COPAS ACCOUNTING PROCEDURES, THE 2005 COPAS ACCOUNTING PROCEDURE, THE AUDIT PROCESS, AND LEGAL AND PRACTICAL CONSIDERATIONS

By

Karla Bower
ConocoPhillips Company
Houston, Texas

Howard Blunk
OGC Consulting
The Woodlands, Texas

Jonathan D. Baughman
McGinnis, Lochridge & Kilgore, L.L.P.
Houston, Texas

Paper 15

KARLA BOWER

Karla Bower is a Joint Interest Consultant at ConocoPhillips Company. She joined the company over twenty-five years ago after graduating from the University of Kansas. Most of her career has been spent in various joint interest positions, coordinating issues involving Land and Joint Interest Accounting. She currently advises several business areas within ConocoPhillips on joint interest matters and provides guidance on emerging issues within the industry. Karla has been a member of the Board of Directors for the Council of Petroleum Accountants Societies, Inc. (COPAS) since 2004, and was the association's President for 2007. From 1998-2001 she served on the Board of Directors of the Petroleum Accountants Society of Houston (PASH), and is currently serving another year on the PASH Board. She has chaired both the COPAS and PASH Joint Interest Committees and served as COPAS' AAPL Liaison for six years. Karla co-led the task force that developed the COPAS 2005 Model Form Accounting Procedure. She has participated on numerous other COPAS task forces, including the Project Team Accounting Procedure, Overhead Interpretation, Allocation of Rig-Related Expenditures Guideline, Material Pricing Manual, Overhead Negotiation & Calculation Guideline, Drilling Overhead Interpretation, and the Awards Interpretation.

H. G. (HOWARD) BLUNK

H. G. (Howard) Blunk is founder and owner of OGC Consulting, located in The Woodlands, Texas. His company provides a variety of accounting/audit services focusing on the full range of Oil and Gas Contract negotiations, analysis and development of overhead recovery rates, compliance reviews, and dispute resolution. OGC is now in its ninth year of operations serving a variety of clients. With OGC's primary emphasis on joint interest agreements and related COPAS Accounting Procedures, Mr. Blunk offers a unique perspective as he is actively involved in COPAS and has personally helped develop many of their publications. He is the past National Audit Committee Chair for COPAS, has also chaired their Emerging Issues and Internal Review Sub-Committees, has served on the COPAS Board of Directors, and is a past President of COPAS. Mr. Blunk is a course instructor for the Professional Development Institute at the University of North Texas (PDI), and author of the course books used in PDI's National Accounting and Auditing School for Joint Interest Operations, and their Joint Interest agreements course for Landmen. Mr. Blunk has made a number of presentations to industry groups including COPAS, the American Association of Professional Landmen (AAPL), and the American Petroleum Institute (API) on joint interest accounting and auditing, and oil and gas contracting activities. With over three decades of experience in Oil and Gas Accounting/Auditing, Mr. Blunk has held a variety of supervisory and managerial positions in the United States and overseas. As Audit Manager (Non-Operated Joint Ventures) for Chevron, he was responsible for audit coverage of all non-operated properties in the United States and Canada. Working in London (England), Mr. Blunk was Assistant Audit Manager for the Middle East and Africa where he oversaw the full range of audit department activities including internal controls, joint venture agreements, and contractor/vendor reviews for all operations in the host countries.

JONATHAN D. BAUGHMAN

Jonathan D. Baughman is a partner in the Houston office of McGinnis, Lochridge and Kilgore, LLP. He is licensed to practice law in Texas and Louisiana and received his B.S. degree from Louisiana Tech University, *magna cum laude*, and his J.D., *magna cum laude*, from Loyola Law School where he was the managing editor of the Loyola Law Review. Prior to practicing law, Mr. Baughman worked as a certified public accountant in the energy section for a major international public accounting firm and later as an internal auditor for a major natural gas pipeline company.Mr. Baughman represents clients in a wide variety of litigation including oil and gas litigation in federal and state courts. For example, Mr. Baughman has litigated disputes involving joint operating agreements, gas processing agreements, and leases. He has litigated a multitude of oil and gas issues related to title, lease covenants, implied and express covenants to pool, royalty payments, COPAS, natural gas trading, reservoir damage, and well blowouts. Mr. Baughman has written articles and spoken before the American Association of Professional Landmen and other legal organizations related to the COPAS accounting procedure attached to most joint operating agreements. Mr. Baughman is currently the Treasurer of the Oil & Gas Section of the Houston Bar Association. He is also a member of the Rocky Mountain Mineral Law Foundation.

COPAS Accounting Procedures, the 2005 COPAS Accounting Procedure, the Audit Process, and Legal and Practical Considerations

Karla Bower
ConocoPhillips Company
Houston, Texas

Howard Blunk
~~OGC Consulting~~
The Woodlands, Texas

Jonathan D. Baughman
McGinnis, Lochridge & Kilgore, L.L.P.
Houston, Texas

I.

COPAS ACCOUNTING PROCEDURES[1]

A. Introduction & Purpose

The operating agreement establishes the overall structure and framework for sharing the costs of the exploration and production deal. It establishes who is liable for the various operations and activities, and under what circumstances. The operating agreement also provides for the operator to pay the costs, and bill each non-operator for its proportionate share.

Operating agreements do contain some specifics on what costs can be charged to the joint account. For example, cost issues addressed by AAPL model forms include: cost of title work; penalty & interest on tax assessments; cost of providing certain information; cost of turning over operatorship; cost of non-operator access to property and records; cost of accounting if a non-operator's interest is divided among four or more parties; and the cost of taking production in-kind. The AAPL 610-1989 operating agreement also addresses the cost of regulatory hearings (Article IV.A). However, these provisions represent only a small fraction of the costs, and ones that tend to occur infrequently. For the most part, the operating

---

[1] This section was authored by Karla Bower. It should be noted that there have been a number of articles published over the years concerning COPAS and the accounting procedure forms. *See, e.g.,* John E. Jolly & Jim Buck, "Joint Interest Accounting—Petroleum Industry Practice" (The Prof'l Dev. Inst., Denton, Tex. 1988); John E. Jolly, "The COPAS Accounting Procedure Demystified," 34 *Rocky Mt. Min. L. Inst.* 21-1 (1988); Granville Dutton, "Accounting Procedures: Contracts or Controversies," 19 *Rocky Mt. Min. L. Inst.* 117 (1974); Russell W. Hawkins, "The COPAS Exhibit: An Operational Perspective," 15 *E. Min. L. Inst.* 475 (1994); Robin Forte; "COPAS: Tips for the Non-Operator in Interpreting, Negotiating, and Drafting," 41 *Rocky Mt. Min. L. Inst.* 21-1 (1995); J. David Heaney, "The Joint Operating Agreement, the AFE and COPAS—What They Fail to Provide," 29 *Rocky Mt. Min. L. Inst.* 743 (1983); Jolias Melton, "Cowboy COPAS: A Primer for Attorneys," presented at the 27th Annual Ernest E. Smith Inst., Houston Tex., Mar. 30, 2001; Owen L. Anderson, "Royalty Valuation: Calculating Freight in a Marketable-Product Jurisdiction," 20 *Energy & Min. L. Inst.* 331 (1999) (this article, while directed toward royalty issues, discusses in detail the application of COPAS principles in resolving certain cost issues insofar as they impact royalty computations); John Burritt McArthur, A Twelve Step Program for COPAS to Strengthen Oil and Gas Accounting Protections, 49 SMU *L. Rev.* 1447 (1996).

agreement provisions dealing with costs address *who* pays, rather than the classification of costs as direct or overhead. Examples of these include the costs associated with non-consent operations, abandonment and surrender liability, and occasionally the allocation of costs between zones.

The details surrounding the accounting are left to the accounting procedure. Specifically, the accounting procedure sets out how the operator is to be compensated for all operations and activities conducted under the agreement, aside from the exceptions in the operating agreement. It is the accounting procedure that outlines the basis of direct charges and credits to the joint account, what is included in overhead and how it is to be recovered, and the handling of materials and inventory.

B. History

Accounting procedures have been in existence for many years, evolving in the early 1960s into the model form accounting procedures developed by the Council of Petroleum Accountants Societies, Inc. (COPAS) that are used today. Other petroleum accounting organizations that have published model form accounting procedures over the years, and their publications/dates, include the following:

Mid-Continent Oil and Gas Association - 1938

Petroleum Accounting Society – Los Angeles:

PAS 1 - Unknown date

PAS-1956.

PAS-1962

Petroleum Accounting Society of Oklahoma:

PASO-1949

Petroleum Accounting Society of Oklahoma – Tulsa:

PASO-T 1955

Petroleum Accounting Society – Canada/Western Canada:

PASWC-1953

PASWC-1969

PASWC-1976

PASC-1983

PASC-1986

PASC-1988

PASC-1996

Council of Petroleum Accountants Society, Inc. (COPAS):

COPAS-1962

COPAS-1968

COPAS-1974

COPAS-1976 (Offshore)

COPAS-1984

COPAS-1986 (Offshore)

COPAS-1995

COPAS-Project Team (1998)

COPAS-2005

Accounting procedures have changed over the years in response to business needs as well as a need to clarify the forms. In really old agreements, the accounting procedures were very brief and sometimes embedded in the operating agreement. Even where the accounting procedure was a separate exhibit, it was sometimes no more than two pages long. By contrast, the 2005 COPAS accounting procedure is 15 pages long. The growth in the accounting procedure has much do with clarifying the intent and application of the form, rather than sweeping changes in joint interest accounting practices.

Another shift in the accounting procedures is that they have become more flexible over time to provide for automatic adjustment without having to amend the contracts. Gradually, many fixed factors or percentages have been replaced with factors or percentages that are adjusted by external indices/organizations. Examples of these include the employee benefits rate limitation, freight equalization threshold, interest rate on delinquent bills, loading and unloading costs, and the overhead adjustment factor. The 1995 and later forms even anticipate that, at some point, COPAS may designate a source for vehicle rates other than the currently used Petroleum Motor Transport Association (PMTA) rates.

The 2005 COPAS accounting procedure added even more flexibility. It provided a back-up for the interest rate on delinquent bills, and stated overhead will be adjusted using the rate published by COPAS, without further specifications on the source of that rate. The 2005 COPAS accounting procedure also tied the threshold for charging major construction and catastrophe overhead, as well as operator authority to dispose of certain materials, to the operator's expenditure limit, which tends to get amended from time to time.

The changes from one model form to another and the nuances are best understood by comparing corresponding provisions of each form. In that way, the user becomes more familiar with and develops a better understanding of how the forms have evolved. Seemingly minor word changes can matter, but it is beyond the scope of this paper to get into a detailed discussion of these differences. An explanation of some of these changes can be found in various COPAS publications.

C. Conflict between the Operating Agreement and Accounting Procedure

Usually the operating agreement prevails over the accounting procedure. Occasionally, some companies modify the operating agreement to provide the accounting procedure will prevail in the event of a conflict. Most agreements, however, appear to maintain the standard industry practice of having the operating agreement prevail since it is the core document that establishes the overall framework for the deal. The few cost issues addressed in the operating agreement appear to reflect standard industry practice – e.g., charges for title work – and are usually intentional exceptions to the general rules in the accounting procedures. Negotiators may find it helpful to identify those conflicts, consider the parties' intent, and modify the operating agreement, if necessary, rather than simply accept the proposition that the accounting procedure should prevail.

The operating agreement seldom addresses conflicts between exhibits. An example that comes to mind is the gas balancing agreement (GBA). Many GBAs allow an overproduced party to charge the underproduced party reasonable marketing fees when making a monetary settlement of imbalances. Some GBAs allow interest to be charged to the party who was responsible for delaying monetary settlement, and may contain audit provisions. Although there is some question about whether the accounting procedure governs issues related to production volumes and proceeds, and even whether marketing fees are beyond the scope of the agreement since the parties have a duty to take in kind, the parties still may wish to address potential conflicts.

Other exhibits may also be in conflict with the accounting procedure. For example, the insurance exhibit sometimes addresses cost issues, especially as it pertains to the cost of self-insurance. Exhibits used in some offshore agreements may also contain cost provisions. The security interest exhibit typically provides for attorney fees, court costs, and other costs of collection. The dispute resolution exhibit addresses the cost of mediation/arbitration, and the project team exhibit influences project team costs. Therefore, the parties may wish to consider and address conflicts between the other exhibits and the accounting procedure.

D. Accounting Procedures Overview

Section I of the accounting procedure contains general provisions – definitions, billing, adjustment and audit procedures. This section and the materials and inventory sections are considered boiler-plate provisions, for the most part. The crux of the accounting procedure, and the main focus of joint interest accounting and auditing, tends to be the classification of costs as either direct charges or overhead.

The direct charges section of the COPAS accounting procedures lists only general categories of chargeable items. It does not provide a detailed list of chargeable items, or

provide guidance on allocations or application of the form. For example, drilling units, compressors, flowlines, and construction of well pads are not listed as chargeable costs. Yet they are chargeable under the general categories of labor, materials, and services. It would be virtually impossible to list each and every item or service that could be charged directly to the joint account. Even if such a list were created, it would be too voluminous and would quickly become out-dated as technology, operations, and business practices change.

At the same time, the accounting procedures do not address cost allocation. Allocation of costs and liabilities among parties and operations is generally covered by the operating agreement, or in the case of wells having different ownership in different formations, a cost allocation provision in the operating agreement or a separate side agreement. As for allocating costs of resources (e.g., labor, materials, and facilities) shared by multiple properties that are governed by different operating agreements, it would be difficult to develop a model form with an allocation method that fits each type of facility or operation. The form would increase in complexity and length. More importantly, it would be extremely burdensome to account for and audit if each property sharing the resource called for an allocation method different from the other properties using the same resource.

Because the accounting procedures define chargeable costs in general categories and do not address allocations, joint interest accountants and auditors should have knowledge of the operating agreement and accounting procedures, a basic understanding of the operation, and knowledge of industry guidelines. Even so, it may become necessary to make judgment calls from time to time. For example, COPAS accounting procedures allow direct charges to the joint account for "Material purchased or furnished by Operator for use on the Joint Property." This could include an item such as a fire extinguisher, but to properly account for an invoice for a fire extinguisher, the accountant or auditor would have to determine if it constituted material used in the operation of the property. If the fire extinguisher is for a field installation, such as a compressor station or tank battery, it could be charged direct to the joint account. If the fire extinguisher is used for the operator's headquarters office, it is not chargeable (at least not under a conventional accounting procedure).

E. Changes in Business and Technology

Besides having to apply these general categories to specific charges as they are incurred, there can be other reasons the classification of costs as direct or overhead is not always clear. Other factors that can cause ambiguity include changes in business practices and technology. It can become necessary to interpret the agreement in light of these changes and make judgment calls.

One example of changes in business practices over the years is the way employees are compensated. It has become common practice to compensate employees through at-risk pay, such as incentive plans, stock options, and other performance awards. It can be difficult to determine whether these various types of at-risk pay for chargeable employees fall under the category of salaries and wages, employee benefits, or overhead. There are very different accounting implications/outcomes of each of these choices.

Additional examples of changes in business practices include incentive pay and awards for vendors; operators paying for rig modifications that will be used on multiple properties –

and ultimately owned by the rig contractor; out-sourcing; manufacturers no longer publishing material price lists; and the Bureau of Labor Statistics revamping its wage indices that are used to adjust overhead. Changes in business practices require interpreting the agreement and considering the intent of the parties in light of these changes. Many of these issues have been addressed by COPAS in its publications to help the industry understand the nature of these changes and how they apply to the accounting procedure forms.

Yet another example of changes in the business environment is the provision concerning the charging of abandonment and reclamation costs. This provision first appeared in the 1984 COPAS accounting procedure, ostensibly due to the increased focus by the industry and government agencies on abandonment obligations. One might conclude that abandonment and reclamation costs are not chargeable under the COPAS accounting procedures prior to 1984 since those forms were silent. However, when one considers that abandonment and reclamation costs consist of items such as rig costs, materials, labor, transportation, and services, it becomes clear that these costs can be charged direct under pre-1984 forms. (There may still be some ambiguity about *who* should pay, but that is an operating agreement matter.) Moreover, if one took the position that a type of *operation* – in this case, abandonment and reclamation – is not chargeable because it is not listed in the direct charges section of the older vintage accounting procedures, the next logical conclusion would be that drilling, recompletion, and other types of operations are not chargeable because they are not listed as direct charges in any model form. Obviously that is not the case, but it illustrates the process one goes through in analyzing agreements to determine how they apply to changes in the business environment.

Changes in technology can also create uncertainty in application of the accounting procedure. Technological advances have made it possible to reassign and relocate some labor functions. Specifically, technological advances have made it possible to perform some overhead functions in the field. In the case of accounting, the function is not chargeable to the joint account even when moved to the field, because the accounting procedures specifically list it as an overhead function. (However, there could be a question about that in the case of a contract that calls for district expense to be chargeable to the joint account, since some districts may have included certain accounting functions.) For other overhead functions, it may be less clear, since accounting procedures prior to the 2005 form are not very specific on overhead functions. Determining chargeability can be even more difficult when it comes to re-assigning functions that were formerly performed in the field, since these functions were formerly performed on-site by field or technical personnel. The agreement may require they be on-site to be chargeable. At the same time, these functions were not covered by overhead when the agreement was negotiated.

The proliferation of telemetry and communication devices created some ambiguity or differences of opinion on whether these costs were chargeable to the joint account. Communications cost was not listed in the direct charges section of the model form accounting procedures prior to the 1976 form. One might infer from its absence in pre-1976 model forms that communication equipment is not chargeable to the joint account under these forms. But on further analysis, the 1976 and later model forms state if the communication equipment is owned by the operator, charges for the equipment will be made under the provision dealing with equipment and facilities provided by operator. All COPAS accounting procedures and their predecessors have a provision allowing direct charges for equipment and

facilities furnished by operator, so the absence of a provision dealing specifically with communications does not mean all communication costs are overhead. Even if the equipment is not owned by the operator, it may still be charged direct under pre-1976 forms. If the communication equipment is leased by the operator, it may be chargeable under the provision concerning the cost of contract services, equipment and utilities furnished by third parties, while communication equipment owned by the joint account may be chargeable under other provisions such as labor and materials.

Technological advances further impacted joint interest accounting through the integration of systems that serve both operations and overhead functions, such as engineering and accounting. The cost of communication systems used in field operations is generally considered chargeable to the joint account, while communication systems supporting overhead functions are not chargeable. Interpretation and judgment is required to delineate and properly account for these costs since the accounting procedure does not specify how to allocate the cost of communication systems that serve both field operations and overhead functions. Even when systems serve only field operations, they may be linked to various other properties and facilities, making it difficult to determine what portion is allocable to a specific property.

To provide flexibility in adapting to changes in business, technology, regulations and other unforeseen events, most COPAS accounting procedures have an "Other Expenditures" provision that allows direct charges to the joint account for items that are: necessary and proper in the conduct of joint operations; for the direct benefit of the property; and which do not fall under one of the other categories in the direct charges section, or under the overhead provision. This provision creates some differences in interpretation. It is sometimes cited by operators to justify direct charges to the joint account, particularly in context of costs that did not exist or otherwise were not anticipated when the agreement was signed, and therefore could not have been covered by overhead. From the non-operators' standpoint, the operator agreed to provide overhead services for a fee. The COPAS accounting procedures list a few of the overhead functions, and then state overhead fees also cover any other labor, and the associated cost, that is not covered by the direct charges section. Viewed in this manner, if a charge does not fit under the direct charges section, it can be considered overhead, even if the overhead cost did not exist at the time the agreement was negotiated. Similarly, if overhead costs are reduced, the operator is not required to reduce the overhead rates. The agreed upon rates will "buy" the overhead functions, regardless of how those functions might change and regardless of the actual cost to the operator.

F. Overhead Recovery

The operator may or may not recover its actual cost of providing overhead services, but that is irrelevant except in the context of convincing the non-operators a rate amendment is justified. The operator agreed to provide the overhead services for the specified rates. The overhead rates are often influenced by the "going rate" in the area, rather than determining the rates that will allow the operator to recover its actual overhead costs without gaining or losing money. Also, the rates may have been adjusted upwards or downwards based on other concessions made by the parties to conclude the deal.

Overhead negotiations can also be influenced by the parties' perceptions. Companies tend to view overhead rates in light of the rates they are charging or being charged under

other agreements, or in comparison to their own actual cost structure. If the operator proposes rates that are lower than the rates the non-operator charges on its operated properties, the non-operator is more likely to accept the proposed rates, even if they exceed the operator's actual costs. Conversely, if the operator proposes rates higher than the rates the non-operator charges on its operated properties, the non-operator is more likely to negotiate lower rates.

At the same time, the non-operators perceive that the operator has other advantages by virtue of its position as operator and that this value is additive to the overhead fees. The operator has more knowledge of the property, is more likely to propose operations, determine the type of operation, and direct the type and amount of resources used. These decisions can influence the pace of development, hydrocarbon recovery, and the overall economics of the operation. Given this perceived advantage, a non-operator may not be sympathetic to whether the operator is recovering its actual cost of providing overhead services.

The operator, of course, has a different perspective. It perceives its overhead services – such as safety, environment, engineering, and procurement practices – to be more thorough and of higher quality than its competitors. These services, which provide value to the joint account and mitigate potential liability, are a cost for which the operator should be adequately compensated.

Another consideration is the nature of overhead costs. For the operator, overhead is largely a fixed cost. If it plugs and abandons a well, its overhead costs are not measurably reduced. While overhead costs are very real to the operator, it may take a large reduction in well count to measurably impact its overhead costs. From the non-operator's standpoint, if the well is plugged and abandoned, its overhead costs go down immediately, by a noticeable amount. In other words, on an individual well basis, overhead costs are more or less a fixed cost for the operator and a variable cost for the non-operator. This dichotomy not only makes it difficult to negotiate overhead, but can also lead to different economic evaluations later in the life of the property.

Under some older model form agreements – some of which are still in effect – the operator was compensated for its overhead costs through a combination of a warehousing fee, administrative overhead fee, and district expense. Many old district offices provided for a certain level of engineering, geoscience and administrative services. Over the years, the property may have been operated by a number of different operators and/or the operator has undergone a number of reorganizations. This leads to the question of what costs should be included in district expense, which is an allocated cost to the properties, as it is difficult to equate a district from the 1960s, or earlier era, with a modern organization. Arguably, some, but not all, district costs now reside in a business unit, region, division or other organization unit that does not resemble the district office that existed when the contract was signed. For example, district expense included some off-site technical labor, so a certain amount of technical labor could be allocated as district expense. But not all of the costs in the business unit, region, division or other organization unit were included in the district. Some of these functions may have been performed by other groups such as field personnel, or by offices that were covered by the so-called administrative overhead.

G Summary

The accounting procedure is designed to be flexible to adapt to changes in business and operational practices, technology, and regulatory requirements over the life of the contract. The constant state of change and the form's flexibility will mean that interpretation and judgment calls are required, which inevitably lead to differences of opinion. Any attempts to clear up current issues as they arise will quickly be supplanted by new issues. However, the forms have demonstrated their resiliency, for the most part.

Negotiators are well advised to take time to ensure the operating agreement and accounting procedures are integrated to give full effect to the parties' intent. Overhead negotiations, by their very nature, are contentious, but understanding general theory and industry guidelines behind overhead recovery can be beneficial.

II.

A COMPARISON OF KEY FEATURES OF THE 1984, 1986 AND 2005 COPAS ACCOUNTING PROCEDURES[2]

A. Introduction

COPAS has published model form accounting procedures for over forty years. These model forms have been used, or have served as the basis for customized accounting procedures, for the vast majority of domestic joint operating agreements since the early 1960s. The COPAS accounting procedure is one of the most widely used forms in the industry. In fact, "COPAS" is often used as a synonym for Accounting Procedures, as in "the COPAS Exhibit" or simply "the COPAS."

COPAS approved a new model form – the COPAS 2005 Model Form Accounting Procedure – to replace the 1984 (onshore) and 1986 (offshore) Model Form accounting procedures. While two other accounting procedures were published after the 1984 and 1986 forms – the 1995 and Project Team (1998) Accounting Procedures – those forms were specialized and not as widely used as the 1984 and 1986 forms. Thus, the 2005 Model Form accounting procedure is the first general use accounting procedure since the 1984 and 1986 forms were issued.

As a replacement to the 1984 and 1986 forms, the 2005 COPAS accounting procedure can be used for either onshore or offshore shelf properties. It can also be used for deepwater prospects, although most companies prefer to utilize a customized version of the COPAS Project Team accounting procedure. While the 2005 COPAS accounting procedure was not specifically designed for gas plants, deepwater, or frontier areas, it can be easily adapted to fit a wide variety of operations.

[2] This section was authored by Karla Bower and first appeared as a separate article in *ACCOUNTS*. June 2005: 8-13. It also appeared in *Landman*. May/June 2005, Vol. 50, No. 3, p.15-21, and in *Rocky Mountain Mineral Law Foundation Journal*. Vol. 42, No. 2, 2005, p.421-428.

This section will review the key features and highlight the more significant changes in the 2005 COPAS accounting procedure. The primary focus will be on changes relative to the 1984 and 1986 forms, since those are the forms replaced by the 2005 COPAS accounting procedure.

B. Background

The project for a new accounting procedure developed from an informal survey of COPAS members, which indicated very few companies used the 1995 COPAS accounting procedure, developed by COPAS as an alternative form. Some COPAS members expressed concern about the confusion created by having this alternative form and felt there was a need to clarify and update the forms that were actually being used. This feedback led COPAS to develop the new accounting procedure.

The drafting team represented a cross section of the industry in terms of company size and geographic areas, as well as included both the joint interest and audit points of view. This diversity was viewed as critical in creating a form that was suited for a variety of operations, and would ensure that it would not be viewed as a form that favored operators or non-operators, large companies or small companies, or otherwise lacks balance.

The goal was to create a form that reflected current practices and incorporated standards from COPAS publications, and that would be widely used by the industry. The team realized that for the form to gain wide spread acceptance, it had to be compatible with existing accounting procedures and minimize "exception accounting." A model form that requires extensive changes to existing systems and processes, especially following two model forms that have been in use for approximately 20 years, would not likely succeed.

Another guiding principle was to make the form more user-friendly. The form contains instructions that advise users where they need to "fill in a blank" or select an alternative, and points out an optional provision. The instructions do not provide theories or guidance on these choices. However, COPAS developed a publication, MFI-51 ("2005 COPAS accounting procedure") to provide background information and explanations. Additionally, MFI-51 and the model form itself refer to still other COPAS publications for more information.

C. Key Features

If one were to do a line-by-line comparison of the 2005 COPAS accounting procedure and its predecessors, it appears that there were extensive changes. However, many of these changes have little practical impact on day-to-day business since they were made to clarify the intent and application of earlier model form accounting procedures. In some cases, the modifications consisted of adding phrases or sentences from COPAS Model Form Interpretations (MFIs), while in other cases entire COPAS MFIs were incorporated by reference. The instances where COPAS MFIs were incorporated by reference are as follows:

- Section II.2.A – MFI-37 ("Chargeability of Incentive Compensation Programs")

- Section II.2.F – MFI-35 ("Charging of Training Costs to the Joint Account")
- Section II.2.G – MFI-27 ("Employee Benefits Chargeable to Joint Operations and Subject to Percentage Limitation")
- Sections II.2.H & II.5 – MFI-49 ("Awards to Employees and Contractors")
- Section II.12 – MFI-44 ("Field Computer and Communication Systems")
- Section III.1.B.(4) – MF-47 ("Adjustment of Overhead Rates")
- Sections IV.2.B.(1) and IV.2.E(1) & (2) – MFI-38 ("Material Pricing Manual")

One new feature of the 2005 COPAS accounting procedure is to provide defaults to simplify preparation of the form and prevent omissions. The most notable of these defaults are the elections where the parties must select one of alternative provisions. The first paragraph of the accounting procedure provides that if the parties fail to select an alternative, or select competing alternatives, the parties will be deemed to have selected the first alternative. Other defaults consist of dollar thresholds that establish the operator's authority to use affiliate goods and services, dispose of materials, and to apply major construction overhead. (These are addressed in more detail below.)

Because the form replaces both the 1984 and 1986 Model Form Accounting Procedures, it is designed to work for either onshore or offshore properties. Inclusion of offshore terms in an onshore agreement might be a bit disconcerting to users in landlocked areas. However, the dual nature of the form will not generate charges to the joint account for shore base or offshore facilities that do not provide a direct benefit to the property. Even so, onshore users who wish to delete any references to offshore, can easily accomplish this by striking the "Offshore Facilities" and "Shore Base Facilities" definitions in Section I.1, and deleting these terms and/or references to offshore in the following:

- Section I.1 – "On-site" definition
- Section II.2.A.(2) – Labor
- Section II.6.A – Equipment and Facilities Furnished by Operator
- Section II.11 – Insurance
- Section III.1.B.(2).(a) – Overhead

D. Major Changes

Joint Interest Billings. The form now recognizes that joint interest billings (JIBs) may be sent and received electronically. Each non-operator makes its own election on electronic receipt of JIBs. This election can be changed upon 30-days notice, allowing for flexibility as interests are sold or transferred.

Unlike other forms, which required the non-operator to pay the JIB in full as rendered (subject to the right to take written exception), the 2005 COPAS accounting procedure allows non-operators to "short-pay" the JIB under certain circumstances. The non-operator may withhold payment if it is billed for (1) an incorrect interest, (2) an unauthorized project, (3) a sold or transferred interest, or (4) charges outside the adjustment period. Only the amount in dispute pertaining to these criteria may be withheld, and the non-operator must present documentation to support its position. The remainder of the bill must be timely paid. Delinquent payments bear interest at the prime rate published in the *Wall Street Journal* plus three percent, or if the *Wall Street Journal* ceases to be published, at the prime rate published by the Federal Reserve, plus three percent.

Adjustments. The 1984 and 1986 forms limit adjustments to the joint account to the current year, plus the two prior calendar years. The 2005 COPAS accounting procedure allows the operator to adjust the joint account after this "current year plus two" period has expired for (1) inventory adjustments, (2) an offsetting entry that is the result of a non-operator audit of another property, (3) a government or regulatory audit, or (4) an adjustment to the working interest ownership or participating interest. The exception to the adjustment period is consistent with concepts found in COPAS MFI-40, as well as the 1995 and Project Team accounting procedures.

Audits. The audit provision (Section I.5) was extensively revised. It contains deadlines for issuing the audit report, and for the operator and non-operator to submit responses and rebuttals. If the operator fails to meet its deadlines, it must to pay interest on any exceptions that are ultimately granted. Failure of the non-operator to timely respond delays receipt of any adjustments due it. This delay inherently creates an "interest" penalty for the non-operator as well. In addition, if the operator fails to respond timely, its statute of limitations defense is waived – the operator cannot simply wait and run out the clock. On the other hand, if the non-operator misses its deadlines, the statute of limitations waiver lapses. Some companies prefer tougher penalties, so an optional provision (Section I.5.E) was included. This provision stipulates if the operator fails to respond after one year, unresolved claims are deemed granted. If the non-operator fails to respond after one year, unresolved claims are deemed to be withdrawn. The parties need to check the box or make some other notation to indicate this optional provision is selected if they want it to be part of their agreement.

To further the goal of timely audit resolution, the 2005 COPAS accounting procedure contains a mediation provision. However, since many new JOAs contain alternative dispute resolution (ADR) provisions, the accounting procedure defers to the ADR provisions in the JOA. If there are no ADR provisions in the JOA, the parties may invoke the mediation provision in the accounting procedure.

The audit provision recognizes the role of the lead auditor – usually the non-operator with the largest interest – in coordinating the other non-operators' responses, but it does not preclude a non-operator from acting on its own behalf, particularly if it does not agree with the lead auditor's position or is concerned about the lead auditor meeting the deadlines.

There have been questions as to whether or not the older accounting procedures permit audits of payout accounts. The 2005 COPAS accounting procedure specifically allows a party subject to payout accounting to audit the records of the party responsible for preparing the payout statements, or a party furnishing information used to prepare the payout statements. Thus, an operator could audit a non-operator or one non-operator could audit another non-operator. The audit scope can include quantities of hydrocarbons and proceeds insofar as it pertains to the payout account, and the audit must be conducted within two years from the date the payout statement was rendered. Failure to issue payout statements will extend the audit period.

One other change was made to the audit provision to synchronize it with the adjustment period in Section I.4. The time period to conduct audits is linked to the year in which the statement was rendered, rather than the year in which the expenditure was incurred. This change primarily impacts the bill for December expenditures, which is rendered in January of the following year. For example, an audit in 2005 could cover all JIBs rendered since January 2003, including the bill for December 2002 costs.

Voting. There is a voting provision to address accounting matters that arise (Section I.6.A). For example, the operator may want to obtain approval to charge for off-site technical labor to conduct a reservoir study or an environmental study. This is essentially the same as past accounting procedures, i.e., a vote by a majority in interest of the non-operators is binding on all non-operators, although its application is clarified. The parties are advised to consider this provision in light of any voting provisions in the JOA and the conflict of agreement provisions, to give effect to their intent.

An all-new provision, Section I.6.B, governs amendments. This provision is flexible allowing the parties to amend the accounting procedure with less than 100% working interest, if they so desire. Parties that prefer unanimous approval to amend the contract can do so by inserting 100% in the blank. The operator's vote is required to amend the contract to ensure the non-operators do not unfairly amend the operator's agreed-upon compensation. Another new provision, Section I.6.C, addresses voting by affiliates. If parties to the agreement are affiliates of each other, their vote is treated as a vote of one party having the combined working interest of the affiliate entities. If a non-operator is an affiliate of the operator, votes under I.6.A require a majority in interest of the non-operators, after excluding the interest of the operator's affiliate.

Affiliates. Charges for goods and services provided by an affiliate of the operator are addressed in Section II.7 (except for affiliate communication facilities or systems, which are covered under Section II.12.) Paragraph A deals with affiliate goods and services used in projects or operations that require non-operator approval under the operating agreement, while Paragraph B deals with affiliate goods and services used in operations that do not require an AFE or other authorization. Affiliate goods and services that exceed the applicable dollar threshold (there are separate thresholds for paragraphs A & B) require non-

operator approval. For projects, the threshold applies separately for each project, and the costs must be identified on the AFE or other authorization request. For other operations, the threshold applies separately to each affiliate for a given calendar year. Charges for affiliate goods and services that exceed commercial rates require approval of the non-operators, even if the charges are below the dollar threshold.

If the parties fail to designate a dollar threshold for approval of affiliates, the threshold is deemed to be an amount equal to the operator's expenditure limit in the operating or other agreement to which the accounting procedure is attached. If the accounting procedure is attached to an agreement that does not contain an expenditure limit (e.g., a farmout agreement) the threshold is deemed to be $0.00.

Ecological, Environmental & Safety (EE&S). The costs of off-site technical services and drafting to comply with laws or standards recommended by regulatory authorities are directly chargeable. Examples of this include designing environmental equipment for a property or creating a spill response plan for a specific operation. Costs associated with other EE&S functions are covered by other provisions, such as field labor (II.2), services (II.5) or overhead (III). The costs of off-site technical services and drafting not required by laws or recommended by regulatory authorities are not chargeable under this provision. As such, the EE&S provision will have a greater impact on offshore properties, since they are more extensively regulated. This provision allows direct charges for providing or making available pollution containment equipment, and for the actual costs of pollution clean-up.

Other Expenditures. Charges made under this provision now require approval of the non-operators pursuant to the voting provision (Section I.6.A). This provision allows the operator flexibility to recover unforeseen costs that are not addressed in the direct charges section and that the operator does not believe are included in the overhead rate. At the same time, requiring a vote safeguards the non-operators and allows auditors an objective standard to determine the validity of any charges made under this provision.

Technical Services. Technical labor generates frequent questions and is sometimes misunderstood with respect to other model forms. Inexperienced users often believe that all third party technical services are directly chargeable, not realizing all technical labor should receive the same accounting treatment, regardless of the source. Consequently, the 2005 COPAS accounting procedure replaced the term "Technical Employees" with "Technical Services" and expanded the definition to include technical labor provided by operator's affiliates and third parties.

As with the prior forms, Section III contains elections (alternatives) where the parties establish whether on-site and off-site technical services should be treated as either a direct charge or overhead. These provisions were revised, however, so that even novice users could easily understand them. Under the previous forms, the first election ("shall") meant technical labor was intended to be recovered via the overhead rates, while the second election ("shall not") resulted in technical labor being charged direct to the Joint Account. The 2005 COPAS accounting procedure is clearer, using the phrases "charged direct" and "overhead" to distinguish between the elections. Also, the terms "on-site" and "off-site" are used, rather than carrying forward the former language which referred to "on the Joint

Property" in the former case and "assigned to and directly employed in the operation" in the latter case.

The direct charge and overhead elections are competing alternatives. Since the first alternative governs if the parties fail to make an election or inadvertently select competing alternatives, the order of the elections was changed with respect to on-site technical services, so that the default is to charge it direct. The default for off-site technical services is overhead.

One notable change that goes beyond clarification and ease of use is the addition of a third alternative for off-site technical services. This new alternative allows off-site technical services to be direct charged only to the extent they are directly attributable to drilling, redrilling, deepening or sidetracking operations. Under this alternative, off-site technical services for other operations, such as recompletions, workovers and producing operations, are covered by overhead and may not be directly charged (absent a ballot). This third alternative represents a middle ground to allow off-site technical charges, while placing limits on them.

Drilling and Producing Overhead. The drilling and producing well combined fixed rates are now adjusted in accordance with the adjustment factor published by COPAS. While this is a change from the original 1984 and 1986 model forms, it is consistent with the revised versions of those forms, which were issued in 2004 as a result of changes in the Bureau of Labor Statistics indices. If the operator fails to adjust the overhead rates for a period of time, it may recalculate the rates as if they had been adjusted each year since the effective date. However, retroactive adjustments to the joint account for the revised overhead rates are limited to the current year plus the two prior years.

The overhead rates are adjusted each April 1 following the effective date of the agreement to which the accounting procedure is attached. When the accounting procedure is attached to a JOA that becomes effective upon payout, a question arises whether to adjust the overhead rates from effective date of the JOA or the effective date of the farmout agreement. The 2005 COPAS accounting procedure makes it clear the adjustment is calculated from the effective date of the farmout agreement.

The 1984 and 1986 COPAS accounting procedures state that each active completion in which production is not commingled downhole qualifies for a one-well charge, provided the completions are considered a separate well by the governing regulatory authority. Those forms did not anticipate that completions having different ownership and treated as separate wells by the regulatory authorities would be downhole commingled. The 2005 COPAS accounting procedure specifically provides that each active completion that is treated as a separate well by the governing regulatory authority qualifies for separate overhead rate. This applies to all types of wells, regardless of whether they are downhole commingled. However, users are cautioned to consider whether the completions are covered by separate operating agreements, as well as the impact of any supplemental cost allocation provisions or agreements.

Some parties may have existing processes and systems in place to treat downhole commingled completions as one well and allocate the overhead rate between/among the active completions. If they prefer to maintain that approach, they can either modify Section III.1.B.(3).(b) of the accounting procedure or they can lower the overhead rate so that the

separate rate charged to each completion is comparable to a single rate that is allocated between/among completions. Regardless of whether the parties modify the form, or how they assess overhead on multiple completion wells, the supplemental cost allocation provisions or agreement should be reviewed to ensure consistency with the accounting procedure.

Major Construction & Catastrophe Overhead. The 1984 and 1986 forms contained a blank where the parties established a threshold for projects that qualify for major construction overhead. Occasionally, this blank was overlooked in preparing the contract. The 2005 COPAS accounting procedure avoids that problem and simplifies contract preparation by stating the threshold is equal to the Operator's expenditure limit under the agreement to which the accounting procedure is attached. If the accounting procedure is attached to an agreement that does not have an expenditure limit, such as a farmout agreement, the major construction overhead threshold is deemed to be $100,000. Catastrophe overhead is combined with the major construction overhead provision, so that they have the same overhead rates. However, there is no dollar threshold to qualify for catastrophe overhead.

There are two sets of major construction/catastrophe rates. While the use of two sets of major construction rates has been a long-standing practice for offshore properties, it is new for onshore agreements. The first set of rates is for use when the operator absorbs all the engineering, drafting and design work. These rates are generally higher than the second set of rates, where the engineering, drafting and design work is charged direct to the joint account. The operator decides which set of rates to charge for each project.

Material Valuation. The material pricing provisions in Section IV used the 1995 and Project Team forms as their basis, rather than the 1984 and 1986 forms. One significant departure from the latter forms is that unused material must be credited at the same price charged to the joint account when the material was purchased by it. Requiring credit without gain or loss was intended to encourage timely disposition of material. However, the operator may not have a ready use for the surplus material and is under no obligation to purchase it. If it becomes necessary to sell the equipment for less than the price paid by the joint account, the operator should ballot the parties under Section I.6.A.

Premium Pricing. Other COPAS model forms require the operator to notify non-operators of premium prices, and allow the non-operators a 10-day period in which they can elect to furnish their share of materials in kind. The 2005 COPAS accounting procedure eliminated the notice requirement and the right to furnish in kind because it was felt that the provision was impractical to administer and unnecessary. In a premium-pricing situation, the operator may have to make purchasing decisions in a matter of hours, not days. By the time the operator administers the notice and the non-operator's election period expires, the material may no longer be available. Also, non-operators having surplus material are also faced with the same premium-pricing situation where they are operator and are likely to use their surplus in their own operated properties. Finally, if the non-operator wants to get rid of its surplus material, finding a willing buyer in a premium-pricing period should be relatively easy.

Disposal of Material. It is not uncommon for operating agreements to contain provisions concerning the disposal of material, particularly offshore agreements. As such, the account-

ing procedure defers to the material disposal provisions in the JOA. However, if there is no disposal provision in the JOA, the accounting procedure grants the operator the right to sell material to a third party without non-operator approval, if the gross sale value is less than or equal to the operator's expenditure limit. If the gross sale value exceeds this threshold, approval of the parties owning the material (rather than all parties) is required. Eliminating notices and approval for small-dollar items should reduce work for both the operator and non-operator while facilitating timely disposition of surplus.

E. Conclusion

The 2005 COPAS accounting procedure is a milestone for COPAS and the industry. It has clearer and more comprehensive language than its predecessors. Even so, users still have to ensure the form fits the operation and terms of the deal, and that it does not conflict with the operating or other agreement that sets the overall framework. Properly used, it will be a valuable tool to carry out the parties' intent. It has generated a great deal of interest and early indications are that it will be widely used.

Readers who wish to learn more about the 2005 COPAS accounting procedure and its application are encouraged to consult COPAS MFI-51. Still more information can be found in the interpretations incorporated in the model form by reference, and others that are mentioned in MFI-51. For contract negotiators, another valuable resource is COPAS AG-23, "Negotiating and Calculating Overhead."

III.

2005 COPAS ACCOUNTING PROCEDURE PREPARATION & NEGOTIATION—PRACTICAL CONSIDERATIONS[3]

A. Introduction

Even when using the 2005 COPAS accounting procedure without any modifications, it is still necessary to select alternatives and fill in certain blanks. The instructions that accompanied the 2005 model form list the alternatives and blanks that need to be completed, and the optional paragraph, but do not give any further guidance on preparing the form. This section will focus on the basics of preparing the form and familiarize negotiators with implications of the various choices or positions that parties might take.

Preparation and negotiation of the accounting procedure is a matter for each company to evaluate and decide, and the appropriate choices may vary from one type of operation or situation to the next. Users should take into account their own operational, business and legal needs, and exercise their own judgment to ensure the agreement suits their needs.

Not every provision of the accounting procedure is addressed in this section because it is difficult to anticipate every question that might arise, and because some provisions are seldom altered. Nor was there any intent to duplicate other more general reference materials.

[3] Karla Bower authored this section.

This section occasionally refers to "operating agreement," since the accounting procedure is most often used as an exhibit to an operating agreement. However, the accounting procedure may also be used with farmout, net profits or other agreements, and the concepts in this section still apply.

B. Defaults

The 2005 COPAS accounting procedure stipulates that if the parties fail to select one of competing "Alternative" provisions, alternative 1 will govern. Also, if the parties select more than one of the competing alternatives, alternative 1 will govern.

Other defaults have been built into the agreement. For example, if the blanks are not completed in Section II.7 (Affiliates), the threshold will be deemed to be $0, and all affiliate costs, no matter how immaterial, will require non-operator approval. The threshold at which the operator may charge major construction overhead (Section III.2) is equal to the operator's expenditure limit in the operating agreement. Likewise, the threshold at which the operator must obtain non-operator approval to make certain dispositions of surplus materials is equal to the operator's expenditure limit (Section IV.3). If the accounting procedure is attached to an agreement, such as farmout or net profits agreement, which does not have an operator's expenditure limit, the threshold is deemed to be $100,000. If the parties desire different thresholds for these provisions, it will be necessary to modify the accounting procedure.

C. 2005 COPAS Accounting Procedures Usage, Application

The 2005 COPAS accounting procedure is generally acceptable for use in most onshore exploration and production properties and offshore shelf properties. It can be also be used for other operations such as deepwater and gas plants, but most users will find it necessary or desirable to modify the form to adapt it to these other types of operations.

The 2005 COPAS accounting procedure is a dual use form, for both offshore and onshore properties. It is not necessary to strike references to offshore if using the form for properties that are strictly onshore. The provisions pertaining to offshore operations simply will not apply, and should not result in excessive or inappropriate charges, as goods and services must directly benefit the property to be charged to the joint account. Even so, some companies may prefer to delete provisions unique to offshore properties. This may be accomplished by taking the following steps:

- Section I.1 – Strike the defined terms "Offshore Facilities" and "Shore Base Facilities" in their entirety.

- Section I.1 – Modify the definition of "On-site" by deleting the phrase "Offshore Facilities, Shore Base Facilities," in line two.

- Section II.2.A.(2) – Delete the phrase "Shore Base Facilities, Offshore Facilities, or other" in line one.

- Section II.6.A – Delete the phrase "Shore Base Facilities, Offshore Facilities," in line two.

- Section II.11 – Delete the last sentence of this provision.

- Section III.1.B.(2).(a) – Delete the second sentence.

D. Heading

The effective date in the heading should be consistent with the effective date of the operating agreement. If the accounting procedure is being negotiated as a contract amendment, the effective date should be included in the heading to the extent practicable and, in any event, should be communicated to the accounting organization. The effective date impacts fixed rate overhead, which is adjusted April 1 of each year following the effective date of the agreement. Overhead rates in a contract that becomes effective in February or March will be adjusted shortly after the effective date. This is standard industry practice, but occasionally is questioned by those not familiar with the practice.

E. Definitions

Line one of the definition section states "All terms used in this Accounting Procedure shall have the following meaning unless otherwise expressly defined in the Agreement." If one of the defined terms in the accounting procedure is also defined in the operating agreement, the operating agreement definition will prevail, even if the operating agreement provides the accounting procedure prevails in the event of a conflict, because the accounting procedure defers to the operating agreement.

Terms that are defined in both the operating agreement and accounting procedure should be reviewed for consistency. Notable terms that are sometimes found in operating agreements, especially offshore agreements, include Affiliates and Joint Account. If the Affiliate definitions are in conflict, that could affect the application of Section II.7 of the accounting procedure.

If the operating agreement contains a definition of Joint Account, it should be reviewed to determine whether it is broad enough to apply to hydrocarbon volumes/proceeds. The 2005 accounting procedure clearly states that Joint Account excludes hydrocarbons. If the operating agreement and accounting procedure have conflicting definitions of Joint Account, that may affect the parties' rights with respect to adjusting and auditing hydrocarbon records, as well as set up a conflict with the audit provisions in the gas balancing agreement. A review of the definitions and their usage in operative provisions will help the parties determine their impact, and enable them to draft the agreement in a way that reflects the parties' intent.

F. Cash Advances

Many operating agreements contain a provision allowing the operator to request a cash advance. These operating agreement provisions typically do not contain any restrictions on the cash call in terms of the amount, or application to capital costs. The relation-

ship between the cash advance provisions in the operating agreement and accounting procedure should be considered to make sure they are not in conflict.

Some parties may propose revising the accounting procedure so that cash advances can be requested only if the estimated expenditures exceed a certain dollar threshold, and/or apply only to capital expenditures. Other parties may resist applying a dollar threshold or restricting cash advances to capital expenditures on the basis that these limitations would defeat the purpose of a cash advance, which is to keep the operator from having to act as banker and finance the non-operators' share of the operation.

One argument some parties may make for limiting cash advances is that the operator has the non-operators' funds tied up for two months, and that the non-operators are effectively loaning money to the operator. By way of example, if the operator receives a cash advance for May expenditures on May 1, the operator has use of the cash for the entire month. The invoice showing actual May expenses is not issued, and the cash advance reconciled, until the second or third week of June. This argument – that the operator has the money tied up for two months – is based on the premise that the operator is "holding" the money. However, if one considers the operator is spending the money to obtain goods and services for joint operations, and the non-operator is funding only its proportionate share, that argument is diminished.

Another concern with cash calls is that an operator will consistently over-estimate the next month's expenditures. The cash call is only an estimate, and will not exactly equal the actual costs. For mature properties that do not have any projects underway, the costs should be more stable so that any differences between the cash call and actual expenditures should be minimal. While some operators could abuse the cash call provision by consistently overestimating the expenditures by a large amount, this practice appears to be the exception. There are just as likely to be shortfalls in the cash call in some months, and the shortfalls and overages will likely even out over time. As such, the burden of funding the operation will be shared equally by all parties.

The cash advance payment is due within 15 days from the date the request is received, or the first of the month, whichever is later. Some companies may request the due date for the cash advance be extended. (This is usually done in conjunction with a request to extend the payment due date for the joint interest billing for actual costs.) Aside from the concerns over the ability to pay on time and having to pay interest on late payments, there is another practical aspect to this request. Operators may include the cash call for the upcoming month in the same invoice as the joint interest billing for the prior month's actual costs. This can slow the processing of the cash call since the entire invoice is processed and paid at one time. If the bill is large and/or there are a lot of capital projects underway, more time may be needed to process the invoice.

There are a number of reasons a party might want to keep the 15-day deadline intact. First, the 15-day due date is consistent with other COPAS accounting procedures, which makes contract administration easier. Also, electronic transmittal of the invoice enables non-operators to automate much of the invoice coding – generally minimal for an advance – thus allowing quicker processing. Even if there are uncertainties about being able to pay within 15 days, these concerns may be overstated, since many operators do not

routinely charge interest on late payments. Finally, another concern is that some parties consistently pay late, so that if payment were due in 30 days, some parties might stretch out the payment to 45 days.

G. Section I.5.E – Expenditure Audits

Section I.5.E is an optional provision. If the parties want to include it, they must check the box or make some other notation to affirm this optional provision is part of their agreement. This provision was made optional because there was not a consensus or widespread acceptance of penalties that require a party to forfeit money or claims. As an optional provision, it is easier to adapt the agreement to suit the parties' preference.

This provision stipulates the operator is deemed to grant audit claims or exceptions, or the non-operator deemed to have withdrawn audit claims or exceptions, as applicable, for failure to respond to within one year. The provision applies to all written exceptions, regardless of whether or not contained in an audit report.

The argument if favor of including this optional provision is that it helps to ensure both the operator and non-operator are diligent in resolving exceptions in a timely manner. The longer the exceptions go unresolved, the harder it becomes to research and reconcile the accounts, because of changes in personnel and accounting systems, and property dispositions. The one-year deadline is generally viewed as enough time, for most exceptions, to keep the resolution process progressing in an acceptable manner, if not fully resolved. Finally, this provision was written to apply to both operators and non-operators, and is not biased towards any one party.

However, not all companies favor a severe penalty – forfeiture of money for the operator and forfeiture of claims for the non-operator. There are several reasons for their objection. First, it can be particularly difficult to meet the deadlines for a large property that has numerous transactions and complex allocations, such as may occur with production handling and other facilities that serve multiple properties. In addition, the time required for the operator to respond also depends, in part, on the specificity and adequacy of documentation the non-operator submits with the written exception. Another concern is that an unscrupulous auditor might submit numerous, unfounded claims that tie up the operator's resources, contributing to the operator's forfeiting money.

Yet another reason a party may not want the optional provisions is because it is difficult to predict whether its staffing level will be sufficient to timely handle the audit process over the life of the contract. Tracking the deadlines creates even more work, which directs some resources away from actually resolving the claims and exceptions.

Finally, a party might reject the provision for philosophical reasons. The purpose of conducting audits and taking exception is to ensure the joint account is stated properly. This provision is viewed by some as defeating that purpose. This provision could result in the operator paying money for invalid claims or the non-operator losing valid claims. There are other ways to accomplish the goal of ensuring the joint account is stated properly and exceptions resolved in a timely manner. The last paragraph of Section I.5.D provides for mediation, making harsher means, such as forfeiting money or claims, unnecessary as long

as the parties are acting in good faith. In addition, many operating agreements contain dispute resolution procedures.

H. Section I.6.A – General Matters Votes

If the operating agreement to which the accounting procedure is attached has a voting provision, one needs to consider the impact regarding voting on accounting matters.

Under most operating agreement voting provisions, all parties, including the operator, are entitled to vote on certain matters. These voting provisions may differ from the voting provisions in the accounting procedure. Under Section I.6.A of the accounting procedure, ballots pertaining to accounting issues (other than amendments) require the approval of a majority in interest of the non-operators. If that threshold is reached, the vote is binding on all non-operators.

The reason the accounting procedure excludes the operator's vote is because this provision is typically invoked when the operator wants to directly charge some item to the joint account (e.g., technical labor costs, relocation costs, affiliate rates) or to negotiate an alternative price for a material transfer. In these situations, the operator usually has a conflict of interest, relative to the non-operators.

Consequently, the contract negotiator may wish to review the operating agreement to see if it has any voting provisions that will prevail over the accounting procedure in the event of a conflict. Consider which voting procedure the parties want to apply to accounting matters and integrate the voting provisions of the operating agreement and accounting procedure to eliminate any conflict and ensure that the parties' intent is carried out.

I. Section I.6.B – Amendments

This provision allows the parties to determine the number of parties and working interest required to amend the accounting procedure. The contract negotiator needs to fill in the blanks. The accounting procedure does not specify a default if this is overlooked.

The appropriate number and percentages to use may vary according to a company's philosophy. Some companies are adamant that amendments should require 100% in all cases. Other companies may wish to negotiate different numbers and percentages based on factors such as the number of parties to the contract. They may be agreeable to a 100% vote in a situation involving few parties. If the property has numerous working interest owners, as sometimes happens in units, that same company may accept/prefer fewer parties and a lower working interest percentage threshold.

J. Section II.6.A – Equipment & Facilities Furnished By Operator

The parties should insert the interest rate to be charged on undepreciated investment for equipment and facilities furnished by operator. The interest component of the rate is to reimburse the operator for tying up its money in equipment and facilities that are used by the joint account, rather having those funds to invest elsewhere. As the cost of capital

increases, the rates negotiated in this section tend to increase as well. Some contracts negotiated in the 1980s, when interest rates were high, had rates in excess of 15%.

Factors to consider when negotiating a rate:

- This interest rate represents an upper limit.

- The equipment and facility is typically used by more than one property, each subject to a different operating agreement having a different interest rate. For ease of administration, the operator generally charges the lowest rate common to all the properties using the equipment/facilities.

- This interest rate not only applies to initial equipment and facilities supplied by operator, but also to equipment and facilities supplied later in the life of the contract, when the cost of capital may be higher – or lower – than it was when the agreement was signed.

K. Section II.6.B – Equipment & Facilities Furnished By Operator

In lieu of charging a rate based on "actual cost of ownership and operation," as provided in Section II.6.A, the operator may charge a rate that is equal to average commercial rates in the area, less 20%.

Some parties may propose striking the phrase "less twenty percent (20%)" or changing the 20% discount to a lesser amount, such as 10%. Reasons a party may propose reducing or eliminating that number is because the 20% discount was designed to eliminate any profit margin. While that might have represented a reasonable profit margin in the early days of COPAS accounting procedures, there is concern that 20% overstates the profit element in the current business environment. Another reason is that the operator may lose money if it charges 20% less than commercial rates. Charging a rate consistent with commercial rates will not put the non-operators in any worse position than if the operator uses a third party provider.

Other parties may resist reducing or eliminating the 20% discount. First there is the long-standing belief that the operator should not make a profit as a result of operating (although this argument ignores the bigger picture of how to measure overall profit or loss, and over what time period that should be measured). From a more practical standpoint, the 20% discount represents a long-standing industry practice, dating back to the 1968 COPAS accounting procedure. If the equipment or facility serves multiple properties that are subject to accounting procedures with different discounts, it can be very difficult for the operator to apply these different rates. Consequently, many companies prefer to use 20% for consistency and ease of administration and auditing. Finally, if charging commercial rates, less 20% is inadequate, the operator still has the option to charge a rate commensurate with its actual costs, not to exceed commercial rates, under Section II.6.A.

L. Sections II.7.A & B – Affiliates

This provision requires the operator to get non-operator approval to charge the joint account for affiliate goods/services if certain conditions are met. Paragraph 7.A applies to projects that require an AFE or non-operator approval, while Paragraph 7.B applies to ongoing operations that do not require an AFE or non-operator approval. Under 7.A, if the affiliate goods/services are not detailed in the AFE or project proposal or if the expenditure exceeds the threshold, approval is required. Approval of affiliates charges for ongoing operations is required if the expenditures exceed the dollar threshold in Paragraph 7.B. These thresholds apply separately to each affiliate, and are based on annual expenditures.

The parties may negotiate different thresholds in 7.A (projects) and 7.B (ongoing operations). The operator is still bound, under paragraph 7.C, to not exceed commercial rates in the area (unless the parties approve the rate), but that can be difficult to determine because of a lack of published price lists, discounts available to the operator, and differences in accounting practices.

CAUTION: IF THIS PROVISION IS USED AS WRITTEN, BUT THE DOLLAR THRESHOLDS ARE NOT COMPLETED, THE AMOUNT IS DEEMED TO BE $0, AND *ALL* AFFILIATE CHARGES WILL BE SUBJECT TO APPROVAL.

Check the operating agreement to see if it contains a definition of Affiliate, and reconcile it with the definition in the accounting procedure if they are in conflict. Non-operators may wish to inquire what affiliates the operator has, how the affiliate bills its costs, and whether the affiliate includes overhead costs in its rate. To avoid misunderstandings later, operators can help by advising the non-operators of any affiliates it may have and the basis of the rates to be charged to the joint account. Many parties find it helpful to include a provision regarding the right to audit the affiliate records, if not by non-operator representatives, by an independent third-party firm.

Parties using the AAPL Form 610-1989 Operating Agreement should note that Article V.D.1 of the operating agreement states use of affiliates should be pursuant to a written agreement, although it fails to specify whether the written agreement should be between the operator and the affiliate or between the operator and non-operators. In addition, Article V.D.1 has no dollar threshold so it applies to all affiliate charges, regardless of the amount. Parties may wish to review Article V.D.1 and consider what impact, if any it might have on Section II.7 of the accounting procedure.

M. Section III.1 – Overhead – Drilling and Producing Operations

Select the preferred alternative for assessing overhead – either the fixed rate basis or the percentage basis. The fixed rate basis is the method most widely used for onshore properties. Both fixed rate and percentage bases are used for offshore shelf properties, while deepwater properties tend to use percentage basis.

If the parties select the fixed rate alternative, drilling and producing overhead is generally charged only when there is an active producing well or an operation that qualifies for drilling overhead. In the case of percentage overhead, the operator can start recovering

some of its overhead costs with the first dollar spent and does not have to wait until there is a drilling or other well operation to start recouping overhead. Therefore, if a property incurs significant overhead costs and requires a long lead-time before there are any drilling or producing operations that will qualify for overhead under a fixed rate basis – such as happens with many offshore and frontier areas – the operator may prefer to use the percentage basis. Percentage basis may also be preferred as it provides a means for the operator to recover overhead costs even if the wells are shut-in, as during the aftermath of a hurricane or other catastrophic event.

Certain costs and credits have to be excluded when calculating percentage basis overhead. Therefore, some companies may prefer fixed rate basis overhead because it is easier to administer and audit than percentage basis overhead. Non-operators may prefer fixed rate overhead for economic reasons, believing that it will result in lower overall overhead charges.

N. Section III.1.A.(i) – On-Site Technical Services

Select either alternative 1 or alternative 2 to establish the accounting treatment for **on-site** technical services. This election will apply to all technical services, regardless of whether provided by employees, affiliates, or third parties.

Under alternative 1, on-site technical services are charged direct to the joint account. Under alternative 2, the operator must charge on-site technical services to its overhead account, and recover the cost through overhead assessments.

Many companies find alternative 1 acceptable as it matches the cost to the property served by the technical person, while the requirement that the technical person must be onsite to be chargeable tends to limit the charges. However, that acceptance is not universal for every company or even in every situation. The reason for choosing alternative 2 appears to be primarily economical. Ideally, there is a trade-off between direct charges for technical services and the overhead rate being charged. The more items that are charged direct, the lower one expects the overhead to be. Conversely, the more things the operator must recover by the overhead rates, the higher one expects the overhead rates to be.

Note: alternative 1 (direct) is equivalent to checking the "shall not" election under older COPAS accounting procedures; alternative 2 (overhead) is the equivalent to checking the "shall election."

O. Section III.1.A.(ii) – Off-Site Technical Services

Select alternative 1, 2 or 3 to establish the accounting treatment for **off-site** technical services. This election will apply to all technical services, regardless of whether provided by employees, affiliates, or third parties.

Under alternative 1, all off-site technical services are charged direct to the operator's overhead account, and are presumed to be recovered through the overhead assessments. Under alternative 2, all off-site technical services are charged direct to the joint ac-

count. Alternative 3 allows for direct charges to the joint account for off-site technical services, but only with respect to drilling, redrilling, deepening, or sidetracking operations.

Many companies prefer alternative 1 because they are concerned alternative 2 will result in significant charges for off-site technical labor. On the other hand, operators may complain that technical labor costs can be significant and the overhead rates are not sufficient to compensate it for its costs. As such, it will be more fairly compensated under alternative 2. Alternative 3 represents a middle ground – allowing direct charges for certain off-site technical labor functions, without leaving it open-ended. As with on-site technical labor, ideally there should be some trade-off between direct charges for off-site technical services and the overhead rate being charged. The more items that are charged direct, the lower one expects the overhead rate to be. Conversely, the more things the operator has to recover by the overhead rates, the higher one expects the overhead rates to be.

Note: alternative 1 (all overhead) is equivalent to checking the "shall" election under older COPAS model forms; alternative 2 (all direct) is the equivalent to checking the "shall not" election. Alternative 3 is new and has no corresponding provision in pre-2005 forms.

P. Section III.1.B – Overhead – Fixed Rate Basis

Insert the appropriate drilling and producing well overhead rates. Currently, the most common practice is to use a 10:1 ratio for drilling and producing wells. However, this ratio is not mandated and the parties are free to negotiate any ratio they prefer.

In theory, the overhead rate should represent the operator's actual cost of providing overhead services. However, it can be difficult to precisely quantify this cost, and overhead rate negotiations tend to be market-driven. Points to keep in mind:

- The overhead rates represent the total gross amount charged to the joint account. When comparing a counterproposal, consider the net amount charged to the other party. Sometimes comparing net amounts helps in the negotiations, as the gap may be narrower than believed.

- Gas wells generally incur more overhead than oil wells because of the costs associated with gas nominations, and dispatching, managing imbalances, and issuing gas balancing statements.

- Deep wells do not need a higher overhead rate than shallow wells. Deep wells have more drilling days, and therefore generate more overhead charges than shallow wells, even at the same rate. As for producing wells, deep wells and shallow wells generally incur the same amount of overhead costs (accounting, production reporting, etc.).

COPAS AG-23 ("Overhead Negotiation and Calculation") recommends parties not rely on external benchmark studies to determine the overhead rate, because they are contrary to the philosophy that the operator should recover its actual cost of providing overhead services. Other concerns with surveys include the following:

- The survey respondents are not necessarily representative of the industry or the operator.

- The rates reported most likely do not represent the operator's actual cost of providing overhead services.

- For many areas reported, there are few responses, so they are not considered statistically meaningful.

- It is not clear whether the survey responses are reporting recently negotiated contracts or include rates charged under old contracts (which may or may not have been adjusted over the years).

- The rates are often reported by well depth, even though COPAS eliminated well depth as a factor in setting overhead rates, starting with the 1974 form.

- It is not known whether the overhead rates reported in the survey include compensation for on-site or off-site technical employees.

- It is not known what other commercial terms were traded or concessions made in negotiating the overhead rates. The operator or non-operator may have received other value in exchange for a decrease or increase in overhead rates.

Q. Section III.1.C – Overhead – Percentage Basis

Insert the development and operating overhead rates if using the percentage basis method of assessing overhead.

Unlike the combined fixed rate overhead method, percentage overhead does not rely on having drilling activities or producing wells for the operator to start recovering overhead. Therefore, percentage overhead is often used in offshore properties where there are long periods of time where there are no drilling activities or producing wells. It allows the operator to start recovering overhead costs as soon as it starts spending money on joint operations or activities that can be charged direct to the joint account. Percentage basis overhead is also more likely to help overhead recovery keep up with inflation. The downside of percentage based overhead is that it can be more difficult to calculate a rate based on the operator's actual cost of service, and it is driven by "market rates." Also, implementation can be somewhat more difficult than combined fixed rate overhead, because certain charges and credits must be excluded when calculating overhead charges.

R. Section III.2 – Major Construction Overhead

Insert the Major Construction and Catastrophe overhead rates. The rates in sub-section A are generally higher than the rates in sub-section B. Under sub-section A, the operator absorbs all the engineering, design and drafting work related to the project – i.e., it charges those costs to its overhead account regardless of whether those technical services

are performed on-site or off-site. Under sub-section B, all the engineering design and drafting work related to the project (on-site and off-site) is charged direct to the joint account, so the operator has less overhead costs to recover under this option. The operator selects which sub-section to use for any given project.

It is difficult to equate these rates to major construction rates used in a 1984 COPAS accounting procedure because the technical labor elections under the 1984 form varied from one contract to another and because on-site technical labor was often treated differently than off-site technical labor. Under a 1984 form, the parties may have elected for on-site technical to be chargeable, while off-site technical is not chargeable, and this election applied to all types of operations, including major construction projects. Under the 2005 COPAS accounting procedure, the major construction overhead provisions do not distinguish between on-site and off-site technical labor. Either all technical labor is chargeable to a major construction project or none of it is chargeable, and this is independent of the technical labor elections in III.1.A (i) and (ii).

S. Sections IV.2.D – Material Transfers

Sections IV.2.D.(1) and IV.2.D.(2) of the 2005 COPAS accounting procedure state that material transferred to the property, but not used, should be transferred off the property at the same price paid by the joint account when it acquired the material. In other words, unused material should be credited to the joint account without any gain or loss. Some parties may want to revise these sections so that unused material being transferred off the joint property will be repriced at the appropriate condition percentage times current market price for new material.

The reason some companies will prefer to revise these sections is to make the form consistent with the terms of the 1962, 1968, 1974, 1976, 1984, and 1986 COPAS accounting procedures. This consistency will reduce exception accounting, making it easier to administer the contract.

There are other reasons a company may want to make these revisions. Without this change, in periods of rising prices, the non-operators do not enjoy the higher value for their materials. In periods of falling prices, this language can discourage timely disposal of materials, as the operator would have to bear the entire loss for changes in market value that are beyond its control. This can be especially problematic for specialty items, or items for which there is no immediate need. Even if the operator can use the material for another property, it may be more economical to obtain the material elsewhere than to acquire the material from the joint account at a price that exceeds current market value.

Other companies will prefer to keep the model form language intact. The provision was intended to give the operator incentive to timely dispose of material before the prices change. The operator has relative control over surplus and the non-operators have no other means of forcing the operator to maintain reasonable levels of surplus materials. In addition, the operator can use vendor stocking programs to limit surplus material charged to the joint account in the first place. Finally, the operator can ballot the parties and seek their approval to transfer the material at a different price.

T. Summary

Negotiations are made much easier by understanding the basic philosophies of the parties, determining which issues are philosophical and which are merely wording or stylistic matters. Examining the rationale behind the other party's elections and proposed agreement revisions helps the parties find common ground and ensure their intent is carried out.

IV.

THE AUDIT PROCESS[4]

A. Joint Interest Auditing – Background

COPAS has periodically published a Joint Interest Audit Benchmarking Survey. First performed in 1994, the survey was designed to provide a wide range of information including staffing practices, candidate selection, audit costs, claims, and recoveries. The survey also contains data that illustrates the magnitude of the joint interest audit effort in the United States. The survey issued in 2006 contains the following scope data:

- Sixteen oil and gas participating companies
- $3.6 Billion in net exposure
- Nearly 300 audits during the survey year
- Nearly 9,000 audit days during the survey year
- Approximately $273 Million in net audit claims for the survey year
- Approximately $207 Million in cumulative net open claims at year-end

This information represents only a portion of the joint interest audit activity in the country. Although most of the major oil companies usually participate in the survey, only a small number of the many medium and smaller sized oil companies provide survey data. The actual amount of activity, and total value of audit claims generated annually, is much higher and represents a significant effort on the part of operators and non-operators alike.

This high level of joint interest audit activity is a reflection of both the sheer number of joint interest operations throughout the country and the magnitude of the billings sent to non-operators by the operators of these properties. The audit effort is large, complex, and difficult to manage and coordinate with many different companies involved in the same properties.

Although the joint operating agreements contain a clause granting non-operators access to records, and the supporting accounting procedure contains an audit clause, these provisions generally grant the right to audit, but provide little guidance how audits are to

[4] Howard Blunk authored this section. Statistical reference to audit benchmaking activities are derived from COPAS JV Audit Benchmaking Survey published by COPAS in 1994, 1996, 1998, 2000, 2002, 2004, and 2006. Specific excerpts from COPAS publication are reprinted with the permission of COPAS.

be conducted. Model form accounting procedures prior to the 1995 form lack any clear direction on the resolution of audit claims. The 1995 and later model forms contain contractual penalties for not adhering to prescribed deadlines to encourage timely resolution. COPAS recognized the need for detailed guidelines on the audit process and has issued several audit protocol guidelines to help provide this direction. Although it is not contained as part of any executed agreements, COPAS Accounting Guideline No. 19 ("Expenditure Audits in the Petroleum Industry: Protocol and Procedures Guideline") is generally recognized as accepted industry practice when it comes to performing joint interest expenditure audits in the United States.

B. Reasons/Purpose for Joint Interest Auditing

The main reason audits are conducted is because the summary type billings used by operators do not provide sufficient detail to determine the accuracy and propriety of individual charges to the joint account. It would not be cost effective, and likely not even possible, for an operator to generate a joint interest billing that could provide adequate detail to eliminate the need to conduct an audit. Operators achieve operating efficiencies and lower costs by sharing resources among properties, and non-operators benefit from these efficiencies. However, this sharing of resources creates the need to allocate costs to various cost centers, and to distribute the costs to the individual properties. These costs cannot be verified without detailed examination of the source charges and documents. The sheer number of transactions, and the complexity of many arrangements, would make this difficult under even the most comprehensive joint interest billing system.

Such audits generate considerable return for non-operators as the data reproduced with permission of COPAS from their most recent Audit Benchmarking Survey shows:

AUDIT RESULTS - 2006 Survey (based on 2005 data)

Audits of others performed by Large Firms

Audit Coverage – 56 % of total costs billed

Audit Claims/ Audit Cost – 43:1

Audit Recoveries/Audit Cost – 9:1

Historical Recovery (% of claims granted) – 54 %

Audit Cost per Day – $828

Audits of others performed by Small Firms

Audit Coverage – 34 % of total costs billed

Audit Claims/Audit Cost – 12:1

Audit Recoveries/Audit Cost – 9:1

Historical Recovery (% of claims granted) – 53 %

Audit Cost per Day – $898

This relationship of coverage to cost is comparable to the previous COPAS surveys. The joint interest audit is a compliance type review where the terms and conditions of the operating agreement and accounting procedure serve as the basis for determining the propriety of a particular charge. The joint interest audit is also a curative type review where the accuracy of the accounting for transactions charged to the joint account is validated. This means the auditor must have a thorough understanding of the agreements, an up-to-date knowledge of industry practices and accepted accounting treatment of various types of costs, experience with different accounting systems used by various operators, and a sound understanding of field operations.

The audit is performed to validate charges to the joint account. Audit findings can results in claims for credit, or additional charges to the joint account. The audit is to be performed objectively, and findings should be issued without regard to the potential impact on any particular party to the joint account. The audit is an opportunity for the non-operator and operator to work together to validate the accounting for a joint operation. The audit can be a vehicle to highlight concerns and work toward resolution on both a current and prospective basis. The proper conduct of an audit is dependent on cooperation and mutual respect by all of the parties involved. Most importantly, the performance of an audit is a contractual right and should be treated as a normal course of business that needs to be conducted as efficiently and effectively as is possible.

C. Audit Candidate Selection

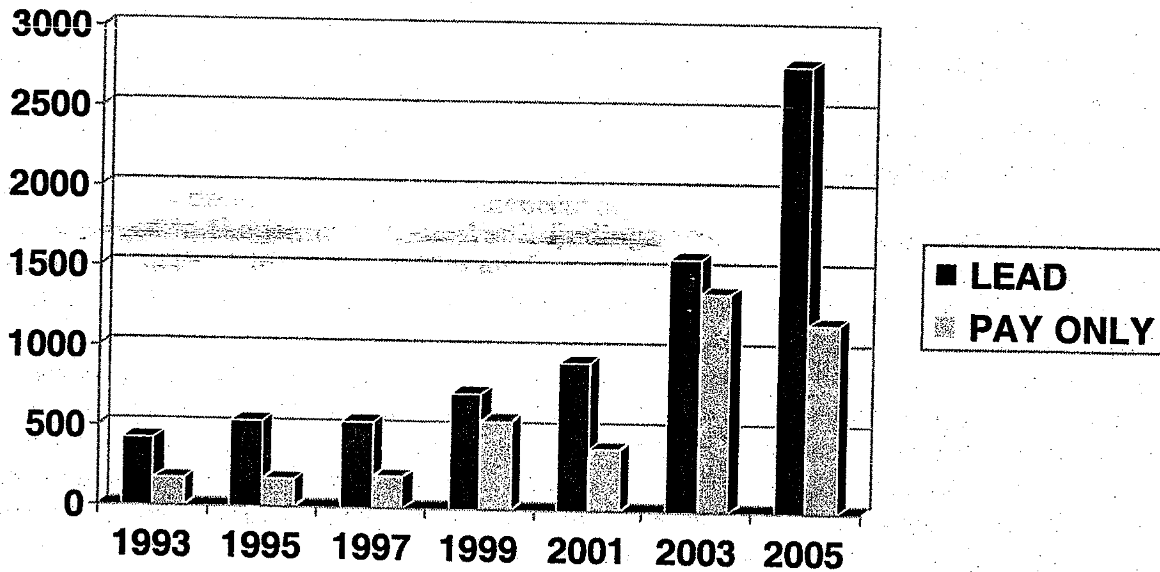
Non-operators, whether they are a large integrated oil company or a small to medium sized independent, use common criteria in selecting audit candidates for the annual program of coverage. The amount of net expenditures for a property and the working interest ownership in the joint interest are the two main driving forces in the decision-making process. Knowledge of the operator, the nature of the operation, and the type of agreement in place are also deciding factors in the selection process. Also, the period covered by the previous audit affects the non-operator's audit rights because of the 24-month limitation for audits and adjustments contained in typical agreements, and is a factor in deciding when to perform an audit.

The most interesting difference between large and small companies noted in the last COPAS survey was the higher ranking that large companies give to prior audit results than did the smaller companies. Because of the impact of new accounting systems and turnover of personnel, prior results are not necessarily a strong indicator of conditions since the last audit for small companies. At the same time, the cost vs. return category also relies on past results as a predictor of the current state of the operator's accounting group.

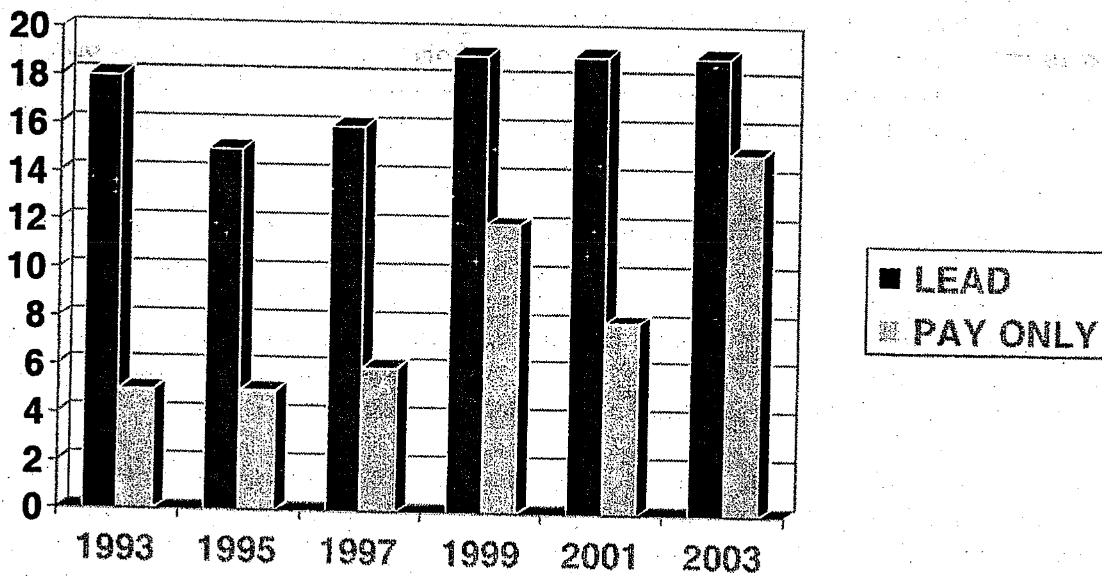
Because cost and working interest ownership are traditionally the key factors in selecting audit candidates, the COPAS survey also contains questions regarding the thresholds commonly used in selecting audit candidates. The following two charts reproduced with the permission of COPAS, one for dollar exposure (net) and the other for working in-

terest, show how companies have become more selective in this process over the past eight years. Note: the dollars are not adjusted for time value of money.

DOLLAR THRESHOLDS FOR PERFORMING AUDITS $ M's



WORKING INTEREST THRESHOLDS FOR PERFORMING AUDITS



(The term **Lead** is used to describe any audit in which a non-operator chooses to participate in the audit by providing an employee or representative to lead or assist on the audit team. The term **Pay Only** is used to describe audits in which a non-operator chooses to participate only by cost sharing an audit balloting process discussed later.)

D. Audit Protocols/Reporting

The COPAS audit protocol guideline provides in great detail what is expected of both the operator and the non-operator. The communications process is quite formal and impacts every aspect of the audit. Information required by both sides in the audit process is necessary to the efficient conduct of an audit, and failure to follow accepted practice can impact audit rights and slow down recovery of claims.

Timely submission of the audit notification, or request, impacts when an auditor can perform the audit. Although the agreements grant the right to audit, when an audit is performed is dependent on how timely the notification is received. A non-operator may wish to perform the audit at a certain time of the year, but if the operator has received other earlier requests the preferred time may not be available. The right to audit does not address when the audit will be performed. The exact timing is usually at the convenience of the operator as long as the 24-month limitation is not affected. If the 24-month period is affected, the operator is obligated to grant access or waive the limitation.

The operator is expected to provide what is known as JADE data (a transactional listing of all charges) and ownership listings well in advance of the audit to allow for effective audit planning and preparation. If needed due to document storage and retrieval constraints, it is reasonable for the operator to request a sample selection well in advance of the engagement to allow for retrieval of source documents. In turn, the operator is expected to have all the necessary records available at the time the audit commences. If an operator does not provide this information in time, the auditors may have to return for follow-up work. These situations can escalate into disputes over audit rights and the impact of the 24-month period, which creates unnecessary tensions and more work for all parties.

Auditors are expected to adequately document all information requests and exceptions, and provide this information to the operator during the audit. The auditors expect the operator to respond timely in order to clear up as many issues as possible during the audit. One of the major barriers to claims resolution is the problem of auditors issuing information requests and exceptions at the conclusion of an audit, and/or operators not responding during the audit to those requests and exceptions that were timely submitted.

Audit exceptions must be presented to the operator before the expiration of the 24-month period. The writing of an audit report is not necessary to satisfy the 24-month limitation, providing a written exception to the operator is all that is really needed. However, this does not give non-operators license to delay reports. The ultimate resolution of audits is dependent on dealing with information on a timely basis. Over time, the model form accounting procedures have become more detailed regarding the timeliness of this process, and the COPAS audit protocol guideline tries to strengthen this by using the approach contained in the COPAS 1995 model form accounting procedure. The COPAS 2005 model form, while restructured somewhat, reinforces the concept of timely resolution.

The audit report itself is expected to contain certain basic information and be presented in such a way that those charged with resolving claims can easily understand the issues involved. Since there can be many non-operators in a joint operation, the report can have a wide audience and claims may be tracked by a number of companies. Following accepted audit protocol will make the process work more smoothly for all involved. This is especially true in how non-operators work together cooperatively in the joint conduct of an audit. Work can be conducted more efficiently for all concerned if both sides in the process communicate and respond effectively.

E. Audit Participation/Costs

The audit provisions in the various COPAS accounting procedures do not explicitly require non-operators to conduct joint audits, but from a practical standpoint it is accepted industry practice to do so and a reasonable expectation of the operator. The model forms used in Canada require this approach and call for the audit costs to be billed though the joint account to the non-operators. The model forms used in the United States do not contain such provisions. Instead, non-operators are simply encouraged to perform these audits jointly, and how that is done is based on industry practice, and not any contractual provisions contained in the agreements. However, it is more cost-effective and a better use of non-operator resources to conduct a joint audit.

The practice of balloting non-operators has evolved over the years and has been formally documented in the COPAS audit protocol guidelines. It is expected that the non-operator with the largest working interest will take on the role of audit lead, and ballot the other non-operators to determine if they wish to participate in the audit by supplying a person to be a member of the audit team, participate by simply sharing in the costs of the audit, or decline to participate in the audit. Costs of the audit are to be calculated using a fixed amount per auditor day, plus actual travel expenses. This per diem rate is an amount published by COPAS each year, and is based on the average labor cost reported in their Audit Benchmarking Survey, in conjunction with U.S. Department of Labor statistics on changes in average wages for professional workers. This rate is intended for use by non-operators to equalize costs, and it is not to be construed as representing any commercial or market rate for contract/consulting auditors.

The cost of performing audits is also an apparent factor in the decision-making process over whether to participate in an audit or to decline an audit ballot received from a co-owner in the property who wishes to have an audit performed. Although another factor to consider in selecting audits is the working interest of the non-operator, if the working interest of the lead audit company is low, and there are no other audit participants, the likelihood the audit will cost more than it recovers will go up. There are times, however, when there may only be one non-operated working interest owner and a non-operator has no choice if the property has sufficiently large dollar exposure to merit audit coverage.

F. Audit Issues

The amount of joint interest audit claims written annually, and the high recovery rates reported year-after-year evidence the complexity of accounting for joint operations. Accounting for and auditing any major operation with a high number of transactions is na-

turally subject to some error. The most recent benchmarking data published by COPAS indicates that on average approximately 7.5 percent of the amounts charged on a joint interest billing result in an exception, and over half of all amounts claimed result in recoveries. The additional challenge of accounting for a variety of properties, all subject to different agreements compounds the chance for error. Likewise, it can result in audit claims that are in error. Auditors are expected to understand how the various accounting procedures in use today vary by vintage, to know the impact of numerous elections contained in these agreements, and to recognize what provisions are frequently subject to dispute over interpretation and accounting application of the agreement.

The various interpretations COPAS has issued over time to provide guidance in implementing their model form accounting procedures have helped clear up some of the "gray areas" surrounding accounting procedure language. But, there still are certain issues that require special examination by the auditor and the experience to understand how charges for a particular function or activity should be classified. Some operators and non-operators simply have a different perspective when it comes to certain costs, and accounting practices. These "problem areas" account for most of the recurring number of audit claims reported, after coding errors, regardless of what accounting procedure may be in effect. This is particularly the case when it comes to some of the older vintage model forms which were written in a far different time, both organizationally and technologically, in the oil and gas industry.

The more common issues encountered involve overhead, supervision, and technical labor exceptions, surplus materials, the location of directly chargeable activities, the 24-month limitation for adjustments and audits, and out-sourced functions which also is overhead-related issue. Theses areas of recurring audit dispute are each addressed individually below, as is an emerging issue regarding catastrophe costs:

G. Overhead Exceptions

Hardly an audit report issued today doesn't contain at least several claims associated with exceptions entitled "Costs Covered by Overhead." COPAS surveys confirm that this has been, and continues to be, an ongoing source of audit disputes. This is due, in part, to accounting procedure forms containing a number of elections in the overhead section, and the various models in use today containing different provisions.

Depending how older agreements were negotiated, "production foremen" and "first level supervisors" may or may not be considered as covered by overhead. Even if considered to be directly chargeable, disputes can arise over both the issue of being "in the field" as opposed to being "on the joint property" and how many people can be charged under the first level supervision provisions. The treatment of technical labor costs as a direct charge or overhead is also an election in some agreements. The accounting for technical labor costs can be different for on-site and off-site employees, and different from one agreement to the next. There are different definitions on what wells may or may not be included in the well counts used to calculate overhead, and the language on when drilling overhead can be applied differs from model form to model form.

Although COPAS has issued interpretative material on what constitutes overhead, not all topics are covered and there continues to be gray areas. Consequently companies of-

ten hold differing viewpoints, and this results in audit claims. Underlying some of these claims can be frictions fueled by the belief of many operators that they are not adequately recovering their indirect costs through the overhead rates and by non-operators that the operator is over-recovering its overhead costs. Non-operators are not usually willing to amend the rates unless they are provided with compelling evidence the operator is not adequately recovering costs, and even then are reluctant to do so since most accounting procedures allow for an annual adjustment of the rates. For example, a $300 a month overhead rate negotiated in 1976 will have escalated to over $1,200 by 2006. Also, unanimous approval of the parties is usually required to amend the overhead rates, unless the operator has the ability to charge different rates for different non-operators, which can be difficult to do.

Regardless of the cause, this difficulty in amending overhead rates can create situations where operators are perceived as being aggressive in classifying items as direct charges to the joint account, which compels non-operators to pay particular attention during joint interest audits for costs charged that could be classified as overhead.

H. Surplus Material Exceptions

Most accounting procedures state the operator should avoid the accumulation of surplus stocks. If for example the operator routinely brought 5-10 percent more tubing and casing to a drill site than called for in drilling program, such actions could be considered prudent to prevent an unexpected need to stop drilling operation because sufficient footages of usable material were not on location. But, if that surplus is not used and the excess not credited timely to the joint property, an audit exception will likely result. If the surplus material is a specialty item, or there is no immediate need for the surplus, the operator is faced with either absorbing the cost of the surplus or receiving an audit exception and claim for credit. The reconciliation of materials charged to materials used in the well is a common audit step that results in frequent exceptions associated with drilling wells.

I. Location of Chargeable Activities

Technical labor can be a significant cost and is treated differently under the various model form accounting procedures. The COPAS 1962 accounting procedure allows direct charges for technical labor employed on the joint property. Beginning with the COPAS 1968 accounting procedure, elections were inserted in the overhead section and the parties would determine during negotiation of the agreement whether technical labor on the joint property (on-site) would be a direct charge or covered by the overhead rates. The same election applies to technical labor not employed on the joint property but directly employed in the operation of the joint property (off-site). This election for off-site technical labor was eliminated in the COPAS 1974 accounting procedure, but was reinstated with the 1984 model form. In addition, the COPAS 2005 accounting procedure contains a third technical labor election in the overhead section of the document which allows direct charges for off-site technical labor but only as to drilling, redrilling, deepening, sidetracking, operations.

Auditors closely review the overhead elections in this area as it relates to company personnel, and recognize that these elections also apply to costs for third-party consultants and professional services in these different accounting procedures. In addition, whether or not an election has been made that allows for the direct charging of technical labor, indus-

try practice is that technical labor still has to meet a litmus test of work related to a specific operating problem or condition. If the technical person is performing overhead functions (such as accounting or administrative activities) his or her time can not be charged, irrespective of the technical labor elections.

Additionally, the auditor needs to consider the underlying meaning of the joint property definition in these accounting procedures. Although the question "where is the property" seems a simple one, it is not and auditors have been observed taken exceptions to charges because they did not fully appreciate that "on-site" does not necessarily mean "on the lease." The joint property definitions in the various COPAS accounting procedure remained almost the same over time, and provide that the joint property consists of both the <u>real</u> and <u>personal</u> property of the joint account. An example of employees working directly on the joint property but not being on the lease would be work performed in fabrication yards where equipment and facilities are tested or constructed, including the sites where such equipment is loaded out for shipment. The COPAS 2005 accounting procedure was the first to provide examples of such activity where in the definitions section of the accounting procedures COPAS states:

> " '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 Base 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."

The excerpt below from the COPAS MFI-21, "Overhead – Joint Operations" helps further define chargeable technical labor functions and addresses several issues the auditor needs to consider in reviewing such charges:

> "On-site Technical Labor is a term used to refer to time spent on the Joint Property by Technical Personnel to handle specific operating conditions or problems. "On the Joint Property" or "on-site" means that activities are performed in the vicinity of the real and personal property subject to the agreement.
>
> Work performed at the site of construction yards is considered on-site even though the Joint Property is not physically installed at its permanent location, because Joint Property includes personal property regardless of its location. Time spent by Technical Personnel at the site of construction yards in verifying satisfactory performance of the contractor and in performing quality control inspections will qualify as "handling a specific operating condition or problem" as indicated in the preceding paragraph. In addition, Technical Personnel performing offshore operations may visit tie-in platforms on production systems that are not owned by the Joint Account but which serve the Joint Operation in question. Visits to these sites are considered on-site Technical Labor."

MFI-21 also provides definitions of professional and technical skills, discusses the issues surrounding the use of outside consultants, and addresses the question of travel time to and from the joint property. The questions over which employees should be classified as

professional and/or technical, and when then employees may or may not be directly charged, should be considered by auditors as they review the technical labor elections in accounting procedure.

J. COPAS 24-Month Limitation

A basic audit test is to be alert for charges that relate to prior periods. The COPAS accounting procedures and Model Form Interpretation No. 40 ("24-Month Adjustment Period for Joint Account Adjustments") clearly state that " … no adjustment favorable to the Operator shall be made unless it is made within said 24-month adjustment period…" and although the interpretation provides for logical exceptions to this rule, the intent is that the joint account closes after 24 months from the end of the calendar year in which the billing is rendered. COPAS rewrote this interpretation in 1998 because the previous language was not sufficiently clear to prevent disputes between operators and non-operators. In addition, the model form has changed to allow many out-of-period adjustments that are not initiated by the operator and are beyond its control. The current version of MFI-40 is much more specific and seems to have resolved many of the issues.

One common area of dispute involved costs not previously billed to the joint account. The argument was that if something had never been charged in the first place, there was no "adjustment" and the 24-month limitation did not apply. The current version of this interpretation does allow an operator to charge to the joint account a bill from a third-party that had not been previously received from the contractor. But, if the operator had received the bill and simply failed to process the charge it is considered out-of-period and not billable to the joint account.

Another "gray area" involved audit claims. Non-operators found that audit claims sometimes resulted in additional charges to the joint account arising from corrections that were discovered in researching unrelated items. Although it was logical that lodging an audit claim opened the 24-month period, it was not logical that the entire joint account was opened for retroactive adjustment because one or more specific transactions were questioned. The current version of MFI-40 addressed this issue in the examples section of that document:

> EXAMPLE G1: An audit exception regarding the basis of an allocation does not permit adjustment to costs subject to that allocation or other aspects of the allocation. In addition an audit exception regarding a charge(s) in the allocation pot does not permit adjustment to other costs included or not included in the allocation pot or any other aspect of the allocation.
>
> EXAMPLE G2: An audit exception regarding the direct charge or allocation of a specific individual charge does not permit adjustment to similar direct charges or allocations of a like nature within the same or other periods.

At issue is a basic question of trust between operator and non-operator, specifically, whether audits are conducted with objectivity, identifying both potential overcharges and potential undercharges. Concerns that operators had undue advantage in making retroactive adjustments were also considered. Consensus developed by focusing on the common

goal of avoiding disputes before they became significant, and on the benefits to all parties to close the open audits and audit periods as timely as possible.

K. Out-Sourced Functions

It has become commonplace for oil and gas companies to outsource certain support functions as part of reorganization efforts to reduce costs. It may simply be more efficient for a company to procure services from the outside rather than maintain large staff, and it may be more practical to use experienced personnel from service firms than to hire, train, and manage a large work force from within. In times of unsteady workloads it is far easier to hire consultants on a short-term basis, than to keep an internal support group productive over the long term.

If an operator has outsourced part of its work force, the auditor needs to closely examine third-party invoices charged to the joint account to see if functions charged directly to the joint account should be covered by overhead. Certain functions, whether based on activities of operator employees, affiliates, or contractors, are not allowed as a direct charge because the function determines the classification of costs as direct or overhead. The 1984 COPAS accounting procedure addresses this issue in the direct charges section:

> 5. SERVICES
>
> The cost of contract services, equipment, and utilities used in the conduct of Joint Operations, except for contract services, equipment, and utilities covered by Section III (*Overhead*), or Section II.7 (*Affiliates*), or excluded under Section II.9 (*Legal Expense*). Awards paid to contractors shall be chargeable pursuant to COPAS MFI- 49 ("Awards to Employees and Contractors").
>
> The costs of third party Technical Services are chargeable to the extent excluded from the overhead rates under Section III (*Overhead*).

Many auditors have developed special audit sampling techniques to identify overhead costs that were charged directly to the joint account through third-party service contractors. Based on experience from other audits, and knowledge of the types of work performed by various service firms, a specialized sample can be developed from the JADE file supplied by the operator (if vendor names are provided). This has been an effective approach, particularly as to engineering, design, and drafting services.

L. Emerging Issue – Catastrophe Costs

As discussed earlier, COPAS 1995, 1998, and 2005 accounting procedures changed the overhead provisions used in previous model forms by eliminating the use of different overhead rates for cost related to catastrophes and cost related to major construction. It was always difficult determining when a catastrophe ended and reconstruction began, and it was also difficult to support from an accounting standpoint why the two related activities didn't require the same administrative and technical effort. It appears there is also an inconsistency in the earlier model forms between the technical labor elections under the major construction and catastrophe overhead provisions. What this change did not address is

that like all the other model form accounting procedures in use, the 2005 COPAS accounting procedure is not designed to address the unknown, unusual, and unforeseeable cost that may be associated with a major disaster, and the special efforts required to bring a property back to operational readiness. The 2005 COPAS accounting procedure defines a catastrophe as follows:

> "Catastrophe is defined as a sudden calamitous event bringing damage, loss, or destruction to property or the environment, such as an oil spill, blowout, explosion, fire, storm, hurricane, or other disaster. The overhead rate shall be applied to those costs necessary to restore the Joint Property to the equivalent condition that existed prior to the event."

Although it seems at first glance the costs being addressed would be the very types of costs provided for as direct charges in an accounting procedure, events of the past several years suggest that costs and allocation issues may arise that are simply not contemplated in a standard accounting procedure. For example, all model forms accounting procedures allow for the charging of direct labor employed in joint operations. However, operators have been faced with having to provide housing and other assistance to even keep their labor force intact after a major disaster such as occurred in the Gulf Coast areas in 2005. This is not a cost contemplated by typical model accounting procedures, and could be construed by some as a cost otherwise covered by overhead even though the rates agreed to when an agreement was negotiated would in all likelihood not have taken such a cost into consideration.

It has been estimated that during the fall of 2005 over 100 platforms in the Gulf of Mexico were destroyed and that over 50 other platforms were severely damaged. The damaged platforms that could be repaired required long-term restoration efforts. While the repair work was underway, the production workers still needed to be paid in order to retain this highly skilled work force. Whether the cost of standby labor is chargeable to a joint account is not an item addressed by a typical accounting procedure. Also, many of the types of activities and costs covered by fixed per well overhead rates for producing overhead are being incurred by operators even when a platform is being repaired. However, these overhead rates are only chargeable when there are wells being produced. This raises the question of whether it is appropriate for an operator to bill these overhead rates when the wells are down, and whether it is reasonable for non-operators to expect operators to absorb these costs solely.

COPAS initiated a study in the fall of 2005 of the accounting and auditing issues associated with these disasters. The charge of the team assigned this project was to identify the challenges and unforeseen costs facing operators, as well as the difficulties already being encountered by operators and non-operators in dealing with the sharing of these costs, and to develop recommended solutions for use by both. It is contemplated this work will result in the issuance of a Model Form Interpretation.

In addition to the issues posed above, the team has identified additional areas where problems may arise in attempting to apply accounting procedure provisions in dealing with the unforeseen costs associated with reconstruction. One of the issues identified include questions over handling well count based allocations of facility costs, when there are no wells producing. Costs of staffing and maintaining idle production facilities, facilities that

traditionally were billed out based on production volumes handled, is another example of where operators need other ways to bill these costs that are provided for in the agreements. Surcharges for fuel and material, added costs for using temporary staging areas for conducting operations, and facility sharing are also being studied.

From an accounting and auditing perspective, the simple administration of the joint interest billing process has been affected which also impact the auditing process. Accounting offices were destroyed or shut down for extended periods; accounting records were also destroyed or lost. Many operators were simply not able to issue billings for a number of months. Yet, costs were still being incurred. Non-operators were asked to delay or defer audits. Some non-operators were told there are no records to audit. These are all issues that will have impact when audits of 2005 and 2006 costs, to be performed in the 2007 and 2008 audit cycles. It is contemplated that COPAS will have published an interpretation to meet this timeframe.

V.

LEGAL ISSUES IN THE PAST AND LEGAL ISSUES THAT MIGHT ARISE IN THE FUTURE[5]

A. Contract Interpretation Applicable to COPAS Accounting Procedures

Before addressing a number of the specific issues that courts have addressed which involve the COPAS accounting procedures, one must keep in mind that the accounting procedure is an exhibit often attached to a contract—the joint operating agreement—which is interpreted by the courts as any other contract. As such, courts have routinely used general rules of contract interpretation to interpret accounting procedures. *Oklahoma Oil & Gas Exploration Drilling Program v. W.M.A. Corp*, 877 P.2d 613, 615 (Okla. Ct. App. 1994).

As a contract, the language in the COPAS accounting procedure is to be given its plain and ordinary meaning unless some technical term is used in a manner meant to convey a specific technical concept. *Id.* If the language is clear and unambiguous, the courts interpret the language as a matter of law. *Id.* The court in *Pitco Production Co. v. Chaparral Energy, Inc.*, 63 P.3d 541, 545-46 (Okla. 2003) recapitulated the rules for construing a JOA:

> "The JOA is a contract to be construed like any other agreement. If language of a contract is clear and free of ambiguity the court is to interpret it as a matter of law, giving effect to the mutual intent of the parties at the time of

[5] This section was authored by Jonathan D. Baughman. For additional legal analysis of COPAS accounting procedures, see Karla Bower & Mark D. Christiansen, COPAS For Landmen And Lawyers, 48 Rocky Mt. Min. L. Inst. § 26 (2002); Susan Richardson, Will Stapling Create Harmony? Or The Art Of Reconciling The JOA And The COPAS, Dallas Bar Ass'n, August 19-20, 2004, "Review of Oil & Gas Law XIX;" Ben H. Welmaker, Oil And Gas Accounting Procedures: Claims For Adjustments And Audit Issues, State Bar of Texas, 24th Annual Advanced Oil, Gas and Energy Resources Law Course (October 2006); Jonathan Baughman & Derrick Price, COPAS And The 2005 COPAS Accounting Procedures—Significant Changes For Changing Times, State Bar of Texas, Section Report, March 2005.

contracting. Whether a contract is ambiguous and hence requires extrinsic evidence to clarify the doubt is a question of law for the courts....The mere fact the parties disagree or press for a different construction does not make an agreement ambiguous. A contract is ambiguous if it is reasonably susceptible to at least two different constructions. To decide whether a contract is ambiguous we look to the language of the entire agreement."

See also North Central Oil Corp. v. Louisiana Land & Exploration Co., 22 S.W.3d 572, 575-76 (Tex. App.—Houston [1st Dist.] 2000, pet. denied) (contract is not ambiguous if it can be given a definite or certain meaning as a matter of law. On the other hand, if the contract is subject to two or more reasonable interpretations, the contract is ambiguous).

It is only when the contract or COPAS accounting procedure is ambiguous that extrinsic evidence such as the actions and conduct of the parties as well as industry custom and usage become admissible. As one court has pointed out: "[t]he failure of a JOA to expressly address a question may create an ambiguity requiring extrinsic evidence, such as industry custom and usage, to determine the intent of the parties." *Stephenson v. Oneok*, 99 P.3d 717, 721 (Okla. Ct. App. 2004) citing *Oxley v. General Atlantic Resources, Inc.*, 936 P.2d 943, 946) When the meaning of an ambiguous contract is in dispute, evidence of extrinsic facts is admissible, and construction of the contract becomes a mixed question of law and fact and should be submitted to the jury under proper instructions. *Stephenson v. Oneok*, 99 P.3d 717, 721 (Civ. Ct. App. Okla. 2004). For an excellent article providing a detailed analysis of the use of custom and usage in oil and gas litigation *see* David E. Pierce, Defining The Role Of Industry Custom And Usage In Oil & Gas Litigation, 57 SMU L.Rev. 388 (Spring 2004).

In fact, on several occasions, courts have admitted testimony concerning custom and usage in the industry which has included reference to COPAS publications. *See Atlantic Richfield Co. v. Holbein,* 672 S.W.2d 507, 515-16 (Tex. App.—Dallas 1984, writ ref'd n.r.e.) (court admitted testimony citing COPAS manual that industry wide practice was to deduct allocated volume for fuel gas before computing settlement owed to royalty owners); *Cass v. Stephens,* 156 S.W.3d 38, 53-54 (Tex. App.—El Paso 2004, pet. denied) (court admitted expert's testimony and reliance upon COPAS Bulletins in opining that operator failed to comply with COPAS accounting procedure); *HI Mountain Energy Corp. v. Avra Oil Co.,* 2002 WL 660891 (Tex. App.—El Paso 2002) (court found that parties had contemplated additional overhead adjustments as operations continued. However, there was no set overhead adjustment formula and court found future adjustments would be governed by COPAS). Nevertheless, as the Texas Supreme Court has pointed out, while course of performance, course of dealing and trade usage can supplement or qualify the express terms of the contract, they cannot be used to contradict the clear and unambiguous terms of the contract. *Sun Oil Co. v. Madeley*, 626 S.W.2d 726, 732 (Tex. 1981).

Finally, it should be noted that ambiguities could occur when provisions in the COPAS accounting procedure are in conflict with the joint operating agreement. However, each of the pre-printed A.A.P.L. model form operating agreements (the 1956, 1977, 1982 and 1989) 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

prevail. *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.

B. Applicability of COPAS Model Form Interpretations and Accounting Guidelines

COPAS issues publications to assist the industry in addition to issuing the COPAS accounting procedures. COPAS Accounting Guidelines (AGs) assist in establishing industry standards and Model Form Interpretations (MFIs) assist the industry in interpreting the various COPAS 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.[6]

As discussed above, courts generally treat the COPAS accounting procedures as any other contract. Therefore, if the language of the accounting procedure is clear and unambiguous under the circumstances of the dispute, the court should not consider industry custom or usage to contradict the language contained in the accounting procedure. This can become important in whether a court will consider the numerous resources that COPAS has published such as the Model Form Interpretations and Accounting Guidelines.

C. Past Legal Issues Involving The COPAS Accounting Procedure.

When one considers how long COPAS accounting procedures have been used in the industry, it is remarkable how relatively few reported cases there are dealing with the various COPAS accounting procedures. This is a tribute to how well the COPAS organization has established its model forms over time and how well in practice the members in the industry have resolved their disputes. As discussed below, most of the litigation surrounding the COPAS accounting procedures has involved the legal presumption created by the Adjustments provision.

1. The Pertinent Provisions of the COPAS Accounting Procedure: Statements and Billings (Section I of the Accounting Procedure) and the Adjustments Provision.

Undoubtedly, the most heavily litigated aspect of the COPAS accounting procedures has involved the 24-month Adjustments provision. Since the creation of COPAS, each published version of accounting procedures distributed by COPAS has contained an Adjustments provision. In fact, provisions very similar to the Adjustments provision contained in the COPAS accounting procedure were in use prior to the existence of COPAS.[7] From a

---

[6] For instance, COPAS issued Model Form Interpretation 51 for guidance in interpreting the 2005 COPAS Accounting Procedure.

[7] For instance, the Court in *Harris v. Ashland Oil & Refining Co.*, 315 S.W.2d 327, 329 (Tex. Civ. App.—El Paso 1958, no writ) discussed an operating agreement entered into in 1954 which contained the following language:

> "Operator shall furnish to Non-Operator an itemized statement of all expenditures, receipts, charges and credits covering each month's bills hereunder, and such statement covering the preceding month's bill shall be mailed to Non-Operator on or before thirty (30) days thereafter, and within fifteen (15) days after receipt by Non-Operator, Non-Operator shall pay the Operator, subject to further audit and adjustment, if

practical and legal standpoint, the Adjustments provision can have the most significant legal effect on a non-operator's ability to obtain adjustments to the joint interest account. However, the Adjustments provision must be read in conjunction with the Statements and Billings provision.

The 1984 COPAS accounting procedure provides in pertinent part:

> "Statements and Billings. Operator shall bill Non-Operators on or before the last day of each month for their proportionate share of the Joint Account for the preceding month. Such bills will be accompanied by statements which identify the authority for expenditure, lease or facility, and all charges and credits summarized by appropriate classifications of investment and expense except that items of Controllable Material and unusual charges and credits shall be separately identified and fully described in detail."
>
> * * *
>
> "Adjustments. Payment of any such bills shall not prejudice the right of any Non-Operator to protest or question the correctness thereof; provided, however, all bills and statements rendered to Non-Operators by Operator during any calendar year shall conclusively be presumed to be true and correct after twenty-four (24) months following the end of any such calendar year, unless within the said twenty-four (24) month period a Non-Operator takes written exception thereto and makes claim on Operator for adjustment. No adjustment favorable to Operator shall be made unless it is made within the same prescribed period. The provisions of this paragraph shall not prevent adjustments resulting from a physical inventory of Controllable Material as provided for in Section V."

The 2005 COPAS accounting procedure provides in relevant part:

> "2. Statements And Billings. The Operator shall bill Non-Operators on or before the last day of the month for their proportionate share of the Joint Account for the preceding month. Such bills shall be accompanied by statements that identify the AFE (authority for expenditure), lease or facility, and all charges and credits summarized by appropriate categories of investment and expense. Controllable Material shall be separately identified and fully described in detail, or at the Operator's option, Controllable Material may be summarized by major Material classifications. Intangible drilling costs, audit

---

necessary, its proportionate share of the sum or sums so expended by the Operator for the development and operation of the premises for oil, gas and casinghead gas; *provided, that, if no objection is made by the Non-Operator within six (6) months, the statement furnished by the Operator shall be final and conclusive as to the charges.* All accounts shall draw interest at the rate of six (6) per centum per annum after sixty (60) days from the last day of the month in which charge is made. Non-Operator shall have access during regular business hours and at reasonable intervals to Operator's books and all records relating to the operation and may make audits semi-annually of said accounts. The Operator shall not be liable or held for any expense involved in such examination or audit." (emphasis added).

adjustments, and unusual charges and credits shall be separately and clearly identified."

*   *   *

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*)." (emphasis added)

The revisions to the Adjustments provision in the 2005 COPAS accounting procedure (as indicated by the highlighted language above), appear to clear up any gray areas that may have existed under the prior versions of the accounting procedures as well as make it clear that the written exceptions must be "specific and detailed" in order to avoid the conclusive presumption that can be created.

2. Relevant Caselaw Interpreting The Conclusive Presumption

Several federal and state courts throughout the country have interpreted the "conclusive presumption" language used in the Adjustments provision.[8] These cases are discussed below.

a. *Calpetco 1981 v. Marshall Exploration*

In *Calpetco 1981 v. Marshall Exploration, Inc.*, 989 F.2d 1408, 1416 (5th Cir. 1993), James Michael set up numerous limited partnerships ("Calpetco") which invested in oil and gas deals with Marshall Exploration ("Marshall"). Marshall Exploration served as the operator and Calpetco acted as non-operator. The Operating Agreement had "standard accounting procedures" attached which provided:

"Calpetco may pay charges from Marshall without prejudice to its right to later contest their validity. However, all bills and statements issued in the course of a calendar year are "conclusively....presumed to be true and correct" 24 months after the end of the calendar year in which they were rendered unless, within those 24 months, the non-operator (Calpetco) "takes

[8] The Adjustments provision has been described as acting for all practical purposes to shorten the statute of limitations for breach of contract claims. *See,* John Burritt McArthur, A Twelve-Step Program For COPAS To Strengthen Oil & Gas Accounting Protection. 49 SMU Law Rev. (1996). The statute of limitations in most states is longer than 2 years. For example, Texas is 4 years, Texas Civ. Prac. & Rem. Code Ann. § 16.004, Oklahoma is five years, 12 Okla. Stat. Ann. tit. 95 (West Supp. 1996), New Mexico is six years, N.M. Stat. Ann. § 37-1-3 (Michie 1990), Alaska is six years, Alaska Stat. § 09.10.050 (Michie 1994), Wyoming is ten years, Wyo. Stat. Ann. § 1-3-105(a)(i) (Michie Supp. 1995), and Louisiana has a ten-year prescriptive period, La. Civil Code Art. 3499.

written exception thereto and makes claim on Operator (Marshall) for adjustment."

Id. at 1410. In its written opinion, the court noted that "the procedures are virtually identical to those promulgated by the Council of Petroleum Accountants Societies, and are standard in the oil and gas industry." *Id.* at 1410, n.1. The accounting procedures also allowed Calpetco to audit Marshall's accounts and records within the 24 month adjustment period. Audits were to be conducted at Calpetco's expense, and did not extend the time for filing written exceptions and demands for adjustment. *Id.* at 1410. Eventually Calpetco, the non-operator, invested in 55 wells. Calpetco began to review certain charges and requested documentation from Marshall. Extensive communication continued for almost 2 years with Calpetco asserting overcharges by Marshall and Marshall asserting that some of the Calpetco partnerships had not paid amounts due. Marshall conducted at least a partial review of the Calpetco accounts and some adjustments were made. *Id.*

Marshall filed a lawsuit in 1987 against Calpetco seeking a declaration that charges questioned by Calpetco were conclusively presumed correct. In response, Calpetco filed 16 counterclaims against Marshall. Subsequently, Marshall moved for summary judgment on grounds that Calpetco's claims were barred by the 24 month adjustments provision or the Texas 4 year statute of limitations for breach of contract. Marshall claimed that Calpetco failed to provide sufficient written exceptions under the Adjustments provision.

Calpetco responded that the contractual and statutory statute of limitations should be tolled because Marshall had fraudulently concealed its overcharges in addition to the defenses of waiver and estoppel. The district court granted Marshall's motion for summary judgment holding that Calpetco's claims were barred by the 24-month adjustments provision and that Calpetco failed to produce sufficient evidence to defeat summary judgment on its claims of fraudulent concealment, waiver and estoppel. *Id.* at 1411.

On appeal, the Fifth Circuit Court of Appeal held that the 24-month adjustments provision governed all billing and payments between Marshall and Calpetco throughout their drilling ventures and that summary judgment was appropriately granted against the fraudulent concealment, waiver, and estoppel claims. *Id.* at 1413. To establish fraudulent concealment, the Court stated that Calpetco had the burden of proving that 1) Marshall had actual knowledge of the facts it allegedly concealed (the overcharges), and 2) it was Marshall's "fixed purpose" to conceal them." *Id.* at 1313-14. The court found that Calpetco failed to meet its burden.

Calpetco claimed that its counterclaims filed in the lawsuit were sufficient "written exceptions" under the Adjustments provision. In addressing this argument, the court found that Calpetco's counterclaims could not as a matter of law constitute a written claim for adjustment since they did not point to specific charges or specific invoices and did not specify which partnerships or wells had been overcharged. *Id.* at 1416. The Court also noted that the lengthy communications between Marshall and Calpetco lacked sufficient specificity to constitute the requisite exceptions and claims for adjustments. *Id.* The court also rejected Calpetco's claim that Marshall was estopped from asserting the 24 month adjustments provision because Marshall allegedly acted in a manner inconsistent with that right by entering into negotiations with Calpetco. The court reasoned that Calpetco had no reason to be-

lieve that it need not file a written exception or file suit while awaiting the outcome of an audit. *Id.* at 1414.

b. *Exxon v. Crosby-Mississippi Resources*

In *Exxon v. Crosby-Mississippi Resources, Ltd.*, 775 F.Supp. 969, 975 (S.D. Miss. 1991) aff'd in part and rev'd in part, 40 F.3d 1474 (5th Cir. 1995), the district court held that the bills and statements rendered by the operator during the 24-month period were entitled to a "conclusive presumption" of correctness if written exception was not made within the specified time period. In analyzing the 24-month provision, the Court held that the 24-month provision did not violate a Mississippi statute which prohibited the alteration of a statute of limitations for a cause of action by finding that the provision did not alter the statute of limitations but imposed a condition precedent to recovery.

The district court's decision that the 24-month Adjustments provision was valid under Mississippi law was affirmed on appeal by the Fifth Circuit Court of Appeal. *Exxon Corp. v. Crosby-Mississippi Res. Ltd.*, 40 F.3d 1474 (5th Cir. 1995). As discussed below, the Fifth Circuit reversed in part the district court's application of the conclusive presumption for those months where there was insufficient evidence to show that the non-operator received the joint interest billing statements required under the accounting procedure. The only evidence that existed for these two months was a statement lacking the detail required under the accounting procedure. As a result, the court held that the conclusive presumption did not apply to these two months.

c. *Anderson v. Vinson Exploration, Inc.*

In *Anderson v. Vinson Exploration, Inc.*, 832 S.W.2d 657, 665-67 (Tex. App.—El Paso 1992, writ denied), the non-operator contested the reasonableness of charges by the operator. While the court did not quote the applicable provision, the court of appeal observed that the accounting procedure attached to the joint operating agreement required the non-operator to "take written exception to any bills and statements with which they disagreed within twenty-four months after the end of the calendar year in which the disputed bills and statements were rendered." *Id.* The court found that there was no evidence that the non-operator complied with this provision.

d. *In re Antweil.*

A bankruptcy court in New Mexico held that a non-operator's failure to object in writing within 24 months of the end of the calendar year waived his right to object to the amounts billed under New Mexico law. *In re Antweil*, 115 B.R. 299, 303-04 (Bankr. D. N.M. 1990). In this case, the bankruptcy trustee of the estate of a debtor operator brought suit against the non-operator seeking to recover for expenses under the terms of the joint operating agreement. Both the operator and the non-operator had extensive experience in the oil and gas industry and had entered into a joint operating agreement with attached exhibits which were standard in the industry. *Id.* at 304. The parties attached a COPAS accounting procedure to the joint operating agreement.

Beginning in 1982, the operator began sending the non-operator joint interest billing statements. *Id.* at 304. The parties stipulated that some of the invoices issued by the operator contained over-billing. The non-operator testified that he orally objected to the accounting figures on more than one occasion as early as 1982. *Id.* at 304. However, he did not submit written exceptions to the operator until 1986, outside of the 24-month period. At that time, he wrote a letter requesting credit for the overcharges.

The court held that the non-operator waived his right to object to the amounts billed after the twenty-four month period expired. *Id.* at 304. Likewise, the court held that the twenty-four month Adjustments provision which required one party to take written exception within the twenty-four month period was not unconscionable, illegal, contrary to public policy, or grossly unfair. *Id.* at 304. Interestingly, the court upheld the applicability of the 24 month Adjustments provision even though the court noted that it found the result "distasteful" in light of the fact that the non-operator was liable for a debt for which he was admittedly over-billed by the operator. *Id.* at 305. However, the court reasoned that the non-operator had extensive experience in the oil and gas industry and must abide by the agreement he entered into with full knowledge. *Id.* at 305.

e. ***Meridian Oil Production, Inc. v. Universal Resources Corp.***

In *Meridian Oil Production, Inc. v. Universal Resources, Corp.*, 978 F.2d 1267 (10th Cir. 1992) (unpublished), the parties executed two joint operating agreements under which seven oil and gas wells were operated in Oklahoma. The parties attached a COPAS accounting procedure to the joint operating agreements. *Id.* From November 1981 to January 1984, the non-operators audited the operator's charges and prepared audit reports that were sent to the operator. The audit reports detailed exceptions to the joint account. Over the course of several years, the operator granted some exceptions and denied others while communications continued between the parties in an effort to resolve the open audit exceptions.

Several years later, the non-operator filed suit against the operator seeking to recover for the exceptions not granted by the operator. The operator responded by asserting Oklahoma's five year statute of limitations. The district court granted the operator's motion for summary judgment on the basis that the non-operator's claims had expired under the statute of limitations.

On appeal, the non-operator argued that the parties' participation in the audit process tolled the statute of limitations and that the operator by having participated in the audit process could not assert the statute of limitations as a defense. The court of appeals affirmed the district court's ruling. In doing so, the court noted that the operating agreements did not require the completion of the audit procedure prior to filing suit. Likewise, the court pointed out that the operating agreements did not provide that the statute of limitations was tolled once the audit process was invoked and underway. As a result, the court held that the parties' participation in the audit process did not toll the statute of limitations.

In addition, the court rejected the non-operator's argument that the operator was estopped from asserting the statute of limitations because the operator received an immediate, uncontested payment under the Adjustments provision. The court reasoned that the

operator did not do anything to thwart the non-operator's effort to bring their claims within the period required under the statute of limitations.

f. *Caddo Oil Co., Inc. v. O'Brien.*

In *Caddo Oil Co., Inc. v. O'Brien*, 908 F.2d 13, 15 (5th Cir. 1990), the parties entered into a written operating agreement in 1975 even though the parties had operated for a number of years before based on an oral agreement. The dispute centered around whether the non-operator consented to the drilling of seven additional wells and consented to an increased monthly operating fee for other wells operated by the operator. *Id.* at 16. Although the court did not quote the applicable provision, the parties apparently had an Adjustments provision very similar to the COPAS accounting procedure.

The trial court found that the non-operator did not consent to the drilling of the additional wells and was thus not liable for his share of the development costs. The operator argued that the non-operator impliedly agreed to the drilling of the additional wells as the parties had spoken about the wells on numerous occasions and exchanged correspondence about the wells. The operator also showed that the non-operator had accepted production revenue from the additional wells. *Id.* at 16. However, the court found that the non-operator did not consent to the additional wells as it was the practice of the operator to obtain consent in writing and had in fact sought the non-operator's consent by a letter requesting the non-operator's signature. The non-operator did not sign the proposed letter. Instead of treating the non-operator as electing to go non-consent on these wells, the operator treated the non-operator as consenting to the additional wells.

The trial court found that operator's billings were entitled to a presumption of correctness. The court of appeal noted that the non-operator was given ample opportunity to audit the operator's records but did not do so. *Id.* at 17. The trial court also apparently considered evidence by the non-operator to determine whether the non-operator could rebut the presumption of correctness of the operator's billings by proving fraud in the execution or breach of the contract. *Id.* at 16.

D. Some Conclusions That May Be Drawn From The Caselaw For the Conclusive Presumption

1. To Be Entitled to the "Conclusive Presumption," The Bills and Statements Should Comply with the COPAS Accounting Procedure

In *Exxon Corp. v. Crosby-Mississippi Res., Ltd.*, 40 F.3d 1474, 1488 (5th Cir. 1995), the Fifth Circuit Court of Appeal was faced with a situation where the operator had sent out bills and statements for a number of months which were received by the non-operator. However, there were two months of bills and statements which the operator could not establish that the non-operator received. Instead, the operator was able to show that the non-operator received a "status of account statement" which reflected the unpaid balance due from the previous month and added current monthly charges reflected on the joint operations statements.

The Court held that the conclusive presumption applied to the bills and statements received by the non-operator but did not apply to the two months for which the operator was only able to establish "status of account statements" were received by the non-operator. In so ruling, the court held that the operator's "status of account statements" were not detailed enough to satisfy the joint operating agreement's billing requirements. In doing so, the Court noted that the agreement required the operator to prepare bills for the preceding month which "will be accompanied by statements which identify the authority for expenditure, lease or facility, and all charges and credits, summarized by appropriate classifications of investment and expense except that items of Controllable Material and unusual charges and credits shall be separately identified and fully described in detail." *Id.* The Court found that the operator's "status of account statements" was not detailed enough to satisfy the joint operating agreement's billing requirements for these two months and was thus not entitled to the conclusive presumption under the adjustments provision. *Id.*

2. The "Conclusive Presumption" May Be Rebutted for Fraud.

The district court in *Exxon v. Crosby-Mississippi Resources, Ltd.*, 775 F. Supp. 969, 975 (S.D. Miss. 1991), discussed above, held that the conclusive presumption created by the 24-month provision is rebuttable upon a showing of fraud or bad faith breach of contract. Likewise, the Fifth Circuit in reviewing the trial court's decision in *Caddo Oil Co, Inc. v. O'Brien*, 908 F.2d 13, 15-16 (5th Cir. 1990), observed that the trial court bifurcated the trial so that during the second phase of the trial the non-operator could "rebut the presumption of correctness of [the operator's] billings by proving fraud in the execution or breach of contract." *Id.*

3. The "Conclusive Presumption" May Be Overcome If The Non-Operator's Claims Are "Fraudulently Concealed."

In *Cass v. Stephens,* a non-operator was able to overcome the imposition of the conclusive presumption by showing that the operator "fraudulently concealed" the cause of action that the non-operator had against the operator. 156 S.W.3d 38, 64-65 (Tex. App.—El Paso 2004, pet. denied). The operator had kept a very detailed accounting of expenditures for himself but sent out a very abbreviated accounting to the joint interest owners. *Id.* In addition, the non-operator was able to show that the operator tried to conceal his relationship with numerous affiliate companies and that the operator had destroyed relevant documents. *Id.*

4. The Adjustments Provision May Only Defeat Contract Claims.

Likewise, the 24-month Adjustments provision has been referred to by one court as a contract defense that is not applicable to defeat an action in tort. *Ferguson v. Coronado Oil Co.*, 884 P.2d 971, 978 (Wyo. 1994). In Ferguson, a non-operator "net profits" interest owner brought a conversion action (tort) against an operator. The court found that the non-operator's net profits interest was identical to a royalty under the instrument from which the interest was created and was capable of being converted. *Id.* Although the parties' agreement also attached to it a COPAS accounting procedure which contained a 24-month Adjustments provision and a right to audit the operator, the court held that the 24-month

Adjustments provision did not apply to the conversion claim. *Id.* The court reasoned that the Adjustments provision only applied to contractual claims.

5. The Time Period That Must Elapse in Order for the Conclusive Presumption to Be Created.

The 24 month Adjustments period has been described as running from the end of the calendar year in which the bill is rendered. *Calpetco v. Marshall Exploration, Inc.*, 989 F.2d 1408, 1416 n.19 (5th Cir. 1993). For example, an objection made anytime in 2007 would be effective as to charges rendered on or after January 1, 2005. *Calpetco*, 989 F.2d at 1416 n.19. (court discussing time period under applicable facts of case).

6. In General, the Conclusive Presumption Does Not Apply to Revenues.

As one court has noted, the COPAS accounting procedures focus on accounting for the costs of a project and do not govern revenue practices. *Armstrong Petroleum Corp. v. Tri-Valley Oil & Gas Co.*, 116 Cal. Rptr. 3d 412, 417 (Cal Ct. App. 2004). In discussing the effect of the 24 month provision, the court described the 24-month provision as having the practical effect of requiring that a non-operator challenge disputed charges sooner than otherwise required under the statute of limitations applicable to contractual disputes. *Id.* at 418.

It should be noted that, to clear up any potential confusion, the 2005 COPAS accounting procedure has been revised to expressly state that the conclusive presumption applies "with respect only to expenditures."

7. The Conclusive Presumption May Not Apply to Disputes Between Non-Operators.

In *XCO Production Co. v. Jamison*, 194 S.W.3d 622 (Tex. App.—Houston [14th Dist.] 2006, pet. denied), the court was faced with a dispute between two parties over a tax partnership which owned an interest in oil and gas properties located in Louisiana. Jamison brought a breach of contract claim against his partner, XCO Production, Inc. concerning the distribution of revenues from the tax partnership under the terms of this agreement. Although the partnership agreement incorporated the operating agreement which governed the operations of the oil and gas properties and had an accounting procedure attached to it, the court held that the Adjustments provision (identical to the 1984 COPAS accounting procedure) was not applicable to the dispute between the two working interest owners. The court reasoned that the Adjustments provision was applicable to statements rendered by the operator to the non-operator pursuant to the operating agreement and that Jamison's dispute was with XCO Production, a working interest owner, not with the operator.

8. The 24-month Adjustments Provision Applies To Operators As Well As Non-Operators.

In 1989, the Wyoming Supreme Court in *Woods Petroleum Corp. v. Hummel,* 784 P.2d 242 (Wyo. 1989) was faced with interpreting a COPAS accounting procedure which provided:

"Payment of any such bill shall not prejudice the right of any Non-Operator to protest or question the correctness thereof; provided however, all bills and statements rendered to Non-Operators by Operator during any calendar year shall conclusively be presumed to be true and correct after twenty-four (24) months following the end of any such calendar year, unless within the said twenty-four (24) month period a Non-Operator takes written exception thereto and makes claim on Operator for adjustment. No adjustment favorable to Operator shall be made unless it is made within the same prescribed period."

Woods Petroleum Corporation v. Hummel, 784 P.2d 242, 243 (Wyo. 1989). The operator and non-operator entered into a model form operating agreement (AAPL Form 610—1956) in 1977 which incorporated a COPAS accounting procedure. From 1978 to 1984, the operator billed the non-operator for the non-operator's expenses totaling $275,501. In December 1987, the operator claimed that it had billed the non-operator for one-fourth instead of one-third of the expenses and sent an invoice to the non-operator for an additional $91,833 which was beyond the time period set forth in the COPAS accounting procedure. The mistake was the result of a clerical error and not because of failure of loss of title.

Ultimately, the operator brought suit against the non-operator for the amount of the underbilling. The non-operator raised as a defense that the operator was contractually barred from bringing suit under the above quoted provision in the COPAS accounting procedure. The Wyoming Supreme Court affirmed the lower court's decision to grant summary judgment in favor of the non-operator in holding that the 24-month Adjustments provision was clear and unambiguous in prohibiting any adjustment favorable to the operator unless it was made within the prescribed 24-month period.

In reaching its decision, the court discussed the operator's contention that the use of the word "adjustment" in the accounting procedure was ambiguous. The court noted that although the term "adjustment" was not defined in the accounting procedure, the plain meaning of the term was "[a] settlement of a claim or debt in a case in which the amount involved is uncertain or in which full payment is not made." As a result, the court held that the term "adjustment" was not ambiguous and that the operator could not recover the amount of the underbilling by the operator even if in error. Consequently, the court held that the Adjustments provision applied to the operator.

9. Even If The Bills and Statements Are Not Received, The "Conclusive Presumption" May Still Attach Based on Several Court Decisions.

The court in *Grynberg v. Dome Petroleum Corp.*, 599 N.W.2d 261 (N.D. 1999), was faced with a situation where the parties entered into a farmout agreement which attached both an operating agreement and a COPAS accounting procedure. Based on the language of the accounting procedure quoted by the court, it appears that the accounting procedure was probably a 1974 COPAS vintage. The farmor retained a 2.5% overriding royalty interest until payout when it could then be converted to a 50% working interest. The farmout agreement required the farmee to furnish the farmor with an itemized statement of costs and earnings for the well. The court noted that the farmor had a right to audit the operator's books and records within a twenty-four month period following the end of the calendar year and all statements rendered by the farmee were conclusively presumed correct twenty-

four months after the end of the calendar year unless non-operator made a written exception and claim for adjustment within that time.

The farmor failed to make a written exception to the Farmee's expenditures within the twenty-four month period. The farmor also claimed that the farmee failed to provide cost statements to the farmor. Despite the farmor's claim that it never received the "cost statements," the North Dakota Supreme Court concluded that the parties' agreement unambiguously required the farmor to make a written exception to the farmee's cost statements within twenty-four months after the end of the calendar year in which the statements were rendered and that the farmor had failed to do so. As a result, the court held that the farmee's expenditures were deemed true and correct. In reaching this conclusion, the court in *Grynberg*, noted that the language of the contract did not require the farmee to receive the statements to trigger the twenty-four month period. Id. at 267.

In *Willard Pease Oil & Gas Co. v. Pioneer Oil & Gas Co.*, 899 P.2d 766 (Utah 1995), the Utah Supreme Court faced a situation where a working interest owner who had previously farmed out its rights did not become aware of its interests in a well until approximately nine years after the well had been drilled. Upon learning of its interest, the working interest owner offered to pay its share of the cost of the well but demanded an audit of the operator's records. The operator had already destroyed the billing statements associated with the drilling of the well and the working interest owner had never received any of the billing statements. Despite not receiving the billing statements, the court held that the original charges for the wells were conclusively presumed to be true and correct and that the operator was only required to maintain supporting documentation for the costs of drilling the well for a period of three years because that was the maximum period under the COPAS accounting procedure that the operator's records could be audited. Id. at 774.

It should be noted that the decisions in both *Grynberg* and *Willard Pease*, are in conflict with the Fifth Circuit Court of Appeal's decision in *Exxon Corp. v. Crosby-Mississippi Res., Ltd.*, 40 F.3d 1474, 1488 (5th Cir. 1995), where the court held that the conclusive presumption did not apply unless the non-operator actually received the billing statements from the operator. *Id.* It should also be noted that the 2005 COPAS accounting procedure Adjustments provision now expressly applies to "payout statements."

E. What Constitutes a "Written Exception" Under The 1984 COPAS Accounting Procedure?

1. A Pleading May Not Constitute a "Written Exception"

Neither the prior COPAS accounting procedures nor the 2005 COPAS accounting procedure defines "written exception." In *Calpetco v. Marshall Exploration*, 989 F.2d 1408 (5th Cir. 1993) the Fifth Circuit Court of Appeal held that counterclaims raised by a non-operator failed as a matter of law to constitute written exceptions because they did not point to specific charges or specific invoices. As the court pointed out, the allegations in the counterclaim failed to even specify which partnerships or wells were involved in the alleged overcharges. *Id.* at 1416.

The 2005 COPAS accounting procedure now expressly requires that the non-operator issue a "specific detailed written exception" instead of a "written exception." However, the accounting procedure still fails to define what constitutes a "specific detailed written exception." Nevertheless, one can surmise that this revision now requires more detail than just a statement by the non-operator that it objects to a particular joint interest billing.

2. Lengthy Negotiations Between Operator and Non-Operator Lacked Specificity to Constitute a Written Exception.

The Fifth Circuit Court of Appeal in *Calpetco v. Marshall Exploration*, 989 F.2d 1408, (5th Cir. 1993) also dealt with the non-operator's claims that its lengthy negotiations with the operator that occurred over a two year period with written documentation going back and forth constituted "written exceptions." In this particular case, the court held that while the lengthy communications certainly conveyed discontent with the operator's billing practices, the court held that they lacked "sufficient specificity to constitute the requisite exceptions and claims for adjustment." *Id.* at 1416.

3. If It Wasn't Clear: An Oral Objection Is Not A "Written Exception."

In re Antweil, the non-operator orally objected to the operator's accounting procedures but failed to take written exception. 115 B.R. 299, 304 (Bankr. D. N.M. 1990). The court held that the non-operator's oral objection was insufficient under the 24-month Adjustments provision of the accounting procedure. *Id.*

4. What Constitutes A "Specific Detailed Written Exception" Under the 2005 COPAS Accounting Procedure?

The Adjustments provision contained in the 2005 accounting procedure was revised as reflected below:

> "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)." (emphasis added)

The prior versions of the COPAS accounting procedure have not defined what constitutes a "written exception." Now that the 2005 COPAS accounting procedure requires a "specific detailed written exception" which is not defined, one must conclude that in order for the exception to preserve the non-operator's objection to the bills and statements, the non-operator must be precise in lodging its written exceptions.

As discussed above, the court in *Calpetco v. Marshall Exploration,* 989 F.2d 1408, 1416 (5th Cir. 1993) held that a parties' counterclaims did not constitute a "written exception" because the counterclaim failed to even "specify which partnerships or wells were involved in the alleged overcharges." *Id.* Likewise, the non-operator failed to identify the specific charges and invoices it objected to in the lawsuit. *Id.* at 1416. Obviously, a written exception must indicate the property involved, the charges and invoices, and the period at issue.

F. Participation In the Audit Process Did Not Toll the Statute of Limitations In Prior Versions But May Toll The Statute of Limitations Under The 2005 COPAS Accounting Procedure.

The 1984 COPAS accounting procedure as well as previous versions did not contain any express language tolling the applicable statute of limitations while the parties were involved in the audit process and subsequent lengthy negotiations. As a result, the statute of limitations was not tolled during the audit process absent a separate agreement between the parties. For instance, in *Meridian Oil Production, Inc. v. Universal Resources Corp.*, 978 F.2d 1267 (10th Cir. 1992), the non-operator audited the operator's charges for seven wells located in Oklahoma. The non-operator prepared audit reports in accordance with the COPAS accounting procedure which detailed the non-operator's exceptions to the bills that had been received and paid by the non-operator. The non-operator and operator communicated over a number of years in an effort to resolve open audit exceptions.

Even though the non-operator and the operator had communicated over a number of years in an effort to resolve open audit exceptions, the court of appeal held that the non-operators claims had expired under Oklahoma's applicable five year statute of limitations. Id. In doing so, the court noted that the operating agreement did not require that the audit procedures be completed as a condition precedent to filing suit to enforce a claim and that the operating agreement did not provide that the statute of limitations was tolled once the audit process was invoked and on-going.

The 2005 COPAS accounting procedure now specifically tolls the statute of limitations if the parties abide by the strict requirements laid out in the accounting procedure. In particular, the 2005 COPAS accounting procedure provides:

> "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 [Operator responding to audit report within 180 days] or I.5.C [Non-Operator replying to Operator's response within 90 days], **the Operator's waiver of its right 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." (Emphasis added).

Based on the language now in the 2005 COPAS Accounting Procedure, in the event the non-operator submits a timely "specific detailed written exception," and complies with the rules set forth in the procedure for replying to the operator's response, the statute of limitations may be tolled as to those specific written exceptions. One could envision a situation where the parties disagree as to what exactly the written exception covers and whether the operator or the non-operator have complied with the requirements placed on the parties for timely responding to their audit or exceptions lodged.

G. The Non-Operator is Responsible for the Cost of Audit Unless Otherwise Agreed.

In case there was any doubt, absent a separate agreement, the non-operator is not entitled to recover the cost of an audit under the COPAS accounting procedure. *Dime Box Petr. Corp. v. Louisiana Land & Expl. Co.*, 717 F.Supp. 717, 723 (D. Col. 1989). In this case, the non-operator was not entitled to recover the cost of a joint audit under the COPAS accounting procedure. In refusing to permit the non-operator to recover the costs of the audit, the court noted that no evidence was submitted that the operator agreed to share this cost. *Id.* Consequently, unless the parties agree to the sharing of audit costs in the operating agreement or the accounting procedure (or some other agreement) the cost is borne by the non-operator.

H. The Accounting Procedures May Be Modified by The Parties' Conduct.

The COPAS accounting procedure provides formal procedures for amending and changing the accounting procedure. However, the parties should be aware that the accounting procedures might be modified by their conduct.

In *Hondo Oil & Gas Co. v. Texas Crude Operator, Inc.*, 970 F.2d 1433, 1437-38 (5th Cir. 1992), 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-1995-2 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.* The conversion produced a change in the non-operators' monthly overhead charges from approximately $175 per well to over $530 per well. Texas Crude did not notify ARCO that it was changing accounting procedures. However, after making a complaint as to the new rate in October 1978, ARCO paid Texas Crude for six years in accordance with the joint interest billings. *Id.* On the other hand, Amoco another non-operator, had noticed the change in its monthly charges and complained to Texas Crude. Rather than fight with Amoco, Texas Crude agreed to bill Amoco at the lower rate using the PASO Accounting Procedure.

The issue before the Fifth Circuit Court of Appeal 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 procedure to be used under the operating agreements. *Id.* at

1437-38. ARCO argued that the operator could not charge different overhead rates to non-operators (ARCO and Amoco) who have signed the same operating agreement in light of the operating agreement's provisions stating that the parties will be charged their proportionate share of costs and expenses. *Id.* at 1438. The court of appeal disagreed. The court held that although the non-operators signed the same operating agreements, they had no special relationship between them that established any fiduciary duty. *Id.* at 1439. As a result, the court held that the operator could charge using different accounting procedures for the non-operators. Consequently, the operations between Texas Crude as operator and ARCO were governed by the COPAS accounting procedure while the operations between Texas Crude and ARCO were governed by the PASO accounting procedure.

I. Miscellaneous—Cases Involving COPAS Accounting Procedures

1. *Stephenson v. Oneok Resources Co.*

This case involved over 76 oil and gas wells located in several counties in Oklahoma. *Stephenson v. Oneok Resources Co.*, 99 P.3d 717, n.1 (Okla. Ct. App. 2004). The operations for each well were governed by AAPL model form joint operating agreements with various versions of the COPAS accounting procedures (1962, 1968, and 1974). The relevant language in all of the operating agreements and accounting procedures was virtually identical. *Id.*

For a number of years, the operator's predecessor voluntarily decided to forego annual upward adjustments to the producing overhead rates which was permitted by the accounting procedure. *Id.* at 720. Approximately three years after the operator took over operations, the operator discovered that the operator's predecessor had not escalated the overhead rates in prior years. The operator then took the initial rate and adjusted it forward by the applicable index factor for each year beginning from the effective date of the joint operating agreement. Once it had calculated the overhead rate it believed it should have been charging, the operator went back two years and billed the recalculated rate for each well forward. *Id.* at 720. The non-operators refused to pay the recalculated rate. The non-operators claimed that the operator was not able to retroactively escalate the overhead charges. Instead, the non-operators claimed that the operator was required to multiply the rate in effect for the preceding year by the annual adjustment factor. *Id.* The operator took the position that the language of the operating agreement did not allow the previous operator to forego upward adjustments in prior years. *Id.* at 721.

However, the court held that the joint operating agreement did not require the operator to enforce its right to an upward adjustment in each year it was entitled to one in the prior years. *Id.* at 722. The court then determined that based on the facts of the case (where yearly adjustments had not been made) that the COPAS accounting procedure was ambiguous as to whether the "current" overhead rate under the procedure was based on the cumulative rate from the effective date of the agreement or on the rate actually being charged prior to the attempted adjustment to the overhead rate. *Id.* As a result, the court permitted the admission of industry custom and usage in affirming the jury's finding that the current rate was the rate actually being charged immediately preceding the attempted adjustment to the overhead rate. *Id.*

2. *Torch Operating Co. v. Louis Dreyfus Reserves Corp.*

In *Torch Operating Co. v. Louis Dreyfus Reserves Corp.*, 1994 WL 117786 (E.D. La. 03/30/1994), this dispute involved the construction of various agreements entered into between the parties. Westdelta and Enron Gas Bank entered into an offshore operating agreement where Westdelta operated offshore leases. The offshore operating agreement had a COPAS offshore accounting procedure attached. On the same day, Westdelta entered into a operating services agreement with Torch whereby Torch agreed to fulfill Westdelta's responsibilities set forth in the offshore operating agreement. A dispute arose between the parties over whether Torch could charge Westdelta's successor for its shore base facility. The issue between the parties revolved around whether the services agreement or the operating agreement was controlling. The court found that the services agreement was controlling and thus the COPAS accounting procedure was not applicable to the charge at issue.

VI.

CONCLUSION

The COPAS accounting procedure has been arguably one of the most important exhibits attached to the joint operating agreement. For over 40 years, the various COPAS accounting procedures have sought to bring consistency and uniformity to accounting for joint operations. The accounting procedure has withstood the many changes in the industry brought on by changes in the business and technology. With publications in the form of Model Form Interpretations and Accounting Guidelines, COPAS has provided and continues to provide the industry with resources for operators and non-operators to resolve their differences. COPAS has been quite successful in this endeavor as evidenced by the relatively few reported cases over the years involving COPAS. Now, with the 2005 COPAS accounting procedure, COPAS appears to have cleared up some of the "gray areas" that may have existed under the prior versions and now provides a mechanism for the speedy resolution of claims. While one might always expect there to be a struggle between the operator and the non-operator in the future, one may hope that the 2005 COPAS accounting procedure will assist the parties in focusing on resolving their issues in an efficient manner.