Evaluating Oil & Gas Lease Proposals

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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

• **Water wiki**

• **Penn State Agricultural Law Resource and Reference Center**
  – [http://law.psu.edu/academics/research_centers/agricultural_law_center/resource_areas/natural_gas_exploration](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.
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