

Rightly Dividing the Division of Interest

**An Analysis of
Correct and Proper
Ownership Changes**

Section 4

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Introduction

Division Order Analysts carry out a vital and important function for an oil and gas company. Their tasks are many. They are called upon to calculate each owner's interest in a well to the 8th decimal place. They are often called upon to cure very complex title problems. They often handle substantial amounts of suspended funds. They speak with mineral owners, non-operators, overriding royalty owners, title attorneys and are called upon to coordinate well ownership with marketing, engineering and production. They provide correct information to the accounting department so people can get paid correctly. After a well is drilled and is producing, they become the guardians of everyone's interest in that producing well.

Many tasks are handed to the division order analyst. One task that can often be challenging is that of correctly dividing the division of interest when ownership changes are being made. Proper analysis of every conveying document or contract must be made in order to facilitate a proper outcome.

This course takes the division order analyst on a journey whereby they will look at various elements of a conveyance or contract in order to rightly divide the division of interest. The course asks the analyst to study each of these elements and then examine actual deeds and/or contracts. Several real-life scenarios are posed to the analyst. Their task is to examine the facts and documents as set out and then determine proper and correct ownership outcomes.

LANGUAGE IN CONTRACTS

The Joint Operating Agreement (JOA) is an agreement between two or more parties that will set out the joint operations for a particular property. As with every other oil and gas contract, there are no “cookie cutter” standard forms.

Although many different operating agreements may be used in the oil and gas industry, the AAPL Model Form Operating Agreement has become the standard within the industry. The Model Form 610 (1989 Version) contains nineteen pages in the body of the contract, along with the various exhibits which are attached.

The Joint Operating Agreement addresses several vital aspects for developing an area referred to as the “Contract Area.” This Contract Area is set out on the cover page, and the JOA becomes the legal and binding contract that governs the development of the designated contract area. The JOA also creates a formula for sharing expenses and production.

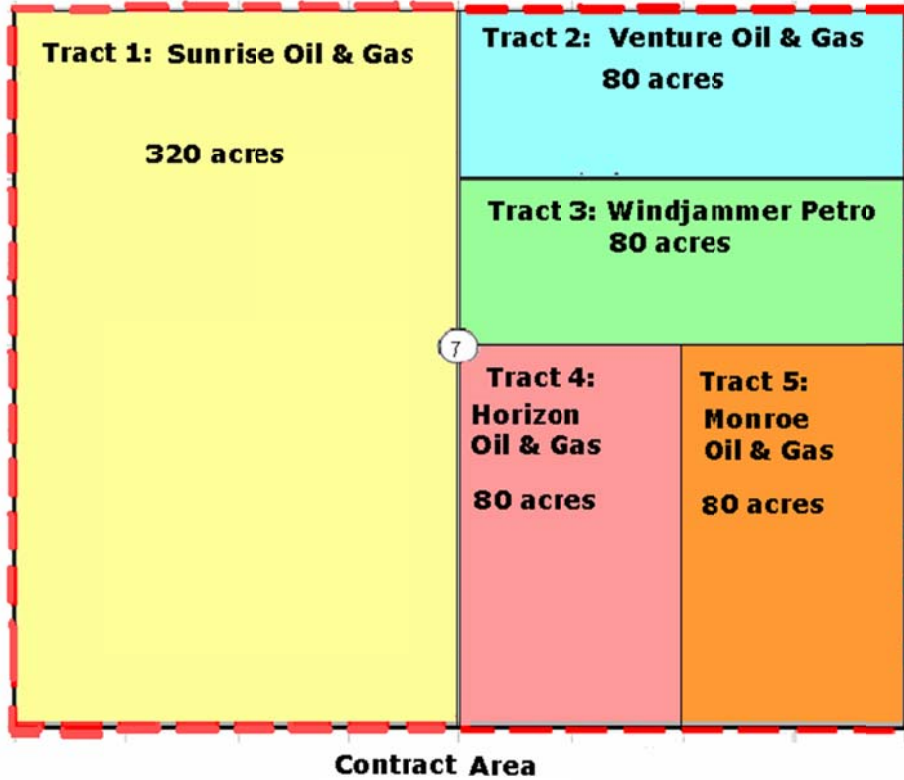
According to this Article III.B., expenses are to be paid and production revenues are to be split as the interests are set forth in Exhibit “A.”

Article III INTERESTS OF PARTIES

B. Interests of Parties in Costs and Production:

Unless changed by other provisions, all costs and liabilities incurred in operations under this agreement shall be borne and paid, and all equipment and materials acquired in operations on the Contract Area shall be owned, by the parties as their interests are set forth in Exhibit “A.” In the same manner, the parties shall also own all production of Oil and Gas from the Contract Area subject, however, to the payment of royalties and other burdens on production as described hereafter.

Assume the plat depicts the contract area as set out on the Joint Operating Agreement. The interests set out on the Exhibit "A" to the Operating Agreement would therefore be as follows:



**Exhibit "A"
to the Operating Agreement
Description of Contract Area**

<u>Interest Owner</u>	<u>Percentage of Interest</u>
Sunrise Oil and Gas	50.000%
Venture Oil and Gas	12.500%
Horizon Oil and Gas	12.500%
Windjammer Petroleum	12.500%
Monroe Oil and Gas	12.500%
Total	100.000%

Article III.B. establishes how burdens are paid. Several fractional amounts could be placed in the blank in this article. Usually, 1/8 or 3/16 would be the amount placed in this blank. If 1/8 were placed in the blank, all parties to the JOA would be obligated to pay their proportionate share of the 1/8 burdens. Sunrise would pay 50% of the 1/8. Venture, Windjammer, Horizon, and Monroe would each pay 12.50% of the 1/8.

**ARTICLE III.
INTERESTS OF PARTIES**

B. Interests of Parties in Costs and Production:

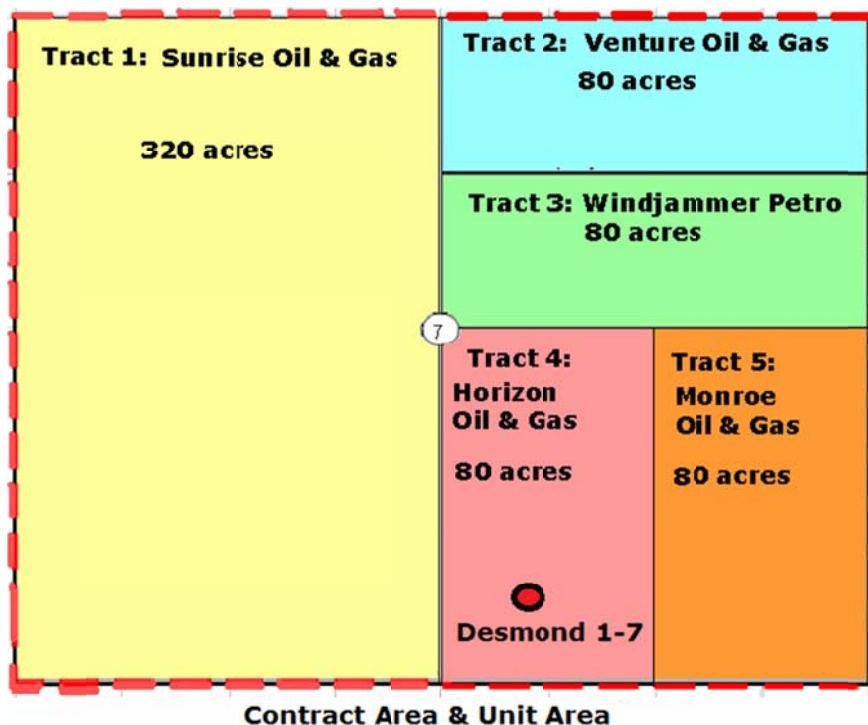
. . . Regardless of which party has contributed any Oil and Gas Lease or Oil and Gas Interest on which royalty or other burdens may be payable . . . each party shall pay or deliver . . . all burdens on its share of the production from the Contract Area up to, but not in excess of, 1/8th and shall indemnify, defend and hold the other parties free from any liability therefore. Except as otherwise expressly provided in this agreement, if any party has contributed hereto any Lease or Interest which is burdened with any royalty, overriding royalty, production payment or other burden on production in excess of the amounts stipulated above, such party so burdened shall assume and alone bear all such excess obligations and shall indemnify . . . harmless from any and all claims attributable to such excess burden. However, so long as the Drilling Unit for the productive Zone(s) is identical with the Contract Area, each party shall pay or deliver, or cause to be paid or delivered, all burdens on production from the Contract Area due under the terms of the Oil and Gas Lease(s) which such party has contributed to this agreement, and shall indemnify, defend and hold the other parties free from any liability therefor.

Burdens in excess of the fraction inserted in the blank must be borne by the party who contributed the lease. Therefore, if 1/8 was placed in the blank and Sunrise's burdens exceeded 1/8, that company alone would be responsible to bear the excess.

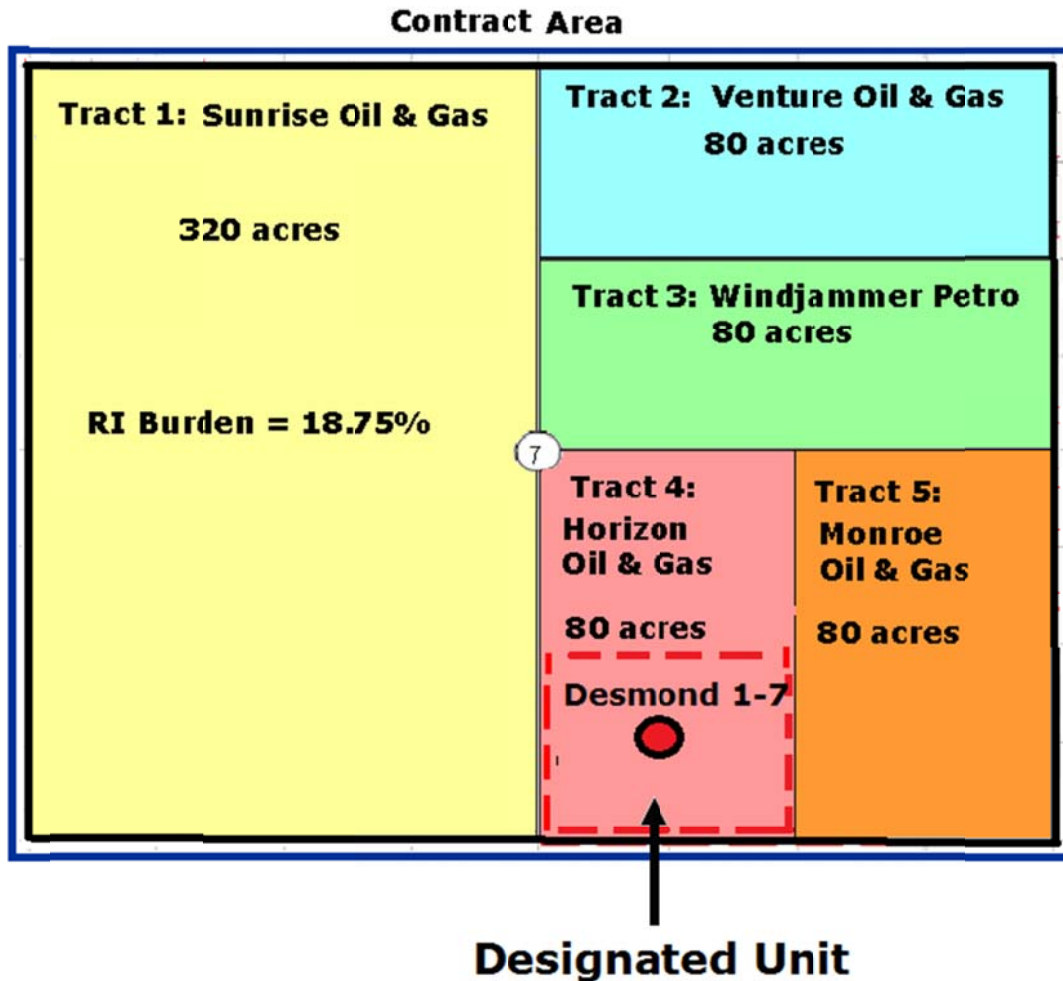
Scenario #16: The Joint Operating Agreement

Scenario: Assume you work for Sunrise Oil and Gas. Your company only owns one lease that was pooled with four other leases to form the following drilling unit. At the time, everyone signed a Joint Operating Agreement and designated Section 7 to be the Contract Area.

Since your lease covers 320 acres in the unit, which comprises 640 acres, you own a 50% working interest in the unit wells. Your lessor, William Bennett, negotiated a 3/16 royalty and has been getting paid based on his interest in the unit ($320/640 \times .1875 = .09375000$ RI).



Next, assume that the state's oil and gas commission has de-sized the units in this field from 640 acres to 40 acres. You can see the new unit boundary on the plat (SW/4SE/4 = 40 acres.) The producing unit boundary no longer encompasses any of your lease with William Bennett. Your company no longer has any leased acreage inside the new unit boundary.



Question 1: How do you change these companies' interests, if at all?

- Keep everyone's interests as they were before.
- Eliminate Sunrise, Venture, Windjammer, and Monroe from the division of interest. Only keep Horizon and their burdens in the well.
- Keep Sunrise, Venture, Windjammer, and Monroe in the well, but eliminate each of their lease burdens.

Answer: All states allow the de-spacing and re-spacing of units. In our scenario, the contract area still covers the entire 640 acres; however, the redefined unit is now smaller than the contract area. Since everyone agreed to the terms of the JOA, expenses will still be paid and production revenues will still be split as the interests are set out on Exhibit "A" to the JOA. Even though the unit size has changed, the contract area did not change. The interests set out on Exhibit A are still in force. Your company would still own a 50% interest in the well.

Question 2: What royalty owners should be paid from the well?

Answer: Generally, only the royalty owners within the drilling and spacing unit will be paid out of the unit's production. In this case, the only royalty owner to be paid now would be Horizon's lessor. Your lessor would not receive any royalty from the new unit boundary.

Hint: The JOA will establish how the oil companies will get paid; the oil and gas lease will establish how a lessor will get paid.

Question 3: Sunrise is to pay for 50% of the cost of the well and receive 50% of production. Since your lessor is not entitled to any royalty revenue, is Sunrise obligated to pay any burdens out of its interest?

Answer: Yes, according to the JOA, Sunrise is responsible to pay its proportionate share of any royalty as set out in the blank of Article III.B. If 1/8 were placed in the blank, Sunrise would still pay 50% of this amount.

Question 4: Prior to the de-spacing of the unit, Sunrise's NRI in the unit was based on having a 81.25% interest in its lease. (William Bennett was entitled to 18.75%; Sunrise was entitled to 81.25%.) After the de-spacing of the unit, will Sunrise's NRI be affected? Will your company still receive 81.25% NRI from its lease?

Answer: Since a company is only obligated to pay its share of what was placed in the blank, or 12.5%, Sunrise's new NRI will be 87.5%.

Scenario #17: The Joint Operating Agreement

Scenario: Assume your company assigned and recorded a 5% ORR (overriding royalty) to you on all their leases. The recording date was prior to the signing of a JOA. Your ORR was not set out on the "Exhibit A" to the JOA.

Your company non-consented the drilling of a well, and the other parties picked up your company's non-consent interest. Should you get paid for your ORR, and if so, by whom?

- Yes
- No

Answer: A Subsequently Created Interest is defined in the JOA as any burden created after the date of the JOA or any burden not listed on the Exhibit "A." Unless the other parties state differently, even interests that were recorded prior to the JOA being signed would be considered subsequently created if they were not listed or set out on Exhibit "A."

According to Article III.C, parties that are burdened by a Subsequently Created Interest shall assume and alone bear, pay, and discharge the Subsequently Created Interest and shall indemnify, defend, and hold harmless the other parties from and against any liability thereof. You should get paid for your ORR by your company alone.

ARTICLE III. INTERESTS OF PARTIES

C. Subsequently Created Interests:

If any party has contributed hereto a Lease or Interest that is burdened with an assignment of production given as security for the payment of money, or if, after the date of this agreement, any party creates an overriding royalty, production payment, net profits interest, assignment of production or other burden payable out of production attributable to its working interest hereunder, such burden shall be deemed a "Subsequently Created Interest." Further, if any party has contributed hereto a Lease or Interest burdened with an overriding royalty, production payment, net profits interest, or other burden payable out of production created prior to the date of this agreement, and such burden is not shown on Exhibit "A," such burden also shall be deemed a Subsequently Created Interest to the extent such burden causes the burdens on such party's Lease or Interest to exceed the amount stipulated in Article III.B. above.

The party whose interest is burdened with the Subsequently Created Interest (the "Burdened Party") shall assume and alone bear, pay and discharge the Subsequently Created Interest and shall indemnify, defend and hold harmless the other parties from and against any liability thereof.

Scenario #18: Terms in a Contract

Scenario: Assume you work for Windjammer Petroleum. Your company is buying into a project owned exclusively by Sunrise Oil and Gas. Sunrise already has all lease and seismic assets in place in order to drill a well. According to the terms of the agreement, both parties agree to participate in the drilling of this test well.

There are several key components found in the agreement. Read the portion of the agreement shown and then determine the following:

- What is your company's NRI? _____
- What ORR has been secured by the divesting party? _____
- What percent of drilling costs did your company agree to pay?

Contract Agreement

From: Sunrise Oil & Gas
To: Windjammer Petroleum
RE: Madison 1-32

This Contract Agreement shall set forth the terms and conditions for Windjammer Petroleum's participation in the Sunrise Oil & Gas interest in the Madison 1-32 well.

Specifically, Windjammer shall agree to participate with a 40% Working interest, subject to the following:

1. Windjammer agrees to purchase an undivided 40% Working Interest the following three leases at an 81% Net Revenue Interest basis:
 - a. Ada Smith, Lessor Dated 1/22/14 Royalty: 18.75% T34N, R15W, Sec 32: W/2
 - b. Ben Smith, Lessor Dated 1/27/14 Royalty: 12.5% T34N, R15W, Sec 32: NE/4
 - c. Tom Smith, Lessor Dated 1/27/14 Royalty: 1/6 T34N, R15W, Sec 32: SE/4
2. Windjammer agrees to pay 40% of all geological 3-D imaging acquired for the Madison 1-32.
3. Windjammer agrees to participate in the Drilling Operations bearing an additional 15.5% carried Working Interest. Carried working interest shall be to casing point.
4. Windjammer's Before Casing Point Interest shall be 55.5% and Windjammer's After Casing Point Interest shall be 40%.
5. Windjammer's Net Revenue Interest in the Madison 1-32 shall be 81%

Signed:

Windjammer Petroleum

Sunrise Oil & Gas

Answer: Windjammer's Net Revenue Interest is limited to 81% even though the current burdens on each lease would suggest that the NRI should be higher. The first lease contains an 18.75% burden. This leaves 81.25% left over for the lessee. Lease 2 contains a 12.5% lease burden leaving 87.5% for the lessee. Lease 3 contains a 1/6 royalty or 16.666667% leaving 83.333333% for the lessee. Since Sunrise is assigning 40% of the leasehold to Windjammer, Sunrise keeps the other 60%. This 60% would have the higher NRI's.

The ORR retained by Sunrise would be the difference between what is left over after the lessors are paid and the 81% NRI being delivered to Windjammer.

Lease 1 = $.8125 - .81 = .0025$ ORR

Lease 2 = $.875 - .81 = .065$ ORR

Lease 3 = $83.33333 - .81 = .02333333$ ORR

Windjammer has agreed to pay for their 40% of the Drilling Operations costs, plus an additional 15.5% interest that otherwise should have been paid by Sunrise. This 15.5% is referred to as a Carried Cost. In other words, Windjammer is carrying a portion of the Sunrise's costs.

Scenario #19: Terms in a Contract

Scenario: Assume you have acquired four leases in a prospect and have chosen to flip them by selling them to an oil company. According to the terms of the sale contract, you can receive an ORR in each of the leases. The purchasing company has asked you to help draft the language regarding your ORR.

You research the topic and realize that you can create the ORR with different types of language. Examine the following three portions of contracts and determine which language you wish to use.

Assume that these are the four leases:

1. Ada Smith, Lessor	Dated 1/22/14	Royalty: 18.75%	T34N, R15W, Sec 32: NW/2
2. Ben Smith, Lessor	Dated 1/27/14	Royalty: 12.5%	T34N, R15W, Sec 32: NE/4
3. Tom Smith, Lessor	Dated 1/27/14	Royalty: 1/6	T34N, R15W, Sec 32: SE/4
4. Bill Smith, Lessor	Dated 1/27/14	Royalty: 1/5	T34N, R15W, Sec 32: SW/4

Would you choose...

- Example #1 language?
- Example #2 language?
- Example #3 language?

Example #1

Such assignment shall be subject to Seller's reservation of a proportionately reduced overriding royalty interest equal to the difference between the sum of existing burdens and twenty percent.

Example #2

Such assignment shall be subject to Seller's reservation of a 3% proportionately reduced overriding royalty interest in each of the leases being assigned.

Example #3

Buyer's Net Revenue Interest in each of the leases will be set at 81%.

Answer: It would appear that the language in the Example #1 would be slightly more advantageous than the language in Example #2. Example #3 would be the least advantageous.

Example #1

Lease 1 ORR is $.20 - .1875 = .0125$
Lease 2 ORR is $.20 - .125 = .075$
Lease 3 ORR is $.20 - .16666667 = .03333333$
Lease 4 ORR is $.20 - .20 = .0$

$$(.0125 \times .25) + (.075 \times .25) + (.03333333 \times .25) + (0 \times .25) = .03020833$$

Example #2

Lease 1 ORR is .03
Lease 2 ORR is .03
Lease 3 ORR is .03
Lease 4 ORR is .03

$$(.03 \times .25) + (.03 \times .25) + (.03 \times .25) + (.03 \times .25) = .03000000$$

Example #3

Lease 1 ORR is $.8125 - .81 = .00250000$
Lease 2 ORR is $.875 - .81 = .06500000$
Lease 3 ORR is $.83333333 - .81 = .02333333$
Lease 4 ORR is $.80 - .81 = .01000000$

$$(.0025 \times .25) + (.065 \times .25) + (.02333333 \times .25) = .02270833$$