

Topic 2: Controllable vs non-controllable materials

MFI – 38 Materials Manual Section II.B

“The classification of material as non-controllable does not, however, eliminate the operator’s responsibility for properly accounting for material purchases, transfers and dispositions. The terms controllable and non-controllable are used synonymously with the terms detailable and non-detailable.”

Appendix B – Glossary

NON-CONTROLLABLE MATERIAL	Material used in joint operations that is not subject to record and inventory control. Non-Controllable Material does not need to be detailed on billings to the joint working interest owners. Also referred to as non-identifiable material. The classification of material as Non-Controllable Material does not eliminate the operator’s responsibility for properly accounting for purchases, transfers and Dispositions.
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- 1) What does the requirement for “proper accounting” of non-controllable material include?
- 2) Does proper accounting of non-controllable material include proof of material installation if not listed as an operator’s responsibility?
- 3) If non-detailable is synonymous with non-controllable, is the operator required to prove installation?
- 4) What level of detail/audit evidence is needed for disposition of non-controllable material?

Section II. B

“Appendix C lists materials classified as controllable.”

“When items utilized in joint operations are not listed in this appendix, an operator may choose to classify additional items as controllable for the purpose of more detailed joint interest billing or for better internal control and tracking.”

- 1) If material is not listed as controllable in Appendix C do you agree it is by default non-controllable?
- 2) Can the non-operator write exceptions if the auditor’s opinion is a material not listed in Appendix C, should be controllable?
 - a. What would the exception need to reference to justify the opinion when MFI-38 only allows an operator to choose to classify additional items as controllable?
- 3) How would you propose addressing differences in opinion on the classification of controllable or non-controllable material?
- 4) Does the list of controllable materials in Appendix C need to be updated?

Well accessories - Any supplemental or fabricated component installed on or around the well.

- 1) Do the requirements for controllable material no longer apply if tubing or casing is used for making well accessories?
- 2) Is there an accepted industry % or footage loss that can be applied to tubing and casing when used to make accessories?
- 3) If a well accessory is purchased and is non-controllable, does the operator have to provide proof of installation?

Rental Tools & Equipment

MFI – 38 Material Manual

Section II. A

“For purposes of this manual, Rental Tools/Equipment are not considered materials, because they do not belong to the joint account; rather, they are rented as needed from the operator or a third party and covered by accounting procedure provisions other than those in the Materials section.

Question:

- 1) Under what circumstances would an auditor write up a tool/equipment rental charged to a well as a material exception because it was not shown on the installation reports as used in the well?
- 2) Under what circumstances does an operator need to respond to an exception for a tool/equipment rental not used in the well?

Topic 3: Drilling & Completion OH

Scenario

Operator ABC drills and completes a well under a 1984 Accounting Procedure. Per the daily operations reports, the D&C operations dates were as follows:

Activity	Start	End	Days
Drill Conductor Hole	06/28/20	06/28/20	1
Drilling Rig	08/03/20	08/16/20	13
Completion	09/03/20	09/03/20	1
Completion	12/19/20	01/15/21	28
			43

The Operator initially charged D&C OH based on the daily operations report dates, but then, after doing a GL review of invoice service dates, charged total D&C OH as follows:

Activity	Start	End	Days
Drilling	06/28/20	08/16/20	50
Completion	09/02/20	09/03/20	2
Completion	12/01/20	01/15/21	46
			98

Questions

- 1) Does the operator have to state operations/activity is suspended in the daily operations report or does it automatically occur after 15 days?
- 2) Would a hauling invoice for mud/chemicals on 07/11/20 and a hauling invoice for a tool 07/24/20 qualify for the additional 36 days of D&C OH to be applied?
- 3) Would an invoice to install a riser plate 10 days after the conductor rig was release allow for an additional 10 days of D&C OH to be applied?
- 4) Would there be any scenario after the release of the completion unit, and cease in daily operations reports, that D&C OH would still be applicable?
- 5) Should the non-operator be able to reasonably rely on the operator's daily operations reports as an indicator that D&C Operations were occurring? Does the absence of a daily activity report for a specific date have any bearing?
- 6) Does prep work or work between drilling and completion while not in hole count?
- 7) Should COPAS define what qualifies as an activity?
- 8) Can we get an opinion from the drafters of MFI-48? Did the drafters of the language in MFI-48 about suspension of operations intend for the application of OH in this

way? Meaning does any service at all, regardless of rig status as defined by the governing Accounting Procedure, qualify as drilling & completion operations?

- 9) Does the interpretive language in MFI-48 supersede the language in MFI-17 for wells governed by a 1984 Accounting Procedure? In particular, the language in MFI-17 regarding evidence of operations being a rig?

COPAS Language

1984 Accounting Procedure

(2) Application of Overhead - Fixed Rate Basis shall be as follows:

(a) Drilling Well Rate

- (1) Charges for drilling wells shall begin on the date the well is spudded and terminate on the date the drilling rig, completion rig, or other units used in completion of the well is released, whichever is later, except that no charge shall be made during suspension of drilling or completion operations for fifteen (15) or more consecutive calendar days.

MFI-17 (1984 Interpretation)

Section III – Drilling Well Rates

The date for terminating the overhead charges has always been hard to express, as it was felt the well attracted drilling overhead as long as the well was sustaining some type of drilling or completion work. The only evidence that such an operation is continuing is the use of some type of unit used in drilling operations, or a unit used in completion work remaining in use on the well. These provisions are not intended to cover equipment used in production testing, cleanup operations, testing for state and federal regulations, etc. Conversely, if work is suspended, for whatever reason, for a period of up to fourteen days, and then drilling or completion work is continued, overhead may be charged for the suspended time. If, however, the suspension is for a period of fifteen days or more, even though drilling or completion work is continued following such suspension, overhead is not chargeable for the suspended period.

MFI-48 (Application and Calculation of Drilling Overhead)

Section II.A – Commencement and Termination of Drilling Overhead – Drilling Wells

In the 1962, 1968, 1974 (onshore provision), 1984, 1995, 2005 and 1998 Project Team Accounting Procedures, the drilling overhead terminates “on the date... rig is released.” In

the 1974 (offshore provision), 1976, 1986 and 2005 Accounting Procedures, the drilling overhead terminates “on the date... equipment moves off location or rig is released, whichever occurs first...”. The rig release date is generally well known and noted on drilling reports and invoices for day rate type drilling contracts. “Equipment moves off location” raises the same arguments as the commencement issues discussed above – i.e., the equipment leaves in stages, so does overhead terminate when the first shipment or the last shipment takes place? In order to be consistent with the “moves on location” logic, the recommended method is to terminate drilling overhead on the date the last equipment leaves the location. It is important to remember that under the 1974, 1976, 1986 and 2005 Accounting Procedures, either one of two events – rig release or rig moving off location – can cause drilling overhead to cease. Therefore, the “moves off location” trigger will apply only if that event occurs prior to rig release.

Section II.C – Suspension of Operations

There sometimes are differing interpretations as to the activities that constitute “operations”. For example, with multi-staged frac techniques, there are often days or weeks of downhole inactivity while other work is performed on the surface such as assembling frac equipment, filling frac tanks or digging and filling a frac pit. A question has arisen if this fracing preparatory work qualifies as “operations”, or counts as a suspension of operations. The accounting procedures refer to a suspension of operations but do not qualify that by limiting it to a suspension of downhole activities. For ease of administration and consistence in applying drilling overhead, COPAS recommends that as long as the well is sustaining some type of drilling, completion, workover or recompletion activity, and as long as there is no suspension of such work for 15 or more consecutive days, drilling overhead is chargeable. These provisions are not intended to include time spent production testing, cleanup operations, etc. These are considered production activities.

1984 Percentage Basis Overhead

B. Overhead - Percentage Basis

The base used for applying the agreed percentage provisions is the total chargeable costs currently billed less certain specific exclusions; which for the development of the Joint Property is Legal Expense and credits for equipment salvaged, and for operating the Joint Property is Rentals and Royalties, Legal Expense and credits for equipment salvaged. Additionally, items to be excluded are the value of purchased secondary recovery injected substances, and any and all taxes levied, assessed and paid upon the mineral interest for the Joint Property. Although the accounting procedure uses the term "secondary," the intent was all inclusive and should be read as meaning "secondary and/or tertiary."

Application of Overhead - Percentage Basis

The determination of the overhead charges using the Percentage Basis is relatively simple in that Development means all costs and expenses incurred in the preliminary preparation of the location, to drill, redrill, deepen, or any remedial operations on any well or wells which involves the use of a drilling rig and crew, capable of drilling to the formation anticipated to produce or already producing on the Joint Property. Also, costs associated with the abandonment of a well at the time of drilling, i.e. costs to salvage material, clean up location restore location to its original condition, are included in the base. Costs connected with the construction, installation or expansion of fixed assets, are also included.

Percentage basis allows overhead on chargeable costs less defined exclusions.

- 1) Percentage basis acknowledges activities occur before, during and after drilling and completion of the well. Does this factor into the need for COPAS to define work/activity to determine the 15 days under fixed rate?
 - 2) 1984 COPAS
 - a. Drilling a well focuses on the date the rig spuds the well and terminates when released.
 - b. Workover focuses on commencing work and terminates when released
- 1986 COPAS
- a. Drilling a well focuses on the date the rig arrives and terminates when moved off location.
 - b. Workover focuses on when rig or equipment work commences and terminates when released.

COPAS 1984

Charges for drilling wells shall begin on the date the well is spudded and terminate on the date the drilling rig, completion rig, or other units used in completion of the well is released, whichever is later, except that no charge shall be made during suspension of drilling or completion operations for fifteen (15) or more consecutive calendar days.

Charges for wells undergoing any type of workover or recompletion for a period of five (5) consecutive work days or more shall be made at the drilling well rate. Such charges shall be applied for the period from date workover operations, with rig or other units used in workover, commence through date of rig or other unit release, except that no charge shall be made during suspension of operations for fifteen (15) or more consecutive calendar days

COPAS 1986 OFFSHORE

Charges for drilling wells shall begin on the date when drilling or completion equipment arrives on location and terminate on the date the drilling or completion equipment moves off location or rig is released, whichever occurs first, except that no charge shall be made during suspension of drilling operations for fifteen (15) or more consecutive calendar days.

Charges for wells undergoing any type of workover or recompletion for a period of five (5) consecutive work days or more shall be made at the drilling well rate. Such charges shall be applied for the period from date workover operations, with rig or other units used in workover, commence through date of rig or other unit release, except that no charge shall be made during suspension of operations for fifteen (15) or more consecutive calendar days.

COPAS focuses on dates when the equipment is being used for determining 15 day or 5-day periods. Vendor services/materials can be procured by the operator before rig or equipment work starts in the field. Why doesn't COPAS use dates on vendor invoices to determine the 15 day or 5-day period? Should vendor invoice dates be used?

Topic 4: TIK Owner's Royalty Obligation on Vented, Flared, and Lease Use Volumes

Facts:

The operator of a Texas oil and gas well reports the total production including vented, flared, and lease use volumes to the RRC. Under the terms of the lease agreements, royalties are due on 100% of the natural gas volume produced. The lease agreement is silent on how to pay the royalties. The operator is marketing its share of natural gas sales along with two other working interest owners. Another working interest owner is marketing only its share of natural gas sales.

Scenario:

A newly completed well is in the 13th month of production. Each of the four owners are selling their respective share of the natural gas sales. The operator and the two working interest owners selling with the operator are paying royalties on sales, vented, flared, and lease use volumes. The TIK owner who is marketing its share is paying royalties on sales.

Question:

1. Who should remit royalties for vented, flared, and lease use volumes on the TIK owner's lease(s)?
2. How are royalties reimbursed when royalties are paid on behalf of another working interest owner?
3. If royalties are paid on behalf of another working interest owner, what valuation is used when prices are confidential?

Topic 5: Audit Rights with/without an AP

Scenario

Operator of property charges working interest partner for drilling, completion, lease and well equipment and LOE in year 2024 and 2025. The partner requests to audit expenditures charged in 2024-2025.

Questions:

- 1) Can the Operator deny audit rights in the following instances:
 - a. Joint Operating Agreement with an Accounting Procedure (are there any that do not allow audits)
 - b. Joint Operating Agreement without an Accounting Procedure
 - c. Forced Pooling Situation
 - d. Pooling Agreement
 - e. No Joint Operating Agreement but in a State with applicable statutes
 - i. Oklahoma
 - ii. North Dakota
 - iii. New Mexico
 - iv. Montana
 - f. No Joint Operating Agreement, Pooling Agreement, any other applicable agreement or applicable State statutes
- 2) If the Operator has denied audit rights in the situations above, are there any other avenues to use if the partner wishes to avoid the hassle of involving the state's governing body?
 - a. Joint Operating Agreement without an Accounting Procedure
 - b. Forced Pooling Situation
 - c. Pooling Agreement
 - d. No Joint Operating Agreement but in a State with applicable statutes
 - i. Oklahoma
 - ii. North Dakota
 - iii. New Mexico
 - iv. Montana
 - e. No Joint Operating Agreement, Pooling Agreement, any other applicable agreement or applicable State statutes
- 3) If no agreement exists, what exceptions can be written?
 - a. Coding Error
 - b. Allocation Error

- c. Material Reconciliations
- d. Covered by Overhead
- e. Overhead Reconciliation

Topic 6: Charging for AI

As adoption of AI becomes more prevalent with wider use cases, can the operator charge out the cost?

Would AI cost chargeability be covered under MFI-44 Field Computer and Communications Systems?

A. Would it be classified as Software?

The AI Large Language Model (LLM) comes from 3rd party, but the use case is developed by the operator?

A. If software, how does it get classified as “from third party” or “developed by the Operator”?

2. Software

- a. Software used exclusively for field operations and acquired from a third party.

Accounting Treatment – a direct charge based on the purchase price, or lease payment, plus the costs to configure, install, and support the software. If more than one property is served, an allocation would be required. The allocation should be based on the number of connected devices, wells served, or some other equitable basis.

- b. Software used exclusively for field operations and developed by the Operator.

Accounting Treatment – a direct charge, based on actual costs, for the development, configuration, installation, and support of the software. If more than one property is served, an allocation would be required. The allocation should be based on the number of connected devices, wells served, or some other equitable basis.

- c. Software used for both field operations and administrative functions, and used by both direct charge field employees and administrative and technical employees, regardless of who provides the software.

Accounting Treatment – the cost should be allocated between the administrative and operating functions using an equitable allocation method, such as processing time. Once this allocation is made, if more than one property is served, an additional allocation of the operations related costs would be required. The allocation should be based on the number of connected devices, wells served, or some other equitable basis.

If an AI use case is not listed in the table below, does it disqualify the cost from being charged out even though MFI-44 says the list is not all inclusive?

However, with the multitude of systems now available, it is important to distinguish between those directly benefiting field operating functions such as measurement, control and communications from those supporting administrative functions considered overhead. The list of applications presented in Table 1 below is not all inclusive, rather it is intended as a guideline to determine the types of systems that may be charged to the Joint Account when used by field operating personnel (employees and contractors that are directly chargeable according to the Accounting Procedure for that field).

EXAMPLES OF COMPUTER APPLICATIONS (Table 1)	
FIELD OPERATIONS (Direct Charge)	ADMINISTRATIVE (Overhead)
Cathodic protection surveillance Chemical analysis E-mail (field personnel) Facility alarm monitoring Job safety analysis Meter calculation tools Meter calibration scheduling Preventive maintenance Production control/allowable monitoring Production volumes/run tickets/tank levels Production/flow rate analysis Spill/Hazardous waste tracking Well service tracking Well tests Wellbore pressure monitoring/analysis Word processing/spreadsheets (field personnel)	Contractor/vendor analysis Drafting E-mail (administrative personnel) Engineering documentation systems Financial/budget (AFE) analysis Gas balancing (over/short) Invoice processing Invoice tracking Payroll Personnel Production accounting Purchasing/inventory management Regulatory reporting Reservoir analysis Timekeeping Word processing/spreadsheets (admin)

MFI-44 says the "Operations systems are chargeable only to the extent they are used by field operating personnel."

"Operations" systems are chargeable only to the extent they are used by field operating personnel. Conversely, "Administrative" systems are not chargeable even when used by field personnel. For example, a timekeeping or AFE system should not be charged even though field operating personnel may use those systems.

What is reasonable audit evidence the Operator needs to provide to confirm use by field personnel?

- Can it be a confirmation statement from the operator?
- Can it be personnel IT accounts or laptop count if the AI is standard software available for Operator personnel and contractors?
- Does it need to be a video of the person at the computer with the software application open on the computer saying their name so their name can be cross referenced with other files used to prove someone was on location?
 - Or would this be an administrative burden per MFI-44?
- With more remote capabilities, does it make sense for COPAS to still limit use by field personnel or expand to include remote use off the Joint Property?
- Others?

What happens if the Operator provides a confirmation statement that the software is used by field personnel and the Non-Operator auditor refuses to accept that response and asks for proof of use by field personnel?

- What can be provided that is not an administrative burden per MFI-44?

Documentation & Allocations:

Any computer or communication system cost charged to the Joint Account is subject to audit by the Non-Operators. The Operator should be prepared to furnish documentation needed to verify the equity of the methodology used. To help determine if an allocation method is equitable, the following factors should be considered:

1. Do the charges match the benefits received by the properties?
2. Is the allocation method consistently applied?
3. Is the allocation method reviewed periodically to ensure it reflects actual operating conditions with updates made as required?

Also, documentation of the allocation bases used needs to be maintained by the Operator to support the charges. The level of support required should not cause an administrative burden on the Operator, but should be reasonably sufficient to justify the charge.

Finally, the establishment of written procedures is recommended to document the chosen allocation method and to help ensure the method is consistently applied to given situations over a period of time.

If the Operator decides not to directly charge the costs, the Operator and Non-Operators should consider (re) negotiating the Overhead rate to provide compensation for the system costs incurred.

IT charges such as AI are often managed at an enterprise level which makes traceability of the amount charged back to an invoice difficult.

- Is an invoice always required to justify a software charge to an auditor?
- The Operator uses the 3rd party for multiple software and invoices the Operator for all software of which AI software cost is included. What then?
 - Does proof that all the software charges were not billed show the Operator has excluded administrative use and only billed a subset of cost for field personnel?
- What if the AI software is billed through an affiliate that manages software spend for the Operator?
- Is there a level at which support for the charges becomes an “administrative burden” on the Operator and what is that?

Audit Firms/Consultants

If contract auditors are paying for AI, can the firm charge their cost?

Does COPAS need to be explicit that the AI costs are covered in the existing per diem rate, change the per diem rate to include AI costs, or publish a separate AI per diem rate?

What are the governance considerations for 3rd party auditor use of AI?