Unit Operating Agreements From a Non-Operator Viewpoint

By JULIAN C. STROUD

Forest Oil Corporation

Unitization is a combining or consolidating of leases to form one operational lease. As related to proven productive reservoirs, the general purpose of unitization is to provide a means for efficient joint development and production practices. Unitization may be accomplished by consolidating as few as two leases or portions of those leases. This is often done to form gas or oil well proration units. That type of unitization is often referred to as a "pooling" of leases. Unitization may also be applied to the consolidation of several leases to form fieldwide units. The same legal principles of unitization generally apply to the various types of lease consolidations. The distinction between kinds of units is based primarily on size and on the specific operational purposes for which they are formed. Remarks in this paper refer to fieldwide units formed for fluid injection programs.

Mr. Henry L. Doherty is generally acknowledged as perhaps the outstanding early advocate of unitization. Although there are some technical papers on unitization prior to 1920, it was a speech made by Mr. Doherty in December, 1924, before the Board of Directors of the American Petroleum Institute which is generally credited with focusing widespread industry and government attention on unitized operations. As a result of the early efforts of Mr. Doherty and others in industry and government, unitization was recognized and practiced prior to 1930. Among the first fieldwide units to be formed were the Salt Creek in Wyoming and the North Dome Kettleman Hills in California.

With the overproduction and resulting depressed oil prices of the 1930's, the incentive for unitization was insufficient to greatly advance its application. However, some units were formed, and during that period both Oklahoma and New Mexico passed laws authorizing compulsory unitization in forming well proration units.

Unitization for the purpose of representing operations began significant growth in the 1940's. Unitization of developed fields for the application of pressure maintenance or secondary recovery processes is the most complicated type of unitization. These units often cover large areas and include many leases and wells. There may be myriad working and royalty interests involved in this type of unit. The recovery process to be utilized in connection with fieldwide unitization is a result of detailed evaluation and planning by engineers and geologists and is based on available information regarding reservoir characteristics and production data.

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Unitization may result in some overall operating economics from the use of centralized facilities and from reduced labor costs. However, lower costs are usually considered as an incidental benefit of unitization, and operating economy is not often the reason for fieldwide unitization of producing properties. The significant advantage of fieldwide unitization is that it provides a single lease entity of sufficient size to make feasible the application of an injection program by which reservoir production behavior may be controlled.

The unit operating agreement is a contract between the working interest owners which governs their respective roles in conducting unitized operations. Working interest owners are those parties who own oil and gas leases or who operate unleased mineral interests in the

unit area; who, together, bear the costs of the unitized project.

The operating agreement provides that the conducting of unit operations is to be a collective function of all working interest owners. The authority of each party in performing that function is equal to his unit participation. Voting procedures are contained in the operating agreement under which the working interest owners reach required decisions.

Ordinarily, the working interest owner having the largest interest in the unit area instigates the formation of the unit. That party is usually designated as the unit operator in the operating agreement. All other working interest owners are referred to as non-operators.

The role of unit operator is to apply to field operations the management decisions of working interest owners. In connection with performing those field operations certain specific authorities are granted the unit operator in the operating agreement. Those powers are given so that the operator may act upon routine and relatively insignificant matters without the delay of obtaining formal vote approval of working interest owners.

Expenses are, of course, incurred by the unit operator in the performance of designated duties. Field personnel engaged on the unit project are employees of the operator whose salaries, wages and expenses are paid by the operator. In addition to those costs of operation directly incurred on the unit project, the operator also provides administrative services required for the unit. The field and administrative functions performed by unit operator benefit all parties, and consequently, the operating agreement provides that all working interest owners bear charges for operator services in proportion to their unit participation. However, those charges should not exceed the actual costs incurred by the unit operator in furnishing operator services for the unit.

The unit operating agreement is generally acceptable to non-operators. However, there are some areas of the operating agreement under which non-operators may encounter problems in unitized operations. It is the purpose of this paper to discuss the provisions of the operating agreement as they relate to non-operator unit problems.

AUDIT RECONCILIATIONS

The unit operator maintains a joint unit account for total unit operations. Non-operators have the right to conduct an audit of the operator's accounting procedures for the unit not more than once a year. The purpose of the audit is to check on the accuracy of operator unit accounting.

Most non-operator exceptions to operator accounting practices are resolved between operator accountants and non-operator auditors, item by item. Errors in operator accounting which are recognized by the operator are designated as audit exception items allowed. Audit exception items not recognized by the operator as accounting errors are considered disallowed items. If an operator cannot satisfactorily explain them, they become unresolved audit exceptions.

Usually the manner of settling unresolved audit exceptions is to put them to vote by working interest owners under the general vote provision. Unfortunately, the parties often vote to benefit their immediate financial interests, instead of on the merits of the accounting exception. Therefore, the validity of the unresolved audit exception item is not always reflected by the vote method of resolving audit exceptions.

Perhaps the submittal of unresolved audit exceptions to professionally qualified disinterested accountants for arbitration would provide a method of obtaining a more equitable settlement on disputed audit items.

GENERAL VOTE PROVISION

The general vote provision is usually considered to be the most important provision of the operating agreement. More unit decisions are subject to settlement under this provision than any other provision of the operating agreement. Non-operators should determine that the affirmative vote required is not so great that a relatively small interest voting against a motion can effectively hold veto power.

The importance of this point is illustrated by the following review of a voting occurrence in an Oklahoma unit. An audit of the operator's accounting resulted in approximately $30,000.00 in unresolved exception items. Working interest owners voted on affirmative motions that the unit recognize those items.

Under the general vote provision, unit operator alone had sufficient voting percentage when voting negative to defeat an affirmative motion.

However, the general vote provision also required that two or more parties must join in voting negative to defeat a motion.

Working interest owners voted on individual motions to recognize 47 audit exception items. The operator voted negative on each of the 47 ballots and was joined in each negative vote on all ballots by one other party. That party had less than .02 per cent voting interest. Under the general vote provision, the negative vote of those two parties was sufficient to defeat each motion. Therefore, all audit exceptions to the operator's accounting subjected to vote were denied. As a matter of interest, those two parties cast the only negative votes on 40 of the 47 ballots.

INFORMATION FURNISHED BY UNIT OPERATOR

Many operating agreements contain a provision as follows:

> "The cost of gathering and furnishing information not ordinarily furnished by Unit Operator to all Working Interest Owners shall be charged to the Working Interest Owner who requests that information."

This contract clause is objectionable to some non-operators because it contains no limitation on operator charges. Non-operators should have the right to acquire existing data by paying only the actual cost incurred by operator in reproducing and mailing copies of that information requested.

DISTRIBUTION OF SALES PROCEEDS

Upon formation of a fieldwide unit, the pipeline purchaser often declines to disburse proceeds directly to the individual owners in unit production. Many unit operators also refuse to accept the responsibility for distributing sales proceeds to each owner of oil and gas on the purported fear of anti-trust violation. As a result, the former lease operator in each tract usually distributes the proceeds of allocated tract production to each payee in the tract on the basis of proportionate ownership.

Some industry attorneys feel that perhaps the unit operator could distribute sales proceeds directly to all payees upon proper agency authorization by the owners of unit production, if that agency is revocable at will, and if a sale by the individual owners is evidenced by appropriate division orders.

WELLS TAKEN OVER

The operating agreement article relative to adjustment of investments provides that all wells are to be delivered to unit operator upon effective unit date. However, the basic form of this provision does not specify that wells delivered are to be in a usable mechanical condition, and further, does not provide remedy in event wells delivered are not in a usable condition.

While the basic well delivery provision possibly implies that those wells delivered are to be in a usable condition, the determination of the existence of that implied covenant would necessarily depend on litigation. On the other hand, express contractual provision can clearly establish the obligation to deliver wells in a usable condition, and in connection therewith, prescribe the remedy in event wells delivered are not in a usable mechanical condition.

The well delivery provision should recite that all wells are to be in a usable condition; that there will be a specific time period commencing at delivery date in which to determine in fact the condition of delivered wells; that either the contributor or the unit may perform remedial work required to put a well in usable condition; that any charge made by unit to the contributor for well remedial work performed by the unit shall be considered as an ordinary unit charge. The recitation that such charge shall be considered as an ordinary unit charge removes any doubt concerning the authority of the unit operator to invoke an operator's lien in event of payment default by well contributor.

INVESTMENT ADJUSTMENT

The unit usually takes over all equipment in the unit area upon unit formation. Within a set number of months the unit declares which part of that equipment is surplus and that surplus equipment is returned to the owner. The investment adjustment is then made on the value of equipment retained by the unit.

The operating agreement usually contains a fixed pricing basis for inventory evaluation and the investment adjustment of retained equipment is calculated on that pricing basis. The market value of equipment may be less than that value designated in the operating agreement for inventory evaluation.

Working interest owners having a disproportionately large amount of contributed equipment declared surplus receive unfair treatment

if the unit pricing basis substantially exceeds market value. Those parties must "buy-in" for cash any deficit incurred under the investment adjustment calculation. In turn, their equipment declared surplus is worth only actual market value.

One method to equate the positions of all working interests in investment adjustment would be that the inventory evaluation pricing basis be set on current market value. Another method to handle the matter would be that the unit take over all equipment, and sell the surplus equipment for the benefit of the joint account.

WITHDRAWAL

The withdrawal provision generally provides that a working interest owner may withdraw from the unit by assigning his interest in unitized oil and gas rights and in unit equipment to the other working interest owners. It is usually further provided that the withdrawing party will be paid for his interest in unit equipment on the basis of estimated salvage value.

There is some industry support to limit the right to withdraw only to those working interest owners having a full 7/8 income interest. Under such withdrawal right restriction, working interest owners bearing any excess royalties could not withdraw from the unit prior to unit termination, even if that meant suffering an operating loss for an extended time during the unit depletion phase. Unit non-operators should ascertain that no qualifications are attached to the right to withdraw from the unit.

ACCOUNTING PROCEDURE

The direct and indirect charges sections of the accounting procedure are the parts of the procedure of greatest interest to non-operators. These sections provide the manner in which the operator will be reimbursed for services furnished in conducting operations for the unit.

Non-operators generally are not disturbed about the direct charges section, which provides that the joint unit account shall be charged with salaries and other operator costs for employees directly engaged on the unit project, as well as those of technical personnel temporarily assigned to the unit.

The indirect charges section is of more concern to non-operators. Indirect charges are comprised of district expense and administrative overhead charges. District expense is the cost incurred by the operator in maintaining an office serving his wells and facilities in a local area. The operator's district office performs services for the unit project which are not chargeable to the unit as a direct charge. The expense incurred by an operator in performing services at the district office level is usually allocated to all the properties served by that office on a par well allocation basis.

Administrative overhead is defined in the accounting procedure as being a charge in lieu of the cost and expenses of all offices of the operator except those of the district office for which district expense is chargeable. Administrative overhead is also in addition to those salaries and expenses payable as direct charges.

The present trend is to combine both district and administrative overhead charges into a designated per well charge.

Non-operator concern is that indirect charges may be excessive in fieldwide units. Total non-operator indirect charges can amount to several million dollars over the life of very large unit projects containing several hundred wells. However, under voluntary unitization, the demand by the operator of acceptable charges is not in violation of competitive enterprise concepts. It apparently does not particularly matter whether or not indirect charges are consistent with operator's true cost, because at a "going rate" in the industry they are the price that non-operators will pay for the opportunity that unit participation affords.

SUMMARY

The determination of fair equity participation and the achievement of overall economic success are the two most important aspects of fieldwide unitization. However, since many non-operator objections to units are related to operational occurrences controlled by the operating agreement, these provisions of that contract are also an important element of unitization. While the operating agreement is generally regarded as being fair, some non-operators feel that the test of actual operations governed thereby indicates needed improvement in some respects.