Spring 2019 Emerging Issues Sub-Committee Meeting
Memphis, Tennessee, April 24, 2019

Case Study 1

Operator-owned Central Production Facilities

Operator XYZ has a large area of operations. It is common for XYZ to build 100% company owned central production facilities to process oil and gas produced from neighboring wells. In order to recoup the costs of the facility, XYZ charges a one-time connection fee to the Joint Account for wells connected to the facility. XYZ markets all production on behalf of its WIO's and no formal marketing agreement is in place. XYZ constructs and uses central facilities because the Operator believes that these facilities are a more efficient use of capital as it is cheaper to construct and operate than building individual well pads. In 2019 XYZ reconciled all producing wells and their associated connection fees and determined that, during the downturn of 2014 and 2015, numerous wells were not charged the connection fee due to personnel turnover/layoffs. These wells are still producing into these 100% owned central facilities.

Discussion Questions:

1) Can the Operator charge for these connection fees to the wells which were not originally charged the connection fee?

2) If not, does the Operator have any other recourse to recoup their 100% capital investment in the central facilities that other owners are benefiting from monthly?

3) Does your answer change if the facilities are not 100% owned and considered affiliates under the following COPAS Accounting Procedures?

   a. 1984 COPAS

   b. 2005 COPAS

4) If these central facilities are associated with marketing, could they be considered mid-stream assets and, as such, not subject to the accounting procedure?

COPAS MFI 51, 2005

"**Affiliate**" means for a person, another person that controls, is controlled by, or is under common control with that person. In this definition, (a) control means the ownership by one person, directly or indirectly, of more than fifty percent (50%) of the voting securities of a corporation or, for other persons, the equivalent ownership interest (such as partnership interests), and (b) "person" means an individual, corporation, partnership, trust, estate, unincorporated organization, association, or other legal entity.

7. AFFILIATES

A. Charges for an Affiliate's goods and/or services used in operations requiring an AFE or other authorization from the Non-Operators may be made without the approval of the Parties provided (i) the Affiliate is identified and the Affiliate goods and services are specifically detailed in the approved AFE or other authorization, and (ii) the total costs for such Affiliate's goods and services billed to such individual project do not exceed $_______. If the total costs for an Affiliate's goods and services charged to such individual project are not specifically detailed in the approved AFE or authorization or exceed such amount, charges for such Affiliate shall require approval of the Parties, pursuant to Section I.6.A (*General Matters*).

B. For an Affiliate's goods and /or services used in operations not requiring an AFE or other authorization from the Non-Operators, charges for such Affiliate's goods and services shall require approval of the Parties, pursuant to Section I.6.A (*General Matters*), if the charges exceed $_______in a given calendar year.

C. The cost of the Affiliate's goods or services shall not exceed average commercial rates prevailing in the area of the Joint Property, unless the Operator obtains the Non-Operators' approval of such rates. The Operator shall adequately document and support commercial rates and shall periodically 16 review and update the rate and the supporting documentation; provided, however, documentation of commercial rates shall not be required if the Operator obtains Non-Operator approval of its Affiliate's rates or charges prior to billing Non-Operators for such Affiliate's goods and services. Notwithstanding the foregoing, direct charges for Affiliate-owned communication facilities or systems shall be made pursuant to Section II.12 (*Communications*).

If the Parties fail to designate an amount in Sections II.7.A or II.7.B, in each instance the amount deemed adopted by the Parties as a result of such omission shall be the amount established as the Operator's expenditure limitation in the Agreement. If the Agreement does not contain an Operator's expenditure limitation, the amount deemed adopted by the Parties as a result of such omission shall be zero dollars ($ 0.00).

Paragraph A represents the threshold for projects while paragraph B represents the threshold for ongoing operations. For example, if the Non-Operator wants approval for use of all Affiliate goods and services, "$ 0" should be inserted in the blanks. Alternatively, if the Parties want to give the Operator authorization to use Affiliates without having to get Non-Operator approval, they may insert a very high threshold or modify the provision to read "Charges for Affiliates may be made without the approval of the Parties" and strike the remainder of the provision dealing with the thresholds.

The Operator can bill Affiliate goods and services to the Joint Account without specific approval of the Parties if the cost for a given Affiliate is less than the threshold, and in the case of project, was specifically included in the AFE or project authorization. The threshold amounts negotiated in "A" and "B" are intended to remain in effect until amended; they do not have to be approved or renegotiated on an annual basis.

Unless a separate agreement has been negotiated, the threshold amount in "B" represents the amount of Affiliate charges allowed by the Operator on an annual basis without obtaining approval of the Parties; annual approval is required if Affiliate charges will exceed the threshold agreed to in "B." The thresholds in "A" and "B" are to be applied separately to each Affiliate, not to the sum of all Affiliate charges to the Joint Account.

A request for approval to use an Affiliate's goods or services should include a description of the goods to be provided or services to be performed, the basis for the charge, and the rates to be charged. The AFE or other project authorization should specifically list the Affiliate and the goods to be provided or services to be performed, as applicable.

The Operator shall furnish to the Non-Operators items such as individual timesheets or other documentation used to support each individual's time billed, each individual's job title, explanation of the specific goods provided or services performed, and the calculation of the charge(s) billed, plus any other items of documentation necessary for the other Parties to audit the costs billed by an Affiliate. The Affiliate is required to maintain accurate time and rate records so the other Parties can audit the time and costs billed, and it would be expected that this detail would be no less than is required to document and support a direct charge for Operator's employees.

The rates charged for an Affiliate should be the direct cost of providing the goods and services, but not to exceed the average commercial rates in the area of the Joint Property. The rates charged by an Affiliate should not include costs otherwise considered included in the overhead functions charged under Section III (*Overhead*), such as human resources, legal, treasury, corporate information technology, accounting, management, and other corporate functions, nor should it include a profit element unless otherwise approved by the parties. The Operator is expected to document the costs included in its Affiliate rate and the method of calculating the rate so the Non-Operators can review such rates and verify that overhead costs and profit are not included in the rate(s) charged. It is not sufficient that the Operator provide only a day rate, unit cost, or total cost as documentation for the rate(s) charged; the Non-Operators must be provided information that will allow them to understand the components of the rate(s) charged. If the Operator or its Affiliate is not willing to allow access to information necessary to verify the rate does not include overhead costs or profit, or the method of calculating the rate, the Operator should obtain Non-Operators' prior approval of the Affiliate rates.

Because the Operator cannot charge more than average commercial rates in the area of the Joint Property and is required to document, support, and update such rates, the Operator should maintain documentation of such commercial rates and be willing to provide it to Non-Operators, upon request during an audit. Likewise, a Non-Operator has the right to verify the Operator's compliance with the contract. As such, all Parties bear responsibility for documenting commercial rates. Commercial rates can be obtained by written quotes from the vendor, trade publications, or price lists, although price lists may or may not be sufficient to document commercial rates. If it is common for a vendor to grant discounts, and those discounts are not

shown on the price list, the price list may not be a reasonable reflection of the widely available commercial rate. Also, comparisons should be made using like pricing methods or units. For example, if the vendor prices its goods or services using an hourly rate or monthly rate, the comparison of the Affiliate's goods or services should be on the same basis, and not using a mileage rate.

It may be difficult to document, support, and update commercial rates if the Operator believes specific Affiliate goods or services are unique and that commercial rates are not available. In such case(s), the Operator would be expected to fully describe the nature of the Affiliate goods or services and document the components and calculation of the rates so that the Non-Operators can (1) verify that only direct costs are included and (2) conduct their own research to determine whether commercial rates exist for the goods or services provided. The Operator is not required to document the Affiliate rates if Non-Operator approval of the Affiliate rates/charges is obtained prior to billing for the Affiliate goods and/or services.

Communications goods and services provided by Affiliates are addressed in Section II.12 (*Communications*) while all other Affiliate goods and services are addressed in this Section II.7 because communications services are oftentimes "captive," and should not be deemed non-chargeable if the Affiliate expenditure threshold is $ 0 and the Non-Operator(s) want(s) to withhold approval of the use of Affiliates.

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Case Study 2

Extension of Audit Rights

Non-Operator BMC requested an extension of audit rights for 2015 costs billed because Non-Operator BMC was unable to audit these costs in 2017. Operator AJR agreed to extend the audit rights for 2015 costs through September 30, 2018. Non-Operator BMC issues the audit report on September 30, 2018. The report included several exceptions for producing overhead charged to wells that did not produce during the audit period. In January 2019, the Operator AJR issued a response to the audit report. The response to the producing overhead exceptions indicated that Operator AJR determined that drilling overhead was not charged for several workover operations during the audit period and that the producing overhead rates were incorrect for multiple wells covered by the same agreement. Operator AJR further stated that they reserve the right to retroactively charge the Joint Account for the undercharges for drilling and production overhead once the Operator has completed their calculations.

Assumptions:

1) The wells in question are governed by a 1989 JOA and 2005 COPAS Accounting Procedure with no modifications.

Discussion Questions:

1) Does Operator AJR's consent to extend 2015 audit rights for Non-Operator BMC also extend the Operator's ability to perform adjustments to 2015 charges/credits beyond the 24-month limitation?

2) Can Operator AJR perform adjustments to the drilling and production overhead charges/rates – would these adjustment be considered to be performed "in direct response and directly related to the charge on which the exception is written" per COPAS MFI-40?

3) Assuming you agree with 1 and 2 above, what is the deadline for Operator AJR to perform these adjustments for drilling and producing overhead charges?

4) Assuming Operator AJR adjusts the drilling and producing overhead charges in March 2019, when does the 24-month limitation begin for Non-Operator BMC?

COPAS MFI-51, COPAS 2005 Model Form Accounting Procedure Interpretation

4. ADJUSTMENTS

A. Payment of any such bills shall not prejudice the right of any Party to protest or question the correctness thereof; however, all bills and statements, including payout statements, rendered during any calendar year shall conclusively be presumed to be true and correct, with respect only to expenditures, after twenty-four (24) months following the end of any such calendar year, unless within said period a Party takes specific detailed written exception thereto making a claim for adjustment. The Operator shall provide a response to all written exceptions, whether or not contained in an audit report, within the time periods prescribed in Section I.5 (*Expenditure Audits*).

A Party may question or challenge a bill by giving the Operator written notice. The written exception may be the result of a desk review of the bill, previous discussions with Operator, previous audits, unusual entries, etc. or it may be the result of the Non-Operator exercising its audit rights under Section I.5 (*Expenditure Audits*).

When challenging an item on the bill, the Non-Operator should provide information concerning the nature of the charge and reasons it believes the charge is not proper.

B. All adjustments initiated by the Operator, except those described in items (1) through (4) of this Section I.4.B, are limited to the twenty-four (24) month period following the end of the calendar year in which the original charge appeared or should have appeared on the Operator's Joint Account statement or payout statement. Adjustments that may be made beyond the twenty-four (24) month period are limited to adjustments resulting from the following:

(1) a physical inventory of Controllable Material as provided for in Section V (*Inventories of Controllable Material*), or
(2) an offsetting entry (whether in whole or in part) that is the direct result of a specific joint interest audit exception granted by the Operator relating to another property, or
(3) a government/regulatory audit, or
(4) a working interest ownership or Participating Interest adjustment.

Joint Account transactions are conclusively presumed to be true and correct twenty-four (24) months after the end of the calendar year in which the transaction was recorded or should have been recorded to the Joint Account. This presumption applies as much to the Operator under this provision as to the Non-Operator under Paragraph A above. The only instances providing for an adjustment by the Operator beyond the twenty-four (24) month period must be associated with one of the four events stipulated within this provision. An exception is made for inventories because inventories are often performed on a cycle that exceeds the current-year-plus-two limitation. The other exceptions were made because they are often the result of factors that are generally beyond the Operator's control.

The phrase "initiated by the Operator" includes any review of accounts or records that is not the result of a detailed written exception as described in Paragraph A above or a government audit. Refer to COPAS MFI-40, *24-Month Accounting Adjustment Limitation,* for additional information.

5. EXPENDITURE AUDITS

A. A Non-Operator, upon written notice to the Operator and all other Non-Operators, shall have the right to audit the Operator's accounts and records relating to the Joint Account within the twenty-four (24) month period following the end of such calendar year in which such bill was rendered; however, conducting an audit shall not extend the time for the taking of written exception to and the adjustment of accounts as provided for in Section I.4 (*Adjustments*). Any Party that is subject to payout accounting under the Agreement shall have the right to audit the accounts and records of the Party responsible for preparing the payout statements, or of the Party furnishing information to the Party responsible for preparing payout statements. Audits of payout accounts may include the volumes of hydrocarbons produced and saved and proceeds received for such hydrocarbons as they pertain to payout accounting required under the Agreement. Unless otherwise provided in the Agreement, audits of a payout account shall be conducted within the twenty-four (24) month period following the end of the calendar year in which the payout statement was rendered.

Where there are two or more Non-Operators, the Non-Operators shall make every reasonable effort to conduct a joint audit in a manner that will result in a minimum of inconvenience to the Operator. The Operator shall bear no portion of the Non-Operators' audit cost incurred under this paragraph unless agreed to by the Operator. The audits shall not be conducted more than once each year without prior approval of the Operator, except upon the resignation or removal of the Operator, and shall be made at the expense of those Non-Operators approving such audit.

The Non-Operator leading the audit (hereinafter "lead audit company") shall issue the audit report within ninety (90) days after completion of the audit testing and analysis; however, the ninety (90) day time period shall not extend the twenty-four (24) month requirement for taking specific detailed written exception as required in Section I.4.A (*Adjustments*) above. All claims shall be supported with sufficient documentation.

A timely filed written exception or audit report containing written exceptions (hereinafter "written exceptions") shall, with respect to the claims made therein, preclude the Operator from asserting a statute of limitations defense against such claims, and the Operator hereby waives its right to assert any statute of limitations defense against such claims for so long as any Non-Operator continues to comply with the deadlines for resolving exceptions provided in this Accounting Procedure. If the Non-Operators fail to comply with the additional deadlines in Section I.5.B or I.5.C, the Operator's waiver of its rights to assert a statute of limitations defense against the claims brought by the Non-Operators shall lapse, and such claims shall then be subject to the applicable statute of limitations; provided that such waiver shall not lapse in the event that the Operator has failed to comply with the deadlines in Section I.5.B or I.5.C.

Audits should be initiated and conducted in accordance with COPAS AG-19, *Expenditure Audit Protocols,* as amended from time to time by COPAS. Resolution of audit exceptions shall be governed by the terms of the Accounting Procedure.

5) If a written exception is not submitted within the twenty-four (24) month period provided, the Operator may deny the exception. This period is not extended by the ninety (90) day period for issuing the formal audit report after completion of audit testing and analysis.

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Case Study 3

Central Tank Battery Chargeability

The Operator, with 90% working interest, drilled five wells, with slight variations in Non-Operator ownership across the wells. Each well has a signed AFE, which includes typical costs to drill and complete a well, including costs of $100,000 for production vessels and installation costs. The wells were drilled and completed separately and put on production as they were completed.

A small tank battery was constructed to serve these wells at a cost of $2 million. This tank battery was eventually expanded significantly to serve the original five wells and two more wells that were drilled. The total cost to build and expanded the tank battery was $3.5 million.

During a Joint Venture audit, the Non-Operator took exception to all tank battery costs, with the reasoning that the costs were not included on the original well AFE and a new AFE covering the costs overrun was not issued. Article VI.D of the Operating agreement requires an AFE to be written and approved by the majority of the working interest owners for any projects with a total cost greater than $50,000. The Non-Operator claims they would have chosen to go Non-consent in the tank battery expansion had they been given the option. Additionally, the Non-Operator indicated that the project was too expensive and they could have completed the project for approximately $1 million.

Discussion Questions:

1) What tank battery costs, if any, should the Non-Operator expect to pay (i.e. only those listed on the AFE, all costs required to get the product to market, etc.)?

2) If the Operator accepts the Non-Operator's Non-Consent election now, would the Non-Operator be subject to Non-Consent penalties related to the tank battery expansion and be required to refund any revenues paid until the Non-Consent penalties are recovered?

3) Since the Operator is the majority WI owner, and the AFE only needs to be approved by a majority to be binding, is it valid to say no AFE was necessary since the Operator would have approved it anyway as the majority?

Article VI, Paragraph D, *Other Operations*: Operator shall not undertake any single project reasonably estimated to require an expenditure in excess of FIFTY THOUSAND Dollars, except in connection with the drilling, Sidetracking, Reworking, Deepening, Completing, Recompleting or Plugging Back of a well that has been previously authorized by or pursuant to this agreement. If Operator prepares an AFE for its own use, Operator shall furnish any Non-Operator so requesting an information copy thereof for any single project costing in excess of FIFTY THOUSAND Dollars. Operator shall deliver such proposal to all parties. If within 30 days the Operator secures the written consent of any party or parties owning at least 60% of the interests, each party having the right to participate in such project shall be bound by the terms of such proposal and shall be obligated to pay its proportionate share of the costs of the proposed project as if it had consented to such project pursuant to the terms of the proposal.