COPAS AND THE 2005 COPAS ACCOUNTING PROCEDURE—SIGNIFICANT CHANGES FOR CHANGING TIMES

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I. PREFACE

It is believed that most attorneys overlook the importance of the various exhibits attached to the Model Form Joint Operating Agreements used in the oil and gas industry. These exhibits form part of the agreement concerning the joint operations and in many cases can limit the parties' rights to recover under the joint operating agreement. As discussed below, the accounting procedure, usually attached as exhibit "C" to the Model Form Joint Operating Agreements, not only determines the manner in which the operator may charge the non-operators for the joint operations, but can, among other things, create evidentiary presumptions, toll the statute of limitations, and require that the parties mediate their disputes. Accordingly, this paper is intended to focus the attorney's attention on the Council of Petroleum Accountants Societies, the organization responsible for creating the model form accounting procedures and the major changes that have been made to the 2005 COPAS Accounting Procedure.

II. INTRODUCTION

The Council of Petroleum Accountant Societies (COPAS)*** is an organization of regional petroleum accountant societies that prepares and publishes the COPAS accounting procedure forms commonly attached to joint operating agreements. These forms are usually attached to the Model Form Joint Operating Agreements promulgated by the American Association of Professional Landmen (AAPL). The accounting procedure is just one of several attachments contemplated in the Model Form Joint Operating Agreements. For instance, the 1989 Model Form Joint Operating Agreement contemplates the following exhibits:

A.) Description of the Contract Area (Exhibit "A")

B.) Form of Lease (Exhibit "B")

C.) Accounting Procedure (Exhibit "C")

D.) Insurance Requirements (Exhibit "D")

E.) Gas Balancing Agreement (Exhibit "E")

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*** The writers would like to acknowledge the assistance and cooperation of COPAS and its current President Mr. Howard Blunk in contributing to this article.

F.) Non-Discrimination and Certification of Non-Segregated Facilities (Exhibit "F")

G.) Tax Partnership (Exhibit "G").

The accounting procedure is arguably one of the most important exhibits for disputes that commonly arise between the parties in conducting joint operations.

Currently, the 1984 COPAS Accounting Procedure is the most commonly used form in the industry for onshore operations, while a 1986 version is most commonly used in offshore operations. However, COPAS has prepared a 2005 COPAS Accounting Procedure, which is scheduled to be voted on by the Council of the COPAS at its spring meeting on April 29, 2005. The 2005 COPAS Accounting Procedure discussed in this paper is the version that has been approved by various internal committees within COPAS and is expected to be formally approved by COPAS at its spring meeting. The 2005 COPAS Accounting Procedure is a single form intended to replace the 1984 Onshore Accounting Procedure and the 1986 Offshore Accounting Procedure.

This paper discusses the history and evolution of COPAS and the accounting procedure forms. Also, this paper highlights the major changes and modifications contained in the proposed 2005 COPAS Accounting Procedure, with an emphasis on how the proposed form differs from the most commonly used form in the industry, the 1984 COPAS Accounting Procedure.

III. COPAS – AN OVERVIEW

A. History

Although COPAS was created in 1961 and published its first accounting procedure form in 1962, the move to create petroleum accountant societies and to develop accounting procedure forms to be used in joint operating agreements started much earlier.[1] The first society of accountants dedicated exclusively to the petroleum industry—the Petroleum Accountant Societies of Los Angeles—was formed in 1926 and subsequently developed what is commonly thought to be the first "standard" form accounting procedure, the PAS No. 1.[2] Following on the heels of the Los Angeles group, several other regional accounting societies were formed, including the Tulsa, Oklahoma Society in 1929, the Wichita, Kansas society in 1936 and the Dallas, Texas society in 1944.[3] This process continued until the 24 regional societies that make up COPAS today were formed in the major energy areas of North America.[4] These societies also produced accounting procedure forms, the most influential of which was the PASO-1949 authored by the Petroleum Society of Oklahoma–Tulsa.[5] Obviously, the existence and use of so many different forms caused disagreements

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[1] *See generally* John E. Jolly, *The COPAS Accounting Procedures Demystified*, 34 ROCKY MTN. MIN L. INST. § 21.02 (1988).

[2] *See id.* at §§ 21.02, 21.04 (explaining that the exact date of the first publication of the PAS No. 1 is not known because the form was revised several times, making it difficult to determine the date it was first written); *see also* HOWARD G. BLUNK, NATIONAL ACCOUNTING AND AUDITING SCHOOL FOR JOINT INTEREST OPERATIONS 50 (Professional Development Institute, University of North Texas 2003).

[3] Jolly, *supra* note 1 at § 21.02.

[4] *Id.* (noting that COPAS had almost 4,000 individual accountants as members in 1988). As of 2004, COPAS has approximately 2,524 members representing 947 companies. *See* COPAS Website About Membership, *at* http://www.copas.org/MembershipAbout.aspx#Societies (last visited Jan. 29, 2005) (listing 24 local societies comprising COPAS).

[5] *Id.* at § 21.04. Prior to the formation of COPAS, the PASO-1949 was the most common form used throughout the mid-continent and gulf coast areas. This form was revised and became the PASO-T-1955 once some of the Texas societies accepted its use. *Id.*

between the industry operating areas.[6] In 1961, representatives of the 12 existing regional petroleum accounting societies met in an effort to resolve these differences.[7] The result of this meeting was the establishment of the Council of Petroleum Accounting Societies, and the subsequent publication of the 1962 COPAS Accounting Procedure, which was merely a revision of a PASO form performed by an ad hoc committee of COPAS.[8]

Since 1962, COPAS has periodically adopted new versions of accounting procedures, with each succeeding version replacing the prior version as the COPAS recommended form.[9] COPAS 1962, COPAS 1968, COPAS 1974, and COPAS 1976 Offshore Operations are now out of print and no longer available from COPAS.[10] However, many of the Joint Operating Agreements to which these older COPAS forms were attached are still in force and effect and therefore, the forms are still part of legally binding contracts.[11] The practice of replacing the older form with the newer form continued until 1995 when COPAS issued the COPAS 1995 Model Form Accounting Procedure as an alternative to the COPAS 1984 Onshore and the COPAS 1986 Offshore Accounting Procedures.[12] The 1995 COPAS Accounting Procedure was not well received by the industry and is not widely used. Similarly, the COPAS 1998 Project Team Accounting Procedure was designed for deepwater and other resource-sharing projects, and was not intended as a replacement for previous COPAS forms.[13] The 2005 COPAS Accounting Procedure is intended to replace both the COPAS 1984 and 1986 Offshore Accounting Procedures.[14]

B. Purpose

The various COPAS accounting procedures have served several purposes. Initially, the purpose of any accounting procedure is to provide the framework for the obligations and responsibilities of each party to the agreement.[15] One commentator recently observed that "[t]he COPAS Accounting Procedure was developed to set the guidelines for the charging of costs by the operator to the non-operators."[16] The Accounting Procedure also provides the "rules" by which the non-operator conducts audits of the joint account.[17] Perhaps more importantly though, the COPAS Accounting Procedures served the purpose of standardizing the accounting procedures used in joint operations to alleviate the problems caused by having no standard set of terms and conditions which were

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[6] *Id.* at § 21.02.

[7] *Id.*

[8] *Id.* at §§ 21.02, 21.04.

[9] *See* Blunk, *supra* note 2, at 49.

[10] *Id.*

[11] *Id.*

[12] *Id.*; *see also* John Burritt McArthur, *A Twelve-Step Program for COPAS to Strengthen Oil and Gas Accounting Protections*, 49 SMU L. REV. 1447, 1448 (1996).

[13] *See* Blunk, *supra* note 2, at 49.

[14] 2005 COPAS Accounting Procedure, Model Form Interpretation, MFI-5X, Publication/Revision Date – October 6, 2004 [hereinafter 2005 COPAS MFI-5X].

[15] Blunk, *supra* note 2, at 54.

[16] Susan R. Richardson, *Will Stapling Create Harmony? or The Art of Reconciling the JOA and COPAS*, State Bar Section Report, Oil, Gas and Energy Resources Law, Dec. 2004, Vol. 29, No. 2, at 22; *see also* Michael E. Smith & Robert D. McCutcheon, *Joint Operating Agreement Exhibit: A Survey*, 47 ROCKY MTN. MIN. L. INST. § 14.04 (2001) (stating that "[t]he principle function of the accounting procedure is to serve as the expense basis upon which the operator is to charge each party with its proportionate share of costs incurred").

[17] Richardson, *supra* note 16, at 22. (noting that various COPAS publications also provide guidance to auditors).

generally accepted by the industry.[18] Although some of the problems associated with the earliest joint operating accounting procedures, which were internally developed by companies or negotiated between the parties to the joint venture, were alleviated by the initial regional societies that eventually collaborated to form COPAS, these regional societies could not provide a set of accounting practices that would be accepted industry-wide.[19] Today, the various COPAS Accounting Procedures forms, and the A.A.P.L. Form 610 Joint Operating Agreements to which they are commonly attached,[20] govern a majority of oil and gas investments, and COPAS accounting procedures serve as the primary source of oil and gas accounting standards.[21]

COPAS issues several publications to assist the industry in addition to issuing the form accounting procedures. COPAS issues Accounting Guidelines (AGs) to assist in establishing industry standards and Model Form Interpretations (MFIs) to assist the industry in interpreting the various model form accounting procedures. These publications are updated by COPAS on a regular basis and provide recommendations and guidelines for joint account issues that tend to arise in practice. Interestingly, COPAS considered providing the parties an option of making the MFIs expressly part of the 2005 COPAS Accounting Procedure. However, COPAS decided not to include such an option in the 2005 COPAS Accounting Procedure due to concerns that, instead of increasing standardization, only variations would result as MFIs were revised over time. In addition, concerns existed over which MFI would be relevant in a dispute: the MFI in existence at the time the agreement is signed or when the dispute arises?

Realizing that the 1984 and 1986 COPAS Accounting Procedures have been the most commonly used forms "for onshore Lower 48 and offshore shelf properties" for the last 20 years, COPAS proposes "to update these forms–to clarify gray areas, and to reflect current industry practices and changes in technology. At the same time the goal [is] to minimize exception accounting that might be caused by using the model form [and] to help [the 2005 COPAS Accounting Procedure] gain widespread acceptance and usage by the industry."[22] Because the 1984 and 1986 forms will no longer be available from COPAS, it is important to understand how the 2005 form differs from these prior versions. This paper points out the major changes embodied by the 2005 form and addresses the impact these changes will have on joint accounting disputes in the future.

IV. A FEW WORDS ABOUT WHAT DID NOT CHANGE IN THE 2005 ACCOUNTING PROCEDURE

Like prior versions, the 2005 COPAS Accounting Procedure attempts to spell out what the operator can and cannot charge the non-operators for operating the joint property. In doing so, the 2005 COPAS Accounting Procedure sets forth what the operator may directly charge the non-

[18] *See* Blunk, *supra* note 2, at 71.

[19] *Id.*

[20] "The 1956, 1977, 1982 and 1989 printed form operating agreements provide for the accounting procedure to be attached as a separate exhibit, usually Exhibit 'C.'" Smith & McCutcheon, *supra* note 16, at §14.04. Additionally, each of the A.A.P.L Form 610 Operating Agreements contain a provision stating that in the event of a conflict between the terms of the operating agreement and the accounting procedure, the terms of the operating agreement prevails. *See, e.g.,* A.A.P.L. Form 610 Model Form Operating Agreement–1956, ¶ 8 *and* A.A.P.L. Form 610-1989 Model Form Operating Agreement, Art. II.

[21] McArthur, *supra* note 12, at 1449,1451.

[22] 2005 COPAS MFI-5X, *supra* note 14.

operators and what types of charges fall under overhead. Typically, there is a constant struggle in the industry between the operator and the non-operator on whether certain types of costs should be covered by the overhead provision set forth in the accounting procedure or directly charged by the operator. This is where the most significant disputes occur between the operators and the non-operators. The 2005 COPAS Accounting Procedure has not changed this framework, thus the struggle still continues to exist. The overhead options previously available under the 1984 Onshore COPAS Accounting Procedure are generally available in the 2005 COPAS Accounting Procedure. Nevertheless, these provisions are still vital in evaluating the accounting procedure for the contemplated joint operations. As a result, the attorney should still review these provisions with a keen eye on the contemplated operations so that any obvious disputes can be avoided.

V. THE MAJOR CHANGES OF THE 2005 COPAS ACCOUNTING PROCEDURE

The 2005 COPAS Accounting Procedure was significantly changed from prior Accounting Procedures published by COPAS. While the body of this paper does not describe each and every change in detail, it does discuss the most significant changes in the view of the authors. For a more detailed analysis, see the more comprehensive line—by—line comparison of the 2005 COPAS Accounting Procedure and the 1984 Onshore Accounting Procedure attached as an Appendix to this paper. The authors have chosen the 1984 Onshore Accounting Procedure for comparison purposes primarily because the 1984 Onshore Accounting Procedure is the most widely used form in the industry. The most notable changes occurred in the following sections of the Accounting Procedure:

A. Statements and Billings [Section I, No. 2 of the Accounting Procedure]

B. Advances and Payments by Non-Operators [Section I, No. 3]

C. Adjustments [Section I, No. 4 of the Accounting Procedure]

D. Audits [Section I, No. 5 of the Accounting Procedure]

E. Labor [Section II, No. 3 of the Accounting Procedure]

F. Affiliates [Section II, No. 7 of the Accounting Procedure]

G. Other Expenditures [Section II, No. 15 of the Accounting Procedure]

H. Amendments [Section I, No. 6 B of the Accounting Procedure]

I. Failure to Elect Provision [Section I, General Provisions of the Accounting Procedure]

A. Statements and Billings.

The 2005 COPAS Accounting Procedure still requires that the Operator provide the non-operators with a bill on or before the last day of each month for the preceding month. However, the 2005 COPAS Accounting Procedure has been revised to reflect the change in technology that has occurred in the last decade. In particular, the 2005 COPAS Accounting Procedure allows the operator to make available to non-operators its statements and bills via "email, electronic data interchange, internet websites or other equivalent electronic media in lieu of paper copies." For timing purposes, the accounting procedure provides that a "statement or billing shall be deemed as delivered twenty-four (24) hours (exclusive of weekends and holidays) after the Operator notifies the Non-Operator that the statement or billing is available on the website and/or sent via email or electronic data interchange transmission." The 2005 COPAS Accounting Procedure still allows

the non-operator to elect to receive paper copies of bills instead of electronic copies.

B. Advances and Payments by Non-Operators

This section has been revised for the first time to allow the non-operator in very limited circumstances to "short pay" or reduce payment for bills that it receives from the operator. The non-operator can only "short pay" to the extent the payment is reduced for

1) an incorrect working interest; or
2) a project or AFE requiring approval of all parties under the joint operating agreement that has not been approved by the non-operator; or
3) a property in which the non-operator no longer owns a working interest, provided the non-operator has furnished the operator a copy of the recorded assignment or letter in lieu; or
4) Charges outside the adjustment period.

To substantiate these limited circumstances, the non-operator must furnish the operator with documentation and an explanation at the time the payment is made.

C. Adjustments

The Adjustments section, in conjunction with the Audit Section of the 2005 COPAS Accounting Procedure discussed below, contains probably the most significant changes to the accounting procedure from a legal and accounting perspective.

From a practical standpoint, the Adjustments section of prior versions of the COPAS accounting procedures can have the most significant legal effect on a non-operator's ability to obtain adjustments to the joint interest account. In particular, even before the inception of COPAS in 1962, many joint operating agreements or accounting procedures attached to these operating agreements had a provision that provided that the joint interest bills issued by the operator were deemed correct unless the non-operator objected in writing within a specified time period.

Since the creation of COPAS, each published version of Accounting Procedures distributed by COPAS since 1962 has contained such a provision. For instance, the 1984 Onshore Accounting Procedure provides that "[a]ll bills and statements are presumed to be correct unless within a 24 month period following calendar year of charge, a Non-Operator takes written exception to and makes claim on Operator for adjustment. No adjustments favorable to the Operator shall be made unless they are made within a 24 month period, with the exception of adjustments resulting from inventory of Controllable Material."

The 2005 Accounting Procedure pertaining to Adjustments has been reworded in several respects.

First, just as initially set forth in the seldom used 1995 COPAS Accounting Procedure, the 2005 COPAS Accounting Procedure requires that the non-operator's "written exception" be a "specific detailed written exception" in order to be entitled to claim an adjustment to the bills or statements. While "specific detailed written exception" is not a defined term in the accounting procedure, one can surmise that, in most situations, a non-operator must do more than lodge a general objection without some specific particularized complaint.

Second, the 2005 COPAS Accounting Procedure states that the presumption of correctness is to apply "with respect only to expenditures." Therefore, the issuance of bills or statements with incorrect revenue

information is not subject to the same presumption.

Third, the Adjustment provision now expressly applies to "payout statements." Fourth, subject to a few exceptions, the Adjustments provision is enforceable against the operator. The Accounting Procedure identifies those circumstances when an operator can still make adjustments outside of the 24-month period. These include adjustments for the following: 1) physical inventory 2) offsetting entries that are the direct result of a specific joint interest audit exception granted on another property; 3) a governmental/ regulatory audit; or 4) a working interest ownership or participating interest adjustment.

The Adjustments provision should be read together with the Statements and Billings section discussed above. The Statement and Billings section describes the level of detail required in the statements issued by the operator. For instance, the section states, among other things, that "intangible drilling costs, audit adjustments, and unusual charges and credits shall be separately and clearly identified." This is important because courts have held that in order for the operator to be entitled to take advantage of the 24-month presumption attached to statements rendered and not objected to by the non-operator, the statements rendered must satisfy the level of detail required for the statements issued by the operator. In *Exxon v. Crosby-Mississippi Resources, Ltd.* the Fifth Circuit Court of Appeals held that several of the operator's monthly statements did not satisfy the level of detail required under the 1974 COPAS Accounting Procedure, and as a result, those monthly statements were not entitled to the presumption afforded other statements that were rendered by the operator. 40 F.3d 1474, 1488 (5th Cir. 1995). Therefore, in determining the applicability of the 24-month provision initially one must determine whether the bills and statements satisfy the level of detail required under the applicable accounting procedure.

D. Audits

From a legal standpoint, the most significant change to the entire 2005 COPAS Accounting Procedure is the Audits section. In particular, following the concept first introduced in the 1995 COPAS Accounting Procedure, the statute of limitations is expressly tolled under this provision as long as the parties comply with the specific substantive and procedural requirements set forth in this section. In addition, the Accounting Procedure for the first time requires that the parties submit their audit disputes to mediation.

Before addressing the specific language concerning the tolling of the statute of limitations, one needs to understand the specific procedural timelines for filing exceptions and conducting audits, as well as the significance of their impact on the tolling of the limitations period.

First, as in prior versions of the COPAS Accounting Procedure, the non-operators have a "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." In other words, for joint interest bills rendered in 2002, an audit can only be conducted during 2003 or 2004. However, from a practical standpoint, in order to comply with the 24 month adjustment period, the audit must be performed sufficiently in advance of the end of 2004 so that the non-operator satisfies its obligation to provide "specific detailed written exceptions."

Second, once an audit is completed, the non-operator must issue an audit report within 90 days after the completion of the audit testing and analysis. Once in receipt of the audit report, the operator must respond in writing to all exceptions in the non-operator's audit report within 180 days.

The operator's denial of exceptions submitted by the non-operator must be accompanied by a "substantive response." If the operator does not provide a substantive response to an exception within this time period, the operator will owe interest on that particular exception if ultimately granted.

An interesting optional provision is included in the 2005 COPAS Accounting Procedure that provides severe penalties for delays in the audit process by either the operator or the non-operators. In particular, this optional provision provides that if the non-operators fail to reply to an operator's response to an audit report within 90 days of receipt, any unresolved exceptions that were not addressed by the non-operators within one year following receipt of the last substantive response of the operator shall be deemed to have been withdrawn by the non-operators. Likewise, if the operator fails to respond to an audit report within 180 days, any unresolved exceptions that were not addressed by the operator within one year following receipt of the audit report or receipt of the last substantive response of the non-operators, whichever is later, shall be deemed to have been granted by the operator and adjustments shall be made, without interest, to the joint account.

As set forth below, in the event the non-operator timely files written exceptions or an audit report, the statute of limitations is tolled in relation to those specific claims. However, through inadvertence or neglect, the non-operator may undo this tolling by failing to comply with the remaining procedural deadlines set forth in the audit provision. In particular, the 2005 COPAS Accounting Procedure provides:

> "A **<u>timely</u>** filed written exception or audit report containing written exceptions (hereinafter "written exceptions") shall, **<u>with respect to the claims made therein</u>**, 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."
>
> "**<u>If the Non-Operators fail to comply with the additional deadlines</u>** in Section I.5.B [Operator responding to audit report within 180 days] or I.5.C [Non-Operator replying to Operator's response within 90 days], **<u>the Operator's waiver of its right to assert a statute of limitations defense against the claims brought by the Non-Operators shall lapse</u>**, 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." (Emphasis added).

Finally, the 2005 COPAS Accounting Procedure maintains the concept that began with the 1995 COPAS Accounting Procedure providing that a party may call an audit resolution meeting after a certain time period has elapsed. However, instead of the 18 month period used in the 1995 COPAS Accounting Procedure, the 2005 COPAS Accounting Procedure provides that either party may call for an audit resolution conference if any audit issues are outstanding 15 months after the operator receives the audit report. Significantly, COPAS added a dispute resolution procedure that either the operator or the non-operators can invoke if the audit issues cannot be resolved by negotiation. In particular, the 2005 COPAS Accounting Procedure provides:

> "If the Agreement contains no dispute resolution procedures and the audit issues cannot be resolved by negotiation, the dispute shall be submitted to mediation. In such event, promptly following one Party's written request for mediation, the Parties to the dispute shall choose a mutually acceptable mediator and share the costs of mediation services equally. The Parties shall each have present at the mediation at least one individual who has the authority to settle the dispute. The Parties shall make reasonable efforts to ensure that the mediation commences within sixty (60) days of the date of the mediation request. Notwithstanding the above, any Party may file a lawsuit or complaint (1) if the Parties are unable after reasonable efforts, to commence mediation within sixty (60) days of the date of the mediation request, (2) for statute of limitations reasons, or (3) to seek a preliminary injunction or other provisional judicial relief, if in its sole judgment an injunction or other provisional relief is necessary to avoid irreparable damage or to preserve the status quo. Despite such action, the Parties shall continue to try to resolve the dispute by mediation."

Based on this language, a party can initiate litigation over an audit dispute without completing the mediation process for "statute of limitations reasons" or if in the party's sole judgment it is necessary to avoid irreparable damage or to preserve the status quo. Interestingly, COPAS considered including a mandatory arbitration provision in the 2005 COPAS Accounting Procedure. However, not enough votes could be garnered to pass the mandatory arbitration provision.

E. Definition of "First Level Supervision" and "On-Site"

The exploration, development, and production of oil and gas has changed tremendously over time. In the early days, many operators conducted operations in remote locations where supervision and office support was closer to the field operations. In most cases, these facilities and related expenditures were not directly chargeable under the accounting procedure unless there was a "district expense" election exercised by the parties. Since then, the nature of oil and gas exploration, development and production has been consolidated and become more efficient through technological advances. As a result, the 2005 COPAS Accounting Procedure appears to take these changes into account. For instance, the 2005 COPAS Accounting Procedure permits the Joint Account to be directly charged for the Operator's expenditures related to "First Level Supervision" based on the function of the supervisor instead of merely whether the supervisor is "in the field."

The 1984 Onshore Accounting Procedure defined "First Level Supervisors" as those "employees whose primary function in Joint Operations is the direct supervision of other employees and/or contract labor directly employed on the Joint Property in a field operating capacity." This provision was generally interpreted as requiring that the First Level Supervisor be "in the field" in order to be chargeable. The 2005 COPAS Accounting Procedure appears to have changed this requirement by deleting the "in the field" language. "First Level Supervision" is defined in the 2005 Accounting Procedure as meaning "those employees whose primary function in Joint Operations is the direct oversight of the Operator's field employees and/or contract labor directly employed On-Site in a field operating capacity." Several examples of what may constitute First Level Supervision functions are included in the definition of First Level Supervision. One example

includes the "responsibility for employment decisions and performance appraisals for field personnel."

In a related issue about the location of employees, COPAS has attempted to clarify instances when technical labor can be chargeable. The 2005 COPAS Accounting Procedure introduces for the first time the definition of the term "On-Site," in what one might consider to be an attempted clarification that the chargeability of an employee is not limited to the boundaries of the joint property. "On-Site" means

> "on the Joint Property when in direct conduct of Joint Operations. The term 'On-site' shall also include that portion of Offshore Facilities, Shore based Facilities, fabrication yards, and staging areas from which Joint Operations are conducted, or other facilities that directly control equipment on the Joint Property, regardless of whether such facilities are owned by the Joint Account."

Based on this language, "On-Site" would include charges for Technical Employees who may not be physically located on the Joint Property but may be working at a fabrication yard or staging area. While the 2005 COPAS Accounting Procedure preserves the traditional definition of "Joint Account," "Joint Property," and "Joint Operations," the addition of this definition of "On-Site" appears to have cleared up any gray areas in this regard.

F. Affiliates

The 2005 COPAS Accounting Procedure addresses the use of affiliates of the operator in performing work for the joint account. "Affiliate" is defined in the Accounting Procedure as 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."

The parties are given options in the 2005 COPAS Accounting Procedure for selecting rates and services to be charged for affiliates. For instance, one option that the accounting procedure provides is for the parties to specify a monetary threshold that permits the operator to use an affiliate to perform work as long as the affiliate is identified and the work is specifically detailed in an approved AFE. For work performed by an affiliate not requiring the issuance of an AFE, the accounting procedure allows the parties to specify that a designated percentage of the parties owning an interest must approve the use of the Affiliate for such work. Finally, as in the 1995 COPAS Accounting Procedure, the 2005 COPAS Accounting Procedure makes it clear that in no event shall the cost of affiliate goods or services exceed the average commercial rates prevailing in the area of the joint property. This is important since arguably under the Audit provision of the 2005 COPAS Accounting Procedure, as well as prior versions, the non-operators are only entitled to audit the *operator's* accounts and records related to the joint account. It is commonly understood in the industry that the non-operators do not have the right to audit the affiliates' records but do have the right to audit the books and records of the joint account. This is an important distinction. Having the right to audit the operator's records in the joint account would allow the non-operator to inspect the documentation kept by the operator for charges incurred. This presumably would include invoices from affiliates. However, generally, the non-

operator would not be able to inspect the affiliates' records supporting such invoices. Nevertheless, the costs charged by the affiliate must not exceed the "average commercial rates prevailing in the area of the Joint Property."

G. "Other Expenditures"

The 1984 COPAS Accounting Procedure provides that the operator may directly charge the joint account for "[a]ny other expenditure not covered or dealt with in the foregoing provisions of this Section II [Direct Charges], or in Section III [Overhead] and which is of direct benefit to the Joint Property and is incurred by the Operator in the necessary and proper conduct of the Joint Operations." The 2005 COPAS Accounting Procedure left this language intact but added language that expressly requires non-operator approval for such costs. As a result, this revision to a large extent closes the door to the operator claiming that costs not clearly addressed in the operating agreement or in the accounting procedure are chargeable under this provision unless the operator has gotten approval by the non-operators. However, the 2005 COPAS Accounting Procedure does not mention whether the non-operators' approval must be in writing. As a result, one can still foresee situations when non-operators who remain silent may be deemed to have consented to the operator incurring and charging the joint account for such costs.

H. Amendments

Another substantial change appears in Section I.6 of the 2005 COPAS Accounting Procedure, which deals with the approval necessary by the parties to the joint operating agreement to change the accounting procedure. The 1984 COPAS Accounting Procedure merely requires the operator to notify the non-operators of the proposed change and approval by a majority in interest of the non-operators to make the change effective. The 2005 COPAS Accounting Procedure keeps this provision intact, but limits its application to "specific situations of limited duration where a Party proposes to change the accounting for charges from that prescribed in this accounting procedure." This provision does not, however, cover amendments to the Accounting Procedure.

Amendments to the 2005 COPAS Accounting Procedure for situations lasting more than a "limited duration" are covered by the new Section I.6.B of the Accounting Procedure. Under this section, amendment of the accounting procedure will require an affirmative vote of a selected number of parties, one of which must be the operator, owning a predetermined percentage of the working interest. The form provides blanks for the parties to fill in the number of parties that will be required to vote and the percentage of working interest that will be necessary to be represented. However, approval of at least one non-operator is required to amend.

A second new provision, Section I.6.C., deals with affiliates. If any of the parties to the agreement are affiliates of one another, they shall be treated as one party having a combined working interest for purposes of voting under Sections I.6.A. and I.6.B. Additionally, if one of the non-operators is an affiliate of the operator, votes under Section I.6.A. will require a majority in interest of the non-operators exclusive of the operator's affiliate. This provision does not apply to votes for amendments under Section I.6.B.

Regardless of these formal procedures for amending and changing the accounting procedure, parties should be aware that the accounting procedures might be modified by their conduct. *Hondo Oil & Gas Co. v. Texas Crude Operator, Inc.*, 970 F.2d 1433, 1437-38 (5th Cir. 1992). In *Hondo*, Atlantic Richfield Company ("ARCO") entered into several operating agreements in 1962 and 1965 with Texas Crude Operator, Inc.

("Texas Crude") as Operator. *Id.* at 1435 – 36. The PASO-T-1955-2 Accounting Procedure was attached to each of these agreements. *Id.* at 1436. In 1978, Texas Crude decided to begin charging Non-Operators using a COPAS accounting procedure, rather than the PASO-T-1955-2. *Id.* Although Texas Crude did not notify ARCO that it was changing accounting procedures, ARCO paid Texas Crude for six years in accordance with the COPAS billings, after making a complaint as to the new rate in October 1978. *Id.* The issue before the Fifth Circuit was whether ARCO and Texas Crude had modified their operating agreements. *Id.* at 1437. The court concluded that because ARCO knew of the change and apparently consented to it, ARCO and Texas Crude had modified the accounting procedures to be used under the operating agreements. *Id.* at 1437-38.

I. Failure to Elect Provision

Probably from experience, COPAS had enough foresight to insert language in the 2005 COPAS Accounting Procedure that provides a mechanism for when the parties fail to select an option in the accounting procedure or the parties inadvertently select two competing options or alternatives that are inconsistent. In particular, the 2005 COPAS Accounting Procedure states at the outset that "if the parties fail to select either one of competing "alternative" provisions, or select all the competing "alternative" provisions, alternative 1 in each such instance shall be deemed to have been adopted by the parties as a result of any such omission or duplicate notation."

Nevertheless, it is possible that this provision may be overridden by the express terms of the joint operating agreement if the alternative is somehow inconsistent with the joint operating agreement. For instance, the 1982 and 1989 A.A.P.L. Form 610 – Model Form Operating Agreements reference "Accounting Procedure" as exhibit "C." The 1982 Model Form Joint Operating Agreement states that if "any provision of any exhibit, except Exhibits "E" [Gas Balancing Agreement] and "G" [Tax Partnership] is inconsistent with any provision contained in the body of this agreement [Model Form Operating Agreement], the provisions in the body of this [Model Form Operating Agreement] shall prevail." The 1989 Model Form Joint Operating Agreement includes an almost identical provision. Therefore, assuming the parties do not modify this provision, situations may arise when the terms of the joint operating agreement may control over the terms of the attached COPAS accounting procedure even when the Failure to Elect Provision has become operative.

VI. CONCLUSION

The 2005 COPAS Accounting Procedure appears to be an improvement over the 1984 COPAS Accounting Procedure. It has re-introduced some of the better concepts first developed in the 1995 COPAS Accounting Procedure that were never really adopted by the industry due to overall problems with the 1995 version. From this, COPAS appears to have developed a model form that is more clear and comprehensive than prior forms. The inclusion of language in the accounting procedure that places severe penalties on both the operator and non-operator in the audit process should encourage the parties to focus on their disputes and attempt to resolve them in a timely fashion. COPAS should be commended for including a mandatory mediation process in the model form accounting procedure. While it will not be a cure for all disputes, the new 2005 COPAS Accounting Procedure will provide a framework for the parties to attempt to work out their differences.