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THE MODEL FORM JOINT OPERATING AGREEMENT – SUBSEQUENT OPERATIONS

PROPOSALS FOR OPERATIONS AFTER THE INITIAL WELL AND CHANGES TO
ARTICLE VI OF THE NEW AAPL 2015 MODEL FORM

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I. INTRODUCTION

Originally introduced as the Ross-Martin form 610 Model Form Joint Operating Agreement in 1956, the American Association of Professional Landmen model form operating agreement has been revised in 1977, 1982, 1989, in 2013 as the 1989 (Horizontal Revisions), and the new 2015 model form is set to be released in April of 2016.¹ This set of forms has collectively become the industry standard beginning point for operating agreements in all producing regions of the United States. In every event, the model form operating agreement is designed only as a starting place intended to streamline negotiations by dealing with common, recurring issues in a predictable and consistent manner.

This paper is intended in part to be an update of a similar paper which I presented two years ago, and in part is an opportunity to discuss some of the revisions to the subsequent operations provisions of the new 2015 model form. For purposes of this paper, we will refer primarily to the 1989 (Horizontal Revisions) version and to the new 2015 version, unless expressly identified otherwise.

As originally written, all versions of the Model Form Operating Agreement through the 1989 version contemplated matters only in the context of a vertical well. Because technology does not stand still, the manner in which oil and

gas wells have traditionally been drilled has changed dramatically so that a significantly large proportion of new wells drilled are horizontal wells. We are only beginning to understand the legal similarities and differences between vertical and horizontal wells, and we are continuing to develop and standardize terminology in a rapidly changing technical environment.

Our primary focus in this paper will be to discuss and understand those provisions relating to proposals for operations taking place after the Initial Well has been drilled. Because this paper is intended to be presented to an audience composed of those who are either new to Texas oil and gas legal practice or are looking for a refresher, we will be focusing somewhat on the basics.

II. Art. VI.A & Organization of Art. VI.B.

Article VI.A addresses, the Initial Well. This well is obligatory and all parties must participate. Typically, the specifics relating to the Initial Well have been negotiated and are well understood by all the parties prior to entering into the operating agreement. One could safely postulate that in most cases, the Initial Well embodies the idea that brings all of the parties together to participate in the project. As a result, the specifics relating to this well are intimately known by the parties and typically need not be spelled out with great detail in the operating agreement. The exception would be those instances where two or more owners of leases combine their interests under an operating agreement with no intent of drilling in the near term. In those instances, Article VI.A is frequently deleted in its entirety and replaced with the notation that “There is no Initial Well,” and the parties rely on the provisions of Article VI.B for all operations.

Article VI.B has 10 subparts. Generally, those subparts address proposed operations,

¹ All references are to the American Association of Professional Landmen ("AAPL") model form operating agreements and will be identified by the vintage for the individual form. The 1989 Model Form (Horizontal Revisions) may also be referred to as the "1989 Horizontal Form". In the event that what we are referring to in this article as the 2015 version of the model form is renumbered by AAPL on final release, all references in this article to the 2015 version should be considered as referring to the same document. Capitalized terms not defined herein have the meaning ascribed to such term in the operating agreement.

operations by less than all of the parties, matters relating to issues arising once operations have begun, spacing, operations conducted on wells that are producing in paying quantities and issues relating to use of a spudder rig. The remainder of Article VI addresses completion, rework and plugging back, other operations, plugging and abandonment, taking production in kind, and in the 2015 version, deviations from approved proposals.

III. Proposed Operations.

The principal purpose of Article VI.B.1 is to require that the information necessary to make an economic decision is provided to the parties entitled to participate in operations to be conducted with respect to a new well, a dry hole, or a well that previously but no longer produces.²

Generally, any party to the agreement may propose an operation under Article VI.B.1, unless (a) modified either by an added provision under Article XVI or by revising Article VI.B.1, or, (b) the party has relinquished its interest in the objective Zone. Likewise, all parties who have not previously relinquished their interest in the objective Zone are entitled to receive the proposal.³

Under the forms that preceded the 1989 Horizontal Form, a well proposal could be relatively simple and need only contain the location of the well, the anticipated depth and objective formation, and an estimate of the cost. For example, a valid proposal might state only that the proposed well is to be drilled “at a legal location in the SW/4 of Section X, John Smith Survey A-123, Midland County, Texas, to an approximate depth of 8,300’ to test the Spraberry Formation, and is estimated to cost

\$2,200,000.” No further information and no AFE (authority for expenditure) is required.

In the past, when discussing operating agreements I have often stated that an AFE originated as a planning tool for engineers. The purpose of an AFE is to itemize the services and material needed to drill and complete a well, or to perform any other complex operation. In addition, an AFE has the benefit of providing a convenient and thorough means to estimate the cost of the individual services, materials and total cost. The result is that AFE’s are useful tools in determining the financial risk of any project. Although useful, and typically used as a component of well proposals, until the 1989 Horizontal Form, an AFE was never *required* as part of a valid proposal.

However, beginning with the 1989 Horizontal Form, an AFE is a required component of a valid proposal. Part of the reason for this change is that with the advent of horizontal drilling, the financial risk to the parties has increased significantly. With a typical horizontal well often costing \$9MM-\$10MM, more information is necessary to make good financial decisions. Accordingly, the 1989 Horizontal Form has added a definition of AFE, and to protect the operator, has made it clear that an AFE is merely an estimate of anticipated expenditures made in good faith, and not a contractual commitment. This approach is carried forward and continued in the 2015 version.

No particular form is required, but a valid AFE must contain certain information. First, the AFE must distinguish whether the proposed is for a vertical or a horizontal well. If the operation is for a vertical well, under the 1989 Horizontal and all prior versions of the model form, only the traditional information was required: the operation to be performed, the location, objective zone, depth, and estimated cost. However, the new 2015 greatly expands the required information for vertical wells. Under this new form, the proposal must also specify the bottom hole location if different from the surface location, the utilization of rigs for drilling and completion, the proposed stimulation operations including staging and

² The specific operations that may be proposed under Article VI.B.1 are to drill any well other than the Initial Well, or to Rework, Sidetrack, Deepen, Recomplete or Plug Back a dry hole or a well no longer capable of producing in paying quantities.

³ All parties are entitled to receive the proposal in connection with the Sidetracking or Deepening of a Vertical Well. We will discuss relinquished interests in more detail in connection with Article VI.B.2.

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