wellhead or a specified fee being (specify one option for each item)

(a) in the case of petroleum _____% or $ _____/$m^3$

(b) in the case of natural gas _____% or $ _____/$10^3m^3$

(c) in the case of natural gas liquids and substances other than petroleum and natural gas (but not including sulphur) _____% or $ _____/$m^3$ and

(d) in the case of sulphur _____% or $ _____/t.

Clause 605 i) A party marketing another party s share of production pursuant to this Article may pay the royalties attributable thereto directly to the lessor in which event those royalties would be deducted from the amount remitted to the non taking party

ii) Remember that the operator is required to provide production statements to the parties pursuant to Clause 310 to assist them with the calculation of their royalties

Clause 606 i) The disposing party shall pay the non-taking party its share of net proceeds within 10 days of its receipt If it fails to do so the provisions of Subclause 505(b) shall apply mutatis mutandis such that the non-taking party will be able to charge interest and have access to the other default remedies Since the direct processing and transportation costs may not be known at the time of the distribution of proceeds the disposing party may invoice the non-taking party for those costs after the fact. In such event, the disposing party also has access to the remedies in Subclause 505(b) to secure payment of those expenses

ii) Production rates fluctuate daily Remember that accounts are adjusted once per month

Clause 607 A non taking party has the right to audit the disposing party s records with respect to sales under Article VI However the disposing party shall not be required to provide the auditors with any access to any contract described in paragraph 602(a)(i) Those contracts contain proprietary information which a party is not required to disclose to auditors

Clause 608 A party selling production is often required to provide a title warranty with respect to production being sold by it As it is not feasible for a disposing party and a non-taking party to enter into a side agreement in each instance this general indemnification provision has been included

Subclause 701(a) i) A non operator will occasionally object to the operator s AFE and insist that it can conduct the operation at a lower cost. In some cases it may be attractive to negotiate a turn-key arrangement whereby that non-operator conducts the operation However it is not feasible to include such a provision in the Operating Procedure because of the degree to which the decision to negotiate such a mechanism would depend on such factors as the timing of the operation and the perception of the non operator s financial viability and technical expertise

ii) An AFE will be void unless it is approved by all of the parties within 45 days of its submission to the joint operators This ensures a party that it is not bound by an AFE for a prolonged period while waiting for other non operators to respond to the AFE

iii) The operator shall advise the parties of the status of the AFE as soon as the position of the parties is clear

Subclause 701(b) Assuming that all of the parties approve the AFE a sunset provision is required to ensure that the parties are not bound indefinitely by the AFE This Subclause provides that the AFE is void if the operation is not commenced within the later of 120 days following the issuance of the AFE or 45 days following the estimated date of commencement specified therein subject to the qualification that the operation must be commenced within 180 days of the issuance of the AFE in any event

While the vast majority of operations will be commenced within 120 days of the issuance of the AFE the reference to the anticipated date of commencement is useful when a well is being drilled in a winter access only area environmental approvals are required (i e sour gas wells) or the operation is the construction or installation of a production facility

605 PAYMENT OF LESSOR S ROYALTY -- Each party shall pay or cause to be paid the Lessor s royalty and all other payments required pursuant to the title documents which are attributable to its proportionate share of the production of petroleum substances hereunder However the party disposing of a non-taking party s share of production pursuant to Clause 602 or 603 may pay the royalty attributable to that share of petroleum substances directly to the Lessor on behalf of the non taking party in which case the amount so paid shall be deducted from amounts owing to the non taking party pursuant to Clause 606

606 DISTRIBUTION OF PROCEEDS -- Subject to the foregoing provisions of this Article a party that disposes of another party s share of production pursuant to Clause 602 or 603 shall forthwith pay the proceeds of such sale less all direct processing and transportation expenses pertaining to such production (if known at such time) and any applicable marketing fee prescribed by Clause 604 to the party on whose behalf such production was sold and shall include with such payment a statement showing the manner in which the amount was calculated If the disposing party does not pay such amount within ten (10) days following its receipt or if not previously deducted from the proceeds of such sale hereunder the non taking party does not pay the direct processing and transportation expenses applicable to such production within thirty (30) days of being invoiced therefor by the disposing party the provisions of Subclause 505(b) shall apply mutatis mutandis between the non taking party and the disposing party with respect to such outstanding amounts Proceeds of sale of a party s share of production pursuant to Clause 602 or 603 and the applicable marketing fee prescribed by Clause 604 shall be determined by reference to the volume of production taken by each party in a month

607 AUDIT BY NON TAKING PARTY -- To the extent only that a party sells all or a portion of the share of production of a party which does not take in kind and separately dispose of the same hereunder the audit provisions of the Accounting Procedure shall apply mutatis mutandis with respect to such sale between the party who sold such production and the party on whose behalf such production was sold provided that the party who sold such production shall not be required to provide the auditors with access to any contract described in paragraph 602(a)(i)

608 DISPOSING PARTY TO BE INDEMNIFIED -- In the event a party does not take in kind and separately dispose of its share of production and another party disposes of such production on behalf of the non taking party pursuant to this Article the non taking party shall indemnify the disposing party with respect to any injury loss or damage which the disposing party may suffer with respect to such sale by virtue of defects in the non taking party s title to such production

## ARTICLE VII

## OPERATOR'S DUTIES RE CONDUCTING JOINT OPERATIONS

701 PRE COMMENCEMENT REQUIREMENTS -- If the Operator proposes to conduct a joint operation the following conditions shall apply

(a) The Operator shall submit an Authority for Expenditure for such operation to each Joint Operator for its approval if required by Clause 301 Such Authority for Expenditure shall be void unless it has been approved by all of the Joint Operators within forty five (45) days of being submitted to them by the Operator The Operator shall promptly advise the Joint Operators whether such Authority for Expenditure has been approved by all of the Joint Operators

(b) An Authority for Expenditure which was approved by the parties shall be void if the operation to which it relates is not commenced within the later of one hundred and twenty (120) days following the date the Authority for Expenditure was submitted to the other parties by the Operator or forty five (45) days following the anticipated date of commencement specified therein with respect to such operation as the case may be provided that in no event shall such operation be commenced later than one hundred and eighty (180) days following the submission of such Authority for Expenditure to the parties by the Operator

(c) Submission or approval of an Authority for Expenditure shall not preclude any party from giving an operation notice under Clause 1002 with respect to the operation proposed in the AFE However approval of the Authority for Expenditure by all parties before expiration of the response period provided in Clause 1002 with respect to that operation notice shall nullify such operation notice

(d) If the operation is the drilling of a well for the joint account the Operator shall submit to each Joint Operator at least forty eight (48) hours prior to the commencement of the well

(i) written notice of intention to spud such well

Paragraph 701(d)(iii) The operator s proposed program should be provided to the non-operators at the earliest opportunity so that the parties would have an adequate opportunity to resolve any differences they may have with respect to the program

While it would be preferable to require an operator to forward the proposed program with the AFE (or at least a week before commencement) industry experience indicates that operators would be unlikely to comply with the obligation unless specifically requested to do so by the non operators

Notwithstanding the fact that the program is generally provided to the non-operators close to the time the well is spudded most objections would tend to be with respect to the proposed logging and coring program such that there is usually an adequate opportunity to resolve any differences without disruption to the operation While these objections tend to be resolved fairly easily in practice there is admittedly a problem if the parties are unable to negotiate an acceptable arrangement after the commencement of the well

However there may be circumstances in which the drilling program may address major issues which are fundamental to the operation (i e special treatment of formations) In such circumstances it is the better practice to discuss those issues before the approval of the AFE

This treatment of the proposed program differs significantly from that prescribed by Clause 902 with respect to the completion program because of the increased probability that there would be differences of opinion on major components of the completion program

Clause 704 Remember that the completion approval is obtained pursuant to Article IX or Clause 1002 (re-entry and completion under Clause 1008)

(ii) a copy of the plan of each well location survey the application for the well licence and when available a copy of the well licence and

(iii) a copy of the proposed program of drilling coring logging testing and casing the well and subject to Article IX a Joint-Operator shall be deemed to have approved the program unless it notifies the Operator to the contrary within seven (7) days of receipt of such program

702 DRILLING INFORMATION AND PRIVILEGES OF JOINT-OPERATORS – During the drilling of a well for the joint account the Operator shall provide to each Joint Operator

(a) immediate notice of the spud date of the well

(b) the surface elevation of the well

(c) daily drilling and geological reports

(d) access to the Operator s set of samples of the cuttings of formations penetrated and a complete sample description or if specifically requested by a Joint-Operator a complete set of samples of the cuttings of the formations penetrated for its own retention

(e) access to all cores taken and copies of any core analysis conducted for the joint account

(f) immediate advice of any porous zones with showings of petroleum substances encountered and the proposed tests if any to be run on those porous zones

(g) a reasonable opportunity for each Joint Operator to have a representative present to witness and observe any tests conducted pursuant to Subclause (f) of this Clause

(h) access to each well including derrick floor privileges as set forth in Clause 307 and

(i) estimates of current and cumulative costs incurred for the joint account

703 LOGGING AND TESTING INFORMATION TO JOINT OPERATORS – Upon a well being drilled for the joint account reaching total depth (or during the drilling of the well if any such operations are to be conducted prior to the well reaching its projected total depth) the Operator shall

(a) test it in accordance with the approved program

(b) make such further tests as are warranted in the circumstances of any porous zones with showings of petroleum substances encountered or indicated by any survey and provide each Joint Operator with a reasonable opportunity to have a representative present to witness and observe any such tests

(c) take representative mud samples and drillstem test fluid samples in order to obtain accurate resistivity mud filtrate and formation water readings and supply each Joint Operator with the information pertaining thereto in a timely manner

(d) supply each Joint Operator in a timely manner with copies of the drillstem test and service report on each drillstem test run including copies of pressure charts and

(e) run all log surveys agreed upon among the Joint Operators supply each Joint Operator in a timely manner with copies of each log so run and provide each Joint Operator with a reasonable opportunity to have a representative present to witness and observe any such surveys

704 WELL COMPLETION AND PRODUCTION INFORMATION TO JOINT OPERATORS – During any completion operation conducted for the joint account the Operator shall

(a) complete the well in accordance with the approved program and supply each Joint Operator with current reports on all completion activities which without restricting the generality of the foregoing shall include

(i) a summary of the casing program

(ii) the location and density of perforations

(iii) details of formation treatment and stimulation

Clause 706 The operator shall supply all prescribed data in accordance with established industry standards If a party requires data in an unusual format the operator might determine that it is prepared to accommodate the request only if that party agrees to reimburse the operator for the additional expense it would incur as a result

Clause 707 This is an enabling provision A party may conduct additional testing programs in a well at its sole cost risk and expense provided hole conditions are in the operator s opinion satisfactory Remember that the liability and indemnification provisions of Clause 1017 apply to a testing program conducted pursuant to this Clause

Clause 708 The previous provisions pertain to wells drilled for the joint account. If an operation is not conducted for the joint account the provisions of this Article shall apply mutatis mutandis to the participating parties

Clause 801 i) Provisions such as this Clause are often used in farmout agreements and many parties will continue to address the issue in the head agreement This Clause is included in the Operating Procedure because of the possibility that the parties may forget to address the issue in the head agreement.

ii) The Clause states that a party which has an encumbered interest shall free the interest from that burden when the interest is surrendered forfeited or subject to a production penalty If it fails to free the interest from that burden it shall indemnify the parties for any resultant losses they may suffer

The only way that it can free the interest from the burden of course is to structure the contract creating the encumbrance in a manner which enables it to do this It is imperative therefore that a company which encumbers its interest attempts to structure its arrangement so that it does not have an adverse impact on its co-venturers in the event they subsequently acquire the interest through the application of the surrender or penalty provisions of the document

Clause 802 i) The purpose of this Clause is not to encourage the creation or recognition of encumbrances It is to distinguish between encumbrances which the parties believe warrant special treatment under the Operating Procedure and those which they believe do not Remember that encumbrances which are not created in the agreement only fall within the scope of Clause 802 if the parties voluntarily agree to provide them with the special status in the agreement Many parties will not wish to become involved in a contract which does not apply to its interest. Those parties therefore will presumably be extremely reluctant to accept any special treatment for encumbrances which are not created in the agreement

ii) Encumbrances which are not borne for the joint account may be created under the provisions of the head agreement such as a farmor s ORR or may be acknowledged as being legitimate therein If an encumbrance not borne for the joint account

(iv) results of back pressure tests

(v) daily completion reports and

(vi) estimates of current and cumulative costs incurred for the joint account and

(b) promptly provide each Joint Operator with all relevant information pertaining to any formation tests and production tests conducted on the well and daily advice as to the nature rate and amount of petroleum substances and other fluids produced from the well

705 WELL INFORMATION SUBSEQUENT TO COMPLETION – Subsequent to the completion of any well completed for the joint account the Operator shall supply to each Joint Operator

(a) copies of any directional temperature caliper or other well surveys conducted for the joint account

(b) copies of any petroleum natural gas water or other substance analyses made with respect to the well provided that if the Operator does not make analyses of water and petroleum substances representative samples of water and petroleum substances (other than natural gas) recovered from each test shall be supplied

(c) a complete summary of the drilling and completion of the well

(d) written notice of the commencement of production of any of the petroleum substances from the well and

(e) initial production rates and the nature kind and quality of petroleum substances and any other substances produced from the well

706 DATA SUPPLIED IN ACCORDANCE WITH ESTABLISHED STANDARDS – The Operator shall supply all data to be provided to the Joint Operators hereunder in accordance with established industry standards

707 ADDITIONAL TESTING BY LESS THAN ALL JOINT OPERATORS – After giving written notice to each of the other Joint Operators of its intention to do so any Joint Operator may at its sole risk and expense (including rig costs) conduct such other or additional tests of its choosing in a well to which it is entitled to have access hereunder unless the Operator advises such Joint Operator that, in the Operator s opinion the hole is not in satisfactory condition for that purpose Subject always to Article IX and Clauses 1017 and 1801 the Joint Operator so conducting any such tests shall retain all rights thereto and shall not be required to make the results thereof available to any other Joint Operator pursuant to this Operating Procedure

708 APPLICATION OF ARTICLE VII WHEN OPERATION CONDUCTED BY LESS THAN ALL PARTIES – If an operation hereunder is not conducted for the joint account, the provisions of this Article VII shall apply mutatis mutandis among those parties participating therein

## ARTICLE VIII

## ENCUMBRANCES

801 RESPONSIBILITY FOR ADDITIONAL ENCUMBRANCES – If the working interest of a party is or becomes encumbered by any royalty overriding royalty production payment or other charge of a similar nature other than the royalties payable to the grantor of the title documents and any charge to be borne for the joint account pursuant to either the Agreement or the agreement of the parties such party shall be solely responsible for such additional encumbrance In the event of any surrender forfeiture or production penalty provided for in this Operating Procedure such surrendered forfeited or affected interest shall be freed of any such additional encumbrance caused suffered or created by or through such party (or its predecessor in interest) at the sole cost and expense of such party and such party shall indemnify the other parties for any losses they may suffer as a result of the failure of such party to fulfill the obligation to remove such additional encumbrance

802 EXCEPTION TO CLAUSE 801 – Notwithstanding the preceding Clause (but subject to the provisions of the Agreement) the obligation to remove an additional encumbrance and to indemnify the other parties with respect thereto shall not apply insofar as such additional encumbrance is created pursuant to the provisions of the Agreement or is specifically acknowledged therein to be a charge applicable to a party s working interest which shall continue to apply to such working interest following the application of the surrender forfeiture or production penalty provisions hereof to such working interest

is one which the parties agree should attach to the interest, that encumbrance should be an exception to the general rule in Clause 801 See also Subclause 1007(b)

iii) The user should check the head agreement in all cases to see whether there was any special treatment of the encumbrance Although an encumbrance may be created pursuant to the head agreement, it is important to remember that the head agreement may include special provisions overriding this Clause

iv) An exception against non-arm s length encumbrances has not been included The parties would most reluctantly agree to accept a non arm s length encumbrance which would run with the interest under Clause 802 However the inclusion of a specific exception for non arm s length encumbrances could operate to extinguish a legitimate encumbrance which is subsequently purchased by a joint-operator

Clause 901 The testing program described in the initial AFE is really only the operator s predicted testing program in the event that certain assumptions are accurate The inconvenience of consultation with the non-operators does not outweigh the right of the non-operators to determine the appropriate evaluation of their interests

Subclause 902(a) The operator shall promptly supply the non-operators with the logging and testing data required by them to determine whether they wish to attempt to complete the well

Subclause 902(b) i) Each non-operator shall elect whether to participate in the completion attempt within 24 hours after the receipt of the pertinent data and program information

ii) A party which elects to participate in the completion attempt shall be deemed to have approved the operator s proposed program unless it otherwise advises the parties in the election period

If the operator proposes to alter its proposed program materially as a result of such an objection all of the parties may re elect whether to participate in the operation since the operation differs materially from that to which the election pertained The operator would likely convene a meeting of the parties if there were a significant difference of opinion among the parties to attempt to resolve the issue

iii) A party may elect only to participate in the setting of production casing and the suspension of the well (Remember that this is a limitation on the operation and not a monetary limit.) If one or more of the other parties proceed to conduct the completion attempt at that time a penalty prescribed by Alternate 903A with respect to that party would be based only on that portion of the costs not assumed by it.

Subclause 902(c) Clause 304 requires the operator to conduct operations diligently Suppose that the operator obtains approval for a completion attempt and proceeds only to set production casing with the intention of conducting the remainder of the operation at an indefinite date To what degree can the operator rely on the original approvals of the parties to participate in the operation?

In some instances Clause 304 may allow the parties to claim that the operator is required to obtain additional approvals particularly if the AFE included a statement as to the intended completion date and there was no reasonable technical justification for the delay

If the operator had stated in the AFE that the completion attempt was to be conducted within a specified period following the setting of production casing the non-operators might also attempt to argue that a material deviation from that representation voided their approval of that portion of the AFE (See the reference to the Axford case in the notes on 101(e) )

It is not appropriate to include an arbitrary termination mechanism however because of the multitude of potential fact situations

Subclause 902(d) The operator s proposed program may be the setting of production casing and the suspension of the well so that the well may be re-entered at some later date for the conduct of an unspecified completion program Approval of that program by the parties does not empower the operator to re-enter the well at a later date to attempt to complete the well for the account of those parties without obtaining additional approvals pursuant to Article X (See Clause 1008 )

Clause 903 A non participating party is subject to a production penalty under A and a forfeiture under B The magnitude of the production penalty under A will depend on the classification of the zone(s) as being in a development well or an exploratory well

## ARTICLE IX

## CASING POINT ELECTION

901 AGREEMENT TO DRILL NOT AUTHORITY TO COMPLETE – Agreement by the parties to drill or deepen a well for the joint account shall not be deemed to include agreement by any Joint Operator to participate in the setting of production casing the attempted completion of the well or any completion program set forth in the Authority for Expenditure submitted pursuant to Subclause 701(a)

902 ELECTION BY JOINT OPERATORS RE CASING AND COMPLETION –

(a) The Operator shall immediately notify the Joint Operators when a well being drilled for the joint account has been drilled to the authorized total depth and the logs and tests conducted pursuant to Article VII have been run The Operator shall also notify the Joint Operators at such time of the Operator s proposed program for completing the well and forthwith provide an AFE therefor

(b) Subject to Subclause 1002(c) each Joint Operator shall have a period of twenty four (24) hours after both the logs and results of the tests in which it participated and the Operator s proposed completion program respecting the well have been made available to it, to inform the Operator whether it wishes to participate in the setting of production casing and a completion attempt Failure to reply to the notice from the Operator within such period shall be deemed to be an election by a party to participate in such completion attempt If a party which elects to participate in the completion attempt fails to object to the Operator s proposed completion program by notice to the Joint Operators within such period that party shall be deemed to concur with that program If the Operator proposes to alter the proposed completion program materially as a result of a party s objection to the Operator s proposed program the Operator shall immediately notify all parties and each party shall have the right for twelve (12) hours following the receipt of such notice to re-elect to participate in such completion attempt Notwithstanding the foregoing portion of this Subclause if Alternate 903A applies and a party s objection to the Operator s proposed completion program is that such party wishes to limit its participation in such operation to the setting of production casing and the suspension of the well that party may so limit its participation in such operation In such event the cost recovery prescribed by Alternate 903A with respect to such party s limited participation shall apply only to that portion of the costs of such completion attempt not assumed by such party if one or more of the other parties proceed to conduct such completion attempt at such time

(c) If one or more Joint Operators elect to participate in the completion attempt the participating parties shall proceed to run production casing and attempt to complete the well for the taking of petroleum substances If none of the Joint Operators elect to participate in the completion attempt the Operator shall abandon the well

(d) Notwithstanding the foregoing Subclauses of this Clause and Clause 903 in the event the Operator s proposed program pursuant to this Clause is the setting of production casing in the well and the suspension of the well so that the well may be re-entered at some unspecified later date for the conduct of an unspecified completion program the approval of a Joint Operator to participate in such program shall not constitute the approval of that Joint Operator to participate in the attempted completion of such well at such time as it may be conducted and Clause 1008 shall apply to such subsequent re-entry and completion attempt

903 LESS THAN ALL PARTIES PARTICIPATE – If one or more but not all of the parties elect to set production casing and attempt to complete the well and the well is completed for the taking of petroleum substances in paying quantities ALTERNATE _____ below (Specify A or B) shall apply namely

ALTERNATE A

The setting of production casing and the completion attempt shall be considered an independent operation under the provisions of Article X (including the provisions of Clause 1009 if the well is abandoned before the penalty in Clause 1007 is recovered) as if the independent operation were with respect to a development well or an exploratory well as the case may be provided that the drilling costs of the well shall not be considered when calculating the amount recoverable pursuant to paragraph 1007(a)(iv)

OR

Clause 904 If the well is abandoned within six months of the casing point election the well would be abandoned for the joint account of the parties which had participated in the drilling of the well subject to qualifications respecting additional costs resulting from the completion attempt and the application of the proceeds from salvagable material to the penalty account

If the well is subsequently abandoned prior to the recovery of the penalty it shall be abandoned for the account of the parties which participated in the setting of production casing/completion If it is abandoned after the recovery of the penalty it shall be abandoned by the parties having interests in the well at that time

Clause 905 A completion attempt by less than all of the parties is really just a special type of independent operation Without this Clause users might not remember that the principles in such provisions as 1013 1017 1018 and 1019 apply to Article IX

Article X General The paramount policy goal of any operating procedure is to encourage the joint evaluation of the lands subject thereto

Despite the inherent desirability of that goal it is important to place it in practical perspective The exploratory strategies of the joint operators will often differ with respect to the nature or timing of an exploration program In practice those differences will usually be resolved through negotiation However there will be instances in which a compromise cannot be negotiated An operating procedure therefore must include some mechanism for the resolution of these differences an independent operations provision

The fact that the exploratory strategies of the joint operators may differ is not inconsistent with the underlying policy goal of encouraging joint operations The independent operations provision of a document, therefore should not include penalties for non-participation which are chosen so that an independent operation will not be a practical alternative Rather one must be resigned to the fact that the joint operators will probably have different exploratory philosophies from time to time and structure the agreement accordingly to neither encourage nor discourage an independent operation where those differences cannot be resolved through negotiation

Subclause 1002(a) i) Although a party may issue an operation notice without prior advice to its co-venturers it is expected that a proposing party would generally discuss the intention to issue the notice prior to the issuance of the notice

This practice has three major direct benefits Firstly it encourages an interchange of ideas among the interest holders which would likely be attractive unless a party is pursuing its individual agenda with respect to a regional play Secondly it enables the proposing party to gauge the degree of support for the operation prior to the issuance of the notice and the allocation of its resources to the operation Thirdly it provides the other parties with additional time to obtain funding or a farmee

ii) The operation notice should include all information which would reasonably be expected to be material to a party s decision to participate in the operation Remember that the proposed location of a well must be specified in detail (See 101(e) )

iii) Note that the proposing party is required to state the application of Clause 1010 in the notice Some operation notices simply refer to a well as being a development well or an exploratory well even though the applicable penalty is actually found in Clause 1010 That practice could be misleading

ALTERNATE B

Each party not participating in the setting of production casing and the completion attempt shall assign to the parties that paid such non participating party s share of such costs all of the assignor s interest in the spacing unit of the well insofar only as it relates to the zone in which the well is so completed subject to Clause 1015 The assignees shall forthwith pay to the assignors the latter s share of the estimated salvage value of the material and equipment placed in or on the well prior to commencement of the completion attempt.

904 ABANDONMENT OF WELL – If one or more but not all of the parties elect to set production casing and attempt to complete the well pursuant to Clause 903 and the participating parties in such completion attempt then propose to abandon the well within six (6) months of the expiry of the twenty four (24) hour period provided in Clause 902 they shall so notify the non participating parties Such abandonment shall be for the joint account, except that

(a) the participating parties in the completion attempt shall bear all extra costs of the abandonment incurred by reason of the completion attempt and

(b) income received by the participating parties from the sale of petroleum substances produced from the well within such six (6) month period and any amounts received from the sale of salvable material and equipment shall firstly be applied to abate costs incurred by those parties in the completion attempt, and the excess if any shall be a credit for the joint account.

If the well is not abandoned within such six (6) month period the participating parties in the setting of production casing and if applicable the completion attempt shall be solely responsible for the costs of abandoning the well subject if applicable to the reacquisition of participation in the well by a non participating party pursuant to Clause 1007 or 1008 as the case may be

905 PROVISIONS OF ARTICLE X TO APPLY – The provisions of Article X shall apply mutatis mutandis to operations conducted pursuant to this Article by one or more but not all of the parties except to the extent that those provisions would conflict with those contained in this Article IX

## ARTICLE X

## INDEPENDENT OPERATIONS

1001 DEFINITIONS – In this Article the following words and phrases shall have the following respective meanings namely

(a) independent operation means an operation to be conducted hereunder by less than all of the parties

(b) non participating party means a party which does not participate in an independent operation

(c) operation notice means a notice of intention to conduct an independent operation

(d) participating party means a party which participates in an independent operation

(e) proposing party means the party or parties which issue an operation notice

(f) receiving party means a party which receives an operation notice

1002 PROPOSAL OF INDEPENDENT OPERATION –

(a) The parties normally shall consult with respect to decisions to be made for the exploration development and operation of the joint lands Whether or not such consultation has occurred or has been requested a party may at any time become a proposing party and give to the other parties an operation notice for an operation on or with respect to the joint lands or the construction or installation of a production facility including therein or therewith

(i) the nature of the operation

(ii) the proposed location of the operation

(iii) the anticipated time of commencement and estimated duration of the operation

iv) Clause 301 does not require a response to an AFE within any specific time That being the case it is the better practice for an operator to propose a joint operation in the context of an operation notice where time is of the essence

Subclause 1002(b) i) Although a receiving party s election is effective if made solely to the proposing party it is the better practice to send a copy of the notice to the other receiving parties

ii) The general reply period to an operation notice is within 30 days of its receipt, but there are two exceptions to that general rule

Firstly the response period is reduced to 15 days if the operation notice pertains to a well and it states that lands within 1 6 kilometres of the proposed well are to be offered for sale by the Crown within 60 days of the receipt of the notice

Secondly the response period will only be 48 hours if the proposed operation is a deepening plugging back whipstocking re-entry and completion recompletion or reworking and the rig to be used in that operation is then at the location of that operation This special election reflects the view that time is of the essence when a party determines that it wishes to propose such an operation while the rig is on location It is not intended to allow a party to determine that it wishes to conduct the operation to move the rig to the location at its leisure and then to issue the 48 hour notice to its surprised co-venturers It would have been possible to eliminate this possibility by providing that the ng would be deemed not to be on location for this purpose if it had been moved there solely to conduct the operation However this would ignore the likelihood that the proposing party decides to conduct the operation when a rig near the well location becomes available on short notice

iii) There are two alternative views on the responsibility for costs incurred during the 48 hour election period The first is that standby costs incurred during that period are for the joint account, since the receiving parties should buy the time to make their decision The alternative position which is included in the provision is that the proposing party and the participants (if any) are responsible for all costs and expenses incurred as a consequence of the issuance of the operation notice The latter provides the proposing party with the incentive to advise the other parties of its plans promptly

Subclause 1002(c) i) Assume that the working interests in the joint lands are A1% B24% C25% and D50% B issues an operation notice respecting an exploratory well and A is willing to participate for a 2% interest

Under the traditional provision (such as former Clause 1015) A is required to participate either to the extent of its working interest (1%) or to the extent of all available interest (4% if C and D elect not to participate) This Subclause provides much greater flexibility since a party may elect to participate for its working interest, its proportionate share of all available interest or its proportionate share of all available interest with a limit on the maximum percentage of participating interest

If even one party elects to assume its proportionate share of available costs the interests will be fully subscribed If there is an unassumed percentage of participation after the process the participating parties shall attempt to allocate the unassumed interest within a prescribed time or the notice shall be void

ii) Assuming that the interests are fully subscribed what are the respective legal rights of the parties if the proposing party unilaterally determines that it no longer wishes to conduct the operation? If the proposing party can enforce the election of a receiving party to participate in the operation the receiving parties may have legal recourse if the proposing party did not proceed to conduct the operation unless the consent of the other participating parties were obtained or the force majeure provisions were applicable A proposing party should consider this risk carefully before issuing an operation notice respecting a well which it is not confident it will drill

Subclause 1002(e) i) While a party may be a proposing party with respect to an unlimited number of operation notices at any particular time suitable protection has been included for the receiving parties

Firstly an operation notice may not be with respect to more than one well This assures the parties that they will not be requested to commit to a long term exploratory strategy or an all or nothing package

Secondly the receiving parties are not required to respond to a proposing party s operation notice respecting a well unless and until each other operation notice served by that proposing party hereunder with respect to a well within 3 2 kilometres of the proposed well (a) has expired (b) has been withdrawn or (c) is no longer in effect because the operation has been conducted If (c) applies a receiving party may also delay its response until it receives any well information to which it is entitled under Clauses 1018 and 1019 basically well information respecting all wells on the joint lands where Clause 1010 does not apply

ii) The mechanism whereby a receiving party may delay its response respecting additional operation notices has limited application where a different party is the proposing party with respect to the second operation notice If for example A B and C are the joint operators with respect to a three section block and A and B each issue an operation notice for a well on the lands the notices are processed independently subject to Clauses 1018 and 1019 because each party as an owner has an equal right to propose its own independent exploration program

Unfortunately one cannot differentiate in the document between cases in which joint operators are genuinely proposing independent programs and those in which they may agree on a common course of action and use different proposing parties solely to alter the rights of the passive party The latter course may be tempting where the more aggressive explorers believe it is inappropriate for the passive party to elect to participate in the second well after having evaluated the results of

(iv) the classification if applicable of the operation as a development well or exploratory well and the application of Clause 1010 thereto if any and

(v) an Authority for Expenditure provided that an Authority for Expenditure otherwise submitted hereunder shall not in itself be construed as an operation notice unless it is specifically part of an operation notice served pursuant to this Article X

(b) A receiving party shall be deemed to have elected not to participate in the operation proposed in an operation notice unless within thirty (30) days after receipt of such operation notice that receiving party has given notice to the proposing party that it elects to participate in the operation However if the operation notice states that the operation is to be conducted for the purpose of evaluating lands specified therein which either have been offered for public tender by a governmental authority or which it is known will be so offered within sixty (60) days after receipt of the operation notice such thirty (30) day period shall be reduced to fifteen (15) days provided that no operation shall be considered as being conducted for such evaluation if none of the lands proposed to be evaluated are within 1 6 kilometres of the location of the proposed well Notwithstanding the foregoing portion of this Subclause if the operation notice pertains to a proposed deepening plugging back whipstocking re-entry and completion of a suspended well recompletion or reworking pursuant to Clause 1008 the drilling or service rig to be used in such operation is then at the location thereof and the operation notice states that such rig is so located such thirty (30) or fifteen (15) day response penod shall be reduced to forty eight (48) hours during which period all incremental expenses accruing as a consequence of the issuance of such operation notice including without restricting the generality of the foregoing standby time shall be for the account of the proposing party and if conducted the other participating parties

(c) The participating parties shall have the right to participate in the independent operation in the proportions that their respective working interests bear one to the other and a participating party which does not elect to limit its participation in such operation shall be deemed to have elected to participate to the extent of its working interest increased by its proportionate share of the unassumed percentage of participation respecting such operation A proposing party in the operation notice and a receiving party in its response thereto may elect to participate in the independent operation only to the extent of its working interest or only to the extent of its working interest increased by its proportionate share of the unassumed percentage of participation respecting such operation with a limitation as to the maximum amount of such increased participation such party is prepared to accept If there remains an unassumed percentage of participation respecting such operation following those elections the proposing party shall be deemed to have withdrawn the operation notice unless the participating parties otherwise agree to assume such unassumed percentage of participation within five (5) days of the completion of such process if the response period applicable to the operation notice is greater than forty eight (48) hours and within twelve (12) hours of the completion of such process if the response period applicable to the operation notice is forty eight (48) hours or less

(d) Once the applicable response period prescribed by Subclause (b) above has expired or upon receipt of the responses of all of the receiving parties to the operation notice whichever first occurs the proposing party shall forthwith give notice to the parties specifying how the costs risks and benefits of the operation will be shared hereunder

(e) A party may become a proposing party with respect to more than one operation at any given time and may serve as many operation notices as it so wishes and proceed to conduct operations pursuant thereto However no single operation notice shall relate to more than one well and the receiving parties shall not be required to respond to an operation notice pertaining to a well unless and until each operation notice previously served by that proposing party respecting a well located within 3 2 kilometres of the proposed well has expired been withdrawn or the operation proposed thereunder has been completed and the information therefrom has been provided to the receiving parties to the extent required by Clauses 1018 and 1019 If a party serves more than one (1) operation notice at one time it shall subject to the foregoing provisions of this Subclause state the order in which the operation notices are deemed to be received by the receiving parties provided that if it fails to specify the order the operation notices shall be deemed to be received in accordance with Clause 2201

1003 TIME FOR COMMENCING THE OPERATION – The proposing party may begin the operation without waiting for the applicable response period prescribed by Clause 1002 to lapse provided that the proposing party shall not be obligated to supply any information with respect thereto to a receiving party until such time as it elects to participate in such operation However the proposing party shall not commence the operation more than ninety (90) days after the operation notice is deemed to be received by the receiving parties unless the operation is the construction or installation of a production facility in which case the operation shall not be commenced more than one hundred and fifty (150) days following such receipt In the event the operation is not commenced within the applicable period such operation notice thereupon shall be void unless and to the extent that the receiving parties consent to the delay of the commencement of the operation If the operation notice lapses in such manner the proposing party may serve a new operation notice for the operation within or after the expiration of such period

the first well However it is important to recall that the parties had agreed at the time they accepted the Operating Procedure that the only penalty attributable to an independent well is a production penalty in the spacing unit thereof subject to 903B and 1010

Clause 1003 The longer period has been included with respect to production facilities because of the logistical difficulties in obtaining approvals designing the facility ordering materials and commencing construction

Clause 1004 i) The traditionally accepted Clause provided that the operator would conduct the operation if it elected to participate in the operation However the operator may have planned to allocate its personnel to other projects Moreover the operator may not be able to conduct the operation under the timing and cost constraints proposed in the notice

To ensure that a proposing party remains accountable with respect to operations it proposes the Clause has been structured so that the proposing party would conduct the operation unless the parties otherwise agree or that party would be disqualified by Subclause 202(a) If the operator is a participating party but not the proposing party it will succeed the proposing party as operator upon the completion of the operation or that particular phase thereof as the proposing party and the operator may agree

Remember that the non-operators may not want the operator to conduct the operation anyway if they have confidence that the proposing party can conduct the operation properly for the cost set forth in the AFE and they doubt that the operator could conduct the operation for the same cost. That being the case the provision was not structured to provide the operator with the option to conduct the operation

Notwithstanding the general provision there will likely be instances in which the operator would probably conduct the operation If there were safety or other technical concerns respecting the proposing party s ability to conduct the operation (i e sour gas well) the other parties would attempt to negotiate an alternative arrangement. Similarly if the rig is on location the operation is the setting of casing or the deepening of a well and the operator is not prepared to participate it is probable that the participants would want the operator to conduct the operation on their behalf because of the desire for technical continuity and the difficulty in transferring contracts However this mechanism is not included in the document because of the need to address the issue in the context of the particular fact situation

ii) Remember that the proposing party is the operator by virtue of this Clause Subclause 101(a) and Clause 1014 It will have all of the rights and obligations of the operator if the operation is conducted for the joint account or as an independent operation

Subclause 1005(a) i) A well may be in part a development well and in part an exploratory well In such circumstances it is generally accepted that a party should be able to limit its participation in the well to that portion which is a development well A suggestion might be made that the mechanism should be extended to allow a party to limit its participation in an exploratory well to the V formation when the well is intended to evaluate the Z formation The practical implications of such an extension however are worrisome Moreover the suggestion ignores the rationale for the inclusion of the separate status election mechanism that it would be unfair to deny a party the right to participate in the exploitation/evaluation of a discovery because it was not prepared to participate in unrelated exploratory drilling

ii) Note the reference to specialized equipment or casing If for example special equipment or casing is required because of the possibility that sour gas might be encountered in the exploratory portion of the well those costs would have no bearing to the development portion of the well

Subclause 1005(c) i) Suppose that paragraph (ii) applies and that the drilling and completion costs of the well were borne as follows

| | Development Portion ($300 M) | Exploratory Portion ($300 M) |
|---|---|---|
| A | 50% ($150 M) | 100% ($300 M) |
| B | 50% ($150 M) | (0) |

As regards only A and B i) the $300 M reimbursement to A and B (actual $150 M cash to B) is treated as an operating cost in paragraph 1007(a)(ii) such that A would be entitled to recover B s share of that amount from B s share of production without a penalty applicable thereto under paragraph 1007(a)(iv) and

ii) the cost base under Clause 1007(a)(iv) to B for not participating in the exploratory portion of the well excludes the cost of the development well a $300 M reduction

Since C was a non participating party with respect to the entire well C s penalty would continue to be based on the development and exploratory penalties applicable to the respective portions of the well such that the adjustment has no impact on C

ii) Remember that there is nothing to prevent a party from drilling a twin well to exploit the development" zone during the period the penalty is being recovered with respect to the exploratory spacing unit

1004 OPERATOR FOR INDEPENDENT OPERATIONS – Notwithstanding anything to the contrary contained in this Operating Procedure the proposing party shall be the Operator with respect to any operation proposed as an independent operation unless the parties otherwise agree or the proposing party would be disqualified from serving as Operator pursuant to Subclause 202(a) If the Operator is a participating party but not the proposing party with respect to a well proposed as an independent operation the Operator shall succeed the proposing party as Operator with respect to such operation at the completion of such operation or if agreed by the proposing party and the Operator at the completion of a particular phase of the operation

1005 SEPARATE ELECTION WHERE WELL STATUS DIVIDED –

(a) If the proposed independent operation is the drilling of a well which would be in part a development well and in part an exploratory well the proposing party shall identify the respective portions of the well in the operation notice The proposing party shall also estimate the costs separately for each portion of the well in the operation notice For the purposes of such allocation of costs the costs of the development well shall only be those costs which would be anticipated to be incurred if the well were being drilled and if applicable completed as a development well only and all additional costs anticipated to be incurred as a consequence of the well also being drilled as an exploratory well (including without restricting the generality of the foregoing the utilization of any special equipment or casing to enable the well to be drilled to such depth) shall be allocated to that portion of the well which will be an exploratory well

(b) Each receiving party electing to participate in a well described in the preceding Subclause shall elect to participate to the extent only that it is a development well or to the extent that it is both a development well and an exploratory well However a party which elects to participate in such well without specifying the extent of its participation shall be deemed to have elected to participate in the entire well

(c) If the participation in the well varies between the well as a development well and the well as an exploratory well the following shall apply

(i) If the well is capable of producing petroleum substances in paying quantities from at least one (1) zone in each of the development well and the exploratory well portions of the well and such petroleum substances can be produced simultaneously from all such zones through the well the Operator for the participating parties in the deepest producing zone shall operate the well It shall apportion the operating costs of the well to each zone on an equitable basis and deliver to the Operator for the participating parties in each productive zone the total share of production from such zone Each such Operator shall account for such production to the respective participating parties in accordance with Clause 1007 as if a separate operation had been conducted with respect to each producing zone

(ii) Notwithstanding anything to the contrary contained in paragraph (i) of this Subclause if the well is capable of producing petroleum substances in paying quantities from at least one (1) zone in each of the development well and the exploratory well portions of the well but such petroleum substances cannot be produced simultaneously from all such zones through the well the participating parties in the exploratory well portion of the well shall have the pre-emptive right to complete the exploratory well portion of the well However if those participating parties exercise such pre emptive right they shall promptly reimburse the participating parties in the development well portion of the well all costs incurred by them in drilling and if applicable completing the well as a development well Thereafter the well shall be deemed to be a single operation ab initio involving the drilling of an exploratory well only and conducted by the participating parties in the exploratory well portion of the well pursuant to this Article X However for the purposes of the application of Clause 1007 between the participating parties in the exploratory well portion of the well and the participating parties in the development well portion of the well the costs so reimbursed to the latter shall be deemed to be operating costs and included as a charge under paragraph 1007(a)(ii) and the amount prescribed by paragraph 1007(a)(iv) with respect to those parties shall exclude the costs of drilling and if applicable completing the well as a development well

1006 ABANDONMENT OF INDEPENDENT WELL – If an independent operation is the drilling of a well and the well is not capable of production of petroleum substances in paying quantities the participating parties shall abandon the well in a timely manner

1007 PENALTY WHERE INDEPENDENT WELL RESULTS IN PRODUCTION – If an independent operation proposed in an operation notice is the drilling of a well the following shall apply with respect thereto

(a) If such well is completed for the production of petroleum substances from one or more zones the

Clause 1006 This provision pertains to an initial abandonment. Clause 1009 applies to wells which are initially completed but abandoned before the recovery of the penalty

Clause 1007 i) Note the reference to the independent operation proposed in the operation notice and the penalty applicable to such well Suppose that the drilling program was not conducted in accordance with the independent operation notice Would the non-participating party be subject to a penalty?

Given that an operation may differ from that described in an operation notice in costs timing and location/depth and that the differences may be material or of little consequence the answer would depend on the type and degree of the deviation As a general rule immaterial differences in timing or costs should not affect the penalty because of their dependency on external factors Similarly a material difference in costs would probably not affect the penalty if the original cost estimate had been reasonable in the circumstances and the participating parties had no reason to revise the estimate prior to the commencement of the operation Where on the other hand the participating parties have (or should have) knowledge of developments which would materially alter the costs or timing of the independent operation the validity of the operation notice might be jeopardized if those changes might have influenced the non-participating parties to elect to participate in that operation Similar considerations apply to such technical factors as location and depth

If the operation is in essence a different operation from that proposed there is probably a duty on the participating parties at law to advise the non-participating parties of such a change promptly and to allow them the opportunity to re-elect to participate in the operation even if it has already been commenced The rationale for that position is simply that the parties should be in the same position as that in which they would have been had the operation been so proposed initially

This of course also raises an interesting question respecting the obligations of the proposing party to the other participating parties in the event the penalty was not effective

Note that this issue is also relevant to joint operations See for example Passburg Petroleums v San Antonio Explorations Ltd and D W Axford & Associates Ltd [1988] 2 W W R 645 (Alta Q B)

ii) Note the reference "which are paid in (a)(i) The participating parties are not entitled to charge phantom royalties during a royalty holiday

iii) Suppose that a well drilled pursuant to 1005 was not productive in the development well portion but was successfully completed in the exploratory well portion and that the drilling and completion costs of the well were borne as follows

| | Development Portion ($300 M) | Exploratory Portion ($300 M) |
|---|---|---|
| A | 50% ($150 M) | 100% ($300 M) |
| B | 50% ($150 M) | 0 |
| C | 0 | 0 |

Between A and C the cost base for (a)(iv) would be $600 M and between A and B it would be $300 000

iv) A non participating party would elect to obtain its interest in the well following the recovery of the penalty if it believed that the benefit of re-acquiring its share of production would be greater than the potential abandonment costs or accrued environmental liabilities

Subclause 1007(b) i) Remember that this Subclause only applies to those encumbrances which the parties agree flow with the interest in accordance with Clause 802 The Subclause will not apply to the typical Clause 801 encumbrance such that the issue will have to be resolved by the non participant and the encumbrance holder in all cases where Clause 802 does not apply

ii) Suppose that the Operating Procedure is attached to a farmout agreement under which A and B farmed out to C and D and that A has elected to be in a non convertible 15% ORR under the Agreement such that the interests are as follows A ORR (as calculated on 50% of production net 7 5%) B-25% C-37 5% (25% subject to A s ORR) and D-37 5% (25% subject to A s ORR) If B proposes a well C elects to participate for only its working interest and D elects not to participate what is the treatment of A s ORR under Clause 1007?

A s ORR was not an encumbrance borne for the joint account such that the previous provision clearly stated that it had no impact whatsoever This of course would be of concern to both A and D since D had an obligation to pay an ORR to A on the production applicable to the interest acquired from A by D

This result does not occur under 1007(b) with respect to encumbrances recognized under 802 Among the participating parties and the non participating party whose interest is encumbered by a Clause 802 burden the ORR will be taken into account under paragraph 1007(a)(i) by adding 150% of the amount so paid into the amount to be recovered thereunder This additional amount is designed to compensate the participating parties for the delay of penalty payout caused as a result of the inclusion of this amount

Subclause 1007(d) Any cash contribution received by the participating parties for the disclosure of well information pursuant to Clause 1802 shall be applied against the amount in (a)(iv) to reduce the penalty cost base

participating parties shall be entitled to retain possession of the well and all production from such zones through the well until the gross proceeds (calculated at the wellhead) from the sale of such production equals the aggregate of

(i) one hundred percent (100%) of the Lessor s royalty and any overriding royalties or other encumbrances thereon which otherwise would have been borne for the joint account which are paid with respect to such production subject to Subclause 1007(b)

(ii) one hundred percent (100%) of the operating costs applicable to the well

(iii) two hundred percent (200%) of the equipping costs of the well and

(iv) a multiple of the drilling costs and completion costs of the well as a development well or an exploratory well as the case may be being _____% with respect to a development well and _____% with respect to an exploratory well provided that if such well was in part a development well and in part an exploratory well and such well was completed for production only as an exploratory well all of the drilling costs and completion costs of such well shall be deemed to have been incurred solely with respect to an exploratory well except that, subject to paragraph 1005(c)(ii) the costs of drilling and if applicable attempting to complete the well as a development well shall be excluded for the purposes only of determining the amount prescribed by this paragraph with respect to a party which was only a participating party with respect to the development well portion of the well

The Operator for the participating parties shall notify the non participating parties upon recovery of the proceeds prescribed by paragraphs (i) to (iv) of this Subclause not later than thirty (30) days following such recovery Subject to Subclause l02l(b) each non participating party shall have thirty (30) days following receipt of such notice within which to elect to accept or refuse participation in the well the applicable zones and the production therefrom provided that failure of a non participating party to make an election within such period shall be deemed to be an election to accept such participation to the extent of its working interest in the spacing unit of the well Subject to Clause 1015 if a non participating party refuses participation as above provided it shall be deemed to have forfeited its right of participation in and to the well and to the spacing unit of the well insofar only as it relates to the applicable zones and the production therefrom to the participating parties therein If a non participating party elects to accept participation in the well the applicable zones and the production therefrom as above provided its participation shall be equal to its working interest and shall be effective as of the time when the gross proceeds of production from the well equalled the aggregate of the amounts prescribed by paragraphs (i) (ii) (iii) and (iv) of this Subclause whereupon the accounts of the parties shall be adjusted accordingly Thereafter the well shall be held for the account of the parties then participating therein and shall be operated by the Operator if it is one of the parties so participating or an Operator appointed pursuant to Clause 1004 if the Operator has elected to forfeit its interest in the well

(b) Notwithstanding the preceding Subclause in the event the working interest of one or more of the parties is encumbered by an encumbrance not borne for the joint account which falls within the exception in Clause 802 the following shall apply to such additional encumbrance for the purposes of the calculation in Paragraph 1007(a)(i)

(i) if a participating party s working interest is encumbered by such an additional encumbrance amounts paid by that participating party with respect to the application of such additional encumbrance to the production from the relevant well shall not be included in paragraph 1007(a)(i) subject to paragraph (ii) of this Subclause and

(ii) if a non participating party s working interest is encumbered by such an additional encumbrance the participating parties shall make the required payments with respect to the application of such additional encumbrance to the production from the relevant well As between only that non participating party and those participating parties receiving the assignment of the production attributable to that non participating party s working interest pursuant to this Clause one hundred and fifty percent (150%) of the amounts so paid on behalf of that non participating party shall be included in paragraph (a)(i)

(c) Throughout the period that the participating parties are retaining production from a well pursuant to Subclause (a) of this Clause the proceeds from such production shall be applied on a current basis and in order to paragraphs (i) (ii) (iii) and (iv) of that Subclause

(d) If any cash contributions are received by the participating parties pursuant to Clause 1802 with respect to the release of information respecting a well drilled as an independent operation the contribution shall be credited to paragraph (a)(iv) of this Clause to reduce the cost thereof for the calculation of the penalty relating thereto

Subclause 1007(e) Incentives accruing under the regulations do not affect the calculation under Subclause 1007(a) provided that the participating parties are not entitled to charge phantom royalties under paragraph 1007(a)(i) during a royalty holiday

Subclause 1008(b) This Subclause raises an interesting question respecting the case in which a deepening is proposed with respect to a well which was not drilled for the joint account.

Few would dispute the principle that a non participating party should be permitted to participate in an independent deepening However the mechanism whereby that party may elect to participate in the deepening may be contentious

There are three major alternatives The first is that the party may only participate if it pays its share of the up-hole cost of the well The second is that the party has no direct responsibility for the up-hole costs as it has already contributed a penalty in support of the well The third is a compromise whereby the parties negotiate the responsibility of a non participating party for up-hole costs

However the subsequent participation of a non participating party in the deepening would not relieve such party from the penalty applicable to its non participation with respect to the up-hole portion of the well

Subclause 1008(d) i) This provision is analogous to Clause 904

ii) Assume that A B and C hold working interests in the joint lands A and B elect to participate in the drilling of a well and have suspended the well A subsequently conducts a re-entry and completion but elects within six months of that operation to abandon After salvage of the equipment placed by it on the well A turns the well and formation back to A and B for abandonment and salvage of their equipment Assuming that C is still in a penalty position Clause 1015 states that the Clause 1007 penalty shall cease to apply to C s interest

iii) Amounts reimbursed by the participating parties to the non-participating parties are included in the 1007 calculation as operating costs under paragraph (a)(ii)

Clause 1010 General i) Note that the Clause only addresses wells which preserve title If the lands are in Saskatchewan or British Columbia and the joint lands for example include a permit (or may include a permit by virtue of an area of mutual interest) the parties should include an additional provision in their head agreement to address the possibility that other work could enable some of the parties to satisfy the work requirements necessary to maintain portions of the permit lands in good standing/make a lease selection Given that there is no generally accepted provision on this issue at this time and the possibility that the permit lands might not be held in uniform interests it is preferable for the parties to tailor their provision to their particular fact situation

ii) Although the Clause is broad enough to apply to offset obligations in the simple drill or drop case the provision does not address the case in which the parties can delay that decision through the payment of compensatory royalties The parties will have to resolve that issue through negotiation in the context of their particular fact situation

Subclause 1010(a) i) The preserved lands are any lands or zones thereof which would be forfeited pursuant to the relevant title document(s) in the event the operation were not conducted There are several important points to remember about the provision Firstly a well can be a title preserving well with respect to several title documents simultaneously Secondly some zones may be able to be continued without the title preserving well such that a production penalty would apply to those zones instead of the forfeiture Thirdly the title preserving well does not have to be located on preserved lands a step-out well on continued lands can cause the continuation of offsetting lands Fourthly remember that there would only actually be preserved lands/common preserved lands if the work in fact, enabled the parties to retain the lands such that a D&A well on a lease is of little or no value

(e) Notwithstanding anything to the contrary contained in this Article no cash payments incentives grants credits waivers exemptions abatements or other benefits received by (or available to) the participating parties pursuant to the Regulations with respect to an independent operation shall be taken into account when calculating any of the items set forth in paragraphs (a)(i) to (iv) inclusive of this Clause provided that this Subclause shall not entitle the participating parties to include in the amounts to be recovered under paragraph 1007(a)(i) any amount which is not paid by the participating parties

1008 INDEPENDENT DEEPENING PLUGGING BACK, WHIPSTOCKING RE ENTRY AND COMPLETION RECOMPLETION REWORKING OR EQUIPPING –

(a) No operation notice for a deepening plugging back whipstocking recompletion or reworking operation may be given with respect to a well producing or capable of producing petroleum substances in paying quantities No operation notice may be given for a deepening of a well below its authorized total depth if one or more parties propose to attempt to complete the well at or above that depth pursuant to Article IX unless and until either those parties no longer propose to attempt such completion or such completion has been conducted without resulting in the production of petroleum substances in paying quantities

(b) A non participating party with respect to a well may not propose any operation in the well unless and until (and only to the extent that) it has regained the right to share in production from the well

(c) If an independent operation is a deepening plugging back whipstocking re-entry and completion of a suspended well recompletion reworking or equipping operation which results in the production of petroleum substances in paying quantities from one or more zones the provisions of Subclauses 1007 (a) (b) (c) (d) and (e) shall apply mutatis mutandis to such formations the production therefrom the operation and the recovery of costs of the operation (including the penalty provided therein) to the extent that such operation and production relates to the well as a development well or an exploratory well as the case may be

(d) If an independent operation is a deepening plugging back whipstocking re-entry and completion of a suspended well recompletion reworking or equipping operation and within six (6) months of receipt of the operation notice by the receiving parties the participating parties elect to terminate the operation or propose to abandon the well they shall so notify the non participating parties Effective as of the date of issuance of that notice the participating parties shall be deemed to have returned the well and the zones to the parties that held participating interests therein at the time such operation was proposed and all further operations with respect thereto including abandonment shall subject to Clause 904 be deemed to be proposed for the account of the parties then holding participating interests therein except that

(i) the salvable materials and equipment placed in and on the well by the participating parties shall be salvaged by and for the account of the participating parties and

(ii) the participating parties shall bear all extra costs of abandonment incurred by reason of the operation

If the participating parties do not propose termination of the operation or abandonment of the well within such six (6) month period they shall forthwith thereafter pay to each non participating party its proportionate share of the net salvage value of the materials and equipment located in and on the well at the time the operation notice was received by the non participating parties The amounts so paid to those non participating parties shall be deemed to be operating costs and included as a charge under paragraph 1007(a)(ii) Thereafter a non participating party shall have no legal responsibility with respect to the well including the abandonment thereof unless and until (and only to the extent that) it has resumed participation in the well and the production therefrom

1009 WHERE WELL ABANDONED BEFORE PENALTY RECOVERED –

(a) If an independent operation is the drilling of a well and the well is to be abandoned before the gross proceeds of production therefrom equal the aggregate of the amounts prescribed by paragraphs 1007(a)(i) to (iv) inclusive the participating parties shall abandon the well record as a credit to the well the net salvage value of the materials and equipment recoverable from the well as if such amount were proceeds from production and report that credit in the monthly statement provided for in Clause 1013 If the gross proceeds from production from the well then exceed the aggregate of paragraphs 1007(a)(i) to (iv) inclusive the excess amount shall be a credit for the joint account

(b) Subject to Subclause (d) of Clause 1008 if an independent operation is the deepening plugging back whipstocking re-entry and completion recompletion reworking or equipping of a well pursuant to Clause 1008 and the well is to be abandoned before the gross proceeds of production received therefrom by the participating parties after commencement of the operation equal the aggregate of the costs and penalties to be recovered by the participating parties pursuant to Subclause 1008(c) the participating parties shall abandon the well record as a credit

ii) Assume that the applicable title document were a licence that a well which validated less than the entire licence had been drilled and that a party was considering the issuance of an operation notice to ensure that its priority lands would be retained after the expiry of the licence That party should request an early lease selection pursuant to Subclause 309(d) and determine whether it wished to issue the operation notice after the parties make their land retention selection thereunder

iii) A well drilled on preserved lands may be a title preserving well with respect to additional lands A subsequent title preserving well can also be a title preserving well insofar as the lands to be preserved by that well do not duplicate those preserved by an earlier title preserving well This is relevant both areally and stratigraphically If the subsequent title preserving well is a deep test it may cause the continuation of rights deeper than those preserved by the title preserving well

iv) Note the reference to completion or recompletion A title preserving well is not limited to the drilling of a well but also includes a completion or recompletion of an existing well A drilled well though is not required to be completed or recompleted if land retention is a function of activity (i e Alberta licence)

v) Paragraph (iii) does not specify the date by which a title preserving well must be commenced This allows the parties to tailor the provision to their particular fact situation having regard to such factors as surface accessibility and required regulatory approvals in environmentally sensitive areas

Subclause 1010(b) i) Subject to the qualifications in Subclauses 1010(c) and (d) a non participating party with respect to a title preserving well shall forfeit

a) 100% of its working interest in the well and its spacing unit at the completion of the operation insofar only as the well and rights pertain to the preserved lands and

b) 100% of its remaining working interest in the balance of the preserved lands at the date they otherwise would have been forfeited to the grantor of the applicable title document.

If certain shallow rights were not included in the preserved lands the production penalty prescribed by 903 1007 or 1008 would apply to the well and its spacing unit as regards those zones

ii) Note that the participating parties know the type of penalty they will receive in the title preserving well spacing unit at the time they conduct the operation assuming the well proceeds to preserve lands The 1981 document provided that a non participating party only forfeited its interest in that spacing unit if it did not participate in a similar well such that the participating parties did not know the form of penalty at the time they elected to participate in the well

iii) Note the reference to remaining working interest" in (b)(ii) Paragraphs 1010(c)(i) and (ii) operate to reduce the interest to be forfeited to the participants in the title preserving well

Subclause 1010(c) i) This Subclause reflects a major change in perspective from the comparable provision included in the 1974 and 1981 documents with respect to the similar well mechanism Although a significant improvement to the comparable 1981 provision remember that this provision poses a problem where the parties cannot agree on the technical merits of the location and proceed to drill simultaneous wells during the title preserving period particularly with respect to an unvalidated licence In that case it is advantageous for the parties to attempt to negotiate a result which will be appropriate in their particular fact situation

ii) The following shall apply to a subsequent title preserving well

a) A non participating party with respect to the title preserving well which participates in the subsequent title preserving well will not be required to forfeit its working interest in any common preserved lands pursuant to paragraph (b)(ii) (it could still forfeit an interest, though in the spacing unit for the title preserving well pursuant to paragraph (b)(i))

b) Assuming that the subsequent title preserving well is located on a spacing unit of preserved lands a non participating party with respect to the subsequent title preserving well which was also a non participating party with respect to the title preserving well shall forfeit its working interest in the spacing unit of the subsequent title preserving well to the participating parties therein rather than to the participating parties in the title preserving well insofar as the spacing unit pertains to common preserved lands Either paragraph (b)(ii) or Subclause (d) would apply to its remaining interest in the balance of the lands preserved by the title preserving well and

c) A non participating party in the subsequent title preserving well which was a participating party in the title preserving well would generally only be subject to a production penalty respecting the subsequent title preserving well However it would be subject to the forfeiture in paragraph (b)(ii) if the well preserved lands in addition to those preserved by the initial title preserving well since the subsequent title preserving well is also a title preserving well with respect to a portion of the joint lands

Subclause 1010(d) Paragraphs (b)(i) (c)(i) and (c)(ii) include special rules which are applicable to the spacing units for the title preserving well and the subsequent title preserving well This provision addresses the forfeiture of a non participating party s interest in the remainder of the common preserved lands

That interest is allocated equally to the title preserving well and the applicable subsequent title well(s) It is then apportioned among the participating parties in the respective wells pursuant to Clause 1016

to the well the net salvage value of the materials and equipment recoverable from the well as if such amount were proceeds from production and report that credit in the monthly statement provided for in Clause 1013 If the gross proceeds of production from the well then exceed the aggregate of the amounts chargeable to the well pursuant to Clause 1008 the excess amount shall be a credit for the joint account.

1010 EXCEPTION TO CLAUSE 1007 WHERE WELL PRESERVES TITLE –

(a) In this Clause the following terms shall have the meanings hereby assigned to them namely

(i) common preserved lands means that portion of the preserved lands with respect to which a subsequent title preserving well would have been a title preserving well had the title preserving well not been drilled completed or recompleted

(ii) preserved lands means any joint lands which would have been forfeited pursuant to a particular title document had a title preserving well not been drilled completed or recompleted at the time and in the manner prescribed herein subject to the designation of preserved lands pursuant to Subclause 309(d)

(iii) subsequent title preserving well means a well which is drilled completed or recompleted hereunder at such time and in such manner that such well would have been a title preserving well with respect to all or a portion of the preserved lands had the title preserving well not been drilled completed or recompleted

(iv) "title preserving well means a well which is drilled completed or recompleted hereunder where the failure to conduct such operation would result in the forfeiture of all or a portion of the joint lands contained in a title document and such operation is to be commenced not earlier than _____ days prior to the date such forfeiture would occur pursuant to such title document

(b) Notwithstanding Clauses 903 1007 and 1008 a non participating party with respect to a title preserving well shall forfeit

(i) upon completion of such operation one hundred percent (100%) of its working interest in such well and the spacing unit for such well to the participating parties in the title preserving well insofar only as such spacing unit pertains to the preserved lands and

(ii) at the date the preserved lands otherwise would have been forfeited pursuant to the relevant title document one hundred percent (100%) of its remaining working interest in the balance of the applicable preserved lands to the participating parties in the title preserving well subject to Subclauses (c) and (d) of this Clause

(c) The following shall apply with respect to a subsequent title preserving well

(i) a non participating party with respect to the title preserving well which participates in the subsequent title preserving well shall not forfeit its working interest in any common preserved lands pursuant to paragraph (b)(ii) of this Clause

(ii) a non participating party with respect to the title preserving well which is also a non participating party with respect to the subsequent title preserving well shall if the subsequent title preserving well is located on a spacing unit of preserved lands forfeit one hundred percent (100%) of its working interest in the subsequent title preserving well and the common preserved lands included in the spacing unit for such well to the participating parties in the subsequent title preserving well rather than to the participating parties in such title preserving well pursuant to paragraph (b)(ii) or Subclause (d) of this Clause and

(iii) a participating party in the title preserving well which is a non participating party with respect to the subsequent title preserving well shall be subject to the production penalty prescribed by Clause 903 1007 or 1008 with respect to the subsequent title preserving well and the spacing unit for such well provided that if the subsequent title preserving well preserves lands in addition to those preserved by the title preserving well that party shall be subject to the forfeiture of one hundred percent (100/) of its working interest in such additional preserved lands pursuant to paragraph (b)(ii) of this Clause

(d) Subject at all times to paragraphs (b)(i) (c)(i) and (c)(ii) of this Clause the working interest to be forfeited by a party in any common preserved lands shall be allocated equally to the title preserving well and the applicable

Subclause 1010(e) One problem with any title preserving well mechanism is the determination of the lands which are preserved by a title preserving well Ideally the parties would attempt to obtain a predetermination from the applicable regulatory agency to ascertain preserved lands However this determination will probably be achieved through the negotiation of the parties in many cases because of timing problems or the reluctance of regulatory agencies to make a predetermination In practice the reference to arbitration will generally only serve as an impetus towards more timely and reasonable negotiations than might otherwise be the case

Clause 1011 i) Is a party which proposes to conduct a geophysical program over the joint lands under any obligation to the other parties to provide them with the opportunity to participate in that operation?

Clause 1011 permits a party to conduct that operation without having first advised the other joint operators of its intention to conduct the operation The only right of a non participating party to obtain the basic data derived from that operation is the right to purchase it at a penalty percentage if it had initially been offered the opportunity to participate in the operation

That position is admittedly in conflict with the underlying policy goal of encouraging joint operations particularly where the exploration program is primarily conducted on the joint lands However the justification for the inclusion of that provision in conventional agreements is not theoretical but practical Industry experience has indicated that the obligation is not generally appropriate in those agreements The exploration program so conducted on the joint lands could be a portion of a larger regional program In the alternative it may be intended to evaluate formations which are not held jointly

ii) The types and formats of the data supplied to a non participating party shall correspond to industry data sales practices

Clause 1012 Note that the Clause does not include an allocation of capital costs or a fee pertaining to the utilization of capital The inclusion of a capital component would delay payout, even though there would be an immediate benefit (income) to the non participating parties

Subclause 1013(a) The operator of an independent well shall supply the parties with monthly statements showing the status of the penalty recovery under the applicable production penalty provision (903 1007 1008 1021 or 1022) once the non participating party is entitled to information from the operation pursuant to Clause 1018

Subclause 1013(b) If the costs prescribed by the applicable production penalty provision (903 1007 1008 1021 or 1022) have been recovered and notice of that recovery either is not issued to the non participating parties or is issued later than it should have been a non-participating party is entitled to interest on the funds to which it would have been entitled had it elected to resume participation in the well at the time the notice should have been issued

There is of course little likelihood that this provision would apply if monthly statements were in fact being issued pursuant to Subclause 1013(a) The most practical impact of the Subclause will be to ensure that there is an incentive for operators to comply with that Subclause

Clause 1014 This ensures that such provisions as Articles IV VII and Clauses 304 and 311 apply mutatis mutandis to an independent operation

Clause 1015 The production penalties in the document are designed to reward success and not failure If a penalty well is abandoned in a formation before recovery of the prescribed penalty the non participating parties reacquire their full rights in that formation provided that they never assume any costs or risks associated with that abandonment

Except for 903B this provision is tied to production penalties and has no application to wells in which a party forfeits its interest pursuant to Clause 1010

subsequent title preserving well to be then apportioned among the respective participating parties pursuant to Clause 1016

(e) In the event of a dispute as to the classification of a well as a title preserving well or the determination of either the preserved lands or the common preserved lands a party may by notice to the other parties refer the matter to arbitration under the provisions of the Arbitration Act or Ordinance of the province state or territory where the joint lands are situated not later than forty five (45) days after the date at which the preserved lands otherwise would have been forfeited pursuant to the applicable title document. The parties to such dispute thereupon shall diligently attempt to complete such arbitration in a timely manner

1011 INDEPENDENT GEOLOGICAL OR GEOPHYSICAL OPERATION – Nothing in this Operating Procedure shall be interpreted to preclude a party from conducting a geological or geophysical operation on or with respect to the joint lands for its own account provided that such operation shall not interfere with other joint operations The parties not participating in such operation shall not be entitled to any information or data with respect thereto unless such operation was the subject of an operation notice In such event, any non-participating party may prior to the end of the calendar year following the calendar year in which such operation was completed pay to the participating parties two hundred percent (200%) of what its share of the cost of such operation would have been had the operation been conducted for the joint account If a non participating party makes that payment, it shall be entitled to a copy of all basic data obtained from the operation for its own use but it shall not obtain any trading rights respecting that data or any interpretations of such data made by or for the participating parties or any of them The types and formats of data supplied to a non participating party hereunder shall be consistent with established industry practice in data sales

1012 USE OF BATTERY AND OTHER EQUIPMENT FOR INDEPENDENT WELL – To the extent that capacity is available with respect to production facilities operated for the joint account, the participating parties in an independent operation shall be permitted to make use of and to share them in the same manner as if the operation had been conducted for the joint account provided that a reasonable allocation of operating costs is made with respect to such sharing of such production facilities However to the extent that such production facilities are not adequate to accommodate both the independent operation and wells operated for the joint account the latter shall have priority with respect to the utilization of such production facilities

1013 ACCOUNTS AND AUDIT DURING PENALTY RECOVERY –

(a) Subject to Clauses 305 and 1018 the Operator for an independent operation shall supply all parties with a monthly statement showing the status of the recovery of costs and penalties pursuant to this Article during the period of recovery of such costs and penalties The provisions of the Accounting Procedure relating to the audit of accounts shall apply mutatis mutandis to the audit of accounts with respect to such recovery of costs and penalties by the participating parties

(b) If it is determined that the recovery of the costs and penalties prescribed by this Article with respect to an independent operation has occurred and that the participating parties either have not issued the non participating parties notice of such recovery or have issued the notice to the non-participating parties later than thirty (30) days following such recovery each non participating party shall have the right to elect within thirty (30) days following receipt of such notice or the discovery by it that such notice had not been issued to obtain participation in such operation in the manner provided in this Article effective as of the date of such recovery The accounts of the parties shall retroactively be adjusted accordingly if one or more of the non participating parties elect to obtain participation in the well If a non participating party retroactively obtains participation in such operation and amounts are owing to the non participating party as a result of such election the non participating party may charge the participating parties which assumed its share of costs of such operation interest on the amount so owing on the same basis as is provided in paragraph 505(b)(i)

1014 PARTICIPANT S RIGHTS AND DUTIES RE INDEPENDENT OPERATIONS – Subject to the provisions of this Article the provisions of this Operating Procedure relating to the rights duties and obligations of the Operator and the Joint Operators (including the provisions of Article IX) shall apply mutatis mutandis among the participating parties with respect to the conduct of the independent operation and if applicable to the operation of any well during the prescribed recovery of costs and penalties with respect thereto

1015 REVERSION OF ZONE UPON ABANDONMENT – If a geological zone or the right to production therefrom was (or is to be) assigned to the participating parties by the non participating parties as a result of an independent operation respecting a well and such well is subsequently abandoned in such zone each non participating party shall reacquire the interest so assigned (or to be assigned) by it with respect to such zone effective at the completion of such abandonment provided that in no event shall the non participating parties assume any responsibility for the costs or risks associated with such abandonment However nothing in this Clause shall apply to any assignment of a working interest by a non participating party pursuant to Clause 1010

Clause 1016 Suppose A B and C hold respective working interests of 50% 25% and 25% A elects not to participate in an exploratory well B elects to participate only to the extent of its working interest and C elects to assume A s entire share of costs

As C has assumed A s entire share of costs the benefits associated with A s penalty (whether production penalty or forfeiture pursuant to 1010) should obviously accrue solely to C However in the absence of the first sentence the benefit of the penalty would be divided between B and C in the proportions of their participating interests by virtue of the second sentence such that B would obtain 25% of the benefit without assuming any portion of the penalty expenses!

Clause 1017 i) This provision addresses both liability and indemnification It also applies to operations conducted by less than all of the parties pursuant to Clause 707 and Article IX

ii) As a general statement the participating parties are responsible for losses suffered by the non participating parties to the extent they are caused by the actions or omissions of the participating parties There are circumstances though in which it would be arguable that a non participating party had contributed to the loss by its actions or omissions Suppose for example that a party had participated in the drilling of a sour gas objective but elected not to participate in the completion Should it share any responsibility for the loss it suffers as a result of the completion i) if it had voiced safety concerns or ii) if it elected not to participate in the completion because it did not regard the objective as sufficiently prospective? Unfortunately there is no simple test which can be included in the Operating Procedure

Clause 1020 Since the participating parties could also be negotiating tract factors/pooled interests with respect to other lands in which they have an interest they may only unitize or pool a well subject to a production penalty with the consent of the non participating parties which consent may not be unreasonably withheld

Some of the issues to be considered by the non participating parties with respect to a pooling would be the allocation of production clarification of the impact of the arrangement on the penalty calculation the material provisions of a pooling agreement (i e cross-conveyance or no cross-conveyance the pooled substances and zones the treatment of encumbrances restrictions on alienation and elections under the Operating Procedure)

Clause 1021 i) Where the construction of a minor production facility is proposed under the 1981 Operating Procedure and less than all of the parties holding interests in the wells which would utilize such facility choose to participate in such opera tion the non participating parties are left with the option of either taking their production to some other facility or negotiating a processing/transportation arrangement with the facility owners (if sufficient capacity in the facility is available )

Clause 1021 is intended both to expand the options for the non participating parties as well as to provide the parties proposing to construct a facility with the opportunity to achieve greater participation and use of the facility However these provisions do not require that all production facilities must be subject to an independent operations notice or constructed for the joint account.

The preamble to Clause 1021 and Subclause 1021(a) are enabling provisions which allow any joint operator to place a proposal to construct a production facility before the other joint operators through an operation notice Parties receiving such a notice have the option of (i) participating (ii) electing not to participate and taking their production in kind or (iii) electing not to participate and paying a penalty out of their production handled at the facility (Although not specified in the document the parties would generally have a fourth option in practice as noted above to negotiate a fee to use the facility )

1016 BENEFITS AND BURDENS TO BE SHARED – Any resultant assignment of production or forfeiture of any interest in the joint lands by a non participating party pursuant to this Article shall be allocated among the participating parties in the proportions in which those parties have borne that share of the cost of the independent operation which would have been applicable to the non participating party had the operation been conducted for the joint account Except as provided in the preceding sentence the benefits and burdens relating to an independent operation shall be shared by the participating parties in the proportions of their participating interests therein

1017 INDEMNIFICATION OF NON-PARTICIPATING PARTIES – The participating parties in an independent operation shall

(a) be liable to the non participating parties with respect thereto for any losses costs damages and expenses whatsoever (whether contractual or tortious) which those non participating parties suffer sustain pay or incur and

(b) in addition indemnify and hold harmless those non-participating parties and their Affiliates directors officers servants consultants agents and employees against all actions causes of action proceedings claims demands losses costs damages and expenses whatsoever which may be brought against or suffered by those non participating parties their Affiliates directors officers servants consultants agents and employees or which they may sustain pay or incur

insofar as they are a direct result of or directly attributable to any act or omission (whether negligent or otherwise) of the participating parties or their Affiliates directors officers servants consultants agents employees independent contractors licencees or invitees with respect to such independent operation

1018 NON PARTICIPATING PARTY DENIED INFORMATION – If an independent operation is the drilling of a well or is conducted on a well which has been drilled the following shall apply with respect thereto

(a) if the independent operation is the drilling of a well a non participating party shall not be entitled to access to the wellsite or any information with respect to the well including monthly statements and audit privileges as provided in Clause 1013 until the earlier of the date it becomes a participating party or ninety (90) days after the date of the release of the drilling rig used to drill the well or

(b) if the independent operation is conducted on a well which has been drilled a non participating party shall not be entitled to access to the wellsite or any information with respect such operation including monthly statements and audit privileges as provided in Clause 1013 until the earlier of the date it becomes a participating party or one hundred and twenty (120) days after the date the operation notice is deemed to be received by it.

Once a non participating party is entitled to access to the wellsite and such information such party shall be provided with the rights and information to which it is entitled in a timely manner However if a non participating party is required to make an assignment of such well pursuant to Clause 1010 with respect to such independent operation such party shall not be entitled to access to the wellsite or any information with respect to the well pursuant to this Operating Procedure at any time

1019 NO JOINT OPERATIONS UNTIL INFORMATION RELEASED – If the participating parties are temporarily withholding well information from a non participating party pursuant to Clause 1018 no participating party shall propose or conduct any operation pertaining to a well on the joint lands within 3 2 kilometres of such well (except regular production and maintenance operations on producing wells) until it has released such information to the non participating party

1020 POOLING OR UNITIZATION PRIOR TO RECOVERY – If an independent operation is the drilling of a well (or is conducted with respect to a well which has been drilled) to which the forfeiture in Clause 1010 does not apply the participating parties may include the well and its spacing unit in a pooling agreement or unit with the consent of the non participating parties which consent shall not be unreasonably withheld If the well and the spacing unit are included in a pooling agreement or unit the participating parties shall retain the production allocated to the spacing unit until they have recovered all costs and penalties to which they are entitled pursuant to this Article X The credits and debits accruing to the participating parties under a pooling or unit agreement with respect to any adjustment of investment for well costs paid and equipment supplied by them shall be allocated to the payout account of the well by the participating parties in accordance with the principles in Clauses 1007 and 1008 and shall be recorded in the monthly statement referred to in Clause 1013

1021 NON PARTICIPATION IN INSTALLATION OF PRODUCTION FACILITY – The parties normally shall consult with respect to the construction acquisition or installation of production facilities and attempt to negotiate either an individual agreement respecting the construction acquisition or installation of a production facility or the fee to be charged to a party which wishes to utilize such production facility but does not wish to participate in such construction acquisition or installation Whether or not such consultation has occurred or been requested a party may at any time become a proposing party and give to the other parties an operation notice respecting a production facility

A party which receives an operation notice respecting the construction acquisition or installation of a production facility shall

Any penalty will usually be paid out of production from wells located on the joint lands and tied into the facility However the participating parties and the non-participating parties subject to the penalty may agree to apply against the penalty any revenue from the sale of any other production which such non-participating parties may (with the consent of the participating parties) bring into the facility Upon payout of the penalty the non-participating parties which were subject to the penalty have a further election whereby they may choose to reject or accept participation in the facility with rejection amounting to the forfeiture of the rejecting party s interest in the facility

The overriding principle is that the construction of a production facility should be permitted provided that no party is forced to participate in the facility either directly by paying its share of the cost in cash or indirectly through a cost recovery mechanism

ii) Remember the parameters of the definition of production facility when using this Clause Only operations which would result in a facility satisfying the tests in the definition of production facility fall within the scope of this Clause A party which receives a notice for an operation which does not satisfy those tests can object to the notice

Subclause 1021(a) A non-participating party which had elected to incur the penalty might elect not to obtain an interest in the facility after recovery of the penalty attributable to its interest because of its belief that reclamation costs would exceed the value of the facility to it. The election to accept participation in the well and in the facility are distinct elections If it accepted participation in the wells but refused participation in the facility it would have to negotiate a fee if it wished to use the facility for its share of production from the joint lands

Subclause 1021(b) This Subclause addresses the possibility that a non participating party may already be subject to a production penalty on one or more of the relevant wells

Subclause 1021(c) This Subclause states that Subclauses 1007(b) (e) shall apply mutatis mutandis to Clause 1021

Subclause 1021(d) i) This Subclause provides the necessary mechanism to deal with the situation in which a non participating party electing to take its production in kind fails to do so

ii) Remember that the provisions of Article VI also apply to the extent that such a non participating party does not take in kind

pursuant to Clause 1002 elect to participate in such proposed operation not to participate in such operation but to take in kind before the inlet of such proposed production facility its share of any petroleum substances which would otherwise utilize such production facility for production processing treatment, storage or transmission or not to participate in such operation and to incur a penalty with respect to such operation on the basis provided in this Clause Failure of a party to make an election with respect to such operation notice within the penod prescribed by Clause 1002 shall be deemed to be an election by such party not to participate in such operation and to take in kind before the inlet of such proposed production facility its share of any petroleum substances which would otherwise utilize such production facility

If a production facility is constructed acquired or installed as an independent operation the following shall apply between the participating parties and those non participating parties which did not elect to take in kind before the inlet of such production facility their share of petroleum substances which otherwise would utilize such production facility

(a) If the wells on the joint lands to which such operation pertains are held for the joint account the participating parties shall be entitled to retain possession of the production facility and all production from such wells which would utilize such production facility (and a non participating party s share of any other hydrocarbon substances as that party and the participating parties may otherwise agree) excluding any such production owned or attributable to any party which has elected not to participate in such operation but to take in kind such share of such production at the inlet of such production facility until the gross proceeds (calculated at the wellhead) from the sale of such production equals the aggregate of

(i) one hundred percent (100%) of the Lessor s royalty and any overriding royalties or other encumbrances thereon which otherwise would have been borne for the joint account which are paid with respect to such production subject to Subclause (c) of this Clause

(ii) one hundred percent (100%) of the operating costs incurred with respect to such production facility and its utilization for the production processing treatment storage or transmission of petroleum substances and

(iii) two hundred percent (200%) of the cost of the acquisition construction and installation of such production facility

The Operator for the participating parties shall notify those non participating parties subject to the penalty upon recovery of the proceeds prescribed by paragraphs (i) (ii) and (iii) of this Subclause (a) not later than thirty (30) days following such recovery Each such non participating party shall have thirty (30) days following receipt of such notice within which to elect to accept or refuse participation in the production facility provided that failure of such a non participating party to make an election within such period shall be deemed to be an election to accept participation in such production facility If such a non participating party refuses participation as above provided it thereby shall be deemed to have forfeited its right of participation in and to the production facility and may thereafter only use such production facility with respect to its share of production from the joint lands for such fee as may be agreed from time to time with the parties which own such production facility and failing agreement in accordance with Subclause (d) of this Clause If such a non-participating party elects to accept participation in the production facility its participation in the production facility shall be equal to its working interest and shall be effective as of the time the proceeds prescribed by paragraphs (i) (ii) and (iii) above have been recovered whereupon the accounts of the participating parties and those non participating parties so acquiring an interest in the production facility shall be adjusted accordingly Thereafter the production facility shall be held for the account of the parties participating therein and shall be operated under the provisions of this Operating Procedure by the Operator if it is one of the parties so participating or by an Operator appointed pursuant to Clause 1004 if the Operator does not have a working interest in the production facility

(b) Insofar as Clause 1007 applies to a well to which such operation pertains prior to the recovery of the amounts prescribed by Subclause 1007(a) Subclause (a) of this Clause shall apply immediately following the recovery of the amounts prescribed by Subclause 1007(a) such that a non participating party with respect to the well may not resume participation in such well until the recovery of the additional amounts prescribed by Subclause (a) of this Clause

(c) Except to the extent modified in this Clause Subclauses 1007(b) (c) (d) and (e) shall apply mutatis mutandis to this Clause

(d) To the extent that a party which elected to take in kind before the inlet of such production facility its share of petroleum substances which would otherwise utilize such production facility does not take such petroleum substances in kind the parties owning such production facility may on behalf of such party produce process treat store or transmit that share of petroleum substances so delivered to such production facility In such event (but subject always to any individual agreement negotiated by the parties owning such production facility and such other party respecting the utilization of such production facility) the parties owning such production facility shall in addition

Clause 1022 This Clause facilitates the application of the principles in Clause 1021 to situations involving the expansion of an existing production facility subject to Clause 1408 Where such a situation occurs a party only has the option to participate or to be subject to the penalty (with no further election after payout of the penalty)

This mechanism deviates from the principles which would apply to a significant facility under a formal facility agreement A facility agreement does not force a non participating owner to participate in an expansion or to pay for it indirectly through a penalty recovery

When considering this principle it is important to remember that the Operating Procedure is only intended to apply to a minor facility for which the parties do not prepare a formal facility agreement. The application of a penalty to minor expansions of such a facility allows the facility to continue to be governed by the Operating Procedure However if parties find this objectionable they are certainly free to try to negotiate an alternative in the context of the fact situation to prepare a separate facility agreement or to delete this portion of the provision and modify 1408 to exclude any facility under expansion if less than all parties agree to the expansion

Subclause 1101(a) Note the last sentence of (a) In effect it allows a party to change its election any time prior to the expiry of the reply period This could place an additional administrative burden on the operator if it calculated the revised interests prior to the expiry of the response period However the provision does not pose a problem in practice In fact it is likely to minimize the burden on an operator because the most likely utilization of the provision would be the case in which the party which proposed the surrender reversed its position after seeing that its co-venturers elected to retain their interests

Clause 1102 Remember that a production facility may be a profit centre as regards outside substances If that is the case a party would generally wish to retain its interest in the facility

to any marketing fee applicable pursuant to Article VI be entitled to charge such other party a fee sufficient to cover the cost of producing processing treating storing or transmitting as the case may be such other party s share of petroleum substances so utilizing such production facility which fee shall also include a reasonable rate of return on capital investment in accordance with the principles in Clause 1404

1022 NON PARTICIPATION IN EXPANSION OF PRODUCTION FACILITY – Subject to Clause 1408 the provisions of Clause 1021 shall apply mutatis mutandis to an expansion of or an addition to an existing production facility except that

(a) Participation in such operation shall be limited to those parties holding a working interest in such production facility at the time such operation is proposed

(b) A party holding a working interest in a production facility which receives an operation notice respecting such operation shall elect either to participate in such operation or to be subject to the recovery of the costs associated with such operation on the basis provided in Subclause 1021(a)

(c) A party holding a working interest in a production facility which is a non-participating party with respect to such operation shall acquire its working interest in the portion of the production facility resulting from such operation following the recovery of costs prescribed in Clause 1021 and

(d) If such operation is to be conducted prior to the recovery of costs prescribed by Subclause 1021(a) with respect to the construction or installation of such production facility the costs of such operation shall be added to the costs to be recovered pursuant to that Subclause with respect to those non participating parties subject to such cost recovery provided that the proceeds of production to be applied against such costs shall be applied firstly to the penalty prescribed by Clause 1021 with respect to the construction acquisition or installation of such production facility

## ARTICLE XI

## SURRENDER AND QUIT CLAIM OF JOINT LANDS

1101 INITIATION OF SURRENDER PROPOSAL AND QUIT CLAIM OF INTERESTS –

(a) Not later than sixty (60) days before a rental date or other obligation date with respect to the joint lands affected (except an obligation to pay royalty or a drilling obligation not being enforced under the title documents) a party who proposes that some or all of the joint lands be surrendered to the grantor under the applicable title documents shall give notice to such effect to the other parties subject to Subclause (b) of this Clause Not later than thirty (30) days before the next ensuing rental date or other obligation date under the respective title documents included in the surrender notice the parties receiving the notice shall each give notice to all other parties stating whether or not they wish to join in the proposed surrender Failure to respond to such notice shall be deemed to be an election not to join in the surrender Any party giving notice of the proposed surrender or giving notice of its intention to join in the proposed surrender may by notice to the other parties revoke its notice of intention to surrender at any time up to but not later than thirty (30) days before the next ensuing rental date or other obligation date under the respective title documents

(b) Notwithstanding the preceding Subclause the joint lands proposed for surrender must be of such dimensions that the grantor of the title documents to which such lands are subject would be obligated to accept the surrender pursuant to the title documents and a party may not propose the surrender of a portion of the joint lands while an obligation exists with respect to such lands which cannot be avoided by the surrender or quit claim of those lands to the grantor of the title documents to which they are subject

1102 SURRENDER BY ALL PARTIES – Subject always to the provisions of Articles IX and X if all parties join in a surrender under Clause 1101 the Operator shall proceed forthwith to salvage for the joint account all salvable material equipment upon the lands to be surrendered and if applicable any production facilities serving solely wells located upon the lands to be surrendered The parties shall promptly execute and deliver to the Operator all documents necessary to effect the surrender which documentation shall be prepared by the Operator The Operator shall thereafter deliver all such documents to the grantor of the applicable title documents in order to effect the surrender properly

1103 SURRENDER BY LESS THAN ALL PARTIES – If less than all parties join in the surrender the parties not joining in the surrender shall (unless the Operator is one of them) promptly appoint an Operator pro tem for the parties retaining the applicable lands and interests Such Operator shall be responsible for taking the necessary steps to ensure payment of rentals or the meeting of any other obligation to maintain such lands and interests in good standing for the benefit of the retaining parties

Subclause 1104(a) i) Note that the surrender is effective on the day before the obligation date The contractual rights of the parties of course would have crystallized 30 days before this date

ii) Unless otherwise agreed by the retaining parties the assignment shall be in proportion to their working interests

iii) Within 30 days of the assignment, the assignors share of the estimated net salvage value of the material and equipment on the surrendered lands less their share of the abandonment costs of any wells on those lands shall be determined The accounts of the parties shall be adjusted accordingly within 30 days of this determination provided that the parties owed an amount shall have access to the remedies in Subclause 505(b) if the accounts have not been adjusted at that time

Remember that this calculation would require the surrendering parties to pay an amount to the retaining parties if the estimated abandonment costs exceeded the estimated net salvage value of the assigned material and equipment This is included to minimize the possibility that a party would surrender to attempt to avoid abandonment costs

Subclause 1104(b) Note that a surrendering party is not released from obligations which had accrued prior to the surrender (including environmental liabilities) and its obligation to maintain information confidential However this obligation shall not extend to the obligation to abandon any well on the lands so assigned since the estimated abandonment cost (including reclamation costs associated therewith) was taken into account under Subclause 1104(a) at the time the accounts of the parties were adjusted

Clause 1105 Assume that D E and F acquire a licence and that D surrenders its interest in half of the licence E and F would have no obligation to drill a well to validate the licence However unless they subsequently surrendered the interest in the manner prescribed by the regulations E and F would retain the responsibility to pay land maintenance costs applicable to the surrendered lands such as rentals to maintain the licence in good standing

Clause 1201 Unless otherwise agreed by the non abandoning parties the assignment shall be in proportion to their working interests

Clause 1202 i) Within 30 days of the transfer the transferors estimated net salvage value of the material and equipment respecting the well less their share of the abandonment costs of the well shall be determined The accounts of the parties shall be adjusted accordingly within 30 days of this determination provided that the parties owed an amount shall have access to the remedies in Subclause 505(b) if the accounts have not been adjusted at that time

Remember that this calculation would require the transferors to pay an amount to the retaining parties if the estimated abandonment costs exceeded the estimated net salvage material of the assigned material and equipment

ii) Subject to Clause 1203 the non abandoning parties assume all obligations accruing with respect to the well following the takeover

1104 ASSIGNMENT OF SURRENDERED INTEREST –

(a) Effective as of 2400 hours on the day before the rental or other obligation referred to in Clause 1101 is required to be paid or met with respect to a title document included in the surrender notice the parties which elected to surrender shall assign all of their interest in the joint lands and interests which were the subject of the proposed surrender notice to the retaining parties in proportion to the retaining parties working interests in the joint lands or in such proportions as the retaining parties may otherwise agree Within thirty (30) days after receipt of the assignment, the parties shall determine in accordance with the Accounting Procedure the assignors pre-surrender working interest share of the net salvage value of the recoverable material and equipment on the lands so assigned less the assignors pre-surrender working interest share of the estimated cost of abandoning each well on the lands so assigned The accounts of the parties shall be adjusted accordingly within thirty (30) days of such determination and the provisions of Subclause 505(b) shall apply mutatis mutandis in the event the parties have not adjusted their accounts by such time

(b) Upon the assignment described in the preceding Subclause a party which so assigned its interest with respect to the applicable portion of the joint lands shall be released from all obligations thereafter accruing with respect to such lands Such release shall not apply to any obligation which had accrued and any environmental damage which had occurred with respect to those lands or production facilities prior to such assignment provided that such obligation shall not extend to the obligation to abandon any well on such lands

1105 RETAINING PARTIES TO MEET OBLIGATIONS – In accepting the interests of the surrendering parties the retaining parties shall be deemed to have covenanted to satisfy the obligation which prompted the surrender proposal if (i) the obligation could have been avoided had all parties joined in the proposed surrender and (ii) failure to satisfy the obligation would prejudice the title of the parties in any other portion of the joint lands However this covenant shall not require the retaining parties to conduct any operation on or with respect to such surrendered lands in order to maintain them in good standing

1106 FAILURE TO SURRENDER AS AGREED – Where all of the parties have agreed to effect surrender pursuant to this Article (and whether or not some or all of them have taken any action by way of release or assignment pursuant to an intention to join in the surrender) the lands and interests which are the subject of the surrender notice shall be deemed to be held for the joint account until the surrender has been irrevocably effected including the termination of any right to reinstate any title document, so that all of the parties shall receive or have the right to participate in any benefits which might accrue during the period before the surrender is irrevocably effected If however any party to whom any interest is conveyed or released for the purpose of effecting the surrender does not duly proceed with the surrender and thereby causes any further obligation to arise that party shall be solely responsible for meeting the obligation and shall indemnify the other parties for any losses they may suffer with respect thereto

## ARTICLE XII

## ABANDONMENT OF WELLS

1201 PROCEDURE FOR ABANDONMENT – If a party proposes to abandon a well on the joint lands (except at casing point when Article IX shall apply) it shall give notice of the proposed abandonment to the other parties Within thirty (30) days of receipt of the notice each of the other parties shall elect, by notice to the other parties whether it wishes to take over the well Failure by a party to respond to such notice shall be deemed to an election by that party to take over or participate in the takeover of the well Subject to Clauses 1015 and 1202 the parties taking over the well shall be entitled to an assignment without consideration or warranty of the abandoning parties working interests in the well and in the spacing unit of the well insofar as it relates to the producing zone of the well All such assignments shall be proportionate to the non abandoning parties respective working interests each to the other prior to any such takeover or assignment unless the non abandoning parties agree to a different allocation of the assigned working interests If all parties elect to join in the abandonment the well shall be abandoned for the joint account.

1202 ASSIGNMENT OF EQUIPMENT AND SURFACE RIGHTS – If less than all parties elect to abandon a well under Clause 1201 the abandoning parties shall without warranty promptly transfer to the other parties the materials and equipment serving solely the well Within thirty (30) days of such transfer the parties shall determine in accordance with the Accounting Procedure the abandoning parties working interest share of the net salvage value of such materials and equipment less the abandoning parties working interest share of the estimated cost of abandoning the well The accounts of the parties shall be adjusted accordingly within thirty (30) days of such determination and the provisions of Subclause 505(b) shall apply mutatis mutandis in the event the parties have not adjusted their accounts by such time The abandoning parties shall also transfer to the other parties without warranty or consideration the surface rights appurtenant to the well The parties receiving the assignment thereupon shall be responsible for all obligations accruing with respect to such well following such takeover subject to Clause 1203

Clause 1203 The forfeiture is a function of success If the well is subsequently abandoned in a zone the interests shall revert to the original interest holders

Note though that the reversion does not affect either the ownership of the well or the responsibility for the abandonment of the well

Clause 1301 i) One of the more confusing aspects of the document to grasp is its application to the heterogeneous ownership case

In essence the provision states that if pursuant to a provision of the document, any portion of the joint lands ceases to be held by the parties in the same percentages as their working interests in the balance of the joint lands or by less than all of the parties that portion of the lands shall be held by the applicable interest holders as if they are parties to a separate Operating Procedure having the same terms except for the relevant modification to the interests/parties Thereafter those lands would no longer be subject to the Operating Procedure

ii) This provision also applies mutatis mutandis to a production facility assuming that it is not governed by a separate CO&O agreement

Article XIV (General) Production facilities of any significance in terms of capital investment capacity risk or complexity should be governed by individual facilities agreements However there will always be a class of minor facilities which do not justify both the time and expense involved in creating specific agreements to govern them such that it is a common practice for parties to construct own and operate a minor production facility in the absence of a formal agreement specifically intended to cover such activities Usually the applicable parties will attempt to extend the terms of the operating procedure governing the lands served by such facility to administer their relationship regarding the facility

Article XIV has been included in order to provide certain basic terms essential to the construction ownership and operation of such minor facilities Situations which demand more extensive terms than those provided herein should be dealt with by the preparation of a facilities agreement for the production facility in question

In the interest of simplicity and in order to recognize actual operating practice with respect to existing facilities which are very minor the provisions of this Article have been limited to items of universal application to minor facilities Unfortunately the provisions of the Article deviate from the norm found in formal facility agreements in some instances in order to reflect operational reality respecting minor facilities

For example facility owners are not charged a capital fee for using surplus capacity in the Article simply because of the administrative burden that this would place on the operator with respect to a minor facility

Given that this provision will seldom apply to significant facilities in practice it is not feasible to address all of the issues normally included in CO&O agreements Parties which feel uncomfortable with this arrangement should prepare a separate facility agreement in each case

Clause 1401 This provision establishes the basis of ownership for production facilities and is subject to Clause 1021 the independent facility provision

Clause 1402 The commitment to deliver is necessary to ensure that the efficient operation of any production facility is not unfairly prejudiced by the refusal of a joint operator to utilize such facility to produce process treat store or transmit that joint operator s share of production from the joint lands and is subject to Clause 1021

Clause 1403 This provision prescribes the rights of each joint operator to utilize any production facility with respect to primary capacity surplus capacity and priority of use Although production facilities by definition are initially intended to be used exclusively for the production processing transmission etc of petroleum substances produced from the joint lands it is recognized as a principle of ownership in any facility that a facility owner may use his capacity and any available surplus capacity to handle hydrocarbons owned by such owner regardless of the source of such production However the handling of petroleum substances produced from the joint lands takes priority at all times In order to simplify the adminstration of these minor facilities no capital fee would be charged to any joint operator utilizing surplus capacity since the resulting fees would generally not justify the administrative expense if the fee were charged

1203 REVERSION OF ZONES UPON SUBSEQUENT ABANDONMENT – If the parties that took over a well subsequently cease to maintain the well as a producer of petroleum substances from a zone which was assigned to them pursuant to Clause 1202 each of those parties shall re-assign to the applicable assignor all of the interest assigned to it by the assignor in that zone Such interest thereupon shall be vested again in the assignor and included in the joint lands However nothing in this Clause shall be construed to affect the ownership of the well and the materials and equipment appurtenant thereto as determined pursuant to Clauses 1201 and 1202 and the responsibility for the abandonment of the well which shall be retained by the parties that took over the well

## ARTICLE XIII

## OPERATION OF LANDS SEGREGATED FROM JOINT LANDS

1301 OPERATING PROCEDURE TO APPLY – Where by reason of the operation of any provision hereof any portion of the joint lands ceases to be owned by the parties in the same percentages of interest as their working interests or ceases to be owned by all of the parties the parties acquiring the different percentages of interest in such lands shall thereafter hold the same as if they are parties to a separate Operating Procedure the terms of which are identical to the terms hereof having regard only to the different ownership and percentages of ownership interest in those lands and such portion of the joint lands shall cease to be joint lands hereunder The parties holding working interests in the lands which cease to be joint lands under this Clause shall appoint one of them to be the initial Operator under the separate Operating Procedure in accordance with the provisions of Article II thereof This Clause shall apply mutatis mutandis to a production facility

## ARTICLE XIV

## OPERATION OF JOINT PRODUCTION FACILITIES

1401 OWNERSHIP OF PRODUCTION FACILITIES – Subject to Clauses 1021 and 1022 each Joint Operator owns an undivided interest equal to its working interest in each production facility

1402 COMMITMENT TO DELIVER – Each Joint Operator shall subject to Clauses 1021 and 1022 utilize each production facility to produce process treat store or transmit as the case may be its share of the petroleum substances produced from the joint lands

1403 USE OF PRODUCTION FACILITIES – Each production facility shall be used primarily for the production processing treatment storage or transmission as the case may be of petroleum substances produced from the joint lands If surplus capacity in any production facility is available at any time any Joint Operator may use all or a portion of such surplus capacity to produce process treat store or transmit as the case may be other hydrocarbon substances which are produced from lands other than the joint lands (in this Article called outside substances ) and are owned by it provided that

(a) such outside substances are at all times and in all ways (including the manner and timing of the production and delivery thereof to such production facility) compatible with the design nature and operation of such production facility and the petroleum substances produced from the joint lands (including the manner and timing of the production and delivery thereof to such production facility) and

(b) the production processing treatment, storage or transmission as the case may be of petroleum substances produced from the joint lands shall at all times take precedence respecting the use of such production facility and to the extent that all or a portion of such surplus capacity is required for such purpose the delivery of such outside substances shall be curtailed or shall cease as required

In the event that there is competition for surplus capacity such surplus capacity shall be prorated to the Joint Operators desiring to use the same based on the percentage that each such Joint Operator s interest in the production facility to which such surplus capacity relates bears to the total combined interest in such production facility of all of the Joint Operators seeking to utilize such surplus capacity If a Joint Operator is eligible to use more surplus capacity than such Joint Operator desires to utilize pursuant to such calculation such Joint Operator shall be allocated only the desired capacity whereupon such capacity shall be subtracted from the total surplus capacity available The remaining surplus capacity shall then be prorated in such manner to the other Joint Operators desiring to use the same until all of the surplus capacity has been allocated

Clause 1404 i) Although significant third party usage of production facilities should not occur some custom processing/transmission of outside substances is expected during the life of any facility Clause 1404 provides a foundation for this type of arrangement. This ensures that all of the facility owners agree to the arrangement, and share in the resultant benefits The principles in this Clause reflect those most commonly found in industry CO&O agreements

ii) To simplify the administration of these minor facilities the capital portion of any fee received for the custom processing/transmission of outside substances will be allocated among the facility owners in accordance with their ownership interests (as opposed to allocating such fees based on the portion of the surplus capacity contributed by each owner to handle such outside substance)

While this deviates from industry practice with respect to significant facilities under CO&O agreements it is a generally accepted method of allocating such fees with respect to minor facilities

iii) If there is significant third party usage of the facility a separate CO&O agreement might be prepared

Clause 1405 This provision sets out the basis for allocating costs and expenses incurred in the operation of any production facility and reflects standard industry practice

Clause 1406 This provision provides the basis for allocating products generated from the processing or treatment of hydrocarbon substances utilizing a production facility

Clause 1407 This provision reflects standard industry practice respecting the allocation of shrinkage production losses and facility fuel in minor facilities

Clause 1408 This provision facilitates the evolution of minor facilities into more significant facilities as a result of facility expansion In recognition of the potential change in the nature of such a facility as a result of such an expansion this Clause together with the definition of the term production facility provides for the exclusion of the facility from the jurisdiction of this Operating Procedure when that change occurs

Note however that the Clause does not allow the provisions of the Operating Procedure to bridge any gap which may occur if a separate CO&O agreement is not in place on the date that construction relating to any significant expansion commences That being the case concerned parties should ensure that the commencement of the facility coincides with the completion of the CO&O agreement

1404 THIRD PARTY CUSTOM USAGE – A production facility may only be utilized with respect to the production processing treatment, storage or transmission of outside substances owned by a third party with the approval of all of the Joint Operators having an interest in such production facility Any such arrangement to allow a third party to utilize a production facility shall be entered into by the Operator on behalf of all of the Joint Operators having an interest in such production facility on terms and conditions similar to those outlined in Clause 1403 All third party outside substances so produced processed treated stored or transmitted shall be subject to a fee as agreed upon by such Joint Operators Such fee shall be composed of

(a) a capital recovery component so as to provide the Joint Operators with a reasonable rate of return on their capital investment and

(b) an operating cost component which shall be calculated and assessed in accordance with the provisions of Clause 1405 on the same basis that the Joint Operators bear and pay operating costs with respect to the applicable production facility

The capital recovery component of all fees received from a third party under any such arrangement shall be allocated to and distributed among the Joint Operators in accordance with their interests in such production facility The operating cost component of any such fees shall be applied against the operating costs for the production facility

1405 ALLOCATION OF COSTS – Each Joint Operator shall reimburse the Operator for a portion of the operating costs incurred with respect to any production facility This reimbursement shall either be in that proportion which the volume of petroleum substances and outside substances delivered to such production facility by or on behalf of such Joint Operator bears to the total volume of all petroleum substances and outside substances delivered to such production facility or on such other basis as the Operator with the approval of the parties pursuant to the Accounting Procedure may determine is appropriate Notwithstanding the foregoing sentence to the extent that there is a significant variation in the composition of the various streams of petroleum substances and outside substances being delivered to such production facility the Operator shall advise the other Joint Operators who shall meet with the Operator to attempt to determine an equitable method of allocating the operating costs incurred with respect to such production facility Subject to Clauses 1021 and 1022 each Joint Operator having an interest in a production facility shall bear a share of the capital costs subsequently incurred respecting such production facility equal to its interest in such production facility Notwithstanding anything to the contrary contained herein the Operator shall be entitled to deny any outside substances entry into any production facility if the Operator in its sole discretion believes that the cost to process treat store or transport such outside substances as the case may be would be significantly higher than the average cost to process treat store or transport the petroleum substances

1406 ALLOCATION OF PRODUCTS – Subject to Clauses 1021 and 1022 each Joint Operator shall be entitled to and allocated a share of any products produced from the processing or treatment of petroleum substances or outside substances at any production facility when produced from such production facility in that proportion which the volume of petroleum substances and outside substances delivered to such production facility by or on behalf of such Joint Operator bears to the total volume of all petroleum substances and outside substances delivered to such production facility Notwithstanding the foregoing sentence if there is a significant variation in the composition of the various streams of petroleum substances and outside substances being delivered to such production facility at any time the Operator shall advise the other Joint Operators who shall meet with the Operator to attempt to determine an equitable method of allocating the products produced from such production facility

1407 ALLOCATION OF LOSSES AND SHRINKAGE – The Operator shall have the right to flare any petroleum substances outside substances or any product obtained from the processing or treatment thereof at any time and from time to time at its sole discretion in the event of an emergency or operational problem With respect to any production facility each Joint Operator utilizing such production facility shall bear a share of any losses or gains actually incurred with respect to petroleum substances outside substances or any products obtained from the processing or treatment thereof due to evaporation leakage spills flaring handling measurement or use as facility fuel in that proportion which the volume of petroleum substances and outside substances delivered to such production facility by or on behalf of such Joint Operator bears to the total volume of all petroleum substances and outside substances delivered to such production facility Notwithstanding the foregoing sentence if the Operator is able to identify the actual owner of any such gain or loss such owner shall bear such loss or share such gain in proportion to its ownership thereof

1408 EXPANSION OF PRODUCTION FACILITIES – If any proposed expansion of or addition to a production facility would result in such production facility no longer being used primarily for the production processing treatment storage or transmission as the case may be of petroleum substances produced from the joint lands such proposal shall not be subject to the provisions hereof Upon the commencement of any construction relating to such proposal such production facility shall cease to be a production facility and shall no longer be subject to the provisions hereof provided that nothing contained herein shall affect the application of such provisions to the period during which such facility had been held as a production facility hereunder

Clause 1409 If the owners of a minor facility cannot resolve a dispute respecting (a) third party facility usage (b) the allocation of operating costs or (c) product allocation the matter can be referred to arbitration

Clause 1501 i) Notwithstanding the wording of this Clause the provision arguably applies to the relationship of the parties as regards third parties rather than to the actual relationship of the co-venturers

Consider this provision in the context of Clause 506 respecting the reimbursement of the operator In the event a party defaulted in its obligation to pay its working interest share of costs incurred for the joint account that provision ensures that the burden is shared by the non-defaulting parties until (and to the extent that) the operator can utilize its remedies to recover the unpaid amount. Otherwise the operator would always have to bear that burden alone

ii) The provision may not be effective against third party litigants anyway A court is not obligated by the provisions of the contract Unless the court apportions legal responsibility among defendants a successful plaintiff can enforce its judgment jointly against those defendants which were held responsible for its loss

Clause 1601 Note that this definition does not apply to events which a party could have prevented with the exercise of reasonable diligence at a reasonable cost.

Assume for example that a party which intended to drill a well in a critical sour gas area chose to delay its applications to regulatory authorities Should that party be able to rely on the force majeure provision if the well is not commenced at the required time because of a delay in attempting to obtain regulatory approval?

Clause 1602 A force majeure suspends the performance of the affected obligations not only for the period that it prevents the performance of the obligation but also for such additional time as the party may reasonably require to commence to fulfill those obligations The party cannot practically be expected to begin fulfilling its obligations the moment the force majeure is remedied This is apparent when one considers that equipment and personnel may have to be mobilized on short notice

Clause 1701 Only incentives which accrue to the operation (such as the former EDAP s or DIC s) are shared by the participants in this Clause Incentives which accrue to the participants individually such as the former APIP s and CEDIP s are not shared

1409 REFERENCE TO ARBITRATION – If there is a dispute between or among the parties with respect to (i) the approval of a facility usage fee for a production facility pursuant to either Clause 1021 or 1404 (ii) the allocation of operating costs pursuant to Clause 1405 or (iii) the allocation of products utilizing a production facility a party may by notice to the other parties cause the matter to be referred to arbitration under the provisions of the Arbitration Act or Ordinance of the province state or territory where the production facility is located

## ARTICLE XV

## RELATIONSHIP OF PARTIES

1501 PARTIES TENANTS IN COMMON – The rights duties obligations and liabilities of the parties hereunder shall be separate and not joint or collective nor joint and several it being the express purpose and intention of the parties that their interests in the joint lands and in the wells equipment, production facilities and property thereon held for the joint account shall be held as tenants in common subject to the modification of the incidents thereof that are provided in this Operating Procedure Nothing contained herein shall be construed as creating a partnership joint venture or association of any kind or as imposing upon any party any partnership duty obligation or liability to any other party

## ARTICLE XVI

## FORCE MAJEURE

1601 DEFINITION OF FORCE MAJEURE – For the purposes of this Article "force majeure means an occurrence beyond the reasonable control of the party claiming suspension of an obligation hereunder which has not been caused by such party s negligence and which such party was unable to prevent or provide against by the exercise of reasonable diligence at a reasonable cost and includes without limiting the generality of the foregoing an act of God war revolution insurrection blockage riot strike a lockout or other industrial disturbance fire lightning unusually severe weather storms floods explosion accident, shortage of labour or materials or government restraint action delay or inaction

1602 SUSPENSION OF OBLIGATIONS DUE TO FORCE MAJEURE – If any party is prevented by force majeure from fulfilling any obligation hereunder the obligations of the party insofar only as its obligations are affected by the force majeure shall be suspended while the force majeure continues to prevent the performance of such obligation and for that time thereafter as that party may reasonably require to commence to fulfill such obligation A party prevented from fulfilling any obligation by force majeure shall promptly give the other parties notice of the force majeure and the affected obligations including reasonably full particulars in respect thereof

1603 OBLIGATION TO REMEDY – The party claiming suspension of an obligation as aforesaid shall promptly remedy the cause and effect of the applicable force majeure insofar as it is reasonably able so to do and such party shall promptly give the other parties notice when the force majeure ceases to prevent the performance of the applicable obligation However the terms of settlement of any strike lockout or other industrial disturbance shall be wholly in the discretion of such party notwithstanding Clause 1601 and that party shall not be required to accede to the demands of its opponents in any strike lockout or industrial disturbance solely to remedy promptly the force majeure thereby constituted

1604 EXCEPTION FOR LACK OF FINANCES – Notwithstanding anything contained in this Article lack of finances shall not be considered a force majeure nor shall any force majeure suspend any obligation for the payment of money due hereunder

## ARTICLE XVII

## INCENTIVES

1701 INCENTIVES TO BE SHARED – Any drilling or other well incentives geophysical incentive credits or grouping rights which accrue collectively to the parties under the Regulations with respect to any operation conducted on the joint lands shall be shared by the parties which participate in such operation in proportion to their participating interests therein

Clause 1801 i) The inclusion of a provision whereby a party may use information for its own benefit is included to eliminate any possible argument of constructive trust if a party uses joint information to acquire adjacent lands for its own account when there is no express area of mutual interest obligation There would only be a slight chance that the doctrine of constructive trust would be imposed in such circumstances when the agreement is among knowledgeable parties However the reference may be relevant insofar as one or more of the parties has little expertise such as a party which is a pension fund

ii) The references to securities laws consultants bankers transferees and scout check merely reflect the fact that information is released to these persons in practice

iii) A publicly traded company is generally required to disclose all material information to the public in a timely manner The obligation is typified by the TSE requirement to file a report to the Commission whenever there is a material change being a change in the business operations or capital of the issuer that would reasonably be expected to have a significant effect on the market price or value of any of the securities of the issuer and includes a decision to implement such a change made by the Board of Directors of the issuer or by senior management of the issuer who believe that confirmation of the decision by the Board of Directors is probable

Every reporting issuer must file quarterly interim financial statements and comparative financial statements annually

A junior capital pool listed on the Alberta Stock Exchange must also issue a notice when it enters into a major transaction

iv) It is not feasible to require an Affiliate to enter into a separate confidentiality agreement with respect to each disclosure of information to it. However the party disclosing the information to the affiliate remains liable for any losses suffered by the parties as a result of the affiliate s disclosure of confidential information

v) Basically a member of scout check is required to disclose general drilling data such as depth and status A member though may minimize the disclosed information by requesting tight hole status and it may request a two week extension 30 days after rig release of a confidential well by providing a reasonable excuse (i e land sale) Additional extensions may be applied for Failure to disclose the required information after the last extension could result in a one week suspension or in special circumstances a one year suspension

vi) The disclosure of general information such as total depth or status does not enable one to argue that well data is not confidential because that particular information is in the public domain

Clause 1802 i) This provision addresses the release of confidential information to third parties for consideration The party which wishes to release the information is obligated to obtain the consent of the other parties having a proprietary interest in the information and to share the consideration for the disclosure with them

As third party contributions to operations would generally be in the context of bottomhole contributions or drilling options the inclusion of this Clause allowed the deletion of Subclause 1701(a) and Clause 1702 of the 1981 document

ii) Note that participants in an independent operation maintain all proprietary rights to that information notwithstanding that a non participant may have been supplied with that information However the disclosure of the information by the participating parties can affect the penalty account (See 1007(d) )

Clause 1803 A party which surrenders or forfeits its entire interest is not relieved of its obligations to maintain information confidential until it is in the public domain

This differs from the traditional provision which tied confidentiality to the term of the Operating Procedure Assuming that A and B held lands and that A surrendered its entire interest to B that type of provision released A from any obligation to maintain information confidential

Clause 1901 A party does not become a delinquent party if it only fails to settle its accounts hereunder The operator already has legal remedies available to it to address that problem under Article V

## ARTICLE XVIII

## CONFIDENTIAL INFORMATION

1801 CONFIDENTIALITY REQUIREMENT Each party entitled to information obtained hereunder or pursuant to the Agreement may use such information for its sole benefit. However the parties shall take such measures with respect to operations and internal security as are appropriate in the circumstances to keep confidential from third persons all such information except information which the parties have expressly agreed among themselves to release and information disclosed by a party

(a) when and to the extent required by the Regulations and securities laws applicable to such party provided that such party shall invoke any confidentiality protection permitted by such Regulations and securities laws

(b) to an Affiliate provided that such party shall be deemed to have required such Affiliate to maintain the confidential status of the disclosed information in accordance with this Article XVIII that such Affiliate shall be deemed to have accepted such obligation and that such party shall be liable for any loss suffered by the parties or any of them because of the failure of such Affiliate to maintain such information confidential

(c) to a third person to which such party has been permitted to assign a portion of its interest hereunder provided that a binding covenant is obtained from such third person prior to disclosure which provides inter alia that none of such information shall be disclosed by it to any other third person

(d) to the technical financial or other professional consultants of such party which require such information to provide their services to such party or to a bank or other financial institution from which such party is attempting to obtain financing provided that a binding covenant is obtained from such consultant or financier as the case may be prior to such disclosure which provides inter alia that none of such information shall be disclosed by it to any other third person or used for any purposes other than advising such party or providing financing to such party as the case may be and

(e) as and when required to any recognized association within the petroleum industry of which such party is a member that engages in the exchange of factual information relating to the type of operations conducted pursuant to this Agreement, unless and to the extent that the information pertains to a well drilled hereunder which a party had requested to be given tight hole status provided that such party shall invoke any confidentiality protection permitted by such association with respect to such disclosed information

However the confidentiality obligation in this Clause shall not extend to information to the extent it is in the public domain provided that specific items of information shall not be considered to be in the public domain merely because more general information is in the public domain

1802 DISCLOSURE OF INFORMATION FOR CONSIDERATION Notwithstanding Clause 1801 a party which proposes to disclose information obtained hereunder or pursuant to the Agreement for cash in exchange for other information or for other consideration shall notify each other party having a proprietary interest in such information of the details of such proposed transaction Within fifteen (15) days following receipt of such notice each of those parties shall by notice advise the party which proposes to make such disclosure whether it approves of such disclosure on the terms specified in such notice provided that failure of a party to respond within such period shall be deemed to be the approval of such party to the disclosure of such information on such terms Unless the party which proposes to disclose such information obtains such approvals from all of those other parties the proposed disclosure of such information shall be prohibited In the event such approvals are obtained the consideration to be received for such disclosure shall be shared by the applicable parties in the proportions of their proprietary interests in such information

1803 CONFIDENTIALITY REQUIREMENT TO CONTINUE Notwithstanding the foregoing provisions of this Article any party which otherwise ceases to be bound by the provisions of this Operating Procedure shall nevertheless remain bound by the provisions of this Article with respect to information obtained hereunder or pursuant to the Agreement until and to the extent that such information is in the public domain

## ARTICLE XIX

## DELINQUENT PARTY

1901 CLASSIFICATION AS DELINQUENT PARTY -- If a party changes its address and does not provide the other parties with notice of its changed address for service and subsequently cannot readily be located or if any party becomes inactive

Clause 1902 The option of paying funds into court was not included The operator requires the right to deduct that party s share of costs incurred for the joint account in a simple and timely manner In the event other amounts were owing the operator would presumably exercise its rights under Clause 505

Clause 1904 The operator can also use its rights under Article V to secure satisfaction of obligations

Clause 2001 Note the reference to actual or anticipated breaches A prudent party would try to obtain a waiver before the breach not after the fact

or is struck off the corporate register or otherwise consistently refuses or neglects to answer communications addressed to it at its address for service the Operator may send notice by registered mail to that party at its last address for service hereunder advising such party that it shall thereafter be considered a delinquent party within the meaning of this Article

1902 EFFECT OF CLASSIFICATION AS DELINQUENT PARTY – From the fifteenth (15th) day after the Operator has forwarded the notice described in Clause 1901 the delinquent party shall thereafter

(a) not be entitled to any further notices or communications from the Operator or any other party with respect to any matter hereunder including information from operations

(b) be deemed to have elected not to participate in any operation thereafter proposed to be conducted for the joint account and

(c) be deemed to have elected to join proportionate to its working interest with the Operator in the joint lands affected in all farmouts assignments surrenders and abandonments proposed and effected hereunder by the Operator for its own account, and any such dispositions effected by the Operator or by any of the parties at the direction of the Operator shall be binding on the delinquent party

However the proceeds of the sale of the delinquent party s share of petroleum substances and any other funds accruing to the working interest of the delinquent party shall be retained in trust by the Operator for the account and benefit of the delinquent party after deducting the delinquent party s proportionate share of operating costs and all other relevant costs and expenses incurred for the joint account and any marketing fee applicable to the delinquent party s share of such petroleum substances pursuant to Article VI

1903 RESTORATION OF STATUS – If a delinquent party subsequently communicates with the Operator pays all amounts owing by it hereunder satisfies all of its other obligations hereunder and undertakes in writing to comply from that time with the provisions of this Operating Procedure such party s rights and obligations hereunder shall be restored to it provided that such party shall be deemed to have ratified all actions taken pursuant to this Article including without restricting the generality of the foregoing any elections or transactions made on its behalf pursuant to Clause 1902

1904 LIEN NOT AFFECTED – Nothing in this Article shall derogate from the enforcement of the lien of the Operator and the other parties pursuant to Clauses 505 and 506

## ARTICLE XX

## WAIVER

2001 WAIVER MUST BE IN WRITING – No waiver by any party of any breach (whether actual or anticipated) of any of the covenants provisos conditions restrictions or stipulations herein contained shall take effect or be binding upon that party unless the same is expressed in writing under the authority of that party Any waiver so given shall extend only to the particular breach so waived and shall not limit or affect any rights with respect to any other or future breach

## ARTICLE XXI

## FURTHER ASSURANCES

2101 PARTIES TO SUPPLY – Each party shall from time to time and at all times do all such further acts and execute and deliver all further deeds and documents as may be reasonably required in order fully to perform and carry out the terms of this Operating Procedure

Clause 2201 i) Subclause (a) in effect provides that a notice may be personally served on a party during its normal business hours on any normal working day Should a party be closed on a particular day by its own choice (i e a third Friday off) the party will still be deemed to have received the notice on that day assuming there is a representative of the party to receive the notice

Otherwise the parties could have different response dates

Even though a golden Friday has no impact on the deemed receipt of a notice it is the better practice for a party issuing an important notice to consider the work schedules of other parties when serving the notice

ii) Subclause (b) does not require the addressee to acknowledge receipt for that notice to be effective It is sufficient if the party forwarding the notice can demonstrate that it was sent. The party serving the notice should not be required to assume the risk that the addressee s personnel do not handle the notice properly or that its equipment is not functioning properly Otherwise that party would never know whether its notice was effective In the unlikely event that there is actually a problem with receipt of notice the business considerations are such that the matter would be resolved to the satisfaction of the addressee once the problem is brought to the attention of the other parties The onus however is on the addressee to satisfy the other parties of the legitimacy of its request

iii) A notice shall be served pursuant to Subclause (a) or (b) if the applicable notice period is 48 hours or less provided that a telephone notice may be used with respect to the 24 hour casing point election to reflect typical industry practice

## ARTICLE XXII

## NOTICE

2201 SERVICE OF NOTICE – Whether or not so stipulated herein all notices communications and statements (herein called notices") required or permitted hereunder shall be in writing subject to the provisions of this Clause Any notice to be given hereunder shall be deemed to be served properly if served in any of the following modes

(a) personally by delivering the notice to the party on whom it is to be served at that party s address for service Personally served notices shall be deemed received by the addressee when actually delivered as aforesaid if such delivery is during normal business hours on any day other than a Saturday Sunday or statutory holiday If a notice is not delivered during the addressee s normal business hours such notice shall be deemed to have been received by such party at the commencement of the day next following the date of delivery other than a Saturday Sunday or statutory holiday or

(b) by telecopier or telex (or by any other like method by which a written and recorded message may be sent) directed to the party on whom it is to be served at that party s address for service A notice so served shall be deemed received by the respective addressees thereof (i) when actually received by them if received within the normal business hours on any day other than a Saturday Sunday or statutory holiday or (ii) at the commencement of the next ensuing business day following transmission thereof if such notice is not received during such normal business hours or

(c) by mailing it first class (air mail if to or from a location outside of Canada) registered post postage prepaid directed to the party on whom it is to be served at that party s address for service Notices so served shall be deemed to be received by the addressees at noon local time on the earlier of the actual date of receipt or the fourth (4th) day (excluding Saturdays Sundays and statutory holidays) following the mailing thereof However if postal service is interrupted or operating with unusual or imminent delay notice shall not be served by such means during such interruption or period of delay

However where this Operating Procedure provides for a notice period of forty eight (48) hours or less the applicable notice shall be given in accordance with Subclause (a) or (b) of this Clause provided that notices of twenty four (24) hours or less under Article IX may be made by telephone and shall be deemed to be received at the conclusion of the conversation if the telephone conversation is between representatives of the parties who are specifically authorized to accept such notice such representatives are officially on duty at the time of such conversation and such telephone conversation and notice are then confirmed pursuant to Subclause (a) or (b) of this Clause

2202 ADDRESSES FOR NOTICES – The address for service of notices hereunder of each of the parties shall be as follows

Alternate 2401A i) The 20 day deemed consent mechanism ensures that the disposition will be reviewed in a timely manner

ii) The last sentence states that it is reasonable for a party to withhold its consent if it reasonably believes that the disposition would be likely to affect its interest adversely Usually this would apply to a reasonable concern respecting the financial capability of the proposed assignee to fulfill obligations arising out of the Operating Procedure

The sentence reflects the legal test which would be applied under the 1981 provision had the issue of the withholding of consent been litigated While it could be excluded without any significant impact on the scope of the provision it has been included only to reinforce to the disposing party s non legal personnel the obligation of the disposing party to be responsible in the selection of its assignees

Should a party elect to proceed with a disposition following the refusal of consent, a party which refused its consent to the disposition would possibly have a remedy for breach of contract. It would have to prove the resultant loss suffered by it though to be awarded more than nominal damages

iii) The decision to withhold consent should be made very carefully That party could be held liable for damages if the party which proposed to make the transaction commenced an action after the termination of the transaction and a court held that the refusal to grant consent was unreasonable Courts tend to regard this type of covenant as being mostly for the protection of the disposing party that another party shall not refuse its consent unreasonably See for example Cudmore v Petro-Canada Inc [1986] 4 W W R 38 (B C S C)

Alternate 2401B i) Note that a party which does not comply with this provision faces the risk that a court could order specific performance See for example Canadian Long Island Petroleums Ltd et al v Irving Industries (Irving Wire Products Division) Ltd et al [1974] 6 W W R 385 (S C C) affirming [1973] 5 W W R 99 (Alta S C App Div)

Since that decision Alberta has amended The Law of Property Act to address a first right of refusal Subsection 59 1(1) provides that a first right of refusal is an equitable interest in land and may be registered under that Act (application limited to freehold) The common law cases on priority now apply to registrable first rights of refusal

Subclause 2401B(a) A disposing party which is confident that its purchase and sale agreement will not be amended in any material fashion may wish to provide the offerees with a copy of the purchase and sale agreement for certainty Since the disposing party would not want to negotiate a new agreement with an offeree this would ensure that the offerees are aware of all material terms and also that the resultant agreement would be finalized quickly

Subclause 2401B(b) There is no reason for a disposing party to make the effort to include its estimate of an equivalent cash value unless at least one offeree might have an interest in exercising its rights

Subclause 2401B(c) i) Note that the party which requests the cash value of consideration to be determined by arbitration assumes the risk that the arbitrated value will be higher than that proposed by the disposing party If the provision stated that the arbitrated value could never exceed that proposed by the disposing party there would be an incentive for an offeree to refer the matter to arbitration when the disposing party s estimate had been reasonable

ii) Another option would be to have the disputing party assign its value and then provide that the arbitrator may choose only one of the two alternative values Although the simplicity of the mechanism has an inherent attractiveness there are two problems associated with such a mechanism Firstly the possibility of an adverse arbitration award might result in disposing parties assigning overly conservative cash values to the relevant interest such that they may be offering the interest at less than fair market value Secondly such a mechanism might, in fact, encourage the use of arbitration If a receiving party s only potential loss is the cost of an unsuccessful arbitration some parties may gamble that they could acquire the interest for significantly less than its value

The fact that the arbitrator is free to award the costs of the arbitration should be sufficient to deter frivolous references to arbitration in most cases (See for example Section 9 of Schedule 2 of the Alberta Arbitration Act) If costs were to be shared equally regardless of the reasonableness of the respective positions there would be no deterrent to a party which wished to pursue an unreasonable position

Subclause 2401B(d) i) Note that the basic election period has been increased from 20 days to 30 days A party receiving a notice is required to conduct a complex evaluation very quickly often with little or no advance warning such that the 20 day period would not be practicable in many cases While this increased election period of course will not be attractive to a disposing party in a particular instance the disposing party is in the best position to determine the timing of notices being given Moreover presuming that the parties have elected to use Alternate B because of their desire to include a real first right of refusal the change ensures that the mechanism is effective in practice

ii) Note that the offerees have no obligation to respond until 15 days following the receipt of the arbitrated value if applicable If the obligation were not suspended pending a determination by arbitration a disposing party may not have the incentive to provide a reasonable estimate of the cash value of the consideration

One might attempt to argue that the 15 day election period following the determination of the arbitrated value is too short However this ignores the fact that the offeree which disputes the value would have conducted a detailed evaluation to support its position in the arbitration

2203 RIGHT TO CHANGE ADDRESS – Any party may change its address for service by notice to the other parties and such changed address for service thereafter shall be effective for all purposes of this Operating Procedure

## ARTICLE XXIII

## NO PARTITION

2301 WAIVER OF PARTITION OR SALE – No party shall exercise any right to apply for any partition of the joint lands or any production facility or sale thereof in lieu of partition

## ARTICLE XXIV

## DISPOSITION OF INTERESTS

2401 RIGHT TO ASSIGN SELL OR DISPOSE – Other than as required and allowed one party to another elsewhere in this Operating Procedure and subject to Clause 2402 a party shall not dispose of any of its working interest whether by assignment sale trade lease sublease farmout or otherwise without first complying with the provisions of ALTERNATE ____ below (Specify A or B)

ALTERNATE A

The party wishing to make the disposition shall by notice advise the other parties of its intention to make the disposition including in such notice a description of the working interest proposed to be disposed and the identity of the proposed assignee and request their written consent to such disposition which consent shall not be unreasonably withheld Failure of a party to reply to the request for consent within twenty (20) days of its receipt shall be deemed to be the consent of such party to such disposition It shall be reasonable for a party to withhold its consent to a disposition hereunder if it reasonably believes that the disposition would be likely to have a material adverse effect on it its working interest or operations to be conducted hereunder including without limiting the generality of all or any part of the foregoing a reasonable belief that the proposed assignee does not have the financial capability to meet prospective obligations arising out of this Operating Procedure

ALTERNATE B

(a) The party wishing to make the disposition (in this Article called "the disposing party ) shall by notice advise each other party (in this Article called an offeree ) of its intention to make the disposition including in such notice a description of the working interest proposed to be disposed the identity of the proposed assignee the price or other consideration for which the disposing party is prepared to make such disposition the proposed effective date and closing date of the transaction and any other information respecting the transaction which the disposing party reasonably believes would be material to the exercise of the offerees rights hereunder (such notice in this Article called "the disposition notice )

(b) In the event the consideration described in the disposition notice cannot be matched in kind and the disposition notice does not include the disposing party s bona fide estimate of the value in cash of such consideration an offeree may within seven (7) days of the receipt by the offerees of the disposition notice request the disposing party to provide such estimate to the offerees whereupon the disposing party shall provide such estimate in a timely manner and the election period provided herein to the offerees shall be suspended until such estimate is received by the offerees

(c) In the event of a dispute as to the reasonableness of an estimate of the cash value of the consideration described in the disposition notice or provided pursuant to Subclause (b) as the case may be the matter shall be referred to arbitration under the provisions of the Arbitration Act or Ordinance of the province state or territory where the joint lands are situated within seven (7) days of the receipt of such estimate The disposing party and the applicable offeree shall thereupon diligently attempt to complete such arbitration in a timely manner The equivalent cash consideration determined in such arbitration shall thereupon be deemed to be the sale price for the working interest described in the disposition notice

(d) Within the later of i) thirty (30) days from the receipt of the disposition notice as modified by any suspension pursuant to Subclause (b) of this Alternate B or ii) if applicable fifteen (15) days from receipt of notice of the arbitrated value determined pursuant to the preceding Subclause an offeree may give notice to the disposing party that it elects to purchase the working interest described in the disposition notice for the applicable price (in

iii) An election by an offeree to purchase the interest creates a binding contractual obligation such that both the offeree and the disposing party are bound Although not stated this would be subject to the normal due diligence requirements so as to ensure that the interest actually available for purchase corresponds to that represented by the disposing party

Subclause 2401B(e) Note the reference to the reasonable belief that a disposition to a third party would not affect the interest holders adversely Without such a reference the disposing party would be free to dispose of the interest to a third person which may not have satisfied the criteria at the end of Alternate A An offeree should never be forced to pay above what it believes a property is worth solely in order to avoid an unsuitable partner which it could have refused had the lower standard in A been chosen

Subclause 2402(a) Note that the Subclause applies to both financial and non monetary obligations A party for example may be obligated to deliver production at some future date

Subclause 2402(d) This Subclause only applies in cases in which the interest being disposed of in the joint lands represents a very small part of a large transaction

Assume that A holds a 20% interest in a 1 500 ha block (300 net ha) and it is selling its interests in 25 000 ha in which it holds an average interest of 25% including the interest in the joint lands The total net hectares being disposed of pursuant to the transaction would be 6 250 (25 000 X 25%) The net hectares of the joint lands would be 4 8% of the total net hectares in the transaction (300 - 6 250) such that the transaction would fall within the exception

this Article called a notice of acceptance") A notice of acceptance shall create a binding contractual obligation upon the disposing party to sell and upon an offeree giving a notice of acceptance to purchase for the applicable price all of the working interest included in such disposition notice on the terms and conditions set forth in the disposition notice However if more than one offeree gives a notice of acceptance each such offeree shall purchase the working interest to which such notice of acceptance pertains in the proportion its working interest bears to the total working interest of such offerees

(e) In the event that the working interest described in the disposition notice is not disposed of to one or more of the offerees pursuant to the preceding Subclause the disposition to the proposed assignee shall be subject to the consent of the offerees Such consent shall not be unreasonably withheld and it shall be reasonable for an offeree to withhold its consent to the disposition if it reasonably believes that the disposition would be likely to have a material adverse effect on it, its working interest or operations to be conducted hereunder including without limiting the generality of all or any part of the foregoing a reasonable belief that the proposed assignee does not have the financial capability to meet prospective obligations arising out of this Operating Procedure However an offeree shall be deemed to have consented to the disposition to the proposed assignee unless within the time period prescribed in Subclause (d) the offeree advises the other parties by notice that it is not prepared to consent to such disposition

(f) If the working interest described in the disposition notice is not disposed of to one or more of the offerees pursuant to Subclause (d) the disposing party may subject to obtaining the consents prescribed by the preceding Subclause dispose of such working interest at any time within one hundred and fifty (150) days from the issuance of such disposition notice provided that such disposition is not on terms that are more favourable to such purchaser than those offered in the disposition notice

(g) Following a disposition herein or one hundred and fifty (150) days following the issuance of a disposition notice from which a disposition did not result as the case may be the provisions of this Alternate shall once again apply to the working interest described in the disposition notice

2402 EXCEPTIONS TO CLAUSE 2401 – Clause 2401 shall not apply in the following instances namely

(a) An assignment made by way of security for the assignor's present or future indebtedness or liabilities (whether contingent direct or indirect and whether financial or otherwise) the issuance of the bonds or debentures of a corporation or the performance of the obligations of the assignor as a guarantor under a guarantee provided that in the event the security is enforced by sale or foreclosure Clause 2401 shall apply

(b) A disposition to an Affiliate of the assignor or in consequence of a merger or amalgamation of the assignor with another corporation or pursuant to an assignment, sale or disposition made by a party of its entire working interest to a corporation in return for shares in that corporation or to a registered partnership in return for an interest in that partnership

(c) A disposition made by the assignor of all or substantially all or of an undivided interest in all or substantially all of its petroleum and natural gas rights in the province state or territory where the joint lands are situated and for the purposes of this Subclause substantially all means a percentage of ninety percent (90%) or more of the net hectares held by such party in that province state or territory

(d) A disposition by a party in which the net hectares being disposed of by that party in the joint lands represent less than five percent (5%) of the total net hectares being disposed of by that party pursuant to that disposition

However a party making such a disposition pursuant to Subclause (b) (c) or (d) of this Clause shall advise the other parties of such disposition in a timely manner

2403 MULTIPLE ASSIGNMENT NOT TO INCREASE COSTS – If any assignment of working interest is made to multiple assignees so as to increase the expenses or duties of the Operator the Operator may require the assignees (and the assignor if it retains a working interest) to appoint one of their number as representing all of them for the purposes of this Operating Procedure unless arrangements satisfactory to the Operator are made to compensate the Operator for the increased expenses or duties

2404 RECOGNITION UPON ASSIGNMENT – Other than as required and allowed one party to another elsewhere in this Operating Procedure a party which proposes that an assignment of a working interest or a corresponding interest in the Agreement and this Operating Procedure shall be effective against the parties who are not parties to the assignment (in this Clause called the other parties ) shall first comply with the provisions of ALTERNATE _____ below (Specify A or B)

Alternate 2404A This Alternate reflects the traditional manner of effecting novations with respect to the other parties

Alternate 2404B One of the consequences of the large number of corporate reorganizations and industry rationalization programs has been a multitude of novation agreements which have not been executed by the other parties

This Alternate enables the assignor and assignee to effect a novation more simply where the assignor had complied with its other obligations under Clause 2401 if any

The difference from Alternate A is that the other parties shall be deemed to have executed the novation agreement provided to them by the assignor unless within 90 days of its receipt, at least one of the other parties advises the parties that it is not prepared to execute that agreement and the reasonable objections it has to that agreement. (In practice these objections would generally tend to be with respect to the identification of the parties or the description of the agreement or lands )

These are several major points to note about this mechanism

Firstly the Alternate reflects the view that the benefit of effecting transactions in a timely manner outweighs any uncertainty caused by not having all of the parties execute the novation agreement. This view is premised on the determination that the primary reason for the backlog in the processing of novation agreements by other parties is attributable to the novations being assigned a low priority not a multitude of objections to the document.

Secondly the deeming mechanism places some minor but critical additional administrative duties on the parties The assignor is required to provide the parties with a notice respecting the status of the processing of the agreement Upon receipt of that notice the other parties should ensure that a copy of the notice is placed with that agreement in its records if the deeming mechanism applies to a party s execution so that the risk of personnel subsequently missing the notice during a title review is minimized

Thirdly there is a duty on the part of an objecting party to advise the parties of its reasonable objections to the document at the time it gives notice of its objections (A prudent objecting party would probably send the notice by double registered mail and must send a copy to all parties ) There are no guidelines as to what objections would be considered to be reasonable such that it will usually be the subject of negotiation where the objection is something more substantive than not having the opportunity to review the document" within the 90 day period

Fourthly the deeming mechanism would also apply to revised documents issued pursuant to this Alternate

Finally the inclusion of this Alternate may require some minor modifications to the format of the typical novation agreement A counterpart execution clause for example would need to contemplate the deemed execution mechanism

Common Conditions The Alternates and Subclauses (a) and (b) reflect some of the major components of novation agreements-the assumption of obligations by the assignee with respect to the assigned interest the effective date of the assignment (Subclause (a)) and the trust arrangement on which the other parties may rely until the agreement becomes effective pursuant to the Clause (Subclause (b)) That agreement would also include other provisions such as the responsibility for obligations accruing prior to the effective date of the assignment and any discharge of the assignor

Clause 2501 i) The Clause does not prevent a party from commencing an action against another party such as a suit alleging the gross negligence or wilful misconduct of the operator

ii) One dispute resolution mechanism which is gaining popularity is professional mediation In essence the mediator acts as a conciliator to encourage the parties to focus on the nature of the issue and possible solutions which are preferable to the parties than litigation Since the mediator has no authority to determine the outcome of the dispute (unlike arbitration) the parties have nothing to lose by attempting to resolve the dispute through mediation When compared to litigation the three major advantages of mediation are cost timing and the limited scope for damage to long term business relationships

iii) Arbitration may also be preferable to litigation because of the lower cost, the prompt resolution of the dispute and the ability to select an arbitrator who has professional expertise in the area to which the dispute pertains

ALTERNATE A

The assignment of a working interest or a corresponding interest in the Agreement and this Operating Procedure shall only be effective against the other parties if

(i) notice of the assignment has been served on each of the other parties in accordance with Clause 2401 if applicable and

(ii) the assignor and assignee have entered into an agreement with the other parties which is acceptable to the other parties to ensure the assumption of and compliance with the obligations of the assignor by the assignee with respect to the interest assigned to the assignee

OR

ALTERNATE B

The assignment of a working interest or a corresponding interest in the Agreement and this Operating Procedure shall only be effective against the other parties if

(i) notice of the assignment has been served on each of the other parties in accordance with Clause 2401 if applicable and

(ii) the assignor and the assignee have entered into an agreement with the other parties to ensure the assumption of and compliance with the obligations of the assignor by the assignee with respect to the interest assigned to the assignee provided that the other parties shall be deemed to have executed that agreement unless within ninety (90) days of the receipt of that agreement one (1) or more of the other parties have advised the parties by notice that they are not prepared to execute that agreement and the reasonable objections they have to that agreement

The assignor shall forthwith give notice to the parties respecting the status of that agreement upon the earliest of execution of that agreement by the other parties the receipt of notices of one or more of the other parties that they are not prepared to execute that agreement or the expiry of such ninety (90) day period as the case may be

**The following conditions shall be applicable to the ALTERNATE which is specified**

(a) Subject to Subclause (b) of this Clause if an assignment is effected in the manner prescribed in this Clause the assignment shall be effective against the other parties at the time specified in the agreement provided to the other parties pursuant to the Alternate specified in this Clause

(b) Until the agreement provided to the other parties pursuant to the Alternate specified in this Clause has been executed or if applicable deemed to have been executed by the other parties the assignor shall continue to remain liable to the other parties for performance of the obligations applicable to the assigned interest under the Agreement and this Operating Procedure The other parties may also rely on the assignor as being trustee for and authorized agent of the assignee in all matters relating to the assigned interest during such period

(c) This Clause 2404 shall in no event operate to affect or impede an assignment described in Subclause 2402(a)

## ARTICLE XXV

## LITIGATION

2501 CONDUCT OF LITIGATION – Litigation with respect to the title documents the joint lands or any joint operation shall be conducted for the joint account on behalf of all parties unless and to the extent that such litigation is among the parties Each party shall notify the other parties of any process served upon it or of any process it intends to serve in any action involving the title documents the joint lands or any joint operation The parties then shall decide whether an action for the joint account shall be handled by the solicitors of the parties or by joint counsel mutually selected by the parties However nothing contained in this Clause shall preclude a party from also acting on its own (and at its own expense) if in its opinion it considers such action advisable or necessary to protect its particular interest hereunder provided that a party so acting on its own behalf shall not pursue a course of action contrary to litigation then being conducted for the joint account

Clause 2601 This provision is structured broadly enough to be used with respect to both jurisdictions with perpetuities legislation such as Alberta and other jurisdictions in which the conventional principles of common law apply

Clause 2701 All filings pursuant to this Clause are at the sole expense of those parties subject to the Code

Clause 2803 i) An amendment is not effective unless it is executed by the parties

ii) A notice of a changed address for service pursuant to Clause 2203 is an exception to the general rule

Clause 2807 This Clause is included to minimize the possibility that a party could successfully turn to a court for relief in the event that a provision were being utilized to its detriment A court has limited jurisdiction to provide a party with relief against forfeiture notwithstanding the clear wording of an agreement. (See for example Sec 10 of the Alberta Judicature Act)

## ARTICLE XXVI

## PERPETUITIES

2601 LIMITATION ON RIGHT OF ACQUISITION – Notwithstanding anything to the contrary contained herein the right of any party to acquire any interest in the joint lands hereunder shall not extend beyond the period prescribed by the applicable perpetuities Regulations or in the absence of such Regulations twenty one (21) years after the lifetime of the last survivor of the lawful descendants now living of Her Majesty Queen Elizabeth II

## ARTICLE XXVII

## UNITED STATES TAXES

2701 UNITED STATES TAXES – If for purposes of the United States Internal Revenue Code of 1986 as amended ("the Code ) this Operating Procedure or the relationship established thereby constitutes a partnership as defined in Section 761(a) of the Code each of the parties who are entitled under such Section to elect, hereby elects to have such partnership excluded from the application of Subchapter K of Chapter 1 of Subtitle A of the Code or such portion thereof as the Secretary of the Treasury of the United States or his delegate shall permit by election to be excluded therefrom The Operator is authorized to execute such election on behalf of the parties who are entitled to make such election and to file the election with the proper United States government office or agency The Operator is further authorized and directed to execute and file such additional and further evidence of such election as may be required all at the expense solely of those parties subject to the Code However if the Operator is not subject to the Code with respect to the joint lands the obligations of the Operator under this Clause shall be fulfilled by the party who is subject to the said Code with respect to the joint lands and who among those parties subject to the Code holds the greatest working interest.

## ARTICLE XXVIII

## MISCELLANEOUS

2801 SUPERSEDES PREVIOUS AGREEMENTS – Except for the Agreement (other than to the extent that the Agreement by its terms becomes ineffective when this Operating Procedure is made effective) this Operating Procedure supersedes all other agreements documents writings and verbal understandings among the parties relating to the joint lands and any production facilities and expresses all of the terms and conditions agreed upon by the parties with respect to the joint lands and any production facilities

2802 TIME OF ESSENCE – Time shall be of the essence in this Operating Procedure

2803 NO AMENDMENT EXCEPT IN WRITING – Except as otherwise provided in this Operating Procedure no amendment or variation of the provisions of this Operating Procedure shall be binding upon any party unless and until it is evidenced in writing executed by the parties

2804 BINDS SUCCESSORS AND ASSIGNS – Subject to the provisions of Article XXIV this Operating Procedure shall enure to the benefit of and shall bind the parties their respective successors and assigns and the heirs executors administrators and assigns of natural persons who are or become parties

2805 LAWS OF JURISDICTION TO APPLY – This Operating Procedure shall for all purposes be construed and interpreted according to the laws of the jurisdiction within which the joint lands are situated and the laws of Canada applicable therein The courts having jurisdiction with respect to matters relating to this Operating Procedure shall be the courts of that jurisdiction

2806 USE OF NAME – Each party agrees that it will not use suffer or permit to be used directly or indirectly the name of any other party for the purpose of or in connection with the financing in whole or in part of any operation hereunder in connection with the offering for sale of shares of stock or any other securities or for the formation or promotion of any business enterprise without in each instance first obtaining the written consent of that other party

2807 WAIVER OF RELIEF – The parties acknowledge that any default forfeiture or assignment provisions contained in this Operating Procedure are in view of the risks inherent in the exploration for petroleum substances reasonable and equitable Each party waives any and all rights which it may have at law in equity or by the Regulations against default forfeiture or penalty if such provisions are invoked

Clause 2901 i) Remember that confidentiality obligations continue pursuant to Clause 1803

ii) Note the proviso that the provisions relating to audit, liability indemnity disposal and salvage of material and enforcement on default continue for six years after the date the Operating Procedure otherwise terminates

This is particularly relevant with respect to liabilities which were only contingent at the date of termination especially in light of the increased sensitivity to environmental issues

## ARTICLE XXIX

## TERM

2901 TO CONTINUE DURING ANY JOINT OWNERSHIP -- Subject to Clause 1803 this Operating Procedure shall terminate when no portion of the joint lands and no production facility is owned jointly by two or more parties or at that later date upon which joint ownership continuing all title documents have terminated all wells on the joint lands have been abandoned all equipment relating thereto salvaged and a final settlement of accounts has been made among the parties provided that those provisions relating to audit, liability indemnity disposal and salvage of material and enforcement on default shall survive for six (6) years thereafter