

# Basic Considerations in Assessment of an Oil and Gas Lease

Faculty: John Bergin

1. Identification of client ownership rights;
  1. What does your client own? Surface – Minerals – Fee – Other? Do they own a significant or minor interest?
  2. Is the interest encumbered in such a fashion that client benefits are limited or passed along to or shared with another, i.e. Federal crop program / conservation set asides (requiring removal of impacted lands from the program generally having cash penalties and other implications); Deed of Trust / Mortgage requiring diminishment of corpus be shared with lender (requiring subordination agreement); etc.
  3. Risk of reliance upon their knowledge of ownership.
  4. Expense of confirmation of asset.
  5. Expense of not confirming asset.
  6. Your role in confirming current drilling activity / permitting near client's assets.
  7. Is this type of owner appropriate given client's marital, tax, or life status? If not, modify before entering into an agreement.
  
1. Identification of client expectations
  1. Will asset be retained for foreseeable future?
  2. Is there an expectation that asset will be liquidated within primary term of proposed agreement?
  3. Short term benefit? Cash up front - elimination of risk and reward
  4. Long term benefit? Less cash up front – embracing risk and reward
  5. Does client want aggressive production, notwithstanding commodity prices, or more prudent production acknowledging inconsistency of price?
  6. Consider preparing a letter of engagement or like agreement. Include option to secure technical assistance or are you going to do all of this yourself?
  7. Consider preparing a letter of agency or like agreement allowing you to negotiate on behalf of the client. Question: May you negotiate on their behalf OR may you negotiate and enter into the agreement? If the later, a Limited Power of Attorney will also need to be prepared and recorded. Some form of authorization will typically be required before you can enter into negotiations. Companies often hear "I represent all of the mineral owners on Halstead Road" which often turns out to be somewhat less than accurate. Ensure that you and client both agree on your scope of authority to negotiate on their behalf. Yes, it does always go back to simplistic, but fundamental, offer and acceptance. Forging terms accepted by the energy company only to find the client has some "additional thoughts" occurs

**but** is not viewed in a positive fashion by energy companies. You made an initial offer, after good faith negotiation, it was accepted by the energy company, but now you are placed in the position of having to counter an offer that you made AND has been accepted.

As we all know or suspect, when this takes place, the aggrieved party hits the reset button, all things go back to square one, and one of a couple things occur. One is to return to the initial offer while the second is to simply withdraw the entire offer. Your credibility is lost and time seldom allows serious negotiation with one who does not understand “the rules.”

1. Various forms of contracts encumbering surface and sub-surface assets

Brief discussion of the exploration process – Internal geological / geophysical / engineering / land evaluation.

Oil accumulates between layers of the subsurface or in porous rock among other things. The job of the exploration team is to find the right convergence that would be necessary to form an oil pool.

Team members

**A petroleum geologist** uses his or her expert knowledge of geological principles to determine the location and size of crude oil deposits. Some geologists work within a specific geographical area while others tend to specialize in assessment of a specific geological formation.

**A geophysicist** is someone who studies the Earth using gravity, magnetic, electrical, and seismic methods. Some geophysicists spend most of their time outdoors studying various features of the Earth, and others spend most of their time indoors using computers for modeling and calculations.

The geophysicist primarily uses the seismic process to locate oil. Equipment is used to cause vibrations in the earth which are listened to by geophones. The data is processed by computers into dimensional displays that are seismic lines. This data is studied by the geologist to determine locations where oil may be found.

**Petroleum engineers** will determine the most likely locations of hydrocarbon reservoirs, and map the extent of the field. Their reports to the company will include their recommendations for drilling methods, the amount of hydrocarbons contained, and drilling simulation data.

A **Landman** is an individual who performs various services for oil and gas exploration companies. Services include but are not limited to: negotiating for the acquisition or divestiture of mineral rights; negotiating business agreements that provide for the exploration and/or development of minerals; determining ownership in minerals through the research of public and private records; reviewing the status of title, curing title defects and otherwise reducing title risk

associated with ownership in minerals; managing rights and/or obligations derived from ownership of interests in minerals; and unitizing or pooling of interests in minerals.

Historically, oil and gas fields have had a lifespan ranging from 15 to 30 years, from first oil to abandonment. Production can last 50 years or more for the largest deposits. However, with today's technology, wells drilled horizontally through a specific formation tend to have spectacular initial production but can rapidly decline. The gradual or steep decline in production is called a production curve and can easily be created by review of the jurisdictions oil and gas commission or like entity website.

Available information such as well control (wells in geographic area), internal seismic; available seismic; subsurface geological features; surface features enhancing drilling prospects.

1. **Seismic agreement with no lease option** *The seismic survey is one form of geophysical survey that aims at measuring the earth's (geo-) properties by means of physical (-physics) principles such as magnetic, electric, gravitational, thermal, and elastic theories. It is based on the theory of elasticity and therefore tries to deduce elastic properties of materials by measuring their response to elastic disturbances called seismic (or elastic) waves.*
  2. **Seismic agreement with lease option** – Lease to be negotiated later
  3. **Seismic agreement with lease option – Lease to be negotiated now**
  4. **Mineral deed** – Term or perpetual? *“A Mineral Deed typically applies to rights under the land itself. It provides the buyer with the option to extract those minerals, but the deed does not contain title to the surface land or any of the buildings attached to the property.”*
  5. **Royalty deed** – Term or perpetual? A royalty is a payment to an owner for the use of property, in this case, natural resources. *“A royalty deed gives its holder the right to receive a percentage of the profits from the sale of the minerals, if and when they are actually produced. This kind of legal document does not convey all of the mineral rights to the holder, only the right to receive royalties.”*
  6. **Oil, Gas and Mineral Lease – Are rentals required to maintain the lease or is it a “paid-up” lease?**
1. Specific terms and conditions of the “typical” oil and gas lease

1. Date – Question: Do you want the lease to be effective on a specific date or execution date? Tax and other considerations
2. Parties to the agreement –

Ensure that you enter into the agreement using the specific format of your ownership. Best practice is to secure the source deed of client's interest thus avoiding incorrectly naming Lessor.

Lessee should typically be the entity that will drill or manage the well. Insist on having agreement with the ABC Oil Company, not Larry Landman, Agent.

Think the best but expect the worst.

1. Purpose of the agreement –

Do you really want lease to include all matters listed? If not, strike.

While there is an expectation that one would grant some surface rights, ensure that rights are utilized subject to your advice and consent. Specific examples will be addressed in another section of the program.

1. Description of lands – Always use source deed for this description, less any subsequent sales. It is a common practice to fully describe lands then include language along the lines of “As found in Book 123, Page 456 of the Records of King County, State of X.” Insist on the complete description. Do not waiver on this point.

1. Term of lease – Understanding the exploration cycle will help one understand the proposed term of the lease. Early in the cycle, terms will be longer. As the cycle matures, terms become shorter, i.e. what once was five years can become three years or even twelve months. Generally, shorter is better. Rarely would you grant a lease with a term of more than three years. When one hears the phrase “primary term” one is speaking of the initial time period granted to Lessee to perform a specific task. Term is always qualified by inclusion of language along the lines of “...and as long thereafter as oil, gas or other minerals are produced from said land or land with which said land’s pooled hereunder” *or like language*.

It is common for the operator to have an option that can be exercised by the Lessee that the entity may drill a subsequent well beyond the primary term. Additional drilling is always under strictly defined parameters.

1. Bonus The bonus is the money or other form of payment which constitutes the consideration for the execution of the oil and gas lease. The amount of bonus is always negotiable. Knowledge of current market conditions is essential to maximizing your client’s interest remembering foremost that the client may wish to seek a greater royalty and lesser cash bonus.
1. Royalty is the amount of interest paid to the Lessor upon achievement and sale of oil and/or gas and is a significant negotiation consideration. Be prepared for weeping and wailing as you will typically have to counter the proposed royalty provisions.

Basic mathematics affirms that a one-fourth royalty is better than a one-fifth royalty which is better than a three-sixteenths royalty and so on.

Royalty is long term money fraught with risk and reward. The bonus, is short term money with no risk but with little reward.

1. Royalty payments based upon net proceeds or gross proceeds?

Strike any sentence that suggests that you agree to share in the cost of transporting, processing, marketing, or like expense, proportionately reduced or otherwise. Likewise, you want to ensure that you are paid based upon production using meters at the well site, not end user or processor. While there is legitimate loss in transportation, ensure that it is not your problem but the problem of someone than can address the lost product.

1. Limitation to a specific horizon or geological strata. From time to time Ace Oil will have drilled a well and is producing from to a specific formation. In the lease to Ace, you stipulated that Ace could only maintain rights to the depth / formation drilled and produced and was obligated to release all depths below the horizon being produced by Ace. In this case, you could lease to XYZ Oil, subject to Ace's earned rights.

1. Unitization – Normally, unitization is good. Unitization is bad if your lease does not restrict what is maintained by inclusion of a portion of your lease. Limitation of area or horizons are addressed by Pugh Clauses, provisions that will be discussed later in the program.

Units are created by the jurisdictions oil and gas board / commission, or like department within the state the wells are located. There is a logical process involved in creation of units with all parties of interest having an opportunity to support or oppose the proposed action.

The key to any unitization is to protect the correlative rights of mineral owners. The goal is to have enough wells drilled to reasonably and responsibly drain a specific reservoir but not so many that overproduction will diminish the recovered product.

1. Free gas (Lessor) For many years, companies in certain geographic areas would grant the use of a specific amount of free gas to a Lessor typically stipulated for residential use. While many Lessors responsibly used this concession, increasing numbers did not. Over time, lines were piggy backed to allow gas to be used by Lessor's child and spouse in the lot next door and of course, improper connections caused accidents and death so the provisions were slowly removed. In rare cases, they will still exist in leases but I have not seen any for years.

1. Free gas (Lessee) Normally would strike or limit to specific uses and amounts.

1. Free water From time to time Lessee will want to secure a source of water from the premises. This can be as basic as running a line to an existing pond or stream while at other times, Lessee will want to drill a well at its sole expense. This is

another double-edged sword as only the client will be familiar with area aquifers and the pros and cons of allowing a well to be drilled. If allowed, ensure that surface owner can purchase the new water well at conclusion of the drilling activities.

1. Pipelines If Client owns surface, pipelines should be buried at a minimum depth of plow depth plus 36". The lease contemplates that pipelines may be needed to move product to a central collection point. Product **from the unit in which leasehold acreage lies** may be moved by the terms of the lease, but, compensation is required to move product from another unit across the lease acreage.
1. Proximity of residences / barns to drilling pad – Ensure that no portion of the drilling pad is less than 500' from a residence. On a case by case basis, presence of livestock within 500' should be considered. Suggested provisions will be later addressed.
1. Damages caused by operations While most operators will strive to avoid significant disruption to the landowner's operations, it is inevitable that some disruption will occur. There are generally two schools of thought on damages due to disruption or diminishment of asset. One is to have liquidated damages and the other is to assume that the operator will be prudent and that damages, if any, will be amicably agreed upon.

An Operator will typically prefer liquidated damages as a check is simply placed in the mail in accordance with the lease provisions. As a landowner, I would want to ensure that operations are prudent and respect my assets. While contracts are excellent sources of sharing expectations, establishing a positive relationship with the surface owner is the best money that one can spend.

1. Damages to crops Working with the operator will ensure limitation of crop loss. However, should a pad be placed in an active / producing field, do not forget that in addition to loss of crops in the actual pad area, one is also losing the area impacted by having to turn the farming equipment to go around the pad. Think of a flattened football with a square in the middle. The square is the pad and the area on all sides of the square is the lost acreage.
1. Damages to timber Damages to timber is predicated upon "merchantable" timber. When it is necessary to remove timber, it is recommended that operator give landowner a reasonable time to remove and sell the merchantable timber. An offer of two or three times the sales receipt of forcibly harvested timber is a fairly standard practice. Best case is for surface owner to harvest and haul lest timber be placed in windrows

1. Continuous drilling Continuous drilling can occur both during and after the primary term. While from time to time the entire tract will be included in the initial unit, it is far more common that one well will only develop a portion of the acreage. To encourage prudent development, one will include a continuous drilling provision. The continuous drilling provision will provide for ongoing development until all acreage is included in a productive unit or in the alternative, shown to be non-productive and released.

### **Continuous drilling near, at, or beyond primary term.**

*5. If at the expiration of the primary term, oil, gas, or other mineral is not being produced on said land, or from the land pooled therewith, but Lessee is then engaged in drilling or reworking operations thereon, or shall have completed a dry hole thereon within 60 days prior to the end of the primary term, the lease shall remain in force so long as operations on said well or for drilling or reworking of any additional well are prosecuted with no cessation of more than 60 consecutive days, and if they result in the production of oil, gas or other mineral, so long thereafter as oil, gas, or other minerals produced from said land, or from land pooled therewith. If, after the expiration of the primary term of this lease and after oil, gas, or other mineral is produced from said land, or from land pooled therewith, the production thereof should cease from any cause, this lease shall not terminate if Lessee commences operations for drilling or reworking within 60 days after the cessation of such production, but shall remain in force and effect so long as such operations are prosecuted with no cessation of more than 60 consecutive days, and if they result in the production of oil, gas, or other mineral, so long thereafter as oil, gas, or other mineral is produced from said land, or from land pooled therewith. Any pooled unit designated by Lessee in accordance with the terms hereof, may be dissolved by Lessee by instrument filed for record in the appropriate records of the county in which the leased premises are situated at any time after the completion of a dry hole or the cessation of production on said unit.*

Continuous drilling the primary term. Purpose is to include all acreage within a producing unit as quickly as possible, or in the alternative, release the acreage allowing someone else to develop the acreage.

Key elements in the continuous drilling provision are:

1. Reaching a certain depth?
  2. Release of the rig?
  3. Actual sales?
  4. Determination by state regulatory authorities?
1. What action commences the continuous drilling provisions?
  1. What constitutes "drilling"?

1. Commencement of work on a drilling pad?
2. Movement of a rig onto site to drill a preliminary wellbore often referred to as a spudder rig?
3. Movement of a rig onto site that can actually drill to proposed depth? While a spudder rig can successfully drill until bedrock is reached, a significantly more powerful rig is required to successfully drill into the bedrock and beyond. (Think about hanging a picture in sheetrock versus brick or masonry)
4. Commencement of actual drilling

1. Period allowed between rig release or other action listed above and whatever action is required to satisfy operational components. Generally, the deeper the target depth, the bigger the rig, and more complex movement can become. Sixty days can be sufficient and one hundred eighty days can also be reasonable.

1. Is the rig that drilled initial well likely to be skidded over to nearby location or will be rig need to be disassembled and reassembled at the new location?
2. Weather considerations
3. Terrain considerations
4. Pad size and work needed to be done to prepare for moving rig

1. Requirement to drill well to prevent waste Typical language "In the event a well or wells producing oil or gas In paying quantities should be brought in on adjacent land and within 330 feet of and draining the leased premises, or land pooled therewith, Lessee agrees to drill such offset well or wells as a reasonably prudent operator would drill under the same or similar circumstances."

1. Breach of Contract Is the lease void, voidable, or no impact? Remedies and time frames to so remedy?

**Avoid:** "The breach by Lessee of any obligation arising hereunder shall not work a forfeiture or termination of this lease nor cause a termination or reversion of the estate created hereby nor be grounds for cancellation hereof in whole or in part. No obligation reasonably to develop the leased premises shall arise during the primary term.

If after the expiration of the primary term, Lessor considers that operations are not at any time being conducted in compliance with this lease, Lessor shall notify Lessee in writing of the facts relied upon as constituting a breach hereof, and Lessee, if in default, shall have sixty days after receipt of such notice in which to commence the compliance with the obligations Imposed by virtue of this instrument."



1. After the primary term;
2. Lessor to notify in writing;
3. Lessee decides if Lessee is in default;
4. If Lessee finds itself in default it has sixty days after receipt of such notice in which to commence the compliance with the obligations imposed by lease;
5. Question: When is Lessee required to respond? Answer: We will get back to you if we find that we did anything wrong, but thanks for sharing your concerns.

1. Recovery of fixtures It is expected that Operator would have a reasonable time to recover fixtures used in operations.
2. Assignment of Lease **Example:** The rights of either party hereunder may be assigned in whole or in part, and the provisions hereof shall extend to their heirs, successors and assigns.

1. Assignment can occur without your knowledge and you are not entitled to notice
2. Assignment can occur without your knowledge but you must be notified in writing within X days of occurrence, often thirty to sixty days. If this is used, what impact does failure to notify have on the agreement? Void, voidable if not resolved within X period, etc.?
3. Assignment can occur after you have been made aware of the proposed actions and can state reasonable objections to the assignment. Often contains language that the consent may not be unreasonably withheld.
  1. Example: Ace Oil declared bankruptcy and client lost significant revenues.
  2. Example: Ace Oil drilled a well on my lands and did not restore lands.
4. Assignment can be denied for logical or illogical reason.
  1. Example: Ace Oil logo contains a Pegasus and

client's wife ran away with an astronaut.

1. Force Majeure provision Your problem, my problem, or our problem Question: Could this problem have been addressed if Lessee used management tools such as SWOT analysis? Strengths, weakness, opportunities, threats?

**Avoid** "Should Lessee be prevented from complying with any express or Implied covenant of this lease, from conducting drilling or reworking operations thereon or from producing any oil, gas or other minerals therefrom by reason of scarcity of or inability to obtain or to use equipment or material, or by operation of force majeure, and Federal or state law or any order, rule or regulation of governmental authority, then while so prevented, Lessee's obligation to comply with such covenant shall be suspended, and Lessee shall not be liable in damages for failure to comply therewith; and this lease shall be extended while and so long as Lessee is prevented by any such cause from conducting drilling or reworking operations on or from producing oil or gas from the lease premises: and the time while Lessee's so prevented shall not be counted against Lessee, anything in this lease to the contrary notwithstanding.

1. scarcity of or inability to obtain or to use equipment or material
2. or by operation of force majeure
  - Ensure that force majeure is limited to causes outside of the reasonable control of the Lessee. Poor planning on part of Lessee does not fall into the category of "outside of the reasonable control of the Lessee"
  - Lack of available drilling equipment, personnel, or materials can hardly be considered an act of God.

1. Federal or state law
2. or any order, rule or regulation of governmental authority

Y. Shut-in provisions Shut-in provisions are provisions that allow the Lessee to pay a shut-in gas well royalty and therefore keep the lease alive without actual production when and if a well has been drilled which is capable of producing gas in paying quantities but which is shut-in.

A shut-in well is whatever you, through contractual definition, allow it to be. It can contemplate that the well would be temporarily shut-in for routine maintenance; to allow pressure to build thus ensuring higher rates or recovery; lack of market; and any number of creative reasons. As with Force Majeure, ensure that the burden of a shut-in well is equally shared.

A typical provision will be along the lines of "The royalties to be paid Lessee are...an annual royalty of \$50.00 per well on each gas well from which gas only is produced while gas therefrom is not sold or used off the premises, and which such royalty is so paid, said well shall be held to be a producing well..."

5. Additional Provisions - Always

1. Surface operations always to be performed with the advice and consent of landowner, said consent not to be unreasonably withheld
2. Requirement of 72 hour notice of proposed entry upon subject lands. Purpose, who, and expected duration. This allows movement of livestock, gate open/closure etc..
3. Restoration of surface to the purposes in use at time of surface disruption. Specific time based upon season and use of land. Can include specific grasses for reseeding, etc.
4. Limitation on Lessee's ability to assign without notice;
5. Limitation on Lessee's ability to have limitless periods in which the well is shut-in. Significant penalties for unreasonable shut-in tactics;
6. Pugh Clause – Horizontal- Clarity of earned acreage only being horizontal, i.e. severance of a leasehold based upon horizontal planes, i.e. A well drilled under the terms of this lease shall only maintain the lease from the defined top of the producing horizon to 50 feet below the formation in which production is achieved and maintained.
7. Pugh Clause – Vertical - Clarity of earned acreage only being vertical, i.e. severance of a leasehold based upon vertical planes. Lessor has 160 acres of which 40 acres are impacted therefore, the remaining 120 acres must be released at the end of the primary term.

8. Inclusion of both horizontal and vertical Pugh Clauses – Stipulation of when release of unearned acreage must be placed of record.
9. Copy of any Original, Supplement, or Division Order Title Opinion – Redacted to only include subject lands
10. Copy of any matter filed with / response from any governmental agency impacting leasehold
11. Copy of any drilling permit filed within three miles of subject lands
12. Clear definition of what constitutes drilling, completion, and how days between wells will be calculated
13. Ongoing development obligations or one well is sufficient to hold all?
14. Definition of actions of Lessee that will make lease VOID and process by which this finding is made. Non-prevailing party pays for litigation to establish Void lease?
15. Definition of actions of Lessee that will make lease VOIDABLE and process by which this finding is made. Process to remedy, steps resulting in forfeiture for lack of action. Non-prevailing party pays for litigation to establish Voidable lease?
16. Notice required to Lessor within seven days of Lessee placing interest in suspense enumerating basis for suspense. This allows Lessor to “cure” title defect.
17. Required written notice to Lessor upon (a) cessation of production for more than 72 hours and reasons; and, (b) resumption of sales from well impacted by lease, i.e. well is shut-in because of X and second

letter sharing well is now again producing.

18. Provision relating to Nonpayment of Mineral Lease Royalties – Form of written notice; period for Lessee to respond; specificity of written notice; and, burden of Lessee to bear full costs of litigation, if required. Courts have generally adopted the rule that the written notice must be "more than a mere recitation of the lessee's contractual (and in some jurisdictions, statutory) duty to pay royalties."

**No:** On April 1, 2017 we entered into with Ace Oil Company Book 123 page 456, Official Records of Energy County, New York. By this letter you are advised that you have breached contractual duties to timely pay royalties and we want the money you owe us.

**Yes:** We are current holders of a mineral interest under the Ace Oil Company Walter Williams #34, API 123456789, subject to Oil, Gas, and Mineral Lease entered into with Ace Oil Company Book 123 page 456, Official Records of Energy County, New York. We have received no royalty payments for the well for a period in excess of ninety days commencing on January 1, 2017 through April 28, 2017 and by this letter demand accounting for our interest pursuant to §18 C of the aforesaid lease."

5b. Additional Provisions – Case by case

1. Liquidated surface damages for crops, timber, etc.
  2. Plow depth for lines
  3. Non-development provision should tract be less than two acres
  4. Inclusion of all acreage in initial unit or if not, mandated within X days
  5. If a hunting lease is on land, limitation of initial operations until after specific season
  6. If subject to a Federal government set-aside program one will want to be reimbursed for penalty and revenue loss if Lessor lands are removed from the program.
  7. Interference with irrigation in place
  8. Interference with any existing contractual obligation i.e. Have a contract to deliver X linear board feet of veneer quality timber; Lands are a dairy and gates left open allowing cows to escape and as a result daily milk production has been reduced, unable to make contract poundage delivery, and penalties incurred by Lessor.
6. Negotiation strategies – Identification of relevant and less relevant terms and conditions.
  7. When to walk away

Final question: Do you want to place a Memorandum of Lease of record or do you want the lease, addendum and all, recorded?

### **Conclusion**

Practitioner who is from time to time called upon to assess and assist in negotiation of an oil and gas lease, but, whose primary area of practice is not energy related.

