

Evaluating Oil & Gas Lease Proposals

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April 26, 2011

The author expresses his gratitude for permission to adapt these slides to North Carolina based upon the slide set: Natural Gas Leases: Understanding Your Rights, Protecting Your Interests, Ross Pifer, J.D., LL.M., Director, Agricultural Law Resource and Reference Center, The Dickinson Law School, Penn State.

Any errors are solely the author's.

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

Resources

- **Penn State Cooperative Extension**
 - <http://extension.psu.edu/naturalgas>
- **Cornell Natural Gas Resource Center**
 - <http://cce.cornell.edu/EnergyClimateChange/NaturalGasDev/Pages/default.aspx>

Due diligence

- Broker or drilling company?
- Safety/environmental compliance record
- Litigation history
- Registered to do business in NC?
 - NC Secretary of State <http://www.sosnc.com/>

Due Diligence

- Financial condition
 - Financial statement
 - Third party reporting
 - Better Business Bureaus
 - Dun & Bradstreet (fee-based)
 - <http://smallbusiness.dnb.com/>

The Leasing Process

- Landowner presented with standard lease agreement
- Landowner negotiates additional terms as an addendum to the lease
- Lease governs almost the **entire** relationship between the parties, except legally defined obligations

Threshold Issues

- Can you provide good title?
 - Should the landowner ever provide a warranty of title?
- Are your future land use plans compatible?
- Are there restrictions on your property that are incompatible?
 - Zoning
 - Conservation easement

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

Considerations in Hiring an Attorney

- Landowner should inquire about attorney's experience with gas leasing.
- Landowner must be comfortable working with attorney.
- Landowner must understand the basis of all fees charged by attorney.
- Landowner should receive a written retainer agreement from attorney.

Typical Clauses

- Confidentiality (why?)
- Choice of law (should be NC)
- Choice of forum (generally should be county where property is located)
- Attorney fees clause (is it one-sided?)
- Arbitration clause
 - Who pays
 - How selected

Terms of Lease Agreement

- Parties to lease agreement
- Property description
- Length of lease agreement
- Payment terms
- Rights granted by landowner to energy company & limitations on those rights

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 in NC – examine documents
 - Mineral rights not extinguished by NC Real Property Marketable Title Act
- Lessee
 - Lessee could be an independent landman, an energy company, a drilling company, or other.
 - Lessee will change if lease agreement is later assigned.

Parties (continued)

- Assignability of Lease Agreement
 - Most lease agreements are freely assignable.
 - Landowners should require notice of all assignments.

Property Description

- Property will be described by one or more of the following:
 - County and township
 - Metes and bounds
 - Acreage
 - Tax assessment parcel number
 - Neighboring properties

Property Description (continued)

- Title search
 - Lessee generally will perform a title search before making any payments.
 - Implications of lessor providing a general warranty of title.
- Horizontal severance
 - It is possible to limit exploration to a specific strata.
- Possible to limit to oil & gas, exclude other minerals such as uranium and gold

Length of Lease Agreement

- Primary term
 - Primary term is the number of years defined in lease agreement.
 - Lease agreement ends if production activities do not begin by expiration of primary term.
 - If production activities begin, lease agreement is converted to secondary term.

Length of Lease Agreement (cont.)

- Extension of primary term
 - Force majeure
 - Act of God
 - Renewal at option of lessee
 - Terms of current lease agreement will continue.
 - Right of first refusal (better for landowner than renewal)
 - Lessee has opportunity to match contract offers from other companies.

Length of Lease Agreement (cont.)

- Secondary term
 - Secondary term begins upon the initiation of production activities.
 - Subject to the specific provisions in lease agreement, secondary term can extend far into the future.

Length of Lease Agreement (cont.)

- Secondary term can extend:
 - “so long as operations are conducted”
 - “so long as gas is produced”
 - “so long as gas is produced in paying quantities”
 - “so long as a well is capable of production”

Length of Lease Agreement (cont.)

- Expiration limit for shut in wells
- Pugh clause – release of land outside the pool

Payment Terms

- Bonus Payment
 - This is a one-time payment to landowner.
 - It is paid at execution of lease agreement or within a short time thereafter.
 - The amount is negotiable.

Payment Terms (continued)

- Delay Rental Payments
 - These are payments 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.

Payment Terms (continued)

- Royalty Payments
 - These are paid to landowner when natural gas is removed from the land.

Payment Terms (continued)

- Shut-In Royalty Payments
 - These are payments made to landowner when a well is drilled, but gas is not yet marketed.
 - The amount and circumstances under which payments are made is negotiable.

Terms

- Free Natural Gas
 - Lease agreement may provide for landowner to receive a specified amount of extracted natural gas at no cost.
 - Landowner is generally responsible for transportation of gas from wellhead to residence.
 - Landowner can negotiate to receive a payment in lieu of free natural gas.

Rights Granted By Landowner

- Mineral Estate
- Surface Estate

Rights Granted (continued)

- Mineral Estate
 - Mineral estate is severable from surface estate.
 - Lease agreement will specify what products within mineral estate are subject to grant.
 - Lease agreement conveys fee simple determinable title.

Rights Granted (continued)

- Surface Estate
 - Energy company will seek UNLIMITED use of surface estate.
 - Landowner may want to limit energy company's use of surface estate.
 - Consider difference between the terms:
 - convenient
 - necessary

Rights Granted (continued)

- 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
 - Requiring the installation of fencing or gates

Rights Granted (continued)

- Water
 - Landowner may require that all water be obtained off-site.
 - Lease agreement should address disposal of water used in drilling process
 - Injection
 - Treatment

Rights Granted (continued)

- No Surface Rights Lease
 - Landowner may negotiate lease agreement that does not permit use of surface estate.
 - Landowner may or may not receive lower payment terms in exchange for a no surface rights lease.

Rights Granted (continued)

- Storage Rights
 - The grant of storage rights can effectively extend the lease term.
 - The grant of storage rights should be separately negotiated for additional compensation.

Rights Granted (continued)

- Transportation of foreign gas / Installation of pipelines
 - Landowner should avoid granting transportation rights in lease agreement.
 - The grant of transportation rights should be separately negotiated for additional compensation.

Additional Considerations

- Rule of Capture
- Pooling / Unitization
 - Royalties are paid on a proportional basis within drilling unit.
 - Lease agreement may provide for a well siting fee.
 - Inclusion of a Pugh Clause can prevent one well from tying up entire acreage.

Additional Considerations (cont.)

- Indemnification
 - Landowner should require indemnity provision in lease agreement.
 - Indemnity provision should include all costs of litigation.
 - Indemnity provision should encompass environmental harms.

Additional Considerations (cont.)

- Non-Disclosure Clause
 - Landowner should understand types of disclosures prohibited by clause.
 - Landowner should understand consequences of violating clause.
 - Landowner should not agree to clause unless there is benefit in exchange.

Additional Considerations (cont.)

- **Clean and Green / CREP / Farmland Preservation Programs**
 - Participation in these programs may limit drilling activities or result in imposition of penalties.
 - Landowner should seek to shift all potential financial liabilities to lessee.

Additional Considerations (cont.)

- **Access to records**
- **Increased real estate taxes**
- **Imposition of severance tax**
- **Drilling clause / Development clause**
- **Removal or forfeiture of equipment**

Provision for Project Failure/ Termination

- Insolvency/bankruptcy clause
- Provision for removal of equipment
 - Bond or escrow?

Taxes

- Property tax issues
- Income tax issues
 - Ordinary income
 - Capital gain
- Estate tax issues

USDA Programs

- Is leased land included in USDA programs?
 - Any incompatibilities?

Regulatory Issues

- Securities law compliance
- Real estate law compliance
- Notary public law
- Registration of foreign corporations
- Recordation
 - Terms in memorandum versus lease terms
 - Impact upon titles