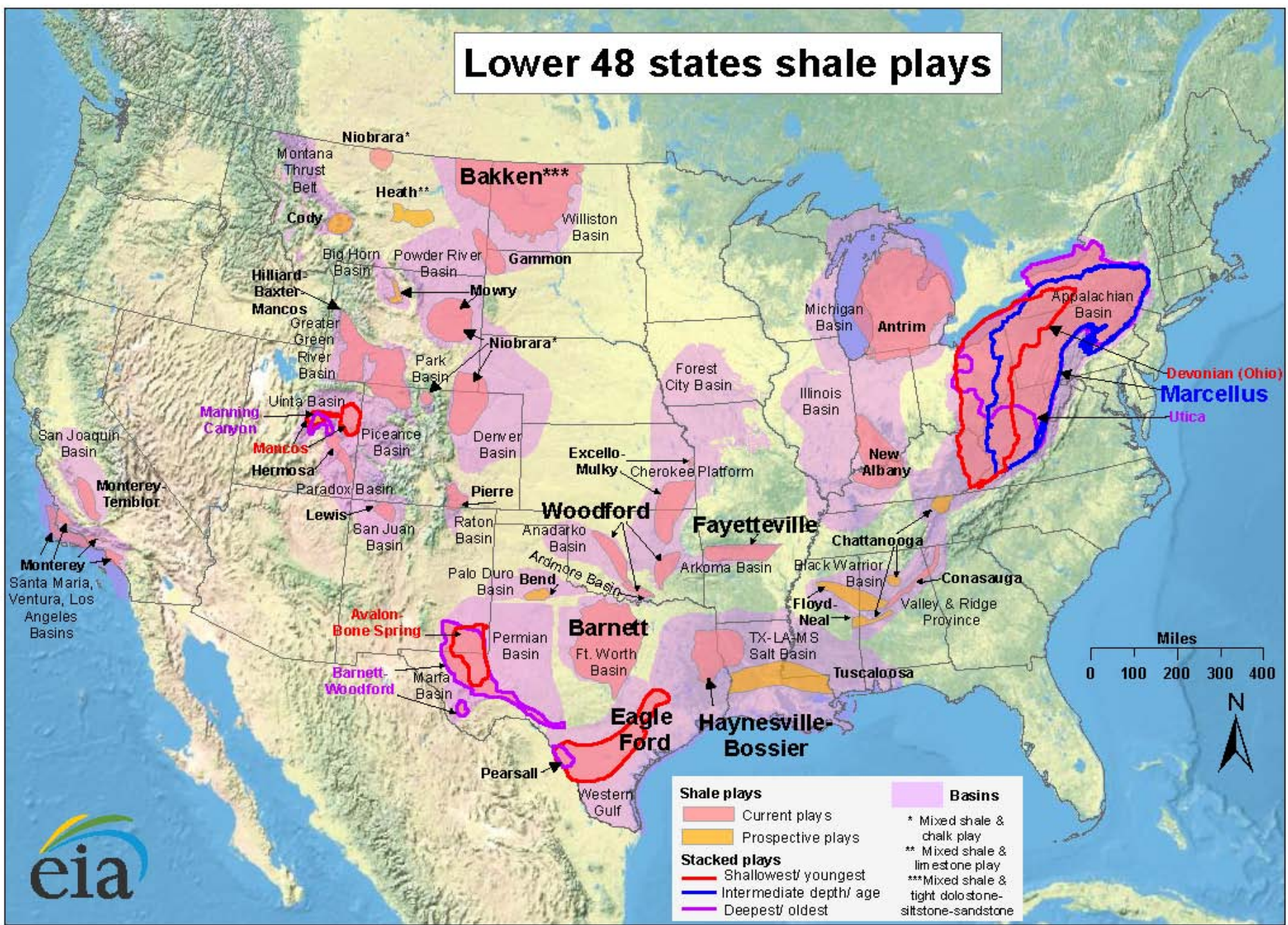


Facilities and Equipment Issues – Shortages Affiliate, Ownership and Audits

Presented by: Mike Cougevan
Martindale Consultants, Inc.



Lower 48 states shale plays



Source: Energy Information Administration based on data from various published studies. Updated: May 9, 2011

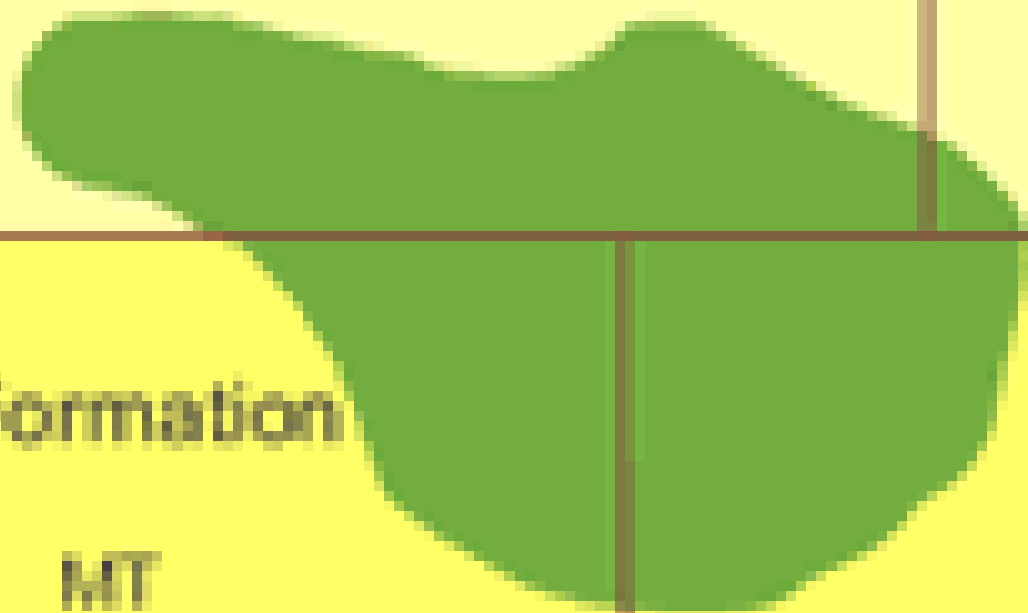


CANADA

Alberta

Saskatchewan

Manitoba



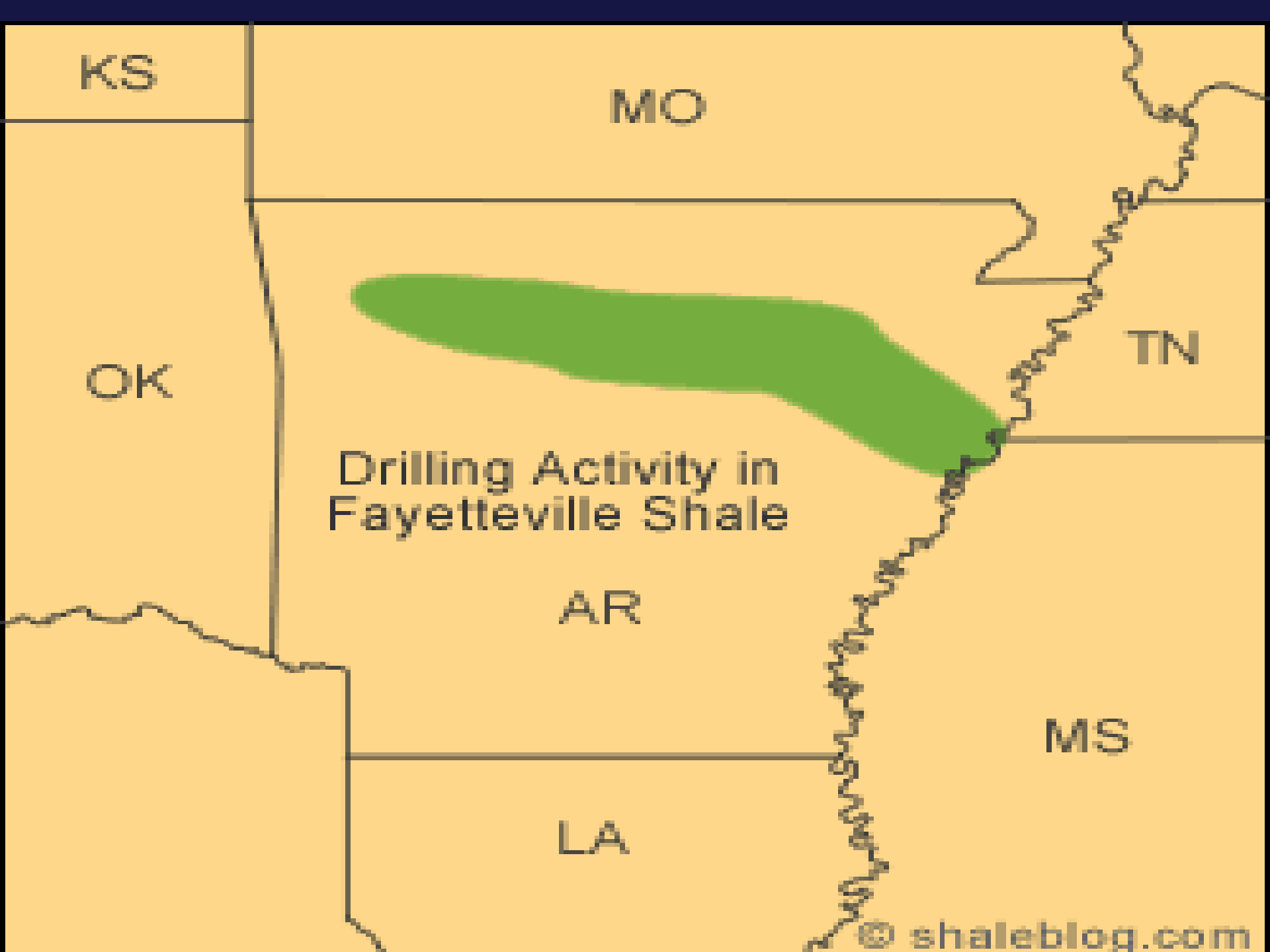
Bakken Formation

MT

ND

SD

WY



KS

MO

OK

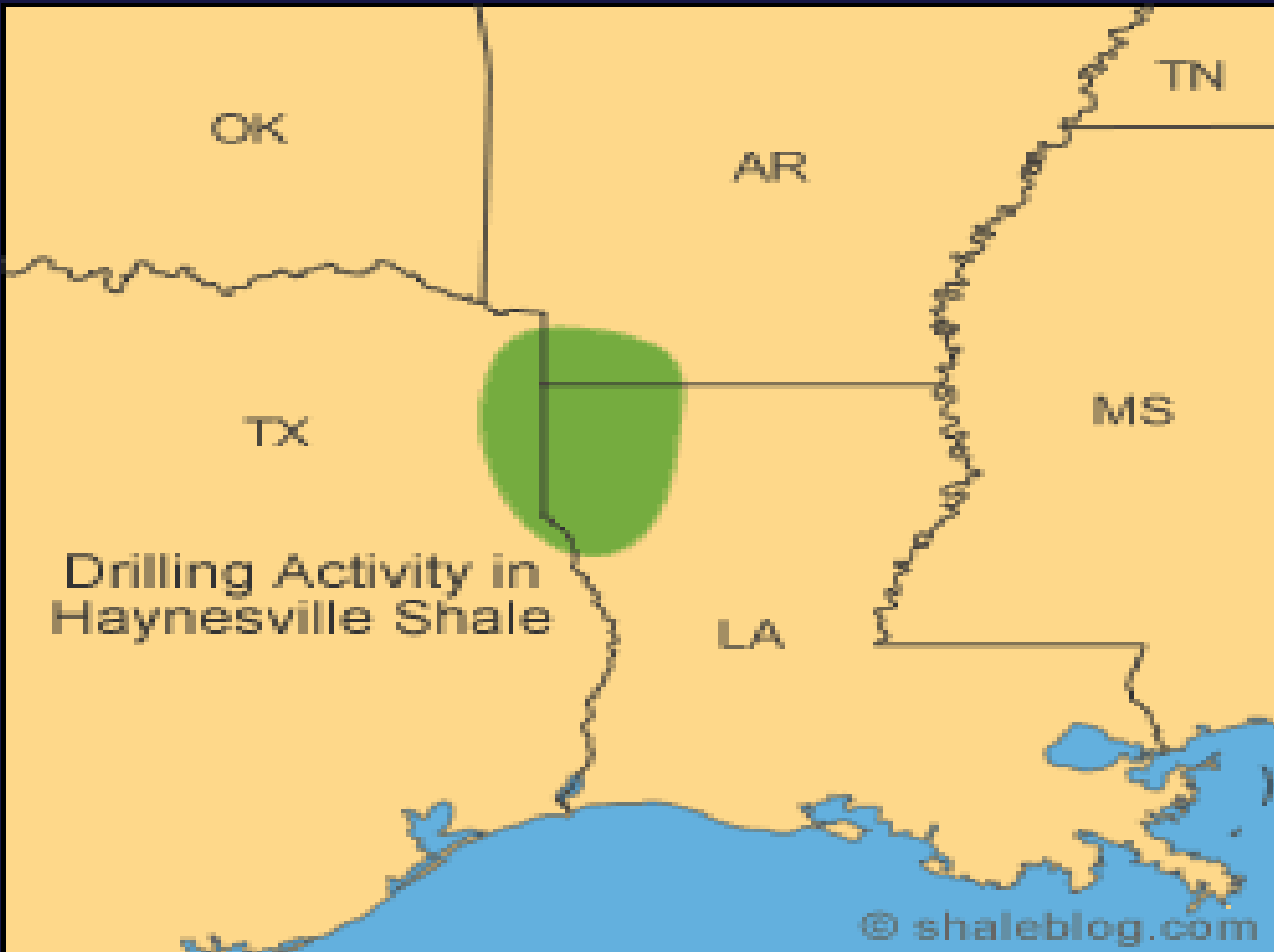
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Drilling Activity in
Fayetteville Shale

AR

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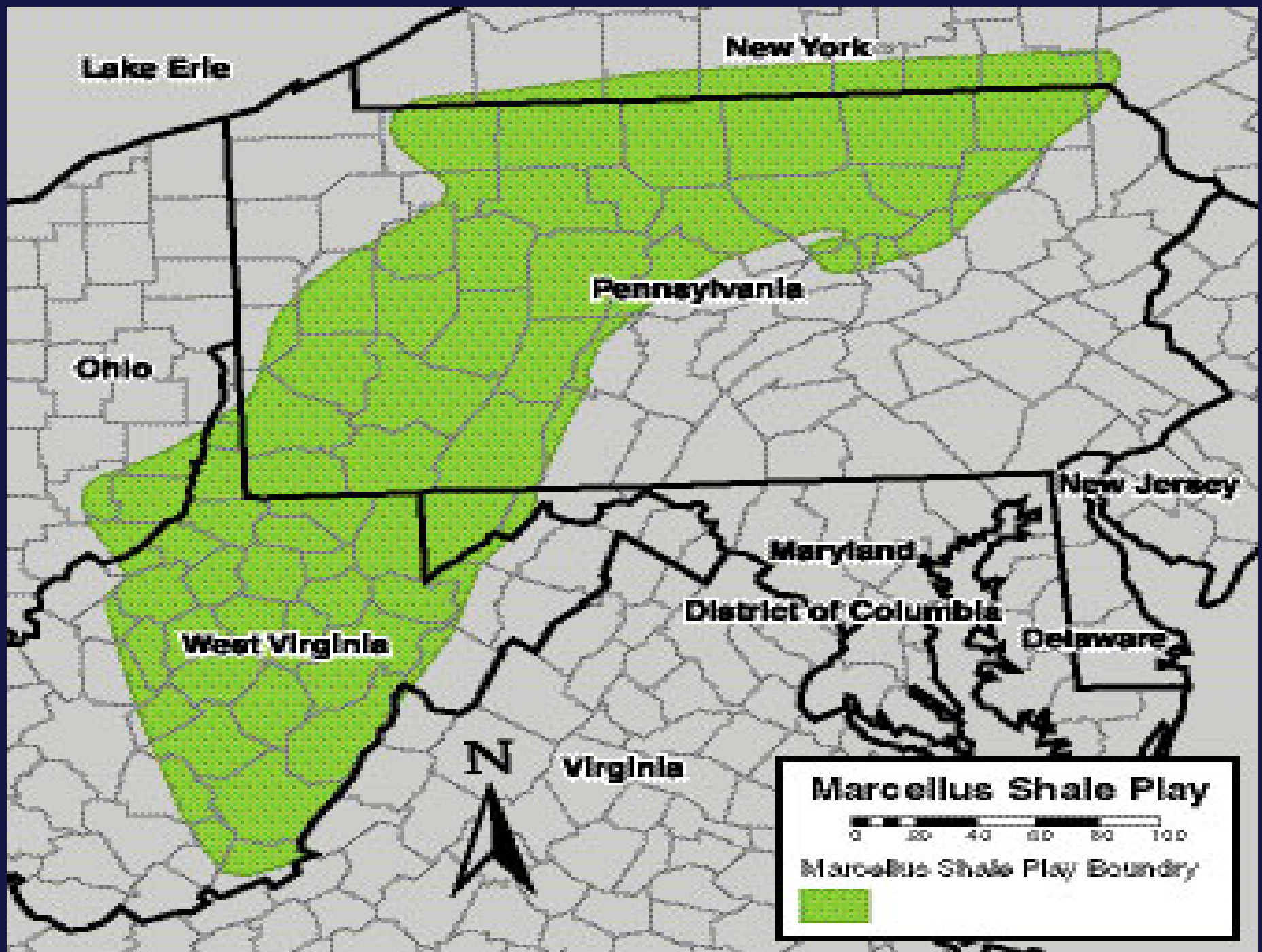
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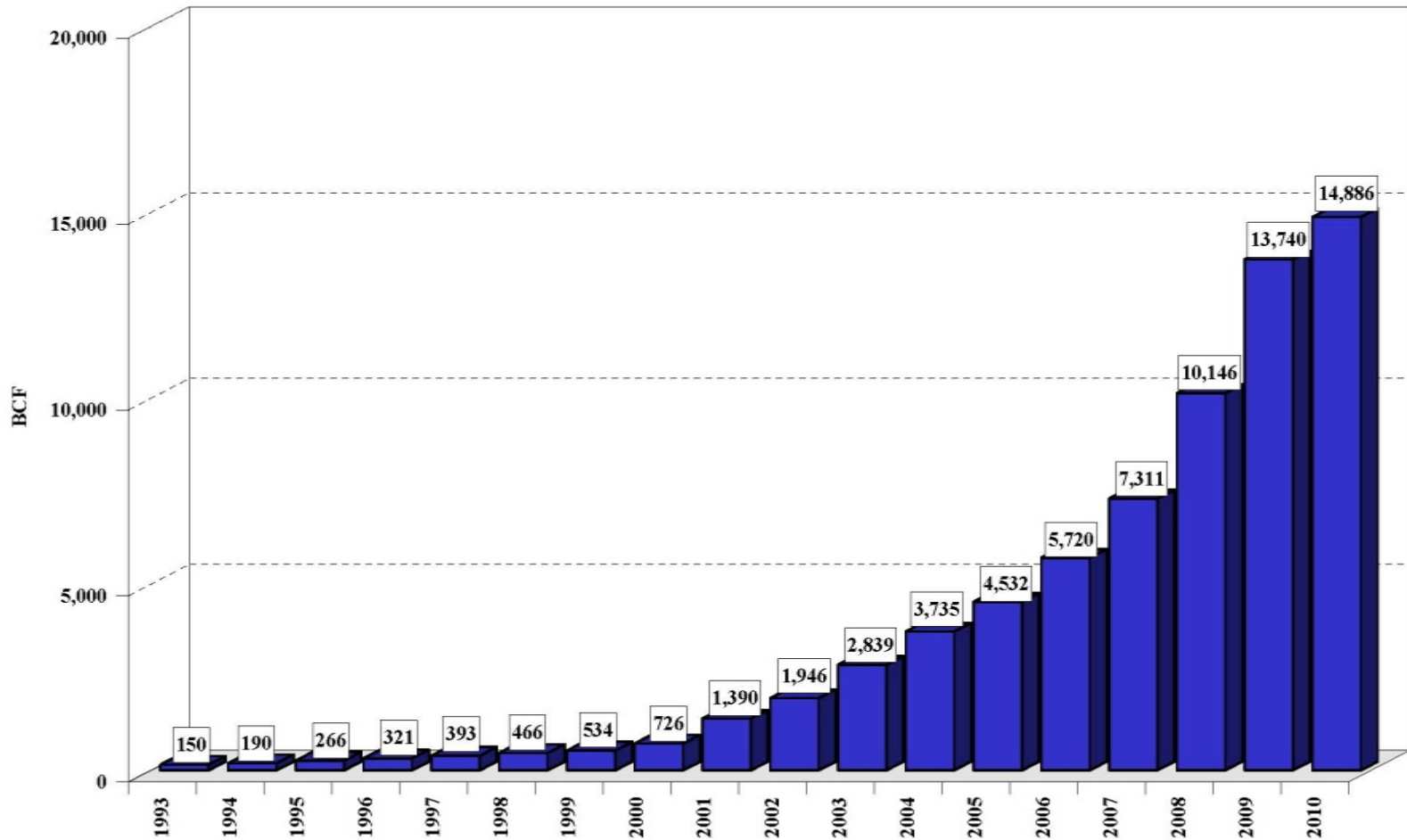
Drilling Activity in
Haynesville Shale

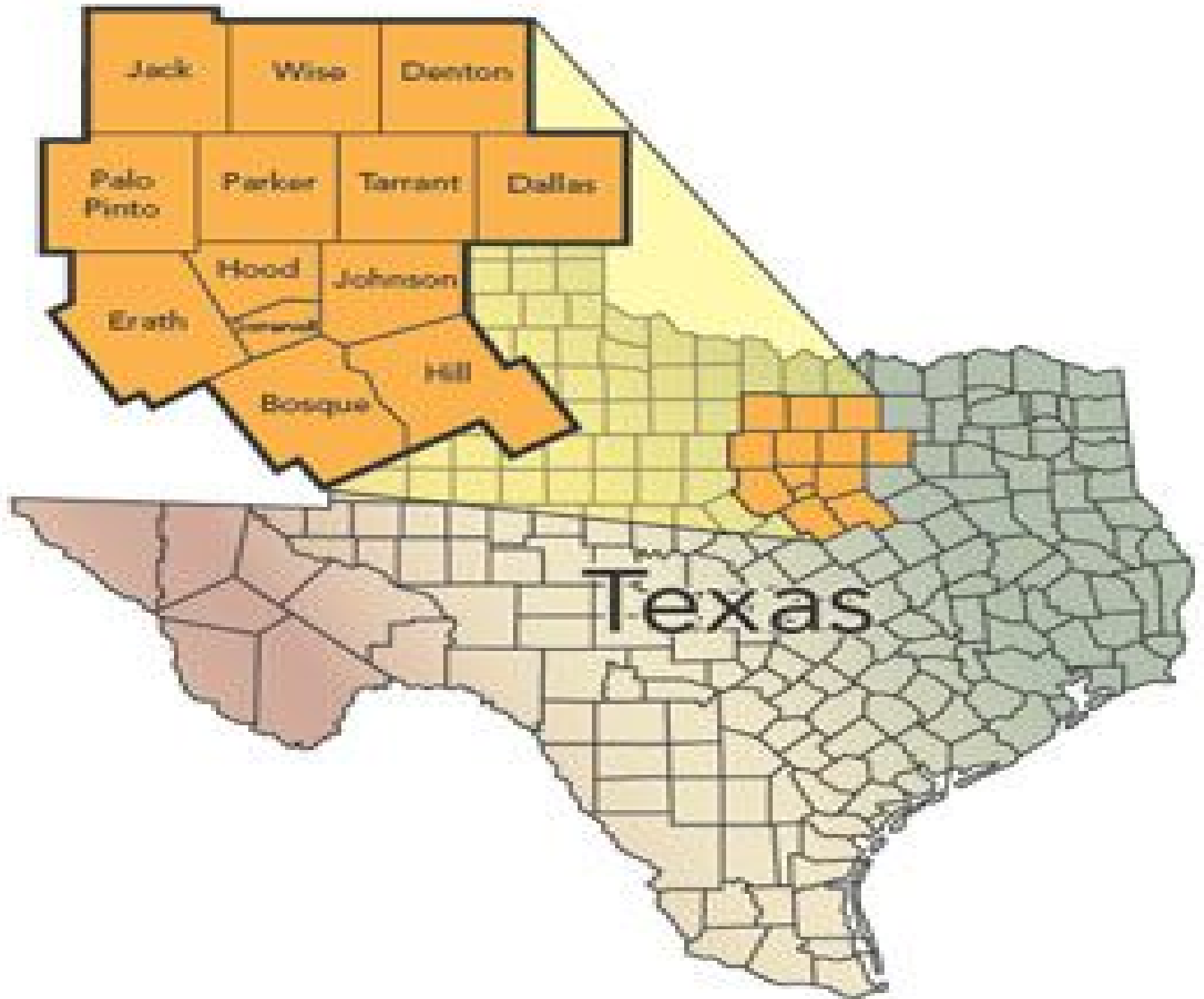
LA





Newark, East (Barnett Shale) Well Count 1993 through 2010





Issues, Support and Solutions for Today's Unconventional Operations

What Will We Discuss?

- Operational Challenges Creating Shortage of Services and Goods
- Operator's Current and Future Actions to Resolve Shortages
- Important Joint Operating Agreement Provisions
- COPAS 1984 and 2005 Accounting Procedure Provisions
- Examples of Best Practices for Implementing Provisions to Avoid Audit Issues

Operational Challenges Creating Shortage of Services and Goods

- ✓ Exploration and Participation Agreements among many parties oftentimes require Operators to drill hundreds of wells to meet specific funding and investment requirements.
- ✓ If requirements not met, Operators typically face stiff penalties.
- ✓ These requirements force Operators to drill multiple wells at the same time and secure proper resources to support the large drilling programs.

Operational Challenges Creating Shortage of Services and Goods

- ✓ Operators required by agreements to drill hundreds of wells annually
- ✓ Horizontal drilling requiring large amounts of resources (i.e. water, frac sand, etc.)
- ✓ Contractor staffing and equipment support for operations (i.e. drilling rigs, completion units, transportation)
- ✓ Remote areas such as Pennsylvania, West Virginia, North Dakota not having sufficient vendors and resources

Operator's Current and Future Actions to Resolve Shortages

- ✓ Build facilities to provide necessary support such as water treatment facilities for frac operations
- ✓ Acquire certain vendors or supply rights to secure consumables required for operations such as sand and water. These types of resources are in such high demand because of horizontal drilling operations
- ✓ Acquire and operate drilling rigs, completion units, bulldozers and trucks, either through Operator-owned or Affiliates, to ensure availability
- ✓ Enter into long-term contracts with vendors to ensure supplies and services

Operator's Current and Future Actions to Resolve Shortages

- Advantages for Operators and Non-Operators taking these actions:
 - ❑ Better logistical planning for operations
 - ❑ Known operational costs for planning and budgeting
 - ❑ Assurance that equipment is properly maintained
 - ❑ Assurance that employees are properly trained and experienced
 - ❑ Assurance that critical lease obligations are maintained
 - ❑ Possible cost savings with long term commitment

Operator's Current and Future Actions to Resolve Shortages

- Disadvantages for Non-Operators:
 - ❑ Not knowing or informed of Affiliate relationship
 - ❑ Not knowing the costs are appropriate
 - ❑ Not knowing the costs are equitable or reasonable
 - ❑ Possibly billed for costs for projects not undertaken

Important Joint Operating Agreement Provisions

The Industry primarily uses two Joint Operating Agreements to govern joint operations, the 1982 AAPL Model Form and the 1989 AAPL Model Form

The 1982 and 1989 AAPL forms contain the same following provision relating to the Operator using its own tools and equipment during drilling operations.

D. Drilling Contracts

All wells drilled on the Contract Area shall be drilled on a competitive contract basis at the usual rates prevailing in the area. If it so desires, Operator may employ its own tools and equipment in the drilling of wells, but its charges therefor shall not exceed the prevailing rates in the area and the rate of such charges shall be agreed upon by the parties in writing before drilling operations are commenced, and such work shall be performed by Operator under the same terms and conditions as are customary and usual in the area in contracts of independent contractors who are doing work of a similar nature.

- Note that with respect to the drilling contracts, the referenced language **REQUIRES**:
 - ❑ The rates charged not exceed prevailing rates in the area;
 - ❑ The rate shall be agreed upon by the parties in writing before drilling operations commence.
 - ❑ Work must be performed under the same terms and conditions as are customary and usual in the area.

Because JOA language overrides Accounting Procedure language, the typical 20% reduction for use of Operator-owned equipment or charging based on cost of ownership and operation is not required.

The 1989 JOA goes further and adds an additional sentence in Article V.D.1., as well as expanding the title.

D.1. Competitive Rates and Use of Affiliates

[Same language as the 1982 JOA followed by:]

“...All work performed or materials supplied by affiliates or related parties of Operator shall be performed or supplied at competitive rates, pursuant to written agreement, and in accordance with customs and standards prevailing in the industry.”

Thus, this 1989 language broadens the “exception” to the Accounting Procedure provision that Operator-owned equipment is to be charged at either commercial-less-20% or the Operator’s cost of ownership and operation.

- But, just as the 1982 language contains restrictions on drilling rig use and rates, the expanded language in 1989 also comes with **REQUIREMENTS** and sideboards.

Work performed or materials supplied shall be:

- At competitive rates;
- Pursuant to written agreement;
- In accordance with prevailing customs and standards

Because JOA language overrides Accounting Procedure language, the typical 20% reduction for use of Operator-owned equipment or charging based on cost of ownership and operation is not required.

What are "Competitive Rates"?

- Competitive rates are the rates commonly available from reputable vendors within the region or near the vicinity of the operation.
- If there aren't any competitors in the near vicinity, what type of contract price would it require to engage a vendor to provide the service for the operation?

What does **"Pursuant to written agreement"** mean?

- This condition requires the Operator and Affiliate to sign a written agreement for services prior to work commencement. It does not mean written agreement between Operator and non-Operators.

How to determine *“Prevailing customs and standards”*?

- Prevailing customs and standards is a requirement that the rates and conditions of service in Affiliate contracts are for the same types of services and/or equipment provided by third party arms-length contracts.
- If discounts are offered by third parties, those same discounts, whether cash or reductions from list prices, must also be given to the Operator.
- The Affiliate/Operator contract must also have the same freight terms, payment terms and material return policies as would a third party contract.
- A rig at a \$15,000 dayrate with a rotary table is not the same as a top drive rig at a \$18,500 dayrate.

COPAS 1984 and 2005 Accounting Procedure Provisions

- COPAS 1984 is currently the most widely used Accounting Procedure
- COPAS no longer publishes nor recommends using COPAS 1984; COPAS 2005 is now recommended
- The applicable 1984 and 2005 Accounting Procedures provision for this discussion are
 - ❑ Section II.8 (1984) and Section II.6 (2005)
“Equipment and Facilities Furnished by Operator”
 - ❑ Section II.7 (2005) ***“Affiliates”***

“Equipment and Facilities Furnished by Operator”

- ✓ Provisions in 1984 and 2005 are identical except for added language in 2005 (highlighted)
- ✓ Two Operator-decided options for charging Operator-owned equipment and facilities
 - Cost of ownership and operation
 - Commercial rates less 20%

Two options for charging Operator-owned equipment and facilities

6. EQUIPMENT AND FACILITIES FURNISHED BY OPERATOR (2005)

In the absence of a separately negotiated agreement, equipment and facilities furnished by the Operator will be charged as follows:

- A.** Operator shall charge the Joint Account for use of Operator-owned equipment and facilities, including but not limited to production facilities, Shore Base Facilities, Offshore Facilities, and Field Offices, at rates commensurate with the costs of ownership and operation. The cost of Field Offices shall be chargeable to the extent the Field Offices provide direct service to personnel who are chargeable pursuant to Section II.2.A (Labor). Such rates may include labor, maintenance, repairs, other operating expense, insurance, taxes, depreciation using straight line depreciation method, and interest on gross investment less accumulated depreciation not to exceed _____ percent (___%) per annum; provided, however, depreciation shall not be charged when the equipment and facilities investment have been fully depreciated. The rate may include an element of the estimated cost for abandonment, reclamation, and dismantlement. Such rates shall not exceed the average commercial rates currently prevailing in the immediate area of the Joint Property.

Two options for charging Operator-owned equipment and facilities

6. EQUIPMENT AND FACILITIES FURNISHED BY OPERATOR (2005)

In the absence of a separately negotiated agreement, equipment and facilities furnished by the Operator will be charged as follows:

B. In lieu of charges in Section II.6.A above, the Operator may elect to use average commercial rates prevailing in the immediate area of the Joint Property, less twenty percent (20%). If equipment and facilities are charged under this Section II.6.B, the Operator shall adequately document and support commercial rates and shall periodically review and update the rate and the supporting documentation. For automotive equipment, the Operator may elect to use rates published by the Petroleum Motor Transport Association (PMTA) or such other organization recognized by COPAS as the official source of rates.

Two options for charging Operator-owned equipment and facilities

- So, unless the equipment is used for drilling a well, the Operator is required to either charge a rate commensurate with cost of ownership and operation not to exceed prevailing rates (option A) or prevailing commercial rates less 20% (option B).

“Affiliates”

COPAS 1984

- ✓ Does not contain language addressing the direct charging of Affiliates. When used with a 1989 AAPL model form, the only limitations are in the JOA provision.
- ✓ When used with a 1982 AAPL model form, equipment and services provided by an Affiliate are treated as if Operator-owned, unless the Operator can provide documentation that the Affiliate provides a *“substantial amount of services”* to other Operators (COPAS MFI-18).
- ✓ Use COPAS Model Form Interpretation 18 (*Affiliates and Related Entities of Operator*) as a guide to determine if a related company qualifies as an Affiliate or third party.



MFI-18 Affiliates and Related Entities of Operator

Issue Date: October 2009

MFI-18 Affiliates and Related Entities of Operator

Problem: Some Operators have affiliate, subsidiary, and/or related entities supply goods and services used on the Joint Property. Questions arise regarding the proper manner for charging the Joint Account for goods and services provided by these “Related Entities.”

MFI-18 Affiliates and Related Entities of Operator

Examples of situations leading to Non-Operator concerns about the propriety of costs charged to the Joint Account:

- ✓ Operator's technical personnel (engineers and geologists) organized as a Related-Entity technical service company and charged at consultant daily rates > actual costs;
- ✓ Operator supplies field labor through a Related Entity that is a contracting service company and charged at commercial rates > actual costs;
- ✓ Joint Account charges for Related Entities' chargeable goods and/or services may include overhead functions that may have been formerly provided by the Operator and, in some cases, a profit element;

MFI-18 Affiliates and Related Entities of Operator

Examples of situations leading to Non-Operator concerns about the propriety of costs charged to the Joint Account include:

- ✓ Operator has Related Entities from which they purchase materials at prices > than those paid by the Related Entity;
- ✓ Related Entities provide services involving the use of drilling contractors, well servicing contractors, etc., charged at commercial rates;
- ✓ Operator outsources goods/services covered by an overhead rate to a Related Entity.

MFI-18 Affiliates and Related Entities of Operator

Interpretation:

The purpose of the Labor, Materials and Equipment and Facilities provisions of the Accounting Procedure is to assure the Operator's employees, material purchased from outside sources and any equipment or facilities owned by the Operator are charged at actual cost, without a mark-up.

The term "Operator" includes entities which are "related" to the Operator **unless** the following criteria (Litmus Test) are met at the time of the transaction:

MFI-18 Affiliates and Related Entities of Operator

Litmus Test:

- The Related Entity must either historically or currently have conducted a substantial amount of its business with companies other than the Operator or other Related Entities. These criteria should be met by the Related Entity in total as well as for the particular services or products provided. The Related Entity should not merely serve as a vehicle for rebilling services or products provided by unrelated companies; **AND**
- Goods and services provided by the Related Entity should be priced on terms that do not exceed the lesser of (1) those offered by the Related Entity to its most favored customers or (2) those offered to or obtainable by the Operator from unrelated entities in the geographical area.

MFI-18 Affiliates and Related Entities of Operator

Conclusion:

Unless the Related Entity is able to comply with the criteria of the preceding paragraph (“*Litmus Test*”),

- (1) the services of employees of a Related Entity shall be charged at the actual cost incurred by the Related Entity, without mark-up,
- (2) material purchased from the Related Entity shall be charged at the price paid by the Related Entity to an independent third party, after deduction of all discounts actually taken, and
- (3) equipment or facilities owned by a Related Entity shall be charged at the rates specified for Operator-owned equipment and facilities in the Accounting Procedure.

“Affiliates”

COPAS 2005

- ✓ Affiliate is a defined term

““Affiliate” means for a person, another person that controls, is controlled by, or is under common control with that person. In this definition, (a) control means the ownership by one person, directly or indirectly, of more than fifty percent (50%) of the voting securities of a corporation or, for other persons, the equivalent ownership interest (such as partnership interests), and (b) “person” means an individual, corporation, partnership, trust, estate, unincorporated organization, association, or other legal entity”

"Affiliates"

COPAS 2005

- ✓ Contains specific provisions for direct charging Affiliates
 - ❑ This section must be carefully negotiated depending on comfort level with Operator or Non-Operators
 - ❑ Separate provisions for AFE and non-AFE projects
 - ❑ Parties decide on expenditure level above which Non-Operator approval is required
 - ❑ Allows for ultimate flexibility for the parties to negotiate expenditure thresholds from \$ 0 to \$ millions
 - ❑ The result is that when used with the 1982 and 1989 AAPL model forms, it allows the parties to put sideboards around the Affiliate costs and requires those costs be properly documented and supported

“Affiliates”

II.7. AFFILIATES (2005)

- A. Charges for an Affiliate’s goods and/or services used in operations **requiring an AFE** or other authorization from the Non-Operators may be made without the approval of the Parties provided (i) the Affiliate is identified and the Affiliate goods and services are specifically detailed in the approved AFE or other authorization, and (ii) the total costs for such Affiliate’s goods and services billed to such individual project do not exceed \$_____. If the total costs for an Affiliate’s goods and services charged to such individual project are not specifically detailed in the approved AFE or authorization or exceed such amount, charges for such Affiliate shall require approval of the Parties, pursuant to Section I.6.A (General Matters).

“Affiliates”

II.7. AFFILIATES (2005)

- B. For an Affiliate’s goods and /or services used in operations **not requiring an AFE** or other authorization from the Non-Operators, charges for such Affiliate’s goods and services shall require approval of the Parties, pursuant to Section I.6.A (General Matters), if the charges exceed \$_____ in a given calendar year.

“Affiliates”

II.7. AFFILIATES (2005)

- C. The cost of the Affiliate’s goods or services **shall not exceed average commercial rates prevailing in the area of the Joint Property**, unless the Operator obtains the Non-Operators’ approval of such rates. The Operator shall **adequately document and support commercial rates** and shall **periodically review and update the rate** and the supporting documentation; provided, however, documentation of commercial rates shall not be required if the Operator obtains Non-Operator approval of its Affiliate’s rates or charges prior to billing Non-Operators for such Affiliate’s goods and services. Notwithstanding the foregoing, direct charges for Affiliate-owned communication facilities or systems shall be made pursuant to Section II.12 (Communications). If the Parties fail to designate an amount in Sections II.7.A or II.7.B, in each instance the amount deemed adopted by the Parties as a result of such omission shall be the amount established as the Operator’s expenditure limitation in the Agreement. If the Agreement does not contain an Operator’s expenditure limitation, the amount deemed adopted by the Parties as a result of such omission shall be zero dollars (\$ 0.00).

Examples of Best Practices for Implementing Provisions to Avoid Audit Issues

JOA Best Practices:

- AFEs can help Operators start communications the right way with Non-Operators by noting those costs included in the AFE provided by Affiliates or by Operator-owned methods. COPAS 2005 requires such.
- If using COPAS 1984, provide letters or attachments to AFEs listing services or equipment either furnished by the Operator or an Affiliate. Include in the letter or attachment the rates proposed to be charged.
- For approval of facilities, equipment, Affiliates and rates, a letter or attachment could contain language requesting approval in order to avoid future controversies and audit issues.

JOA Best Practices (continued):

- “Other Provisions” of the JOA – many Operators and Non-Operators use this section to add additional requirements or provisions stating how the use Affiliates and Operator-owned equipment will be communicated to the parties.
- “Other Provisions” is often used to agree how previously incurred costs such as “batch” location or right-of-way work (prior to the current JOA) will be shared
- “Other Provisions” is also used to provide requirements for how competitive rates or commercial prevailing rates will be supported. How many bids or what other vendor support will be required?
- For large Operator-owned facilities (i.e. water or frac sand), prepare a separate agreement to use between parties that provides explicit details of how the costs will be billed to the operations .

Examples of Best Practices for Implementing Provisions to Avoid Audit Issues

Accounting Procedure Best Practices:

- Notify Non-Operators in advance of plans to use Affiliate and Operator-owned equipment or services in order to get upfront buy-in and approval.
- Stop using COPAS 1984 and use COPAS 2005 when negotiating new agreements.
- Consider switching from COPAS 1984 to COPAS 2005, not just for these types of issues, but for all of the other benefits of COPAS 2005 with respect to clarity and flexibility.

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Presented by: Mike Cougevan
Martindale Consultants, Inc.





Martindale Consultants, Inc.
4242 N. Meridian Ave.
Oklahoma City, OK 73112
Phone: (405) 728-3003

Mike Cougevan
M.Cougevan@marticons.com

www.marticons.com