Risk-Fee Business:
Selected Issues Relating to Louisiana's Risk-Fee Statute

By Dana E. Dupre and Cynthia Nicholson[1]

In Louisiana, the Commissioner of Conservation (the "Commissioner") has the statutory authority to combine or "pool" mineral interests to create a drilling unit –the maximum area of land or deposit of minerals which may be efficiently and economically drained by one well. By default, all of the "owners" in the unit, defined as persons with the right to drill, produce and appropriate production in the unit, share the proceeds of the unit well based upon their pro-rata ownership share of the minerals within the unit. The Commissioner also has the authority to designate a unit operator or "drilling owner", who has the exclusive right to drill a unit well and sell unit production. When there is no contractual relationship between a "drilling" owner and a "non-drilling" owner in a drilling unit formed by the Commissioner, the provisions contained in the Risk Fee Statute (La. R.S. § 30:10 - the "Risk Fee Statute" or "Statute") allocate the risk and expense of drilling certain unit wells.

Under the Risk Fee Statute, a drilling owner has the option to send a notice offering other owners in the unit the opportunity to participate in drilling a unit well. The non-drilling owners are sent an estimate of the total cost of the proposed well (an "Authorization for Expenditure" or "AFE") and given the opportunity to pay their pro-rata share of the costs. When a non-drilling owner receives such a notice and elects not to participate or is deemed to be a non-participant in the drilling of the unit well, the drilling owner may recoup the costs allocated to such non-drilling owner from the non-drilling owner's share of unit production, ***plus*** a risk fee of 200% (or in some cases, 100%) of the drilling owner's allocated share of the cost of drilling, testing, and completing the unit well.

The Risk Fee Statute thus provides a mechanism to compensate the drilling owner for advancing the non-drilling owner's share of the costs in the event of a successful well. Given its oil and gas history and the development of recent shale plays, Louisiana is a legislative leader in this area, and many states watch changes to Louisiana's Risk Fee Statute with interest, especially in light of the growing development of shale plays throughout the country.

The following provides further examination of certain issues relating to the Risk Fee Statute and points out relatively recent changes to the Statute that hopefully will assist in compliance for Louisiana properties.

What wells are eligible under the Risk Fee Statute?

The Risk Fee Statute applies to unit wells or substitute unit wells (which replace original unit wells), alternate wells (where more than one unit well is needed for efficient production) and cross-unit wells (when a unit well drains more than one unit) in Commissioner formed units. Whereas previously there was some question as to whether certain wells qualified, a June 2012 amendment to the Statute (the "Amendment") clearly makes alternate wells and cross-unit wells eligible.

Who may utilize the Risk Fee Statute?

Under the Statute, an "owner" may offer other "owners" the option to elect to participate in the cost, risk and expense of drilling a unit well. The term "owner" is broadly defined as "the person, including operators and producers acting on behalf of the person, who has or had the right to drill into and to produce from a pool and to appropriate the production either for himself or for others." La. R.S.§ 30:3(8).

Importantly, the Statute only affects third parties with whom the drilling owner has no contractual relationship or other cost-sharing agreement in place, and it cannot modify or change the rights and obligations under any contract between or among owners. Additionally, the Risk Fee penalty provisions (described herein) do not apply to any owner not subject to an oil, gas and mineral lease ("Unleased Mineral Owner").

What is considered effective Notice?

To trigger the Risk Fee Statute, the drilling owner must send notice, by registered mail, return receipt requested, or some "other form of guaranteed delivery and notification method" to all other owners in the unit of the drilling or the intent to drill and give each owner an opportunity to elect to participate in the risk and expense of the well (the "Notice"). Note that the Amendment expanded delivery options to presumably allow delivery by private carriers like FedEx or UPS, but expressly prohibits Notice by "electronic communication or mail."

A drilling owner must send Notice to all owners of record as of the date of Notice, meaning that the drilling owner has the obligation to perform at least some title work before spudding the well. The Notice must contain:

- an AFE which shall include a detailed estimate of the cost of drilling, testing, completing, and equipping the proposed well;
  - the AFE should be dated within 120 days of the date of mailing of the Notice
- the proposed location of the well;
- the proposed objective depth of the well;
- an estimate of ownership as a percentage of expected unit size or approximate percentage of well participation, thus the drilling owner must have preliminary survey work done to secure this information; and
- if the well is being drilled or is drilled at the time of Notice, all logs, core analysis, production data, and well test data from the well which has not been made public.

<u>When should Notice be sent?</u>

The Notice must be sent "prior to the actual spudding" of a well if the unit is in place on the spud date and within 60 days of the "date of the order" creating the unit if the unit is created during or after drilling. Likewise, if the unit is revised to include an additional tract or tracts after drilling, then the Notice is required to be sent within 60 days of the "date of the order" revising the unit. If drilling of the proposed well is not commenced within 90 days after receipt of the initial Notice, supplemental Notice is required, meaning a drilling owner must again comply with the full Notice requirements under the Statute.

There is some question as to whether a drilling owner can send notice before the Commissioner has formally designated the well as a unit, substitute or alternate well. Based on *Jones Energy Co., LLC v. Chesapeake Louisiana, L.P.*, F. Supp.2d —, 2012 WL 1981931 (6/1/2012 W.D. La.), which held that the Risk Fee Statute is to be liberally construed in favor of the drilling owner, it seems likely that a court could find substantial compliance with the notice requirements, including sending a pre-designation Notice, sufficient under the Statute.

<u>What must an owner do to participate?</u>

An owner electing to participate in a unit well must notify the drilling owner <u>in writing</u>, <u>by registered mail</u>, <u>return receipt requested</u>, or some "<u>other form of guaranteed delivery and notification method</u>" within 30 days of its receipt of Notice. Failure to give timely written response shall be deemed an election not to participate.

An owner who chooses to participate is obligated to pay his share of drilling costs, as determined by the AFE, within 60 days of the spudding of the well. Likewise, any "subsequent drilling, completion and operating expenses" have to be paid within 60 days of receipt of detailed invoices, to avoid being deemed a non-participating owner.

<u>What is the penalty for non-participation?</u>

If a non-drilling owner, other than an Unleased Mineral Owner, elects not to participate or is deemed a non-participant, he is subject to a risk fee penalty. The risk charge for a unit well, substitute unit well, or cross-unit well that will act as **the unit well or substitute well** for the unit is 200% of an owner's allocated share of the cost of drilling, testing, and completing the well, *exclusive of amounts the drilling owner remits to the nonparticipating owner for the benefit of the nonparticipating owner's royalty and overriding royalty owner* (explained in more detail below). The risk charge for an alternate unit well or cross-unit well that will act as an **alternate unit well** for the unit is 100% of an owner's allocated share of the cost of drilling, testing, and completing such well, *exclusive of amounts the drilling owner remits to the nonparticipating owner for the benefit of the nonparticipating owner's royalty and overriding royalty owner.* These charges supplement the right of the drilling party to recoup 100% of drilling, testing, completing, equipping and operating costs.

Example calculation:

- Assume (a) a drilling owner drills a ***unit well*** in the unit; (b) the owner of a mineral lease with 50% unit participation receives due Notice under the Statute but elects not to participate; and (c) the drilling owner incurs total well costs of $525,000, broken down as follows: drilling costs of $200,000, testing costs of $50,000, completing costs of $150,000, equipping costs of $50,000, supervision charge of $50,000, and operating costs (until all of such costs had been recovered out of production) equaling $25,000.

In the above example, the drilling owner would be entitled to recover production allocable to the non-participating owner in the sum of $662,500 as broken down below:

Costs to non-participating owner:

i. Drilling costs - $200,000 x 50%	= $100,000
ii. Testing costs– $50,000 x 50%	= $ 25,000
iii Completing costs -$150,000 x 50%	= $ 75,000
iv. Equipping costs – $50,000 x 50%	= $ 25,000
v. Supervision charge - $50,000 x 50%	= $ 25,000
vi. Operating costs - $25,000 x 50%	= $ 12,500
vii. Risk charge *	= $400,000
*((total of i, ii & iii above x2) = $400,000)	
	$662,500

Note: The risk charge is 200% of the tract's allocated share of the cost of ***drilling, testing and completing the well.***

Who pays a non-participant's royalty and overriding royalty burdens during the recovery period?

Under previous versions of the Statute, a non-participant was at all times solely responsible for its lessors' royalties and any overriding royalties carved out of its working interest; a drilling owner had no responsibility for these burdens.

Following the Amendment, drilling owners are now required to give non-participants "that portion of production due to the lessor royalty owner under the terms of the contract or agreement creating the royalty between the royalty owner and the non-participating owner's reflected of record at the time of the well proposal" during the recovery period. The Statute defines the recovery period as the time period for "the recovery of the actual reasonable expenditures incurred in drilling, testing, completing, equipping, and operating the well, the charge for supervision and the risk charge…"

With respect to overriding royalties, a drilling owner must now provide to the non-participant during the recovery period (again, for the benefit of the overriding royalty holder), the lesser of:

(I) the non-participating owner's total percentage of actual overriding royalty burdens associated with the existing lease or leases which cover each tract attributed to the non-participating owner reflected of record at the time of the well proposal; or

(II) the difference between the weighted average percentage of the total actual royalty and overriding royalty burdens of the drilling owner's leasehold interest within the unit and the non-participating owner's actual leasehold royalty burdens reflected of record at the time of the well proposal.

Importantly, the overriding royalty calculation in II above incorporates only the "non-participating owner's actual leasehold royalty burdens", not his cumulative royalty and overriding royalty burdens. Note also, that if the overriding royalties attributable to a non-participant exceeds the lesser of the two calculation options noted in the Statute, the non-participant is responsible for that remainder override. While it is not addressed in the Amendment, it appears that the drilling owner is now obligated to determine the extent and amount of the non-participating owner's lessor's royalty and overriding royalty interest burdens.

What types of production data must a drilling owner provide?

A drilling owner must also provide non-participants all of the information required under La. Rev. Stat. § 31:212.31 including:

Lease identification number, if any, or reference to appropriate agreement with identification of the well or unit from which production is attributed;
Month and year of sales or purchases included in the payment;
Total barrels of crude oil or MCF of gas purchased;
Owner's final realizable price per barrel or MCF;
Total amount of severance and other production taxes, with the exception of windfall profit tax;
Net value of total sales from the property after taxes are deducted;
Interest owner's interest, expressed as a decimal fraction, in production from the check stub;
Interest owner's share of the total value of sales prior to any tax deductions; and
Interest owner's share of the sales value less his share of the production and severance taxes, as applicable.

What rights does a royalty or overriding royalty owner have against a drilling owner during the recovery period?

There is no contractual privity between the non-participating owner's royalty and overriding royalty holders and the drilling owner; however, the Amendment specifically provides these burden holders with special direct rights of action against the drilling owner. Specifically, royalty and overriding royalty owners may now seek remedies under Louisiana Mineral Code articles 133-144 (La. R.S. §§ 31:133-144) relating to termination of mineral leases and Articles 212.21-212.23 (La. R.S. §§ 31: 212.21-212.23) relating to royalty payments. Such rights are triggered only upon written notice to both the non-participating owner and drilling owner, and a drilling owner will be insulated from liability upon sufficient proof that royalties and overriding royalties were paid to the non-participating owner.

Notwithstanding these new rights of action, the non-participating owner remains directly responsible to its royalty and overriding royalty holders, and such holders may still seek recovery from the non-participating owner. It is unclear how this new procedure will apply in practice or be interpreted by the courts.

What rights does a non-participant have against the drilling owner for nonpayment of royalty and overriding royalties?

The Amendment added a new provision permitting a non-participant a cause of action against a drilling owner for non-payment of royalty and overriding royalty burdens. In the event (i) the drilling owner fails to pay the burdens ***and*** (ii) the non-participant makes such payment ***and*** (iii) after written notice, the drilling owner either has not paid within 30 days after receipt of notice or responded with reasonable cause for nonpayment, the drilling owner will be subject to damages double the amount of royalties due, interest and reasonable attorney fees.

What is the relationship between a drilling owner and an owner not notified?

A risk charge may not be assessed against an "un-notified owner", but the drilling owner can still recover from production the un-notified owner's allocated share of actual reasonable expenditures incurred in the drilling, testing, completing, equipping and operating the well. A drilling owner cannot, however, avoid payment of an un-notified owner's royalty burdens by foregoing the risk fee charge. The Amendment requires that the "participating owner" (and uses this term instead of the term, "drilling owner") pay the un-notified owner "the proceeds attributable to his royalty and overriding royalty burdens as described in this Section."

What rights does a drilling owner have for recovery of well costs from an Unleased Mineral Owner?

The drilling owner has the right to withhold all proceeds of production until payout is achieved. But after payout, the drilling owner is required to pay the Unleased Mineral Owner its pro rata share of the proceeds within 180 days of sale. There is unfortunately no statutory or jurisprudential guidance regarding the definition of payout (or proper scope of deductable expenses) in this situation. After payout, Unleased Mineral Owners, like non-participating owners, are liable for their proportionate part of the unit operating expenses.

In response to the perceived lack of information available to Unleased Mineral Owners regarding payout, well and operating costs, the Louisiana legislature, in 1950, adopted La. Rev. Stat. § 30:103.1 *et seq* (the "Louisiana Well Cost Reporting Statute").

What is the Drilling Owner's Duty to Report to Unleased Mineral Owners?

The Louisiana Well Cost Reporting Statute sets out two separate reporting requirements for the drilling owner/operator for unleased owners in a unit:
within 90 calendar days from completion of the unit well, the operator must send an initial report which must contain the costs of drilling, completing, and equipping the unit well; and after establishment of production from the unit well, it must send quarterly reports containing the following:
The total amount of oil, gas, and other hydrocarbons produced from the lands during the previous quarter.
The price received from any purchaser of unit production.
Quarterly operating costs and expenses.
Any additional funds expended to enhance or restore the production of the unit well.

The Well Cost Reporting Statute expressly states that reports "shall be sent to each owner of an unleased oil or gas interest who has requested such reports in writing, by certified mail addressed to the operator or producer. The written request shall contain the unleased interest owner's name and address." These reports must be sworn, detailed, itemized and must be sent via certified mail.

Please take note that none of the delivery rules for these reports have been amended and that they are different from the delivery rules under the Risk Fee Statute.

What is the penalty for failure to report to unleased mineral owners?

La. Rev. Stat. § 30:103.2 provides that: "Whenever the operator or producer permits 90 calendar days to elapse from completion of the well and thirty (30) additional calendar days to elapse from date of receipt of written notice by certified mail from the owner or owners of unleased oil and gas interest calling attention to failure to comply with the provisions of La. R.S. 30:103.1 such operator or producer shall forfeit its right to demand contribution from the owner or owners of the unleased oil and gas interests for the costs of the drilling operations of the well."

It has long been believed that the penalties imposed by La. Rev. Stat. § 30:103.2 are triggered when the operator/producer permits:
90 calendar days to elapse from completion of the well;

and

then an additional 30 calendar days to elapse from the date of receipt of written notice by certified mail from the owner or owners of unleased oil and gas interests calling attention to failure to comply with the provisions of R.S. 30.103.1, . . .

However, a recent federal case - *Adams v. Chesapeake Operating, Inc.*, Slip Copy, 2013 WL 1193716 (W.D. La. 3/21/13) - suggests that the unleased owner must send two notices before the penalty may be imposed. That is, an owner must send a first notice providing proper name and address and requesting the information under La. R.S. § 30:103.1 and then, send a second notice under La. R.S. § 30:103.2 advising the operator of its failure to comply with the first.

Assuming this case law is followed, the forfeiture penalty arguably should be triggered **only** when:
90 calendar days elapse from well completion; an owner requests reports by certified mail; the operator does not respond to in a timely manner

and

The owner then sends a non-compliance letter; which the operator does not respond to within 30 calendar days after receipt
With some uncertainty in implementation by the courts, operators are advised to comply at first notice.

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CDOA STUDY QUESTION ANSWERS

1. C
2. C
3. A
4. B
5. D