

CAPLA STANDARD EARNING LETTERS

How often has this happened to you? You are reviewing an old farmout file. Perhaps you are reviewing the file in anticipation of the affected interests being sold. Perhaps you acquired it pursuant to a recent purchase and are now trying to enter it onto your computer system. You have found the part of the agreement outlining requirements for earning. You know from the rest of the file that earning must have occurred, or at least, earning is assumed to have occurred. How do you know earning occurred? Which well on the Farmout Lands is the earning well? Did it drill deep enough and in the time stipulated by the agreement? In other words, how can you prove the Farmee fulfilled its earning obligations? And then how often have you asked yourself why all that effort and rework was necessary?

Some companies currently negate any such potential uncertainty by regularly using earning letters. Some earning letter forms simply state that earning has occurred leaving the specific details to be addressed by the agreement and whatever process exists in the relevant company to record earning. Other earning letter forms provide a thumbnail sketch of what was done to earn and what was earned. After due consideration, the Earning Letter Committee decided to adopt the latter approach in drafting the attached standard earning letters. The advantage is that earning is clarified, and confirmed by all relevant parties, in a manner that can be easily verified many years after the event. A further advantage of this more detailed earning letter concerns possible disputes. If any party disagrees with some aspect of an earning letter, that potential area of clarification is quickly known and dealt with. At the same time, the administrative effort involved is quite minor since the relevant components of such an earning letter would have to be pulled together in any event to record earning.

Farmout agreements can take many forms and may contain earning requirement subtleties requiring careful attention. Therefore, before using these forms, you will need to review the relevant agreement to assess any specific changes that would be required.

One cannot draft an earning letter in a vacuum. To provide a frame of reference, these earning letters were written with the following assumptions:

1. the 1997 CAPL Farmout & Royalty Procedure applied to the relevant agreement; and
2. the basic terms of the relevant agreement conformed to the November 13, 1996 Cat In The Hat Farmout sample two page letter agreement used to illustrate the use of that Farmout & Royalty Procedure (copy of letter agreement enclosed with this package as reference).

If either assumption does not apply to your company's specific agreement, amendments to the applicable earning letter may be necessary. Why was the 1997 CAPL Farmout & Royalty Procedure used as a frame of reference? There are a variety of reasons:

- 1) We had to start with something.
- 2) The trend in industry is to standardize where feasible to increase Land personnel effectiveness. The 1997 CAPL Farmout & Royalty Procedure is a reflection of that trend and we hope for and expect widespread use in industry.
- 3) This package will highlight to Land Administrators the practical aspects of using the 1997 CAPL Farmout & Royalty Procedure while also serving as a platform to introduce earning related concepts to less experienced administrators.

When using these earning letters, the following points should be considered.

1. The sample agreement had 2 Farmor parties and 2 Farmee parties. If there was only a single party for either the Farmor or Farmee, the sentence structure may have to be modified accordingly.
2. If there was a participant, certain additions would be in order to reflect any elections it may have had. For example, a sentence could be added stating that, by notice dated a certain date, the participant had elected to farmout or participate as the case may be.

For casing point deals, the structure of the earning letter would have to reflect the elections made and the effects of those elections upon the final interests. As earning/election arrangements can take many different forms, it is not feasible to suggest precedent sentences. You must refer to the agreement.

With respect to recompletion deals, there may be certain tangibles and surface rights earned by the Farmee. Some reference should be made to those interests together with earned interests in petroleum and natural gas rights. As well, if the recompletion was unsuccessful, was the Farmee obligated to abandon and reclaim the well, to only abandon the zone in which the recompletion was attempted or to return the well to the Farmor?

3. Check the definition of spacing unit in the relevant agreement. To completely describe a spacing unit earned by the Farmee, you may need to ascertain the area, zone(s) and substances affected by the relevant definition in the agreement. Moreover, there is the possibility that a special spacing order may be issued changing the spacing unit size for a particular substance in a given zone. In the 1997 CAPL Farmout & Royalty Procedure, the Earning Well spacing unit is calculated as of the rig release date for that well.
4. If the base agreement did not contain depth or zonal restrictions on earning and/or did not segregate the Earning Well spacing unit in the earned Farmout Lands, amendments must be made accordingly.
5. Did the base agreement exclude certain zones and/or substances from the Farmout Lands? If so, it would be wise to reference any such reserved zones or substances in the earning letter.
6. Where an Earning Well is capped or abandoned but not yet reclaimed in compliance with the earning obligations set forth in the agreement, consideration must be given to Farmee status while completion or reclamation remains outstanding. Ordinarily, the Farmee must finish that well at its sole cost, risk and expense. For a capped well, that usually means completion and for an abandoned wellbore, that usually means reclamation. The two usual choices for Farmee status are:
 - (1) those subsequent operations are an inherent part of earning and earning does not occur until those operations are completed, leaving the Farmee in a state of limbo; or
 - (2) earning has occurred but those subsequent earning operations remain the responsibility of the Farmee as post-earning obligations.

The 1997 CAPL Farmout & Royalty Procedure is aligned with the first choice but with one major difference. During that time those subsequent operations are outstanding, the Farmee is afforded a recognized conditionally earned status.

If the agreement for which the earning letter is being written does not use the concept of conditional earning for capped or abandoned wellbores as envisioned by the 1997 CAPL Farmout & Royalty Procedure, one would make modifications. Perhaps a sentence could be added to the effect that certain post-earning obligations still need to be met by the Farmee at its sole cost, risk and expense despite earning.

1. The 1997 CAPL Farmout & Royalty Procedure provides the Farmor with an election to retain its ORR if the earning well is abandoned. Another common provision is to deem a conversion to a working interest upon

abandonment. If the agreement for which the earning letter is intended provides for a deemed conversion, one could modify Earning Letter 2 to reflect the deemed conversion.

Also with respect to an abandoned well, please note that Earning Letter 2 assumes that proper notification to trigger the Farmor election was issued and all Farmor parties elected to convert to a working interest. If one or more Farmor parties elected to stay in a royalty position, the relevant sentence and the post-earning interests would have to be amended accordingly.

2. With regard to the royalty description, these earning letters follow elections made in the Cat In The Hat Farmout agreement. For example, the 2 gas royalty percentages reflect the cash versus take in kind percentages referenced in 5.01(A)(b) Alternate 2 of the 1997 CAPL Farmout & Royalty Procedure. One will need to refer to the agreement for which the earning letter is drafted to discern any required changes.

Also, the 1997 CAPL Farmout & Royalty Procedure uses the term "Overriding Royalty". Another common term is "Gross Overriding Royalty". In drafting an earning letter, you may wish to use whatever term is used to describe the royalty in the relevant agreement.

3. The multiple well earning letter basically follows the same structure as the single well scenarios. The precedent is set up as if both Earning Wells were capped or completed but can be easily modified to handle abandoned Earning Well scenarios.

In addition, it would be up to individual company preference as to whether an earning letter was issued as each Earning Well was drilled or only upon the last Earning Well being drilled.

4. The earning letters are drafted as if one of the Farmors was preparing it. However, little modification is required should a Farmee issue the letter.

Attached are the following:

- 1) Earning Letter 1 - Capped or Completed Test or Option Well on 1 earning block.
- 2) Earning Letter 2 - Abandoned Test or Option Well on 1 earning block.
- 3) Earning Letter 3 - Capped and/or Completed Test and Option Well on 2 earning blocks.
- 4) Additional Earning Related Issues.
- 5) Cat In The Hat Farmout Sample Letter Agreement.

CAPLA Standard Earning Letter Subcommittee Members: Ted Weryshko, Linda Powers, Glen Sveinson

Additional Earning Related Issues

In addition to its primary purpose of setting out earning, the earning letter may deal with other administrative matters relating to the agreement. Some optional sentences one might consider adding to the letter, if appropriate, are as follows:

1. In accordance with Clause _____ of the Agreement, the Farmee may elect to drill an Option Well on or within _____ days of rig release of the Test Well. As the Test Well rig released _____, that election date is now set as _____.
2. In accordance with Clause _____ of the Agreement, the area of mutual interest period will cease _____ days following the rig release of the last Earning Well. As this well rig released _____ and is to be considered the last Earning Well, that date is now set as _____.
3. Enclosed is a photocopy of the relevant title document for the earned Farmout Lands.
4. In accordance with Clause 6.01 of the Procedure attached as part of the Agreement, the initial payout statement is to be provided to the Farmor within 6 months of rig release of the relevant well. Please forward same in due course. (Applies to Earning Letter 1 and 3; assumes "Procedure" definition is set up)
5. In accordance with Clause 7.01 of the 1997 CAPL Farmout & Royalty Procedure ("Procedure"), the Farmee issued a notice dated _____ to the Farmor regarding their intention to abandon that well. Pursuant to that notice, the Farmor has taken over the well. Therefore, effective as of the rig release of that well, and subject to Clause 3.04 and Article 7.00 of the Procedure, GHI and JKL have conditionally earned an interest in Block ____ of the Farmout Lands in accordance with Clause _____ of the Agreement. (Applies To Earning Letter 2; replaces first, second and third sentence of paragraph following well details.)