Evaluating Oil & Gas Lease Proposals

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Disclaimer: This slide set is provided for informational purposes only. Nothing herein constitutes the provision of legal advice or services.
Resources

- National Agricultural Law Center
  - Renewable Energy Reading Room
  - http://www.nationalaglawcenter.org/

- Water wiki
  - http://sogweb.sog.unc.edu/Water/index.php/Main_Page

- Penn State Agricultural Law Resource and Reference Center
  - http://law.psu.edu/academics/research_centers/agricultural_law_center/resource_areas/natural_gas_exploration

- NC Department of Justice, consumer complaints
Resources

• Penn State Cooperative Extension  
  – http://extension.psu.edu/naturalgas
• Cornell Natural Gas Resource Center  
  – http://cce.cornell.edu/EnergyClimateChange/NaturalGasDev/Pages/default.aspx
• North Carolina Cooperative Extension/NCSU Department of Agricultural and Resource Economics  
  – http://www.ag-econ.ncsu.edu/gasleasing.html
Due diligence is the process of vetting potential lessees. If due diligence is conducted well, it can exclude lessees that are likely to be the source of legal and other problems.
Many leasing companies are not in the business of exploring or drilling for gas. These are brokers who attempt to put together properties with the goal of selling packages of leases to the companies that will actually do the exploration and drilling. Some companies soliciting leases intend to explore for gas and produce it.
Safety/environmental compliance record
Most large companies are involved in litigation most of the time. The pattern of litigation can be revealing. Does the company often sue the landowners from which it leases property? Do landowners or others often sue the company? Is it involved in litigation with regulatory agencies? What is the nature of these disputes?
Registered to do business in North Carolina?
NC Secretary of State
http://www.sosnc.com/
For publicly traded companies, annual and quarterly reports are generally available. Information is also available from the Securities and Exchange Commission. For closely held companies, financial information is much more difficult to obtain. Private organizations such as the Better Business Bureau (<http://www.bbb.org/>) and Dun & Bradstreet (fee-based) (<http://smallbusiness.dnb.com/>).
The Leasing Process
It is customary for a landowner to presented with a standard lease. Everything is always negotiable. Landowners are well-advised to retain an attorney familiar with oil and gas leasing to review the documents before they sign an agreement.
The landowner addendum

Common practice is for the landowner to negotiate an addendum that modifies terms in the standard lease agreement. The addendum will usually contain additional terms that were not in the standard lease agreement.
Since gas leases are generally not capable of completion within three years from making, these leases must be in writing. Any oral statements made prior to, or at the same time the lease was signed, are irrelevant to the lease and may not be relied upon. Except for those things that are required by law, the lease defines the entire relationship between the leasing company and the landowner.
Threshold Issues
In North Carolina mineral rights are an interest in real property. The mineral rights may be severed from the surface rights. If this was done years ago a standard title search may not pick up that the owner of the surface rights does not own the mineral rights. Warranting ownership of the mineral rights in the lease is a major potential source of liability.

In North Carolina there is no distinction between mineral and gas rights. Unless a transfer states otherwise, the transfer includes all minerals including oil, gas, and coal. North Carolina had the first gold rush in the United States in 1799. Since that time many transfers have been made of mineral rights.
Most streams in North Carolina have had mill ponds on them at one time, usually in the early 1800s. Some of these transfers may still be valid and impossible to find with a standard title search. In some cases these transfers may affect rights to groundwater as well as surface water. Leases under which the landowner agrees to provide either surface or groundwater can be a source of liability for the landowner. Warranting ownership of the right to use water in the lease is a major potential source of liability.
Gas production compatible with your future land use plans?
Restrictions on land use
Zoning
Conservation easements
Present use value program
USDA/State conservation programs
Factors That Affect Negotiation of Gas Lease
Amount of acreage
Physical features of property
Geologic features of property
Other production/infrastructure in area
Number of companies in area
Natural gas market
Negotiating skills of parties
Hiring an Attorney
Experience with gas leasing
Returns phone calls within a reasonable amount of time. Discuss what is a reasonable amount of time.
Understand the basis of all fees charged by attorney

All of this should be set forth in a written retainer that is the contract between the landowner and the attorney.
Receive a written retainer agreement from your attorney
Typical Clauses
Choice of law

For leases of North Carolina real property this should always be North Carolina law.
Choice of forum (court)

This should be the superior court in the county in which the property is located.
Attorney fees clause (is it one-sided?)
Arbitration clause

Who pays?
How selected?
Terms of Lease Agreement
Parties to lease agreement
Lessor - owner of natural gas rights

Owner of surface estate need not be party to lease agreement. Reservation or conveyance of mineral rights generally conveys all rights, including those to oil and gas. There is a need to have an attorney examine documents to determine exactly what has been conveyed or retained. Mineral rights not extinguished by NC Real Property Marketable Title Act. There is some local legislation (Chatham County, for example) that purports to extinguish mineral rights that have been severed from the surface rights.
The lessee could be an independent landman or broker, an energy company, a drilling company, or other. The lessee will change if the lease agreement is later assigned. Most lease agreements are freely assignable. Landowners should require written notice of all assignments.
The property description should be the legal description of the property. The lessee will generally perform a title search before making any payments.

Implications of lessor providing a general warranty of title to rights to gas or water can have serious consequences if there are any defects in title. Making a general warranty of title makes the landowner an insurer of the rights leased. If there is a challenge to the title the lessor who has made a general warranty of title may have to pay all legal defense costs including attorney fees. The lessor may also be liable to the lessee under a general warranty of title should the title prove to be defective.

Horizontal severance is possible in the description of the property. It is possible to limit exploration to a specific geological strata. It is possible to limit the lease to oil & gas, and exclude other minerals such as uranium and gold.
Length of lease agreement
During this period the lessee explores the property for gas. The primary term is usually short, 3-5 years, although longer terms are found in some leases. If no gas production begins in the primary term then the lease expires. Production activities convert the primary term of the lease to a secondary term. Force majeure such as a hurricane may operate to extend the primary term of the lease. It is common for lease agreements to contain a renewal provision or a right of first refusal. From the perspective of the landowner a right of first refusal is to be preferred. Under a right of first refusal the landowner has the right to seek competing renewal offers from other companies. The lessee under the primary term has the right to match the best offer.
The secondary term of the lease begins when production activities begin and ends when production activities end. Depending upon the terms of the lease the secondary term of the lease may extend for many years, decades or even more than a century. The level of production activity required to maintain the lease depends upon the terms of the lease. Common terms include: “so long as operations are conducted”; “so long as gas is produced”; “so long as gas is produced in paying quantities”; and “so long as a well is capable of production”. Obviously these terms mean very different things.

Leases should generally contain an expiration time limit for shut in wells. A shut in well is one capable of producing but which, for whatever reason has not been brought into actual production. A Pugh clause allows for release of land from the lease for land that is outside the pool.
Payment terms
Bonus Payment

This is a one-time payment to landowner that is paid at the execution of lease agreement or within a short time thereafter.

The amount is negotiable. It is usually expressed in terms of dollars per acre. Reported amounts range from as little as $1 per acre to more than $15,000 per acre.
Delay Rental Payments

Delay rental payments are payments made to landowner at times specified in lease agreement. The obligation to make scheduled payments terminates when a well is drilled.

The amount and number of payments is negotiable as part of the primary term of the lease.
Royalty Payments

Royalties are paid to landowner when natural gas is removed from the land. Royalties are usually calculated as a percentage of gross revenue from gas sales. Production expenses may be charged against royalties. The landowner should use care in accepting a leases that allows expenses of production to be charged against royalties. Royalty terms in a lease are always negotiable.
Shut-In Royalty Payments

These are payments made to the landowner when a well is drilled, but gas is not yet marketed. The amount and circumstances under which payments are made is negotiable.
The lease agreement may provide for the landowner to receive a specified amount of extracted natural gas at no cost. The landowner is generally responsible for transportation of the gas from wellhead to the point of use. The landowner may wish to negotiate to receive a payment in lieu of free natural gas.
Rights granted by landowner/limitations on rights granted
The mineral estate is severable from surface estate. By ‘estate’ we means rights in real property. The lease agreement will specify which products within mineral estate are subject to grant. The lease agreement conveys fee simple determinable title to the specified minerals. By fee simple determinable title it is meant that the lessee owns the mineral rights for so long as the terms of the lease permit. It is also possible to sell or convey a fee simple title in mineral rights. This is a sale, not a lease, of the mineral rights because, at least in theory, the ownership of the mineral rights is never extinguished, and the rights are not expected to become reattached to the surface rights.
The energy company will seek UNLIMITED use of surface estate. The landowner may want to limit the energy company’s use of surface estate. Consider difference between the terms: convenient on the one hand, and necessary on the other hand. The landowner may limit use of surface estate by:

- defining the permitted activities;
- requiring that landowner approve well sites and access roads;
- specifying the conditions under which the land will be reclaimed, and requiring the installation of fencing or gates.
The landowner may require that all water be obtained off-site. The lease agreement should address disposal of water used in drilling process by means such as injection, reuse, and treatment.
The landowner may negotiate a lease agreement that does not permit use of surface estate. The landowner may or may not receive lower payment terms in exchange for a no surface rights lease.
The grant of storage rights can effectively extend the secondary term of the lease. The grant of storage rights should be separately negotiated for additional compensation.
Transportation of foreign gas/Installation of pipelines

The landowner should generally avoid granting transportation rights in lease agreement. The grant of transportation rights should be separately negotiated for additional compensation.
Additional Considerations
Drilling under the property of another without permission is a trespass. However, if the gas simply moves from one property to another, there is no prohibition.
Pooling/Unitization

Royalties are paid on a proportional basis within drilling unit. The lease agreement may provide for a well siting fee. Inclusion of a Pugh Clause can prevent one well from tying up an entire acreage.
The landowner should require indemnity provision in the lease agreement. The indemnity provision should include all costs of litigation that arises as the result of the lease and exploration and production activities. The indemnity provision should encompass environmental harms. In addition to litigation the indemnity provision should cover environmental and other administrative penalties, and rollback and other taxes.
There is seldom a good reason for a non-disclosure (confidentiality) clause. If there is a good reason then the landowner should receive additional compensation. Any landowner signing a contract with such a clause should understand the liability that may arise from violation of the clause. The landowner should understand the types of disclosures prohibited by the clause.
Participation in these programs may limit drilling activities or result in imposition of penalties. The landowner should seek to shift all potential financial liabilities to the lessee.

The landowner should ask, is land to be leased included in USDA or other programs? Are there any incompatibilities?
Access to records/production audits
Increased real estate taxes
Imposition of severance tax
A drilling clause or development clause is designed to prevent a company from holding acreage without making best efforts to develop the property, i.e., holding the property for speculation.
Removal or forfeiture of equipment
Provision for Project Failure/Termination
Insolvency/bankruptcy clause
A bond or escrow may be required in the lease to ensure removal of equipment.
Before or upon signing a lease a review of existing insurance should be conducted.
A review of property taxes, income taxes, and estate taxes should be conducted as there may be issues to address in all areas. Wills and other estate planning documents may require modification to reflect changed circumstances.
Recordation

Does the recorded memorandum accurately reflect the lease?