2007 CAPL Operating Procedure: Why You Should Be Much More Afraid Of The 1990 CAPL Operating Procedure Than The 2007

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Desired Outcomes

- An understanding of the risks you are choosing to assume by continuing to use the 1990 CAPL Operating Procedure for new agreements.
- An awareness of the extent of support for the 2007 document by the larger companies.
- A willingness to find the time to understand the 2007 document and assess it on its merits.
- A greater sense of comfort with the 2007 handling of identified concerns.
- A greater willingness to use the 2007 document.

Why Was The Update Done?

The 1990 CAPL Operating Procedure generally held up well, so why change?

- A major update was required because of:
  - Opportunities identified by Industry's experiences with the document.
  - Evolving business needs.
  - Changing legal and regulatory landscape.
  - Need to apply "plainer language" principles to simplify the document and reflect a more modern drafting style.

But No One Else Is Using It-Wrong!

Much slower building of support than initially expected, but larger companies allowing their name to be presented as a user of the document are:

- Apache
- ARC
- CNRL*
- ConocoPhillips
- Crescent Point
- Daylight
- Devon
- Galleon
- Husky*
- Imperial*
- NAL
- Nexen
- Pengrowth
- Petrobakken
- Progress
- Shell
- Suncor
- Talisman
- TAQA North

*Approved but use in selective circumstances or little opportunity to use so far.

Still under review: Baytex, Cenovus, Encana, Enerplus and Harvest

Overall Problem With User Vision

Operating Procedure Not A "Staple On" Document

Problem: Historic expectation that the Operating Procedure is a "staple on" document that just requires completion of the blanks and elections.

2007 Fix: Education for users that the onus is always on the Parties to ensure that the document suitably addresses the needs of the particular operating area and transaction.

- Users expected to modify document to address special circumstances.
  - Foothills and unconventional require modifications, for example.
- Comment applies equally to continued use of 1990 document.
- See miscellaneous annotations at the end of the 2007 document.

Breadth And Depth Of Coverage

Breadth, Depth And Clarity Of Coverage

Problem: Content gaps for emerging issues, known problems and other unclear issues that lend themselves to self-serving interpretations.

Fixes: Create a better “car manual” for users that can also be used as a platform to resolve issues under other versions of the Operating Procedure.

- Greater emphasis on “plainer language”, breaking up long clauses.
- Significant expansion of the annotations.
- Additional supporting information for user education.
- Emphasis on helping users become more independent.

Operators-Why You Should Be Afraid

Horizontal Wells

Problem: Prior versions of the document do not address horizontal wells, as they were in their infancy when the 1990 document was created. Not a material issue if the Operator does what it says it is going to do under any version. Potential issue for participants and non-participants if the Operator changes the contemplated operation materially, as elections may be in question.

2007 Fix: Inclusion of Article 8.00 for Horizontal Wells and consequential changes throughout the 2007 document.

The biggest single reason to change to the 2007!

Operators-Why You Should Be Afraid

Liability Of Operator For Its Activities

Problem: Potential for Operator to be held responsible for breach of contract under 1974/1981/1990 Clause 304 "good oilfield practice" obligation without any gross negligence or wilful misconduct.

- Enormous risk to Operators because of Morrison case on 1981 document, but reduced risk under 1990 because of Adeco case.
- Addition like new last sentence of Clause 3.04 should be added immediately to new 1990 documents.

2007 Fix: Sentence at end of Clause 3.04 requiring Gross Negligence or Wilful Misconduct to impose sole liability on Operator.

- Much greater protection for Operator for losses associated with operations.
- See also 3.05 re HSE and 3.10A re administration of Title Docs.

Operators-Why You Should Be Afraid

Liability Of Operator For Its Activities

Problem: Limited exemption for “Extraordinary Damages” under Clause 401 of 1990 (basically linked to loss or delay of production).

2007 Fixes: Clause 4.04 and the associated definition of “Extraordinary Damages” provide broader protection and extend the protection to claims associated with breach of the contract. (Protection also expanded to address claims by a Party against any other Party under the Agreement, rather than just for benefit of Operator.)

Operators-Why You Should Be Afraid

Default Remedies

Problem: 1990 default remedies are suboptimal.

2007 Fixes:

- Take production at the wellhead, versus request for proceeds.
- New remedy to apply Article 10.00 penalty if defaulting Party refuses to pay unpaid amount after special notice.
  - Special notice also allows the other Non-Operators an election to assume a portion of the interest.
  - Debt remedies no longer applicable if this remedy selected.
- Modifications to seizure and sale right to improve enforceability.
  - Time period for use extended to 60 days after default notice from 30.
  - Requirement to obtain court order to effect.
  - Attorney in fact mechanism.

Operators-Why You Should Be Afraid

Change Of Operator Resulting From Sale

Problem: Prior versions do not address clearly the process for appointing a new Operator after a sale.

2007 Fix: Increased clarity for appointment of replacement Operator for the benefit of all Parties.

- Reduced resignation period from 90 days to 45.
- Clarification of transition process from sale of the Operator's interest
  - Operator continues to represent the interest during the period in which the assignment is being effected.
  - Operator able to vote for its successor in interest as the new Operator.
- Modified two party scenario-Non-Operator requires >40%WI.

Operators-Why You Should Be Afraid

Operator's Obligations For Regulatory Requirements

Problems: Term Clause (2901) literally leaves the Operator solely exposed for funding regulatory requirements more than 6 years after receipt of a reclamation certificate. Subclause 301(b) literally leaves the Operator solely exposed for performance of regulatory requirements unless they could result in "prosecution" of the Operator.

2007 Fixes: Broadened scope of Term Clause (1.14) and Paragraph 3.01B(b) to offer Operators much greater protection (e.g., time limits, use of ERCB enforcement ladder).

Non-Operators-Why You Should Be Afraid

HSE Obligations

Problem: Minimal expectations in the document when the Regulations have evolved significantly and safety is now a very high priority for our Province, our industry, our company and our employees and contractors.

2007 Fixes: Added a HSE Clause (3.05) that tries to provide guidance in ways that are not burdensome to the Operator. Added HSE expectations in various other provisions, such as the Abandonment Article (12.00).

Based on the premise that we (Land) are part of the problem if we are not part of the solution.

Non-Operators-Why You Should Be Afraid

Non-Operator's Exposure Re Joint Account Judgments

Problem: A judgment against the Joint Account can be enforced against any Working Interest owner (e.g., a Non-Operator with the deepest pockets). Prior versions of the document do not include any words that allow a Non-Operator to seek proportionate recovery from the other Parties for any such payments made by it.

2007 Fix: Clause 4.03 allows a Non-Operator against which a Joint Account judgment has been enforced to seek proportionate contribution from the other Parties.

Non-Operators-Why You Should Be Afraid

Operator's Responsibility For Breach Of Contract

Problem: Prior versions of the document did not reflect the law in Alberta after the Erehwon and Morrison cases. Those cases held that the Operator could be held responsible for breach of contract, notwithstanding the gross negligence or wilful misconduct test in Clause 401.

2007 Fix: Much clearer that normal breach of contract remedies apply to an Operator for such matters as breaches of the Accounting Procedure and misappropriation of funds.

Note: Some potential confusion after the Adeco case.

Non-Operators-Why You Should Be Afraid

Potential Abuse Of Clause 5.03 Re Capital Advances

Problem: Operators routinely issuing requests for payment of 100% of costs when ability to pay is not in question and funds are being expended over a period of months. Operators often obtaining the benefit of an “interest free loan” they commingle and then use for their day-to-day expenses.

2007 Fixes: Protection against unreasonable requests for front end contribution of 100% of costs when operation approved. Protections for Operator when legitimate concerns (e.g., insolvency, recent default notice). New duties respecting handling of excess funds.

Non-Operators-Why You Should Be Afraid

Difficulty In Removing An Insolvent Operator

Problem: Courts have ignored the wording of Subclause 202(a) and allowed an insolvent Operator to retain its position, notwithstanding the negative impact this can have on the other Parties. Courts basically not understanding that operatorship is not the Operator's property, but service for the joint benefit of the Parties.

2007 Fixes: Stronger statement in Subclause 2.02A that an Operator's ability to perform its obligations is a function of its financial viability. No ability of an insolvent Operator to commingle funds under Clause 5.07.

Non-Operators-Why You Should Be Afraid

Historic Clause 1004 Amendment (1981 Style Change)

Problem: 1981 style amendment that is often used requires the Operator to take over a proposed operation if it elects to participate. Some Operators believe that they then have the authority to change the operation.

2007 Fixes: (i) Operator has option (but not obligation) to take over if it participates. (ii) Duty to conduct in substantial compliance with the Operation Notice. (iii) Clear that Operator has no right to step into regional supply arrangements extending beyond the single well.

Parties-Why You Should Be Afraid

Exposure To Notional Allocations Of Pricing

Problem: Potential for Parties to attempt to use “Market Price” and notional allocations of “out of the money” marketing arrangements to pass on losses associated with poor marketing arrangements to Non-Taking Parties and in penalty accounts.

2007 Fixes: Modifications to definition of Market Price to limit potential for arbitrary, notional allocations of unfavourable marketing arrangements to other Parties and controls on proceeds in cost recovery calculations in Article 10.00 by linking proceeds to Market Price.

Parties-Why You Should Be Afraid

Production Facilities

Problem: Application of simplistic Operating Procedure processes to facilities handling outside substances.

2007 Fixes:

- Narrowed definition of Production Facility further and increased protection (Clause 10.13) if the facility is overdesigned to serve other lands.
- Management of a Production Facility shifted from the Operating Procedure to a CO&O Ag't based on the then current PJVA model in certain circumstances.
  - Any owner may require, by notice, if used for outside substances.
  - Automatic if the facility no longer fits the definition.

Parties-Why You Should Be Afraid

Importation Of Wells Into Agreement

Problem: Prior documents did not provide clear guidance about the potential importation of a well used for another purpose into the Agreement.

2007 Fix: Clause 10.06 outlines the basis on which a well may be imported into the Agreement and the % equalization.

- Restriction on evaluation of 100% zones using a joint well.
- Most common situation is a well initially drilled as a deep test in 100% rights if a Completion later proposed in the Joint Lands.
    - Most frequent negotiated outcome for newer wells is equalization to Joint Account on 50% of notional new drill costs, plus well info for formations to which the reimbursement pertains.

Parties-Why You Should Be Afraid

3.2 Km Election Deferral Mechanism And Pattern Drilling

Problem: Traditional 3.2km election deferral mechanism poses problems for Parties conducting a shallow pattern drilling program.

2007 Fix: Included optional Subclause 10.02G to enable users to except shallow drilling programs from the 3.2km election deferral process.

- Amendment should be considered immediately for applicable new 1990 agreements.
- Subclause aimed primarily at shallow gas projects.

Parties-Why You Should Be Afraid

Temporary Continuations (e.g., AB Section 16)

Problem: Historically, Clause 1010 has not properly addressed temporary continuations by requiring a re-examination of outcomes to link cause and effect of tenure retention at the indefinite continuation point.

2007 Fix: New Subclause 10.10D requires an additional review of resultant continued rights at the indefinite continuation point and an appropriate allocation of rewards.

Parties-Why You Should Be Afraid

Well Takeover Affecting Interests In Lands

Problem: The Abandonment Article has historically seen an abandoning party forfeit certain interests in joint lands. This is a particular problem if the well is later used for another purpose or if there is new drilling (e.g., a new well under a holding).

2007 Fix: Modified Article, so that the forfeiture affects the wellbore and production therefrom, rather than the working interest in lands.

Parties-Why You Should Be Afraid

Status Of Non-Participant If Further Operations

Problem: The status of a non-participant is not sufficiently clear if further operations are proposed in the well. This is particularly a potential problem for an independent completion after a jointly cased well, a deepening and a sidetracking.

Fixes: General status of a non-participant on an in scope activity clarified. Rights of a non-participant to elect on other activities addressed. (Subclauses 10.08B&C)

- Further modifications required for foothills and unconventional, as noted in the miscellaneous annotations at the end of the document.

Parties-Why You Should Be Afraid

Confidentiality Obligations And A&D/M&A Activity

Problem: Limitation in 1990 document that disclosure is to permitted assigns (the actual intended assignee), so much more restrictive than “prospective assigns” reviewing at a data room. Potential vulnerability if disclosures in breach of Subclause 1801(c) cause a ROFR value to be higher than would otherwise be the case.

Fix: Paragraph 18.01(d) allows disclosure to prospective assigns at the data room stage as long as a confidentiality agreement is in place.

Parties-Why You Should Be Afraid

Rights Of First Refusal-Earning Agreements

Problem: ROFR handling of farmouts and other earning agreements has historically been frustrating and confusing for users.

2007 Fixes:

- Treated as disposition when the ag't is entered into, rather than when the WI is earned for purposes of Clause 24.02 exemptions and timing for completion of disposition.
- Increased clarity in compliance with ROFR.
- Use of 35% test under Paragraph 24.02(e) exemption, vs. former 5% net ha test.
- Possible exemption for all Earning Agreements, if so elected.

Parties-Why You Should Be Afraid

Rights Of First Refusal-Perpetual ROFRs

Problem: Perpetual ROFRs do not recognize that the strategic importance of an asset in a portfolio changes over time.

2007 Fix: ROFR turns into consent not to be unreasonably withheld process at the end of a negotiated period.

- Expectation that many Parties would prefer temporary ROFR (e.g., 8-10 years).
- Pick a date 75 years away if you want the pre-2007 status quo result.

Parties-Why You Should Be Afraid

Rights Of First Refusal-"5% Rule"

Problem: "5% exemption" re ROFRs and large transactions does not sufficiently limit interference with large scale transactions.

2007 Fix: Increased to 10%, to limit potential application of ROFRs to large transactions.

- New exceptions for Earning Agreements.

So, What Happens Now?

- The 2007 document offers significant benefits to Operators, Non-Operators, large companies and small companies.
- Completion of the document was only the first step.
  - A focus since 2007 on education and the transition to use.
- Industry's ability to optimize the benefits from the new document is being compromised because the transition to use is scattered and slow.
  - Users inadvertently choosing to assume some material risk.
- Inevitable that the document will be forwarded to you, as now a critical mass of larger company support.
  - How will you choose to respond?
  - Consider taking the one day CAPL course ASAP.