THE NEGOTIATOR

The Magazine of the Canadian Association of Petroleum Landmen
April 2012

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The Single Well Unit PAUAs
Truly Magnificent Legal Documents

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Production Allocation Unit Agreements

The Single Well Unit

The traditional unit agreement and the Production Allocation Unit Agreement (PAUA) are, in my humble opinion, truly magnificent legal documents that:

(a) allow for the equitable and economic production of oil and gas where you have diverse working interest (WI), royalty (GOR) and lessor (LOR) parties in a pool(s) or well;

(b) provide a mechanism for regulatory compliance where you do not have common ownership in a pool or where you are commingling production among pools and spacing units; and

(c) increase lease continuation certainty through the amendment of the leases to provide for continuation by way of unit operations.

The increase in horizontal well drilling has been the driver in the use of PAUAs. A PAUA is required in horizontal wells where the productive horizontal legs cross more than one spacing unit and there are varied WI, GOR or LOR parties.

However PAUAs may also be used for vertical wells, where parties are increasingly producing from multiple pools within a single wellbore and commingling production to a single meter point. This vertical commingled production from multiple pools is more than a vertical pooling (since each pool is a separate spacing unit), and so a PAUA should be used.

Common Ownership

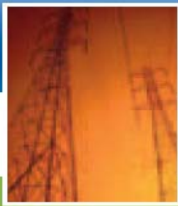
The regulatory requirement of common ownership in a spacing unit or larger production unit is the bedrock rational for PAUAs (see for example the Oil and Gas Conservation Regulations, Alberta). Regulatory bodies require that production occur equitably among the WI and LOR owners. Failure to establish common ownership in a spacing unit or larger production unit is a non-compliance event and can lead to shutting in wells and other regulatory woes.

Where you have varied WI or LORs in production from a single wellbore, equitable production can only be assured where the parties have agreed to the method of allocation of such production. This is especially the case where production from each horizontal leg or vertical completion cannot be individually determined or metered. Where you cannot actually measure production from tracts having differing ownership, the only method to equitably allocate production among owners is by way of a PAUA which allocates production from the production allocation area to the various tracts.

Freehold Lease Continuation

The other fundamental benefit of unitization is the ability to amend freehold leases to provide for continuation by way of unit operations as opposed to actual operations from the said lands under the lease. A PAUA should always contain a article on lease continuation and amendment. A good example is the Alberta Energy model form PAUA (which can be downloaded from the AE website, under Tenure forms). Article 9 of this PAUA provides that:

> 9.1 Continuation of Leases
> *All operations conducted with respect to the Production Allocation Zone* or production of Production Allocation Substances shall, except for the purpose of calculating payments to Royalty Interest Owners, *be deemed conclusively to be operations upon or production from the Production Allocation Zone in each Tract, and such operations or production shall continue in full force and effect each Lease* and



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any other agreement or instrument relating to the Production Allocation Zone or Production Allocation Substances as if such operations had been conducted on, and a well was producing from, each Tract or portion thereof in the Production Allocation Area (emphasis is mine).

9.2 Leases Amended
Each Lease and any other agreement or instrument relating to the Production Allocation Zone or Production Allocation Substances is hereby amended only to the extent necessary to make it conform to this Agreement.

These magic words must appear in your PAUA in order to properly amend your lease and the lessor must be a party to and sign the PAUA. You cannot bind the lessor unless they have agreed in writing to the amendments to the lease.

Please note that such an amendment must also be caveated on title in order to be enforceable as against third parties. The original lease caveat can protect only the terms of the original lease, not amendments. Failure to file such a caveat could lead to a top lessee successfully lapsing your original lease caveat if you do not have production from the said lands under your lease.

Special Consideration for GOR

An often overlooked element of common ownership on unitization is the GOR holder. Such parties are often but not always included as parties in the unit agreement such that the GOR holders royalty is calculated based upon unit production

Calculating the GOR

You cannot assume that a GOR is always paid based upon unitized production. You must confirm that the GOR holder was a party to and signed the PAUA. In such a case the GOR will appear as a royalty or encumbrance beside the appropriate tracts in the unit Exhibit. If so, the GOR is calculated based upon unitized production.

However, if the GOR holder did not sign the unit agreement, the GOR is not payable based upon unitized production but rather from production from the GOR lands. This can lead to bizarre results in traditional units depending on where the GOR lands are located. Sometimes a GOR holder will refuse to sign onto a unit as a major well is located on the GOR lands. In such a case the GOR will continue to be calculated from production from such well, regardless of the impact of waterflood or other enhanced recovery techniques pushing additional oil through the wellbore. Often after a number of years (and sales of the assets) the GOR stops being calculated based upon the said lands and starts to be paid on unitized production. Not ok.

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GORs and Common Ownership

A potential common ownership issue can also arise if GOR holders are ignored on unitization. As indicated above, PAUA are often used where it is not possible (or economic) to determine the volumes of production from each leg or completion over time as all volumes are measured at a single meter. If a GOR holder is not a party to a PAUA in such a case, they can certainly argue that common ownership has not been established. The rationale for common ownership is equitable production. If a GOR holder cannot establish the share of production from the wellbore that the GOR pertains to, the GOR holder cannot be equitably compensated. This will at least lead to a lawsuit and perhaps regulatory non-compliance measures.

In my practise I run across very few new wide area unit agreements. It seems a shame not to take advantage of unitization in any situation possible. This is especially the case where companies are undertaking enhanced recovery projects (such as complex water floods or CO2 projects) on a pool wide basis on older well defined pools. In such situation a unit will allow for common ownership and tenure certainty in undertaking costly and long term projects.

The good news is that the PAUA seems to have become an industry standard document that horizontal well operators use on a day to day basis. Hopefully we will come to see increased use of the PAUA in vertical well commingling situations.

2012 Updated Commentary

This article first appeared in the June 2008 *Negotiator*. As this horizontal well thing appears to be catching on, we decided to reprint the article. The follow are some random thoughts (or pearls of wisdom) that have occurred to me since that time.

No So PAUA

I foolishly stated that PAUAs appear to have become an industry standard document. I am kind of an optimist. I should know better.

My more recent experience is that oil companies are increasingly basing production allocation on unilateral letters sent to lessor's indicating that the their lease is subject to production allocation and they will get a percentage share of production from the horizontal well. Full stop. Many letter's even use the word "pooling". Yuck. See above.

There a basis under the CAPL form of freehold lease to assert a lessee's right to unilaterally unitize the lands and allocate unit production to the lessors. This may be ok, but I am not totally convinced that a series of unilateral letters to lessor's is a defined "Unit Agreement" under the CAPLs. The risk is entirely on the lessee (oil company) that if there is, in fact, not a true Unit Agreement. If not, you have not properly unitized and you may not be able to prove to a Court that you have operations on the lands sufficient to continue the lease. Not worried, here is a tip for you, oil companies never win against lessors in court.

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Further, such letters do not typically work for nonCAPL leases which are much less likely to have a unilateral right to unitize. The problem is that once a sloppy practise starts, it is very hard to stop the bus. "We only send letters out, we never do PAUAs". I have heard that many, many times since my very optimistic statement above.

Return of the Unit

The other change I have noticed over the last four years, is a tiny seed of hope that the true unit agreement is starting to finally get some love.

The emergence of EOR focussed companies working on old plays in the checkerboard, or other freehold areas, had allowed us to push for, and finally get, corporate lessors and our goofy client lessees to understand the fundamental importance of unitizing a pool subject to EOR.

The almost universal inclusion of spacing unit reversion, quarter section maximum leases and the lack of injection as a continuation mechanism under corporate forms of lease means that a unit agreement overlaying the pool subject to your enhanced recovery scheme is an absolutely essential requirement prior to commencing operations. Not doing so is simply negligent in my mind.

Sure you say, another boogyman story by Negenman. Give it a rest dude. Most of the time, I can tell clients, yeah big risk but low probability, your call. The EOR without unitization is not one of those times. The recently filed Statement of Claim in *Crew Energy Inc. v. Cenovus Energy Inc.* (Alberta Court of Queen's Bench Action No. 110107197) is a powerful and tragic tale of this very predictable issue playing out in Court. Huge swath of land and huge effect on the operations and potential revenue of Crew. This is a public document. Get yourself a copy if you want a primer in the very bad spot you can end up in if you don't do your land and legal homework.

Paul Negenman
Partner, EnerLaw LLP

Get Smart

The CAPL Education Committee is pleased to present the following courses:

Preparing For a Surface Rights Board Hearing (PSL®)

April 3, 2012 8:30 a.m. to 4:30 p.m.

This seminar is suitable for individuals who require a better understanding of the Surface Rights Board hearing process from start to finish. This course will begin by covering the types of surface rights board hearings, including compensation, rent review, damage claims and back rent. The next section will focus on the structure of the hearing and deal with procedural elements, evidence taken under oath, direct and cross examination of witnesses and questions from the board. From there, the course will focus on evidentiary issues like the burden of proof and discuss privacy issues before closing by discussing the orders ultimately issued by the board.

Surface A&D (PSL®)

April 10, 2012 8:30 a.m. to 12:00 p.m.

This half day seminar is designed for surface land personnel requiring an introduction to surface rights management in the acquisition and divestiture of operated properties. The course is also valuable to supervisors and managers in the area. Topics include a sample checklist, lease and agreement conveyancing, well licenses and LLR review, transfers, easements and rights-of-way, transfer of caveats, road use agreements, notice to landowners and occupants, electronic processes in Crown dispositions and license transfers, and environmental approvals. The course is presented from an Alberta perspective, but much of the material and process are relevant to other jurisdictions.

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