The Development Phase

"Madison Prospect" Scenario

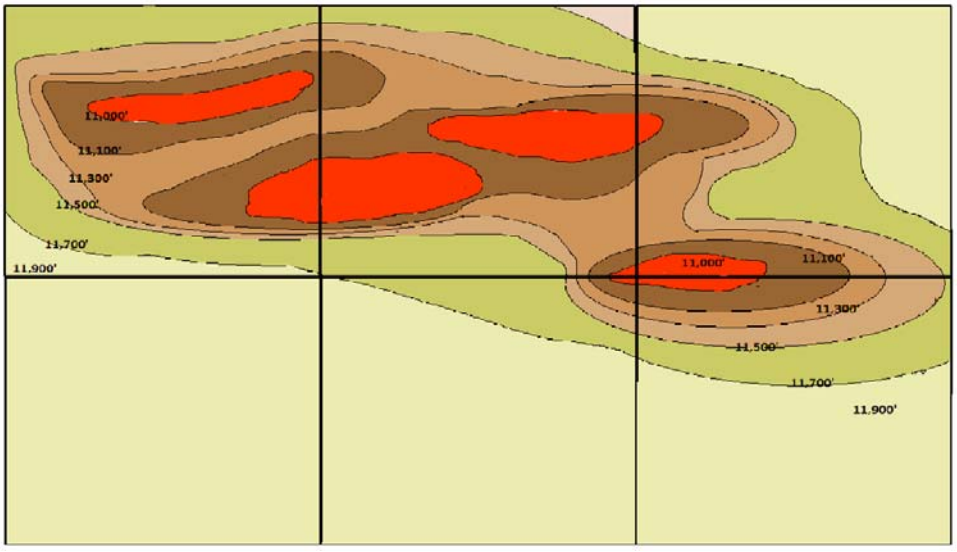
For the purposes of this study, assume the following: A seismic company had previously completed a 3-D seismic shoot over many miles of land that included the six sections of land in the Madison Prospect. All seismic access consents obtained by the seismic company were taken in the form of permits.

Realizing that this study had already been done, both Sunrise Oil & Gas and Venture Oil & Gas, independently from one another, chose to purchase a license from the seismic company for the Madison Prospect area.

After receiving the geologic data, both companies independently evaluated the area for potential drilling locations. Both companies became very excited when they located three to four potential drill sites. They believed that if the acquisition of leases and the drilling of these locations was successful, their company could make potentially multiple millions of dollars.

With these drilling locations in mind, both companies initiated the "Development Phase" of the Madison Prospect.

Since only seismic permits had been taken by the seismic company, Sunrise and Venture set out to secure oil and gas leases from the appropriate mineral owners.



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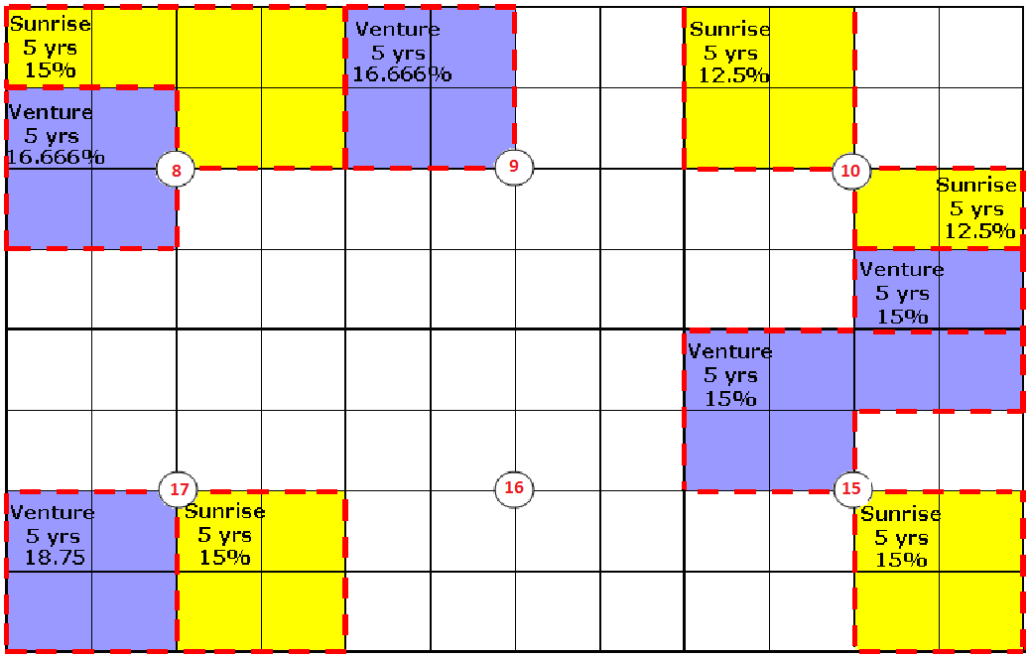
The initial leasing phase for the Madison Prospect

Assume that the following plat depicts the initial leasing phase of the Madison Prospect. After the first two weeks of leasing, and realizing that two companies were battling over the same acreage, competition began to drive up the price of leases. The signing bonuses for the initial leases were under $100 per acre with a 12.5% royalty. The last leases taken were going at a rate of $250 an acre and an 18.75% royalty.

With over 2,000 acres yet to be leased, both companies realized that the total acquisition costs for signing bonuses could exceed a half of a million dollars and exploration budgets were tight for both companies.



The Madison Prospect Dilemma

Sunrise Oil & Gas – Sunrise's landman reported back to his land manager that competition from Venture had driven up the leasing costs. The reply he received was not one he had expected. He was told that because of economic concerns all prospect budgets had been "slashed" and that the budget for the Madison Prospect had been reduced to $4 million. The landman objected and was met with the following reply, "Find a way to get the wells drilled! If you're successful – expect a big bonus in December! Now, go do your job!"

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Venture Oil & Gas – Venture's management was also concerned about economic concerns and was not happy that leases were now going for $250 an acre. The land manager told the landman, "You have $4 million to get the job done. Like everyone else, we are facing cutbacks. *Read my lips.* The company's in trouble! Do your job and make us some money. You have what you have. Be grateful!"

Both landmen had their backs against the wall. *Low-end drilling costs for an 11,000' well would exceed $5.5 Million.* Completion costs, pipelines and other infrastructure would cost another $500,000. Adding those amounts to the excessive lease acquisition costs, attorney fees, consultant's fees, surface damage fees, permits and surveying fees, one low-end 11000' well could cost over $6 million.

			Low end costs	High end costs
Lease Acquisition:	$100 - $500 per acre	@160 acres	$ 16,000	$ 80,000
Consultant's fees:	$10,000 per visit		$ -	$ 20,000
Title Attorney:	$10,000		$ 10,000	$ 10,000
An Environmental Impact Statement	$35,000 per location		$ -	$ 35,000
Drilling Costs:	$500 per feet	from 11,000 to 12,000'	$ 4,840,000	$ 5,445,000
Well Completion Costs:	$400,000		$ 400,000	$ 400,000
Pipelines and infrastructure:	$100,000		$ 100,000	$ 100,000
*Settle surface damages:	$5,000 - $30,000		$ 5,000	$ 30,000
Location surveyed:	$1,000		$ 1,000	$ 1,000
Permit for drilling:	$1,500		$ 1,500	$ 1,500
		Total	$ 5,500,000	$ 6,000,000

*Costs can include: clean up of the location, building all weather roads to the location, building cattle gaps or gates, and/or loss of crops on a per acre basis.

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Estimated costs for drilling wells in the Madison Prospect

Costs for drilling deeper than 11,000' would drive costs up. A high-end well could run in the $6 million range.

A $4 million budget would not even touch one well let alone three to four wells. Even if the two competing companies entered into some sort of a joint agreement, whereby they pooled their money, corporately, they would only have enough money to drill one well.

Solving the Dilemma

Both landmen went to work attempting to find a solution for their dilemma.

Sunrise's landmen made a phone call to an old geologist friend now working for Windjammer Petroleum. Windjammer is a small geological firm. They have never acquired a lease nor do they employ any land experts. Over the years, they have made millions by simply spotting prospective areas and investing in the area, allowing the exploration company to do the land work. Sunrise made the following proposal to his friend. "We have a prospect that looks great! We're looking for an investor partner for three to four wells. Take a look at the geology and tell me what you think."

Venture's landman had heard about a small start up company by the name of Horizon Oil and Gas. Word on the street was that Horizon had plenty of investment money backing them. He made a call to their land manager and realized that they were looking for drillable prospects and wanted to buy into the area as a non-operator.

Note: Windjammer is willing to invest $5 million dollars in any prospective area that shows great potential and Horizon is willing to invest $5 million dollars in any area that shows great upside potential.

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THE CONFIDENTIALITY AGREEMENT

A Non-disclosure Agreement or a Confidentiality Agreement is, in effect, the same type of document. Each will accomplish the same purpose and provide that the "receiving party" will protect any confidential or proprietary information, data, intellectual property, seismic study information, proposals or the like that they receive from the "disclosing party."

Confidentiality Agreements can be used when oil and gas properties are being offered for sale in a given area. The seller would require any potential buyer to sign a confidentiality agreement before they would be allowed to review the sale properties. The agreement would guarantee that any information seen would be held confidential by the potential buyer.

In other cases, a land brokerage company hired to secure leases for a client might be required to enter into a Confidentiality Agreement. During the acquisition period of the project, vital information would be gathered and shared between the two companies. Protecting this information from getting into the hands of competitor companies would be vital and a confidentiality agreement would probably be in order.

A Confidentiality Agreement is also the exact type of agreement Sunrise and Venture would use before showing their seismic data to a potential investing company. Both have already experienced one too many companies driving the costs up. The last thing they would want is other companies with their independent hands in the mix. They also know that sharing their seismic data would be necessary before any potential investor would bring additional millions to the table.

A Confidentiality Agreement should be signed by both parties and will become effective as of the date specified in the Agreement.

"Madison Prospect" Scenario

Before either Sunrise or Venture would share their seismic data with their respective potential partners they would have them sign a Confidentiality Agreement similar to that on the following page.

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Confidentiality Agreement

This Agreement is entered into by and between _____ ("Disclosing Party") and _____("Receiving Party"). In consideration of the mutual covenants set forth below, the parties agree as follows:

1. **Disclosing Party holds certain confidential information referred to as the *"Madison Prospect Seismic Study and Leases"* ("The Properties") more specifically described in Exhibit "A" which is attached and forms part of this Agreement.**
2. **Receiving party desires to review certain information and data pertaining to the Properties, and Disclosing Party is willing to disclose such Data subject to the terms and conditions of this Agreement.**
3. **Receiving Party shall maintain all Data strictly confidential and therefore agrees not to disclose, trade or otherwise divulge the Data to any third party without the prior written consent of Disclosing Party.**
4. **Disclosing Party represents and warrants that it owns the Data and has the right to disclose the Data to Receiving Party. Disclosing Party makes no representations or warranties, express or implied, regarding the completeness or accuracy of the Data and Receiving Party agrees to release and hold Disclosing Party harmless from all responsibility or liability for conclusions or interpretations drawn therefrom.**
5. **The Receiving Party shall only use or permit the use of the Data disclosed to the extent necessary to evaluate the Properties and determine whether to make an offer to acquire all or part of the Disclosing Party's rights in the Properties, provided however that the Receiving Party may use its own analyses of the Data in its evaluation and acquisitions of properties outside The Properties.**
6. **If the Receiving Party acquires all or part of the Disclosing Party's interest in the Properties, this Agreement shall terminate automatically on the date of such acquisition and shall be superseded by whatever confidentiality obligations attached to the rights so acquired.**

IN WITNESS WHEREOF, the duly authorized representatives of the Parties have caused this Agreement to be executed to be effective as of _____ the effective date.

Disclosing Party	**Receiving Party**
_____	_____

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THE JOINT VENTURE AGREEMENT

"Madison Prospect" Scenario

Assume that after a review of the Madison Prospect, both Windjammer and Horizon choose to invest in its future acquisition and drilling costs in the Madison Prospect – Windjammer with Sunrise and Horizon with Venture. The Confidentiality Agreement addressed none of the issues now facing these companies. In order to address those issues, a separate agreement called a *Joint Venture Agreement* must be drawn up.

A Joint Venture Agreement (JVA) must not be confused with an Area of Mutual Interest Agreement (AMI). Whereas, an AMI is designed to bring two or more parties together who each own oil and gas leasehold interest or geologic information in a given area the Joint Venter Agreement (JVA) is designed for a totally different purpose.

The JVA forms a type of relationship among two or more parties; however, one of those companies is only bringing finances to the table.

1. JVA's are, generally, created for a single project, thus have a term;
2. Have one partner who owns both geological data and leasehold interest but do not want to carry the entire risk of the project;
3. Have one partner who is looking for a drilling prospect (they are bringing to the table only investment money; and
4. Will set forth the investing party's obligations and the receiving party's obligations.

Prospect Expos

Each year prospect Expos serve in much the same capacity as eharmoney.com. Eharmony.com has made millions based on the idea of putting two parties together that are *compatible*. That is also the attempt of oil and gas expos. One group of participant individuals or companies brings drilling prospects to the expo. This group sets up booths in an attempt to showcase different prospects. The other group of individuals or companies comes to the expo looking for good investment opportunities. This group is only bringing cash. Both are looking for a drilling partner that is compatible with their particular needs.

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Confidentiality is always a key factor when JVA's are formed and usually contain some sort of confidentiality language, if not; the JVA would reference the separate Confidentiality Agreement.

The JVA will also set out the management roles of each of the partners.

Three types of Joint Ventures

1. Contractual Joint Venture Agreements – When two or more companies or individuals come together to form a Contractual Joint Venture, the agreement sets out the term, duties, requirements, and liabilities of all parties.
2. Corporate Joint Venture Agreements – When a long term relationship that covers several projects occurs a Corporate Joint Venture Agreement might be used. It is formed when two or more companies or individuals come together in order to incorporate and structure a new legal entity for the purpose of carrying out the joint venture. Because of this, the agreement can become much more extensive.
3. Partnership Joint Venture Agreements – Companies or individuals can create either a general partnership or a limited partnership through a joint venture agreement. Usually, this partnership is designed for limited purposes.

Other JVA Characteristics

The JVA will outline the specific amount of consideration the investing party is bringing to the table. This money might represent:

a. A percentage of the current lease acquisition costs;
b. a percentage of the seismic costs; and
c. a percent of the future drilling costs.

A JVA with a "Promote"

Often the party bringing the financial investment to the table is "promoted". Promoted mean this party will be bringing more money to the table than they will be receiving in leasehold interest. The "promote" might be to pay for 1/3 of the selling parties costs but only receive 1/4 of the interest. In a case like this, the investing party will be "carrying" a portion of the other party interests. This portion is only carried to a certain point.

1. Pay 1/3 for a 1/4 to casing point – If this language is used, the investor would pay for 1/3 of the seller's costs prior to the election to

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set casing in the well. However, the investor would only receive 25% of the seller's interest in production from the well.

2. Pay 1/3 for a 1/4 through completion – If this language is used, the investor would pay 1/3 of the seller's drilling costs and 1/3 of the seller's completion costs. *Completion costs* is a term usually defined as the point where a participant can elect to consent or non-consent the completion of the well. Once the well is completed, the investor would receive 25% of the seller's interest in production from the well.
3. Pay 1/3 for a 1/4 through the tanks – If this language is used, the investor would pay 1/3 of all drilling, completion, and equipping the well through setting the tanks. Again, the investor would only receive 25% of the seller's interest in production from the well.
4. Pay 1/3 for a 1/4 to payout – If this language is used, the investor would pay 1/3 of all of the seller's costs for drilling, completing, equipping and operating the well through payout.

   In this scenario, the question should be asked, "During the payout period, is the investor paying for 1/3 of the costs but only receiving 25% of the revenue less burdens?" The answer is that the investing party would receive 1/3 of production less burdens during the initial payout period; after payout they would receive 25% of production less burdens.

Costs associated with completing the well

Costs associated with completing the well are far less than the costs associated with drilling the well, none the less, they can be significant. Completing the well takes several steps:

1. The well bore will be filled with an additive based drilling fluid that will inhibit the deterioration of the casing.
2. Casing (steel pipe) is lowered into the well bore.
3. Cement is injected into the casing and forced to the bottom of the hole, out the end of the pipe and upward to a specific height encasing the steel pipe in the cement.
4. The drilling rig is removed and replaced by a workover or completion rig.
5. In order for oil and or gas to flow into the casing, holes known as perorations must be blown through the steel pipe and cement. This is done with a tool that is lowered into the hole with a cable. The cable contains electrical circuits. The perforating tool contains a number of charges. When the charges are in position, they are fired.

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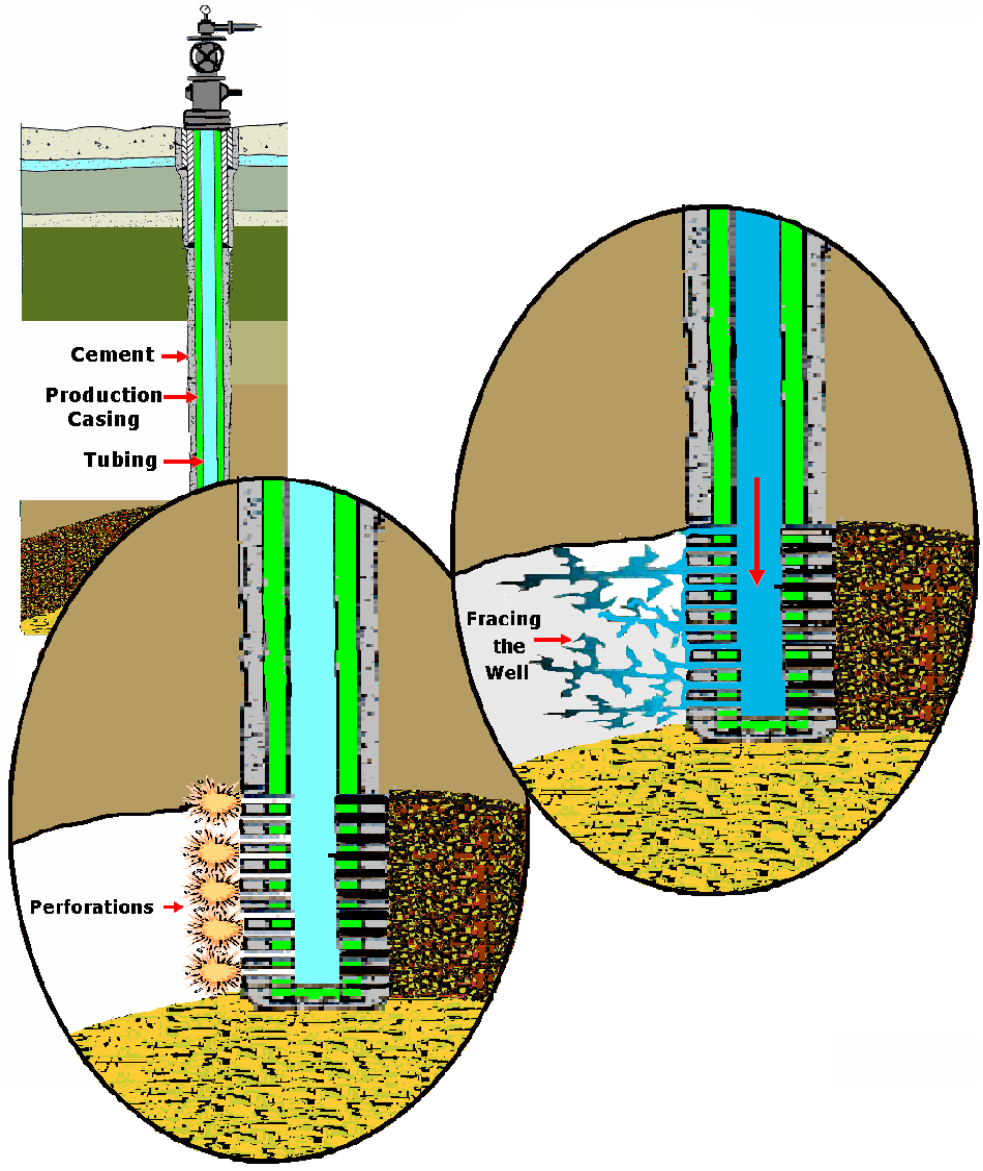
6. Tubing (a smaller pipe) is then lowered into the casing.
7. Often the reservoir rock must be treated or “fractured” to enhance the permeability or flow of oil or gas. This is accomplished by forcing acid or other fluids into the reservoir rock at very high pressure.

Equipment containing valves and known as a “Christmas tree” is placed at the well head. This will control the flow of oil or gas from the well. There are two types of Christmas tress. One is used for a well that has natural pressure causing the substance to flow to the surface. The other has a mechanism which pumps the fluids to the surface.



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The Joint Venture Agreement Checklist:

The following is a checklist of topics to be covered by a JVA. Please note this is not an exhaustive list and, depending upon the scope of a project, additional topics should be covered. As with any agreement of this kind, legal counsel should be sought and utilized.

- □ **The effective and execution dates of the agreement**
- □ **Names and addresses of the joint venture parties**
- □ **Name of the Joint Venture**
- □ **Definitions**
- □ **Objective and reason for the joint venture**
- □ **Terms of the joint venture**
- □ **A designation of the funds that will be used for the joint venture**
- □ **A provision for future funds (if needed) with outlined penalties associated for non-compliance**
- □ **Designation of the percentages owned, in expenses and benefits by each joint venture participant**
- □ **Designation of any initial consideration to be paid by the investing party along with any carried interests**
- □ **Designation of ownership in any equipment**
- □ **Agreement by all parties to sign any necessary documents**
- □ **Establishment of the controlling party to the agreement along with the managing duties and responsibilities of this party**
- □ **Establishment of periodic progress reporting**
- □ **Establishment of a joint venture bank account**
- □ **Contingency in case of death, bankruptcy or insolvency of any party to the agreement**
- □ **Insurance clause**
- □ **Indemnification clause**
- □ **Terms of confidentiality**
- □ **Assignment clause**
- □ **Dispute and arbitration clause**
- □ **Notice clause**
- □ **Applicable jurisdiction clause**

Although there are no standard JVA letter agreements, an example of a complete letter agreement can be found in the Addendum section of the book.

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LETTER AGREEMENTS

The Use of Letter Agreements

Landmen will often use a "letter agreement" in order to tie up a deal. This is a common way that a contract can be formed prior to the drafting of the more formal, lengthy contract. There are a couple of advantages for using letter agreements including, the short amount of time it might take to prepare the document and the less intimidating appearance of a one to three page informal agreement compared to the more intimidating appearance of a 32 page formal agreement.

Letter agreements are usually a short contract written in the form of a letter and are, usually, no longer than one to three pages. Although this short agreement lacks the appearance of the multi page agreement that is to follow, they are, in fact, a valid, binding contract.

The bottom of the agreement contains a sentence of acceptance on the part of the receiving party. Their signature confirms their consent and acceptance of the terms outlined in the agreement.

Letter agreements can be used to tie down any of the following oil and gas agreements: Joint Venture Agreements, Area of Mutual Interest Agreements, Participating Agreements, and or Farmouts.

Following is a sample Joint Venture Letter Agreement whereby Windjammer Petroleum has agreed to purchase 40% of Sunrise's interest in the Madison Prospect. According to the terms, as outlined in the agreement, Windjammer's investment will cover:

1. 40% of the Sunrise's initial acquisition costs
2. All future leasehold costs at an sum of $250 per acre
3. Costs to casing point for three wells
4. 40% of all geologic 3-D seismic imaging

In addition, Windjammer agrees to:

1. Receive a 78% net revenue interest on any and all leases. This means that Sunrise will retain an override on any lease assigned to Windjammer that carries less than a 22% existing burden.
2. Carry and additional 15.5% of Sunrise's drilling costs through completion.
3. Windjammer's before casing point (BCP) working interest will be 55.5% and their after casing point (ACP) working interest will be 40%.

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Joint Venture Letter Agreement

From: Sunrise Oil & Gas
To: Windjammer Petroleum
Dated:

This LETTER AGREEMENT shall set forth the terms and conditions for Windjammer Petroleum's ("Party B") participation in the Sunrise Oil & Gas (*"Party A"*) interest in the Madison Prospect located in _____, County, _____. 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 in the Madison Prospect for a total Buy-In Cost of $88,000 ($220,000 x .40) which is their proportionate share.**
2. **All future leasehold costs shall be billed to the Joint Account at $250/acre at a 78% net revenue basis.**
3. **Windjammer's Buy-In Cost includes all leasehold acquired (800 net acres) all prospect fees, geologic fees and brokerage expenses associated with the Madison Prospect.**
4. **Windjammer agrees to pay their Buy-In Cost, as well as their proportionate share of the estimated costs to casing point for the three wells in the Madison Prospect.**
5. **Windjammer agrees to pay 40% of all geological 3-D imaging acquired for the Madison Prospect.**
6. **Windjammer agrees to participate in the Drilling Operations in three wells with their interest, bearing an additional 15.5% carried Working Interest in all of three operations. The carried working interest shall be to casing point.**
7. **Windjammer's Before Casing Point Interest *"BCP"* shall be 55.5% and Windjammer's After Casing Point Interest *ACP"* shall be 40%.**
8. **Windjammer's Net Revenue Interest *"NRI"* in the Madison Prospect shall be 78%.**
9. **Windjammer acknowledges that they are a sophisticated & accredited investor and fully understand the inherent risks associated with oil & gas investing. Further, they acknowledge that no Return on Investment or Rate of Return has been guaranteed or promised, and, in fact, accept the possibility that they could lose 100% of their investment in this program.**

Should Windjammer agree with these terms and conditions expressed herein, please execute this LETTER AGREEMENT in the space provided below.

Agreed and accepted this _____ day of _____, 20___

_____

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Joint Venture Letter Agreement

From: _____
To: _____
Dated:

This LETTER AGREEMENT made and entered into by and between _____("Party A") and _____ ("Party B") shall set forth the terms and conditions of Party B's participation in the Madison Prospect. Specifically, Party B shall agree to participate with a _____% Working Interest, subject to the following:

1. **Party B agrees to purchase an undivided _____% Working Interest in the Madison Prospect for a total Buy-In Cost of $_____ ($250,000 x ____%) which is your proportionate share.**
2. **All future leasehold costs shall be billed to the Joint Account at $250/acre at a ____% net revenue basis.**
3. **Party B's Buy-In Cost includes all leasehold acquired (800 net acres) all prospect fees, geologic fees and brokerage expenses associated with the Madison Prospect.**
4. **Party B agrees to pay their Buy-In Cost, as well as their proportionate share of the estimated costs to _____ casing point, _____ completion, or _____ payout for the thee wells in the Madison Prospect.**
5. **Party B agrees to pay _____% of all geological 3-D imaging acquired for the Madison Prospect.**
6. **Party B agrees to participate in the Drilling Operations in three wells with their interest, bearing and additional _____% carried Working Interest in all of the operations. The carried working interest shall be to casing point.**
7. **Party B's Before Casing Point Interest *"BCP"* shall be ____% and Party B's After Casing Point Interest *ACP"* shall be _____%.**
8. **Party B's Net Revenue Interest *"NRI"* in the Madison Prospect shall be ____%.**
9. **Party B acknowledges that they are a sophisticated & accredited investor and fully understand the inherent risks associated with oil & gas investing. Further, they acknowledge that no Return on Investment or Rate of Return has been guaranteed or promised, and, in fact, they accept the possibility that they could lose 100% of their investment in this program.**

Should Party B agree with these terms and conditions expressed herein, please execute this LETTER AGREEMENT in the space provided below.

Agreed and accepted this _____ day of _____, 20___

_____

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"Madison Prospect" Scenario

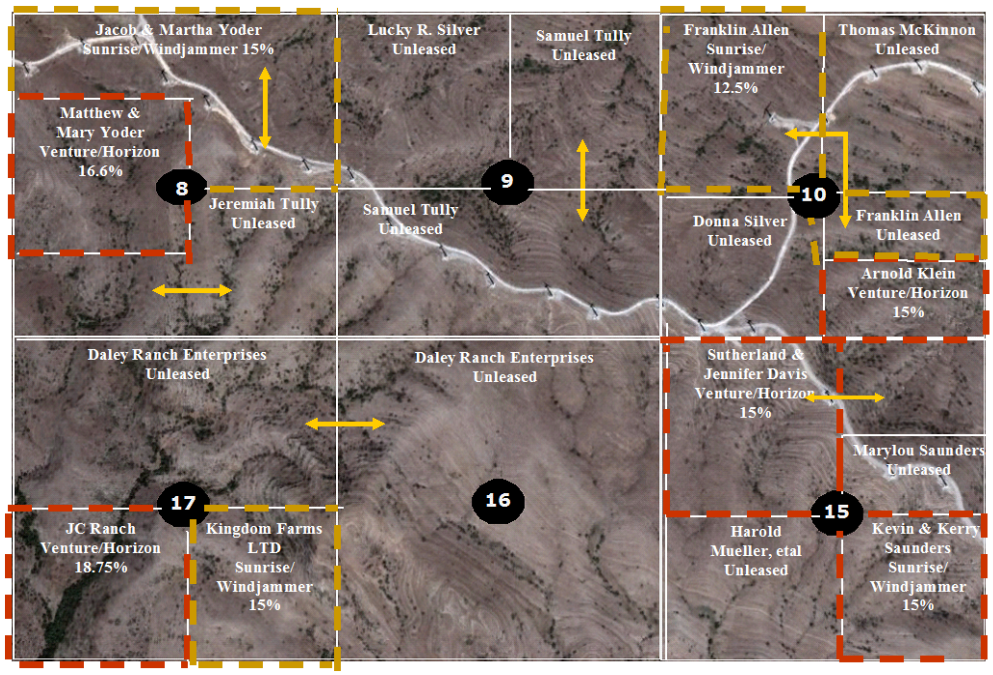
Continuing to Develop the Madison Prospect

Assume that Windjammer signed a JVA with Sunrise and Horizon signed a like agreement with Venture. Also assume that all units in the area are to be spaced with 320-acre spacing. For instance, if a company wanted to drill a well in any of the sections, the unit would cover half of the section – either the North or South half of the section or the East of West half of the section.

The following is a land plat that depicts which tracts of land are already under lease. Notice that the Sunrise leases have now become the Sunrise/Windjammer leases and the Venture leases have become the Venture/Horizon leases.

Because several tracts of land are still unleased each of the two groups implemented the following 5-step plan for continued lease acquisitions:

1. Locate potential drill sites.
2. Concentrate on leasing drill site tracts of land.



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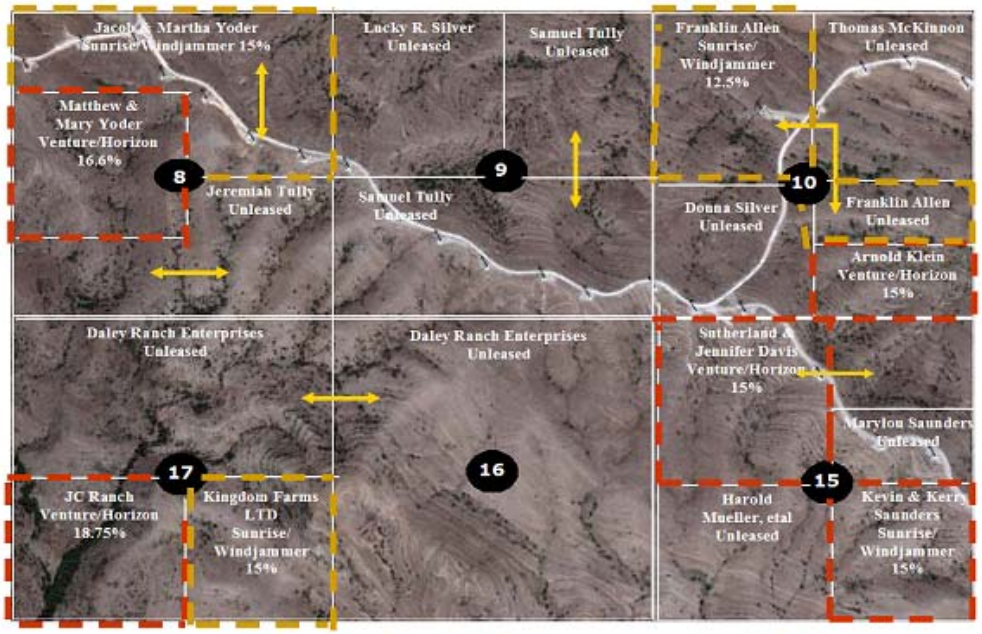
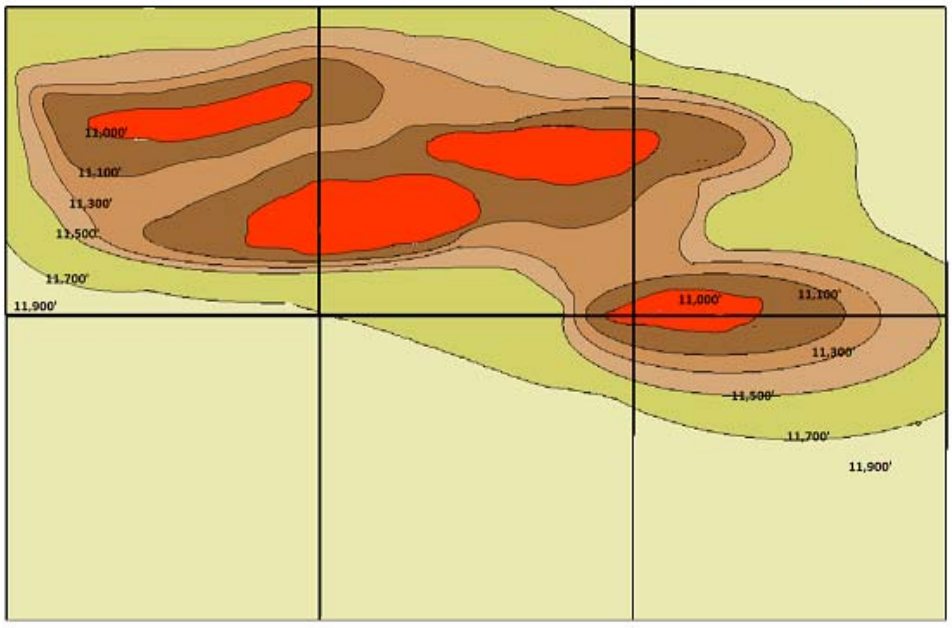
3. Since drilling units in the area will be based on 320-acre spacing and these units will either be a “stand up” or “sit down” unit, lease acquisitions should be concentrated in 320 acre blocks.
4. Determine where the competitor company is buying leases. If possible, buy leases in the same 320-acre blocks.
5. Try and keep the lease bonus payment down as much as possible.



Assume that this Seismic “Structure Map” illustrates the result of the Madison Prospect 3-D seismic.



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From the illustration, it appears that the initial test well location could be located either in the E/2 or W/2 of Section 9.

Subsequent drilling locations could be:

- N/2 of Section 8,
- SW/4 of Section 10

If this were true, a mixture of stand up and lay down spacing units would be appropriate in the prospect.

What lands should be leased if the structure map was overlaid on top of the land map?

What mineral owners should be contacted?

Leasing the lands

The oil and gas lease is, without question, the foundation of every oil and gas exploration company. It can be said, with a great deal of certainty, that these simple pieces of paper (contracts) are, indeed, the greatest assets a company can own.

The purpose of an Oil and Gas Lease

An oil and gas lease is a contract that grants the oil company the rights to enter upon a tract of land in order to conduct tests by drilling or other methods.

1. In order to acquire these rights, the oil company must offer consideration (signing bonus) to the mineral owner at the time the lease is signed.
2. A lease will contain a specified term (primary term) usually three to five years and as long thereafter as oil or gas, or either of them, is produced from the land. If the oil company does not locate oil or gas in commercial quantities during the primary term of the lease, the lease will expire on its own terms and the mineral rights return to the owner.
3. When a producing well is located, the mineral owner will receive a percentage of the production based on the royalty amount negotiated in the lease contract.
4. Other terms and conditions set forth in the lease contract must be *strictly* observed and managed.

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Madison Prospect" Scenario

Continuing to Develop the Madison Prospect

Assume for the sake of this study that competition between the oil companies continued to drive the leasing prices up. Landowners knowing that the companies were bidding against each other decided to "wait it out" until the prices reached "unheard of" levels.

The Madison Prospect Dilemma

Sunrise Oil & Gas – Sunrise's landman reported back to his land manager that the leasing strategy was not working. Competition continued to drive bonuses up. The reply he received was not one he had expected. "Then stop the competition!" he said. "Find a way to get the wells drilled! If you're successful – expect a bigger bonus in December! Now, go do your job!"

Venture Oil & Gas – Venture's management was also upset that leasing was at a standstill. Venture's landman was told, "I told you before – you only have $4 million dollars to get the job done. *Read my lips.* Do your job or loose it! You have what you have. Be grateful!"

Both Windjammer and Horizon, sensing that the leasing was taking way too long, began to ask their respective partners, "What's going on out there? Why haven't the leases been secured?" After hearing about the competition they stated, "Competition? What competition? We barely have enough money to drill any wells. Why would you let this happen?" Both companies started having second thoughts about their investment.

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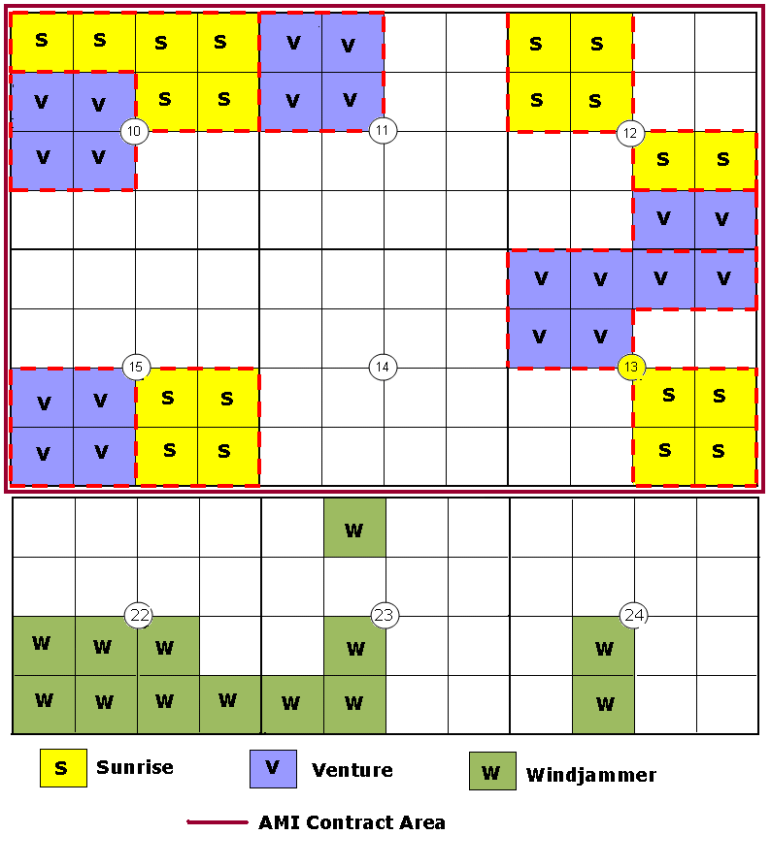
THE AREA OF MUTUAL INTEREST AGREEMENT

An Area of Mutual Interest (AMI) is entered into by two or more parties. This agreement should not be confused with a JVA. The two contracts are very different in nature. Whereas, a JVA is used when one of the parties is only bringing money to the table an AMI is used when all parties are bringing mutual interests to the table (leases, geology, etc.).

The Purpose of the AMI

AMI's are generally seen in exploratory areas or wildcat areas. The purpose of the agreement is to do away with needless competition in an area and protect all parties making sure that none of the parties can benefit to the exclusion of the others. Generally, once an AMI is formed an ownership split is determined for each of the parties. If each party owns 50% of the leasehold acreage the split would probably be on a 50/50 basis. If one party is bringing 75% of the leasehold acreage, the split would probably be 75/25. Assignments are made between the parties in order to accomplish the split. The AMI will stipulate that if, during the term of the AMI, companies were to acquire new oil and gas interests or geologic data in the contract area they must offer this interest to the other parties.



An AMI is an area of *"mutual"* interest. In other words, an AMI is formed in a discovery area where one or more companies already have a *mutual* interest and can bring to the table existing oil and gas leases or seismic data.

In the illustration, Sunrise Oil & Gas and Venture Oil & Gas each have several oil and gas leases in the northern portion of the plat. Windjammer Petroleum has minimal leases in the southern portion of the plat.

Since Windjammer's leases are

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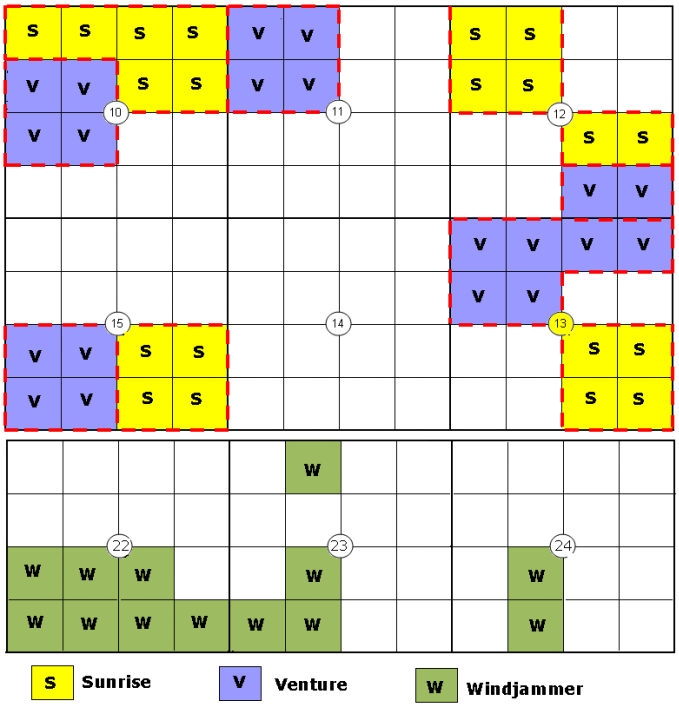
farther to the south of the other company's leases, Windjammer, most likely, would not be included in the AMI.

An AMI is also a specific *"area"* of mutual interest. Once the decision is made as to which companies are included and which companies are excluded from the AMI, a boundary line is established which will designate the "contract area" for the AMI.

As can be seen in the illustration, the Contract Area has been limited to the northern portion of the plat.

Generally, AMI's do not cover huge areas of land. The reason is because of the exploratory nature of the venture. Since the area is a wildcat area, the risks can be very expensive. The smaller the AMI, the less risk involved.



There is; however, another practical reason for their size. Assume that Sunrise had acquired the leases south of the contract area instead of Windjammer. In this case, Sunrise might have limited the contract area as to the six sections seen in the illustration (area where the mutual interest was located). The reason is simple. If discovery wells were located in the contract area indicating a southward trend into sections 22, 23 or 24, Sunrise would be under no obligation to share the leases to the south with Venture. On the other hand, if the AMI contract area had incorporated all nine sections, Sunrise would be required to share this acreage with Venture.

Advantages of the AMI

1. An AMI will create a *potential uniformity of interest* throughout the Contract Area. This uniformity of interest is not guaranteed.
2. Developing a wildcat field is risky business with a higher degree of dry holes with several wells planned in order to maximize the endeavor.
3. Before drilling, a company would want as much seismic data as would be reasonable. Seismic shoots are expensive.
4. An AMI also does away with needless competition. AMI's create a partnership not competition between two or more companies.

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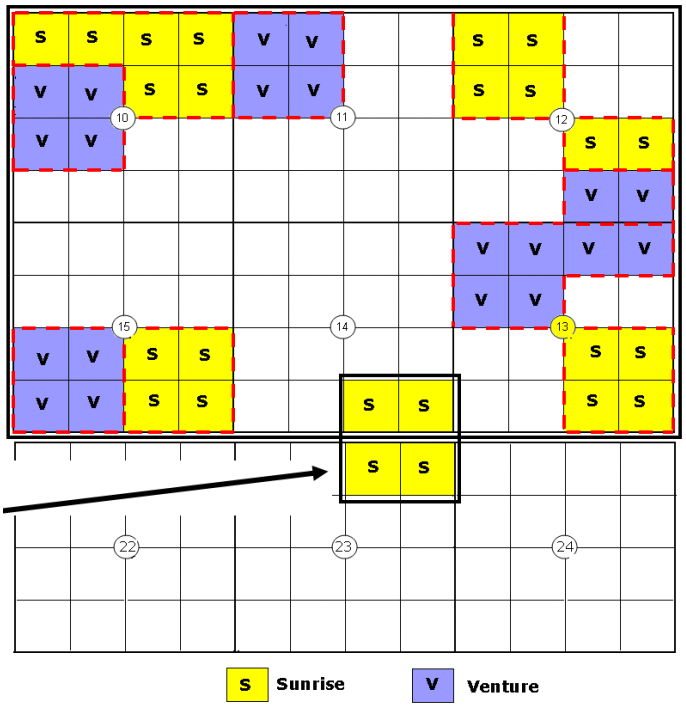
5. If a competitor company has more money to spend in the area, a greater number of leasehold acres in the area, or better geologic knowledge in the area, it would be to the other company's benefit to partner with the competitor in order to benefit from their resources, leasehold acres or knowledge.

AMI's should contain the following:

1. The Statute of Frauds, as referenced at the beginning of this study, holds that any contract used for the conveying of property must contain a legally sufficient description of the property. Therefore, an accurate and complete description of the AMI area must be designated. Surveys and/or plats are also often included.
2. The AMI boundary should be limited in size.
3. The number of companies should be limited
4. The *oil and gas rights* that are to be offered to the other parties must be specifically defined. Are only "acquired leases" to be shared? What about acquired rights through farmouts, acquired mineral rights, royalty rights, options, net profit interests, production payments, or seismic info?
5. How these acquired rights will be offered to other partners must be clearly spelled out. What is the duration of the election period? How is the option to accept or reject such offers handled? What is the end result for any party who rejects or does not respond to such an offer?
6. Language should address how leases that contain lands both inside and outside the AMI boundary are to be treated.

   In the illustration Sunrise acquired a lease covering lands both inside and outside the AMI boundary. Should they be obligated to share the acreage outside the AMI with their AMI partner?



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7. Most AMI's include a provision whereby any successor to a party's interest is also bound by the terms of the AMI.
8. The term of the AMI should be limited. Commonly, AMI's are limited in term for a period of 1 to 3 years.

There is a practical reason for having a shorter term rather than a longer term.

Assume that a 20 year AMI was created between Sunrise and Venture. Many things will happen in 20 years. One of the companies could go out of business or have diminished interest in the area. One company could sell their assets in the area, Sunrise and Venture could grow to intensely distrust one another or deeper or shallower reservoirs could be discovered giving rise to a second AMI. In a case like this, one AMI would be sitting on top of the other AMI. Regardless of any of these events, as long as the 20 year clock was ticking, the terms of the contract must be upheld.

The AMI and Land Administration

Managing leases and staying on top of every lease obligation is a full time job. Throw an AMI in the mix and the situation can prove daunting.

Pointers for the Land Professional

- Any assignments of leases made, under the term of an AMI agreement, should contain language referencing the AMI agreement.
- If a partner were to assign interest in the AMI leases to a non-AMI company, the AMI should be binding on the future owners.
- When lease obligation payments are due on an AMI lease, the question should be asked, "Who is in charge of making the payment?

"Madison Prospect" Scenario

Continuing to Develop the Madison Prospect

Understanding the value of an AMI in an area like the Madison Prospect, Sunrise asked Windjammer if they would agree to approach Venture and Horizon with the idea of forming a Madison Prospect AMI. Upon further review of the idea, they realized that the AMI would do more than just stop the competition during leasing. The combined investment money of all four companies would be at $18 million dollars, enough to drill three wells!

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Following is an AMI checklist that each company might use in order to make sure that the AMI they negotiated was in their best interests.

	AMI Checklist
☐	Establish AMI Boundary
☐	Establish AMI Partners
☐	Establish How Ownership will be Split between partners
	_____ Is it based on percentage of acreage currently owned in AMI?
	_____ Is it based on some arbitrary percent?
☐	Establish if this split will be for
	_____ New Leases only?
	_____ All Leases including current and new?
	_____ Leases that contain acreage both inside and outside the AMI?
☐	Establish if split on new leases is:
	_____Mandatory for all partners
	_____Optional for partners
☐	If optional, establish the time frame for electing to pick up share of new leases
	_____45 days?
	_____30 days?
	_____15 days?
☐	Establish Term of AMI
	_____1 year
	_____24 months
	_____ months
☐	Establish the type of Rights that will be split
	_____ Only Leasehold rights
	_____ Seismic Information
	_____ Mineral acquisitions or royalty acquisitions
☐	Establish the depth covered in the AMI
☐	Establish which company is in charge of rental payments and lease obligations

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AREA OF MUTUAL INTEREST AGREEMENT

Date: _____

This AGREEMENT made and entered into, by and between

AMI Partner #1_____ AMI Partner #2_____

AMI Partner #3_____ AMI Partner #4_____

WHEREAS each of the above named partners are owners of certain oil and gas interests, covering land in the Area of Mutual Interest, shown on Exhibit "A" and described as follows:

_____

WHEREAS each of the partners desire to assign interests from their Oil and Gas Rights to the other partners so that the following uniform interest among the partners exist throughout the AMI.

AMI Partner	AMI Interest
1._____	_____
2._____	_____
3._____	_____
4._____	_____

WHEREAS the AMI shall remain in effect for a period of _____ months from the date of this agreement.

WHEREAS during the term of this AMI, should any party acquire oil and gas rights within the AMI, such party shall provide the other parties written notice within fifteen (15) days of the acquisition of such Lease. Such notice shall include a full description of the Oil and Gas Rights so acquired; a copy of the instrument by which the Acquiring Party acquired such rights; and the Acquisition Price paid, or to be paid.

Option to Participate. Within _____ days after receipt of such notice each AMI partner may elect to acquire an interest in the Oil and Gas Rights so acquired by notifying the Acquiring AMI partner in writing within _____days.

Each AMI partner electing to participate in such acquisition shall be entitled to an assignment of an interest in such Oil and Gas Rights equal to the percentage as previously set forth. Following the expiration of the election period, each AMI partner who elected to participate in the Oil and Gas Rights shall promptly pay to the Acquiring AMI partner its proportionate part of the Acquisition Price.

Operator. _____ shall be designated the operator of the Genesis Project and be responsible for all lease administration, drilling, completion and production from the prospect lands.

Please indicate your acceptance and approval of this agreement by executing below.

AMI Partner #1 _____ AMI Partner #3_____

AMI Partner #2_____ AMI Partner #4_____

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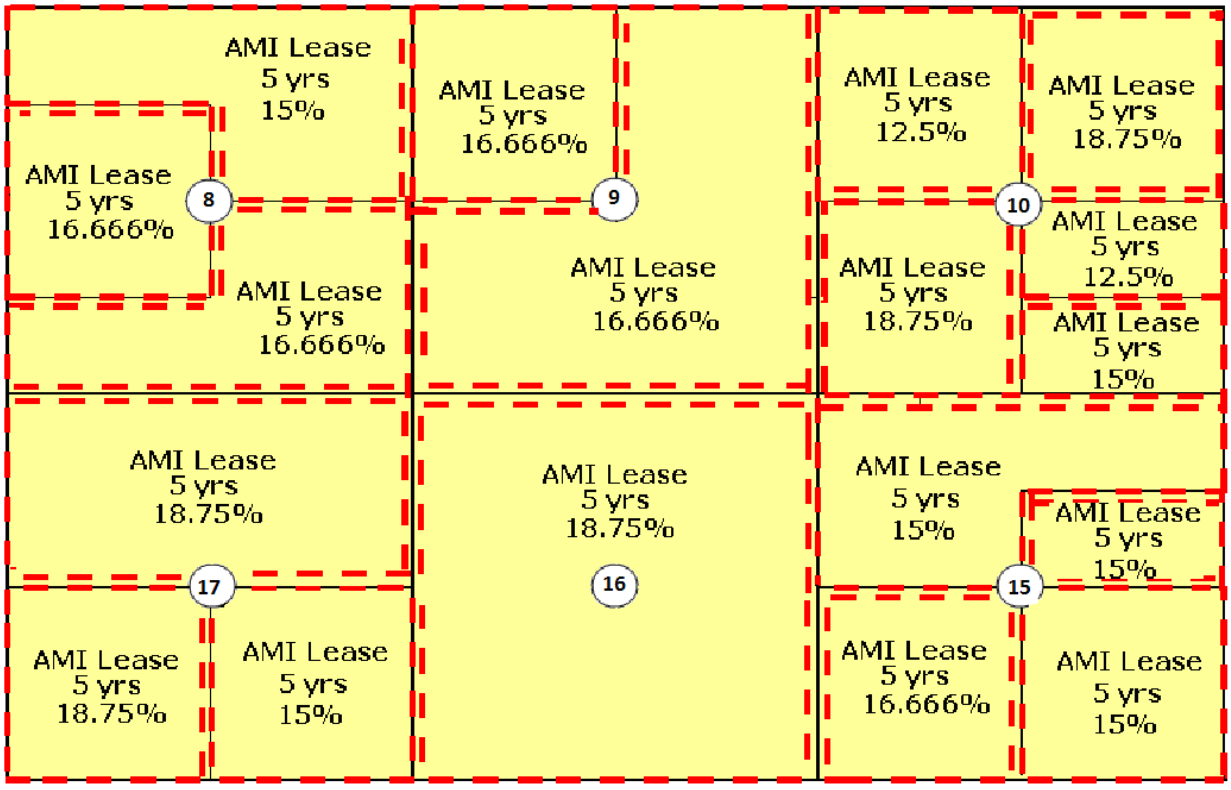
“Madison Prospect” Scenario

Continuing to Develop the Madison Prospect

For the purpose of this study, assume all parties including Sunrise, Venture, Windjammer and Horizon entered into an AMI covering the six section area of the Madison Prospect. Jointly they began leasing those critical tracts of land.

At the conclusion of the leasing phase, the entire Madison Prospect was leased as shown in the following illustration. The average acquisition cost per acre was $200.



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THE FARMOUT

Continuing to Develop the Madison Prospect

For the purpose of this study, assume the following:

Venture Oil & Gas – Venture's CEO called an emergency meeting with all of the company's employees. The meeting was solemn as he explained that the company was in a serious fiscal dilemma. "Like everyone else," he said, "we are facing financial cutbacks. Layoffs are possible; however, before we let anyone go, we are first cutting our exploration budget for all wildcat areas. The money allocated to each of these projects is being cut in half. *Read my lips.* If you have a project you're working on then go do your jobs. You just have less money than before!"

Venture's landman immediately called an old landman friend at Monroe Oil & Gas, explaining his dilemma. He asked his friend, "Would you be interested in participating with 50% of our interest in the Madison Prospect?" The Monroe landman agreed to look at the project. "Monroe is still in great financial shape," he said. "If it looks good, count us in!"

What is a Farmout?

A farmout agreement is a contractual agreement between two parties. The first is an owner of a working interest in an oil and gas lease or leases (the "farmor"). The farmor desires to assign all or a portion of that interest to a second party (the "farmee"). In exchange, the farmee agrees to fulfill specified conditions outlined in the farmout agreement. Once the farmee fulfills the stipulations, they will have earned an assignment to the lease or leases. The farmor may also add language that would create benefits for them out of production.

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Why would a company farmout their leases?

There are several reasons why a farmor would desire to farm their interest out to another company. There are also reasons why a farmee would desire to farm the interest into their company.

1. The farmor may lack the money to drill in a particular exploratory area. Financial issues can often be an issue that motivates a farmout.
2. A farmor might feel the risk of drilling in a particular area is too great. In cases like this, the farmor would be willing to allow another company to bear the risk, thus saving the leases from expiring during the primary term.
3. If a company was not going to drill on a lease, they could structure a farmout so they would receive production money from a successful well but pay none of the costs for drilling the well.
4. Lack of rig availability can be an issue. A company may have leases that are expiring. Rigs may not be available in time to save the leases; therefore, the company would want to hand the leases off to a company who could get them drilled in time.
5. A farmout may be used in order to gain valuable geologic information in an area.

Three primary issues addressed in a farmout agreement

Every farmout will contain a handful of crucial ingredients. Several of these ingredients are *peculiar* to the "Farmout Agreement" and are what make this contract different from others used in the oil and gas industry.

1. What is the farmor willing to give up?
2. What must the farmee do to earn an assignment?
3. What interest is the farmor reserving?

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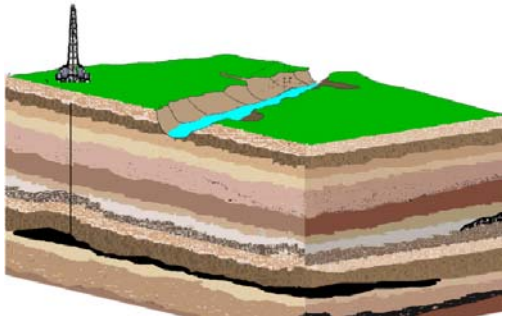
1.

What is the farmor willing to give up?

What the farmor is giving up may vary from farmout to farmout. The farmor might be giving …

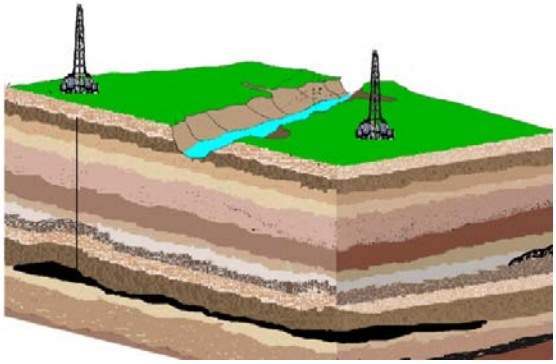
1. *A Leasehold farmout*. Assume that Venture had leased the illustrated tract of land. Their geologist felt that drilling on this lease was far too risky. Therefore, Venture granted a "*leasehold farmout"* to Monroe Oil & Gas.

   Proving Venture's geologist wrong, Monroe successfully drilled a great well on the lease. The well was such a good well that Monroe chose to drill a second well on the east side of the stream. Knowing now that the geology was good, can Venture participate in the drilling of the second well?

   Answer: No. Because they granted a "leasehold" farmout, they no longer have any hold on the lease. The asset belongs to Venture.

2. *A Wellbore farmout*. Assume the same scenario as was described above except that the farmout was a *"wellbore farmout"* instead of a *"leasehold farmout." Monroe* has chosen to dill a second well east of the stream. Can Venture participate in the drilling of the second well?

   Answer: Yes. Venture still has a hold of the lease. The only leasehold rights they had given Monroe were their rights in the borehole of the first well. In this case, Monroe would not be able to propose or participate in the second well.

3. *A Single well farmout*. In many cases the lease(s) being farmed out will only allow the farmee to drill one well.

4. *A Multiple well farmout*. In many other cases, scores of leases may be farmed out in the same area "farmout lands." In cases like this, the farmee may have the option to drill several wells on the farmout lands.

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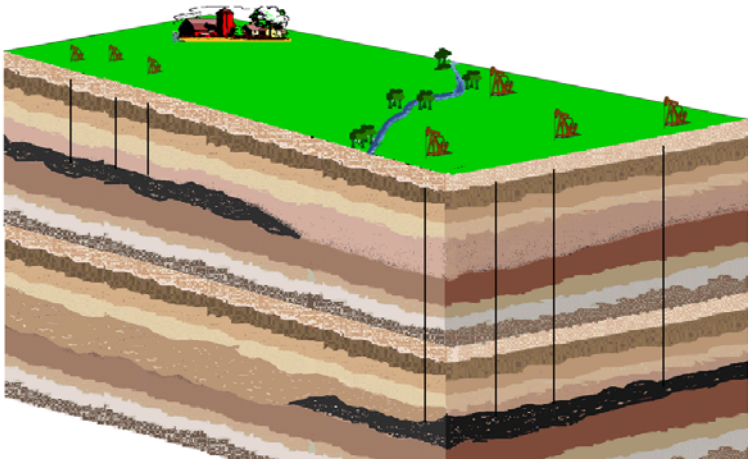
5. *A farmout where earning rights are the same in each well drilled*. If a farmout allows the farmee to drill multiple wells, they may earn the same interest in each of the wells.

6. *A farmout where earning rights are different is each well drilled*. In many cases, a farmee with rights to drill multiple wells will earn a different interest in the test well (first well) than in subsequent wells. Assume Sunrise has a large leasehold area in an exploratory area. They farmout their leases to Venture, wanting them to test the area and pay for all of the risk. Venture would probably earn 100% interest in the test well but earn less in subsequent well.

7. *A farmout with no depth restriction*. Many farmouts will grant rights from the surface to the center of the earth with no depth restrictions. In cases like this, the farmee would be allowed to drill wells to difference horizons as seen in the illustration.



8. *A farmout with depth restrictions*. Many farmouts will include depth restrictions that will limit the farmee to a specified depth or horizon.

Most farmouts provide that any interest earned will be limited as to depth. Some depths commonly specified are 'from the surface of the earth to'…

(1) 100 feet below the total depth drilled,
(2) the total depth drilled, or
(3) the total depth drilled, plus 100 feet of operating rights.

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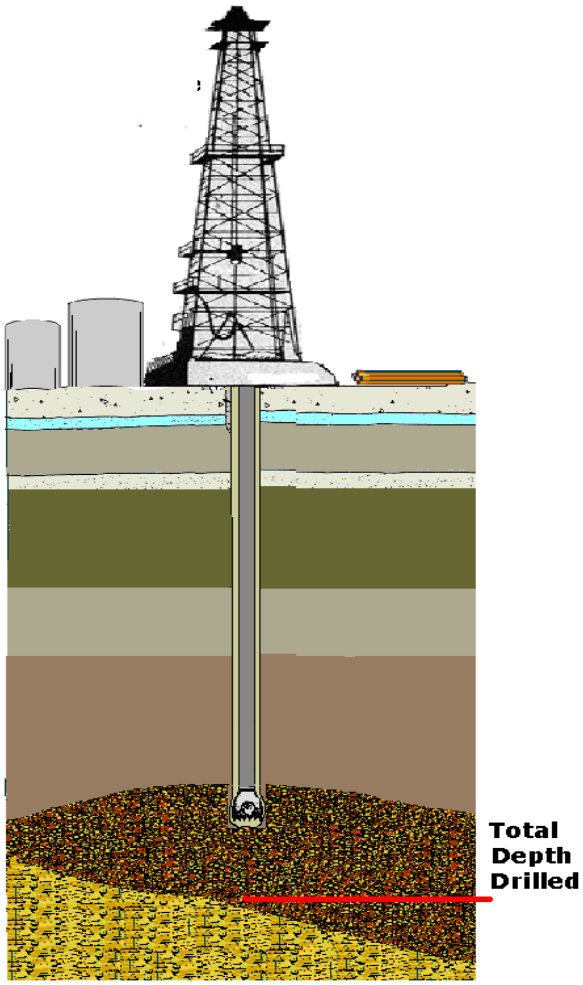
100’ below the total depth drilled is language that is most often used. Total Depth = TD plus 100’

Any of the previous language can lead to problems.

For instance, the producing reservoir may very well exist 100’ below the deepest point drilled in the test well as seen in the illustration.

In a case like this, would the farmee have the right to produce the reservoir that lies deeper than 100’ below the total depth drilled?



In this scenario, a well is being completed at a shallower formation than the total depth drilled. During the drilling of the well, tests showed that a deeper formation could be produced if a second well were drilled at another location.

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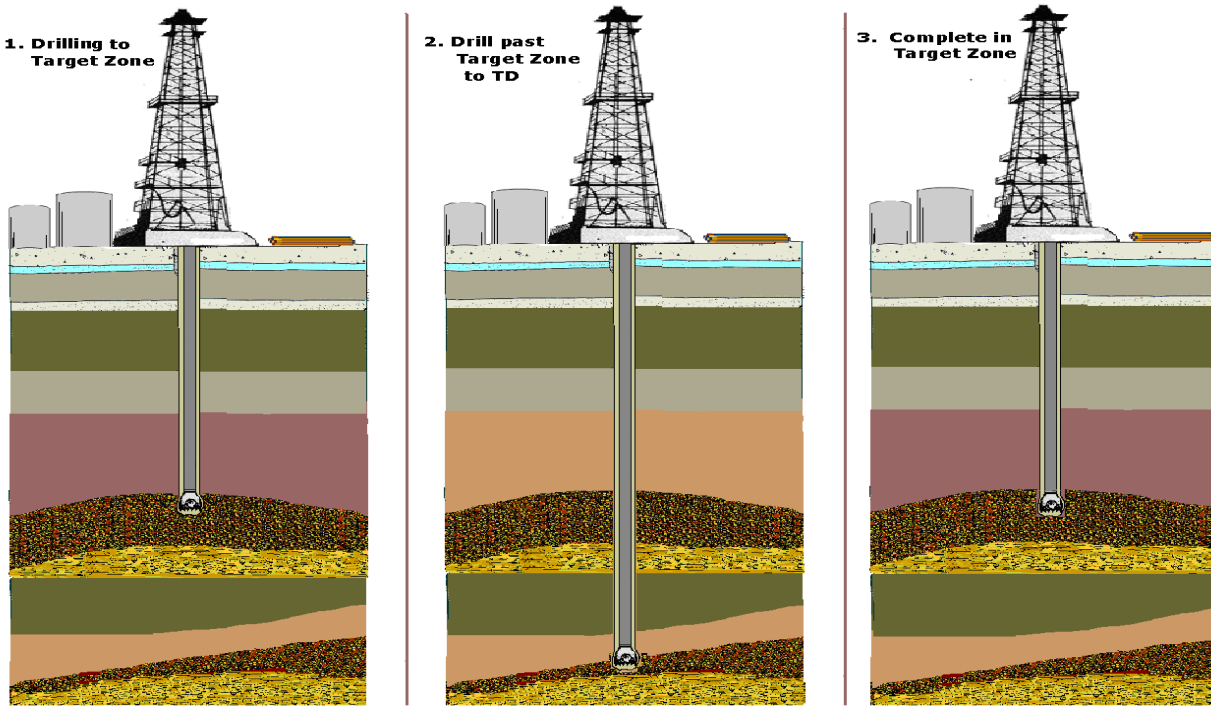

The farmee paid a lot of money to find this information out and might feel they had earned the right to the second location. Would they; however, have the right to produce the second deeper zone?

Because of these issues with this type of language, the following language might be used:

"the base of the deepest producing formation penetrated in the test well."

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What is the Farmor giving up?

In this case, what is the farmor giving up?

_____

What is the Farmor willing to give up?

After such time as *Farmee* has drilled and completed an Earning Well as a well capable of producing in paying quantities, *Farmor* shall deliver to *Farmee* an assignment to (1) 100% of *Farmor's* right, title and interest in the 160 acre spacing unit established for the Earning Well and (2) an undivided 75% of *Farmor's* right, title, and interest in and to the balance of the farmout acreage within the earned section.

What is the Farmor willing to give up?

After such time as *Farmee* has drilled and completed an Earning Well as a well capable of producing in paying quantities, *Farmor* shall deliver to *Farmee* an assignment to (1) 100% of *Farmor's* right, title and interest in and to the wellbore of the McGregor 1-15 well as to the stratigraphic equivalent of the total depth drilled.

In this case, what is the farmor giving up?

_____

In this case, what is the farmor giving up?

_____

Earning Language

By drilling the Initial Test Well at a legal location of Farmee's choice on the farmout lands, Farmee shall have earned an assignment of one hundred percent (100%) of Farmor's right, title, and interest in and to the farmout lands included within the drillsite "spacing" unit to the stratigraphic equivalent to total depth drilled; however, in no event shall Farmee earn any interest to any depths below 5,250 feet.

Again, every farmout is motivated by what interest the farmor is willing to part with. One case may see 100% of all right, title, and interest being assigned as to all depths and all leases in a given area. Another farmout might limit depth, limit the percent, and limit the time that the interest is being assigned.

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2.

What must the farmee do to earn an assignment?

The second primary issue addressed in a farmout is that the farmee is given the opportunity to drill a well on farmout acreage and by doing so; they *earn* the right to an assignment. Farmout interest is ***earned*** rather than ***purchased*.**

The farmee must accomplish certain tasks or meet certain requirements in order to earn the farmout acreage.

In the example, the farmee must do two things to earn an assignment in the initial test well. What are they?

Earning Language

By drilling the initial Test Well and completing same as a well capable of commercial production, the Farmee shall have earned an assignment of one hundred percent (100%) of Farmor's right, title and interest in and to the farmout lands included within the drillsite "spacing unit". By drilling the Initial Test Well, Farmee shall have earned the continuing option, to drill similar test wells on the remaining undrilled farmout lands and earn an undivided seventy-five percent (75%) of Farmor's interest, as long as no more than sixty (60) days elapse between drilling rig release in one well and commencement of drilling operations for the next succeeding well.

1. _____
2. _____

Also, in the example, the farmee can continue to earn if they continue drilling wells in the contract area as long as no more than 60 days elapse between drilling rig release in one well and the commencement in the succeeding well.

As to the first "earning" condition, a key question is whether the well must be a producer to earn.

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Generally, it must; however, there are times when the farmor will agree that even a dry hole will earn. An example of such a time would be when the farmor's main objective is to obtain information.

3.

What interest is the farmor reserving?

The third primary issue addressed in the farmout is that the farmor may keep certain interests or rights.

Farmouts can have strings attached

Farmouts are like gifts with strings attached. Each string represents revenue, potential revenue or valuable information that will come to the farmee.

These strings might vary from one farmout to another and could include one or more from the following list:

1. A farmout with an override attached
2. A farmout with a backin at 100% payout
3. A farmout with a promote of 1/3rd for a 1/4 at casing point
4. A farmout with a promote of 1/3rd for a 1/4 at completion
5. A farmout with a promote of 1/3rd for a 1/4 at payout
6. A farmout where payout of the initial test well affects all wells
7. A farmout where payout is based on a well by well basis

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String #1: A farmout with an overriding royalty interest attached

Generally, every farmout will have a provision whereby the farmor is reserving an overriding royalty interest. The amount of the override is, of course, a matter for negotiations and will be carved out of the assigned leasehold interest.

The override can be established a couple of ways. The language could simply state that the reserved override will be a 3% override or a .25% override. In the following example, the override is created with different language.

Interest Assigned and ORR Reserved

Such assignment shall be subject to Farmor's reservation of a proportionately reduced overriding royalty interest *equal to the difference between the sum of existing lease burdens and twenty-five percent (25%).*

This latter approach is intended to give the farmee a net revenue interest of 75% and reserve to the farmor an override equal to whatever is left after deducting the other burdens.

Calculating the Override

The wording in the example sets out exactly how to calculate the override. The wording sets out a math problem and even explains what type of math problem will be used to calculate the override. Notice the word ***"difference".*** This is a subtraction problem!

The override is to be calculated by simply subtracting the **difference** between the sum of existing burdens on the lease from an arbitrary number **twenty-five percent (25%).**

Twenty-five percent (25%), as used in this language, is an arbitrary number. The language could have said 20% or 23%. If the land professional knew the sum of existing lease burdens they would simply subtract that number from 25%. The answer to that number would be the override reserved by the farmor on this lease.

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Existing lease burdens represent any burden that is currently attached to the lease.

Example 1:

Assume that Sunrise farmed out a lease to Monroe Oil & Gas in the Madison Prospect. The mineral owner had negotiated a ***12.5% lease royalty*** and Sunrise had previously assigned a ***3% override*** to their geologist. If these were the only existing lease burdens, the sum of them would be ***15.5%.***

25.0% Arbitrary Number
- 15.5% Sum of existing lease burdens
= 9.5 % Reserved Override on this lease

NOTE: Not all leases attached to a farmout would necessarily have the same lease burdens. The reason is simple. The 25% would stay the same in each equation but the sum of existing lease burdens might be greater or smaller in other leases.

What does the arbitrary number (25%) represent?

Answer: The arbitrary number represents the maximum amount of burdens the farmee is willing to have attached to the lease. In example 1, the maximum amount of burdens attached to the lease is 25%. Existing burdens = 15.5% and the farmout override = 9.5% totaling 25%. This means that for every million dollars the lease generates in revenue …

$250,000 goes to pay the burdens

$750,000 is kept by the farmee

Example 2:

Assume that Monroe Oil & Gas had negotiated a farmout with Sunrise whereby the arbitrary number was 20% instead of 25%. In this case the outcome would be different.

20.0% Arbitrary Number
-15.5% Sum of existing lease burdens
= 4.5% Reserved Override on this lease

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Question: If this lease generated a million dollars from production, how much of the money would Monroe be able to keep?

How much would they have to payout in burdens?

Example 3:

If a well produced $1,000,000, calculate how much the farmee would pay in burdens and be able to keep if the arbitrary number was 23%.

Sum of existing burdens 15.5%
Reserved override by Farmor + _____%
Total burdens = _____%

Total amount due the burdens = $_____
Total amount farmee is able to keep = $_____

String #2: A farmout can provide for a backin after payout (APO)

Often, a farmout will give the option but not the obligation for the farmor to come back into the well with a working interest at the point in time the well reaches payout. The term "back-in" refers to an event that happens when an owner reacquires a previously owned interest in a well.

Payout occurs when the farmee has recovered all drilling costs out of their share of production after deducting operating costs, certain taxes, and other expenses.

When creating the back-in string, the farmout should include a complete definition of "payout" including what expenses and taxes will be deducted in order to calculate the payout.

If this provision is added to the farmout, at payout two things usually happen:

1. The override converts (goes away).
2. The farmor's new working interest is a reduction of the farmor's original working interest.

The agreement may call for a backin of 25% of the original working interest, 30% or 40%.

If the farmor's original working interest, prior to the farmout, was based on 160 net acres and the backin provided for a 25% backin in the Farmor's

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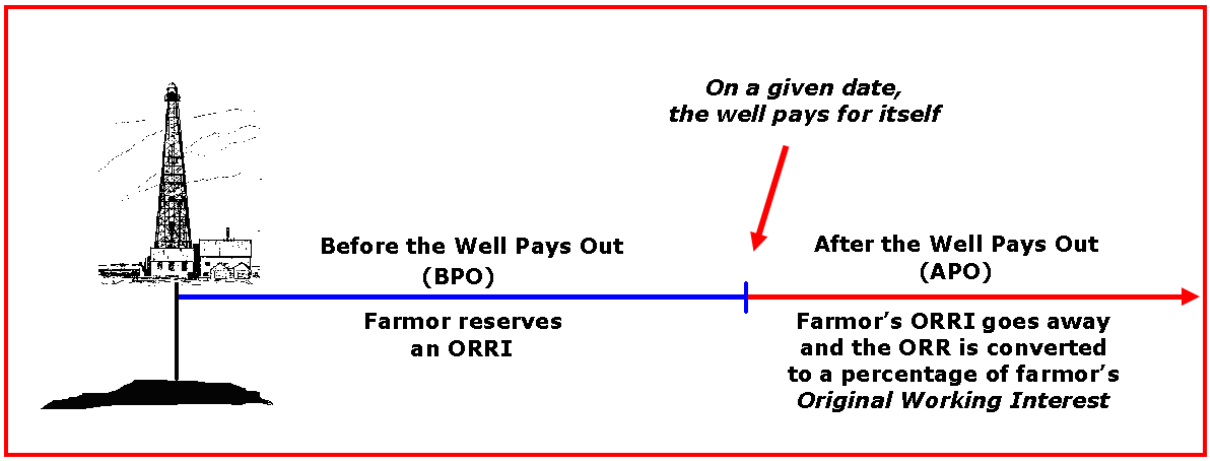
original working interest, the new APO working interest would be based on 40 net acres (160 X 25%). The Farmee would keep the additional 120 net acres in interest (160 X 75%).

If the backin provided for a 30% backin, the new APO interest would be based on 160 X 30% = 48 net acres. The Farmee would keep the additional 160 X 70% = 112 net acres in interest.



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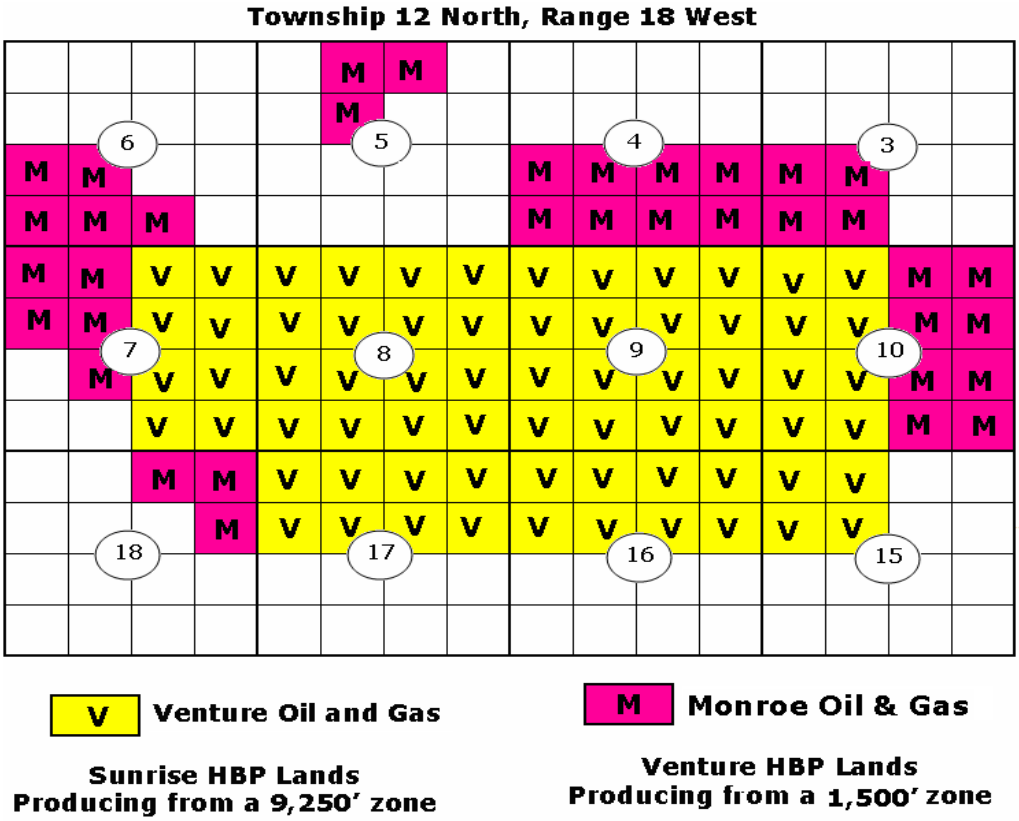
Practice Negotiations #1

Certain designated captioned lands on the following plat are currently held by production (HBP) from deep 9,000' wells that Venture Oil and Gas drilled years ago. Designated captioned lands are currently HBP from shallow 1,500' wells that Monroe Oil & Gas recently drilled.

Venture's geologist (whose strength is drilling deep wells) is not really interested in drilling shallow wells on the acreage. However, Monroe having been very successful in shallow drilling recently approached Venture with a farmout proposal for these shallow rights.

Venture's management has directed that any farmouts must have valuable "strings attached".

Monroe's management has directed that any farmouts must be economically feasible.



Assume that you work for Venture Oil and Gas. Using the Farmout template on the following page determine the best possible farmout terms for your company.

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Farmout Proposal Letter

RE: Farmout Request

Farmout Land: T12N, R13W, Sec 7: E/2, Sec 8 & 9: All, Sec 10: W/2, Sec 15: NW/4, Sec 16, 17: N/2

_____"Farmee" is interested in acquiring the interest of _____"Farmor" under the above captioned lands. Therefore, Farmee respectfully requests that Farmor grant a Farmout covering its interest in the captioned lands.

1. **On or before _____(date) Farmee shall commence, or cause to be commenced, an Initial Test Well at a location in the above lands.**
2. **In the event the Initial test well is drilled and completed as a well capable of commercial production, Farmee shall have earned an assignment of (a)_____100%, (b) _____75%, or (c)_____ Other Percent of Farmor's right, title and interest in the spacing unit designated for the initial test well together with (a)_____100%, (b)_____(75%), or (c)_____other Percent of Farmor's right, title and interest in and to any Option well(s) as to (a)_____all depths, (b)_____the stratigraphic equivalent of total depth drilled, (c)_____some other depth.**
3. **By drilling the Initial Test Well, Farmee shall have earned the option, but not the obligation, to continuously drill Option Wells at locations of Farmee's choice on the Farmout Lands as long as no more than (a)_____60 days, (b)_____90 days, (c)_____ other elapse between drilling rig release in one well and commencement of drilling operations for the next succeeding well.**
4. **Such assignment shall be subject to Farmor's reservation of a proportionately reduced overriding royalty interest equal to the difference between the sum of existing lease burdens and (a)_____ 25% or (b)_____ Other Percent_____.**
5. **Upon payout of the Initial Test Well Farmor will have the option, but not the obligation, to convert their overriding royalty interest reserved herein into a _____ (a) 25%, _____ (b) 35%, or _____ (c) Other Percent _____.**

Should the terms and conditions herein above provided be acceptable, please execute in the space provided below.

Farmor _____Farmee _____

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Practice Negotiations #2

The captioned lands found on the following farmout template are located in a "Wildcat Area". Venture Oil & Gas has no leasehold interest under the captioned lands but is interested in participating in a drilling program that would minimize their risk. They have purchased 3-D seismic on the area, have located 5-6 drillable locations and believe that if a discovery reservoir is found, the rewards would be tremendous.

Currently, the captioned lands are leased to Monroe Oil & Gas. Monroe has also purchased 3-D over the area and is looking for a partner who will share in the risk by taking a portion of their leasehold.

Both companies desire to drill several wells and want to enter into a farmout with the other company. They also want to create the best possible farmout possible.

Farmout Proposal Letter

RE: Farmout Lands: T12N, R13W, Sec. 7: NW/4, Sec. 8: W/3, Sec. 9: All

_____ ,"Farmee" is interested in acquiring the interest of _____,"Farmor" under the above captioned lands. Therefore, Farmee respectfully requests that Farmor grant a Farmout covering its interest in the captioned lands.

1. **In the event the Initial and/or Option Well(s) are drilled and completed as a well capable of commercial production, Farmee shall have earned an assignment of (a)_____ 75%, (b)_____ 50%, (c)_____ Other Percent of Farmor's right, title and interest in the spacing unit designated for the initial test well together with (a)_____ 75%, (b)_____ 50% or (c)_____ other Percent of Farmor's right, title and interest in and to the Option Well(s) as to (a)_____ all depths, (b)_____ the stratigraphic equivalent of total depth drilled or (c)_____ some other depth.**
2. **Such assignment shall be subject to Farmor's reservation of a proportionately reduced overriding royalty interest equal to the difference between the sum of existing lease burdens and (a)_____ 25% or (b)_____ Other Percent.**
3. **Upon payout of the Initial Test Well and/or Option Well(s) drilled, Farmor will have the option, but not the obligation, to convert their overriding royalty interest reserved herein into a (a)_____ 25%, (b)_____ 35%, or (c) _____ Other Percent _____.**
4. **"Carried Costs" in consideration of farming out captioned lands, Farmee shall pay Farmee (a)_____ 33.3%, (b)_____ 40%, (c)_____ other percent of costs through (a)_____ casing point of any well drilled or (b)_____ completion of any well drilled.**

Should the terms and conditions herein above provided be acceptable, please execute in the space provided below.

Farmor _____ Farmee _____

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Task: Assume that you work for Venture Oil & Gas. On the following Letter Agreement template determine the best possible farmout terms for your company.

Farmout Letter Agreement

Madison Prospect

Date: _____

RE: Farmout Request
Farmout Lands: _____

_____"Farmee" is interested in acquiring the interest of _____"Farmor" under the above captioned lands. Therefore, Farmee respectfully requests that Farmor grant a Farmout covering its interest in the captioned lands.

1. Farmee shall commence, or cause to be commenced, an Initial Test Well at a location in the Madison Prospect.
2. By drilling the Initial Test Well, Farmee shall have earned the option, but not the obligation, to continuously drill Option Wells at locations of Farmee's choice on the Farmout Lands.
3. In the event the Initial and/or Option Well(s) are drilled and completed as a well capable of commercial production, Farmee shall have earned an assignment of (a) _____100%, (b) _____50% or (c) _____% Other Percent of Farmor's right, title and interest in the spacing unit designated for the initial test well together with (a) _____100%, (b) _____50% or (c) _____% Other Percent of Farmor's right, title and interest in and to an Option Well(s).
4. Such assignment shall be subject to _____ reservation of a proportionately reduced overriding royalty interest equal to the difference between the sum of existing lease burdens and (a)_____25%, (b) _____ 20% or (b) _____% Other Percent.
5. Upon payout of the Initial Test Well and/or Option Well(s) drilled, and payout will be calculated on an individual well-by-well basis, Farmor will have the option, but not the obligation, to convert their overriding royalty interest reserved herein into (a) _____ 25%,(b) _____ 35% or (c) _____% Other Percent of their original interest.

Should the terms and conditions herein above provided be acceptable, please execute in the space provided below.

AGREED TO AND ACCEPTED THIS _____ DAY OF _____ , 20___

Company_____

By: _____

Title: _____

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PRODUCTION PAYMENT AGREEMENTS

"Madison Prospect" Scenario

Continuing to Develop the Madison Prospect

For the purpose of our study, assume the following: Supreme Oil Well Drilling & Completions is the most reliable and cost effective Drilling and Completion Company in three counties. Sunrise, Venture, Horizon and Monroe use them for all of their well drilling and completion needs. Over the years, Supreme has been competitive, trustworthy and honest. Last week, Supreme sent the following letter to each of its clients.

To whom it may concern,

As with all oil well drilling companies, costs have continued to go through the roof. Inflation has more than doubled the price of goods and services. Therefore, effective immediately and with great consternation we regret to inform you of the following drilling rate and completion costs increase.

	Prior Costs	*Current Costs*
Drilling Rates	$605 per foot	$725 per foot
Completion costs	$400,000	$500,000

Sincerely,

Supreme Oil Well Drilling & Completions

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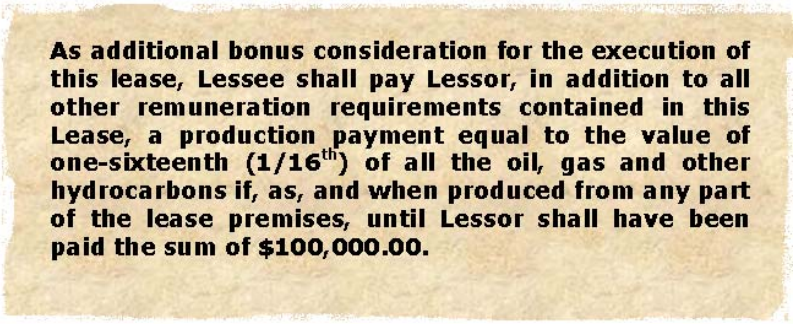
This unexpected bad news will obviously set the Madison Prospect back…unless the companies can find a way to problem solve the issue.

What is a Production Payment?

A production payment can simply be defined as "a right to a specified fraction of the production until a specified sum has been received." First City Nat'l Bank v. Concord Oil Co., 808 S.W.2d 133 (Tex.. App. El Paso 1991); Griffith v. Taylor, 156 Tex.

1. Since production payments are often created because of a need to fund a particular exploration project, the party receiving the specified fraction of production would be a financial investor in the project.
2. Production payments create a type of ownership similar to that of a debtor/creditor relationship; however, the assignor, unless stated differently in the agreement, is only obligated to pay if there is production.
3. Vendors may receive a vendor production payment if services rendered for a project are to be paid from the production of the project.
4. A production payment can be carved out of a mineral owner's royalty or even out of an overriding royalty. Following is example language from an oil and gas lease which creates a mineral owner's production payment.



5. The owner of the production payment is to receive payment only when the minerals in the particular project are being produced.
6. The party responsible to make these payments have no personal liability to the receiving party if the reserves are inadequate to pay off the production payment.
7. The production payment is usually free from any operating costs.

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8. The production payment can be in the form of a certain amount of production in volumes (volumetric production payment).
9. The production payment can be in the form of a certain sum of money (monetary production payment).
10. The life of the production payment lasts as long as the specified volume or money has not been paid. Once the amount has been reached, the payment concludes.
11. A production payment is similar to that of an override except that an override can be tied to a lease for the life of a lease. A production payment is tied to the lease as long as payment is still owed.
12. An agreement that establishes a production payment will usually address the following issues of concern: (1) the expenses that will be borne by the borrower, (2) the formula by which the total dollar amount of proceeds or production volumes will be paid out of production, (3) and the formula by which to calculate the termination of the production payment.

The following News Release touches on several key elements of a production payment:

E&P News Release

March 4, 2005

Dominion Announces Volumetric Production Payment Transaction with UBS Investment Bank

Houston **– Dominion (NYSE: D), one of the nation's largest energy producers, announced today an agreement for a volumetric production payment (VPP) with UBS Investment Bank.**

Under the terms of the agreement, Dominion will receive $424.4 million in cash for a fixed-term overriding royalty interest in more than 2,900 producing natural gas wells located in Utah, New Mexico, Alabama, West Virginia and Michigan. Dominion will retain control of the properties and rights to future development drilling, as well as production above the VPP volumes.

This VPP transaction will allow UBS to receive 76.4 billion cubic feet (Bcf) of natural gas over the next four years.

"This VPP transaction allows us to monetize a portion of our reserves while retaining control of the underlying assets," said Duane Radtke, president and chief executive officer of Dominion Exploration & Production. "It also provides a stable and predictable supply of natural gas to UBS from our long-lived gas production."

www.dom.com

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Once the well produces ...

what is the difference between a

Production Payment, a Net Profit Interest and an Overriding Royalty Interest?

	The Production Payment	v.	The Net Profit Interest
1.	The Production Payment bears no part of the costs associated with the operating expenses in production.		The NPI is paid after the costs from production are deducted.
2.	The Production Payment will terminate once the total monetary amount or production volumes have been met.		The life of the NPI is usually for the life of the producing property.
3.	A Production Payment is stated as a total dollar amount of proceeds or a production volume paid out of production.		A Net Profit Interest is stated as a percentage of profits.
4.	The Production Payment remains the same no matter if the project is moderately successful or a huge success.		If the project is successful, A Net Profit interest can have a better return than a Production Payment
5.	If there are unexpected operating expenses, they will not affect the production payment.		If there are unexpected operating expenses, they will be deducted before the NPI is calculated.

	The Production Payment	v.	The Overriding Royalty Interest
1.	The Production Payment can be created out of any type of interest (WI, ORRI, RI).		An ORRI is created only out of a WI.
2.	Production Payments are made when there is *production* from the associated project or properties. If an associated project ceases to produce, no additional payments will be made.		ORRI payments are made out of production from the lease(s) in which it was created. If one part of the lease ceases to produce - yet another part is included in a separate producing unit, the ORR continues to be paid.
3.	A Production Payment may end prior to the associated lease(s) termination.		The ORR will continue to be paid during the life of the lease(s) from which it was created.

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Production Payment Agreement

Date: _____

WHEREAS *Supreme Oil Well Drilling & Completions,* (the vendor) has given agrees to drill _____ wells in the *Madison Project*, and

WHEREAS, the estimated cost of drilling these wells is $_____ ,

WHEREAS, in exchange, the Lender shall receive as consideration a production payment of $_____ payable out of _____% of 8/8th of all oil, gas and associated hydrocarbons produced, saved and sold from the Genesis Project.

This interest shall be paid in the same manner as royalty is paid. All operational expenses including the payment or royalties, gas gathering, processing and transportation fees are to be borne by the Borrower.

At such time as the Lender receives the $_____, the _____% of 8/8ths revenue interest from the production payment shall revert to Borrower.

Signed:

_____

Supreme Oil Well Drilling & Completions

_____ _____

_____ _____

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