Updates To The CAPL Farmout & Royalty Procedure-Part I
CAPL Negotiator, June, 2016

The parallel updates to the 2007 CAPL Operating Procedure, the 1997 CAPL Farmout & Royalty Procedure and the 1997 CAPL Overriding Royalty Procedure were endorsed by CAPL in late 4Q2015. The documents were finalized after three industry drafts and various additional iterations with the commenting parties to optimize the handling of their comments, to obtain their insights on other changes and to confirm alignment.

This is the fourth of a series of articles to outline the more significant changes in the updated documents, and is the first of the series on the 2015 updates to the 1997 CAPL Farmout & Royalty Procedure. This article provides a context for change and begins an overview of the most critical changes, or the “magnets to use”.

The CAPL website includes various materials relating to the 2015 CAPL Farmout & Royalty Procedure (“FO&RP”) and the largely parallel 2015 CAPL Overriding Royalty Procedure that are designed to facilitate a transition to use of the new documents. These materials include: (i) an overview of the project scope and the major changes in a user friendly format; (ii) a detailed 38 page table that outlines in summary form all material changes relative to the 1997 CAPL Farmout & Royalty Procedure and the rationale for those changes; (iii) a clean copy of the text and annotations for each of the documents; (iv) a Word version of a sample election sheet for each of the documents; (v) a redlined copy of the text and annotations relative to the June, 2015 drafts; (vi) a matrix showing industry comments on the June, 2015 draft of the FO&RP and our responses; and (vii) copies of letters of support for the project from CAPLA, CAPPA, EPAC, PASC and the PJVA.

We’re Still Very Fond Of Our 2001 Honda Odyssey, But….

We still have our 2001 Honda Odyssey. It has been a great vehicle, and the only significant problem we have ever had was the need to replace the transmission several years ago. It drives very well and looks much younger than its age-almost like new after a wash actually. It has been a big part of our lives, having been with us all the way from car seats to being used to teach our two oldest daughters how to drive. Truth be known, it will be a sad day for all of us when we switch to a new vehicle at some point because of the happy memories of family vacations and watching our once little girls grow into young women.

With that context, imagine if we were approached by Honda and offered a new 2016 Honda Odyssey at no charge whatsoever, other than for the time required by us to learn about its many new and improved features and to take it for a test drive to become comfortable with it.

As much as we still like our 2001 Honda Odyssey a lot and would want it to find a good home, we would gladly take this gift of a 2016 Honda Odyssey if our review of the new features and road test confirmed that it was another very good vehicle.

I have presented this as an analogy to the 2015 FO&RP. The 2001 Honda Odyssey, of course, is the 1997 document, Honda is the CAPL and the 2016 vehicle is the 2015 FO&RP that has been offered to you at no charge, other than for the effort to familiarize yourself with it. It also has the same designer, with the benefits of the insights gained by 19 years of intervening experience with the intricacies of the model and other models, as well as user questions and feedback over time. It has many new and improved features, and has been extensively lab and road tested prior to its release. And it costs you absolutely nothing, other than for the time required by you to learn about those updated features and to take it for a test drive!

This series of articles will introduce you to the many new and improved features of the FO&RP, to facilitate your transition to this new vehicle, assuming, of course, that you would like a free upgrade.

The Case For Change

The following comment on the initial draft of the FO&RP from a company not involved in the project summarizes far more eloquently and succinctly than I ever could the case for change for a shift to the updated 2015 FO&RP:

> "After reviewing the document with the …. team we noticed a constant theme. This agreement is predominately providing context and clarity on almost all clauses compared to the 1997 FO and Royalty Procedure. This context and clarity are welcomed as this document is addressing current situations that the industry is facing with the focus on resource plays, technology and horizontal drilling."

As was the case with respect to the updates in the 2015 CAPL Operating Procedure, the update to the 1997 CAPL Farmout & Royalty Procedure largely relates to the changes required to address the needs of Horizontal Wells and resource projects.

As shown on the 38 page matrix summarizing the changes made in the 2015 FO&RP and the rationale for those changes, the 1997 document had a wide range of other performance issues that were inevitably going to manifest themselves at some point over time. While many of the modifications identified in the matrix are relatively modest, I believe that the overriding conclusion from a review of that document is that it proves beyond a reasonable doubt the case for change.

There are two other major factors that will influence industry's transition to the 2015 FO&RP.

The first is that industry's response to the updated materials has been very positive. In this regard, 41 of the more active E&P companies were invited to attend a half-day training session on the 2015 FO&RP and the 2015 CAPL Operating Procedure. The feedback from the 34 companies that chose to attend that session was very positive, as has been the feedback from the 110 attendees at the subsequent half-day introductory training courses on the documents. No significant concerns with respect to either the FO&RP or the new Operating Procedure were identified at any of those sessions.

The second is that this update was completed in parallel with the update to the Operating Procedure. This was done largely to optimize the alignment between the two documents on an ongoing basis. One of the other anticipated benefits of this is that the interrelationship of the updated documents encourages users to shift to each of the new documents in a timely manner.

The net effect is that a critical mass of industry is at various stages in transition to the new documents.

This article and the September article focus on the most impactful changes in the FO&RP, what I refer to as the "magnets to use". This month's article addresses the first two of those magnets to use-the increased breadth and depth of coverage in the 2015 FO&RP and the updates to Article 3.00. The September issue focuses on the other magnets to use-the handling of Royalty Allocation Wells; the handling of deductions against an ORR; the drilling of an additional well in the same formation on the same Spacing Unit as a BPO/APO well; and updates to the Area of Mutual Interest Article.

A Better "Car Manual", Albeit A Bigger One

In recent years, I have described the CAPL Operating Procedure and the CAPL Farmout & Royalty Procedure in the context of a user manual for a car.

After an initial familiarization with the features of a new vehicle, the owner typically puts the user manual back into the glove compartment until there is (dramatic pause)….. a problem. At that point, the user pulls out the car manual and wants two things more than anything else-to find the applicable section of the user manual that addresses the problem and a complete and logical answer that enables the user to understand and resolve the problem.

Not once in over 25 years of answering questions on the Operating Procedure, for example, have I ever heard anyone tell me that the provisions and the annotations have given them too much information when they are looking at the materials in the context of their specific real world problem.

The challenge in trying to write a car manual that provides users with reasonably complete solutions to reasonably foreseeable problems, of course, is that the cumulative length of the car manual is usually longer than what one would ideally prefer. Compounding this is that a car manual is hardly light vacation reading. This would obviously be of great concern if one read a car manual from cover to cover every time there were an issue. Fortunately, we actually use a car manual by finding, reviewing and applying the relevant information-typically a page of content or less.

In that context, the first "magnet to use" of the 2015 FO&RP is, as noted in the quotation above, the greater "context and clarity" it offers users. The simple fact is that our industry is fundamentally different than existed at the time the 1997 document was prepared because of the increasing emphasis on horizontal drilling, resource plays and more technologically complex projects.

Unfortunately, the resultant updated FO&RP is 40 pages long, compared to the 22 page 1997 document. There were a number of factors that contributed to this incremental length.

There was a significant expansion to some of the 1997 provisions to address recognized issues (e.g., Clauses 1.02, 3.01, 3.02, 5.05, 6.02, 8.01 and 9.03). New provisions were included to address the major changes in the landscape of our business, such as: (i) nine new definitions; (ii) a number of modifications to accommodate the possibility of Re-entry Programs; (iii) new Subclauses in Clause 3.03 to mitigate the future need for trust agreements as a consequence of earning agreements; (iv) a new Clause 5.03 to address the increasingly common circumstance in which a Royalty Well straddles Royalty Lands and other lands; (v) a new Article 10.00 to address the increasing number of partial interest farmouts; and (vi) modifications to Article 18.00 to address a restriction on drilling during the earning phase and the possibility that the Title Documents relating to the Farmout Lands might be administered by a Party other than the Operator.

There were also a number of stylistic changes made to the document that increased its length. Longer provisions were subdivided into Subclauses or lists to make the provisions more user friendly as part of our attempt to move to a plainer language presentation. Headings were included for every Subclause to provide a context about the content of the Subclause and to enable users to find required content more easily. Several words of context were also added for the vast majority of cross-references to position users to understand if or why they needed to look at the referenced provision.

Finally, the simple truth is that we didn't know what we didn't know when we created the 1997 document. It was only after many years of experience with the document and seeing how it held up when faced with the increased complexity of today's business that we understood fully the degree to which changes were required to position us for the current and anticipated needs of our industry.

Article 3.00-Obligations Relating To A Test Well

There were many issues associated with this Article, only some of which related to Horizontal Wells. The resultant updated Article is about five pages, compared to only 1.25 pages in the 1997 document.

An overview of the more substantive updates to the Article follows:

Difficulties In Commencing Test Well Operations (Subclause 3.01B)

The typical drilling commitment included in a Head Agreement includes a reference that performance is subject to "rig availability, surface access and receipt of required regulatory approvals". That type of qualification is deficient in several ways. There is usually no requirement that the Farmee notify the Farmor of the perceived difficulties in a timely manner once it determines that it may be unable to Spud the Test Well. The proviso also typically does not include a restriction whereby the Farmee may only rely on the qualification if it has been proceeding with reasonable diligence (i.e., not having a drilling rig because the Farmee waited until two weeks before the Spud date to contact drilling companies would not meet this criterion).

The updated Subclause addresses the issue in a way that provides the desired operational flexibility without the potential abuse that could occur under the typical industry provision. Paragraph 3.01B(a) addresses the types of events contemplated in the typical industry Clause, with the inclusion of a pre-requisite that the Farmee had been diligently using reasonable efforts to address those matters. The incorporation in Clause 1.02 of Clauses 16.01 and 16.02 of the Operating Procedure addresses the notification and periodic update aspects of the obligation.

Farmee's Obligations For Evaluation Of A Test Well (Subclause 3.01D)

Clause 3.01 was substantially rewritten in the 2015 FO&RP to offer greater clarity about the interrelationship between the obligations to "Complete, Cap or Abandon" the Test Well, the obligation to evaluate it to the Farmor's reasonable satisfaction and the obligation to test each prospective formation of the Farmout Lands. The 1997 document potentially created confusion if the initial Completion attempt was unsuccessful and another prospective formation was identified on logs.

The 2015 FO&RP introduces a qualification in Paragraph 3.01D(a) that a Completion is not regarded as successful for this Subclause if the well is proposed for Abandonment before producing for at least 60 days (i.e., the Farmee assumes all such Abandonment costs in a "straight up" deal), notwithstanding that the Operating Procedure may otherwise apply to the well. (See Paragraph 6.02A(a) and Subclause 7.01A too.)

The 2015 document introduces an optional Paragraph 3.01D(b) that sees a differentiation in duties for evaluation between Horizontal Wells and other wells. If selected, that Paragraph will typically require the Farmee to conduct one *bona fide* continuous Completion attempt in the horizontal interval. Any further Completion attempt will not be a condition of earning, such that an additional Completion attempt would be presented under any applicable Operating Procedure. This reflects an assumption that a Horizontal Well is drilled to be Completed and recognition of the cost and risk inherent in the Completion of a Horizontal Well.

Farmors in this type of project will often want to prescribe some expectations for the extent of a multi-staging fracing obligation, so that the initial program offers a meaningful evaluation of the formation at the Farmee's expense. For example, Parties considering an evaluation of a longer reach Horizontal Well should describe their expectations carefully in their Head Agreement respecting consultation obligations, the number of frac stages and any distance restriction between frac stages.

For a well other than one to which optional Paragraph 3.01D(b) applies, Paragraph 3.01D(c) requires the Farmee to set casing for the well and conduct a Production Test on the prospective formation(s) if Petroleum Substances are reasonably anticipated to be present in Paying Quantities. A well placed on production for 30 days (or sooner ceasing to be capable of production) is deemed to meet this requirement for the applicable formation in the Production Test definition.

The testing obligation under Paragraph 3.01D(c) is for each formation for which it is reasonably anticipated that Petroleum Substances will be present in Paying Quantities in the Test Well. The second sentence of Subclause 3.01B of the 1997 document included a similar requirement. That presentation was suboptimal because of the unclear interrelationship with the obligations in Subclause 3.01A thereof. The potential implications of the issue were not fully understood when the 1997 document was created because “straight up” deals were used less frequently and because there was much less emphasis on multi-target prospects.

This was the most significant flaw in the 1997 document, and it was independent of the more recent experiences with Horizontal Wells. The fundamental issue created by this obligation for a Test Well that is prospective in multiple formations was in determining when the Farmee’s obligations for that well were complete.

For context when considering this issue, it is important to recall that a Farmor has four basic expectations for a Test Well. Its major objectives are: (a) to retain tenure; (b) to obtain an understanding of the prospectivity of the Farmout Lands; (c) to preserve its capital; and (d) to obtain production and income in due course.

To illustrate the issue, consider four potential scenarios in which the Farmee under a “straight up” earning structure has conducted a Completion program on the Test Well in circumstances in which there are two prospective formations recognized on logs.

In the first, the Farmee has conducted an unsuccessful Completion in the deeper formation and immediately conducts a second test in the shallower target. Should the Farmee be able to serve an Operation Notice for the proposed Completion? The Farmor would intuitively seem to have a strong argument that this activity is part of the initial evaluation of the Test Well, such that it should be at the Farmee’s cost. This is because of the sequential nature of the Farmee’s Completion program.

In the second, the Farmee has conducted a successful Completion in the deeper formation and has produced the well for 60 months. It now wishes to conduct an uphole Recompletion in the shallower formation. Should the Farmor be able to argue that the Completion of the uphole formation should be at no cost to it because of the original obligation to evaluate each prospective formation? The Farmee would intuitively seem to have a strong argument that this activity should be conducted under the Operating Procedure because of the sustained productivity that generated revenue to the Farmor.

In the third, the uphole Completion is proposed after the Test Well was suspended for six months after an unsuccessful Completion in the deeper formation. Should the Farmee be able to serve an Operation Notice to the Farmor for the proposed Completion? The Farmor would intuitively seem to have a strong argument that this activity should be regarded as part of the initial evaluation of the Test Well, such that it should be at the Farmee’s cost. To provide otherwise would reward the Farmee for its own inactivity.

In the fourth, the uphole Completion is proposed after the Test Well initially produced for four months. This scenario can easily lead to disputes, as each of the Farmee and the Farmor can make persuasive arguments about its preferred outcome.

The literal handling in the 1997 document was too onerous on a Farmee if there were multiple prospective formations included in the Farmout Lands. The onus is on the Farmee to modify the document to include a cap on the number of formations that the Farmee could be obligated to evaluate in that circumstance or some other control on the potential scope of the obligation.

Optional Paragraph 3.01D(d) was included in the 2015 FO&RP to offer certainty about the duration of obligations under Paragraph 3.01D(c) if there is prospectivity in multiple formations, and states:

This Paragraph applies if the Farmee has successfully Completed a Test Well under Paragraph 3.01D(c) for production in Paying Quantities from a formation of the Farmout Lands (including satisfaction of its Production Testing requirements for that formation). Notwithstanding Paragraph 3.01D(c), the Farmee will be relieved from the obligation to conduct further Production Tests in that formation or additional formations of the Farmout Lands in that Test Well at the earlier of the following:

(i) *the day on which that well has produced for _____ cumulative production days; or*

(ii) *the day on which the cumulative gross (100%) Equivalent Production (before lessor royalties, the Overriding Royalty and the Encumbrances and after the removal of water, basic sediment and other applicable impurities) is _______ cubic metres.*

This Paragraph offers a level of clarity that is entirely missing today in the context of Farmout Lands with stacked zonal potential. It uses the earlier of a negotiated number of production days or the attainment of a negotiated volume of production. The linkage to productivity (rather than a simple time test) is designed to ensure that a Farmee will not be rewarded for Suspending a well that may be prospective in another formation. (For context, the *Oil And Gas Conservation Rules* (Alberta) includes as part of the definition of “productive well” the expectation that an oil well have “produced either a cumulative volume of 400 cubic metres of oil or its full base allowable for two consecutive months.”)

In practice, it is very unlikely that Parties selecting use of this Paragraph would agree to a period that would be for 700+ production days or a period of only 15 production days. Whether that negotiated period is 45, 60, 90, 120 or 180 production days is a matter of negotiation between the Parties.

Optional Subclause 3.03D is also relevant to this Subclause. It recognizes that ready access to regional infrastructure or competitive drainage concerns are such that conditional earning for Capping prior to the required well evaluation might not be acceptable to the Farmor. If selected, that Subclause provides that Capping may not be used by the Farmee to earn its Working Interest conditionally.

<u>Clause 3.02-Substitute Well</u>

The 1997 version of this Clause largely reflected the traditional way of handling this low probability event. Historically, the only issue about this provision had been whether the substitute well was optional or mandatory. The optional position has evolved to be the majority position in industry because of the potential financial burden of a second well and the fact that the Farmee would earn nothing for the first well. The provision is generally academic, except for wells in: (a) the foothills; (b) areas with limited well control; and (c) other selected high cost/limited accessibility areas. The Clause has been expanded significantly in the 2015 FO&RP, as major deficiencies were observed in a situation in which the Clause applied.

The Clause now refers to “substantially impenetrable formations”, rather than “impenetrable formations”. This reflects the fact that almost any formation can be drilled if an explorer is prepared to spend enough money. Farmees that know they are drilling a well in which this may be an issue might consider modifying the Subclause to quantify a drilling rate over a prescribed period that meets this test. This could be something like “…*a formation then being penetrated at a drilling rate of less than X metres per hour for at least Y hours in the absence of other mechanical difficulties*”. The period should be sufficiently long so that there is a genuine attempt to drill through that formation.

The updated Clause offers greater guidance about the circumstances in which a Farmee may terminate the initial well. It includes a “commercially impracticable” test, rather than the traditional “impractical” reference to increase clarity. Would a reasonable Farmee facing these continued mechanical difficulties and substantially impenetrable formations continue drilling the well? Subclause

3.02A qualifies the reference by noting that the test is not satisfied simply by the Farmee's belief that the well will not encounter Petroleum Substances, that the costs are higher than anticipated or that the expected well results will not offer a satisfactory return on its investment. Again, this is designed to reinforce the exceptional nature of this remedy.

Subclause 3.02D was another significant upgrade introduced in the 2015 FO&RP. Industry's traditional substitute well provision did not state expressly that a Farmee that chose not to proceed with the substitute well did not face a potential damages claim against it for its failure to fulfill its drilling commitment. This provision addresses that issue, while being clear that nothing in this Clause otherwise operates to release the Farmee from its other accrued obligations and liabilities, such as its responsibility for Abandonment of the initial well and any associated Environmental Liabilities.

<u>Subclauses 3.03B&C-Trust Duties</u>

Parties have traditionally prepared separate trust agreements in situations in which the Farmor has retained Reserved Formations. Those trust agreements outline the respective rights and obligations of "the trustee" and "the beneficiary". They create incremental administration, particularly if the lands are subsequently being disposed.

The 2015 FO&RP attempts to eliminate the need for a separate trust agreement by creating a comparable outcome within Subclause 3.03B. The provision is of limited application if the Farmor does not hold a registered interest in the Title Documents.

That Subclause is also clear that the Parties are expected to proceed with transfers of the legal interest in the relevant Title Documents in due course if transfers subsequently became feasible. This would be the case, for example, if the original Reserved Formations later reverted to the lessor of the Title Documents.

Subclause 3.03C recognizes that the Farmor will sometimes transfer the legal interest to the Farmee. This may be because of such factors as: (a) the value of the Farmout Lands relative to the Reserved Formations/other rights; (b) a concern about potentially being responsible for unpaid royalties or other liabilities; or (c) the nature of the respective organizations. In the absence of any separate trust agreement at the time, this Subclause creates a trust relationship in that circumstance, and applies Subclause 3.03B, *mutatis mutandis*, to the Farmee in its role as trustee.

May The FORP Be With You!

With the completion of the FO&RP and the initial rollout to industry to a positive response, the focus has shifted to education and the transition to use. By the time that you read this, many of your peers will already have initiated the process to transition to use of the 2015 FO&RP in their companies.

As the Star Wars character Yoda would say, "To join us on the next phase of the journey, we hope that you choose."

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This is the fifth of a series of articles to outline the more significant changes in the updated documents, and is the second of the series on the 2015 updates to the 1997 CAPL Farmout & Royalty Procedure. This article provides a continued overview of the most critical changes, or the "magnets to use". It reviews one of the most useful additions to the document, Clause 5.03, which addresses what we refer to as "Royalty Allocation Wells".

Context

It is increasingly common for Horizontal Wells to be drilled across multiple spacing units to drill through a spacing unit that includes Royalty Lands and a spacing unit that includes other lands. This is particularly the case as advances in technology and the proliferation of shale projects see more long reach wells being drilled.

A "Royalty Allocation Well" is a well in which the horizontal portion of the well penetrates both a spacing unit that includes Royalty Lands and another spacing unit that includes other lands.

This Clause was introduced in the 2015 document to provide clarity for the allocation of an ORR between the applicable Royalty Lands and other lands if there is a Royalty Allocation Well. It is one of the most compelling reasons to use the 2015 document. The Clause also offers a way to address this issue in older agreements, a situation that is already arising frequently.

Allocation Ratio

The allocation of an ORR between the Royalty Lands and other lands with respect to a Royalty Allocation Well is based on the definition of "Allocation Ratio". It includes two Alternates.

One methodology (Alternate 1) basically uses the ratio of the Royalty Length to the well's Total Horizontal Length. That Alternate is generally well aligned with the approach used by Alberta in Production Allocation Unit Agreements for an allocation of production between Crown and freehold rights penetrated by a Royalty Allocation Well.

The other methodology (Alternate 2) was included primarily to accommodate the production allocation approach used by the Saskatchewan Crown for a similar allocation. The current Saskatchewan methodology for lessor royalty allocations involving Crown rights is based on the acreage within a cigar shaped area around the horizontal portion of the well. Alternate 2 aligns directly to the approach prescribed by the Regulations of the applicable jurisdiction for the volume allocation for Crown royalty purposes, recognizing that the Crown methodology could change at any time.

Inherent in a selection of Alternate 1 is that use of this Alternate may prescribe a different outcome than that under the applicable Crown process. It is important to recall when choosing the applicable Alternate, though, that there is no requirement that the contractual outcome between the Royalty Owner and the Royalty Payor must be the same as the lessor arrangements in the applicable jurisdiction. In other words, there is no requirement in the document or the regulations to include Alternate 2 to align the allocation of a contractual ORR with the regulatory approach for the allocation of lessor royalties between Crown and freehold rights.

Calculation Of Allocation Ratio Under Alternate 1

The Allocation Ratio under Alternate 1 is the ratio of the Royalty Length of a Royalty Allocation Well to its Total Horizontal Length based on the As Drilled Survey for the well. To illustrate, the Allocation Ratio for a Royalty Allocation Well with a Royalty Length of 600m out of a Total Horizontal Length of 2000m would be 30%.

If there were oil production of 38 cubic metres/day (i.e., 239.1 b/d), the Allocation Ratio of 30% (600/2000) would see 11.4 cubic metres/day of oil allocated to the Royalty Lands (i.e., 342 cubic metres/30 day month). Assuming the typical 23.8365 divisor and the 5-15% sliding scale applied, the sliding scale ORR accruing to the Royalty Owner for that month would be 14.35% of the allocated 342 cubic metre volume.

As noted in the definition of Toe, the Allocation Ratio will be adjusted if a portion of the horizontal segment of the well is permanently plugged back or cemented off prior to putting the well on initial production. It is clear under Subclause 5.03D that no further adjustments would be made to the Allocation Ratio over the life of the well, though, if productivity of the Royalty Allocation Well changed over time or further plugging back activities were conducted in the horizontal portion of that well.

The calculation is complicated if a further allocation is required within a portion of the spacing unit(s) for the Royalty Allocation Well under Clause 5.02 because the Royalty Lands comprise only a portion of the applicable area. A Horizontal Leg of a gas well on Sections 1 and 2 in which the Royalty Lands comprise only S1 and S2 would require an allocation to each Section, for example, so that the allocation within each of the Sections could then be made under Clause 5.02.

To illustrate this application of Alternate 1, assume that the Royalty Lands are all Section 1 and N2, that a Royalty Allocation Well targeting gas is drilled on S1 and 2 and that 70% of the Royalty Length is on Section 1 and 30% on Section 2. In that example, 70% of the production would be allocated to Section 1 and 30% to Section 2. That 30% for Section 2 would then typically be further allocated under Clause 5.02 between the Royalty Lands (50% of 30%) and the other lands (50% of 30%).

Notwithstanding the construction of Alternate 1, parties might prefer to use a more complex calculation in some circumstances by linking the calculation to the number and location of the staged fracs in a Royalty Allocation Well or forecast relative production if there are known differences across the well. Those methodologies would be situation dependent, such that they would not be appropriate for inclusion in a document of general application. Care must be taken, though, if the parties are using a methodology that could be manipulated, it is not readily transparent or it could see changes over time (e.g., a recompletion with additional fracs). The parties would also need to be aware that this type of negotiated allocation would be inconsistent with the methodologies applied by regulatory authorities in their Production Allocation Unit Agreements.

Supporting Provisions

Subclause 5.03B provides the Royalty Payor with a high degree of flexibility in its activities with respect to the planning, execution and operation of a Royalty Allocation Well. The Royalty Payor is to provide prior notice to the Royalty Owner of the intention to drill a Royalty Allocation Well, and is to include a copy of the preliminary survey plan associated with that well.

Subclause 5.03C is structured so that the methodology in the Clause will apply to every Royalty Allocation Well drilled under the Agreement. The alternative approach of requiring a separate royalty allocation agreement for each Royalty Allocation Well would offer negotiating leverage to a party at the time the applicable well is being planned. Creating a consistent, logical methodology for all Royalty Allocation Wells before the drilling cycle avoids partner issues as the well schedule advances.

There may be circumstances in which the methodology contemplated in this Subclause will not be appropriate. As a consequence, the Subclause was structured to enable the parties to negotiate a different handling of the issue in their Head Agreement or through a different negotiated outcome at the time for any particular Royalty Allocation Well. The Royalty Payor, for example, should confirm that the obligations under this Clause would not conflict with its obligations under another agreement.

A Royalty Payor will sometimes place a Royalty Allocation Well on production prior to finalization and notification of the Allocation Ratio. Subject to any application of Alternate 2 of the definition of Royalty Allocation Ratio, Paragraph 5.03C(c) allows it to calculate an initial Allocation Ratio by applying the Alternate 1 methodology to the preliminary survey plan used for the drilling of that well.

There is a potential modification to the Allocation Ratio if a Royalty Allocation Well is permanently plugged back and cemented off before production commences. Once placed on initial production, Subclause 5.03D is clear that there is no further modification to the Allocation Ratio for a Royalty Allocation Well, unless the Parties agree to one.

Subclause 5.03E addresses a Royalty Allocation Well with multiple Horizontal Legs. Subject to any application of Alternate 2 of the definition of Allocation Ratio, each is regarded as a separate Royalty Allocation Well for purposes of Clause 5.03 and Subclause 5.01A under the Clause 1.02 definition of Horizontal Well. However, the Royalty Payor is able to use an averaging methodology based on relative horizontal length to the sum of the horizontal lengths to determine the respective production volumes if it is not feasible to determine the production applicable to an individual Horizontal Leg.

Subject to any application of Alternate 2 of the definition of Allocation Ratio, Subclause 5.03F requires the Royalty Payor to notify the Royalty Owner of the Allocation Ratio and the basis for its determination in reasonable detail within 45 days after the Royalty Payor receives the As Drilled Survey for the Royalty Allocation Well. The Royalty Owner has a window of 30 days within which to object to that determination.

Subject to any application of Alternate 2 of the definition of Allocation Ratio, Subclause 5.03G addresses the adjustment process if the final Allocation Ratio differs from the initial Allocation Ratio created from the preliminary drilling survey.

There will be many instances in which the adjustment process contemplated in Subclause 5.03G and Paragraph 5.03C(c) will not be relevant because of the diligence with which the Farmee approaches its obligation to confirm the Allocation Ratio. There will be others, though, in which the Farmee does not have the same plotting technology or be as diligent in satisfaction of its obligations. The adjustment process offers real protection in the latter case.

Do Try This At Home

The Royalty Allocation Well provisions of the 2015 CAPL Farmout & Royalty Procedure address an increasingly common circumstance, so that it does not need to be addressed on a custom basis each time the situation arises. This Clause, the additional functionality offered in the 2015 document respecting Horizontal Wells more generally and the greater breadth and depth of coverage in the document are the most compelling reasons to use the 2015 document for new earning agreements.

Although there are relatively few new earning agreements being prepared at this time, this Clause offers a readily available platform that can be used to address the allocation of an ORR across multiple spacing units as the issue arises under older agreements.

Next month’s article will address deductions against an ORR under the 2015 document.

Updates To The CAPL Farmout & Royalty Procedure-Part III
CAPL Negotiator, October, 2016

The parallel updates to the 2007 CAPL Operating Procedure, the 1997 CAPL Farmout & Royalty Procedure and the 1997 CAPL Overriding Royalty Procedure were endorsed by CAPL in late 4Q2015. The documents were finalized after three industry drafts and various additional iterations with the commenting parties to optimize the handling of their comments, to obtain their insights on other changes and to confirm alignment.

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This is the sixth of a series of articles to outline the more significant changes in the updated documents, and is the third of the series on the 2015 updates to the 1997 CAPL Farmout & Royalty Procedure. This article provides a continued overview of the most critical changes, or what I refer to as "the magnets to use" with respect to the 2015 document. It reviews the handling of deductions against an Overriding Royalty, with a focus on the modifications in the 2015 document.

<u>Royalty Payor's Allowed Deductions</u>

<u>Context</u>: The key provision of the FO&RP that addresses the handling of deductions is Clause 5.05, which was significantly modified in the 2015 document. This article will highlight those modifications, while providing an overall context on the manner in which the FO&RP addresses deductions.

Subclause A applies to costs through the First Point of Measurement in all cases. Subclauses B-E apply only insofar as the Royalty Owner does not take the ORR in kind under Clause 5.03.

The foundation of Clause 5.05 is that the Royalty Owner's interest is in the Petroleum Substances within, upon or under the Royalty Lands. The Royalty Owner also owns a share of the Petroleum Substances as produced from a Royalty Well. Subject to any limitations on deductions under Subclause 5.05C, the Royalty Owner bears its share of expenses incurred beyond at least the First Point of Measurement to make the Petroleum Substances merchantable and to transport them to market as a result, unless the "no deductions" Alternate 5.01A(b)(2) is selected for gas and associated substances.

There are two other reasons why the Royalty Owner is responsible for its share of those product enhancement expenses. The first is that it is inconsistent to require the Royalty Owner to share in those expenses when it takes in kind, but not when it takes its share of cash proceeds. The second is that product enhancement expenses, such as processing and transportation, add value to the product that is shared by the Royalty Owner. If the production were sold at the wellhead (or in an unprocessed state), the price received by the Royalty Payor (and the resultant proceeds received by the Royalty Owner) would be lower.

<u>Subclause 5.05A</u>: This Subclause addresses the expenses to remove basic sediment, water and other impurities up to the First Point of Measurement, and includes two Alternates as of the 2015

document. The Alternate selected under this Subclause also impacts the responsibility for expenses through the First Point of Measurement, including those described in Paragraph 5.04C(d) if the Royalty Owner takes its ORR volumes in kind at the First Point of Measurement.

Alternate 1 reflects the traditional treatment of expenses incurred through the First Point of Measurement in farmout agreements (including the 1997 document). Those expenses have typically been minor, and there could be a significant administrative burden to change a well-established industry practice for projects for which that is expected to be the case.

As contemplated by the annotations to the 1997 document, the initial expenses to remove sediment, water and other impurities through the First Point of Measurement can sometimes be significant. Parties sometimes negotiated modifications to that document in those cases.

Alternate 2 was introduced in the 2015 document for those cases, so that the Royalty Owner can be responsible for its share of those expenses from the wellhead, subject to the qualification in Paragraph 2(c) for the handling of water associated with fracing programs. Other than as provided in that Paragraph, Alternate 2 provides a similar outcome to the handling prescribed by Paragraph 4.01(a) of the CAPL Royalty Procedure, Version 1 (early 1990s) for all ORRs. The logic for Alternate 2 is that a Royalty Owner would receive a large benefit if it were not responsible for its volumetric share of significant production handling expenses prior to the First Point of Measurement.

Paragraph 2(c) is a very important qualification to the handling otherwise prescribed if Alternate 2 has been selected. As is the case with many other provisions of the 2015 document, this Paragraph reflects the learnings from industry's experiences with Horizontal Wells and resource projects. It has been included to differentiate the handling for water associated with a fracing program and water produced during normal producing operations.

Even if Alternate 2 were chosen, this Paragraph ensures that the Royalty Owner is not responsible for any water handling expenses relating to a fracing program before, during and immediately after that program. This is because those expenses are more properly categorized as Completion Costs, not production handling expenses. The water associated with a fracing program will typically be substantially recovered during a "cleanup" period in which specialized equipment will be on site to manage the higher than normal water volumes. Not surprisingly, this Paragraph has its greatest impact for shale projects.

<u>Subclause 5.05B</u>: This Subclause applies to the expenses of handling ORR production volumes after the First Point of Measurement, assuming that the "no deductions" Alternate 5.01A(b)(2) does not apply to gas and associated substances.

Paragraph 5.05B(a) is different from traditional industry agreements, in that Facility Fees are also applied against crude oil and liquids extracted at the wellhead. This recognizes the fact that the Farmee's facilities may be required to prepare these substances for market, as is often the case with medium or heavy crude. The application of the Facilities Fees definition also provides protection against the expenses potentially associated with a non-arm's length use of facilities for oil.

Subparagraph B(b)(iii) is new in the 2015 document. It provides an enhanced authority to make deductions with respect to some of the more complex product handling arrangements associated with shale projects, such as the use of "stabilizers" and any secondary removal of water.

<u>Subclause 5.05C</u>: The foundation of Clause 5.05 is the general principle that a Royalty Owner not taking in kind should bear its volumetric share of production handling expenses incurred after the First Point of Measurement. However, the potential deductions often associated with gas and the use of

the Royalty Payor's owned facilities can be high, so this Subclause is included to qualify the blanket authority to take deductions under Subclauses 5.05A (if Alternate 5.05A(2) applies) and 5.05B.

It has been common since the mid-1980s for Royalty Owners to include controls to manage those deductions. Subclause C includes three Alternates that can be used singularly or in combination.

There are four key contextual points of which users must be aware with respect to these Alternates. The first is that these Alternates limit the availability to take actual deductions otherwise permitted under Alternate 5.05A(2) and Subclause B-no Alternate allows the Royalty Payor to take deductions for expenses that were not actually incurred. The second is that the selection of "none of 1, 2 or 3" does not mean that no deductions are permitted-instead it means that there are no limits on the deductions permitted under Subclause B. The third is that the interrelationship of the selected Alternates is that the lowest authorized deduction applies if more than one Alternate is chosen-the same outcome that applied under the 1997 document. The fourth is that the deduction regimes applicable to Title Documents that are freehold leases and this Agreement will probably be inconsistent-there is no ability to apply a "one size fits all" approach to deductions that would see non-compliance with the requirements under a freehold lease.

Alternate 1 has been traditionally used, either alone or in conjunction with Alternate 2. It links deductions to the authority prescribed under the Regulations in calculating Crown royalties in the applicable jurisdiction. However, it posed problems for gas in Alberta between January, 1994 and 2009 because of the Alberta Royalty Simplification Program. That program had seen allowable expenses allocated to each owner's capital pool, making them difficult to track at a facility level. The 2009 Alberta changes see costs aligned at an AER facility level.

The negotiated cap on deductions in Alternate 2 has been widely used by Farmors since the late 1980s to manage the ORR revenue stream on gas and associated substances. This is particularly the case if the Royalty Payor is anticipated to use facilities owned by it. Users must recall, however, that the cap on deductions applies after the Market Price has been adjusted to reflect transportation tolls after the plant and any enrichment expenses contemplated under Subclause 5.05D.

Parties have often structured Alternate 2 so that the "deductions must not be greater than 50% of the Market Price". Increasing the percentage to 60% benefits the Farmee/Royalty Payor. Lowering it to 40% benefits the Farmor/Royalty Owner. The traditional 50% cap may be excessive in a high price environment unless high handling expenses are expected (e.g., sour gas using third party facilities). On the other hand, a Farmee will probably struggle with a low cap if it will be using a third party facility that has high fees.

Alternate 3 was introduced in the 2015 document. It reflects the fact that periods of favourable gas pricing had seen the percentage cap of Facility Fees to Market Price offer a greater than expected latitude in charging Facility Fees for owned facilities against ORR revenues, including a higher recognized gas cost allowance under Alternate 1. Alternate 3 includes an absolute financial cap for those deductions, notwithstanding that the proposed deductions may still be within the range of the cap permitted under Alternate 2.

It is easy to perceive Subclause 5.05C as benefiting only the Royalty Owner because of the controls it introduces on deductions. A Farmee that owns the facilities that are anticipated to be used to handle production volumes from an attractive prospect can use this provision to its advantage in negotiations, though. That Farmee can use the options in the Subclause to differentiate itself from its competition by offering controls on deductions against the ORR that are very attractive to a potential Farmor.

<u>Subclause 5.05D</u>: Production sometimes must be enriched with other hydrocarbon products to make the product suitable for transportation or to make the product marketable. This is particularly the case

for heavy oil and bitumen. This Subclause was introduced in the 1997 document, and is structured to ensure that the Royalty Payor is kept whole when it is required to incur this type of expense. Agreements had typically been silent on this issue prior to the 1997 document.

The structure of this Clause and the handling of deductions (and the associated controls on deductions) are designed to ensure that the value of the ORR stream is normalized to the real value of the produced resource before making the Subclause 5.05C calculations. This sees the Royalty Payor net out enrichment expenses incurred by it to facilitate marketing of production volumes.

Any other outcome would see the Royalty Owner receiving the benefit of the enrichment expenses by being paid its ORR on the higher value production stream without incurring any responsibility for its associated enrichment by the Royalty Payor.

<u>"No Deductions ORRs"</u>

Farmors will typically be very concerned about the potential for a Farmee to apply large deductions against the ORR for use of the Farmee's own gathering, transportation and processing infrastructure, particularly when the basis for the calculation of those deductions will typically not be transparent or readily verifiable. Farmors have frequently chosen to structure their ORR as a "no deductions ORR" since the early 1990s to mitigate their risk against high deductions.

Notwithstanding the frequency with which Farmors choose to create a "no deductions ORR", Subclause 5.05C does not include a fourth option of allowing no deductions from the wellhead to the ultimate point of sale.

This is ultimately because of the "no deductions" optionality offered by Alternate 5.01A(b)(2) as of the 1997 document. That provision basically enables a Royalty Owner that does not take in kind to have the Royalty Payor pay all of the production handling expenses to make the ORR share merchantable and to deliver it to market.

If selected, the Royalty Owner would typically "compensate" the Royalty Payor for the assumption of those expenses through a negotiated ORR lower than would be the case if the ORR were taken in kind under Subparagraph (ii) of this Alternate. This reflects the fact that the Royalty Owner would assume responsibility for production handling expenses if it took it kind.

Many users do not realize that this Alternate already provides the Farmor with the ability to obtain the same outcome as a custom "no deductions ORR" provision, subject to three important qualifications. The first is that it ultimately only applies to Facility Fees incurred through the outlet of a gas plant, as transportation expenses after that point are captured as revenue adjustments (rather than deductions) under the Market Price definition. The second is that the calculation applies after any adjustment for enrichment expenses incurred by the Royalty Payor under Subclause 5.05D. The third is that the typical custom industry provision effectively eliminates the Royalty Owner's right to take in kind.

The last point is critical for Royalty Owners to understand. The motivation to take in kind would typically be very low if a Royalty Owner would receive the same percentage of production volumes when taking in kind and not taking in kind, while being required to assume production handling costs after the First Point of Measurement if it took its share of production in kind. Similarly, the right to take in kind in this Alternate offers additional optionality for the Royalty Owner in a high gas price environment (i.e., the benefit of no responsibility for Facility Fees being much more modest relative to the incremental value of the forgone ORR volume than in a low to moderate price environment) and greater protection (e.g., the Royalty Payor selling at the wellhead before any meaningful product enhancement costs were actually incurred).

The corollary of this is that a Farmor that wishes to create a “no deductions ORR” without using the optionality already available to it in the 1997 and 2015 documents will need to modify the definition of “Market Price” with respect to the adjustment of price for transportation tolls to deliver product to the point of sale. Similarly, a Farmee willing to accept a negotiated “no deductions ORR” needs to ensure that the revenue stream is normalized to reflect any Subclause 5.05D enrichment expenses.

Follow The Money

One of the ongoing challenges in land agreements has been to address the handling of costs associated with ORR volumes in a way that is logical and transparent to users. The 2015 CAPL Farmout & Royalty Procedure builds on the major changes introduced in the 1997 document to enhance significantly the handling of deductions for ORRs associated with resource projects with outcomes that attempt to balance the objectives of both Royalty Payors and Royalty Owners.

Next month’s article will address the drilling of an additional well on a spacing unit then subject to a potential Article 6.00 conversion by the Royalty Owner from an ORR to a Working Interest.

Updates To The CAPL Farmout & Royalty Procedure-Part IV
CAPL Negotiator, November, 2016

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This is the seventh of a series of articles to outline the more significant changes in the updated documents, and is the fourth of the series on the 2015 updates to the 1997 CAPL Farmout & Royalty Procedure. This article provides a continued overview of the most critical changes, or what I refer to as "the magnets to use" with respect to the 2015 document. It reviews Clause 6.06 and the handling of an additional well on the spacing unit of an Earning Well then subject to a potential Farmor conversion from an ORR to a Working Interest under Article 6.00. It is one of the more complex provisions, and has been modified significantly in the 2015 document to address the situation in which the additional well is being drilled to exploit the same formation as is productive in the Earning Well.

Clause 6.06-Additional Well On Spacing Unit Before Conversion Election

Context: Clause 6.06 was originally introduced in the 1997 CAPL Farmout & Royalty Procedure to reflect an increased emphasis on prospects with multi-zone potential. There are two important points to recall when working with this Clause in the context of the 1997 document. The first was that it was written at a time when industry was increasingly drilling vertical wells with multi-zone targets. The second was that the regulatory restrictions of that time typically precluded the owners from drilling multiple wells to exploit the same productive target in the same spacing unit.

As originally structured, the Clause would apply if the Farmee proposed to drill a twin well to the Earning Well to exploit a different prospective formation. In essence, the Clause provided the Farmor with the choice to assume its share of the risk of the well (participate or apply the Operating Procedure consequence of non-participation-typically a cost recovery) or to limit its interest in the additional well to the ORR if it chose not to assume risk.

Without this right or an alternative provision, the Farmor probably would have retained its ORR until its conversion right for the relevant Earning Well were triggered. Although this may initially appear attractive to the Farmee, we had originally concluded that the typical net effect of that type of structure would be that the Farmee would assume 100% of the geologic and commercial risk associated with the additional well, while positioning the Farmor for a no risk election to convert to its APO interest. The negative aspect of this structure to a Farmor would have been that it would potentially see a payout account being used to subsidize additional wells that may not be of interest to it.

As readers are aware, the regulatory landscape changed significantly following the creation of the 1997 document because of the greater density drilling permitted under the Regulations, such as under a holding or the more general permissible authority to have a drilling density greater than one well/spacing unit prescribed under Part 4 of the *Oil And Gas Conservation Rules* (Alberta), for example. Those changes required major modifications to the Clause in the 2015 document, and parties facing this situation under the 1997 document should consider the 2015 Clause as a potential platform for a negotiated handling of the issue if it were to arise in their agreement.

Notwithstanding the words of the Clause, the Farmee in a two party scenario might sometimes attempt to streamline the process by approaching the Farmor prior to issuance of the notice to gauge if the Farmor requires compliance with the full notification process for a pending well (i.e., it has no interest in participating in any additional well on the spacing unit for the Earning Well).

<u>Subclause 6.06A</u>: The triggering event for a response under either Subclause 6.06B or D is service of an Operation Notice for the drilling of an additional well on the same spacing unit as an Earning Well subject to a live Farmor conversion right under Article 6.00. The requirement to respond is not contingent on delivery of a current payout statement for the Earning Well. The Farmor has good insights about the well performance from the receipt of well information and other information that is probably in the public domain, as in the "Volume Recovery" approach included in the 2015 document.

The right to serve an Operation Notice for the additional well applies only to the Farmee, not also to the Farmor. This may initially seem like an inappropriate restriction. However, extending this right to the Farmor could see it accelerating capital programs or proposing activity that the Farmee had intended to conduct subsequently for its own account before the applicable conversion date as an additional operation (e.g., an uphole completion). Taking this option away from the Farmee could ultimately compromise its ability to recover its costs associated with the Earning Well, an outcome inconsistent with the principle of the Article 6.00 conversion.

It is very important for the Operation Notice and the resultant election letter to be structured very clearly for the applicable rights subject to the election. Otherwise, there could be confusion for administrative personnel once the additional well is drilled.

<u>Subclauses 6.06B and C</u>: Subclauses 6.06B and 6.06D are mutually exclusive. Subclause B only applies if the additional well is targeting a different formation than the one that is productive in the Earning Well, and Subclause 6.06C applies only to a Subclause 6.06B well. Within the applicable response period to the Operation Notice prescribed by Clause 10.02 of the Operating Procedure (i.e., typically 30 days, but not necessarily), the Farmor may elect to:

(a) convert its ORR to the Working Interest set forth in Subclause 6.04A in the applicable spacing unit for the additional well, such that it would also need to elect within the prescribed election period if it will participate in that well on the basis set forth in Clause 10.02 of the Operating Procedure (i.e., the converted Working Interest, plus any greater share of participation assumed under Subclause 10.02C thereof) or subject itself to the applicable consequence of non-participation); or

(b) retain a non-convertible ORR in the additional well and its applicable spacing unit, subject to any application of the Abandonment provisions of Clause 7.05.

The net result under Subclauses 6.06B and C is that the additional well election for a well targeting the J formation would apply to Farmout Lands in the applicable spacing unit down only to the base of the J formation, with the exclusion of any zones in which the Earning Well was already Capped or Completed. Inherent in this is that the spacing unit for the applicable original Earning Well that remains subject to a potential conversion in due course under Clause 6.02 or 6.03 would be modified as a consequence, by excluding that portion of the Farmout Lands to which the applicable Subclause 6.06B election pertained.

Subclause 10.02C of the Operating Procedure allows a Farmor that converts to a Working Interest for the additional well to participate for a greater share of costs than its Working Interest if there are existing Working Interest owners that are non-participants in the well. However, this would not allow it to assume any costs on behalf of a Farmor that didn't convert to a Working Interest, as the Farmee would retain that Working Interest as part of the Farmee's pre-conversion Working Interest.

If the Farmor chooses to retain its ORR position for the additional well, that ORR continues to be calculated on the same Working Interest as the ORR for the Earning Well, not on the Farmor's post-conversion Working Interest. Some users of the 1997 document did not understand that the net effect of the ORR election for the additional well was to lock any such Farmor Party into the same ORR structure that applied to the Earning Well. This handling recognizes that any such Farmor Party basically waived its conversion right for the additional well. One element of this is that the calculation uses the Working Interest on which the Earning Well ORR was calculated. Paragraph 6.06B(b) was modified in the 2015 document to make this clearer.

A conversion to a Working Interest in the Earning Well at the "ORR Conversion Date" of that Earning Well (e.g., Payout) would not affect any prior Working Interest or ORR election under Subclause 6.06B for the additional well and the spacing unit of that additional well.

<u>Subclause 6.06D</u>: As noted in the introductory comments on the Clause, there had not been any need to consider in the 1997 document the possibility of an additional well being drilled to target the same formation as is producing in the Earning Well, as this was an unlikely event under the Regulations in effect at that time. This changed significantly once holdings began to be used widely in Alberta since the late 1990s, and the Regulations have subsequently been modified more generally to allow for an increased drilling density in many areas.

It is now quite common for a Farmee to proceed to develop a productive formation with a drilling density greater than one well per spacing unit. One of the consequences of this is that Farmees often want to drill an additional well to the producing formation on the same spacing unit as an Earning Well subject to a convertible ORR.

This was problematic under the 1997 document because, firstly, the additional well contemplated under that document was in a different formation and, secondly, the mechanism in that document applied to the spacing unit for the additional well.

This Subclause and the other changes to Clause 6.06 in the 2015 document were primarily designed to address this issue.

The starting point in reviewing this Subclause is the realization that this Subclause (rather than Subclause 6.06B) applies if an additional well is being drilled to produce from the same formation as is already capable of producing in the Earning Well.

In essence, this Subclause attempts to apply the logic of the 1997 Clause to the greater drilling density scenario. This is subject to the "common ownership" requirement under the Alberta Regulations (e.g., Section 4.021(2) of the *Oil And Gas Conservation Rules* (Alberta)). That requirement allows the regulatory authority to terminate a holding, for example, if the rights subject to the holding are no longer held in "common ownership". "Common ownership" for this purpose is regarded by the regulatory authority as the Working Interests after any applicable conversion right (e.g., Article 6.00 conversion from ORR to a Working Interest, Working Interest participation in a well after any prescribed cost recovery under the Operating Procedure).

The election process in Subclause 6.06D was structured largely to honour that regulatory "common ownership" requirement. Within the applicable response period to the Operation Notice prescribed by Clause 10.02 of the Operating Procedure, the Farmor may elect:

(a) to participate in the well for the Working Interest share of costs prescribed for it under Subclause 6.04A (without any actual conversion to a Working Interest in the applicable Farmout Lands at that time), plus any additional cost participation it chooses to assume under Clause 10.02 of the Operating Procedure with respect to another Working Interest owner that is a non-participant;

(b) to elect not to participate in the well and to be subject to the consequence of non-participation applicable to the Working Interest prescribed for it under Subclause 6.04A for at least the period up to any subsequent election by the applicable Farmor Party to lock into the ORR under Paragraph 6.06D(c) in response to an Operation Notice for another such additional well; or

(c) to retain a non-convertible ORR for the additional well, provided that a Farmor Party making this election is also deemed to have waived its Article 6.00 right of conversion for the Earning Well and its spacing unit with respect to all formations for which its conversion right then applies. (Any prior Subclause 6.06B election(s) by that Farmor Party would already have modified the strata to which an Earning Well conversion election would apply at the time of a Paragraph 6.06D(c) election.)

A Farmor's participation election for such an additional well does not result in any conversion of a Working Interest in the lands *per se*, but a Working Interest sharing of the risks (costs) and rewards (production) associated with that well. The acquisition of the Working Interest in the applicable spacing unit is linked to the Article 6.00 election for the Earning Well in due course. Subject to the stratigraphic impact of any prior Subclause 6.06B elections by the applicable Farmor Party, the net effect of this is that the conversion right for other strata in the spacing unit remains linked to the conversion right for the applicable Earning Well. In other words, participation in the additional well in the same producing formation as the Earning Well will not trigger a conversion for any other strata.

It is important when considering this Subclause to recall that the spacing unit for the Earning Well applies to formations in addition to the productive formation because of the definition of spacing unit in the document. The alternative approach whereby the participation in an additional well would result in a conversion of the Working Interest in all Farmout Lands then subject to the right of conversion within the spacing unit for the Earning Well (but not the Earning Well and its production) would have implications that might not be immediately appreciated by users. This would require the applicable Farmor to accelerate its conversion for other formations, such that any converting Farmor would then be free to propose operations in the affected Farmout Lands. In addition, a converting Farmor would not then have access to the options provided under Subclause 6.06B for any uphole additional well, such that the Farmor would have to allocate capital, become subject to a potential cost recovery or possibly farm out the converted Working Interest if there were an uphole additional well.

A Farmor that elected to participate in one or more additional wells under this Subclause could theoretically subsequently elect to forgo its Article 6.00 right to convert its ORR to a Working Interest as of the ORR Conversion Date. The likelihood of this ever occurring if the additional wells are at all economic at that time is remote, though. This is something that would most appropriately be addressed by the parties at the time in the context of their particular situation.

This Subclause will apply on the same basis to each such additional well on the Earning Well spacing unit that targets a producing formation, insofar as the Farmor is not already locked into a non-convertible ORR for the Earning Well and its spacing unit under Paragraph 6.06D(c). It is unlikely that a Farmor would exercise its Paragraph 6.06D(c) ORR election for an additional well if the Earning Well or a prior additional well in which it had participated were attractive. However, it might do so if it had previously elected to participate in an additional well that was unsuccessful or the Farmor was already subject to a Paragraph 6.06D(b) cost recovery for a prior applicable additional well. The parties would need to address the outcomes at the time if a Farmor subsequently made a Paragraph 6.06D(c) election after having participated in an earlier additional well under Paragraph 6.06D(a). However, Paragraph 6.06D(a) is clear that the Operating Procedure would continue to apply to obligations that had accrued to the Farmor with respect to any such additional well in which it had participated under that Paragraph (e.g., accrued liabilities and abandonment costs).

<u>Subclause 6.06E</u>: A conversion to a Working Interest under Subclause B is effective as of the date of issuance of the applicable Operation Notice. The Farmor, therefore, would also have to make its participation election under the Operating Procedure within the period prescribed under the Operating Procedure for response to the Farmee's Operation Notice. In theory, a Farmor could elect to convert to a Working Interest, while electing not to participate, but this is unlikely to occur.

This Subclause states that an Operation Notice served under Subclause 6.06A is void if the additional well described therein is not commenced within 120 days following service of that Operation Notice, or such other period for commencement of the well as may be prescribed by Clause 10.03 of any Operating Procedure that was amended on this point. This period is consistent with the base commencement period in Clause 10.03 of the 2015 CAPL Operating Procedure, and accommodates the circumstance in which the Operating Procedure was amended. The parties should consider a longer period for remote areas and areas with restricted or seasonal access, as noted in the annotations on the Operating Procedure.

When In Doubt, Review The Most Recent CAPL Document

A provision like Clause 6.06 was typically not included in agreements that pre-dated the CAPL Farmout & Royalty Procedure, and agreements using the 1997 document do not address the situation in which the additional well is being drilled to exploit the same formation as the Earning Well.

Notwithstanding that the Clause was constructed to address the most likely situations that users would face, there will undoubtedly be fact situations that will not fit neatly within the four corners of the Clause. In those situations, the parties will need to apply the principles in the Clause as a foundation for their negotiations on their particular issue.

This Clause reinforces why it is always important for users to review the most recent CAPL document form whenever they must address a gap that exists under a prior version of the CAPL document or an older agreement that did not include a CAPL document. A review of the most recent CAPL document will often help identify an approach that offers a reasonable platform for a negotiated resolution of what might otherwise be an issue that would escalate unnecessarily. This is particularly the case if the proposed resolution is presented to the other parties so that the linkage to the objective standard in the most current CAPL document is transparent.

While a useful approach when negotiating with the other party, this will often also be a helpful frame for internal consideration of an issue when the other party has made a reasonable proposal to resolve an issue that is not addressed specifically in your agreement. Presenting that proposal through the lens of a reference to the objective standard included in the most current CAPL document can provide internal decision makers better information on which to determine their preferred approach.