FEDERAL EXPLORATORY UNITS

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I. UNITIZATION AUTHORITY

A. Mineral Leasing Act allows BLM to approve unit agreements "for the purpose of more properly conserving the natural resources of any oil or gas pool, field, or like area, or any part thereof." 30 U.S.C. §226(m).

B. Generally, at least 10% of the minerals within the unit boundary must be federal.

C. Operations on and production from any committed unit lands are deemed operations on and production from each tract of unitized land; *i.e.*, the unit can be considered one big lease.

II. ADVANTAGES OF UNITIZATION

A. All committed leases are treated as a single lease so multiple leases can be extended by drilling a single well.

CAUTION: Merely committing leases to a unit does not hold federal leases. There must be rental paid, drilling operations conducted over the expiration date of the primary term, or completion of a well capable of producing in paying quantities.

B. Unitized federal leases are excluded from acreage chargeability.

C. State spacing rules generally do not apply within a federal unit.

III. FORMATION OF UNIT

A. Area and depth meeting.

1. Applicant proposes the area logically subject to unit development and provides supporting geologic information.

2. Applicant proposes the depth of the test well (target formation).

3. After BLM approval of proposed unit area and depth of test well, the applicant seeks ratifications and joinders from each owner of an interest in the unit.

a) Working interest owners must also sign unit operating agreement.

b) State and fee royalty owners. Some fee leases grant unitization authority to the lessee (distinguish from pooling authority).

c) Override owners should be invited to join unit.

B. Commitment Status.

1. Defined only in BLM Manual.

2. Fully Committed – all interest owners in that tract have committed their interests to the unit.

3. Effectively Committed – all interest owners except overriding royalties are committed.

4. Partially Committed – For a federal tract, the operating rights owner is committed but not the record title owner. For a fee tract, the working interest is committed but not the royalty interest. This can result in excess royalty being owed.

5. BLM rule of thumb: tracts covering at least 85% of the lands within the unit must be committed in order for the unit operator to demonstrate "effective control" of the acreage.

6. BLM does have the power to compel a federal lessee to commit its interest to a unit, although that authority is not often used. *Chevron U.S.A. Inc.*, 111 IBLA 96 (1989).

C. Approval of Unit.

1. If sufficient amount of land within the proposed unit is committed, BLM will sign the Certification Determination.

2. Operator has six months from date of unit approval to commence to drill an initial test well at a location approved by the BLM (Article 9).

D. Segregation of Leases.

1. Federal leases.

a) Lands within a lease which are not within the unit boundary are segregated into a separate lease effective as of the approval of the unit.

b) Segregated lease continues for the term of the original lease but for not less than 2 years from the date of segregation. 43 C.F.R. §3107.3-2.

i) If the "term" of the lease on the date of segregation is an indefinite extended term by reason of production, segregated lease retains that HBP status, even if production was from the

portion of the lease committed to the unit.

ii) Even though the term of the segregated lease may be measured by the life of production from the parent lease, rental must be timely paid to maintain the segregated lease in effect until there is a well capable of producing in paying quantities located on the segregated lease.

2. Fee leases – no segregation unless optional paragraph 18(h) is included in the unit agreement.

3. State leases – depends on statute and regulation of the specific state.

IV. PUBLIC INTEREST REQUIREMENT

A. Added to the regulations effective June 15, 1988.

B. Requires that the unit obligation well or wells be timely commenced and diligently drilled in accordance with the terms of the unit agreement.

C. If the public interest requirement is not satisfied, the approval of the unit is deemed void *ab initio* and all lease segregations and associated extensions are invalid, as if the unit had never been approved in the first place, and there will be no extensions of leases for unit termination.

D. No operations will be approved for lands segregated into a separate lease beyond the expiration date of the original lease until the public interest requirement has been satisfied. 43 C.F.R. §3107.3-2.

V. PARTICIPATING AREAS ("P.A.")

A. That part of the unit area which is considered reasonably proven to be productive of unitized substances in paying quantities or which is necessary for unit operations and to which production is allocated in the manner prescribed in the unit agreement. 43 C.F.R. §3180.0-5.

B. Paying Quantities.

1. "Paying quantities," for purposes of forming a participating area, means quantities sufficient to repay the costs of drilling, completion, and producing operations, with a reasonable profit; *i.e.*, a well that will pay out. (Article 9 of the Unit Agreement).

2. If BLM agrees that the well satisfies this paying unit well test, it will approve a participating area surrounding that well (or an expansion of an existing participating area).

3. *Yates* well. A well which will produce sufficient quantities to pay royalties

and operating costs, with a reasonable profit, but which will not produce enough to pay out and so does not justify formation of a P.A.

a) A *Yates* well is still considered, for lease extension purposes, as a well capable of producing in paying quantities, so it will hold all committed leases.

b) *Yates* well does not satisfy the drilling obligations of Article 9 of the Unit Agreement. Thus, another well must be commenced within six months from completion of the *Yates* well or the unit will terminate.

c) A *Yates* well (provided it is drilled to the unit obligation depth) satisfies the public interest requirement (as does a dry hole).

C. Size and Shape of P.A.

1. No regulations dictate the size or shape of a P.A. – it is whatever the unit operator and the BLM agree is the area reasonably proved productive in paying quantities.

2. Initial P.A.

a) In most states, BLM assumes radial drainage and estimates a drainage area for the well. However, scientific evidence controls.

b) A circle is drawn around the paying well in the size of the drainage area. (For example, the radius of a 640 acre circle would be 2,979 feet).

c) All 40 acre subdivisions 50% or more of which are within the drainage circle will be included in the P.A.

d) If the lands reasonably proved productive of unitized substances in paying quantities can be described in legal subdivisions smaller than 40 acres, then those subdivisions will constitute the P.A. *Champlin Petroleum Co.*, 100 IBLA 157 (1987).

e) In New Mexico, BLM tends to follow state spacing units.

f) Initial P.A. is effective as of the completion date of the discovery well.

3. P.A. Revisions.

a) As more paying unit wells are drilled, new or expanded P.A.s are formed.

b) In the absence of other scientific data, BLM may use the "circle-tangent method" for P.A. expansions, though it is not required by the

regulations.

c) Separate participating areas must be formed for each separate pool or deposit.

d) Some CBM unit agreements prescribe in advance the size and shape of P.A.s.

e) Effective date of a P.A. revision is the first of the month in which the knowledge or information is obtained upon which the revision is predicated. (Article 11 of the Unit Agreement).

D. Allocation of Production

1. All unitized substances are allocated to the committed tracts within the approved P.A. on an acreage basis.

2. Although a P.A. may have an uncommitted tract within its boundaries, no production is allocated to a tract that is not fully or effectively committed.

3. Production from a well on an uncommitted tract is allocated solely to that tract.

4. An uncommitted overriding royalty is paid based on 100% of the production from that tract. *Moncrief v. Harvey*, 816 P.2d 97 (Wyo. 1991). That override owner gets no allocation of production from other unitized lands.

5. Uncommitted override can result in excess royalties; *i.e.*, the production is allocated proportionately to all tracts in the unit plus the uncommitted override owner is paid based on 100% of production from that tract.

VI. UNIT OPERATING AGREEMENTS

A. Agreement among working interest owners governing the allocation of costs and production among them.

1. A copy is required to be filed with the BLM.

2. BLM is not a party to the unit operating agreement and cannot control its terms.

B. Divided Type (Form 2)

1. Most commonly used.

2. Allocates working interest ownership on the same basis as royalties; *i.e.*, P.A. basis.

3. Working interest ownership in production changes as P.A.s are revised.

4. Wells drilled outside a P.A. are based on drilling blocks as provided in the unit operating agreement. (Article 9). Costs are allocated among the owners in the drilling block.

5. The resulting P.A. often does not mirror the drilling block. Article 13 of the unit operating agreement provides a means for adjusting ownership and costs to reflect the P.A. once it is approved ("investment adjustment").

C. Undivided Type (Form 1)

1. Working interest owners fix their percentage shares of costs (participating interest) and revenues (beneficial interest) when the unit is formed.

2. No change in share of costs or production when P.A.s are formed or revised.

D. Hybrid

1. Some companies have been amending Form 2 to provide that working interest ownership in a well remains fixed on a drilling block basis, notwithstanding any P.A. approval.

2. Eliminates accounting headaches for investment adjustments.

VII. TERM OF UNIT

A. If the initial well is a dry hole or a *Yates* well, then unit operator must commence a second well within six months after completion of the first well in order to continue the unit in effect.

B. The unit agreement will remain in effect for five years from the effective date of the Initial P.A. unless continuous drilling operations are being conducted on lands outside the P.A.s. (Article 2(e) of Unit Agreement). There is no drilling obligation during the initial five year term.

C. After an Initial P.A. is approved, all unit drilling must be in conformance with the annual Plan of Development ("POD") filed by the unit operator with the BLM. (Article 10 of Unit Agreement).

D. Contraction

1. Unless continuous drilling operations are occurring on non-P.A. lands, the unit automatically contracts to the boundaries of its P.A.'s on the fifth anniversary of the Initial P.A.

2. The unit will remain in effect as to all lands (whether or not in a P.A.) after the fifth anniversary of the initial P.A. for so long as diligent drilling operations are being conducted on non-P.A. lands, with not more than 90 days elapsing between completion of one well and commencement of the next.

3. Five year limit on diligent drilling, for a total ten year term of the unit.

4. Ten year term can be extended for a single two year term with the consent of 90% of the working interest owners in the non-participating land and 60% of the landowner's royalty interest (other than the U.S.) in the non-participating lands.

5. Always review the language of the specific unit agreement. Some unit agreements approved prior to 1955 have no automatic elimination provisions.

6. There is no segregation of leases upon unit contraction even if only a portion of a lease is contracted out.

7. A federal lease which is entirely eliminated from a unit upon contraction (or unit termination) continues in effect for the original term of the lease but not less than two years from the date of elimination.

E. Voluntary Termination

1. Prior to the discovery of unitized substances in paying quantities, unit may be terminated with the agreement of at least 75% of the working interest owners on an acreage basis. (Article 20(d) of the unit agreement).

2. No extension of leases after voluntary termination if the public interest requirement has not been satisfied.

3. Agreement will also terminate automatically upon the failure to timely commence any well after the initial obligation well where there has yet been no discovery of unitized substances in paying quantities.

VIII. RENTALS

A. Federal Leases

1. Rentals continue to be due until there has been a well completed capable of producing in paying quantities.

2. Even after a paying unit well has been drilled, rentals continue to be due until some portion of the lease is included in a P.A. However, failure to pay rental on non-participating acreage will not result in automatic termination of the lease. The rental is a debt due to the U.S. (That means you must file a relinquishment to drop non-participating federal leases within a producing federal unit.)

B. Fee Leases

1. Rentals continue to be due until some portion of the lease is included in a P.A.

2. What about paid up leases?

3. Committed fee leases which might expire prior to the termination of the unit agreement are extended beyond any such term and shall be continued in full force and effect for the term of the unit agreement. (Article 18(d) of Unit Agreement).

IX. SUSPENSIONS OF LEASES AND OF UNIT OBLIGATIONS

A. Article 25 of unit agreement contains a broad *force majeure* clause that allows suspension of unit drilling obligations if the operator is prevented from complying despite the exercise of due care and diligence by matters beyond its reasonable control. Examples:

1. Lack of rigs

2. Timing restrictions on operations (big game, sage grouse, etc.)

B. IMPORTANT: Suspension of unit obligations does not suspend federal lease terms and suspension of federal leases does not suspend unit obligations. Suspension of leases must be separately requested.

C. Unit Operator may request a suspension of operations or a suspension of operations and production ("SOP") on behalf of the owners of all committed federal leases in the unit.

1. SOP is granted in the interest of conservation; typically, because BLM must prepare a NEPA document that will delay approval of the APD. Rentals and lease terms are suspended with SOP.

2. A suspension of operations only may be granted where the operator is prevented from drilling by matters beyond its reasonable control but not caused by BLM. Rig unavailability is the usual reason. A suspension of operations suspends the lease term but does not suspend rentals.