Farmout Agreements

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Farmout Agreements

Oil and gas leases are freely assignable.

Oil companies routinely assign leases for various reasons.

- Leases are considered inventory by oil companies.
- They are frequently traded to permit development of prospects.
- Fractional working interests are assigned to investors.
- Overriding royalty interests are often assigned to geologists or landmen.

Farmout Agreements (Continued)

FARMOUT AGREEMENTS

~~A farmout is basically an agreement under which one who owns an oil and gas lease (the farmor) assigns an interest in it to another person (the farmee) in exchange for testing and~~ drilling operations.

Reasons for Farmout Agreements.

- The farmor may use the agreement to maintain the lease by securing production before the expiration of the primary term or to comply with offset drilling or development covenants; it may wish to acquire geological information that will enable it to assess the productive potential of retained acreage or simply to obtain an interest in production without costs.
- The farmee may view the farmout as a way to acquire leased acreage not otherwise available or at lower cost than would otherwise be possible.
- The farmout may be used as a mechanism for sharing the risk of drilling an expensive or high-risk well.

- Whether the drilling provision in the farmout agreement is a condition precedent or a firm obligation, the farmee who

complies with its terms is entitled to the assignment specified in the agreement.

- This assignment may be of the entire leasehold estate owned by the farmor or some portion of it.
- A partial assignment may be limited to an undivided interest in the lease, a specific amount of the land covered by the lease, a specific depth or formation, or even a type of production, such as natural gas.
- The assignment may or may not be combined with the reservation of a noncost-bearing interest in the farmor.
- The most common assignment resulting from a farmout has traditionally been the entire working interest in the drilling site, subject to an overriding royalty in the farmor, which is convertible into a 50 percent working interest upon payout and a 50 percent interest in the working interest in the remainder of the land subject to the farmout.

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Farmout Agreements (Continued)

Typically, the farmee agrees to drill one or more wells at its sole cost or expense.

- In almost all cases the farmor will retain an interest in the assigned acreage (an overriding royalty interest or a production payment) and the farmee will earn the assignment only if he drills the well.
- Farmout agreements mainly used by oil companies in trading for leases to assemble blocks of acreage needed to develop their prospects.
- Farmouts are a means of spreading costs and sharing geological information.
- The essence of a farmout is earning leasehold acreage by drilling.
- If earning by drilling is not part of the deal, then it is not a farmout, but rather a lease purchase.

What business factors motivate farmors and farmees to enter into farmout agreements.

- The farmee's motive is to put together a block of acreage on which to conduct operations.
- The farmout agreement is usually a cost effective way of earning acreage because the consideration usually paid (overriding royalty interests or production payments) is often an interest in future production, rather than an up-front cash payment.

Farmout Agreements (Continued)

Form of Agreement

- While the essence of all farmouts is earning acreage by drilling, within that basic framework the deals can vary significantly.
- Their substance and structure will depend on the purpose, motives and relative negotiating strengths of the farmor and farmee.
- Most farmouts are in the form of letter agreements from the farmor to the farmee, which specify what the farmee will do to earn the acreage (drill a well, complete a producer, provide information) and the nature and size of the interest the farmor will earn as consideration for the farmout (an override).

Farmout Agreements (Continued)

Farmout agreements, being real estate contracts, are within the statute of frauds.

- They are governed by rules that govern contracts generally.
- Farmout agreements are rarely recorded.
- The assignment, once earned, will be recorded.

What are the main items that the farmor and farmee negotiate.

- What acreage the Farmee may earn.
- What the farmee has to do to earn the acreage.
- The size of the override or other consideration that the farmor will receive.

Farmout Agreements (Continued)

What provisions do Farmout Agreements typically Contain?

- Identity of Leases and Lands
- Obligations of Farmee
  - Drilling initial well
  - Conditions to drilling
  - Tests to be performed
  - Information and reports
- Obligations of the Farmor
  - Interest Farmor will retain
  - Interest Farmor will assign
  - Conditions of the assignment
- Further development of the prospect area, subsequent wells, et cetera.

DRILLING OBLIGATIONS

Drilling Obligations

- Occasionally farmout agreements are entered into that are predicated upon one party undertaking some sort of seismic testing.
- Commonly, the agreement requires drilling a test well or wells.
- If the farmor's primary interest is in testing a specific formation, a provision that the well called for in the agreement must be completed to a stated depth may be inadequate if it turns out that the desired formation is below the specified depth at that particular location.
- The requirement that the well be "completed" may be subject to differing interpretations.
- The agreement must make clear exactly what is required for the farmee to earn an interest.
- The more common agreement contains a produce-to-earn provision under which the farmee is entitled to an assignment only by completing a well capable of producing in paying quantities.
- Under a drill-to-earn agreement, the farmee earns its interest merely by drilling to the required depth.
- Frequently the agreement contains a requirement that the farmee complete the well "within XX days after commencement."
- Under such a clause, a farmee who has spent large sums of money in drilling a well may nonetheless lose his right to an assignment of the acreage if he encounters impenetrable substances or unforeseeable delays in drilling.

Retained Interest

Retained Interest

The interest retained by the assignor in a farmout varies greatly.

A common type of reservation is an overriding royalty that equals the difference between a stated percent of production and any other royalties, overriding royalties, or production payments outstanding at the time of the farmout.

- For example, the stated percentage is 25%.
- Assume the lease when assigned is subject to a one-eighth royalty in the lessor and a production payment of $25,000 payable out of one-sixteenth of production, which is owed to a third party.
- The assignor would be entitled to one-sixteenth of production until termination of the production payment, at which time he would be entitled to one-eighth of production.
- The effect of such a reservation is to give the assignee a "net revenue interest" of 75 percent of production.

Many farmout agreements contain a "back-in" provision.

- Under such a clause the farmor has the option of converting his overriding royalty into a share of the working interest once payout has occurred.
- Like the overriding royalty, the size of the share of the working interest that the assignor is entitled to will vary.
- Difficult problems are presented if the back-in interest is conditioned upon payout on a leasehold or "package" basis.
- The farmor may find it difficult to keep informed as to when payout occurs, or an enterprising farmee may be able to defer payout interminably by drilling or causing to be drilled additional wells.

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