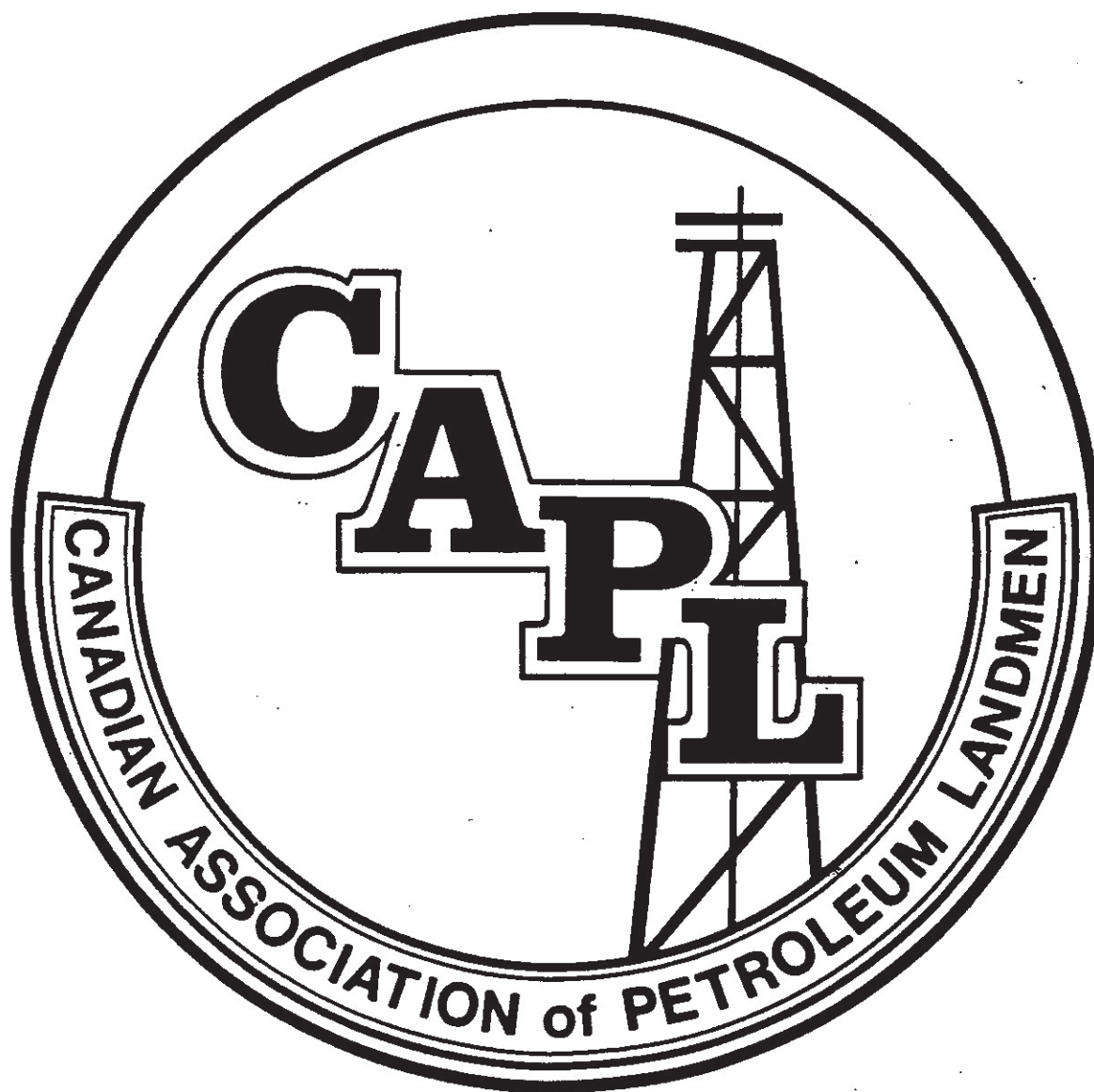


# **FARMOUT AGREEMENT**

(Annotated)



**CANADIAN ASSOCIATION OF PETROLEUM LANDMEN**

**Version 1.0**

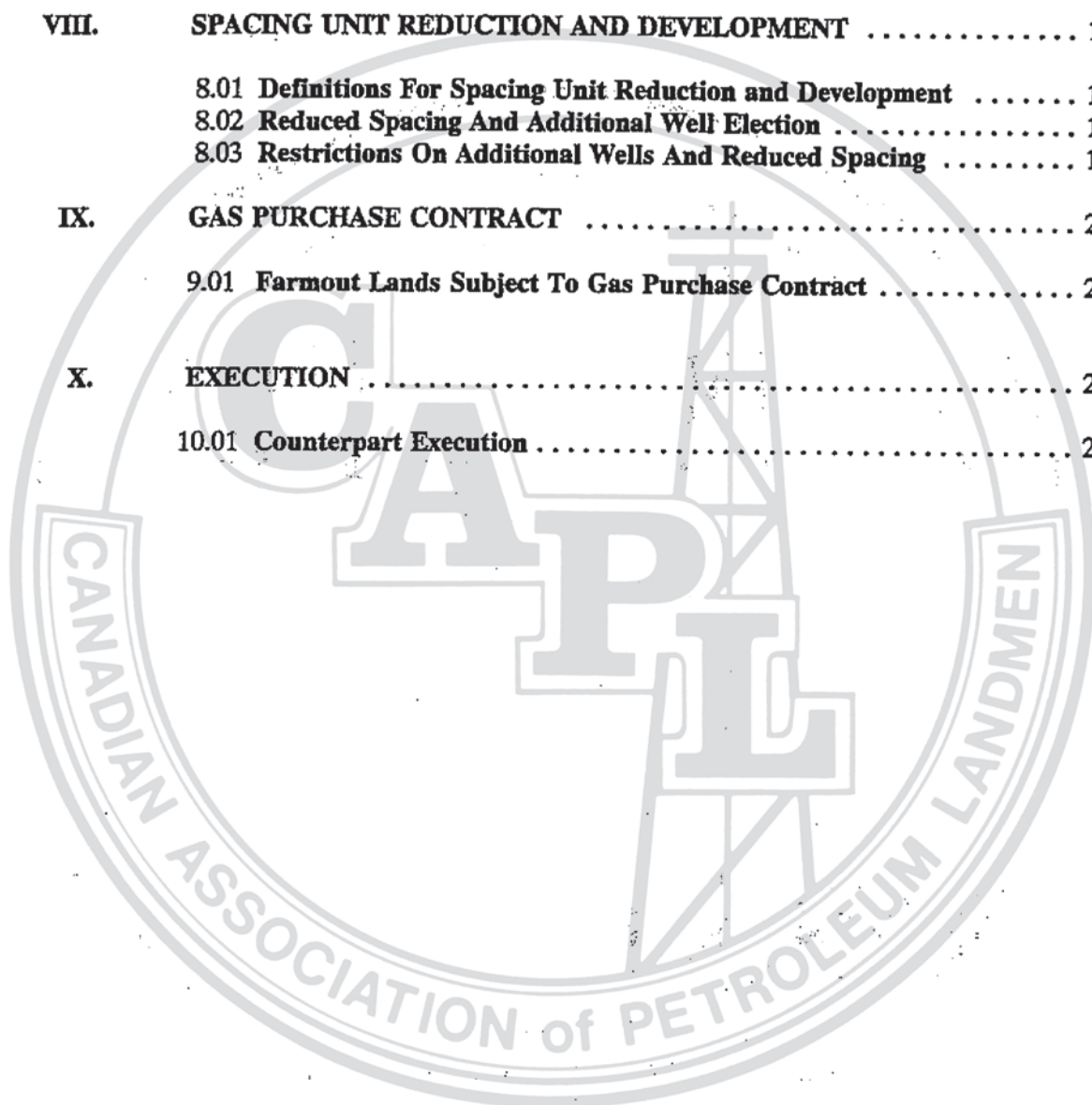
# FARMOUT AGREEMENT

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## Farmout Agreement

The explanatory notes reflect the observations of the authors and other commentators on the intention and scope of the provisions of the Farmout Agreement. 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.

i) The authors have designed this instrument to be used as a Model. One may choose to incorporate any or all the terms of this instrument as you may require for a particular farmout agreement. The authors suggest that it be used in conjunction with both the CAPL Farmout Procedure, Version 1.0 ("Farmout Procedure") and the CAPL Royalty Procedure, Version 1.0 ("Royalty Procedure").

ii) This Model covers a basic farmout from one or more Farmors to one or more Farmees. The Farmee will be entitled to earn (a) all the Farmor's interest in the Spacing Unit of the Test Well and an interest in the balance of the Farmout Lands (b) all the Farmor's interest in all of the Farmout Lands subject to the Overriding Royalty, or (c) a percentage of the Farmor's Working Interest in all the Farmout Lands. At the point of earning for (a) and (b), the Farmor will reserve a gross overriding royalty until Payout (or until Test Well Abandonment) from production attributable to the Test Well.

iii) The Model provides Clauses for an Option Well to be drilled on Option Lands. To simplify the necessity of continuously referring to Option Well and Option Lands throughout the body of the Model, the Model states that one may treat all references to Test Well and Farmout Lands to apply equally to Option Well earning.

NOTE: In these comments, all references to Operating Procedure means the 1990 CAPL Operating Procedure, unless otherwise indicated.

Clause 1.01: This Model does not contain a complete set of Definitions. It refers only to those items necessary for its use in conjunction with the Farmout Procedure. We recommend that you familiarize yourself with those definitions and the notes to those definitions contained in the Farmout Procedure.

Subclause 1.01(a): The inclusion of Schedule A into the agreement is especially important where additional provisions are written in Schedule A (e.g., pooling).

Subclause 1.01(b): This definition requires you to insert the formation or zone into which you require the Farmee to drill, so as to drill through what will be the target zone for the Agreement. To describe the "break" below which you require the Farmee to drill (i.e., the base of the target zone) we recommend that you take care to insert a recognized formation or zone name and avoid using a reference to a Period. You should also be careful where the Farmout Lands are in a geologically complex area, such as the foothills.



## FARMOUT AGREEMENT

This Agreement is made effective the \_\_\_\_ day of \_\_\_\_\_, 19\_\_

**BETWEEN/AMONG:**

**THIS AGREEMENT WITNESSES** that in consideration of the following mutual covenants and agreements, the Parties agree as follows:

### I. DEFINITIONS AND INTERPRETATION

#### 1.01 Definitions

In this Agreement, Article I of the Farmout Procedure excepting Clause 1.08 (References) thereof, is incorporated by reference herein and the following words and expressions shall have the meanings described in this Clause:

- (a) "Agreement" means this agreement including Schedule A (and, for clarity, all alternate earning provisions or additional provisions contained in Schedule A are part of this definition of Agreement) and excluding all other Schedules attached hereto.
- (b) "Contract Depth" means, for the Test Well, a depth down to and including the lesser of:
  - (i) \_\_\_\_\_ metres below the top of the \_\_\_\_\_, or
  - (ii) \_\_\_\_\_ metres subsurface.

Subclause 1.01(c): This definition enables you to insert the percentage participation of each Farmee beside the names of those Farmees. This avoids any need to refer to a Schedule to your agreement to find this information. It also acts as a convenient check to ensure that you insert the relative participation.

Clause 1.03:

- (i) Future editions of this Farmout Agreement will cover a wider range of agreement types such as farmouts with participants involved, seismic options or farmouts where a pooling is required to form a spacing unit. In the meantime, one could use Schedule A to add such provisions into this Model.
- (ii) At the time of writing of the Farmout Agreement an Industry Assignment and Novation Committee was investigating ways to reduce or eliminate the need for novation agreements. This committee will soon seek endorsement by CAPL. A new form of assignment clause will likely be proposed which would have to override certain provisions in the Operating Procedure or the Royalty Procedure. That provision could be added to Schedule A until this Model Farmout Agreement is revised.

- |                   | <u>Party</u> | <u>Participation in<br/>drilling operations</u> |
|-------------------|--------------|---|
| c) "Farmee" means |              |   |

- (d) "Farmor" means

whose interests in the Farmout Lands are set out in Schedule "A".

- (e) "Farmout Agreement" means this Agreement and the Schedules attached to it.

- (f) "Farmout Procedure" means the Schedule, if any, attached to this Agreement entitled "Farmout Procedure".

## 1.02 References

The references "hereunder" "herein", "hereof" and "hereto" refer to this Agreement and unless stated to the contrary in this Agreement, references to Articles, Clauses, Subclauses or paragraphs in this Agreement refer to Articles, Clauses, Subclauses or paragraphs respectively of this Agreement.

## 1.03 Schedules

The following Schedules are attached hereto and made part of the Farmout Agreement:

- (a) Schedule "A", which describes the Title Documents, the Farmout Lands, the interests of the Farmor in the Farmout Lands and if applicable, the Option Lands, the interests of the Farmor in the Option Lands, Encumbrances, alternate earning provisions and additional provisions;
- (b) Schedule "B", which is the Farmout Procedure;
- (c) Schedule "C", which is the Royalty Procedure; and
- (d) Schedule "D", which is the Operating Procedure.

Clause 2.01: The Model retains the familiar expression "at Farmee's sole cost, risk and expense." The Model provides you with this statement at the beginning of the Model to avoid the need to repeat it throughout.

Clause 2.02:

- (i) In this Clause the Model provides you with a short statement of the obligations which the Farmor will require the Farmee to perform.
- (ii) In our introductory statement of the Farmee's obligations, we have not made any reference to the Equipping of the Test Well. Our reason is that, for Revenue Canada purposes, an agreement of farmout is a specially recognized disposition of an interest in a Petroleum and Natural Gas Lease. Rather than to require the Farmee (the buyer) to classify the earning expenses as a purchase payment of rights to an already improved lease, Revenue Canada permits the Farmee to treat those expenses incurred to "improve" the lease as unique classes of expenses deductible against business income.

Clause 2.03:

- (i) The Farmee must promptly production test the Test Well where crude oil is found in Paying Quantities.
- (ii) Where natural gas is found in Paying Quantities, options are provided. The reality is that the Farmee for reasons both within and outside the Farmee's control, frequently conducts production testing a considerable time after the drilling rig release and even into the next drilling season. The Model provides a choice of a period of one year (Alternate A) or a period to be selected (Alternates B and C) by the expiry of which the Farmor will require the Farmee to production test the Test Well.



## II. TEST WELL

### 2.01 Farmee's Liabilities

The Farmee shall discharge all the Farmee's obligations hereunder in accordance with this Farmout Agreement at the Farmee's sole cost, risk and expense.

### 2.02 Drilling Test Well

On or before \_\_\_\_\_, the Farmee shall Spud the Test Well for the recovery of Petroleum Substances at a location of its choice on the Farmout Lands and shall diligently and continuously drill the Test Well to Contract Depth and shall Complete, Cap or Abandon that well. The Farmee shall drill and, if applicable, Cap or Complete the Test Well within a Target Area unless the Farmee obtains prior written consent of the Farmor (which consent shall not be unreasonably withheld) to drill and, if applicable, Cap or Complete the Test well outside a Target Area.

### 2.03 Production Tests

When the Farmee has drilled the Test Well to Contract Depth and if Petroleum Substances from any zone in the Farmout Lands are reasonably anticipated to be in Paying Quantities, the Farmee shall case the well and:

- (a) conduct production tests as soon as practicable if Petroleum Substances other than natural gas in Paying Quantities is indicated; or
- (b) if Petroleum Substances composed predominantly of natural gas in Paying Quantities is indicated, (i) conduct production tests as soon as practicable or (ii) Cap the Test Well and conduct production tests on or before that date specified in ALTERNATE \_\_\_\_\_ below (Specify A, B or C):

**ALTERNATE A:**

*the first anniversary date of the Test Well drilling rig release;*

**ALTERNATE B:**

*the last day of the \_\_\_\_\_ month following the month in which the drilling rig release date occurs;*

**ALTERNATE C:**

*the later of the first anniversary date of the Test Well drilling rig release and as soon as practicable after an economic market for those Petroleum Substances becomes*

Clause 3.01:

- (i) Some farmout agreements require Completion or Abandonment for earning. Where a well is initially Capped, awaiting market or where the wellbore is plugged and abandoned but the reclamation of the wellsite is slow, the time of earning could be significantly later than the rig release of the Test Well. The authors believe the Farmee should be afforded some earning status at Capping or at an earlier stage of Abandonment than whenever the Farmee may obtain a reclamation certificate. This will be accomplished by permitting the Farmee to conditionally earn at Capping or the "partial" Abandonment provided in Clause 3.02. The Farmee will need to satisfy conditions subsequent (e.g., production tests, finalizing Completion or Abandonment) failing which the Farmor may treat the conditional earning to have failed.
- (ii) The first paragraph described the various events that cause earning. Only paragraphs (a) and (b) do not give rise to the conditions subsequent described in the second paragraph.
- (iii) Alternate A for paragraph (e) makes production tests a condition precedent for earning. If production tests are delayed pursuant to paragraph 203 (b), the earning for the Farmout Lands will be in a state of limbo, which is the reason the last paragraph to Clause 3.01 is required. As to the two alternates, the Parties must decide whether production testing is a requirement to conditionally earn.
- (iv) Provision is made for three earning situations which are currently fairly common. That is not to say these should be the only earning scenarios. The Parties may provide alternate earning provisions in Schedule A.
- (v) Despite the actual date of earning, earning will be effective at drilling rig release. This conforms with industry practice.
- (vi) The third last paragraph clearly sets out the conditions subsequent applicable to the Farmee's earning in the Farmout Lands. The conditions are not unusual in industry. What was uncertain in many industry farmout agreements was the status of these obligations. If a farmout agreement provided that Capping was sufficient to earn, was the subsequent Completion obligation a condition subsequent or a post-earning obligation?
- (vii) While conditions subsequent remain outstanding, the Farmor is not required to give transfers to the Farmee. If a condition subsequent is breached, it would be more difficult for the Farmor to take back the conditionally earned interest if that interest is already in the Farmee's name.
- (viii) Note that the insertions for Alternates A1 and C1 refer to a percentage of the Farmor's Working Interest rather than a specified percentage Working Interest. Therefore, if the Farmor only had a 50% Working Interest and the insertion in the relevant Alternate was 50%, the Farmee would earn a net 25% Working Interest.
- (ix) This Farmout Agreement form works best when 100% of the Working Interest in the Farmout Lands or Option Lands are subject to the farmout. What if the relevant lands are held jointly by A and B subject to an existing agreement and operating procedure (which for the purposes of our example, shall be called the "first agreement") but only B will farm out to C and A refuses to become a party to the farmout as a participant? The parties to the farmout (B and C) must be aware of the potential difficulties in "meshing" this farmout agreement with the first agreement. Among the items to consider are:
  - 1) first right of refusal or other restrictions on assignment in the first agreement;
  - 2) confidentiality requirements under both the first agreement and the farmout agreement;
  - 3) novation of the Farmee (C) into the first agreement;
  - 4) proposal of wells under the first agreement during the earning phase of the farmout agreement;

*available, provided that, if the Farmee has not fulfilled its obligations pursuant to this Alternate C within one year of the drilling rig release of the Test Well, the Farmee shall, at the end of that year and every 6 months thereafter until the Farmee has fulfilled its obligations pursuant to this Alternate C, give notice to the Farmor of its plans to production test and produce the Test Well, if any.*

When the Farmee has conducted the production tests, the Farmee shall finish that Completion or Cap or Abandon the Test Well as soon as practicable.

### III INTEREST EARNED BY FARMEE

#### 3.01 Test Well Earning

If the Farmee drills the Test Well to Contract Depth in compliance with Article II (TEST WELL) and:

- (a) Completes the Test Well;
- (b) where the Farmee is in compliance with Clause 2.03 (Production Tests), proposes to Abandon the Test Well, following which the Farmor elects to take over that well pursuant to Article IX (ABANDONMENT OF TEST WELL) of the Farmout Procedure;
- (c) where the Farmee is in compliance with Clause 2.03 (Production Tests), Abandons the Test Well to the extent required to comply with Clause 3.02 (Abandonment For Earning);
- (d) where Petroleum Substances other than natural gas in Paying Quantities are indicated in the Test Well, production tests and Caps the Test Well; or
- (e) where Petroleum Substances comprising natural gas in Paying Quantities are indicated in the Test Well, conducts the operations specified in Alternate \_\_\_\_\_ below (Specify A or B).

#### ALTERNATE A:

*the Farmee production tests and Caps the Test Well;*

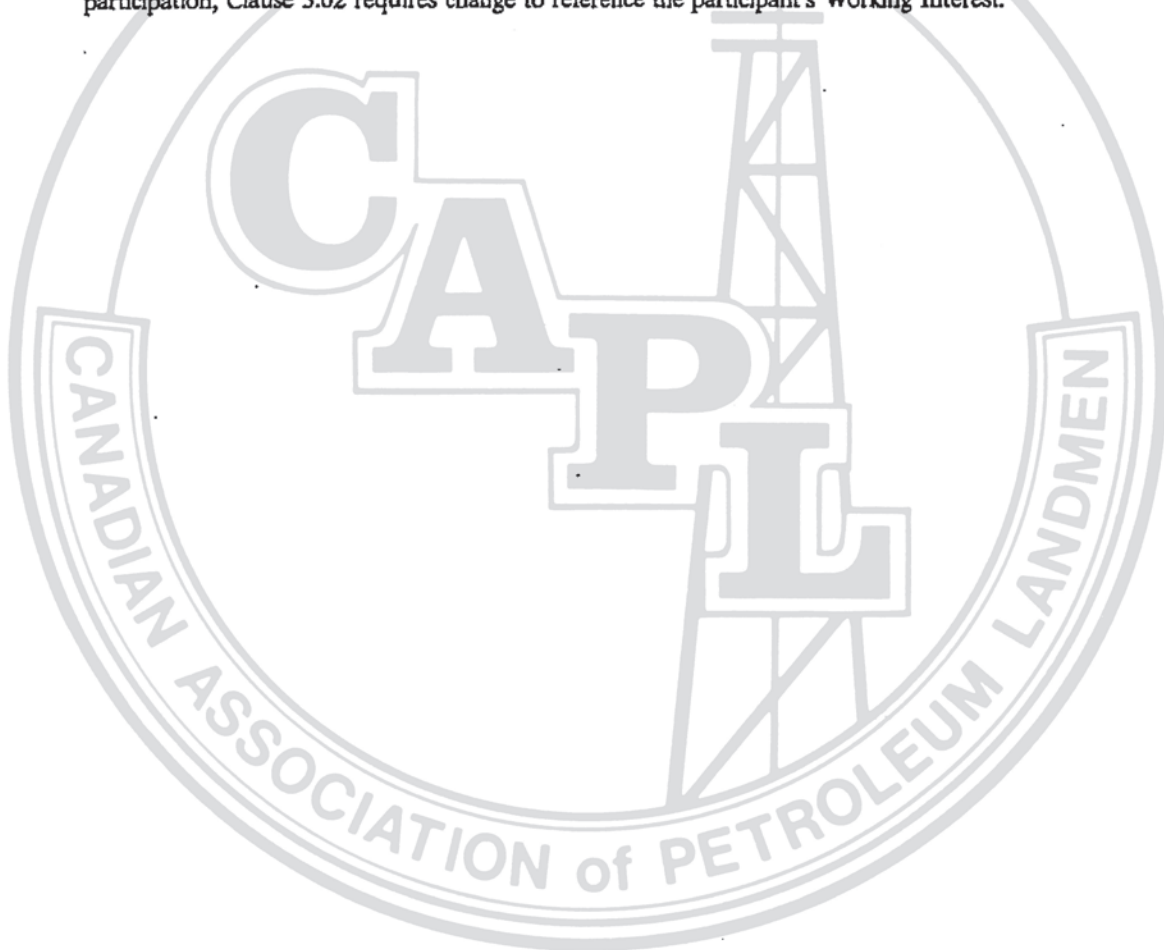
#### ALTERNATE B:

*the Farmee Caps the Test Well with the obligation to conduct production tests at a later date;*



- 5) responsibility for pre-existing encumbrances;
- 6) co-existing areas of mutual interest;
- 7) priority issues with respect to abandonment, first rights of refusal, or surrenders/expiries;
- 8) priority issues with respect to operations: should the Farmor, after earning is finished, have the right to participate in a well in which the Farmee elects not to participate under the first agreement and, if so, what are the mechanics of this participation;
- 9) recognition of the Overriding Royalty created by the farmout agreement as an encumbrance on the Farmee's Working Interest (once novated) under the first agreement whether under Article VIII of the 1990 form Operating Procedure or by specially providing for such recognition for other forms of operating procedures; and
- 10) payment of or providing for the delivery of the Overriding Royalty where the Farmee elects to be in a penalty position for a well drilled under the first agreement; the Royalty Procedure, if not amended, would require that the Overriding Royalty be paid even if the Farmee is not receiving any revenue from the wells concerned.

Even if A agreed to be a participant, some of these difficulties still apply (e.g., items 7, 8 and 9 above). Note that the Model needs to be modified to allow for participants. Aside from the setting out the terms of the participation, Clause 5.02 requires change to reference the participant's Working Interest.





and in so doing, has performed all related obligations under this Farmout Agreement to the Farmor's reasonable satisfaction, the Farmee shall earn the interests in the Farmout Lands as set out in ALTERNATE \_\_\_\_\_ below (specify A1, B1 or C1):

**ALTERNATE A1:**

*all the Farmor's undivided Working Interest in the Farmout Lands in the Spacing Unit of the Test Well, subject to the reservation to the Farmor therefrom of the Overriding Royalty; and*

\_\_\_\_\_ % of the Farmor's undivided Working Interest in the Farmout Lands, other than the Spacing Unit of the Test Well.

**ALTERNATE B1:**

*all the Farmor's undivided Working Interest in the Farmout Lands, subject to the reservation to the Farmor therefrom of the Overriding Royalty.*

**ALTERNATE C1:**

\_\_\_\_\_ % of the Farmor's undivided Working Interest in the Farmout Lands.

If the Farmee earns an interest in the Farmout Lands by Capping the Test Well or by Abandoning the Test Well to the extent required to comply with Clause 3.02 (Abandonment For Earning), the Farmee's earning in the Farmout Lands shall be subject to the conditions subsequent that the Farmee conduct the production tests on the Test Well as required by the Agreement and finish Completing or finish Abandoning the Test Well, all at the Farmee's sole cost, risk and expense. When the Farmee discharges these conditions subsequent to the Farmee's earning in the Farmout Lands, the Farmee's earning in the Farmout Lands shall become unconditional. Until that time, the Farmor shall not have any obligation to sign and deliver to the Farmee any instruments to witness the Farmee's earning in the Farmout Lands and the Parties shall continue to be bound by the Farmout Agreement for all undischarged obligations relating to operations comprising the conditions subsequent.

Earning shall be effective as of the day of drilling rig release for the Test Well.

While the Farmee remains obligated to perform Test Well earning obligations under the application of paragraph (e), Alternate A of this Clause, the following shall apply to the same extent as if the Farmee had already earned an interest in the Farmout Lands by discharging those obligations:

Clause 3.02: This Clause describes the point of abandonment at which the Farmee may say it has earned. Alternate B is more stringent than Alternate A but neither Alternate requires full Abandonment described in the definition in the Farmout Procedure.

Clause 3.03:

- (i) Except for (a) joint Abandonment by the Parties after the Farmor elects to convert at Payout and (b) sole Abandonment by the Farmor after the Farmor takes over the Test Well through the operation of either the Farmout Procedure or the Royalty Procedure, the Farmee will be obligated indefinitely to discharge all requirements for the Abandonment of the Test Well, its wellsite and access road and to indemnify the Farmor for any claims which may be brought against the Farmor in that regard.
- (ii) This provision is to establish at least between the Parties to the Farmout Agreement, the competing responsibilities for Abandonment and any environmental concerns which may arise in the future concerning that Abandonment.
- (iii) The premise upon which the Clause is based is that the Farmee is the Party which agrees to risk the drilling and related operations for the Test Well. The Farmee should remain liable for the consequences of the Farmee's actions. This should apply even if the Farmor subsequently becomes a joint Party with the Farmee in the Farmout Lands after the Farmee earns by Abandoning the Test Well at drilling rig release or after the Farmee conducts other operations on the Test Well and Abandons the Test Well prior to Payout. Note that in these circumstances the Farmor will never have agreed to become an active participant in the rights and obligations for the operations for that Test Well.

- (a) from the Drilling rig release date, the Farmee shall be responsible for performing all obligations associated with the Title Documents as they relate to the interests in the Farmout Lands which the Farmee remains entitled to earn; and
- (b) the Farmee may exercise any available rights relating to Option Wells.

### 3.02 Abandonment For Earning

For the purpose of earning under Clause 3.01 (Test Well Earning), the Farmee shall satisfy its obligation to Abandon the Test Well when it conducts to the Farmor's reasonable satisfaction, Abandonment to the extent provided in ALTERNATE \_\_\_\_\_ below (Specify A or B):

#### ALTERNATE A:

*Abandonment other than the restoration of the well site and access roads.*

#### ALTERNATE B:

*Abandonment including the restoration of the well site and access roads, to the extent those restorative operations ought reasonably to entitle the Farmee to obtain the satisfaction of any governmental body having jurisdiction with respect thereto for Abandonment, reclamation and environmental Regulations compliance.*

### 3.03 Post Earning Obligations

The Farmee shall have a continuing, post-earning obligation to the Farmor, to expeditiously develop the Royalty Lands for the taking and marketing of Petroleum Substances. The Farmee shall Equip the Test Well as soon as an economic market is available and market Petroleum Substances producible from the Test Well.

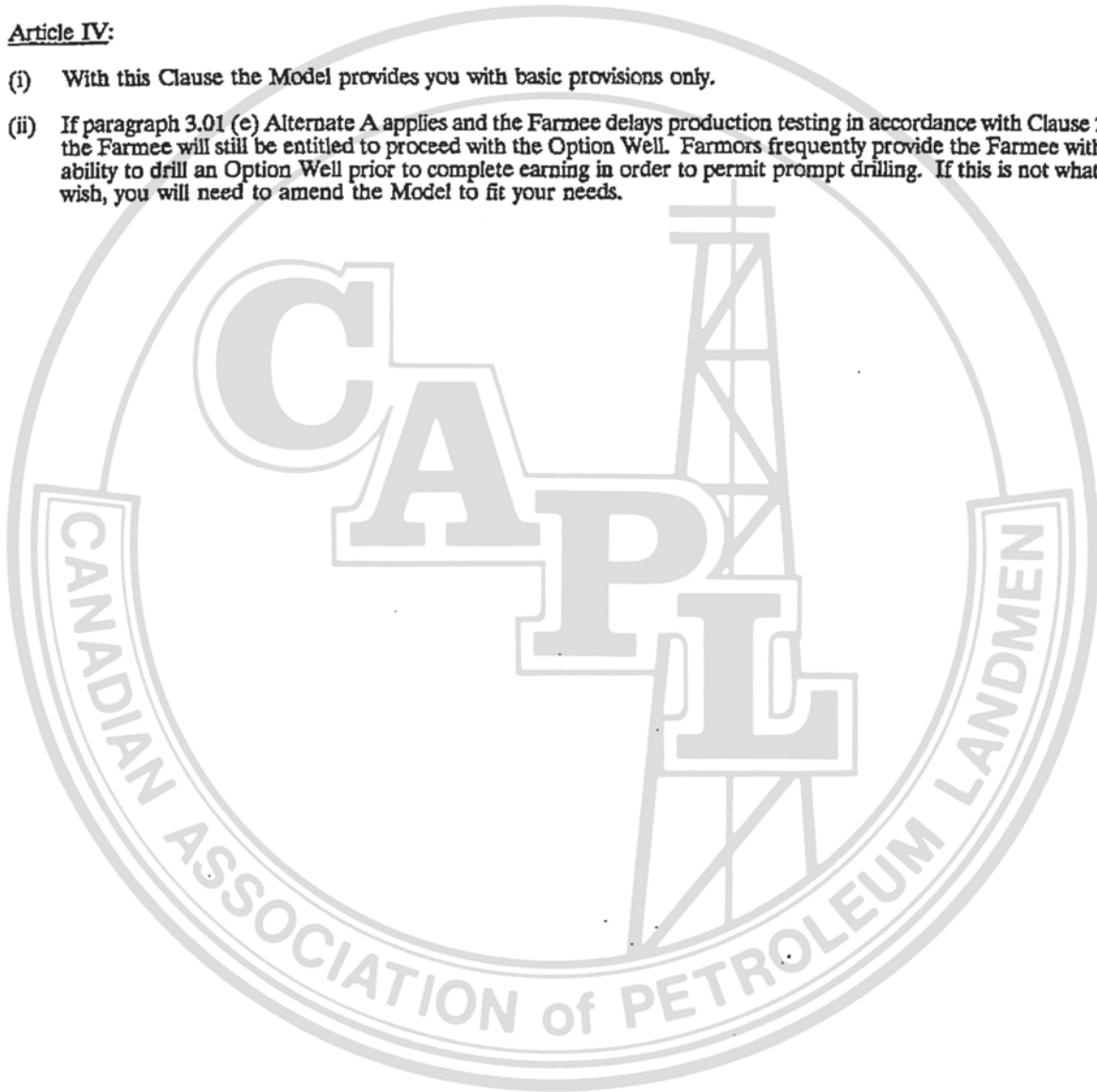
If the Farmee (i) Abandons the Test Well to earn an interest in the Farmout Lands or (ii) Caps or Completes the Test Well but Abandons that well before the Farmor's right to convert its Overriding Royalty to a Working Interest accrues, thereby causing conversion of that Overriding Royalty to occur automatically for the Test Well Spacing Unit pursuant to Article VI (CONVERSION OF OVERRIDING ROYALTY), the Farmee shall:

- (a) remain solely liable for all obligations for the Abandonment of the Test Well; and
- (b) remain liable and shall indemnify the Farmor from all future environmental compliance obligations which may arise relating to the ownership of those Title Documents, the Test Well and those associated surface rights.



Article IV:

- (i) With this Clause the Model provides you with basic provisions only.
- (ii) If paragraph 3.01 (c) Alternate A applies and the Farmee delays production testing in accordance with Clause 2.03, the Farmee will still be entitled to proceed with the Option Well. Farmors frequently provide the Farmee with the ability to drill an Option Well prior to complete earning in order to permit prompt drilling. If this is not what you wish, you will need to amend the Model to fit your needs.





The obligations created by this Clause shall survive the termination of all other provisions of this Farmout Agreement.

#### IV. OPTION WELL

Article IV shall not \_\_\_\_/shall \_\_\_\_ (Specify) be included herein.

##### 4.01 Option Well Election

If the Farmee drills the Test Well to Contract Depth and has complied with this Farmout Agreement in all material respects, the Farmee, by notice to the Farmor to be received by the Farmor on or before the \_\_\_\_ day following the day of drilling rig release of the Test Well, may elect to drill another well (hereinafter called the "Option Well"). If the Farmee makes this election, the Farmee shall Spud the Option Well at a location of the Farmee's choice on the Option Lands on or before the \_\_\_\_ day following the day of drilling rig release of the Test Well and shall diligently and continuously drill the Option Well to Contract Depth and Complete, Cap or Abandon that well.

##### 4.02 Test Well Provisions Apply

If the Farmee gives notice to drill the Option Well, all the provisions of the Farmout Agreement which apply to the Test Well and Farmout Lands shall apply in the same manner to the Option Well and the Option Lands except as may be provided to the contrary in Schedule "A" hereto.

##### 4.03 Option Well Elections With Multiple Farmee Parties

If the Farmee comprises more than one Party and if fewer than all Farmee Parties elect to participate in the Option Well, the participating Farmee Parties for the Option Well shall:

- (a) in the notice of election to the drill the Option Well, provide the Farmor with the name of the Farmee Party which the participating Farmee Parties appoint as their Managing Farmee for the Option Well obligations if the Managing Farmee under Clause 1.10 (Multiple Farmee Parties) of the Farmout Procedure is not participating in the Option Well;
- (b) be jointly and severally liable for all Farmee obligations for the Option Well; and
- (c) be the only Farmee Parties entitled to earn an interest in the Option Lands.

Clauses 5.01 and 5.02: These Clauses clarify the matters to be covered by the various procedures. As provided in Clause 3.01, the Parties may record earning at drilling rig release (though that earning may be conditional).

Sub-clause 5.02 (b): As the Overriding Royalty is created by the Agreement (as defined in the Operating Procedure), the last phrase is redundant where the farmout comprises 100% of the Working Interest in the relevant lands. In cases where there is a participant, the phrase can serve to emphasize that if the participant acquires a Farmee Party's interest pursuant to the Operating Procedure (e.g., by way of a production penalty where the Farmee Party elected not to participate) the participant becomes responsible for the payment of the Overriding Royalty as it pertains to that Working Interest.

## V. APPLICATION OF PROCEDURES AND FURTHER OPERATIONS

### 5.01 Application Of Farmout Procedure

The Farmout Procedure shall come into effect as of the Effective Date and shall apply to all matters or operations related to the Farmout Lands accruing or conducted prior to the date the Farmee fully performs its earning obligations for the Farmout Lands under Clause 3.01 (Test Well Earning) or the Farmee's right to earn the Farmout Lands expire, and shall apply, as applicable, to conditions on earning under Clause 3.01 (Test Well Earning), to post earning obligations under Clause 3.03 (Post Earning Obligations), to matters arising under Article VI (CONVERSION OF OVERRIDING ROYALTY), Article VII (AREA OF MUTUAL INTEREST), Article VIII, (SPACING UNIT REDUCTION AND DEVELOPMENT) and Article IX (GAS PURCHASE CONTRACT).

### 5.02 Application Of Operating Procedure And Royalty Procedure

Effective the day when the Farmee fully performs its earning obligations for the Farmout Lands pursuant to Clause 3.01 (Test Well Earning):

- (a) the Operating Procedure shall come into effect between the Farmor and the Farmee for those earned Farmout Lands other than the Royalty Lands and the initial undivided Working Interests for the Parties under the Operating Procedure in those earned Farmout Lands (which lands shall become joint lands under the Operating Procedure) shall be:

Party

Working Interests

100%

- (b) the Operating Procedure shall come into effect between the Parties comprising the Farmee (if more than one) for the Royalty Lands and the initial undivided Working Interests for the Farmee Parties in the Royalty Lands (which Royalty lands shall be joint lands under the Operating Procedure among those Farmee Parties) shall be:



**Clause 5.03:** If the Farmee earns the Farmout Lands by Capping the well without production testing it, the Farmee cannot propose a joint well on the Farmout Lands subject to the Operating Procedure. The Farmor will have the benefit of those production tests before being forced to elect on a joint well. Where there is another operating procedure governing the Farmout Lands (i.e., less than 100% Working Interest farmed out) that first operating procedure should also be referenced.



Party

Working Interests

100%

and the Overriding Royalty retained by the Farmor shall be an encumbrance on each Farmee Party's Working Interest acknowledged under the Operating Procedure to continue to apply to that Working Interest following the application of the surrender, forfeiture or production penalty provisions of the Operating Procedure to that Working Interest;

- (c) the Royalty Procedure shall come into effect between the Farmor and the Farmee for the Royalty Lands.

The Managing Farmee is appointed Operator under the Operating Procedure. Despite the appointment of Operator, \_\_\_\_\_ shall be responsible for complying with all terms and conditions of and all maintenance and administration for the Title Documents and in that capacity, that Party shall have the same rights and obligations as the Operator holds under the Operating Procedure.

If the Accounting Procedure is a form other than the Petroleum Accountants Society of Canada 1988 (Revised February 1991) Accounting Procedure, the following sentence shall be deemed to be part of the Accounting Procedure:

For refundable value added, goods and services or sales taxes: the Operator is authorized to make all elections and file all forms or documents required to administer such taxes on behalf of the Joint Account, including any documents which are required to deem all purchases of goods and services to be purchased by the Operator and all recoveries to be recoveries of the Operator.

**5.03 No Operations During Earning Or While Production Tests Outstanding**

The Farmee shall not issue an operation notice under the Operating Procedure for the Farmout Lands which the Farmee earns and, except for the development and exploitation of the Test Well, shall not conduct any operations for the Royalty Lands until the last of the following events occur:

- (i) the Farmee's rights to earn an interest under this Agreement end; or

Clause 5.04: This Clause only applies to the formations which the Farmor retains from earning. It does not apply to new acquisitions of deep rights. Normal legal rules apply to such rights, so that the Farmor is on the same footing as any other third person.

Article VI: The Model provides detailed terms for the Farmee to deliver information to the Farmor during the Payout period. Too frequently both parties to a Farmout Agreement do not serve themselves well for their respective interests in monitoring a Payout account. Farmees neglect to prepare and issue Payout account statements and Farmors fail to satisfactorily conduct informal or formal audit reviews of those Payout accounts.

With the tighter reporting requirements for the Farmee concerning Payout account reporting, the Farmor may more readily be alerted when the Farmee is not keeping current with this reporting. This may create an onus on the Farmor to look after its interests promptly and to seek satisfactory performance of these reporting obligations.

- (ii) the Farmee has finished all production tests required under Clause 2.03 (Production Tests).

The Farmor shall not issue an operation notice under the Operating Procedure for the Farmout Lands which the Farmee earns until the Farmee's rights to earn an interest under this Agreement end.

#### 5.04 Farmor's Access To Reserved Formations

The Farmor shall have the right at any time to enter upon the Farmout Lands to drill a well to penetrate the Reserved Formations and to take production therefrom. The Farmor shall conduct its drilling and any resultant producing operations in such manner as to interfere as little as is reasonably possible with drilling or producing operations being conducted on the Farmout Lands. Nothing in this Clause, however, shall permit the Farmor to use such well for the production or testing of Petroleum Substances from any zone contained in the Farmout Lands unless otherwise agreed by the Parties. If the Farmee suffers a loss as a result of such Farmor operations for the Reserved Formations, Article X (LIABILITY AND INDEMNITY) of the Farmout Procedure shall apply to allocate responsibility for such loss.

### VI. CONVERSION OF OVERRIDING ROYALTY

Article VI shall not \_\_\_\_/shall \_\_\_\_ (Specify) be included herein.

#### 6.01 Payout Accounts And Statements

If the Farmee earns a Working Interest in the Farmout Lands by Capping or Completing the Test Well, the Farmee shall establish and maintain in Alberta accounting records in accordance with Canadian Generally Accepted Accounting Principles (GAAP) and the Accounting Procedure for the calculation of Payout. The Farmee shall supply the Farmor with a written statement evidencing all debits and credits made in calculating Payout (together with calculations used to arrive at those debits and credits) at the intervals specified in ALTERNATE \_\_\_\_ below (Specify A or B).

##### ALTERNATE A:

*Every 6 months when the Test Well is not producing Petroleum Substances, every 3 months when the Test Well is producing Petroleum Substances and every month when the Test Well is producing Petroleum Substances and the Payout account balance is less than the amount by which the Payout account balance was reduced in the preceding 6 months.*



Clause 6.02:

- (i) This Clause would apply when the Farmee earns the Farmout Lands by Capping or Completing the Test Well but later (and before Payout in the case of a Completed Test Well) decides to Abandon that well.
- (ii) If the Farmee earned by Abandoning the Test Well, Clauses 3.01 and 6.01 are set up such that the Overriding Royalty and Payout account never come into existence.
- (iii) Another way of dealing with Test Well Abandonment prior to Payout is to deem a Payout such that the Farmor may elect to remain in an Overriding Royalty position on the Abandoned Test Well Spacing Unit.

Clause 6.03:

- (i) The conversion election is effective at Payout, not at the beginning of any month thereafter. Therefore, adjustments will be required for the period between Payout and the Farmor's election to convert. The authors recognized that this would create an accounting inconvenience; however, if a prolific well paid out early in a month, the Farmor Parties could be foregoing substantial sums of money if, for example, the conversion becomes effective the first day of the month following Payout. Contrast this with the effective date of conversion in Clause 6.02. In the Abandonment situation envisioned by Clause 6.02, there is not likely to be large sums to adjust.
- (ii) Clause 1.11 of the Farmout Procedure ensures each Farmor Party has an election.

Clause 6.04:

- (i) Alternate A is broad enough for use in a Farmout involving participants as long as the Working Interest of the Farmor Parties and the participants are uniform throughout the Farmout Lands.
- (ii) Alternate B is required where the Test Well Spacing Unit comprises all the Farmout Lands. The definition of Spacing Unit in the Farmout Procedure and the way Alternate A1 for Clause 3.01 is structured could avoid the need for Alternate B but the authors decided not to rely on that construction, since Clause 3.01 could be replaced.



**ALTERNATE B:**

*Every \_\_\_\_\_ months when the Test Well is not producing Petroleum Substances, every \_\_\_\_\_ months when the Test Well is producing Petroleum Substances and every \_\_\_\_\_ months when the Test Well is producing Petroleum Substances and the Payout account balance is less than the amount by which the Payout account balance was reduced in the preceding 6 months.*

The interval for the first statement showing the status of Payout shall be measured from the first day of the month following that month in which the Farmee Caps or Completes the Test Well. If the Farmor requests, the Farmee shall use reasonable efforts to prepare the Payout statements in the format requested by the Farmor.

**6.02 Automatic Conversion Upon Abandonment Or Takeover**

If the Farmee commences the Abandonment of the Test Well before Payout occurs, the Farmor's Overriding Royalty in the Royalty Lands comprising the Test Well Spacing Unit shall automatically convert to a Working Interest effective the first day of the month following that month containing the day of rig release of the rig used to Abandon the Test Well.

If the Farmor takes over the Test Well pursuant to the Royalty Procedure or the Farmout Procedure, the Farmor's Overriding Royalty in the Royalty Lands comprising the Test Well Spacing Unit, to the extent it still applies, shall automatically convert to a Working Interest in those Royalty Lands effective at that Test Well takeover.

**6.03 Election For Conversion At Payout**

On or before the 60th day following Payout, the Farmee shall give notice of that event to the Farmor, which notice shall specify the date of Payout. On or before the 30th day following receipt of that notice by the Farmor, the Farmor may elect to convert its Overriding Royalty to a Working Interest in the Royalty Lands comprising the Test Well Spacing Unit, the Test Well wellbore and all equipment related thereto (to the extent the costs for that equipment were included in calculating Payout) effective at Payout. A failure by the Farmor to give notice to convert within the specified period shall be deemed to be an election not to convert.

**6.04 Interests At Conversion**

The Working Interest to which the Farmor may convert the Farmor's Overriding Royalty in the Royalty Lands shall be that specified in ALTERNATE \_\_\_\_ below (Specify A or B):

Clause 6.05: While this Clause entitles the Farmor to interest where the Farmee failed to give notice of Payout at the time prescribed, there is no provision for extra interest (e.g., prime + 5% rather than prime + 2%) in Clause 12.03 of the Farmout Procedure.

Clause 6.06:

- (i) This Clause creates an obligation in the Farmee to deliver whatever appropriate conveyance documents may be necessary for the recognition of the Farmor's newly converted Working Interest.
- (ii) The second paragraph clarifies what happens when fewer than all Farmor Parties convert. The Farmor Parties electing to retain their Overriding Royalty do not acquire any interest of the Overriding Royalty interest of the converting Farmor Parties. The phrase beginning with "acknowledged under the Operating Procedure" is to ensure that the Overriding Royalty retained by the remaining Farmor Parties become recognized under Article VIII of the Operating Procedure. Note that only the Farmee's interest is affected; the converting Farmor Parties are not subject to the Overriding Royalty at conversion. However, if those Farmor Parties subsequently acquire all or a portion of the Farmee's interest under the Operating Procedure, they would be responsible for the Overriding Royalty for such interest.
- (iii) This Clause also addresses the reality of the Farmor's needs for the use of downstream facilities at conversion, to process and transport its production. Therefore the Farmee is required to make provision for or, at least be ready to address, the downstream concerns of the Farmor whenever the Farmor converts.

**ALTERNATE A:**

*The same Working Interest in the Farmout Lands other than the Royalty Lands which the Farmor retains when the Farmee earns an interest in those Farmout Lands.*

**ALTERNATE B:**

An \_\_\_\_\_ % undivided Working Interest.

**6.05 Late Notice Of Payout**

If Payout occurs and the Farmee either has not issued to the Farmor notice of Payout or has issued that notice to the Farmor at a date later than that required by this Article, the Farmor may give notice to the Farmee that the Farmor elects to convert its Overriding Royalty as provided in Clause 6.03 (Election For Conversion At Payout) and the accounts of the Parties shall be retroactively adjusted.

If the amount payable to the Farmor by the Farmee on account of the Working Interest to which the Farmor converts exceed the payments made to the Farmor on account of the Overriding Royalty after Payout, the Farmee shall pay interest to the Farmor from the date that excess amount became due to be paid until the date that amount is paid pursuant to Clause 12.03 (Right To Charge Interest For Financial Default) of the Farmout Procedure.

**6.06 Operations At Conversion**

The Operating Procedure shall apply to the Working Interests of the Farmee and those Farmor Parties which convert their Overriding Royalty. The Farmee shall sign and deliver to the Farmor those conveyances the Farmor may reasonably consider necessary to confirm the conversion of the Overriding Royalty to a Working Interest.

If fewer than all the Farmor Parties elect to convert their Overriding Royalty rights, the following shall apply:

- (i) that converted portion of the Overriding Royalty shall terminate and shall not accrue to any of the Farmor Parties electing not to convert;
- (ii) for that portion of the Overriding Royalty retained by Farmor Parties electing not to convert to a Working Interest, the Royalty Procedure shall apply among the Farmee and those Farmor Parties electing not to convert to a Working Interest; and
- (iii) that portion of the Overriding Royalty retained by Farmor Parties electing not to convert to a Working Interest shall be an encumbrance on each Farmee Party's Working Interest acknowledged under the Operating Procedure to continue to apply



Clause 7.01:

- (i) The term of the area of mutual interest (AMI) should be expressed in either events or dates. Actual dates are of course the easiest to administer. In the first blank the most usual insertion would be "the Effective Date" but the authors recognized the need for flexibility. As to the second blank, where the Parties wish to refer to events, they could insert "the X month following the latest of: (i) the rig release of the Test Well (ii) the rig release of the Option Well or (iii) the termination of the Farmee's right to elect to earn any further interest in lands subject to the Farmout Agreement."
- (ii) What if the Farmee defaults in drilling the Test Well? If the term of the AMI was based solely on Test Well rig release, the spectre of a never ending AMI looms. The first paragraph of Clause 12.01 (Farmor's Remedies In The Event Of Default) of the Farmout Procedure allows the Farmor to terminate the Agreement which would terminate this AMI Article.

Clause 7.02:

- (i) This Clause takes the definition of New Lands far beyond the often seen Crown Sale AMI. If a Party buys a Working Interest or a royalty interest from a third party within the AMI lands, that party would have to offer that interest to the other Parties. The same is true if a Party farmed-in on a third party's interest within the AMI. The authors believed all forms of interests in Petroleum Substances should be captured by an AMI Clause.
- (ii) The 50% restriction is inserted to prevent conflicting AMI's. A Farmee may have entered into multiple farm-ins in the vicinity of the Farmout Lands.
- (iii) The last portion of this Clause dealing with beneficial interests ensure that lands acquired by a Party by an agent prior to the commencement of the AMI would not get caught by the AMI. The fact that these lands are in an agent's name is a matter of form rather than substance; those lands belong to the principal.



to that Working Interest following the application of the surrender, forfeiture or production penalty provisions of the Operating Procedure to that Working Interest.

Subject to payment to or reimbursement of the Farmee, either by negotiated transportation and processing fee or ownership adjustment, the Farmor shall have the right, through the Farmee, to use a sufficient capacity in any facility beyond those included in Equipping Costs, through which the Petroleum Substances subject to the conversion to a Working Interest were being handled or processed prior to the conversion of the Farmor's Overriding Royalty. This right shall be subject to the terms of the Farmee's agreements, if any, with third parties (other than Affiliates of the Farmee) for the ownership and operation of that facility.

## VII. AREA OF MUTUAL INTEREST

Article VII shall not \_\_\_\_/shall \_\_\_\_ (Specify) be included herein.

### 7.01 Term Of AMI

This Article shall bind the Parties for the period commencing on \_\_\_\_\_ and ending on \_\_\_\_\_.

### 7.02 New Lands

In this Article, "New Lands" means any interest in petroleum substances which interest arises out of a single instrument where over 50% of the surface area of that interest is contained in the lands described as "AMI Lands" in Schedule "A" and which become available for acquisition either:

- (a) under the Regulations, including by presentation of a bid at a Crown sale; or
- (b) by agreement with any third party by purchase and otherwise;

and which interests may include any arms' length encumbrance such as a production payment, a net profits interest or a royalty, but shall not include interests acquired by a Party pursuant to a corporate reorganization of that Party, the amalgamation of a Party with a third party or beneficial interests held by a third party on behalf of a Party, which beneficial interests were acquired by that Party prior to the date this Article becomes effective.

### 7.03 AMI Participating Interests

The Parties shall have the right to participate in the acquisition of New Lands in the following percentages:

Clause 7.04:

- (i) To illustrate the need for and the mechanics of the second paragraph, consider the following example: A, B and C consult regarding a joint bid; B and C agree on a bid but A believes the bid too high. Without the second paragraph, B and C could each go to the Crown sale with no obligation to the other Party (subject to the 5% rule in Clause 7.05). The authors did not believe that fair.
- (ii) The second paragraph also allows a Party to restrict its participation in a Crown bid, which concept is also applied in Clause 7.06. To continue with our example, B may decide it is only willing to participate for the percentage interest specified for B in Clause 7.03. C can then take the balance of the interest. B and C would then go to the sale on that basis. What if neither B nor C wished to acquire any interest beyond that specified for them in Clause 7.03? Then the Parties are free to put in individual bids still subject, of course to the 5% rule in Clause 7.05.

Clause 7.05: If New Lands are acquired in the circumstances outlined in this Clause, the acquiring Party will acquire those New Lands subject to a trust in favour of the other Parties.

Party

Interests Acquired  
in New Lands

100%

**7.04 Joint Acquisition Of Crown New Lands**

If any Party wishes to acquire New Lands which the Crown makes available during the term of this Article, that Party shall first consult with all other Parties to establish a joint bid to acquire those New Lands. If unanimous agreement is reached by the Parties for joint acquisition of those relevant New Lands, the Farmee shall submit that bid at the relevant Crown sale on behalf of all Parties. If the Parties are not in agreement on the terms of a joint bid with respect to the New Lands, any Party may submit an independent bid with respect thereto.

If, after that consultation and a reasonable time prior to the date of the relevant Crown sale, agreement is reached by two or more but not all Parties, the Parties which were able to agree on the terms of a joint bid shall consult further on the basis that each of those Parties may elect to participate in the acquisition of those New Lands only to the extent of the percentage interest stipulated for that Party in Clause 7.03 (AMI Participating Interests) or to the extent of that percentage interest increased by its proportionate share of the unassumed percentage of participation respecting that acquisition of New Lands. If, after this consultation, these Parties are unable to agree on the terms of a joint bid for the entire interest of those New Lands, any Party may submit an independent bid with respect thereto.

**7.05 Notice Of Acquisition Of New Lands**

If any Party acquires New Lands:

- (a) at a Crown sale without consulting the other Parties or without disclosing to them the price it was prepared to pay for that acquisition;
- (b) at a Crown sale where unanimous agreement was not reached pursuant to Clause 7.04 (Joint Acquisition Of Crown New Lands) and the price to acquire the New Lands paid

Clause 7.06:

- (i) A Party may restrict its participation in the New Lands. The wording is adapted from Clause 1002 of the Operating Procedure.
- (ii) If a Party (which would probably be a Farmor Party but could be a Farmee Party other than the Managing Farmee) is not in receipt of certain Test Well information, its election to acquire the New Lands concerned is postponed. The type of information which would bring about postponement differs depending on the nature of the New Lands. For Crown Leases acquired at a sale or for freehold leases acquired by a Party, well logs constitute the minimum information. For other forms of New Lands (e.g., farm-ins or purchases) drillstem tests and production tests from the Test Well are required.
- (iii) The third paragraph deals with farm-ins, seismic options and other similar agreements comprising New Lands.



by the acquiring Party differs by more than 5% from the last price disclosed by that Party as being the price to which it was prepared to agree for the acquisition of those New Lands; or

- (c) by means other than by bidding at a Crown sale;

the acquiring Party shall acquire those New Lands subject to a revocable trust in favour of the other Parties in accordance with their rights under this Article and immediately deliver notice to all other Parties describing all material provisions of that Party's acquisition of New Lands no later than the close of business on the third business day following, as applicable, the day of the Crown sale at which the New Lands were acquired, the closing day for an agreement entered into for the acquisition of New Lands where that agreement specifies a closing date, the day an agreement or acquisition is entered into for the acquisition of New Lands or the day a document of title is acquired from a lessor if acquired by means other than a Crown sale.

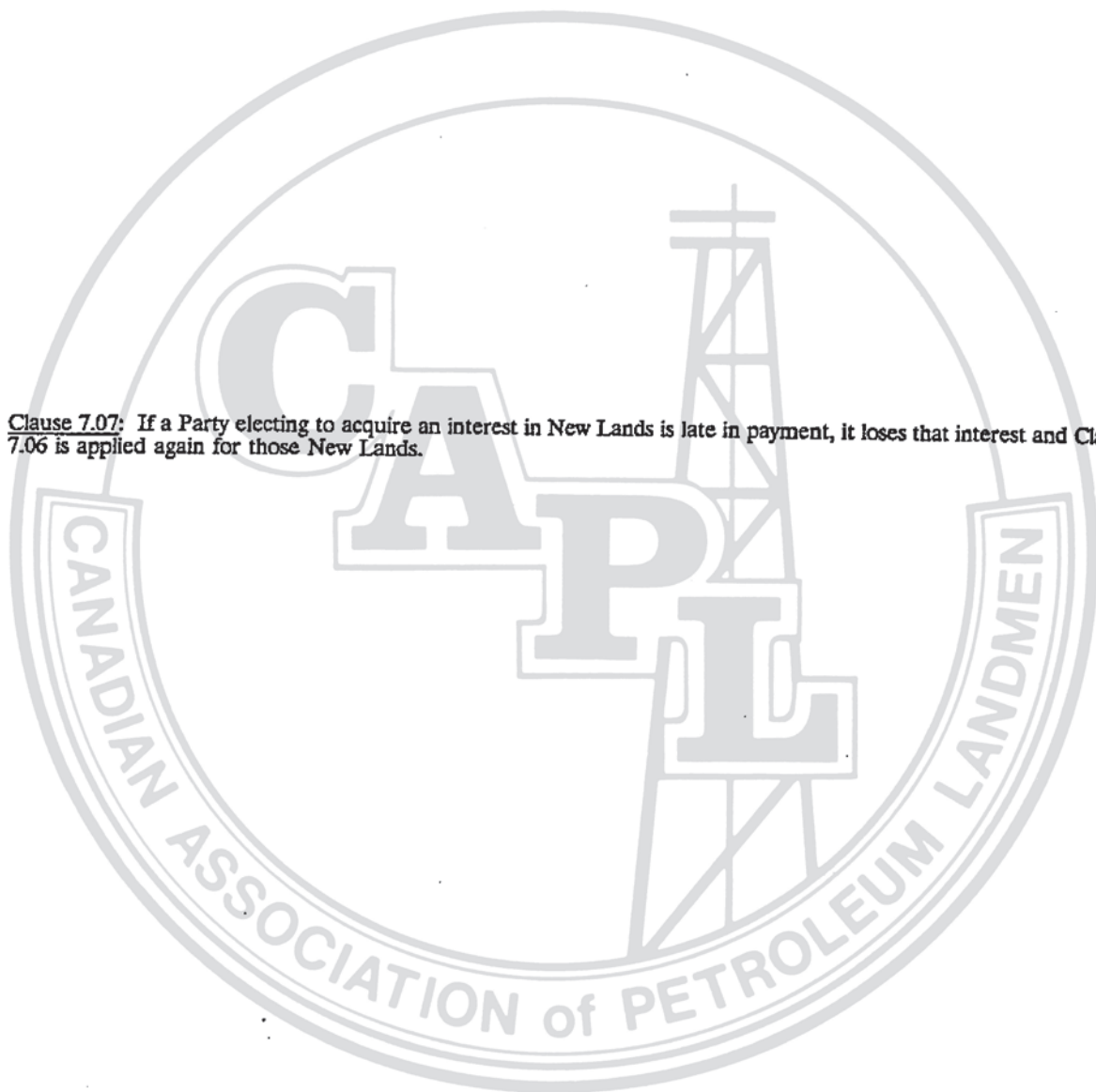
#### 7.06 Right To Acquire New Lands

Each Party receiving a notice delivered under Clause 7.05 (Notice Of Acquisition Of New Lands) may, on or within ten (10) days following the receipt of that notice, elect by notice delivered to the acquiring Party to acquire an interest in the rights to the New Lands by committing to assume a share of all obligations relating to the acquisition of those New Lands. In that notice to the acquiring Party, a Party may elect to participate in the acquisition of those New Lands only to the extent of that percentage interest stipulated for that Party in Clause 7.03 (AMI Participating Interests) or only to the extent of that percentage interest increased by its proportionate share of participation in that acquisition, with a limitation as to a maximum amount of such increased participation which that Party is prepared to accept. Failure by a Party to limit participation in the acquisition of New Lands in its notice to the acquiring Party shall be deemed to be an election to participate to the extent of the percentage interest stipulated for that Party in Clause 7.03 (AMI Participating Interests) increased by its proportionate share of any unassumed percentage of participation in that acquisition. Any unassumed percentage of participation in that acquisition of those New Lands following these elections shall remain with the acquiring Party.

If at the time of the acquisition of the New Lands, the Test Well has not reached Contract Depth and a Party has not received all the following information:

- (a) for New Lands comprised of documents of title acquired from the Crown or from an owner holding or entitled to hold fee simple title to the New Lands concerned, all logs from the Test Well to which that Party is entitled; and
- (b) for New Lands other than documents of title acquired from the Crown or from an owner holding or entitled to hold fee simple title to the New Lands concerned, all logs,

Clause 7.07: If a Party electing to acquire an interest in New Lands is late in payment, it loses that interest and Clause 7.06 is applied again for those New Lands.



drillstem tests, production tests and all other material information regarding the Test Well to which that Party is or will be entitled;

the Party not having received that information may elect to acquire these New Lands in accordance with this Article on or within 10 days following the receipt of the last of that information.

If the consideration of the acquisition of New Lands is the drilling of a well or the conducting of certain geological or geophysical operations, a Party which elects to acquire a portion of the acquiring Party's interest or rights in such acquisition shall be required to assume a corresponding share of the cost, risk and expense of those operations which are required to be conducted pursuant to the terms of such acquisition. To the extent that the conduct of those required operations entitles the Parties to further rights to an interest in the New Lands subject to that acquisition through the conduct of optional operations, those rights shall be exercised in a manner as those Parties may agree. However, those rights shall only be shared by those Parties which participated in the previous operations conducted under that acquisition.

#### **7.07 Payment For Acquisition Of New Lands**

If a Party gives notice to acquire an interest in New Lands pursuant to Clause 7.06 (Right To Acquire New Lands) and if the consideration for the acquisition of those New Lands is money which has already been paid by the acquiring Party, that Party electing to acquire an interest shall make payment of monies due for that Party's share thereof on the day of delivery of that Party's notice to acquire those New Lands, provided that, if the percentage participation of a Party so electing is not then known by virtue of an election by that Party to acquire a percentage interest greater than that stipulated for that Party pursuant to Clause 7.03 (AMI Participating Interests), the acquiring Party shall give notice to that Party of the percentage participation in that acquisition of New Lands when determined and that Party electing to acquire that interest shall immediately make payment of monies due for its share thereof to the acquiring Party.

If a Party gives notice to acquire an interest in New Lands pursuant to Clause 7.06 (Right To Acquire New Lands) and if the consideration for the acquisition of those New Lands is the drilling of a well or the conducting of certain geological or geophysical operations which have commenced by the time the notice to acquire that interest is given to the acquiring Party, the acquiring Party shall invoice the Parties electing to acquire an interest in those New Lands for their share of the costs incurred to that date and the Parties invoiced shall pay the invoice within thirty (30) days of receipt thereof.

If payment by a Party of its obligations for acquisition of rights to New Lands is not made in the period specified above, that Party's notice to acquire those New Lands under Clause 7.06 (Right To Acquire New Lands) shall be void and Clause 7.06 (Right To Acquire New



Clause 7.09: To illustrate the need for this Clause, consider the following example. A farms out to B and the agreement contains an area of mutual interest. B drills the Test Well and earns. B proposes a joint well on the earned Farmout Lands but A does not participate; B drills the well. B uses that information in conjunction with Test Well information to develop a play. B consults with A regarding a joint bid at a Crown sale on lands within the area of mutual interest, which Crown sale will occur before A is entitled to information from the independent well drilled by B. Should B be required to disclose the play it has developed? Should B be required to disclose the information from the independent well it drilled to help explain that play? The authors did not believe so. See also the first sentence of Clause 14.01 (Confidentiality Requirement) of the Farmout Procedure which sentence is the same as the first sentence of Clause 1801 (Confidentiality Requirement) of the Operating Procedure.

Article VIII: The definition of Test Well Spacing Unit includes multiple zones and all forms of Petroleum Substances included in the farmout. However, according to the Regulations, spacing units are applied zone by zone and substance by substance. Therefore, the Test Well Spacing Unit contains many potential spacing units in which a Farmee may wish to drill a well.

More spacing units may be created if the appropriate application is made to reduce the size of the existing spacing units. Where the Overriding Royalty is convertible the question arises as to how additional wells and reduced spacing (which hold the potential for additional wells) should be treated.

Clause 8.01: The definitions for Additional Well Spacing Unit and Reduced Spacing Unit have areal, zonal and substance components. For example, if the Farmee proposed to drill an additional shallow oil well in X zone with normal spacing when the Test Well Spacing Unit comprises a whole section, the Additional Well Spacing Unit would be a quarter section as to oil in the X zone only. Gas would not be affected.

As another example, if a Reduced Spacing Order reduced the gas spacing unit in Y zone from 1 section to a quarter section and if there were already a gas well capable of producing from Y zone in the south east quarter, the Reduced Spacing Units would be the north east, north west and south west quarters of that section as to gas in Y zone only. Oil would not be affected.



Lands) shall be proportionately re-applied amongst the acquiring Party and the remaining Parties which elect to participate in the acquisition of those New Lands.

#### **7.08 Application Of Operating Procedure**

If the Parties have complied with this Article and New Lands are acquired by more than one Party without being subject to an agreement which provides for the joint operation of those New Lands, the acquiring Parties shall be bound by the Operating Procedure for the maintenance and operation of those New Lands. If the Operator under the Operating Procedure is not an acquiring Party for the New Lands, the acquiring Parties shall appoint an operator for the New Lands as provided in the Operating Procedure.

#### **7.09 Parties Not Required To Disclose Information**

Nothing in this Article requires a Party to disclose to any other Party:

- (i) any information beyond that information which that Party is required to provide to that other Party pursuant to the Farmout Agreement;
- (ii) where that other Party's right to information has been delayed pursuant to any provision of this Farmout Agreement, any such information prior to the time specified for that other Party's entitlement to same; or
- (iii) any geological, geophysical or other interpretation of data developed by that Party wholly or partially from information acquired by that Party under this Farmout Agreement.

### **VIII. SPACING UNIT REDUCTION AND DEVELOPMENT**

Article VIII shall not \_\_\_\_/shall \_\_\_\_ (Specify) be included herein.

#### **8.01 Definitions For Spacing Unit Reduction And Development**

In this Article, the following phrases shall have these meanings:

- (a) "Additional Well Spacing Unit" means, with respect to an additional well for which the Farmee gives an operation notice to the Farmor pursuant to this Article, the area allocated by the Regulations to that well for the purpose of producing Petroleum Substances from that additional well insofar only as that area pertains to the target zone and the specific Petroleum Substance for which that additional well is drilled.
- (b) "Notice Lands" means an Additional Well Spacing Unit or a Reduced Spacing Unit.

Clause 8.02:

- (i) The first paragraph applies to all Reduced Spacing Orders whether or not the Farmee makes the application. This is to cover the possibility that another company active in the area of the Royalty Lands makes an application which affects the Royalty Lands.
- (ii) This Clause does not require the Farmor to consent to the Reduced Spacing Order. The Farmor may exercise such rights as are available to it under the Regulations to dispute the application.
- (iii) Alternate B amends the Payout account but it is still one account. Alternate C creates multiple Payout accounts which will create multiple Payout elections at the various Payout dates.
- (iv) To illustrate how Clause 8.02 applies, consider the following example.

The Farmee earns by Completing the Test Well in a deep zone.

The Farmor has a convertible Overriding Royalty.

The Farmee gives the Farmor an operation notice to drill an oil well in a shallower zone.

The following will apply:

- (a) The Farmee's operation notice will establish the Additional Well Spacing Unit for the shallower zone;
- (b) The Farmor may convert the Overriding Royalty to a Working Interest for a portion of the shallower zone formerly within the Test Well Spacing Unit but which now will become the Additional Well Spacing Unit. Under the Operating Procedure which will apply from the date the Farmor receives the Farmee's operation notice for the additional well, the Farmor may elect to participate in the additional well or go penalty;
- (c) The Farmor may retain the Overriding Royalty on the terms specified in the Alternate selected for 8.02(b).

Let us say the Farmor elects to remain in a convertible Overriding Royalty position. The Farmee successfully drills the additional well and applies for a Reduced Spacing Order to reduce the quarter section spacing for the oil in the Additional Well Spacing Unit, to one legal subdivision. The Farmee gives notice to the Farmor of the Reduced Spacing Order, describing the three Reduced Spacing Units comprising the three undrilled legal subdivisions which were previously within the quarter section Additional Well Spacing Unit. The Farmor may then elect to either convert or remain in an Overriding Royalty position for those three Reduced Spacing Units.

If the Farmor again remains in an Overriding Royalty position and later the Farmee gives an operation notice to drill an additional well on any of those three Reduced Spacing Units, the Farmor will have a further opportunity to elect whether or not to convert the Overriding Royalty and to participate in that operation.

- (v) Note that Clause 8.03 sets out restrictions.



- (c) "Payout Period" means the period from the date on which the Farmee earns its interest in the Royalty Lands comprising the Test Well Spacing Unit to the first to occur of:
- (i) the date the Farmor's Overriding Royalty converts to a Working Interest pursuant to Clause 6.02 (Automatic Conversion Upon Abandonment Or Takeover); or
  - (ii) the first to occur of the date the Farmor issues an election or, if the Farmee gives notice of Payout to the Farmor, the expiry of the Farmor's right to elect to convert its Overriding Royalty, pursuant to Clause 6.03 (Election For Conversion At Payout) or Clause 6.05 (Late Notice of Payout).
- (d) "Reduced Spacing Order" means a Regulation which, after coming into effect, reduces the area allocated by the previously effective Regulations for the purpose of producing one or more Petroleum Substance from one or more zones contained in the Royalty Lands comprising the Test Well Spacing Unit.
- (e) "Reduced Spacing Units" means the areas allocated by the Regulations (after a Reduced Spacing Order comes into effect) for the production of Petroleum Substances affected by that Reduced Spacing Order insofar only as those areas pertain to Petroleum Substances and zones affected by that Reduced Spacing Order and excepting any such areas containing wells capable of producing such Petroleum Substances from such zones as of the time the Reduced Spacing Order comes into effect.

#### 8.02 Reduced Spacing And Additional Well Election

If a Reduced Spacing Order is issued during the Payout Period, the Farmee shall promptly give notice to the Farmor of that Reduced Spacing Order attaching a copy of the Reduced Spacing Order and describing the Reduced Spacing Units so created.

If the Farmee proposes to drill an additional well on Royalty Lands comprising the Test Well Spacing Unit during the Payout Period, the Farmee shall give the Farmor an operation notice for that additional well on the same basis as prescribed by Article X of the Operating Procedure.

Within thirty (30) days of a notice which the Farmee gives to the Farmor under this Clause, the Farmor may give notice to the Farmee that it elects to:

- (a) convert the Farmor's convertible Overriding Royalty to the Working Interest specified in Clause 6.04 (Interests At Conversion) for the Notice Lands, and effective the day the Farmor receives that notice from the Farmee, the following shall apply:
  - (i) the Operating Procedure shall apply to those Notice Lands; and

- (ii) the notice the Farmee gave to the Farmor shall be deemed to have been an Article X Operating Procedure operation notice received by the Farmor on that day.
- (b) retain its Overriding Royalty for the Notice Lands on the basis described in Alternate \_\_\_\_\_ below (Select A, B or C):

**Alternate A:**

*The Farmor's convertible Overriding Royalty shall be amended to a non-convertible Overriding Royalty for the Notice Lands.*

**Alternate B:**

*The Farmor shall retain its convertible Overriding Royalty for the Notice Lands but the definition of Payout shall be amended to include all costs, expenses and receipts relating to any well which the Farmee drills on the Notice Lands as if such well were the Test Well.*

**Alternate C:**

*The Farmor shall retain its convertible Overriding Royalty for the Notice Lands and the definition of Payout shall be amended to provide that each well which the Farmee drills on the Notice Lands shall be subject to an individual Payout account on the same terms as for the Test Well.*

The Farmor's notice shall be effective as of the date of receipt by the Farmor from the Farmee of the notice given under this Clause. If Alternate B or C above is in effect, this Article shall apply to the affected Notice Lands and the definition of Payout Period shall be adjusted accordingly.

If the Farmor fails to give notice of its election, paragraph (a) shall apply.

**8.03 Restrictions On Additional Wells And Reduced Spacing**

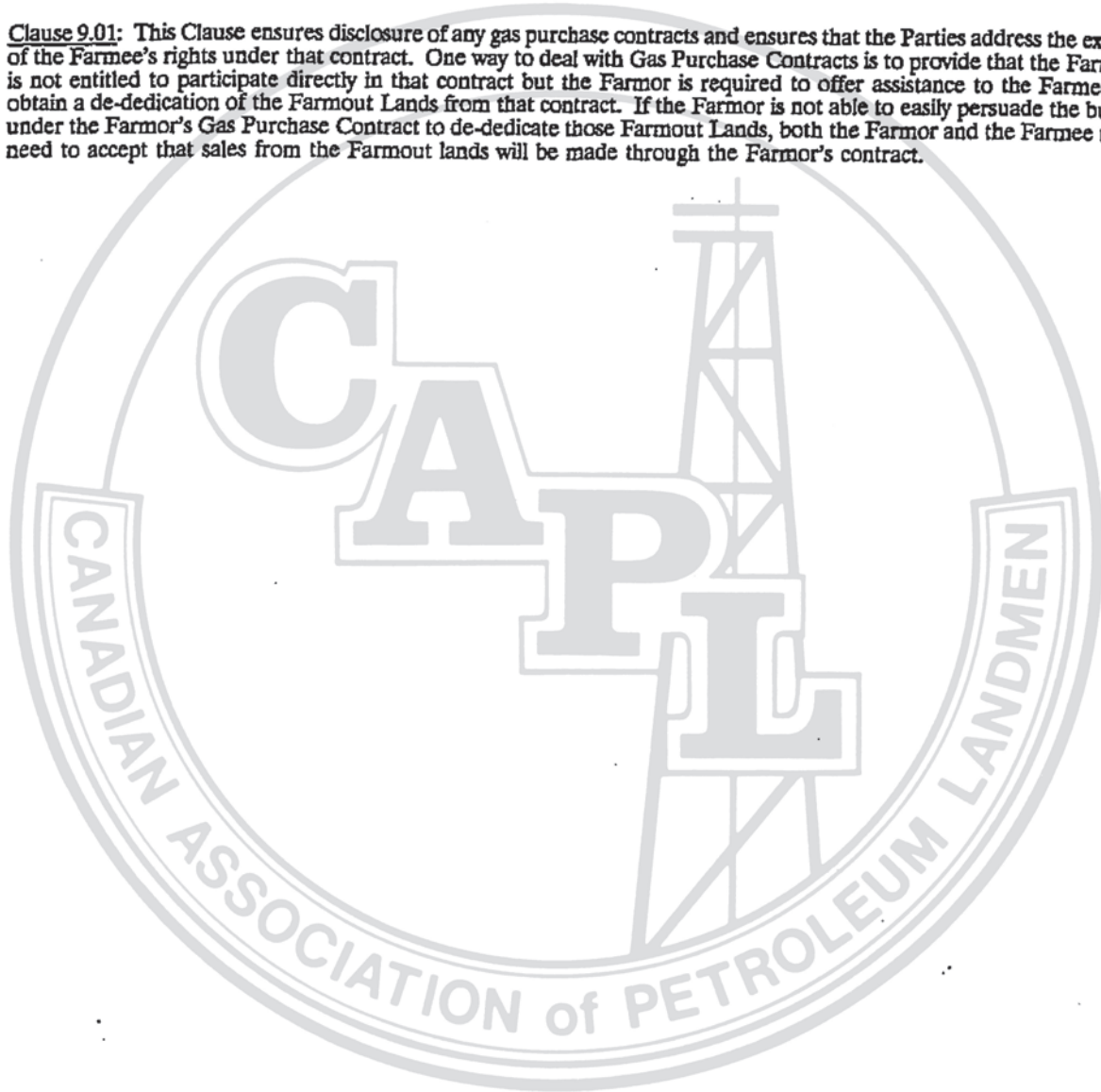
The Farmee shall not issue an operation notice to drill and shall not drill an additional well on the Royalty Lands comprising the Test Well Spacing Unit for a zone for which the Test Well has been Capped or Completed.

If the Farmee fails to commence the drilling of an additional well on or before the 180th day after the date the Farmee issued an operation notice for that well, the Farmee shall be deemed not to have issued that operation notice.

If the Test Well is producing Petroleum Substances and the Payout account balance is less than the amount by which the Payout account balance was reduced in the preceding six



**Clause 9.01:** This Clause ensures disclosure of any gas purchase contracts and ensures that the Parties address the extent of the Farmee's rights under that contract. One way to deal with Gas Purchase Contracts is to provide that the Farmee is not entitled to participate directly in that contract but the Farmor is required to offer assistance to the Farmee to obtain a de-dedication of the Farmout Lands from that contract. If the Farmor is not able to easily persuade the buyer under the Farmor's Gas Purchase Contract to de-dedicate those Farmout Lands, both the Farmor and the Farmee may need to accept that sales from the Farmout lands will be made through the Farmor's contract.



months, the Farmee shall not issue an operation notice for an additional well and shall not make any application to any governmental authority for a Reduced Spacing Order.

## IX. GAS PURCHASE CONTRACT

Article IX shall not \_\_\_\_/shall \_\_\_\_ (Specify) be included herein.

### 9.01 Farmout Lands Subject To Gas Purchase Contract

The Farmout Lands are subject to a gas purchase contract, the particulars of which are described in Schedule "A" (the "Gas Purchase Contract"). The Farmee shall keep confidential from all third parties, this information and any other information it may acquire from the Farmor regarding the Gas Purchase Contract for the term of that contract or the term of this Farmout Agreement, whichever is longer. The Farmor and the Farmee acknowledge that their status with regard to the Gas Purchase Contract has been addressed pursuant to a separate agreement entered into at or prior to the execution of this Farmout Agreement.

## X. EXECUTION

### 10.01 Counterpart Execution

This Agreement may be executed in separate counterparts and all those executed counterparts when taken together shall constitute one agreement.

IN WITNESS WHEREOF the Parties hereto have duly executed this Agreement.

FARMOR

Per: \_\_\_\_\_

Per: \_\_\_\_\_

FARMEE

Per: \_\_\_\_\_

Per: \_\_\_\_\_

**SCHEDULE "A"**  
**OF FARMOUT AGREEMENT**

Farmout Lands

Title Documents

Formations:

Date of Issue:

from:

Term Commencement Date:

to:

Option Lands

Formations:

Date of Issue:

from:

Term Commencement Date:

to:

Interests of Farmor

Farmout Lands:

Option Lands:

Reserved Formations

AMI Lands

Encumbrances

Alternate Earning Provisions

Additional Provisions

