

The following is an excerpt from an article published in the April 1, 2013 SWKROA newsletter:

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LINN ENERGY'S PROPOSED ATU'S

A number of our SWKROA members have received requests from their operator to form an Alternate Tract Unit (ATU). Pioneer Natural Resources USA, Inc. (Pioneer), and Linn Operating, Inc. (Linn), are the two firms which have lately been working on forming ATU's. As noted, above, Will Higgs, a surface landman for Linn Operating will be making a presentation at our annual meeting on April 27th [2013] regarding Linn's ATU program. We would like to give thanks and acknowledge the assistance of Stanford J. Smith Jr, of the Wichita law firm of Martin, Pringle, Oliver, Wallace & Bauer, LLP, for helping to make connections with Linn for having Mr. Higgs speak at our annual meeting. Mr. Smith, local counsel for Linn Operating, Inc. on its ATU project, submitted the following article:

“You might have already received, or in the near future might receive, a letter from Linn Operating, Inc. (Linn) providing you with notice of Linn's proposed additional drilling plans together with the formation of a new Alternative Tract Unit (ATU) and requesting your written consent as a Linn royalty owner under one or more leases that will be included in a proposed new ATU.

The Kansas Corporation Commission provides a process to combine four 160-acre tracts from four sections, or two 320-acre tracts from two sections, to form an entirely new 640-acre drilling and production unit that is referred to as an ATU. Payment of revenues for a new well in an ATU would not be limited to the royalty owners of the half section or quarter section that contributes to an ATU, but rather would be paid on a proportionate basis to all royalty owners of each unit that contributes a half section or quarter section to an ATU.

In order to obtain final approval from the KCC to form an ATU and to drill a well, Linn must first obtain the written and notarized consent from at least 75% of royalty owners that would own a share of the revenues in a new well.

Linn indicates that, depending on the results of Linn's evaluation of potential drilling opportunities on ATU's, Linn may form more than 100 ATU's.”

ALTERNATE TRACT UNITS (ATU's)

With Pioneer's and Linn Energy's recent requests for ATU's, the SWKROA office has been receiving a number of telephone calls and letters from our members. As such, we thought it might be helpful to review the Kansas Corporation Commission Basic Integrated Proration Order for the Hugoton Gas Field and Panoma Council Grove Gas Field (Integrated BPO), which permits the formation of ATU's. Much of this information was earlier reported in the January 2011 SWKROA newsletter.

The Integrated BPO provides that, “In addition to the existing basic production units in the Hugoton Gas Field and Panoma Council Grove Gas Field, operators, working interests, and owners of minerals in the Chase Group or the Council Grove Group, or both, may pool their interests in such production units to create an “alternate tract unit” only for the purpose of drilling one well on said unit, designated the “alternate tract unit well” for said unit, with production from such well shared equitably among all of the owners of working and royalty interests in the existing basic production units that contribute acreage to the alternate tract unit as agreed by those owners of the alternate tract unit. In the event of less than full agreement among all such owners, nothing in this order shall either prohibit or authorize the filing of an application for unitization under K.S.A. § 55-1301, et seq.”

ATU’s shall consist of approximately 640 acres forming an approximate square, consisting of either: (a) two half-sections in two governmental sections or production units directly adjacent and contiguous, forming a “stand-up” north-south oriented rectangle or a “laydown” east-west oriented rectangle; or (b) four quarter sections in four governmental sections or production units directly adjacent and contiguous forming an approximate square. Alternate tract unit wells drilled on such alternate tract units shall be located as near to the geographic center of the unit as practicable, but in no case less than 1,250 feet from any alternate tract unit boundary. And, as stated above, not more than one alternate tract unit well may be drilled on each alternate tract unit.

The Commission’s order comments that, “In the event of less than full agreement among all such owners (operators, working interests, and owners of minerals), nothing in this order shall either prohibit or authorize the filing of an application for unitization under K.S.A. 55-1301, et seq.” In practice, most operators have used subsection (a)(2) of K.S.A.55- 1304 as their authority for the formation of the ATU gas production units. Subsection (a)(2) provides for the formation of a unit for the “unitized management, operation and further development of the pool or the part thereof sought to be unitized is economically feasible and reasonably necessary to prevent waste within the reservoir and thereby increase substantially the ultimate recovery of oil or gas.”

K.S.A. 55-1305 provides for the Commission to approve an application for an order for the unit operation of a pool or part thereof, filed under subsection (a)(2) of K.S.A. 55-1304 shall not be approved unless the ATU has been approved in writing by those persons who, under the commission’s order, will be required to pay at least 63% of the costs of the unit operation, and also by the owners of at least 75% of the production or proceeds thereof that will be credited to royalties, excluding overriding royalties or other like interest which are carved out of the leasehold estate. As such, at least 75% of the royalty owners involved in the ATU must consent to the formation of an ATU.

Typically, royalties from an ATU well drilled into the Hugoton Gas Field and/or Panoma Council Grove Gas Field will be shared amongst the royalty owners from the contributing original units (described by your Secretary here as “Parent Units”) based on how much acreage each Parent Unit contributed to the formation of the new ATU. For instance, on a ‘stand-up’ ATU, each Parent Unit contributed 320 acres (or 50%) to form the new 640-acre ATU. Royalty owners in each Parent Unit will receive royalty payments based on their Parent Unit’s 50% share of the production from the ATU well, and then allocate that share to all of the royalty owners in the Parent Unit, based on their usual share of production from their Parent Unit.

For example, on the original parent unit assume a mineral owner owns an undivided one-half interest in a quarter section of minerals, and their lease has been unitized with other leases to form a 640 acre unit, and assuming their lease provides for a 1/8th royalty. Then, the resulting fractional interest could be described as $1/2$ (being the undivided mineral interest) \times $160/640$ (being a ratio of the lease acreage to the unit acreage) \times $1/8$ (being the royalty rate under the gas and oil lease). Applying that formula for royalties payable from an Alternate Tract Unit well, the fraction share of such mineral owner could be described as $320/640$ (being the ratio of the Parent Unit acreage contribution to the ATU acreage ratio) \times [the royalty share of unitized production, as described in the preceding sentence for production from wells located in the Parent Unit].

Royalties payable for production from the previous wells drilled in the Parent Unit should not be changed by the ATU agreement.

What does this mean for you, as a royalty owner? When you receive notice regarding a fourth well application, an initial inquiry should be to review the application to determine whether the subject fourth well would be drilled where your minerals are located (or on lands unitized with your mineral interests), or whether your minerals (or lands unitized with your mineral interests) are adjacent to and not part of the unit where the fourth well is to be drilled.

If the fourth well is to be on your property (or lands unitized with your mineral interests), then it is likely good for you to have another well from which you would be paid royalty. As such you may not have a reason to object to a fourth well being drilled.

On the other hand, if you received notice as an adjoining mineral owner, then you probably would want to contact your lessee to inquire of their plans to drill a fourth well on your property or to otherwise protect you from potential drainage. Often the company which sent notice to you for the fourth well application on a neighboring unit may also be the lessee on your unit. If your lessee has plans to timely drill the fourth well on your unit, then there may not be a compelling reason to formally object to the application for a fourth well on the neighboring unit.

With regard to an additional well on an Alternate Tract Unit, the same principals as mentioned above should apply — if there is a possibility of receiving royalty from another well, and then it is likely a positive event. A caveat though would be that your share of the total production from the well would be limited by your Parent Tract's participation in the alternate tract unit.

Your lessee should be able to address whether such a well would target reserves of natural gas which might not otherwise be recoverable. Your lessee should welcome your questions. In addition, as with any legal document which may affect your rights, you should also consider consulting your legal advisor. Your Secretary's office will also be glad to address your general inquiries.