THE NEGOTIATOR

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UNCONVENTIONAL RESOURCES

WHEN WATER AND OIL (AND GAS) DO MIX

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The Lonely Vertical Wellbore

Excluding Vertical Wellbores Tenure and Contract Considerations

ONCE UPON A TIME, NOT SO VERY LONG AGO, THERE LIVED IN THE WCSB A BEING OF IMMENSE POWER AND PRESTIGE. This being would appear in mere days, on the tops of hills, or in forests, or in the bottoms of great valleys. Very often, the first sighting would be, but a mere prelude, to a deluge of these beings across full townships of land, moving like an unstoppable herd, until the entire horizon was dotted with the metal caps of their long bodies drilled deeply into the earth. This being was the vertical gas well (VGW).

But alas, the age of the great VGW herds is coming to an end. The age of expensive gas is over. The magic of the perforated vertical wellbore was being lost to the sands of time. For now we are entering a new age, the age of the horizontal wellbore. An age not of great herds of VGWs, but rather of princely horizontal wells, with great legs and fractures of the earth. To bring forth oil from rock which had previously denied us.

So what will become of the existing VGWs that still roam this land? This is our tale.

Please excuse the heavily Lord of the Rings inspired introduction. Each year over the holidays, my boys and I have a tradition of watching the entire series (directors cut, extended versions) in one sitting. This year we added in almost three hours of the new Hobbit movie. Finished last night at 11 p.m. and I need to write this article today. Needless to say, I am a tad middle earth punch drunk.

But hey, the alternative introduction reads as follows:

> *This article will deal with the complex tenure and contractual novation issues associated with the exclusion of existing VGWs upon a farmout of disposition of PNG rights that include the pool where the existing wellbore is perforated.*

Be honest, if I had started with the above paragraph, would you still be reading this article? Sure you would.

Wellbore Exclusion NonProducing Well

Tenure

The first example of this issue is not new, nor is it complicated from a tenure perspective. In this scenario we have a VGW which is a pure abandonment liability. The well will never produce. The purchaser/farmee has agreed to acquire PNG rights in the pool where the existing VGW is situated. The clever purchaser has managed to have the vendor/farmor exclude the wellbore from the purchase and sale agreement (or farmout agreement).

As we are simply excluding the wellbore, very few tenure issues arise. The purchaser will earn the entire interest of the vendor in the PNG rights, excluding the abandonment and reclamation obligations pertaining to the existing wellbore. Drafting this language into a sale agreement or farmout agreement is not difficult. You simply need to be clear that all PNG rights will be sold (or earned). It is merely the wellbore and its associated surface rights, abandonment, reclamation and environmental obligations that are being excluded. No tenure split occurs.

The main land issue is how to deal with the excluded wellbore in your land system (such as CS Explorer). For the purchaser, a good land administrator will create a separate split for the wellbore, or at least a remark in the applicable PNG split, indicating that the wellbore was excluded and liability remains with the vendor. Once inputted, this split or remark is often the only indication that the purchaser has in its records to determine if they need to pay for the casing vent leak or environmental damage claim that arises down the road. Failure to properly input wellbore exclusions into CS quickly leads to knowledge of the exclusion being lost. This can result in the purchaser mistakenly paying abandonment and reclamation costs it did not acquire.

For the vendor, the decision to retain a split in your land system for an excluded wellbore is very, very rare. However, it really should be done. Part of the reason such splits are generally not set up in vendors land systems is due to the lack of a tenure interest associated with the wellbore. Land systems are for tenure rights, not mere liabilities, some would argue. Also, the NOA "common crappy approach" discussed below often means there is no file to link the wellbore to in your land system. No file reference, no input. I know it is tough to find the time to create a split for a straight up wellbore liability, but really, there is nowhere else for this information to exist and it should be done. Yeah, and my kids really should read books over the Christmas break rather than playing 14 hours a day of video games. I understand. There is only so much we can hope for in life.

Contractual Novation

If you are dealing with a 100% property, you can (obviously) ignore contractual novation issues. However, if you have partners and a JOA (or other operating agreements) you must consider contractual novation in each instance where you are leaving behind a VGW. This is not a minor issue. This is not someone else's problem. If you are the landman setting up these deals, it is your job to make sure the NOAs work.

The proper (or improper) preparation of the NOA can have significant go forward implications if any cost or liability issues arise with respect to the excluded wellbore. So what to do. There are only two options. The right answer and the common crappy approach.

The right answer is to prepare a partial NOA in every case where a wellbore is excluded. The 4B election would read something like:

> *"100% of Assignor's Interest, excluding abandonment and reclamation obligations with respect to the XXX wellbore."*

The problem with the right answer is that it is hard to do. From an internal perspective, you need to determine which agreement the well pertains to and then use 4B. Simple for a one well scenario, much more difficult in a wide area sale or farmout where many wells are excluded and many separate contracts are involved. You will also face difficulty from external sources. Some administrators will attempt to reject a partial NOA that excludes only wellbore abandonment and reclamation liabilities. There is no basis for such a rejection, but hey I hear yah, I generally try to keep my head down and just get stuff done too.

This, of course, leads to the alternative common crappy approach. Under this method, the vendor prepares full NOAs and ignores the excluded wellbores. Easier to prepare and less rejections. Also, no need to copy mineral and lease files for retained interests. Yippee. Let's go for coffee. The problem is relatively minor if the wellbore is already abandoned and reclaimed. There will, hopefully, be no further AFEs or JIBs for abandonment or reclamation costs and no one really needs to know that the assignor/vendor/farmor kept some liabilities.

Very common. The problem is that this approach sometimes leads to, painful, discussions of who is responsible for the post transaction AFE or JIB relating to the excluded wellbore, months or years after the deal closed. The assignee gets the AFE or JIB as they are the novated party to the contract. They will hopefully remember to forward same to the assignor who will promptly pay. Works ok if the proper CS inputting was done above and no one has subsequently sold their interest. Works poorly if proper land system work was not done or if the accountants get involved. Smells like a series of painful and useless meetings trying to remember what was done with the wellbore in the sale agreement/farmout agreement.

Always remember that the sale agreement/farmout agreement is the contact that deals with beneficial ownership and obligations. It cannot be trumped by a full NOA. A NOA only deals with legal rights between the assignee and third parties. It never, ever, supersedes the underlying contractual bargain between the vendor and purchaser. Honest. Never. I will keep preaching this till I die. Too bad most vendor land administrators simply ignore my ranting and point to the full NOA and the fact that they no longer have a contract file in the file room.

Zonal Exclusion: The Simple Case

In the old days, when VGWs were still valuable and we were simply selling or farming out certain PNG rights, excluding the zone/formation/pool perforated by the VGW, there was a simple twist to the above scenario. We would exclude the three dimensional VGW spacing unit in the section and defined formation. On small deals, we would specifically define the excluded formation by reference to a specific well log. On larger deals, we would sometimes need to use a more generic formation exclusion (such as the Belly River).

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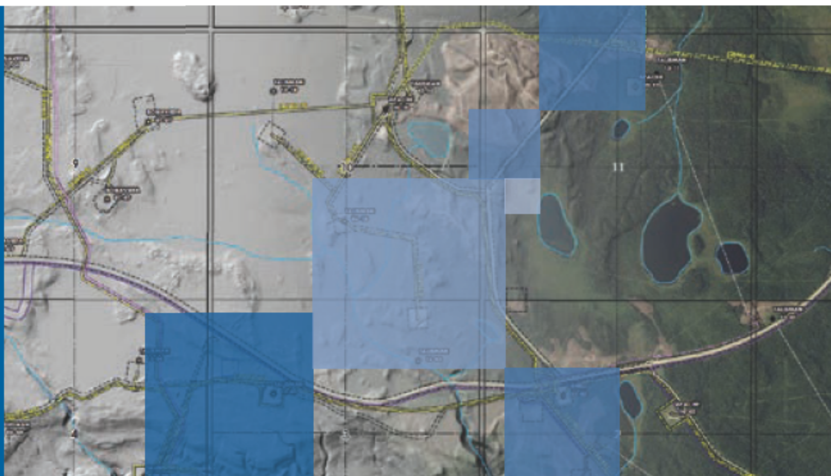

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In any event, the tenure and contract concerns are typically less complex than for the wellbore exclusion scenario discussed above, since we were specifically excluding described PNG rights.

Tenure

For tenure, we are excluding a defined PNG formation for the one section gas spacing unit. Perfect. Simply exclude same and create a new split in CS.

Contractual Novation

Where you are excluding a formation with wellbores and probably production, there is no way to be sloppy. You need to prepare a partial NOA which assigns the entire interest in the contract excluding the assignor's entire interest in the excluded zone. Again simple and clean.

Excluding Production From a Wellbore: The Complex Case

Lastly, we will examine the exclusion of producing VGWs from a sale or farmout. This is a twist on the pure zonal exclusion example discussed above. Typically, we have a vendor/farmor with existing gas infrastructure tied into existing gas production from VGWs. Not puking cash like the good old days, but enough production to keep the facilities running and not abandon the wells. The purchaser/farmee wants nothing to do with the VGW production. They are drilling shiny new horizontal oil wells, or sometimes even shiny new horizontal gas wells that can actually make money.

Complexity increases due to the prevalence of commingled VGWs that are perforated and fraced across many formations, including the juicy oil bearing formation that the purchaser/farmee is interested in drilling. The old zonal exclusion method simply does not work if the existing VGW is already perforated in the purchaser/farmee's target pool.

The solution is to restrict the VGW exclusion to production from the current VGW in its existing configuration (i.e. from existing perforations and completions).

Oddly enough, this type of exclusion has always been possible and is sometimes seen in very old contracts and land splits where the prior owner would retain production only from existing wellbores and sell the balance of the PNG rights. Tricky split to set up, but it can be done and it is a legally enforceable interest. This type of split is rare in Alberta due to our old school one well per pool spacing regulations. But times are quickly changing.

ERCB Baseline Density Regulations

Today, this type of production only split is being facilitated by the new ERCB baseline density drilling regulations for drilling spacing units under Part 4 of the Oil and Gas Conservation Regulation. In short, the single well spacing unit is dying a not so slow death. However, the death is by a thousand cuts. We are not yet abandoning

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drilling spacing units. Rather, we are incrementally changing the rules for the areal size of spacing units (i.e. easier and easier down spacing and holdings) and now we are adding the concept of allowing more than one well per pool (i.e. increased baseline density).

Increased baseline density allows for multiple producing wells from the same ERCB designated pool. The rules apply to gas wells and oil wells. The broadest baseline density rule is contained in clause 4.040(1)(a) which allows production from two gas wells per spacing unit in a pool province wide. The remainder of the baseline density rules are either well type specific (i.e. coal bed methane) or limited to a geographic areas of the province as set out on scheduled maps.

The only proviso to these rules is under clause 4.021(2), which requires that "*No well shall be produced unless there is common ownership throughout the drilling spacing unit*". This creates a bit of problem for our poor unloved VGWs, but generally we have been ignoring this issue. Topic for another day, or even a fancy pants board hearing if someone complains.

Tenure

From a tenure perspective, it is crucial to understand that excluding a producing well is fundamentally different than either wellbore exclusion or zonal exclusion discussed above. You must be very clear about what you are intending to do in your sale/farmout agreement and you must ensure that this tenure split is properly reflected in your land system. Failure to be clear will lead to problems in the future.

In the agreement, you need to carefully and specifically describe:

- the VGWs you are excluding;
- the extent of the vendor retained ownership right to production from the VGWs (all petroleum substances or NG only? If substance limited, what about liquids?);
- the ability (if any) for vendor to recomplete, rework or perforate the VGW in the future. Generally these rights are severely restricted. You do not want the vendor to have the right to convert the excluded VGW into a new horizontal well in the pool you just bought.

It is also common to include a belt and suspenders provision that specifically states that all abandonment, reclamation and environmental liability for the excluded VGW remain with the vendor. Not necessary, but pretty standard.

In your land system, both vendor and purchaser must specifically set up splits for production from the VGW. The split must be based upon the wellbore itself and must clearly indicate that production from the wellbore (in its current configuration) is retained by the vendor.

The split cannot be set up as a standard PNG rights split (such as PNG in the XXX formation) since the vendor does not own tenure to any zones or formations, but merely the right to production from the wellbore. In this age of greater than one well per pool per spacing unit baseline density, this distinction is critical. If the split is improperly set up, either party may incorrectly assume that vendor owns the formation (not simply production from the excluded wellbore). If so, the vendor may improperly recomplete the existing VGW or drill a second well in the pool, or the purchaser may improperly believe it cannot drill a new well into the pool.

Contractual Novation

Equally important is the preparation of a proper partial NOA to reflect the excluded right to production from the wellbore. Unlike an excluded nonproducing wellbore, a producing VGW has production to allocate each month and so the third party operator of the well must be provided with a proper partial NOA so they continue to properly allocate production.

Further, the partial NOA will very often be immediately followed by an ION from the assignee (purchaser) for a new horizontal well into the same pool as the VGW. Therefore, the partial NOA must clearly express that the PNG rights in the pool have been sold (or farmed out) to the purchaser, such that the ION is valid.

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