

ROUND 2

General Facts for Both Sides

Axel Oil Company ("Axel Oil"), a domestic oil and gas company, is actively engaged in the exploration and production of oil and gas in the Permian Basin. They currently hold 150,000 net mineral acres scattered throughout the play and are considered one of the largest companies in the region. However, they have found it increasingly difficult to maximize the recoverables from their acreage position because of the location of their existing units and wells, some of which have been in place and producing for over 20 years. They are seeking to drill on currently un-assigned acreage between two leases they already have in existence, the Smith Lease and the Jones lease. The new site will be known as the proposed Smith-Jones (Allocation) Well No. 1H.

In 2000, Axel Oil obtained the Smith Lease containing 280 acres, in which Axel Oil owns 100% of the working interest. The Smith Lease provides for a one-eighth (1/8) royalty, and does not include pooling authority. The lessor, Elvira Smith, adamantly refused to allow for pooling during the original negotiations with Axel Oil, but has since consented to any proposed allocation well that may be drilled on her tract and any adjacent tract. The Smith Lease also contains a Continuous Operations clause and Pugh clause, which states that if operations for the commencement of drilling an additional well has not begun within 12 months of the completion of the previous well, then all acreage not assigned to an existing well/proration unit will be released. The last well drilled on the Smith Lease (Well B) was completed 10 months ago and all acreage under the Smith Lease has been assigned to either the proration unit for Well A or Well B, except for the acreage to be included in the proposed Smith-Jones (Allocation) Well No. 1H.

In 2001, Axel Oil obtained the Jones Lease containing 320 acres, in which Axel Oil owns 70% of the working interest and Big Oil Resources ("Big Oil") owns the remaining 30% of the working interest. The Jones Lease provides for a one-sixth (1/6) royalty, and also lacks pooling authority. The Jones Lease contains a Continuous Operations clause and Pugh clause similar to the clauses in the Smith Lease. The last well drilled on the Jones Lease (Well E) was completed 11 months ago and all acreage under the Jones Lease has been assigned to either the proration unit for Well C, Well D, or Well E, but for the acreage to be included in the proposed Smith-Jones (Allocation) Well No. 1H.

It is noted that in December of 2015 the Jones Lease tract had been effectively subdivided into three sub-tracts (identified as Tracts 1.1, 1.2 and 1.3) in which portions of the right to receive royalty had been partially conveyed to parties other than the Jones family, creating varied royalty ownership between these three tracts.

The geologists for Axel Oil have suggested that an additional well would be highly profitable, however, because of the existing locations of currently producing wells located within each unit, the only way to fully exploit these remaining resources would be to drill a horizontal well that traverses the lease lines between the Smith Lease and the Jones Lease. In initially meeting with Grandpa Jones (the mineral interest owner of the Jones tract at the time the Jones Lease was taken) in July of 2015, he verbally consented to the execution of a Production Sharing

Agreement ("PSA"). However, later that month as he was walking into Axel Oil's office to execute the PSA, Grandpa Jones was hit by a train and died on the spot, having never executed a formal PSA in writing. His mineral interest eventually devolved to his kids (there were 7). The Jones family has since refused to execute any PSA.

After internal discussions, Axel Oil has decided to file an allocation well application with the Texas Railroad Commission ("Commission") for a drilling permit for its proposed Smith-Jones (Allocation) Well No. 1H. The application purported to form an 80-acre unit for the well composed of 50 acres from the Smith Lease and 30 acres from the Jones Lease. *Please see Exhibit A below.*

Subsequent to the filing of the application, the Commission received several letters supporting the proposed allocation well and several letters protesting said well, including letters from the current lessors under the Jones Lease, which disputed the legality of such a well and asserted that neither an allocation agreement or production sharing agreement existed for the proposed well. In addition, the letters indicated that the subject leases do not allow for pooling. This dispute led to the creation of Complaint File 2015-0001.

Axel Oil notes that the Commission has approved hundreds of similar allocation well permits in the past and that its current application is no different than any of those, but for the fact that Big Oil owns a 30% working interest under the Jones Lease. Big Oil is risk-averse and would like to see an agreement in place prior to contributing any capital towards the drilling of the proposed Smith-Jones (Allocation) Well No. 1H. However, despite the fact that Big Oil is not on board, Axel Oil believes that with no unleased mineral interest within the minimum spacing distance, it will have demonstrated a good faith claim to title for issuance of a drilling permit.

Axel Oil believes that there are no Commission rules regarding the allocation of production from an allocation well and is not aware of any Texas court cases that have specifically addressed this issue. Axel Oil does not seek Commission endorsement as to any particular method of allocating production, as it believes that payment of royalties is a contractual matter between the lessor and the lessee, and determining whether the proposed proceeds allocation comports with the leases is not a matter within the Commission's jurisdiction, but a matter for the parties to the lease, and if necessary, a Texas court.

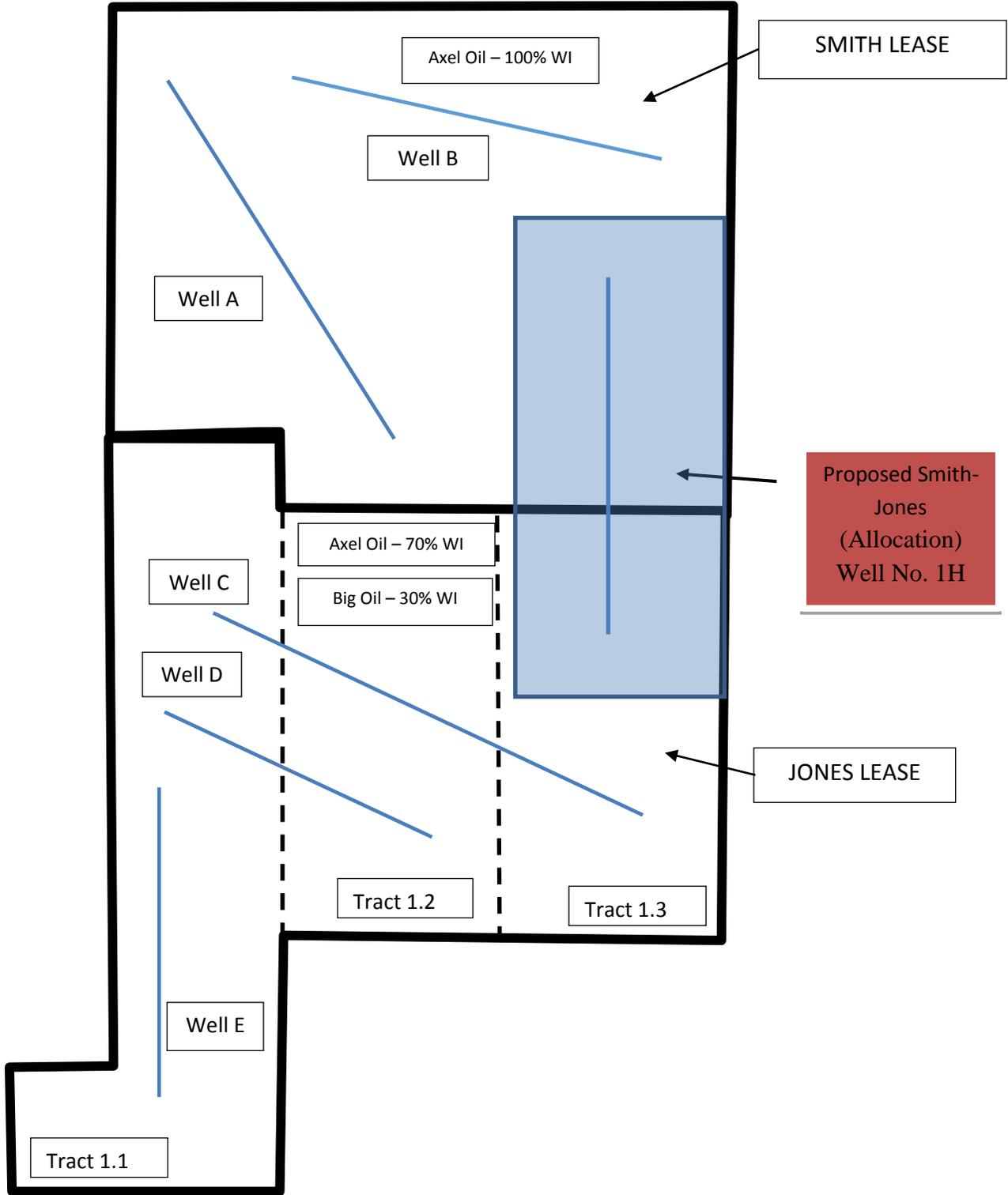
It is noted that methods of calculating the allocated production from "allocation wells" utilized in the past include, but are not limited to, the following:

1. *Springer Ranch v. Jones Formula*— allocation is considered a reasonable apportionment of production among the tracts penetrated by the wellbore when the value of production is proportionately reduced by the percentage of the wellbore that is actually under the tract. The length of wellbore under the tract is divided by the length of the entire lateral well from the first take point to the last take point.

2. *Relative Bore Length Formula* – Production royalty is allocated based on the length of the horizontal wellbore within a particular parcel in relationship to the total horizontal length (i.e., the length between the upper perforation point and the lower perforation). In other words, the royalty is based on how many linear feet of the wellbore actually passes underneath the leased tract from the point it penetrates the targeted formation to the point it terminates within said targeted formation.
3. *Take Point Formula* – Allocates production royalty based on how many wellbore “take points” or open perforations are located within a particular tract in relationship to the total number of take points along the entire producing lateral wellbore.
4. *Surface Acreage (MIPA or Voluntary Pooling)* – If the lessor agrees to pooling or is force pooled per MIPA (“Mineral Interest Pooling Act”), royalties will be apportioned among the royalty owners based on the percentage of the acreage each unit owns within the pooled unit.

Pursuant to the dispute resolution clause between the parties to the Jones Lease, any and all disputes arising out of the lease contract shall be resolved by negotiation prior to the pursuit of a legal determination through the Texas court system. The parties have thirty days to attempt negotiation prior to filing suit.

EXHIBIT A



TERMS AND DEFINITIONS

Allocation Wells: The term “allocation well” is used in the oil and gas industry to refer to a horizontal well that is drilled across lease lines without pooling the tracts on which the well is located.

Production

Sharing Agreement: The term “Production Sharing Agreement” or “PSA” refers to an agreement among royalty interest owners in the two existing units in which it is agreed that production from the horizontal well will be “shared” between the two units based on the percentage of lateral length on each unit, and production allocated to each unit will be treated for lease and royalty payment purposes as if produced from the unit.

Take Points: A take point in a horizontal well is a point along a horizontal drainhole where oil or gas can be produced from the reservoir or defined field. A horizontal well is tantamount to a series of vertical wells drilled along the linear path of the horizontal wellbore. Each take point is the equivalent of the production point at the bottomhole of a vertical well.

Treatable Lateral: That portion of the horizontal leg of a wellbore that can be stimulated by hydraulic fracturing for the active production of oil or gas.

NOTE: Statewide Rules 10, 26, 27, 37 and 40 can be found under Title 16, Part 1, Chapter 3 of the Texas Administrative Code.

Confidential Facts for Axel Oil's Attorneys

Axel Oil has been in the oil and gas business for over 40 years and has drilled close to 240 wells, mostly in the Permian Basin. Their drilling experience and knowledge of the plays in the Permian Basin is unrivaled. They have filed, and received approval, for over 37 similar allocation well permits within the past 15 years and have found that it is the only way to fully explore and exploit the full potential of the plays comprising the Permian Basin, because of the location and positioning of their assets (being their acreage and existing wellbores).

Ken Cippelle, the lead geologist for Axel (and husband of Elvira Smith – the mineral interest owner of the Smith Lease acreage, being her separate property), has thoroughly reviewed the seismic data available to him and has determined that because of an existing fault line and the nature of the strata between the surface and the targeted formation, the optimal target area for the proposed allocation well is as indicated on Exhibit A, with the wellbore traversing the lease lines between the Smith Lease acreage and the Jones Lease acreage.

Further geologic data suggests that there is a “down-dip” in the Smith Lease acreage which will produce an estimated 85% of recoverables from the well and there is an “up-dip” in the Jones Lease acreage which will only produce an estimated 15% of the total recovery. Because of this geological data, Ken has proposed 18 take points on the portion of the wellbore located in the Jones Lease acreage and only 10 take points on that portion of the wellbore located in the Smith Lease acreage in order to increase what can be taken from the less productive acreage. In addition, the length of the wellbore located in the Smith Lease acreage will be two times the length of that located in the Jones Lease acreage.

Bob Womack, the in-house land manager for that region, met with Axel Oil's attorneys and indicated that the royalty attributable to the Smith Lease is only a one-eighth (1/8) and that the royalty attributable to the Jones Lease is a one-sixth (1/6). Therefore, in addition to the geologic underpinnings, it would be more advantageous if most of the wellbore was located in the Smith Lease acreage, as it would maximize Axel Oil's net revenue interest in the unit. Axel Oil is amenable to increasing the royalty interest in the Jones Lease, but no higher than a one-fifth (1/5) if it will help get the allocation well drilled.

Bob has stated that his attempts to obtain pooling authority from the Jones family have been to no avail. Bob has also indicated, in conjunction with Ken's information, that Axel would be able to drill 62,000 feet of combined treatable lateral on these two leases with an allocation well and only 49,000 feet of treatable lateral without the ability to drill these types of wells. He has admitted that the economics only work if they can drill the well to the full suggested length, as drilling costs would be too high for a shortened wellbore compared to what they would recover.

Axel Oil is aware that allegations have previously been made that allocation wells could be in violation of several Statewide Rules including, but not limited to, Rules 10, 26, 27, 37 and 40. However, it does not believe that these rules apply to allocation wells. Axel Oil doesn't want to risk drilling the allocation well only to be sued under a potential “confusion of goods” theory and

losing the well, but will proceed if necessary, as it feels pretty confident about its legal stance. They are willing to negotiate as to the terms and potential location of the proposed allocation wellbore, but they need to do so in a hurry, as they are worried about expiring acreage under the Pugh clauses contained in the both the Smith Lease and the Jones Lease.

Confidential Facts for Landowner's Attorneys

The Jones family, as a whole, is one of the largest mineral interest owners in the area. As such, they are considered to be rather sophisticated when it comes to knowledge of oil and gas. The Jones are ultimately opposed to the allocation well and, while not aware of the economics involved, do not understand why the proposed well cannot be drilled entirely within their lease acreage. The Lessors are well aware that Axel Oil needs to move forward with the proposed allocation well and have engaged attorneys to present viable arguments that would result in a scenario which works in favor of the Lessor, should the Railroad Commission grant a permit for said well.

After the Jones were approached to possibly sign the proposed Production Sharing Agreement and they refused, they became aware of the fact that Elvira Smith (the mineral interest owner of the Smith tract), is married to Ken Cippele, the lead geologist for Axel Oil, and that their attempt to obtain the requisite 65% approval for a PSA well may not have been done in good faith.

The attorneys for the Jones feel that the proposed allocation well, if drilled, could violate several Statewide Rules under Title 16, Part 1, Chapter 3 of the Texas Administrative Code including, but not limited to, Rules 10, 26, 27, 37 and 40. However, they feel that these are not their best arguments. They feel that any production from this potentially illegal well could fall under the "confusion of goods" theory in which it would be impossible to accurately determine what portion of production is attributable to the Jones Lease acreage and therefore, Axel could be required to account to them as if 100% of the production from the proposed well had come from their tract. The Jones feel that because the proposed allocation well would result in the commingling of production from separate, unpooled tracts, the burden is on the commingling party (Axel Oil) to establish the aliquot shares of each owner.

The Jones are no strangers to negotiating preferential situations involving their mineral interests. In the past they have obtained overriding royalty interests and even production payments in exchange for certain agreements. Ultimately, the Jones are unhappy that its lease royalty is a one-sixth (1/6) and have advised their attorneys that a one-fifth (1/5) royalty would be acceptable. The Jones have also been advised by their attorneys that there exists various theories and methods of royalty allocation, and are open to reasonable suggestions that might improve their position monetarily.

To date, the Jones have not been privy to any seismic and geologic data utilized by Axel Oil throughout the leasing process and accordingly, they do not currently know how much of the actual production will be obtained from the portion of the wellbore traversing their tract of land.

One of the attorneys hired by the Jones has drilling engineering experience and is aware that not every foot of a horizontal well is equivalent to every other foot. He does not believe that Axel Oil will have uniformity of production over the length of the horizontal lateral, which will lead to the problem of accounting for production before it leaves the lease. If they acquiesce to the well, he believes it is imperative to negotiate the most advantageous method of royalty allocation possible. Tying this up in court does not benefit anyone and the Jones are not interested in making case law, but would like the well drilled so they can receive their entitled royalty as soon as possible.