Oil and Gas Farmout Transactions: Planning for the Key Tax Issues in the Lifecycle of the Trade

12th Biennial Parker C. Fielder Oil and Gas Tax Conference

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November 21, 2013

Oil and Gas Farmout Transactions

- What are farmout agreements?
  - "Common form of agreement between operators, whereby a lease owner not desirous of drilling at the time agrees to assign the lease, or some portion of it to another operator who is desirous of drilling the tract. The assignor in such a deal may or may not retain an overriding royalty or production payment."
  - "The primary characteristic of the farmout is the obligation of the assignee to drill one or more wells on the assigned acreage as a prerequisite to completion of the transfer to him."

Source: Williams and Meyers, Manual of Oil and Gas Terms (2007)

Oil and Gas Farmout Transactions

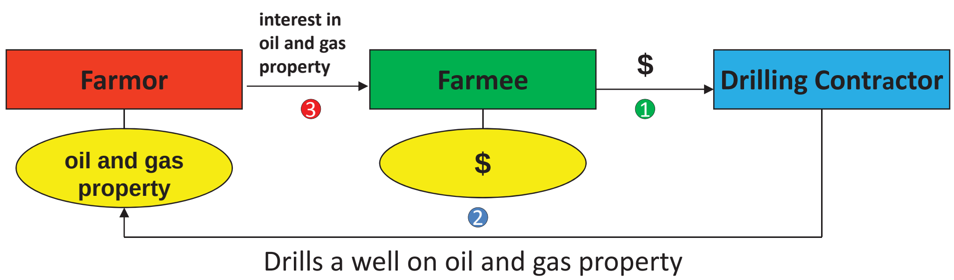
- Who are the parties?
  - Farmor: the party owning the oil and gas lease who chooses to engage another operator to fund the cost of drilling a well on the lease in exchange for a working interest in the lease
  - Farmee: the party who intends to earn a working interest in the oil and gas lease by arranging for and paying the costs of the “earning” well

Oil and Gas Farmout Transactions

- Why are these transactions entered into?
  - Farmor does not want to undertake the risk and cost of drilling the well
    - Unsure of the geology?
    - Short of drilling funds?
    - Lease about to expire?
    - Access to the proper drilling technology?
  - Farmee sees value in drilling the well
    - More favorable view on the geology
    - Available risk capital
    - Favorable risk/reward ratio on the equity investment
    - Obtain valuable information from the well

Oil and Gas Farmout Transactions

- The key component of the farmout agreement is that no assignment is made by the Farmor to the Farmee unless the Farmee drills and pays for a well in accordance with the terms of the farmout letter agreement



Oil and Gas Farmout Transactions

- What distinguishes a farmout agreement from a lease agreement or sublease agreement?
  - Assignments pursuant to leases and subleases are not conditioned on the assignee's agreement to drill a well at assignee's sole risk and expense
  - Example: Mineral fee owner assigns the working interest to a party for a cash bonus and retains a royalty interest. Assignee need not drill a well.
  - Example: Working interest owner assigns the working interest to a party for a cash bonus and retains an overriding royalty interest. Assignee need not drill a well.

Oil and Gas Farmout Transactions

- Key operating terms in a farmout agreement
  - Specify the lease or leases in which a working interest can be earned
  - Specify whether Farmee will assume the obligation to pay delay rentals prior to drilling the earning well
  - Determine whether Area of Mutual Interest and Preferential Right to Purchase provisions are to be included
  - Specify the well location, the target formation and total depth of the earning well
  - Specify whether the assignment is contingent on "drill to earn" or "produce to earn"
  - Specify any interest retained by the Farmor during the payout period (*e.g.*, convertible overriding royalty)

Oil and Gas Farmout Transactions

- Key financial terms in a farmout agreement
  - Specify the financial commitment of Farmee
    - Is the commitment limited to the costs of drilling, completing and equipping a single well or is the commitment a "carry" until a specified dollar amount has been incurred by Farmee?
  - Specify whether a "payout" provision is included so that both "pre-payout" and "post-payout" working interest ownership and net revenue interest ownership are clear
  - Specify exactly how "payout" will be computed
  - Determine whether the joint operation should elect to be excluded from the partnership tax provisions or whether the "election out" provision in the joint operating agreement should be deleted and a tax partnership exhibit attached thereto

Oil and Gas Farmout Transactions

- Documents involved in a farmout agreement
  - Letter agreement setting forth key financial and operating terms of the trade
    - Single letter countersigned by the offeree or an exchange of letters
  - Joint operating agreement pursuant to which all joint operations of the parties will be conducted
    - AAPL Model Form 610 JOA and other similar forms contain the provisions governing how and when wells will be drilled, how the wells will be paid for and operated, which party will be named operator and the liability of the parties for damages
  - Form of assignment of mineral interest once the interest is earned

Oil and Gas Farmout Transactions

- Intended federal income tax results for the parties
  - Farmor
    - No gain recognized on the assignment of the earned interest to the Farmee
    - Cost depletion deduction for entire cost of the original working interest
  - Farmee
    - No income or gain on the receipt of the assignment of the interest from the Farmor
    - IDC, depreciation and business expense deductions for the capital utilized to drill, complete, and operate the earning well/s