LANDOWNERS RIGHTS IN OIL AND GAS LEASING

Nathan M. Bouray

Ebeltoft . Sickler . Kolling . Grosz . Bouray PLLC

46 West Second Street

P.O. Box 1598

Dickinson, ND 58601

(701) 290 6713

nbouray@eskgb.com

You have an Oil and Gas lease offer. Now What?

- Don't be rushed.
- If you can, figure out what you own, how much, and where.
- Ask around.
- You are not bound by the decisions of other mineral owners.
- If you have any questions or concerns, consult your attorney.

Leasing and alternatives to leasing

- If you own minerals that are to be developed there are three options:
  - Leasing—You allow an oil company to develop the mineral estate. The oil company bears the cost of building the well and operating it thereafter. In exchange, the mineral owner takes a percentage of the gross production he or she would otherwise be entitled to, as well as any bonus payment received at signing.
  - Participating—In this scenario, the mineral owner pays his or her share of the cost of construction and operation of the well, and receives 100% of the net production from the well(s).
  - Non-participation –This is what happens when a mineral owner does nothing, refusing to lease or to pay the proportionate share of expenses. The operator is entitled to deduct the mineral owner's share of expenses from production, as well as a 50% risk penalty; However, the mineral owner does receive a share of the royalty from the commencement of production (weighted average or 16% at operator's choice). N.D.C.C. §38-08-08.

The Terms of the Offer

- The three basic terms of the lease
  - Length—3 to 5 years; Be careful with options to extend; Primary term vs. extended term;
  - Royalty—Your share of production. Can be anywhere from 12.5% to low 20's.
  - Bonus—Received at or around signing. The amount varies considerably from lease to lease, but also most room for negotiation; Based on amount of net acres;
    - Price is dependent on a number of factors including location, type of well, size of holding, actions of other mineral owners in the spacing unit, market conditions, etc;

Other important lease clauses

- Pugh clause
  - Pugh clause named after LA attorney that created this clause for his clients;
  - Pugh Clause releases non-producing minerals upon completion of the "primary term" of the oil and gas lease;
  - Lease that covers minerals covered by different spacing units will be construed as holding all minerals, even non-producing minerals unless this clause is included;
  - So, for instance, we may see a marginal well from the 1950's holding minerals in several other sections that are not producing, but those non-producing sections are in a rich development area for current exploration. Not only will the land owner not be able to do anything with regard to development of those other sections, even if they are developed, the royalty will likely be the same as from the original lease, which typically had 12.5% royalty rates;

Other clauses, contd.

- Vertical Pugh Clause
  - Same idea as Pugh clause, only applies to geological formations of different depths;
  - Protects mineral owner by allowing for leasing of developments discovered in the future, or not developed during primary term of the lease;

Other clauses, contd.

- Continuous drilling operations
  - Most leases include provision to extend lease if operator is in the process of drilling a well upon the end of the primary term, for so long as drilling operations continue, and allowing for gaps of a specified duration;
  - Allows operator additional window of time to begin drilling additional wells if first wells drilled have issues or are non-productive;
  - Key is to allow operator sufficient time to complete wells, but not so long as to drag out the process indefinitely;

Other clauses, contd.

- Warranty of Title
  - Most leases include a provision whereby mineral owner "warrants" title and agrees to defend his or her title;
  - "Warrant" in this context is analogous to a guarantee;
  - There is no benefit to the mineral owner;
  - Even if there were a benefit most mineral owners do not have a sufficient grasp of their mineral holdings to do this;

Ramifications: Lessee may pursue recovery of excess bonus payment if mineral owner warrants title and has fewer mineral acres than were paid;

Other Considerations

- Bonus payment delivery
  - After signing your lease, you will typically be asked to wait some period from 30 to 120 days before you receive payment, during which the lease company will check and confirm title status;
  - You will be asked to send the original lease to the lease company or broker to start this process, and the lease could be recorded during this time, even before you have been paid;
  - Most reputable companies will allow the original lease to be held by your attorney, or some other neutral, until title is confirmed and payment is sent;
  - This prevents your lease being recorded and then the lease company fleeing without paying you your bonus payment.

Top Leases

- A top lease is a lease that takes effect upon the expiration of a prior lease.
- Used by oil companies to prevent gaps in leasehold interests. Usually means there is at least interest in production in the near future, if not plans for drilling.
- Often able to negotiate more favorable terms than upon the original lease.
- Should have language dealing with commencement and termination of prior lease
- Should also discuss division of payment of bonus upon execution/upon effectiveness.
  - May not become effective if production starts before prior lease expires.

Additional Leasing Considerations for Governmental entities

- Government leasing subject to additional statutory restrictions.
  - When acreage is less than the size of the minimum drilling unit allowed under spacing regulations for that field, then normal, private negotiation may be conducted.
  - If the above conditions are not met, then leasing may only be done through advertisement and public bidding or auction; N.D.C.C. §38-09-19.
- Majority of governmentally owned mineral interests in ND are held by Board of University and School lands, and are auctioned for lease by the State Minerals Management division. Results of recent auctions are at http://www.land.nd.gov/minerals/oilandgasleasing.aspx
  - If so, leasing will be done with the State's lease form. Auction is based around the bonus amount. Royalty for these leases is set by the state. Currently at 1/6th, or 16.66%, except for leases in Mountrail, Divide, Williams, McKenzie, Billings, Dunn, and Golden Valley counties, where it is set at 18.75%.

Questions?

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