



Joint Operating Agreement

This following is aimed at providing insights into the most critical areas in joint operations and how they are likely to be resolved if your company is a party to a Joint Operating Agreement (“JOA”).

Question 1:

Assume your company assigned and recorded a 5% ORR 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 by whom?

Question 2:

Every month the Operator bills you in advance for its operations. The bill states that your payment must be made within 15 days of receipt of the bill. To your knowledge you are the only non-operator being billed in advance.

Last month you paid the bill but paid it 30 days after receipt. This month’s bill charged you interest on last month’s bill. Can the operator do this?

Question 3:

Assume your company owned one lease in the drilling unit. Due to an unfortunate error, the lease was lost due to a late rental payment. Your company was able to secure a new lease from the lessor four months after the original lease was lost.

Given these facts, what do you think should happen to everyone’s interest in the unit?

Question 4:

Assume it has been decided to proceed with a drilling operation. Do you think the operator should be allowed to spend any amount of money they want? Do you think the operator should be given limits? Do you think the operator should seek approval from the other non-operators?

The Model form has a Table of Contents that will look much like the one set forth below. Often portions on a particular article will be changed or deleted. Often, other conditions or obligations will be added.

- I. DEFINITIONS
- II. EXHIBITS
- III. INTERESTS OF PARTIES
 - A. OIL AND GAS INTERESTS
 - B. INTERESTS OF PARTIES IN COSTS AND PRODUCTION
 - C. SUBSEQUENTLY CREATED INTERESTS
- IV. TITLES
 - A. TITLE EXAMINATION
 - B. LOSS OR FAILURE OF TITLE
- V. OPERATOR
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RESIGNATION OR REMOVAL OF OPERATOR AND SELECTION
OF SUCCESSOR
 - 1. Resignation or Removal of Operator
- VI. DRILLING AND DEVELOPMENT
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 - 2. Operations by Less than All Parties
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 - A. LIABILITY OF PARTIES
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 - D. DEFAULTS AND REMEDIES
 - 1. Suspension of Rights
 - 2. Suit for Damages
 - 3. Deemed Non-Consent
- VIII. ACQUISITION, MAINTENANCE OR TRANSFER OF INTEREST
 - B. RENEWAL OR EXTENSION OF LEASES
 - D. ASSIGNMENT; MAINTENANCE OF UNIFORM INTEREST
- IX. INTERNAL REVENUE CODE ELECTION
- X. CLAIMS AND LAWSUITS
- XI. FORCE MAJEURE
- XII. NOTICES
- XIII. TERM OF AGREEMENT
- XIV. COMPLIANCE WITH LAWS AND REGULATIONS
- XV. MISCELLANEOUS
- XVI. OTHER PROVISIONS

Exhibits

This contract will also provide for a handful of exhibits. The content of each becomes a critical part of the JOA and should be understood within the context of the agreement.

The “Exhibit A” becomes a focal point around which many aspects of the contract revolve. On this exhibit, one will find a list of the member parties along with their interests, a list of the leases which are part of the JOA, the lands which are included within the Contract Area and the addresses of each party.

The “Exhibit B” is nothing more than a blank lease form. However, the provisions within this lease form are binding upon any party said to own an “oil and gas interest.”

The “Exhibit C” deals with all accounting procedures and those items that can be billed against joint operations.

The “Exhibit D” deals with insurance.

The “Exhibit E” is often omitted when operations within the contract area would not face gas balancing issues.

The “Exhibit F” is a “Certificate of Non-Discrimination and Non-Segregation of Facilities”.

The “Exhibit G” is provides for an optional “Tax Partnership”.

In this study, we do not attempt to cover all of the parts of the model form. A review of the Table of Contents below helps put this study in perspective:

Table of Contents of this Study

- 1. How Interests are Calculated**
- 2. What Happens when Interests are Lost**
- 3. Issues Regarding the Operator**
- 4. Drilling and Development**
- 5. Expenditures & Liabilities of the Parties**
- 6. Acquisitions & Transferring of Interests**

The Joint Operating Agreement

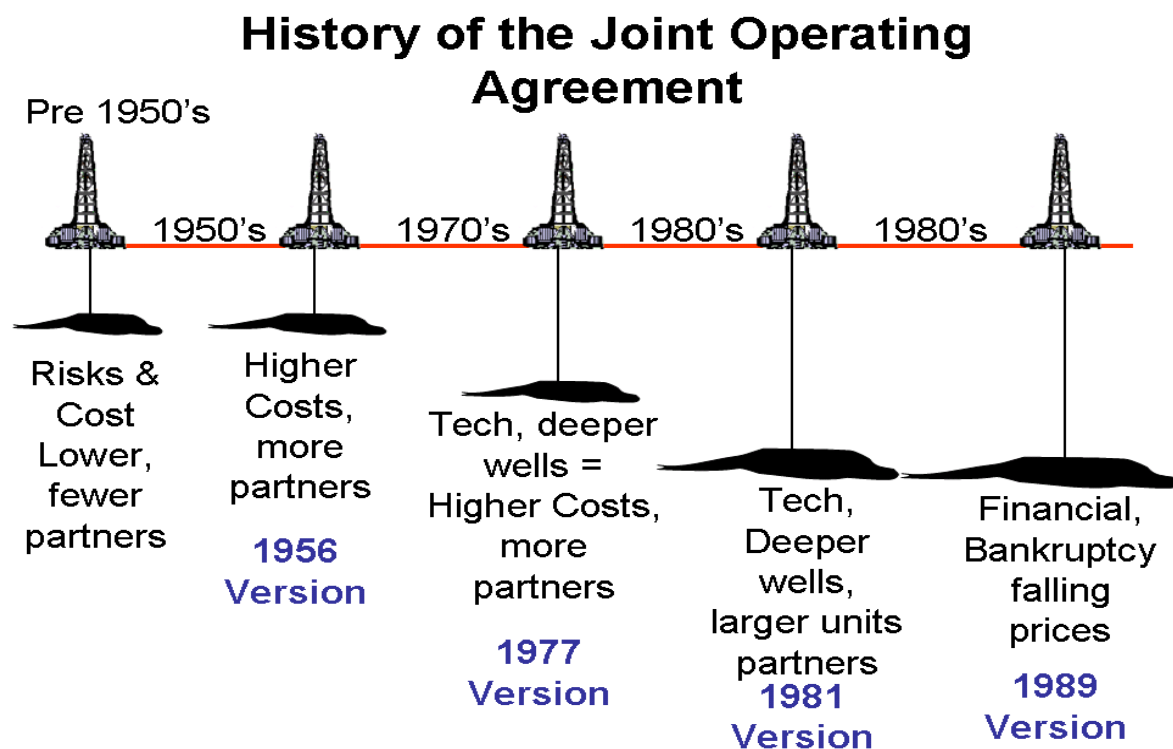
What is a JOA?

The 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 within the body of the contract along with the various exhibits which are attached.

History of the Joint Operating Agreement

This course will be covering one of the most important oil and gas contracts, used in the industry. As can be seen in the chart, the current form has evolved over the years.



Prior to 1950, drilling was much different than it is today. Costs were lower, units were smaller, partners were fewer and when joint operations did occur, they were usually done with the concept of drilling one well at a time.

Since the 1950's, the oil and gas industry has seen several periods of growth and decline. The growth came in the form of larger units, multiple producing zones, distinct spacing requirements, technology advancements, deeper wells and the number of oil companies wishing to drill wells. The declines came in the form of financial woes, litigations, bankruptcies, falling oil and gas prices, greater risks and more expensive wells.

From time to time, and as the industry entered into or came out of one of these periods, the American Association of Petroleum Landmen ("AAPL") set about to create a contract that would address such issues.

As can be seen, the results have been the 1956 Model Form, the 1977 Model Form, the 1981 Model Form and the most recent 1989 Model Form.

Definitions

The definition section of the JOA may appear to be a benign section of the contract; however, the issues addressed in the agreement are often complicated and can not be fully understood unless one has absorbed the definitions as set forth in the JOA. While reading the definitions will clarify some of the terms, it will also reveal that some definitions do not have the meaning one might expect.

The Contract Area

The Joint Operating Agreement addresses several vital aspects for developing an area referred to as the "Contract Area". This Contract Area, as set out on the cover page becomes the legal and binding contract that governs the development of the designated contract area.

Problems that may arise when dealing with the Contract Area

The Contract Area portion of the JOA does not appear to be of large concern since it only establishes a boundary in which operations will be taking place. However, this portion of the JOA is very important simply because the area as outlined as the contract area is bound by all of the terms and conditions as set forth in the agreement. In almost all cases, the contract area should be identical to that of the proration unit.

Problems can arise if the established contract area is larger than the units formed inside the area. Such problems will be discussed during the "Interests of Parties in Cost and Production" section of this study.

Conversely, problems can arise if the contract area is smaller than the development area.

Task

Assume that a well is to be located in Township 12 North, Range 15W, Section 7, Blaine County, Montana and that the contract area is to be identical to the proration unit. Assuming that all units in this area are based on a 640-acre unit, fill out the cover page to the JOA. Assume that Sunrise Oil & Gas has been designated as the operator. Establish the Contract Area.

A.A.P.L. FORM 610-1989

MODEL FORM OPERATION AGREEMENT

OPERATING AGREEMENT

DATED

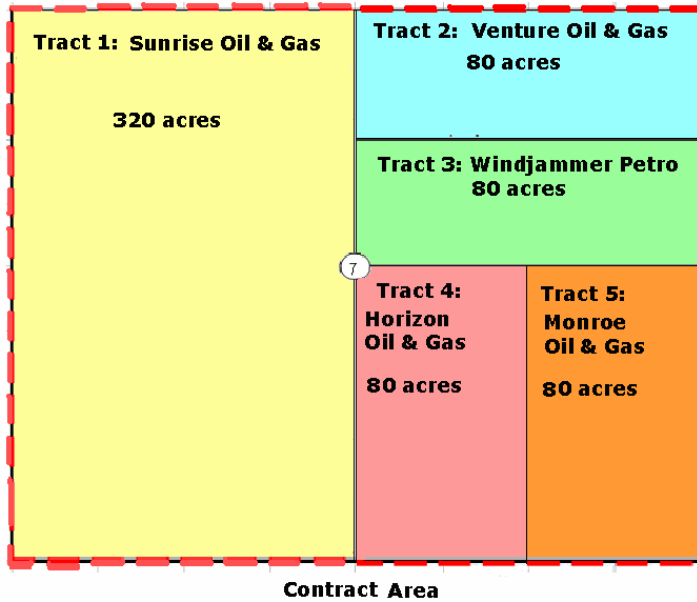
_____, 20__

OPERATOR _____

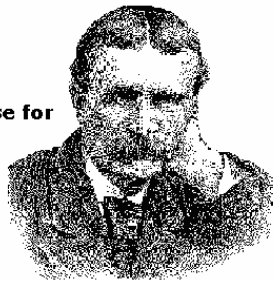
CONTRACT AREA _____

COUNTY OR PARISH OF _____ **STATE OF** _____

The following 640-acre plat depicts the contract area as designated by the JOA. Five tracts of land are included in the contract area, each held by a different lessee. The lessor's for each of the tracts of land are illustrated below the plat.



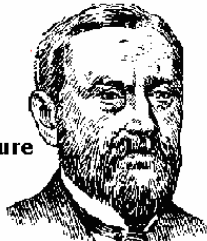
Tract 1
Don Price leased to Sunrise for an 18.75% royalty



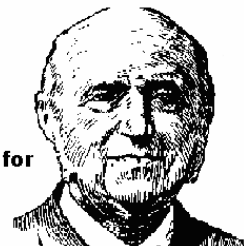
Tract 3
Kim Carter leased to Windjammer for an 18.75% royalty



Tract 2
Jerry Yancey leased to Venture for an 18.75% royalty



Tract 4
Matt Love leased to Horizon for an 18.75% royalty



Tract 5
Tom Kessler leased to Monroe for an 18.75% royalty



Article III. Interests of Parties in Cost and Production

In this Article, we will be looking at how interests are calculated inside the Contract Area.

In General, Exhibit "A," sets forth the percentages or fractions that indicate how the parties will own...

1. Production,
2. Equipment,
3. Other materials, and
4. How they will bear costs.

These percentages or fractions are usually based on the relative acreage position each party has in the Contract Area.

Owners of "oil and gas interests"

Read Article III. A. Who is this article referring to? Who are the owners of "oil and gas interests?"

As mentioned previously, the definition section of the JOA may appear to be a benign section of the contract; however, portions of the agreement can not be fully understood unless one has absorbed the definitions as set forth. This is one of those times. The term "Oil and Gas Interests" or "Interests" shall mean unleased fee and mineral interests in Oil and Gas in tracts of land lying within the Contract Area which are owned by parties to this agreement. Therefore, this provision is referring to those mineral owners who have not signed an oil and gas lease.

ARTICLE III.

INTERESTS OF PARTIES

A. OIL AND GAS INTERESTS:

If any party owns an Oil and Gas Interest in the Contract Area, that Interest shall be treated for all purposes of this agreement and during the term hereof as if it were covered by the form of Oil and Gas Lease attached hereto as Exhibit "B," and the owner thereof shall be deemed to own both royalty interest in such lease and the interest of the lessee thereunder.

The JOA also creates a formula for sharing expenses and production.
How are interests and expenses split?

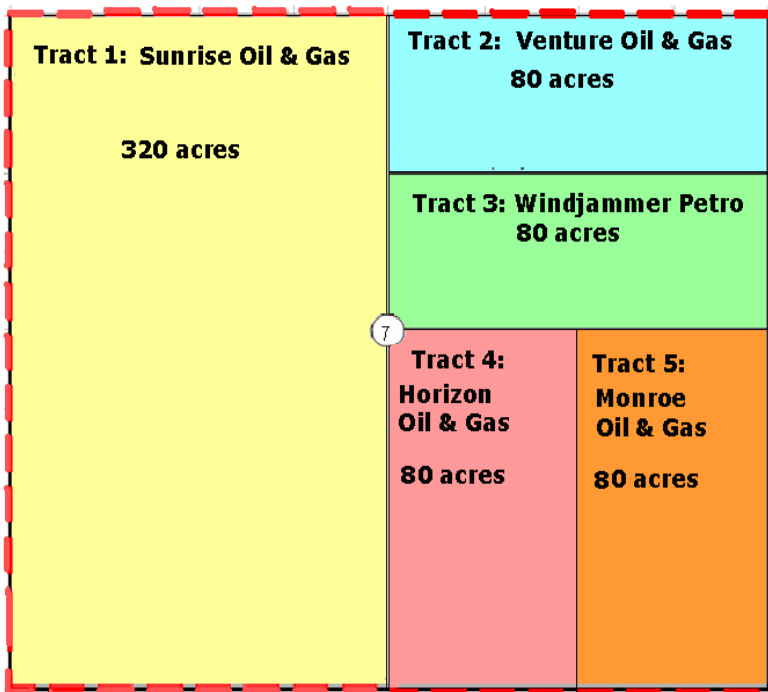
Question 1:

According to Article III.B., expenses are to be paid and production revenues are to be split as the interests are set out on 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.



Contract Area

The most common way to calculate the companies' interest as set out on the Exhibit "A" would be to divide the acres they are contributing to the unit by the total acres in the unit.

The result is the company's share of costs and production with each company bearing its own lease burdens.

Task 1: If the plat depicted the contract area as set out on the Joint Operating Agreement, determine what interests should be set out on the Exhibit "A" to the Operating Agreement.

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

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

Article III.B. Establishes how burdens are paid

Several fractional amounts could be placed in this blank. Usually, 1/8th or 3/16th would be the amount placed in this blank. If 1/8th were placed in the blank, all parties to the JOA would be obligated to pay their proportionate share of the 1/8th burdens.

Sunrise would pay 50% of the 1/8th, Venture, Windjammer, Horizon and Monroe would each pay 12.50% of the 1/8th.

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, _____ and shall indemnify, defend and hold the other parties free from any liability therefor. 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.

Payment of Royalties

Below are the leasehold interests for the referenced Contract Area:

Leasehold Interests

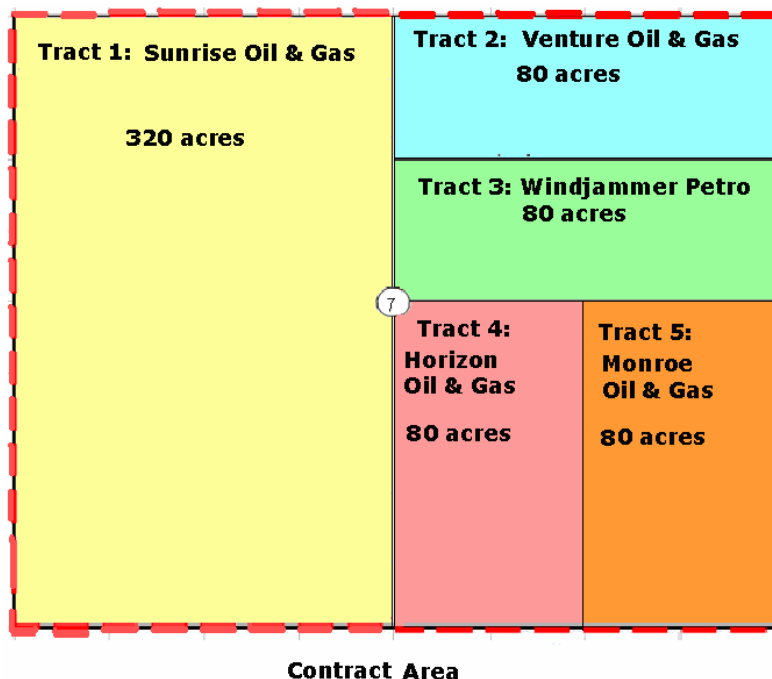
	Tract 1	Tract 2	Tract 3	Tract 4	Tract 5
Lessor	Don Price	Jerry Yancey	Kim Carter	Matt Love	Tom Kessler
Lessee	Sunrise Oil & Gas	Venture Oil & Gas	Windjammer Petro	Horizon Oil & Gas	Monroe Oil & Gas
Legal Description	T12N, R15W, Sec 7: W/2	T12N, R15W, Sec 7: N/2NE/4	T12N, R15W, Sec 7: S/2NE/4	T12N, R15W, Sec 7: W/2SE/4	T12N, R15W, Sec 7: E/2SE/4
Burdens	18.75% RI	18.75% RI	18.75% RI	18.75% RI, 6.25 ORR	18.75% RI

Question: Is the Operator is responsible to pay all royalty burdens on behalf of the Non-Operators?

- Yes
- No

According to the JOA, royalties are not an item that the operator is responsible to pay on behalf of the other partners. Each Non-Operator is responsible to pay their own burdens.

Burdens in Excess of this amount placed in the blank



Burdens in excess of the fraction inserted in the blank must be borne by the party who contributed the lease. Therefore, if $1/8^{\text{th}}$ was placed in the blank and Venture's burdens exceeded $1/8^{\text{th}}$, they alone would be responsible to bear the excess.

In the example as cited, Monroe Oil & Gas leased Tract 5. Their lease carries a $3/16^{\text{th}}$ royalty burden. According to Article III.B., Monroe Oil &

Gas is responsible to pay their proportionate share of the 1/8th and responsible to pay 100% of the excess burden (6.25%) they are contributing to the contract area.

When the Contract Area is Larger than a Single Drilling and Spacing Unit...

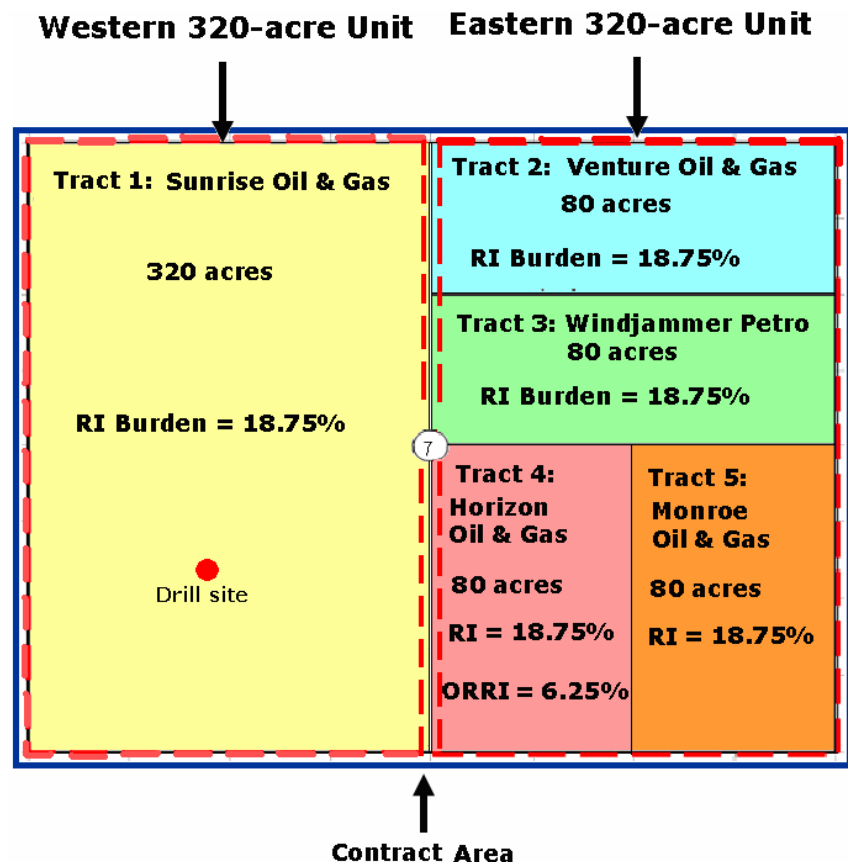
When drilling units are identical in size to the Contract Area, this does not pose any problem. However, oil companies may want to develop a Contract Area that is larger than a single Drilling and Spacing Unit. In these cases, the JOA's Contract Area can cover multiple drilling and spacing units as seen in the illustration.

Assume that Sunrise, Venture, Windjammer, Horizon and Monroe have all entered into a JOA covering a 640-acre tract of land, designated as the "Contract Area" Section 7: All.

Also assume that the Contract Area was divided into two separate 320 acre Drilling and Spacing Units and the Initial Test Well was to be drilled in the Western Unit or the W/2.

This can pose a particular problem when calculating interests.

The same issue would result if the original well was reclassified and the governing regulatory agency de-spaced the unit from a 640-acre unit and re-spaced it to a 320-acre or smaller unit. All states allow the de-spacing and re-spacing of units. The contract area would still cover the entire 640 acres; however the unit would be smaller than the contract area.



Assume Sunrise Oil & Gas owns the W/2 of the section in its entirety. The W/2 is its own Proration unit. Sunrise wishes to drill a well in the western unit? Who pays for the costs of drilling the well in the western unit? Who owns what percentage of the production from the well?

Answer: Each party is bound by the terms of the JOA. According to Article III B. "Interests of Parties in Costs and Production: Unless changed by other provisions ... shall be borne and paid ... on the Contract Area ... as their interests are set forth in Exhibit "A". Therefore, the interests are: Sunrise = 50%, Venture, Windjammer, Horizon and Monroe each 12.5%.

If the Contract Area was divided into two separate Proration Units and the W/2 unit was producing, which royalty owner(s) are to be paid?

**Tract 1
Don Price**

- Yes
- No



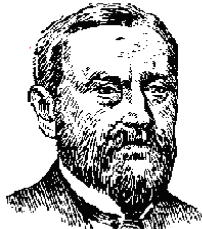
**Tract 3
Kim Carter**

- Yes
- No



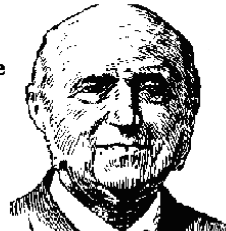
**Tract 2
Jerry Yancey**

- Yes
- No



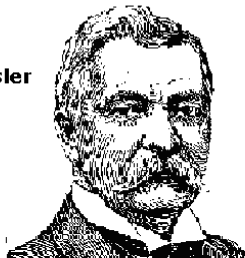
**Tract 4
Matt Love**

- Yes
- No



**Tract 5
Tom Kessler**

- Yes
- No



Answer: Generally, only the royalty owner 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 would be Don Price, Sunrise's lessor.

Assume the W/2 is its own Proration Unit and the royalty burden in each of the leases in the Contract Area is 18.75%.

The only ORR burden is on the Horizon lease. This lease is not located in the producing unit.

One-eighth (1/8th) was placed in the blank in Article III.B.

Any burdens over and above that interest are considered an excess burden. Therefore, every royalty has an excess over and above the 1/8th and the Horizon ORR has an additional excess over and above the 1/8th.

Sunrise is obligated to pay for 50% of the well expenses and receive 50% of the revenue. They also are responsible to pay 50% of the 1/8th burden and a full 6.25% of the excess burdens on their lease.

In a situation like this, Sunrise's net revenue on their lease has been significantly impacted. The other parties to the JOA are only paying their share of the 1/8th (12.5%) burden giving them 87.5% net revenue on their leases. Sunrise is paying their share of the 1/8th (12.5%) and an additional (full) 6.25% in excess burdens giving them a 75% net revenue interest.

ARTICLE III. INTERESTS OF PARTIES

B. Interests of Parties in Costs and Production:

...Regardless of which party has contributed any Oil and Gas Lease ... 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 ...if any party has contributed hereto any Lease or Interest which is burdened with any royalty, overriding royalty, production payment or other burdens on production in excess of the amounts stipulated above, such party so burdened shall assume and alone bear all such excess obligations ...

Based on this information, calculate the Net Revenue Interests of each of the Oil Companies.

Western Half Unit

	GWI	NRI
Sunrise	50.000%	
Venture	12.500%	
Winjammer	12.500%	
Horizon	12.500%	
Monroe	12.500%	
Total	100.000%	

Subsequently Created Interests Article III.

A Subsequently Created Interest is defined as any burden created after the date of the JOA or any burden not listed on the Exhibit "A". Unless the other parties to the JOA 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 the Exhibit "A".

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 therefor.

Scenario

Assume that Monroe Oil & Gas assigned a 5% ORR to their geologist after the JOA was signed. Sunrise Oil & Gas proposed the drilling of a subsequent well in the Contract Lands and Monroe Oil & Gas decided to go non-consent in an operation. According to this provision, the other parties to the JOA are not responsible to pay the Geologist's Override.

Since the participating parties are not obligated to pay the ORR out of their share of production, the question should be asked, "Who is responsible to pay?" The answer is that even though Monroe Oil & Gas has non-consented the operations, they are responsible to pay their override burden.

Article IV. Titles

An issue that poses a particularly troublesome problem for operations is when a lease is lost or terminated. An entire section of the JOA is dedicated to addressing this issue. Article IV. deals with four scenarios surrounding the loss of interests and the issue of acquiring title examination prior to the commencement of drilling operations.

1. Loss of interest due to Title Failure
2. Loss of interest due to Improper payment
3. Losses of interest that are considered a Joint Loss
4. Losses of interest due to the Surrender of leases

The Requirement for Title

Article IV.A requires title examination prior to the commencement of any drilling operations.

ARTICLE IV.

Titles

A. Title Examination:

Title examination shall be made on the drillsite of any proposed well prior to commencement of drilling operations or, if the Drilling Parties so request, title examination shall be made on the leases and/or oil and gas interests included, or planned to be included, in the drilling unit around such well. The opinion will include the ownership of the working interest, minerals, royalty, overriding royalty and production payments under the applicable leases....

Loss of Interest Due to Failure of Title

According to Article IV., if a lease is lost due to failure of title, the loss becomes an individual loss. Read the article and determine what an individual loss means.

ARTICLE IV. TITLES

A. Loss or Failure of Title:

1. Failure of Title: Should any Oil and Gas interest or Oil and Gas Lease be lost through failure of title, which results in a reduction of interest from that shown on Exhibit "A", the party credited with contributing the affected Lease or Interest ... shall have ninety (90) days from final determination of title failure to acquire a new lease or other instrument curing the entirety of the title failure, which acquisition will not be subject to Article VIII.B., and failing to do so, this agreement, nevertheless, shall continue in force as to all remaining Oil and Gas Leases and Interests; and,

(a) The party credited with contributing the Oil and Gas Lease or interest affected by the title failure ... shall bear alone the entire loss and it shall not be entitled to recover from Operator or the other parties any development or operating costs which it may have previously paid or incurred ...

(b) There shall be no retroactive adjustment of expenses incurred or revenues received from the operation of the Lease or Interest which has failed, but the interests of the parties contained on Exhibit "A" shall be revised on an acreage basis, as of the time it is determined finally that title failure has occurred, so that the interest of the party whose Lease or Interest is affected by the title failure will thereafter be reduced in the Contract Area by the amount of the Lease or Interest failed;

Scenario

Assume the Venture lease was lost due to failure of title. Would the contract area be revised?

If a third party leased the Venture tract, the "contract area" could remain the same, so the 'contract area' would not need to be revised. The only thing that would change would be interests on the Exhibit "A".

**ARTICLE IV.
TITLES**

A. Loss or Failure of Title:

(c) If the proportionate interest of the other parties hereto in any producing well previously drilled on the Contract Area is increased by reason of the title failure, the party who bore the costs incurred in connection with such well attributable to the Lease or Interest which has failed shall receive the proceeds attributable to the increase in such interest (less costs and burdens attributable thereto) until it has been reimbursed for unrecovered costs paid by it in connection with such well attributable to such failed Lease or Interest;

(d) Should any person not a party to this agreement, who is determined to be the owner of any Lease or Interest which has failed, pay in any manner any part of the cost of operation, development, or equipment, such amount shall be paid to the party or parties who bore the costs which are so refunded;

According to Article IV., the party who lost the lease can recover previous expenditures such as drilling related costs.

These costs would be recovered not from parties to the JOA but from the party who succeeded to the interest that was lost.

Loss of Interest Due to an improper Payment

Also provided for is the loss of title involving a leasehold interest due to an unintentional failure to pay or a mistake in the amount of any money due a lessor. This could happen in any one of the following cases:

- a delay rental payment
- shut-in royalty payment
- minimum royalty
- royalty

**ARTICLE IV.
TITLES**

2. Loss by Non-Payment or Erroneous Payment of Amount Due: If, through mistake or oversight, any rental, shut-in well payment, minimum royalty or royalty payment, or other payment necessary to maintain all or a portion of an Oil and Gas Lease or Interest is not paid or is erroneously paid, and as a result a Lease or Interest terminates, there shall be no monetary liability against the party who failed to make such payment. Unless the party who failed to make the required payment secures a new Lease or Interest covering the same interest within ninety (90) days from the discovery of the failure to make proper payment, which acquisition will not be subject to Article VIII.B., the interests of the parties reflected on Exhibit "A" shall be revised on an acreage basis, effective as of the date of termination of the Lease or Interest involved, and the party who failed to make proper payment will no longer be credited with an interest in the Contract Area on account of ownership of the Lease or Interest which has terminated.

According to Article IV.2., if a lease is lost due to a late rental payment, the interests as set out on the Exhibit "A" will be revised.

**ARTICLE IV.
TITLES**

If the party who failed to make the required payment shall not have been fully reimbursed, at the time of the loss, from the proceeds of the sale of Oil and Gas attributable to the lost Lease ... previously paid on account of such Lease ... it shall be reimbursed for unrecovered actual costs previously paid by it (but not for its share of the cost of any dry hole previously drilled ... from so much of the following as is necessary to effect reimbursement:

(a) Proceeds of Oil and Gas produced prior to termination of the Lease ... less operating expenses and lease burdens ... up to the amount of unrecovered costs;

(b) Proceeds of Oil and Gas, less operating expenses and lease burdens ... up to the amount of unrecovered costs attributable to that portion of Oil and Gas thereafter produced and marketed ... which, in the absence of such Lease or Interest termination, would be attributable to the lost Lease or Interest on an acreage basis and which as a result of such Lease or Interest termination is credited to other parties, the proceeds of said portion of the Oil and Gas to be contributed by the other parties in proportion to their respective interests reflected on Exhibit "A" and,

(c) Any monies, up to the amount of unrecovered costs, that may be paid by any party who is, or becomes, the owner of the Lease or Interest lost, for the privilege of participating in the Contract Area or becoming a party to this agreement.

First Scenario

Assume the company who lost the lease had paid for 100% of their share of drilling costs but, at the time the lease was lost, had only received reimbursement for 25% of those costs. A recovery of the additional 75% of costs already paid can be recovered out of any future production.

Second Scenario

Read the portion of Article IV found on the previous page and then assume the following: Windjammer leased Kim Carter under Tract 3 in the Contract Area. A rental payment of \$160.00 was due Kim Carter on October 17th. On October 17th, the entire Windjammer land department was sailing in the Mediterranean. The rental payment was not sent to Kim Carter until October 31st.

Because of the late rental payment, Windjammer lost the Kim Carter lease. For several weeks, Windjammer attempted to re-lease Kim Carter but she refused unless Windjammer paid her a bonus of \$48,000.

If Kim Carter signed a renewal lease with Windjammer Petroleum on December 17th (within the ninety day 90 window) then the new acquisition lease would not be subject to Article VIII.B and the Contract Area and interests on the Exhibit "A" would remain the same.

If Kim Carter signed a renewal lease with Windjammer Petroleum on January 31st, (outside of the ninety day 90 window) the outcome would be very different. In most cases, the JOA partners would most likely offer grace to Windjammer and nothing would change. However, if they wanted to hold Windjammer to a strict interpretation of the JOA, they would refer to Article VIII.B.

Read this article and determine what could be the result.

There are three possible scenarios:

1. A new lease is secured within the 90 day time frame as set out in the JOA. The result is that nothing happens and everyone proceeds as if the lease had not been lost.
2. A new lease is not secured. The results are that the interests on Exhibit A is revised and the party will not be credited with and interest in the contract area.
3. A "Replacement Lease" is secured after the 90 day time frame as set out in the JOA. The results found in Article VIII.B the acquiring party must offer the lease to the other parties in the JOA.

**ARTICLE VIII.
ACQUISITION, MAINTENANCE OR TRANSFER OF INTEREST**

B. Renewal or Extension of Leases:

If any party secures a renewal or replacement of an Oil and Gas Lease or Interest subject to this agreement, then all other parties shall be notified promptly upon such acquisition or, in the case of a replacement Lease taken before expiration of an existing Lease, promptly upon expiration of the existing Lease. The parties notified shall have the right for a period of thirty (30) days following delivery of such notice in which to elect to participate in the ownership of the renewal or replacement Lease, insofar as such Lease affects land within the Contract Area... Each party who participates in the purchase of a renewal or replacement Lease shall be given an assignment of its proportionate interest therein by the acquiring party.

...The acquisition of a renewal or replacement Lease by any or all of the parties hereto shall not cause a readjustment of the interests of the parties stated in Exhibit "A", but any renewal or replacement Lease in which less than all parties elect to participate shall not be subject to this agreement but shall be deemed subject to a separate Operating Agreement in the form of this agreement.

...Any renewal or replacement Lease taken before the expiration of its predecessor Lease, or taken or contracted for or becoming effective within six (6) months after the expiration of the existing Lease, shall be subject to this provision so long as this agreement is in effect at the time of such acquisition or at the time the renewal or replacement Lease becomes effective...

The provisions in this Article shall also be applicable to extensions of Oil and Gas Leases.

Losses of Interest that are Considered a "Joint Loss"

There are also losses that would be a "joint loss." Many companies will modify their JOA's so that all losses are considered joint losses. Under a Joint Loss Agreement, losses are shared and no adjustment to ownership interest is made with respect to the remaining acreage in the Contract Area.

**ARTICLE IV.
TITLES**

3. Other Losses: All losses of Leases or Interests committed to this agreement, other than those set forth in Articles IV.B.1 and IV.B.2 above, shall be joint losses and shall be borne by all parties in proportion to their interests shown on Exhibit "A". This shall include but not be limited to the loss of any Lease or Interest through failure to develop or because express or implied covenants have not been performed (other than performance which requires only the payment of money), and the loss of any Lease by expiration at the end of its primary term if it is not renewed or extended. There shall be no readjustment of interests in the remaining portion of the Contract Area on account of any joint loss.

Joint Losses would normally occur when

1. Leases are lost due to failure of development
2. Leases are lost due to express or implied covenants
3. Leases are lost due to expiration of primary term

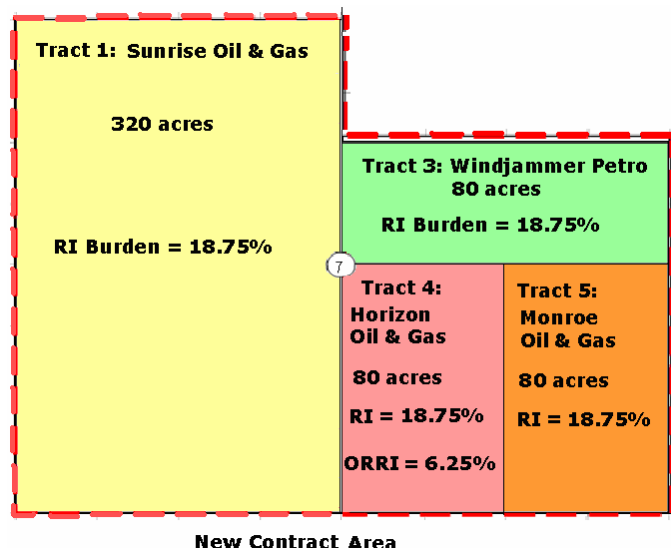
Scenario

Assume the Venture's lease expired prior to the drilling of a well through a "joint loss" provision. If this lease is not renewed, its lands are no longer included in the Contract Area and the loss becomes a "joint loss".

The Drilling and Spacing Unit stays the same but...

The new Contract Area would include only the W/2, SE4, S/2NE4.

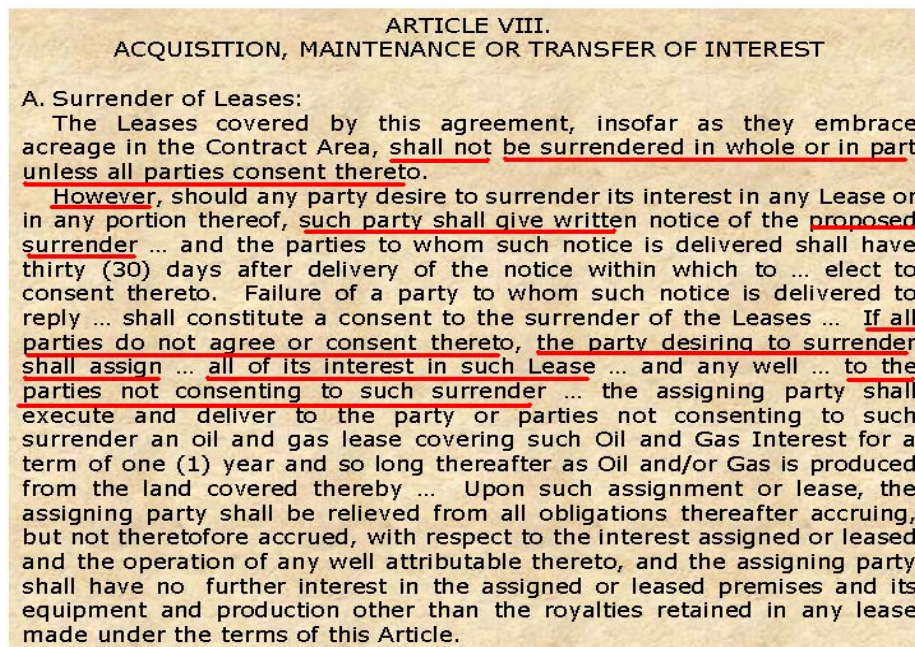
Assume that the Venture lease was lost due to a "joint loss" issue.



Venture now owns no interest in the Contract Area; however, Venture would still remain as a WI owner in the Joint Operating Agreement.

Venture owns no leases within the new Contract Area, yet, the interests as set out on the Exhibit "A" are not revised as to the new Contract Area. Venture, although no longer contributing any leases to the contract area, still owns a 12.5% interest in the contract lands.

Losses of Interest Due to a Surrender of the leases



Scenario

Read Article VIII.A and then assume the following. Sunrise was drilling the initial test well on Tract 2 (the Venture Oil & Gas lease and the Jerry Yancey Tract of land). Sunrise was unaware that at a depth of 500' they would encounter contaminated water – and lots of it!

The contaminated water flowed up the well bore through the grass and down to the lake on Jerry Yancey's property!

Within 3 days...there were dead fish everywhere!

Jerry Yancey was so angry he threatened to sue all of the parties to the JOA!

Under the terms of the JOA, Venture Oil & Gas (Jerry Yancey's Lessor) immediately wanted to surrender its lease in the contract area.

Sunrise, Windjammer and Horizon consented to the surrender; however, Monroe did not give their consent for the surrender.

According to the language in the JOA, Venture would assign its interest in the lease to the party or parties that did not agree to the surrender. In this case, the assignment would go to Monroe.

Article VIII.A is speaking about surrendering or giving the lease back to the lessor. Most leases contain language whereby the lessee can give up the lease by surrendering it back to the lessor. When this happens the lease has been terminated. You might see this happen when a company is in danger of a lawsuit. In the situation as described, Venture wanted to terminate their lease by giving it back to Jerry Yancey.

The heart and soul of Article VIII.A is to keep leases from being surrendered back to lessors and gives the other parties to the JOA the option to non-consent the surrender. Any party that disagrees or non-consents the surrender would receive an assignment of the lease. This non-consenting party must then reimburse the assignor for the reasonable salvage value of equipment.

Type of Loss	1. Loss Through Title Failure	2. Loss Through Non-payment	3. Loss Through Joint Loss	4. Loss Through Surrender of Lease
Affect of Loss	Individual Loss	Individual Loss	Joint Loss	Individual Loss
Requirement	90-days to Acquire a new lease	90-days to Acquire a new lease	Exhibit "A" is not Revised - Loss is no longer a part of the Contract Area	Must give notice to others. They have 30 days to elect or non-consent the surrender
If Requirement is met	If acquired in 90-days the interests in contract area stay the same	If acquired in 90-days the interests in contract area stay the same		Assign interest/lease to the non-consenting party(s)
If Requirement is not met	If not acquired in 90-days, Exhibit "A" is revised	If not acquired in 90-days, Exhibit "A" is revised		Interest assigned is not subject to this JOA but subject to a JOA in the form of this JOA
What happens to the Contract Area?	Failing party's interest is reduced in Contract Area	Failing party's interest is reduced in Contract Area	Failing party's interest remains the same in the new Contract Area	Failing party's interest is reduced in Contract Area

Article V. Operator

Issues relating to the Operator

It is obvious that many companies choose to become Non-Operators rather than operators simply because they do not want to deal with the day-to-day issues related to operating properties. Many smaller companies simply do not have the personnel needed to administrate properties under operations. These companies do; however, want those that choose to become operators to be honest, diligent and work in their best interest.

It is important to note that in order for an operator to carry out its responsibilities in a prudent manner the JOA must grant them certain power and control over operations. It is widely accepted that the 1989 Model Form grants significant powers to an operator. For example, consider the following portion of the 1989 JOA.

Sunrise Oil and Gas shall be the Operator of the Contract Area, and shall conduct and direct and have full control of all operations on the Contract Area as permitted and required by, and within the limits of this agreement. In its performance of services hereunder for the Non-Operators, Operator shall be an independent contractor not subject to the control or direction of the Non-Operators except as to the type of operation to be undertaken in accordance with the election procedures contained in this agreement...

This language grants full control over operations as “permitted and required by, and within the limits of this agreement.”

There are instances when limitations are placed on the operator. Examples would be when a new operation is being initiated or when an existing operation is being terminated.

Operator Mistakes

ARTICLE V. OPERATOR

ARTICLE V.A.(From 1989 Model Form). DESIGNATION AND RESPONSIBILITIES OF OPERATOR:

...Operator shall conduct its activities under this agreement as a reasonable prudent operator, in a good and workmanlike manner, with due diligence and dispatch, in accordance with good oilfield practice, and in compliance with applicable law and regulation, but in no event shall it have any liability as Operator to the other parties for losses sustained or liabilities incurred except such as may result from gross negligence or willful misconduct.

Operators have been known to make mistakes. Those mistakes can cost every party to the agreement a significant amount of money. The 1989 Model Form simply says that the Operator must carry out operations in a good and workmanlike manner, with due diligence and dispatch, in accordance with good oilfield practice and in compliance with applicable law. Thus, the operator can not be held liable for any mistake or event occurring within the boundary of these terms.

Removal of the Operator

In order to remove an Operator under the terms of the 1989 Model Form, an affirmative vote among two or more of the Non-Operators is required. This vote must contain a majority interest based on the ownership on the Exhibit "A" excluding the interest of the Operator. The action must also cite the existence of specified types of cause.

Note: the language simply says that an operator may be removed only for good cause. Such language has often breed court action and Non-Operators have found that removing an Operator is very difficult.

Note: the 1989 form provides for the voluntary resignation of the Operator and the designation of a new Operator.

Art. V.B.

RESIGNATION OR REMOVAL OF OPERATOR AND SELECTION OF SUCCESSOR:

1. Resignation or Removal of Operator: Operator may resign at any time... Operator may be removed only for good cause by the affirmative vote of two or more Non-Operators owning a majority interest based on ownership as shown on Exhibit "A" remaining after excluding the voting interest of Operator; such vote shall not be deemed effective until a written notice has been delivered to the Operator by a Non-Operator detailing the alleged default and Operator has failed to cure the default within thirty (30) days from its receipt of the notice or, if the default concerns an operation then being conducted, within forty-eight (48) hours of its receipt of the notice. For purposes hereof, "good cause" shall mean not only gross negligence or willful misconduct but also the material breach of or inability to meet the standards of operation contained in Article V.A. or material failure or inability to perform its obligations under this agreement.

Scenario

Read Article V.B and then assume the following. Sunrise is the operator of the contract lands. Sunrise drilled and completed two producing wells inside the unit.

The last well was completed six months ago.

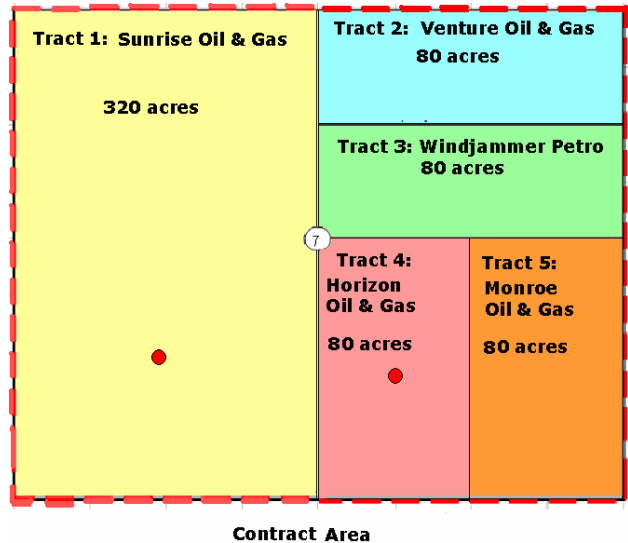
The Non-Operators just received their monthly "Operational and Administrative Cost Invoice" from Sunrise for their share of the costs of the unit.

Among other things, this bill included the cost incurred from the death of two cows and a supplemental title opinion done by one of Sunrise's attorneys.

Horizon Oil & Gas compared this invoice with past invoices and noticed that this was the fourth dead cow; that six months earlier they had been charged for a supplemental title opinion; and that the pumper's fees had increased by more than 30% over the same time period.

Horizon called Monroe Oil & Gas and inquired about their concerns of over billing, the number of dead animals and the reasonable rates for pumpers. Both companies agreed that something should be done; that Sunrise should be removed as operator and that Horizon should be appointed as the new operator. Monroe and Horizon want Sunrise removed as Operator but they need to contact the other Non-Operators for their support. The companies attempted to contact Windjammer to get their support, but Windjammer's entire land department was sailing in the Mediterranean. During their phone conversation with Venture's landman, they realized that Venture's CEO was married to the daughter of Sunrise's CEO.

What options, if any, are at Horizon and Monroe's disposal?



Administration of the Unit

According to the terms in the JOA, Non-Operators do have the right to access the "Contract Area" and the right to receive information about operations they have chosen to participate in and also those operations in which they have chosen not to participate.

Art. V.D. 5-7 (from 1989 Model Form)

5. Access to Contract Area and Records: Operator shall, except as otherwise provided herein, permit each Non-Operator or its duly authorized representative, at the Non-Operator's sole risk and cost, full and free access at all reasonable times to all operations of every kind and character being conducted for the joint account on the Contract Area and to the records of operations conducted thereon or production therefrom, including Operator's books and records relating thereto. Such access rights shall not be exercised in a manner interfering with Operator's conduct of an operation hereunder and shall not obligate Operator to furnish any geologic or geophysical data of an interpretive nature unless the cost of preparation of such interpretive data was charged to the joint account.

Accurate Records

One of the clear obligations of the Operator is that of keeping accurate records for the joint account. This information is also available to the Non-Operators.

Article. V.D. 2 from 1989 Model Form

1. Discharge of Joint Account Obligations: Except as herein otherwise specifically provided, Operator shall promptly pay and discharge expenses incurred in the development and operation of the Contract Area pursuant to this agreement and shall charge each of the parties hereto with their respective proportionate shares upon the expense basis provided in Exhibit "C." Operator shall keep an accurate record of the joint account hereunder, showing expenses incurred and charges and credits made and received.

Accounting and Payments

The Accounting Procedure establishes how the billing on non-operators is to take place and Article V.D.3 expressly states that the Operator will keep the Contract Area free from any liens and encumbrances.

Art. V.D. 3 from 1989 Model Form

1. Protection from Liens: Operator shall pay, or cause to be paid, as and when they become due and payable. all accounts of contractors and suppliers and wages and salaries for services rendered or performed, and for materials supplied on, to or in respect of the Contract Area or any operations for the joint account thereof, and shall keep the Contract Area free from liens and encumbrances resulting therefrom except for those resulting from a bona fide dispute as to services rendered or materials supplied.

Article VI. Drilling and Development

Procedures

The type of activity and the JOA Model Form version will set forth the procedures for beginning various types of operations, conducting such operations and how disputes are to be resolved between the parties concerning such operations. The JOA addresses five types of operations:

1. The initial well
2. Subsequent wells
3. Operations for existing wells
4. Extension, surrender or renewal of leases
5. Construction

Usually, when a proposal is made and the parties need to elect to proceed, it has to do with operations on a previously commenced well. Or, it has to do with a proposal to drill a subsequent well.

Remember, the initial well was approved when the parties signed the JOA. For that well, all the parties must participate in the same ratio as their interests were set forth in Exhibit "A."

The procedures for reworking, plugging back, deepening, completion, etc. of the initial well is typically the same as those for conducting wellbore operations for any subsequent well that is in the Contract Area.

Where the Operator May Proceed Without Consent

Some operations do not require the consent from all non-operators. This does not mean that the non-operators do not share in the cost of the procedures. They do. Assume that a fire broke out at a drilling location, an explosion occurred or a tornado destroyed a site. In cases when emergencies demand immediate action, the Operator must act decisively, promptly and does not need the consent of non-operators.

Activities that require Mandatory Consent

There are; however, activities that can only be performed with the consent of all parties. If that full consent is not obtained, the procedure can not be performed. Read the following. In this case, the initial well can only be drilled with the consent of all parties. That consent was obtained with the signing of the JOA.

Article. VI.A. A. (From 1989 Model Form).

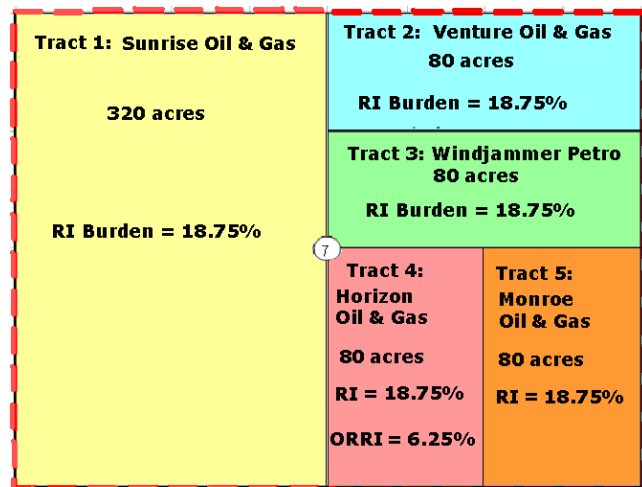
INITIAL WELL:

On or before the 1st day of July, 2001, Operator shall commence the drilling of the Initial Well at the following location:

660' FEL & 1980' FSL, SECTION 8, BLOCK 341, T-7-S, T&P RR Co. Survey, Midland County, Texas.

The drilling of the Initial Well and the participation therein by all parties is obligatory, subject to Article V1.C.1. as to participation in Completion operations and Article V1.F. as to termination of operations and Article XI as to occurrence of force majeure.

Assume that all parties in the illustrated contract area signed the JOA. According to Article.VI.A.A they could not choose to non-consent the drilling of the well, instead they are now obligated and committed to participate in the drilling of the initial test well.

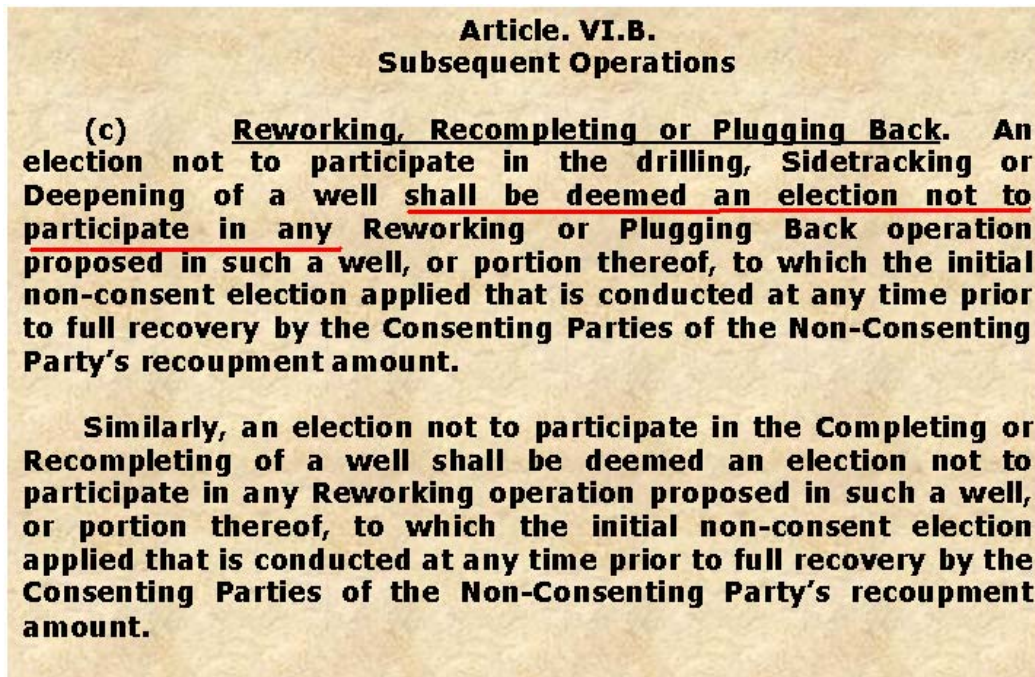


Contract Area

Other activities that require mandatory consent:

1. Discontinuing drilling of an initial test well
2. Not completing an initial well
3. Not putting an initial well on-stream.

Subsequent Operations



Subsequent operations are a category whereby the parties to the JOA can elect to participate or not participate in the operation.

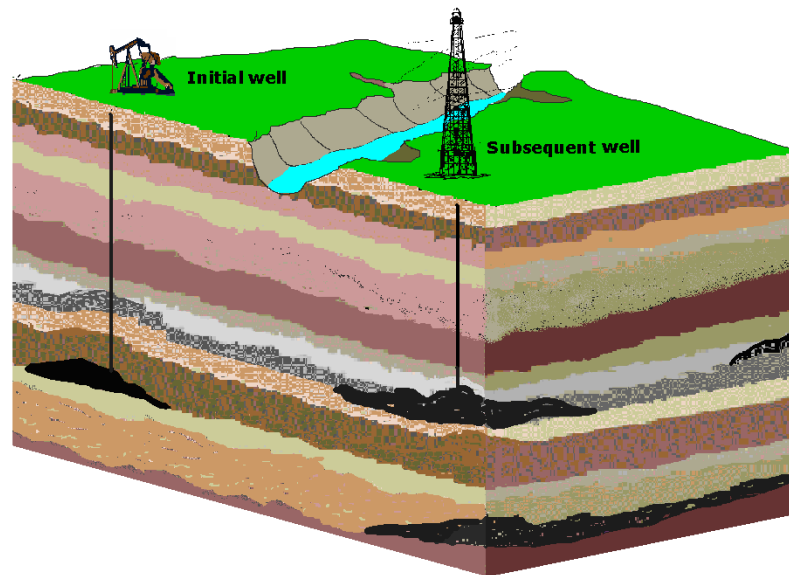
Subsequent operations that require an election of the parties include:

1. Drilling for a subsequent well
2. Reworking a well
3. Plugging back a well
4. Deepening a well
5. Completion, etc. of the initial well

Assume the following:

First Scenario

Windjammer Petroleum participated in the initial test well as illustrated. They then chose to participate in the drilling of the subsequent well which was to be completed in a shallower zone. That zone showed some potential but had significant geologic and engineering issues. Windjammer chose to non-consent the completion of that well. Sunrise, the operator, recently proposed the reworking of that zone.



The question should be asked, "According to Article.VI.B can Windjammer participate in the reworking procedure?" _____

Second Scenario

If, instead, Sunrise proposed the deepening of the well to deeper zone, could Windjammer participate in this operation? _____

The answer to this question is not necessarily easy to decide. Land professionals vary in their response. For instance, Dorsey T. Roach an expert on the Joint Operating Agreement poses the same question,

"Some oil and gas professionals subscribe to the belief that when a well reaches total depth and a recommendation to set pipe and attempt a completion is presented to the drilling parties, an election to go non-consent results in forfeiture of all rights in the wellbore for subsequent recompletions until payout of the non-consent penalties. This goes against the argument

that you get a separate election as to each separate completion, or recompletion attempt. Who is right?"

Some would state that if Windjammer was still in the penalty phase of the original non-consent, they would not be able to participate in the reworking, recompleting, and plugging back of the well. Others might disagree.

Defining recompletion may add to the confusion

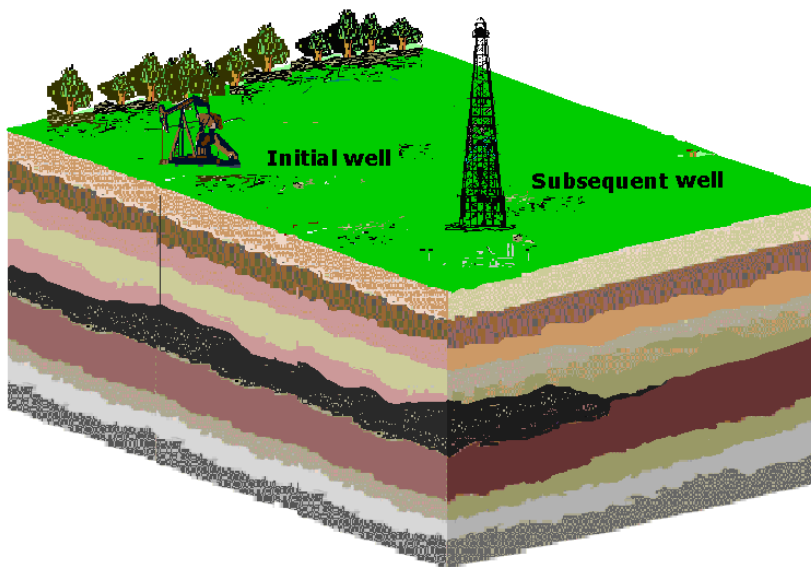
According to the US Department of Labor – Oil and Gas Well Drilling and Servicing, recompletion takes place after the initial completion of a well and becomes the actions and techniques of reentering the well and redoing or repairing the original completion to restore the well's productivity.

According to Minerals Management Consultants, recompletion would be the completion for production of an existing well bore in another formation from that in which the well has been previously completed.

According to Oil.net, Recompletion would be an operation involving any of the following: (1) Deepening from one zone to another zone.(2) Completing well in an additional zone.(3) Plugging back from one zone to another zone.(4) Sidetracking to purposely change the location of the bottom of the well, but not including sidetracking for the sole purpose of bypassing obstructions in the borehole.(5) Conversion of a service well to an oil or gas well in a different zone.(6) Conversion of an oil or gas well to a service well in a different zone.

Operation by Less than all Parties

The 1989 Model Form establishes what will happen when less than all parties agree to an operation. Any party who non-consents an operation is subject to what is called a "production penalty." Meaning, they will be penalized their share of production during the penalty phase, as set out in the JOA. Their interest is said to be "carried" during this penalty phase. Meaning, other parties to the agreement will be paying the non-consenting parties share of costs.



First Scenario

Assume that Horizon chose to non-consent the drilling of a subsequent well. A few days before the well began drilling; Horizon changed its mind and notified the operator that they now wanted to participate. Can they do this?

This is one question that the JOA does not specifically address. With that being said, the other partners, may in fact, allow Horizon

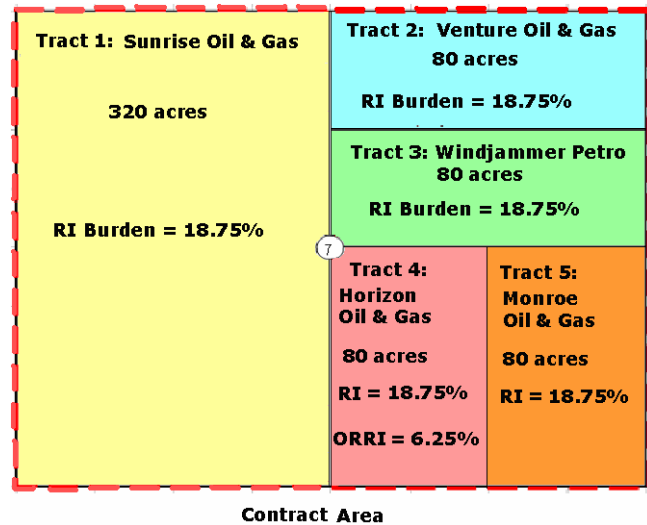
to participate in the drilling operation. If Horizon did go non-consent in the drilling of the subsequent well, the JOA will allow them to have access to all well information.

Second Scenario

Assume that Sunrise proposed a subsequent well anywhere inside the contract area and both Horizon and Monroe Oil & Gas felt that the second well was too risky and decided not to participate in the drilling of the well.

Since these non-consenting parties own leasehold interests inside the unit boundary, the question should be asked, "What do we do with their interests? Do we re-draw the unit boundary and exclude these leasehold tracts?"

If we do not re-draw the unit outline, who pays for the expenses associated with the Horizon and Monroe tracts of land? The answer will be found in the terms of Article VI. Of the JOA. In most cases all parties who are participating in the well will have the option but not the obligation to pick up their proportionate share of the non-consent interest.



If the well was drilled and was found to be productive, who would receive the revenue associated with that portion of the unit? This is an example of carried interests. Those parties that picked up the non-consent interest would pay their share of costs and receive their share of the revenue associated with the non-consent interest.

Not all JOA Model Forms address this issue the same

Read the following language from two different Joint Operating Agreements and determine how the non-consent interest is treated differently by the consenting parties:

Example 1

If less than all parties approve any proposed operation, the proposing party, immediately after the expiration of the applicable notice period, shall advise the Consenting Parties of (a) the total interest of the parties approving such operation, and (b) its recommendation as to whether the Consenting Parties should proceed with the operation as proposed. Each Consenting Party, within forty-eight (48) hours ... after receipt of such notice, shall advise the proposing party of its desire to (a) limit participation to such party's interest as shown on Exhibit "A", or (b) carry its proportionate part of Non-Consenting Parties' interest.

Example 2

If any party receiving such a notice elects not to participate in the proposed operation (such party referred to as "Non-Consenting Party"), then in order to be entitled to the benefits of this section, ... such other parties as shall elect to participate in the operation (all such parties referred to as the "Consenting Parties") shall, within thirty (30) days after the expiration of the notice period (or as promptly as possible ...where the drilling rig is on location...)actually commence work on the proposed operation and complete it with due diligence.

The entire cost and risk of conducting such operations shall be borne by the Consenting Parties in the proportions that their respective interests as shown in Exhibit "A" bear to the total interests of all Consenting Parties.

Example 1 allows the consenting parties the opportunity to pick up their proportionate part of the non-consenting parties' interest. According to Article VI, If the consenting parties do not agree to pick up 100% of the non-consenting party's interest, the party proposing the well can withdraw the proposal.

**ARTICLE VI.
DRILLING AND DEVELOPMENT**

If less than all parties approve any proposed operation, the proposing party . . . shall advise all Parties of the total interest of the parties approving such operation and its recommendation as to whether the Consenting Parties should proceed with the operation as proposed. . . The proposing party, at its election, may withdraw such proposal if there is less than 100% participation. . .

Non-consent Penalties

Article VI. will set out the penalties that any non-consenting party will incur. These penalties would be considered a "Production Penalty" meaning that they would share in no production from the operation until the penalty had been met. In the example, the production penalty for non-consenting the operation is payback of 100% of certain costs and 300% of other costs. The percentages as shown are often modified and changed in this section of the JOA.

**ARTICLE VI.
DRILLING AND DEVELOPMENT**

(i) 100% of each such Non-Consenting Party's share of the cost of any newly acquired surface equipment beyond the wellhead connections (including but not limited to stock tanks, separators, treaters, pumping equipment and piping), plus 100% of each such Non-Consenting Party's share of the cost of operation of the well commencing with first production . . . ; and

(ii) 300% of (a) that portion of the costs and expenses of Drilling, Reworking, Sidetracking, Deepening, Plugging Back, Testing, Completing, and Recompleting, after deducting any cash contributions received under Article VIII.C., and of (b) that portion of the cost of newly acquired equipment in the well (to and including the wellhead connections), which would have been chargeable to such Non-Consenting Party if it had participated therein.

Read this portion of Article VI. And then determine what the non-consent penalties are for these expenses.

1. Drill Bits



- 100%**
- 300%**

3. Pump Jack



- 100%**
- 300%**

2. Drilling Mud



- 100%**
- 300%**

4. Wellhead equipment



- 100%**
- 300%**

Calculating Non-consent

The following chart illustrates how non-consent interests are picked up by the consenting parties. In the example, Sunrise, Venture, Windjammer and Horizon have chosen to participate in the drilling project while Monroe has chosen to non-consent the drilling. In this example, all participating parties are picking up their share of the non-consenting party's interest.

Follow the column description in order to populate the spread sheet

First Scenario

	#1	#2	#3	#4	#5	#6	
WI Owner	Original GWI	Election	Participating Totals	Percent of #2	Share of Non-Consent	Total BPO Interest	Total APO Interest
Sunrise	50.00%	Participate					
Venture	12.50%	Participate					
Windjammer	12.50%	Participate					
Horizon	12.50%	Participate					
Monroe	12.50%	Non-Consent					
Total	100.00%						

#1 Elections must be made to determine who is participating and who is Non-Consent in the well.

#2 Determine what percentage of the well is participating.

#3 Determine each participant's proportionate part of the total participating interest. (original GWI / total participating interest #2)

#4 Determine each participant's share of the non-consent (#3 X non-consent interest).

#5 Total BPO interest is made up of the participant's original interest plus their share of the non-consent #4.

#6 Total APO interest is the same as the original interest before the elections were made.

Second Scenario

In this exercise, Sunrise, Venture, and Windjammer have chosen to participate in the drilling project, while Horizon and Monroe have chosen to non-consent the drilling. In this example, all participating parties are picking up their share of the non-consenting party's interest.

Follow the column description below in order to populate the spread sheet.

Calculating Payouts through Non-Consent

	#1	#2	#3	#4	#5	#6	
WI Owner	Original GWI	Election	Participating Totals	Percent of #2	Share of Non-Consent	Total BPO Interest	Total APO Interest
Sunrise	50.00%	Participate					
Venture	12.50%	Participate					
Windjammer	12.50%	Participate					
Horizon	12.50%	Non-Consent					
Monroe	12.50%	Non-Consent					
Total	100.00%						

According to the results from the second scenario, create a Revised Exhibit "A" to the Operating Agreement.

Revised Exhibit "A" to the Operating Agreement	
BPO Non-Consent	
<u>Interest Owner</u>	<u>Percentage of Interest</u>
Sunrise Oil and Gas	
Venture Oil and Gas	
Windjammer Petroleum	
Horizon Oil and Gas	
Monroe Oil and Gas	

Total	
APO Non-Consent	
<u>Interest Owner</u>	<u>Percentage of Interest</u>
Sunrise Oil and Gas	
Venture Oil and Gas	
Windjammer Petroleum	
Horizon Oil and Gas	
Monroe Oil and Gas	

Total	

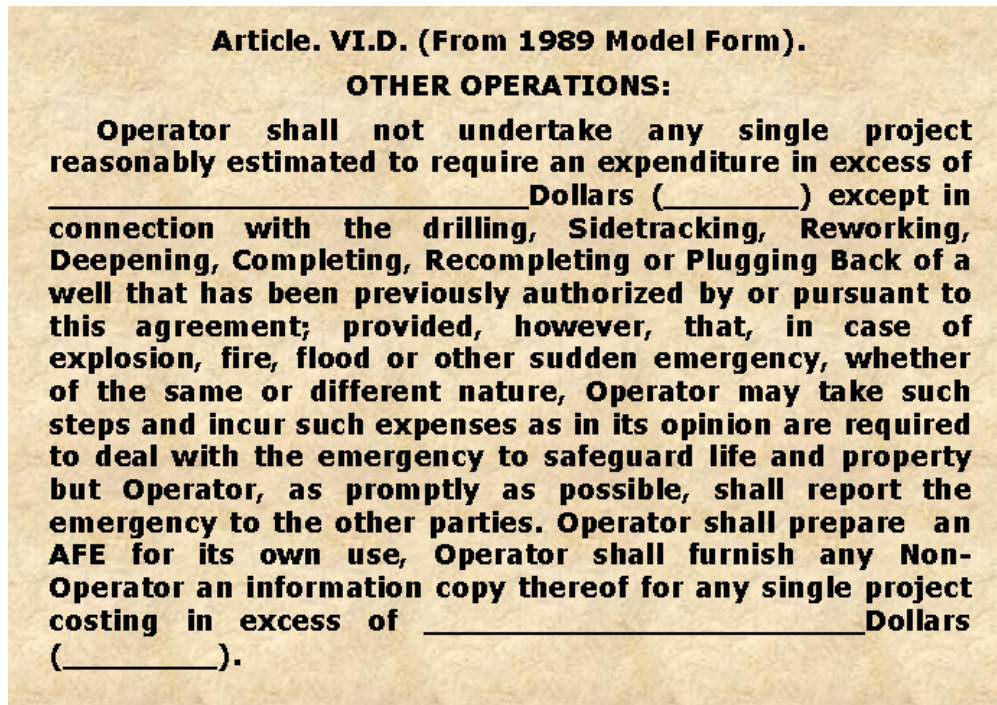
Procedures from “Other Operations”

The Model Form also makes provision for what it calls “Other Operations”.

This portion of the JOA categorizes these other operations into high cost, medium cost and low cost projects.

High Cost Projects

The Operator must gain unanimous approval for “high cost” projects defined as those exceeding the dollar amount as placed in the blank of Article VI.D.



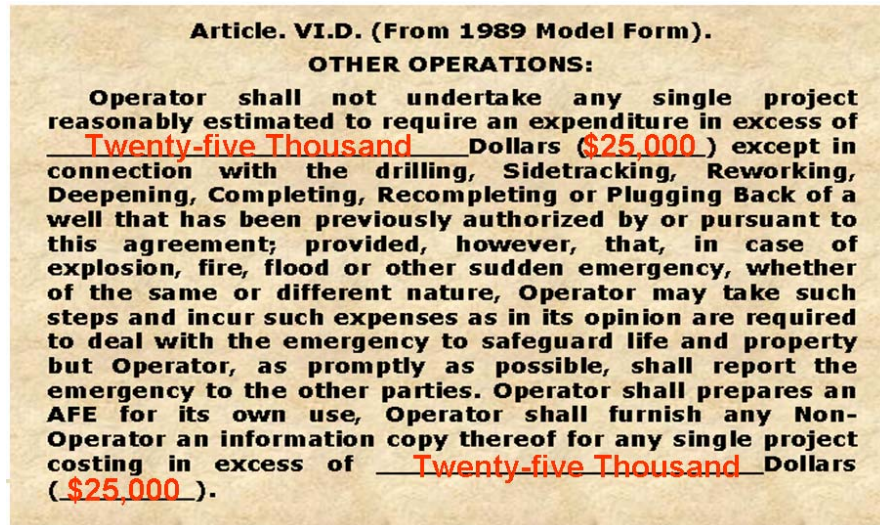
Medium Cost Projects and Low Cost Projects

Operators do not need approval from the Non-Operators for “medium or low cost” projects. If the Operator prepares an “Authority for Expenditure” (“AFE”) for their purposes they are; however, obligated to provide it to the Non-operators simply for informational purposes.

First Scenario

According to Article VI.D, assume the following.

Sunrise Oil and Gas, as operator of a producing well, placed the dollar amount of \$25,000 in the blanks (as seen in the illustration).



Sunrise hired an attorney to do curative title work at a cost of \$5,000 without the consent of the non-operators. Can they do this? _____

According to the "Other Operations" section of the JOA, Sunrise can spend up to \$25,000 on any single project that is reasonable.

Second Scenario

Sunrise wanted to recomplete the well in a different zone. The estimated cost for this procedure was less than the \$25,000 dollar amount placed in the blanks.

Read the "Other Operations" clause and determine if they can do this recompletion without the approval of the non-operators?

The Article VI.D. provision only deals with "Other Operations" such as day-to-day operations. Drilling, sidetracking, reworking, deepening, completing, recompleting or plugging back are not considered "Other Operations". Sunrise could not proceed with the recompletion without the approval of the non-operators.

Third Scenario

Assume it has been decided to proceed with a drilling operation. Or, assume that Sunrise, the operator, has the authority to make a decision to proceed with a wellbore operation based on his own authority without the need to consult Non-Operators. In cases like this, is the Operator's expenditure authority unlimited?

Since operations such as drilling operations do not fall in the "Other Operations" category and the operation is approved, the Operator's expenditure authority has no limits. Emergencies also fall into this category.

Acreage Penalty

Do not confuse an "acreage penalty" with a "production penalty". They are not the same thing. A production penalty occurs when a party non-consents a drilling operation. They are penalized production for a certain time period. An acreage penalty is found in Article VI.E.2 which deals with the Abandonment of Wells.

According to the JOA, no well shall be abandoned without the consent of all parties. There are cases; however, when a party does not agree to abandon a well. The question should be asked, "Are all parties then bound to paying for and marinating this well simply because one party does not agree to have it plugged and abandoned?"

Question:

What does an "acreage penalty" mean – where the non-consenting party will "forfeit out" of any interest?

**Article VI. E.2. (from 1989 Model form)
ABANDONMENT OF WELLS:**

2. Abandonment of Wells That Have Produced: ... any well which has been completed as a producer shall not be plugged and abandoned without the consent of all parties. If all parties consent to such abandonment, the well shall be plugged and abandoned in accordance with applicable regulations and at the cost, risk and expense of all the parties hereto. .. If, within sixty (60) days after delivery of notice of the proposed abandonment of any well, all parties do not agree to the abandonment of such well, those wishing to continue its operation from the Zone then open to production shall be obligated to take over the well ...

Parties taking over a well as provided herein shall tender to each of the other parties its proportionate share of the value of the well's salvable material and equipment ... less the estimated cost of salvaging and the estimated cost of plugging and abandoning and restoring the surface; ...

Each abandoning party shall assign to the non-abandoning parties, without warranty, express or implied, as to title or as to quantity, or fitness for use of the equipment and material, all of its interest in the wellbore of the well and related equipment, together with its interest in the Leasehold insofar and only insofar as such Leasehold covers the right to obtain production from that wellbore in the Zone then open to production. If the interest of the abandoning party is or includes an Oil and Gas Interest, such party shall execute and deliver to the non-abandoning party or parties an oil and gas lease, limited to the wellbore and the Zone then open to production, for a term of one (1) year and so long thereafter as Oil and/or Gas is produced from the Zone covered thereby ...

In cases like this, the party wanting to keep the well alive has the right to take over the well. In this case, the other parties are the ones who face the acreage penalty. They must assign their wellbore interest and interest owned in the wellbore equipment to the party wishing to maintain the well.

Order of Preference of Operation

In some cases, non-operators wish to propose the drilling of wells within the contract area. This can lead to disputes, especially when an operator proposes different locations or zones. Article VI.B.6. addresses how these disputes will be resolved.

**Article. VI.B.6. (From 1989 Model Form).
Order of Preference of Operations.**

... if any party desires to propose the conduct of an operation that conflicts with a proposal that has been made by a party under this Article VI, such party shall have fifteen (15) days from delivery of the initial proposal, in the case of a proposal to drill a well or to perform an operation on a well where no drilling rig is on location, or twenty-four (24) hours, from delivery of the initial proposal, if a drilling rig is on location for the well on which such operation is to be conducted, to deliver to all parties entitled to participate in the proposed operation such party's alternative proposal . . . Each party receiving such proposals shall elect by delivery of notice to Operator within five (5) days after expiration of the proposal period, or within twenty-four (24) hours if a drilling rig is on location . . . to participate in one of the competing proposals . . . The proposal receiving the vote of parties owning the largest aggregate percentage interest of the parties voting shall have priority over all other competing proposals; in the case of a tie vote, the initial proposal shall prevail.

SEE ALSO ARTICLE XVI. D, OTHER PROVISIONS.

Article VII. Expenditures and Liabilities of Parties

According to the Model Form, the Operator can request advance payment of estimated expenses for the next month. The "Exhibit "C" Accounting Procedure provides for the billing, collection, non-operator's rights of audit, "proper" types of charges and "proper" levels of charges. Note that the JOA only specifies how "proper" charges are to be allocated. If a party objects to a charge, the accounting procedure permits (but does not require) that it pay the amounts billed, and then dispute the charges in accordance with the Accounting Procedure provisions.

Read Article VII.B. and determine what could happen if one of the parties to the JOA failed to promptly pay their share of the bills?

B. LIENS AND SECURITY INTERESTS:

Each party grants to the other parties hereto a lien upon any interest it now owns or hereafter acquires ... in the Contract Area, and a security interest... in the personal property and fixtures ... to secure performance of all of its obligations under this agreement including but not limited to payment of expense, interest and fees...

In addition, upon default by any party in the payment of its share of expenses, interests or fees...the other parties shall have the right, without prejudice ... to collect from the purchaser the proceeds from the sale of such defaulting party's share of Oil and Gas until the amount owed by such party, plus interest...has been received...

If any party fails to pay its share of cost within one hundred twenty (120) days after rendition of a statement therefore by Operator, the non-defaulting parties ... pay the unpaid amount in the proportion that the interest of each such party bears to the interest of all such parties. The amount paid by each party so paying its share of the unpaid amount shall be secured by the liens and security rights ... and each paying party may independently pursue any remedy available hereunder or otherwise.

Each of the Model Forms establishes what an Operator can do when one party does not promptly pay its bills.

The following is a portion of Article VII.D. and cites remedies allowed:

D. DEFAULTS AND REMEDIES:

If any party fails to discharge any financial obligation ... including ... the failure to make any advance under the preceding Article VII.C. or any other provision of this agreement, within the period required for such payment hereunder, then ... the remedies specified below shall be applicable ...

1. If the Operator is in default, a new operator can be appointed.
2. There can be a suspension of information to the defaulting party.
3. The right to participate in proposed operations will be declined.
4. The right to receive proceeds out of production will be declined.

Suit for Damages

The non-defaulting parties can sue the defaulting party for damages. This provision also allows the non-defaulting parties to collect interest.

Deemed Non-Consent

The non-defaulting parties may deliver a written Notice of non-consent election to the defaulting party at any time after the expiration of the thirty day cure period following delivery of the Notice of Default.

What should be done?

Assume the following: Sunrise, the operator of the Unit, sent out a proposal to drill a subsequent well in a location that Horizon did not feel was the optimal drilling location or zone.

Five days after receiving Sunrise's proposal, Venture mailed out their own proposal for a different location and different zone.

All parties made their election for the proposal they wished to participate in by mailing their consents back to Sunrise.

Sunrise reported to Venture that their proposal had received the largest aggregate percentage of votes and that they were going to proceed with

their drill site location and zone.

Venture immediately called Windjammer, Horizon and Monroe and inquired how each had voted. Each company responded by telling Venture they had opted to elect for the Venture proposal.

On June 1, Sunrise mailed advanced payment notices for the estimated \$5,000,000 expenses for the drilling operations.

Venture believed that Sunrise had intentionally misrepresented the vote and was not acting as a prudent operator working in a good and workmanlike manner. Since Venture was still receiving well information during the drilling operation, they chose not to pay their share of costs until their concern about the risk had diminished.

On September 1, Venture, under Exhibit "C" to the JOA, demanded the right to an audit of Sunrise's handling of the current operations.

On October 1, Venture received the following certified letter from Sunrise:

Notice of Default

To whom it may concern,

Whereas, on June 1, Sunrise Oil and Gas mailed an AFE in the amount of \$5,000,000 to Venture Oil and Gas for the drilling of a subsequent well in the Contract Area, and

Whereas, for over 120 days Venture has refused to pay their proportionate share of said costs, and

Whereas, Venture is currently in default,

Therefore, Sunrise has suspended all future well information to the defaulting party and will decline all payments out of production until such time as the amount owed is paid in full.

Signed

Sunrise Oil and Gas

What options, if any, are at Venture's disposal?

Article VIII. Transferability of Interests

In an attempt to maintain uniform interests, during the life of the agreement, the 1989 Model Form restricts companies from transferring their interests in certain circumstances. Parties are not allowed to transfer their interest unless the transfer covers their entire interest or an equal undivided interest in all their leases in the Contract Area.

Article VIII.D.

Assignment; Maintenance of Uniform Interest

For the purpose of maintaining uniformity of ownership in the Contract Area in the Oil and Gas Leases, Oil and Gas Interests, wells, equipment and production covered by this agreement no party shall sell, encumber, transfer or make other disposition of its interest in the Oil and Gas Leases and Oil and Gas Interests embraced within the Contract Area or in wells, equipment and production unless such disposition covers either:

- 1. the entire interest of the party in all Oil and Gas Leases, Oil and Gas Interests, wells, equipment and production; or**
- 2. an equal undivided percent of the party's present interest in all Oil and Gas Leases, Oil and Gas Interests, wells, equipment and production in the Contract Area.**

Article VIII.D. goes on to add...

Article VIII.D. Continued

If at any time the interest of any party is divided among and owned by four or more co-owners, Operator, at its discretion may require such co-owners to appoint a single trustee or agent with full authority to receive notices, approve expenditures, receive billings for and approve and pay such party's share of the joint expenses, and to deal generally with, and with power to bind, the co-owners of such party's interest within the scope of the operations embraced in this agreement; however, all such co-owners shall have the right to enter into and execute all contracts or agreements for the disposition of their respective shares of the Oil and Gas produced from the Contract Area and they shall have the right to receive, separately, payment of the sale proceeds thereof.

Preferential Right to Purchase

Article VIII.F set out the preferential right to purchase; however, this provision is usually omitted by the parties.

**VIII.F. Preferential Right to Purchase
(Optional; Check if applicable.)**

Should any party desire to sell all or part of its interests under this agreement, or its rights and interests in the Contract Area, it shall promptly give written notice to the other parties, with full information concerning its proposed disposition...The other parties shall then have an optional prior right, for a period of ten (10) days after the notice is delivered, to purchase for the stated consideration on the same terms and conditions the interest which the other party proposes to sell...

Assume that Windjammer was selling its entire company to a third party. The third party has made an offer to purchase all of Windjammer's leases and production in the contract area for a price of \$3,000,000. Assume that Sunrise wishes to invoke its preferential right to purchase Windjammer's interest. Their offer to purchase must only match that of the third party it does not need to exceed their offer.



UNIT OPERATING AGREEMENTS

“Federal exploratory units” can include hundreds to tens of thousands of acres of federal, state and fee lands in one exploratory area. This is much different than the normal spacing unit seen in many parts of the country.

Most of these exploratory units are formed prior to the discovery of oil or gas; therefore, the unit operating agreement must address the unique issues that can arise during the life and development of the unit.

Federal exploratory units are controlled by strict federal governmental guidelines and will require two separate contracts:

1. The Unit Agreement
2. The Unit Operating Agreement

Both of these contracts must comply with all federal regulations.

The Unit Agreement

The unit agreement is signed and agreed to by both the royalty owners and the working interest owners and provides for the following:

1. An initial test well
2. An initial participating area (PA) if the initial test well is successful
3. Provisions for drilling until a successful well is achieved
4. An expansion and contraction of the participating area as other wells are drilled
5. The establishment of additional participating areas as other producing zones are located
6. How royalty owners are paid and how they share in production from the expanding or contracting of participating areas (usually, they will receive their proportionate part based on acreage contribution to total acres in a participating area).
7. How the royalty owner's interest will change as participating areas contract or expand
8. The obligatory duties and obligations of the working interest owners
9. The unit agreement does not establish how working interest owners share production from the unit operations nor how costs are borne

Unit Operating Agreements

There are two model unit operating agreement forms used – Model form 1 and Model form 2. Both establish how working interest owners share production from the unit operations and how costs are to be borne.

Model Form 1 (Undivided Unit)

An *undivided unit* is one where most things such as sharing of costs and revenue stay the same for the working interest owners throughout the life of the unit. An undivided unit establishes how those costs and revenue will be split and the working interest owners participate in sharing of production and costs based on a fixed percentage. This fixed percentage is usually based on their acreage contribution, divided by the total acreage in the unit and is established prior to the drilling of the initial test well.

Although this type of unit is easiest to administrate, it can contain a ***fatal flaw***. Nobody knows where the producing zones are located. One oil and gas company's acreage may be located in a completely unproductive area of the unit, thus ***they are contributing condemned acreage***. Yet, they would share in every well, wherever it was located in the unit. This concern would not, normally, be an issue for a small unit; however, for a unit containing thousands of acres, ***this might be a grave issue for those companies contributing the more valuable acreage***.

Model Form 2 (Divided Unit)

Most companies use Form 2 (a divided unit) when a federal exploratory unit is created. With divided type unit, each working interest owner will share in costs and production from the first well, based on a mutual agreement.

This first well will necessitate the establishment of what is called a "participating area" (PA). And, each company will share in costs and production based on their proportionate part of the participating area.

A "participating area" is like having a smaller unit (the PA) inside a larger unit (the entire federal unit.)

As each participating area is established, expanded or contracted, a company's interest will change based on their new proportionate part of the PA. Over the life of the unit and with the expansion and contraction of the PA, the reallocation of costs and production may occur many times. Ultimately, a company will not know what interest they have in each of the wells until the participating area is fully developed.

Both Unit Agreements and Unit Operating Agreements contain several pages

of conditions and regulations regarding the life of a Federal Unit. For our purposes, we will be examining the concepts as set forth in the agreements by looking at the “life” of a federal unit that we will call the “Cornerstone Unit.”

The “Life” of the Cornerstone Unit

Companies may choose one of two types of units:

1. An Undivided Unit provides that all companies participate in every well no matter where it lies within the unit boundaries and regardless of owning any leasehold interest in a given PA from which the wells produce.
2. A Divided Unit provides that only those companies owning interests in the individual Participating Areas will pay their proportionate share or costs and receive their share of production.

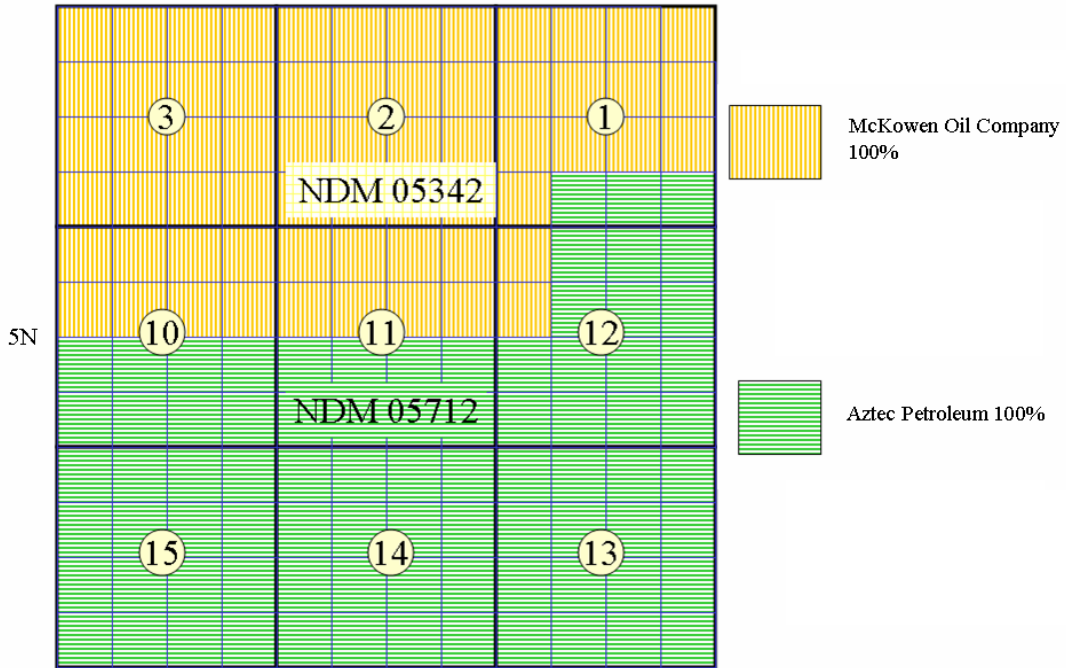
General rules related to a Federal Unit

1. State and Fee lands are often included in federal units.
2. The unit is formed prior to the drilling of the first well.
3. This first well must be drilled within 6 months after the unit is approved by the Bureau of Land Management (BLM).
4. If this well is a dry hole, additional wells must be drilled within not more than 6 months between wells until a well capable of producing in commercial quantities is found.
5. When this well is established, a proposal for the initial PA must be submitted. This PA will cover only those lands that are being drained by this well.
6. Royalties are paid to only those mineral owners within the boundaries of the PA.
7. A unit may include multiple Pas.
8. One PA may sit on top of another PA
9. The unit area may be contracted or expanded.
10. Five years from the effective date of the first PA, the unit area will automatically contract down to only lands within the Pas.

For the purpose of this study, two federal leases will be examined. Federal leases are given lease numbers as seen in the illustration and can cover hundreds of acres. Lease NDM 05342 is owned by McKowen Oil Company and Lease NDM 05712 is owned by Aztec Petroleum.

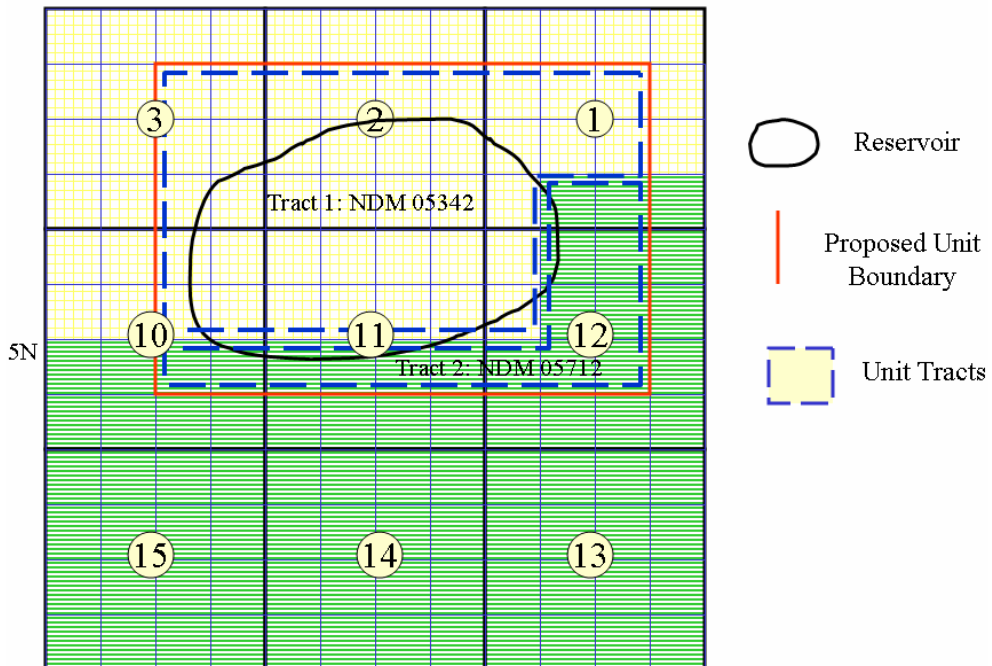
Lease Ownership

20E



McKowen identifies a prospect and proposes forming
"The Cornerstone Unit"

20E



Initial Exhibit "A" to the Cornerstone Unit

The Cornerstone Unit Exhibit "A"

Tract Number	Lease Number	Legal Location	Tract Acreage	Royalty %	Ownership %
1	NDM 05342	T5N, R20E			
		Sec. 1: SWNE, S2NW, N2SW, SWSW, NWSE	1,560 acres	12.50%	McKowen
		Sec 2: S2N2, S2			100%
		Sec 3: S2NE, SE			
		Sec 10: NE			
		Sec 11: N2			
		Sec 12: W2NW			
2	NDM 05712	T5N, R20E			
		Sec 1: SESW, SWSE	600 acres	12.50%	Aztec
		Sec 10: N2SE			100%
		Sec 11: N2S2			
		Sec 12: W2NE, E2NW, N2SW, NWSE			
			<u>2,160 acres</u>		

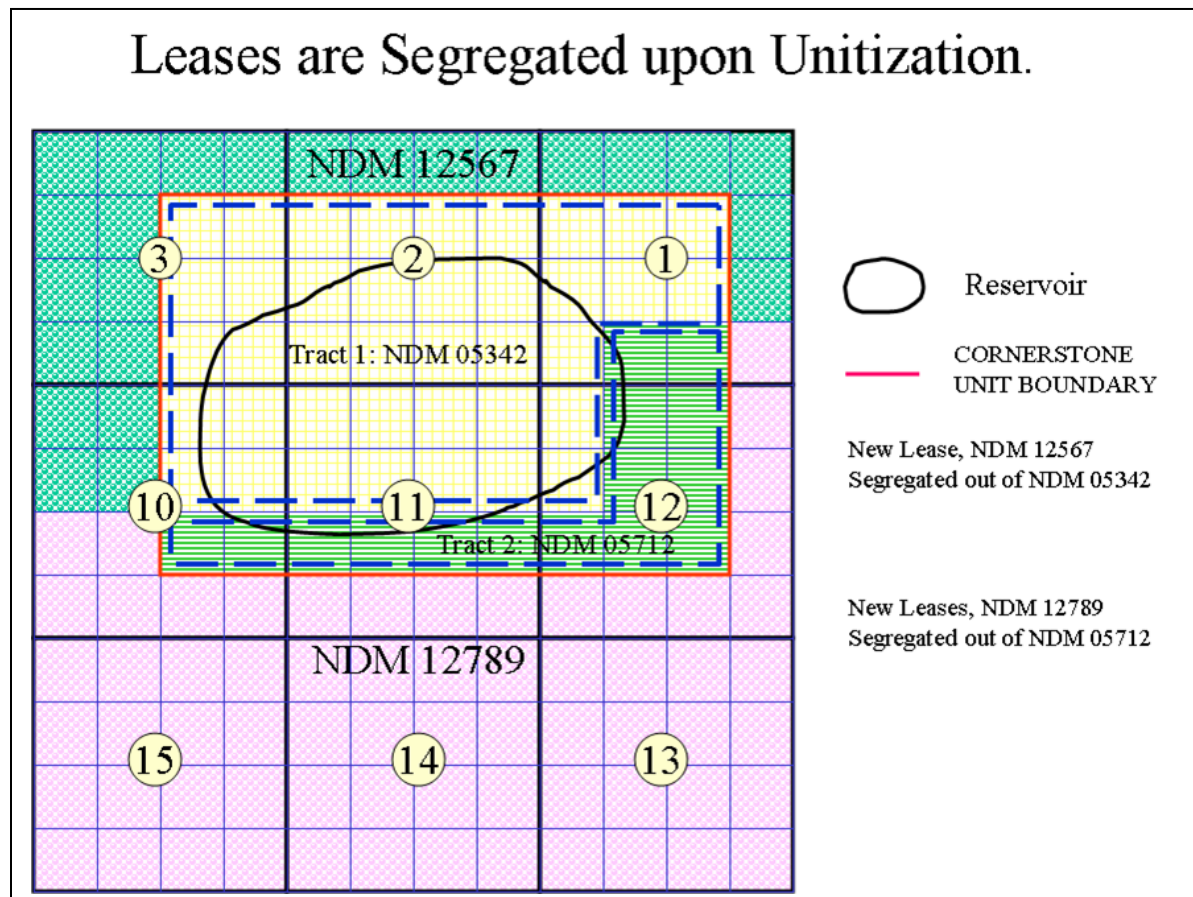
Total Unit Acreage = 2,160 acres

McKowen = 1,560 acres	72.22%
Aztec = 600 acres	27.78%
Total	100.00%

Segregation of Federal Leases

When only a portion of a federal lease is committed to a unit, the non-unitized portion of that lease is *segregated* into a separate lease effective as of the approval date of the unit. This creates the separation of the Federal lease into two individual leases.

In our example, only portions of both federal leases are committed to the Cornerstone Unit; therefore, both leases will be segregated. The segregated portion of the original lease NDM 05342 is now designated as *NDM 12567* and the segregated portion of the original lease NDM 05712 is now designated as *NDM 12789*.



Cornerstone Unit Plan of Exploration

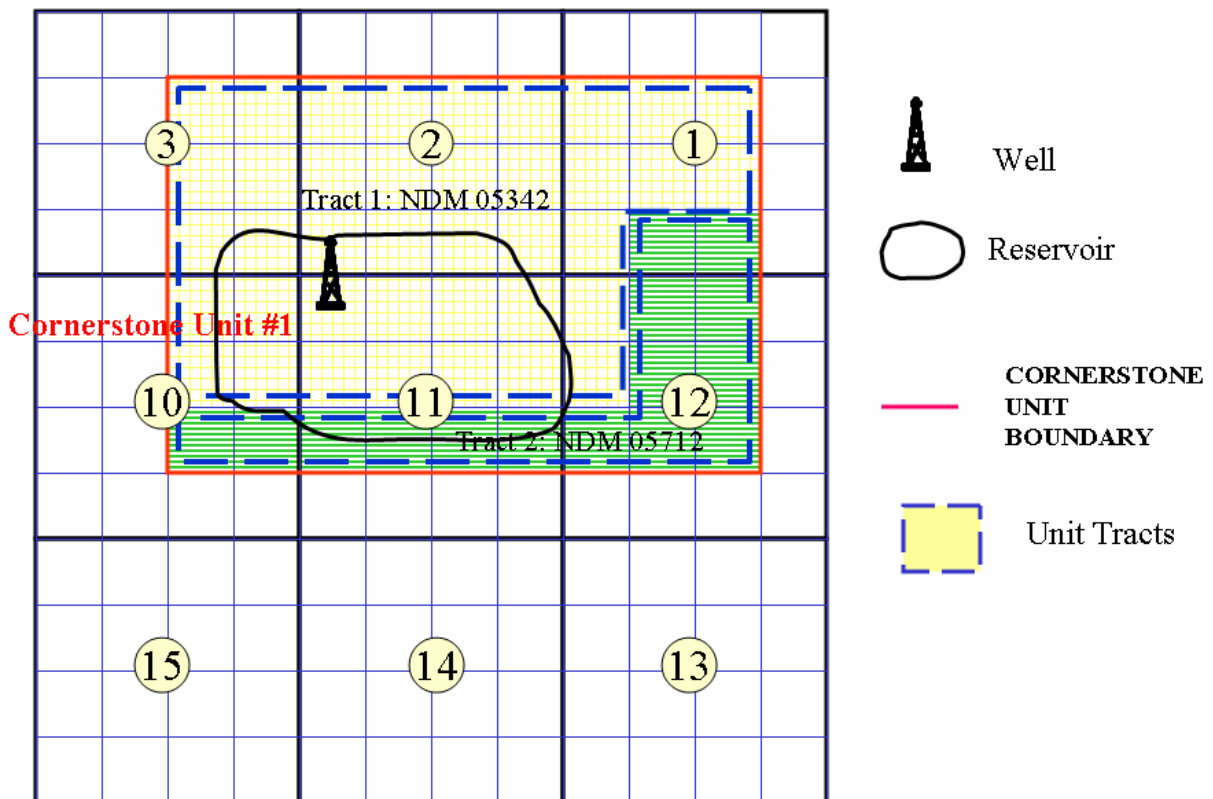
Assume the effective date of the unit is August 1, 2010; therefore, operations for the obligation test well must begin within 6 months or by February 1, 2011.

1. Once a well is drilled, capable of producing in paying quantities, a PA will be established.
2. The effective date of the initial PA marks the start of the initial five year term of the Unit Agreement.
3. All lands within the unit which are not in a PA are automatically dropped from the Unit at the end of this five year term.

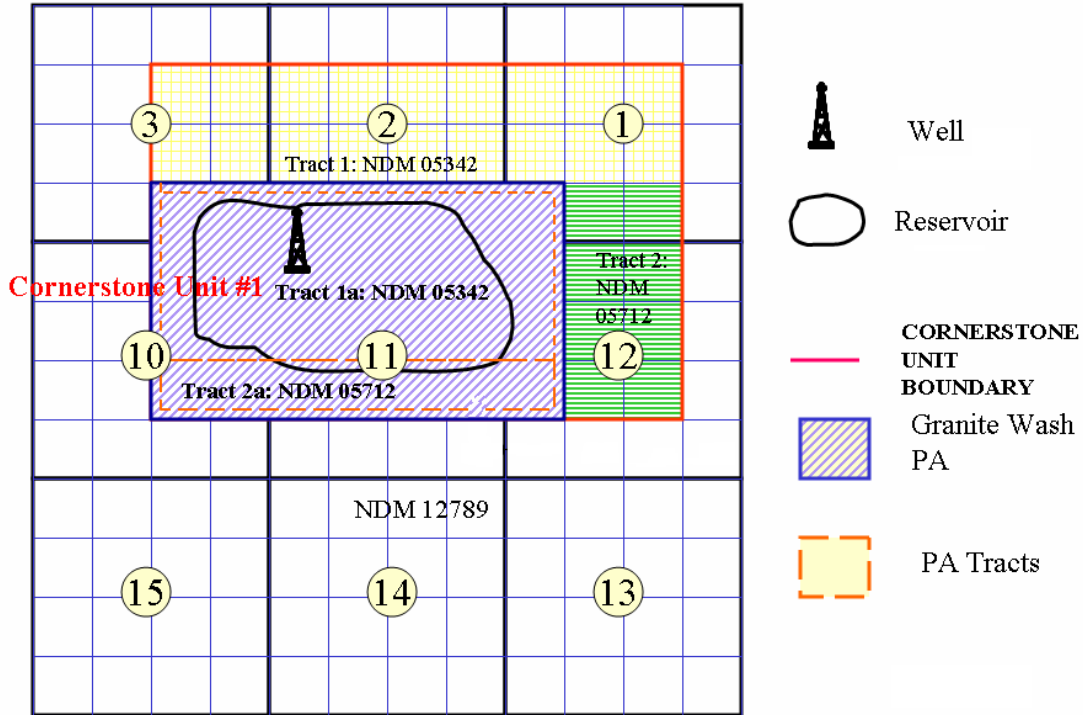
Assume that McKowen drills and completes the initial test well as a well capable of paying quantities prior to February 1, 2011 and the well is named the Cornerstone Unit #1 well.

From the geologic information gained from drilling this well, the known reservoir outline has been re-drawn (as seen in the illustration).

McKowen drills the Obligation well on Tract 1



Since the well was drilled and is producing from the Granite Wash formation, a "Granite Wash Participating Area" is formed and the Granite Wash Participating Area Ownership is established.



**The Cornerstone Unit
Granite Wash Participating Area**

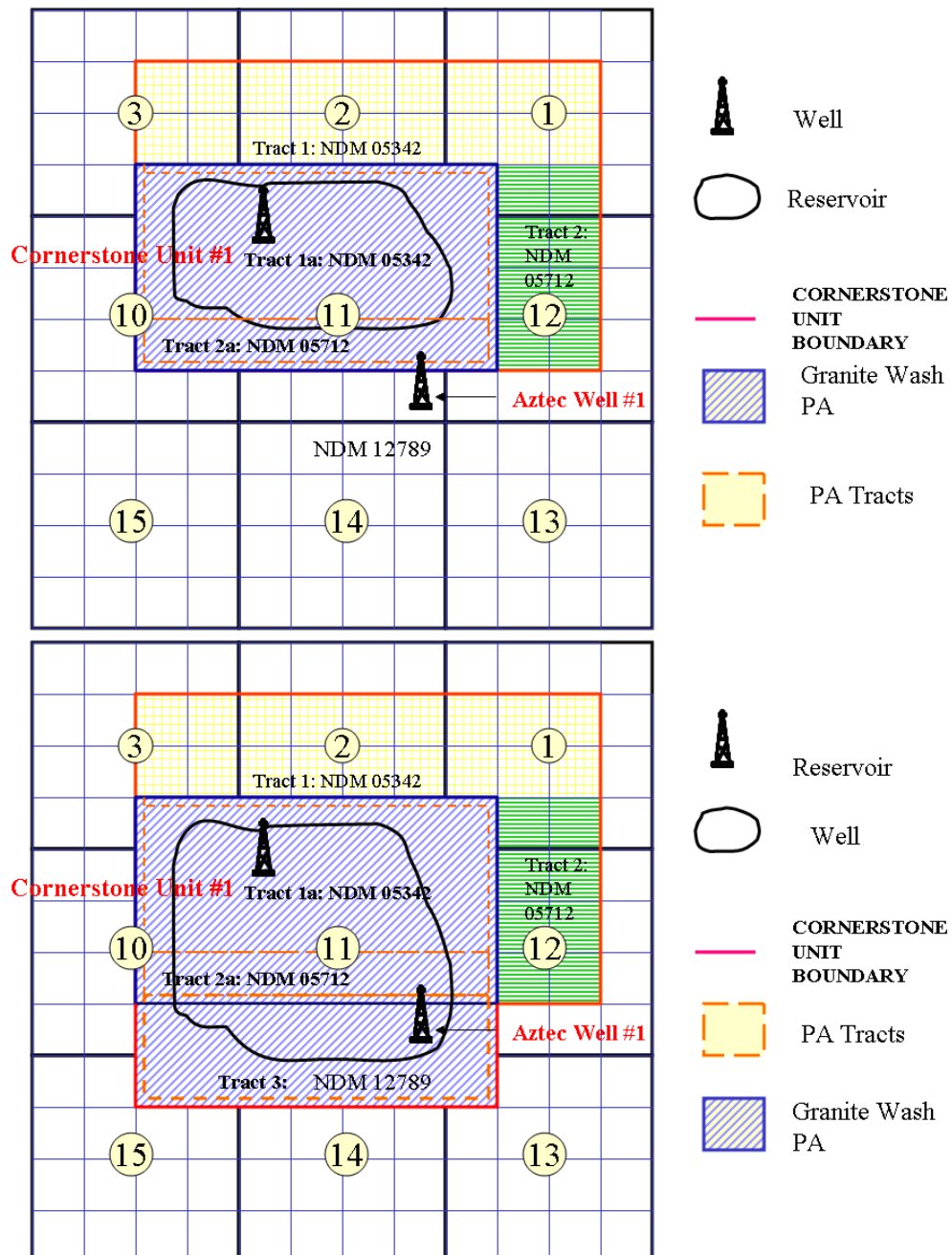
Tract Number	Lease Number	Legal Location	Tract Acreage	Royalty %	Tract Allocation	Ownership %
1	NDM 05342	T5N, R20E				
		Sec. 1: SWSW	840 acres	12.50%	75.00%	McKowen
		Sec 2: S2S2				100%
		Sec 3: S2SE				
		Sec 10: NE				
		Sec 11: N2				
		Sec 12: W2NW				
2	NDM 05712	T5N, R20E				
		Sec 10: N2SE	280 acres	12.50%	25.00%	Aztec
		Sec 11: N2S2				100%
		Sec 12: NWSW				
Total PA Acreage = 1,120 acres						

Notice the current split of ownership. McKowen = 75% and Aztec = 25%.

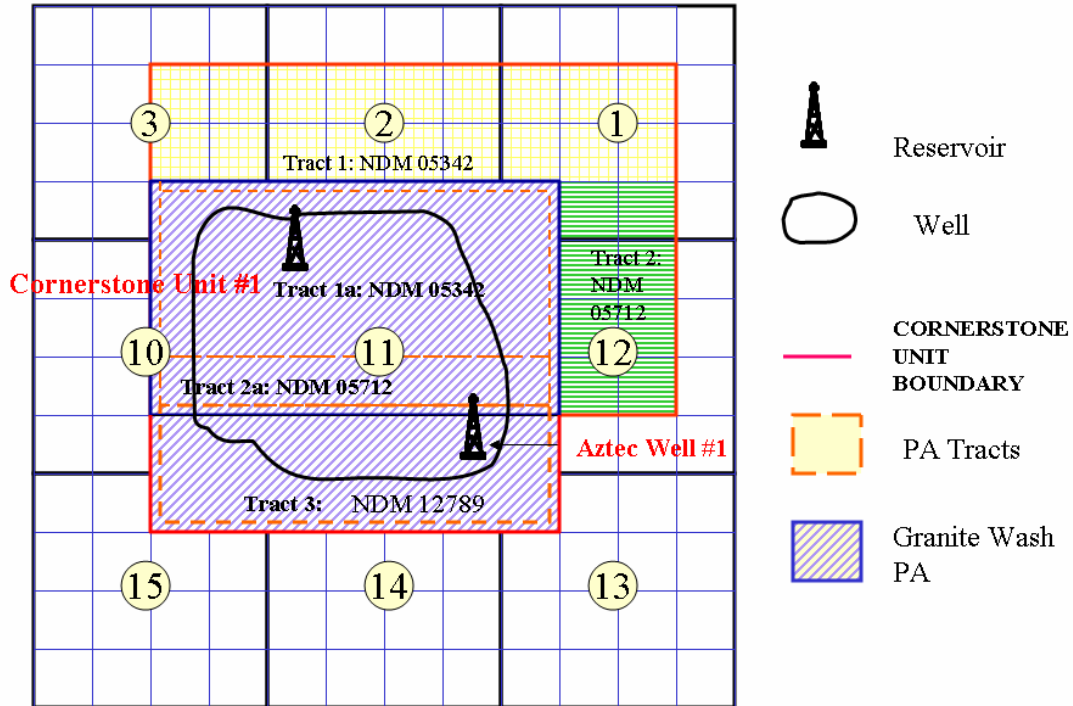
Units can Expand or Contract

When it is practical, the unit can expand. This would happen when lands outside the unit prove that the reservoir extends beyond the current unit outline. Units can also be contracted to exclude lands that would condemn lands within the current reservoir outline.

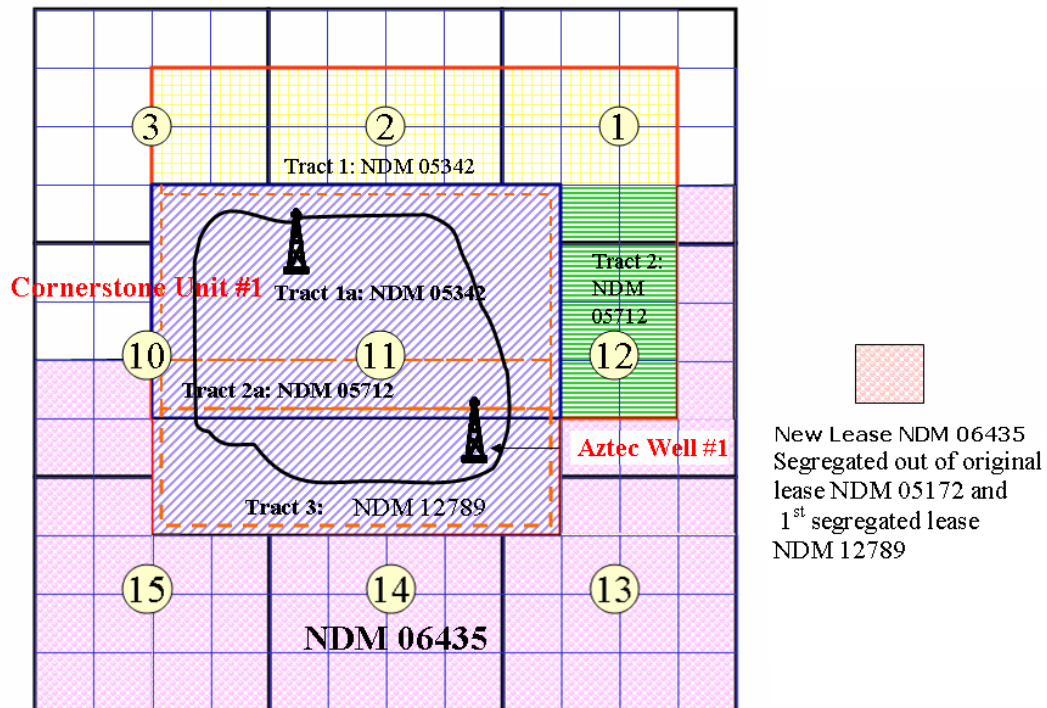
Assume that Aztec chooses to drill a well outside the unit boundary in order to test the extent of the Granite Wash reservoir. They chose to name the well the Aztec #1. If the well is successful, an application to expand the Cornerstone Unit and the Granite Wash PA would be submitted to the BLM.



Expansion of a PA can include portions of prior segregated Leases
 Notice that the expansion of the Cornerstone Unit now includes a portion of the previously segregated Lease NDM 12789.



Since the unit was expanded a second segregation of original lease NDM 05172 must take place



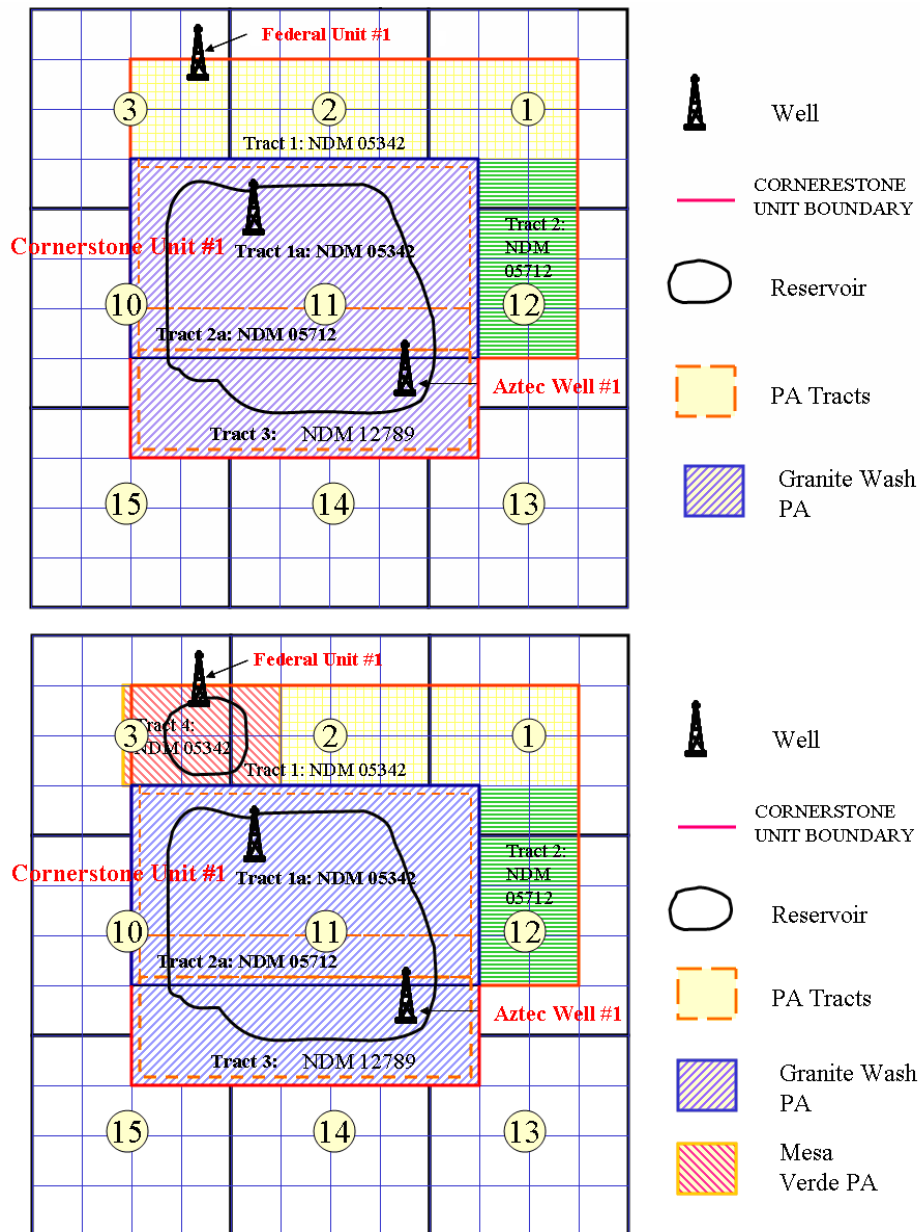
An expansion of the unit necessitates a new Exhibit "A"

The New Cornerstone Unit					
Exhibit A					
Tract Number	Lease Number	Legal Location	Tract Acreage	Royalty %	Ownership %
1	NDM 05342	T5N, R20E			
		Sec 1: SWNE, S2NW, N2SW, NWSE	720 acres	12.50%	McKowen
		Sec 2: S2N2, N2S2			100%
		Sec 3: S2NE, N2SE			
1a	NDM 05342	T5N, R20E			
		Sec 1: SWSW	840 acres	12.50%	McKowen
		Sec 2: S2S2			100%
		Sec 3: S2SE			
		Sec 10: NE			
		Sec 11: N2			
		Sec 12: W2NW			
2	NDM 05712	T5N, R20E			
		Sec 1: SESW, SWSE		12.50%	Aztec
		Sec 12: W2NE, E2NW, NESW, NWSE	320 acres		100%
2a	NDM 05712	T5N, R20E			
		Sec 10: N2SE	280 acres	12.50%	Aztec
		Sec 11: N2S2			100%
		Sec 12: NWSW			
3	NDM 12789	T5N, R20E			
		Sec 10: S2SE	560 acres	12.50%	Aztec
		Sec 11: S2S2			100%
		Sec 12: SWSW			
		Sec 13: NWNW			
		Sec 14: N2N2			
		Sec 15: N2NE			
Total Unit Acreage = 2,720 acres					
McKowen			1,560 acres	57.35%	
Aztec			1,160 acres	42.65%	
				100.00%	

Since the unit boundary increased, the Granite Wash PA boundary would also increase; therefore, a new PA Exhibit will be done including the tract 3 lands. Companies owning an interest in the new PA boundary would share in all costs and production from the PA area as it now stands.

Federal Units can have more than one Participating Area

Assume the unit operator proposes to drill a well in Section 3: SE/4NE/4 in order to test the Mesa Verde reservoir. They name the well the Federal Unit #1. If this well is successful, a second PA is formed which might be named the Mesa Verde Participating Area.



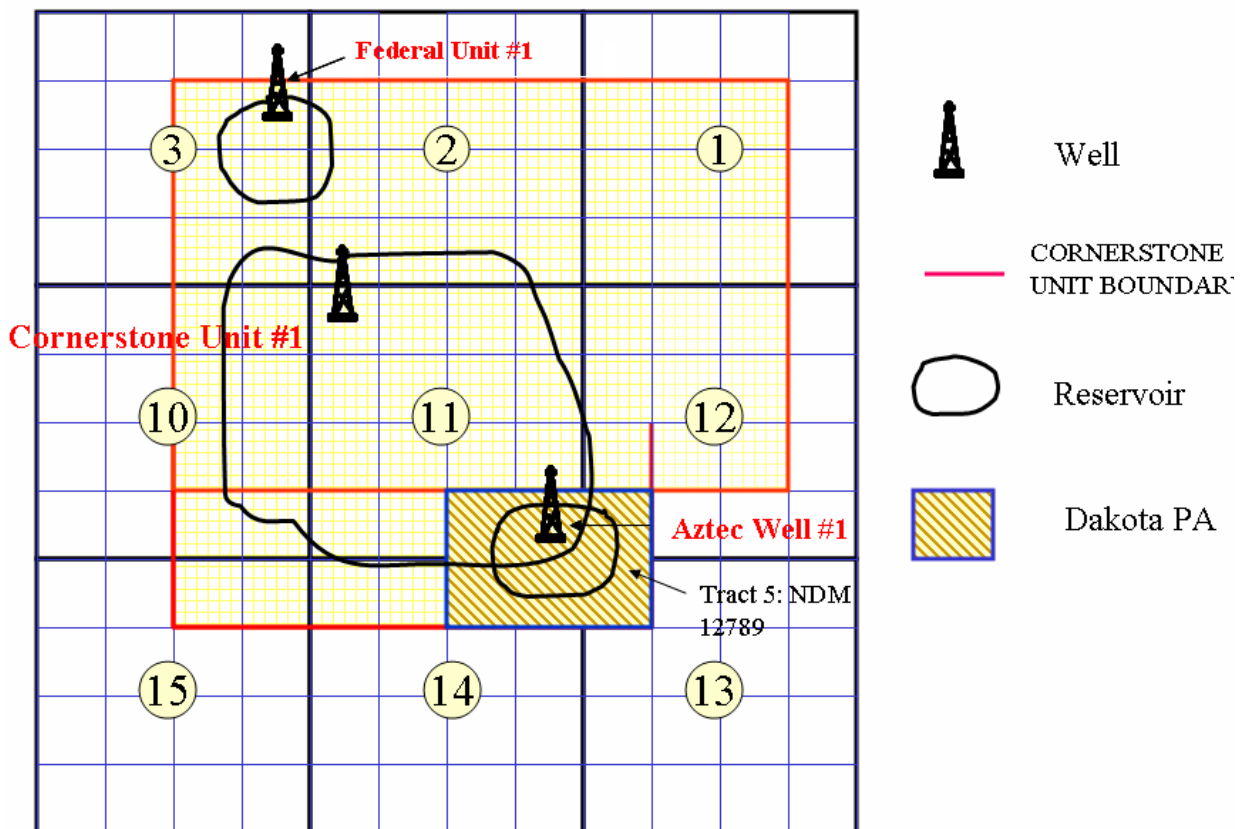
Only those companies contributing acreage to the new PA will be entitled to participate in the drilling costs and share in the production from the PA. In this case, McKowen is the only company contributing acreage to this PA.

Very often a PA can sit on top of another PA

Since different reservoirs are often produced from this type of unit, it is not uncommon to have a shallower horizon sit directly above a deeper horizon. In cases like this, one PA will sit on top of a second PA.

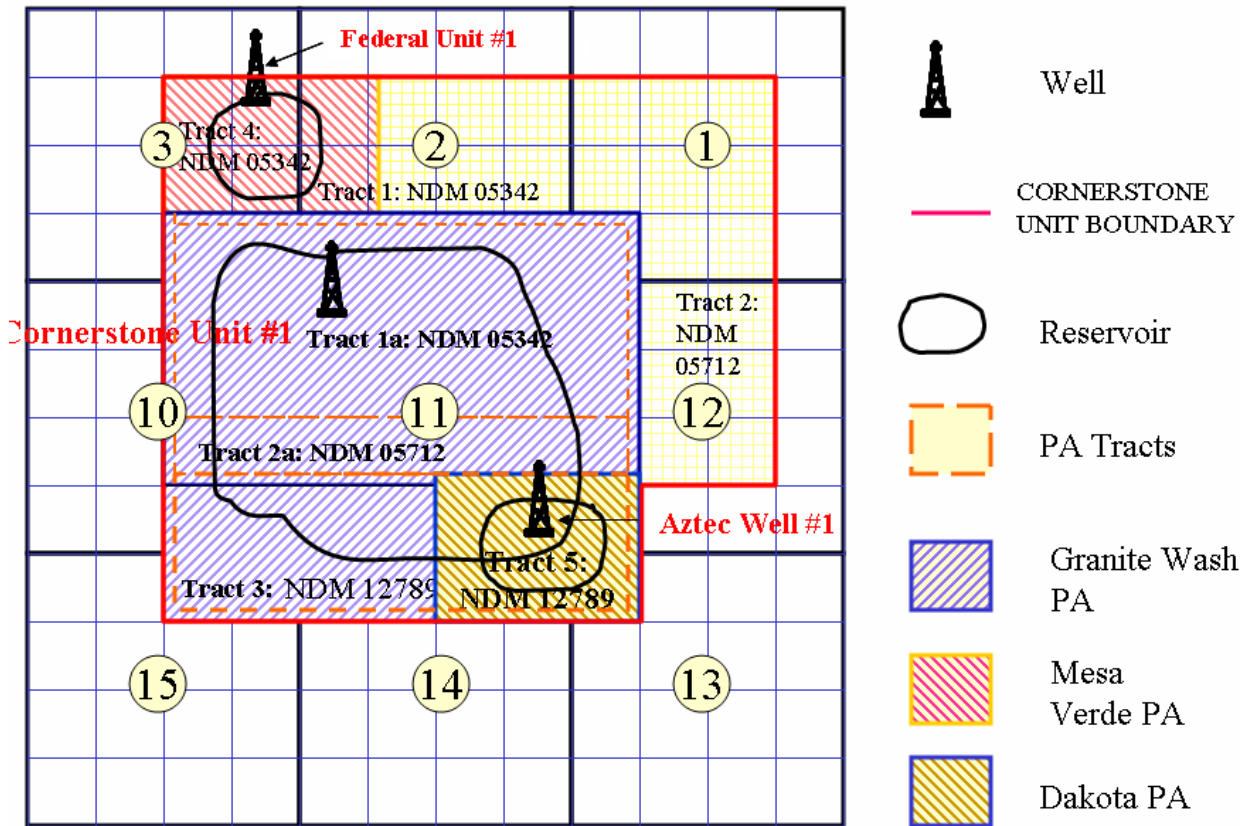
For our purposes, assume that when the Aztec #1 was being drilled, the Dakota Formation was penetrated. Initially, the Granite Wash formation was completed but it was also decided to produce the Dakota formation.

Since the Aztec #1 well is produced from both zones, a third PA named the Dakota PA would be formed.



The New Cornerstone Federal Unit

Following is an illustration of the Cornerstone Unit which contains three Pas.



Automatic Contraction

Five years from the effective date of the first PA, the unit area will automatically contract down to only lands found within PAs.

In our illustration, portions of original federal leases NDM 05342 and NDM 05712 contracts out of the unit.

Cornerstone Unit After Contraction

