Denver Law Review

Volume 29 | Issue 5 Article 4

January 1952

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Recommended Citation
Arthur Thad Smith, Operating Agreements for Oil and Gas Devleopment, 29 Dicta 166 (1952).

OPERATING AGREEMENTS FOR OIL AND GAS DEVELOPMENT

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An operating agreement is an agreement for sharing the costs and the rewards of an oil and gas operation.

Parties to the agreement are the working interest owners of the leasehold estates in the lands upon which the operations are to be conducted. They are the parties who must do the work and put up the money for the enterprise. Royalty and overriding royalty owners are not parties to an operating agreement because they are never required to bear the costs of operations.

The subject of the agreement is the land believed to contain oil or gas and a schedule or description of this land always appears in or is attached to the agreement. This schedule also sets forth in detail the exact interest of each party in the leasehold estate or leasehold estates covered by the agreement. Sometimes there is an operating agreement for one lease. Sometimes one operating agreement covers many leases.

The agreement contains various terms and provisions setting forth the manner in which the parties to the enterprise are to conduct themselves. The enterprise is a joint venture. The object of the venture is the discovery of oil or gas and its production. The object of the agreement is to set forth a fair arrangement for sharing the burdens of the enterprise among the parties and a fair basis for sharing the proceeds of oil or gas produced. The agreement will also spell out the rights and duties of the parties.

One of the parties is by common consent designated as operator. That party is charged with the responsibility of carrying out the operations under the agreement, drilling the wells, purchasing materials and equipment, setting up the joint account, charging the parties their respective shares of the costs and distributing the proceeds of production to the various parties.

All the other parties to the agreement are non-operators. If there are only two parties, then one is the operator and the other the non-operator. Non-operators will have the right to receive complete reports on all operations, have free access to the premises, inspect the wells and operations, examine the books of account and frequently to approve or disapprove proposed drilling. Non-operators will be responsible for their share of all costs in the manner set forth in the agreement and will likewise be entitled to their share of production.

Every different factual situation provides a setting for a different type of operating agreement. Parties confronted with similar factual situations also have various ideas as to what is the best plan of operations. So we have operating agreements for:

1. A single tract with two working interest owners;
2. A block of three tracts with a separate working interest owner for each;
3. A large block of many tracts with several working interest owners who decide to operate on a share and share alike basis;
4. Developed lands where tracts are given different values on the basis of known reserves and productive capacity;
5. Large blocks which are unitized under the Standard Form Federal Unit Agreement;
6. Farm-out deals;
7. Carried Accounts and net profit interests.

Let us take a simple situation suitable for a carried account and analyze a few points which should be considered in preparing the agreement.

In a carried account the operator carries the non-operator, i. e., Operator advances Non-operator's share of all costs and looks only to oil or gas produced for reimbursing himself.

Assume Non-operator owns 12 leases covering four sections in a solid block in the form of a square. He talks to several prospective operators about developing the block and finds one who has some geological data on the area which indicates it is an interesting prospect. They make a deal as follows:

1. Operator to pay Non-operator in cash sufficient to reimburse Non-operator his out-of-pocket costs in acquiring the block plus a reasonable profit based on time spent in so doing.

2. Non-operator to assign to Operator an undivided 75% interest in the leases.

3. Operator to drill a free well.

4. Operator to carry Non-operator on all subsequent wells.

First the operator will insist that the deal be subject to acceptance of titles. That means that titles must be or must be made satisfactory to the operator. Operator may wish, and in oil operations has a right to insist on a perfect title because after the discovery of oil even a shadowy claim may command a nuisance value running to thousands of dollars. Non-operator should not view these title requirements as an irksome matter because they are as much for Non-operator's protection as Operator's.

The initial test well is the first major development provision. This well differs from later development wells for the reason that it carries a high risk. Its drilling is based on geological data only. In later wells there will be available the results of this first well and far less risk will be involved.

The initial test well provision may run as follows: "On or before June 1, 1952, Operator shall begin to drill an adequate test well at a location of its selection on the leased lands and thereafter continue such drilling diligently until the Dakota formation has been tested or until, at a lesser depth, oil or gas shall be discovered which can be produced in paying quantities or until granite or some impenetrable substance or condition is encountered which renders further drilling unwarranted or impracticable, provide, however, that operator shall not in any event be required to drill said well to a depth in excess of six thousand feet."

Note the depth limitations—the Dakota Sands—granite—6,000 feet. The Dakota Sands are the agreed upon objective. The other two limitations are to protect Operator in the event unexpected subsurface formations are encountered. If there is no Dakota formation under the drill site, the 6,000 foot limitation saves Operator. If, due to faulting or folding, granite is encountered above the Dakota, the granite limitation saves Operator. Such limitations are universally employed.

INTENTION SHOULD BE SPELLED OUT

But note the provision relieving Operator if oil or gas is discovered which can be produced in paying quantities. The words "paying quantities" must be defined and, in this instance, mean in quantities sufficient to repay the cost of drilling and producing operations plus a reasonable profit. This insures Non-operator a good well if a shallow discovery is made with the result that the Dakota is not tested. But if a Dakota test is what Non-operator is bargaining for, rather than just oil or gas production, the clause should be omitted. This may be the case where shallower production is believed to underlie the drill site but Non-operator wants a deep test. Then to get the shallower production, Operator must drill to the Dakota and if this formation is dry, plug back to the productive sand.

Since this test well is to be free to Non-operator, the agreement should provide something like this: "All costs and expenses of drilling and testing such well shall be borne and paid for by Operator and Non-operator shall never be liable for any part thereof nor shall any part thereof be charged against Non-operator's share of production."

Note that only the costs of drilling and testing are free. Running casing, equipping and completing the well and all other expenses incurred only after discovery, will be charged, as to Non-operator's share, to the carried account. This is because, when a discovery has been made, Non-operator has gotten what he bargained for, i. e., a test of the lands covered by his leases. From then on his share of costs go against his share of production.

The free well often carries with it the right of Non-operator to his share of production from the well free of charges for costs and expenses of subsequent wells. This enables Non-operator, after completion costs have paid out, to receive cash from first well production while the field is being developed.

The location and time for drilling development wells must be left to Operator because efficient development must be based on geological information obtained as drilling progresses. Here the implied covenants in the basic leases will operate in favor of Non-operator and insure proper development of the premises.

In the example we are considering, the carried party has retained a 25% ownership of the basic leases and property and production subject to the agreement. In past years this has been standard practice. Recently there has been a trend toward net profit arrangements. This is because various rulings of the Bureau of Internal Revenue and Tax Court decisions have indicated that such an arrangement places the parties in a more favorable tax position. These rulings and decisions suggest that a carried party may be held liable for income taxes before his carried interest has paid out and consequently before he is receiving any cash income from operations. This will never be the result under the net profit arrangement.

The net profit interest owner retains and holds an undivided interest in net profits instead of in the basic leases and property. He receives exactly the same amount of money at the same time as the carried interest owner of an equivalent interest receives. He receives the full benefits of a free well, the same right to all reports and to inspect the premises and, under the U. S. Supreme Court decision in the Burton-Sutton Oil Company case,[1] he is entitled to the same depletion allowance on all cash received. The first and second annual reports of the Southwestern Oil and Gas Institute contain some excellent material on the advantages of the net profit arrangement.

The accounting procedure for costs and expenses of an oil operation is complicated. This involves questions as to the fair way to charge the joint account for such items as:

1. Disability benefits of operator's employees
2. Costs of hospitalization and retirement plans
3. Moving material to the joint property
4. Loss by fire
5. Costs of litigation
6. Camp expense where one camp serves both the joint property and other leases owned by Operator in the area
7. Overhead.
8. Materials removed from the joint property, junk, salvage, etc.

Because negotiations with respect to such details for each

[1] 328 U. S. 25, 66 S. Ct. 861 (1946).

agreement would result in interminable delays, a standard accounting procedure has been settled upon. It is the result of several years of effort on the part of the members of the accounting section of the Mid-Continent Oil and Gas Association. It represents a procedure which most companies in this region will accept either as operator or non-operator. It is attached to and made a part of the operating agreement and the usual practice is for the non-operator to simply verify that the accounting procedure submitted is the Standard Mid-Continent form. The only questions for discussion are the three or four typewritten insertions in the form.

The Surrender Clause

The last major provision of the operating agreement is the surrender clause. Because conditions are sometimes encountered which confront parties to an operating agreement with possible heavy losses, the surrender provision is essential. It is not safe to rely upon the surrender clause of the basic leases because the parties to the operating agreement may have different views as to prospects for the joint venture. One may wish to quit while the other wishes to go on. In our example, where each of the parties to the operating agreement owns an undivided interest in the basic leases, it may be that neither can surrender the basic lease unless the other joins. This is because, in the absence of special provision, the lessor cannot be required to accept a surrender of an undivided one-fourth only of the leasehold estate. Even if the lease permitted such a partial surrender, the other party to the operating agreement has a right to object to being forced into a tenancy in common with a landowner not a party to the operating agreement. The surrender clause should, therefore, include a provision permitting any party to obtain release from obligations under the agreement by assigning his interest, without consideration, except for the salvage value of equipment on the premises, to the other party or parties. Each party should also have the right to have the interest of the other assigned to it prior to any general surrender being undertaken. This protects a party desiring to continue on with the venture.

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