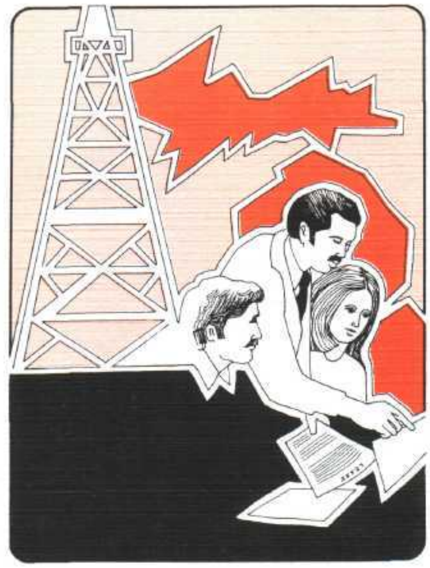
Extension Bulletin E-1615
Oil and Gas Facts #4
March 1982



Oil and Gas Leasing in Michigan: Essential Considerations for Landowners

by William Patric and Peter Kakela, Department of Resource Development

"Is there a 'standard' oil and gas lease for Michigan?" The answer is no, but there are some standard questions to ask yourself and the leaseman before signing.

With oil and gas leasing activity on the upswing throughout Michigan's lower peninsula, a great deal of material has and is being written about leasing. But most landowners are still at a disadvantage when dealing with oil company landsmen. The intent of this bulletin is to summarize available literature and, by doing so, highlight the most important points to negotiating a lease and suggest where landowners can secure more detailed advice.

Key Thoughts on Leasing

1. Read a lease outloud, paragraph by paragraph, with all parties involved present.
2. Don't be in a hurry to sign; don't be pressured into an agreement.
3. Never sign something you don't understand.
4. There is no "standard" lease form; each is an individual contract.
5. All provisions of a lease are negotiable within reason.
6. "Landowners in areas considered 'hot' will have more negotiating power than landowners in areas with unproven reserves" (1).
7. Take time to talk to neighbors considering, or under, a lease to compare your offer with the terms that they have negotiated.

Intent of a Lease

Before considering individual aspects of an oil and gas lease, consider the underlying purpose of the agreement. As Veryl Meyers, a well-known Michigan oil and gas lawyer, states:

> The purpose of the oil and gas lease is to embody and define the relationship between the producer (lessee) and the landowner (lessor), and the rights and duties of each (2).

It gives the producer the right to: (1) explore for oil and gas, (2) produce it from subsurface formations, (3) store it, and (4) transport and market the product. The lease also

> ... defines the period during which its provisions will continue in effect and the terms of compensation to the landowner or mineral owner for the rights to share in the oil and gas produced from his land ... (3).

Clearing Title

Before leasing land for oil and gas exploration, the title to the property must be cleared. The mineral rights to a piece of real estate may have been sold separately from the surface rights (i.e., severed), so ownership can be complex.

How the title is held determines who signs the lease and how. Title holders are responsible for providing clear title to the property leased, but the leasing oil company will usually stand the expense of the costs of "curing" any title defects found, although landowners may be asked to assist in such efforts.

The Granting Clause

Almost any typical oil and gas lease (although there is no "standard" lease form) opens with the granting clause.

> This clause expressly grants to the lessee the right to prospect and explore the leased property by geophysical and other methods and the right to drill and operate for oil and gas (4).

The language of this clause is generally quite straight forward. It is recommended; however, that two key factors be considered relative to this portion of the lease.

1) "With few exceptions, the grant of an oil and gas lease carries with it the implied right to use as much of the surface area as is reasonably necessary to explore and produce the oil and gas."(5) Landowners are advised to either: (a) require their prior written consent relative to the location and construction of individual structures (pipes, storage tanks, etc.) associated with production operations, or (b) insert specific, carefully considered guidelines relative to such structures into the lease.
2) Be sure that the lease covers only oil and gas, or their byproducts as opposed to other mineral types. The terms negotiated for petroleum may fail to serve your best interests

relative to other minerals that may be on your property. The strip mining of coal, for example, may be allowed by some leases being circulated in Michigan that include production of "other related hydrocarbons."

Bonus Payments

Company representatives attempting to lease your land will generally offer an initial one-time bonus payment for signing the lease. This "up front" payment is a great temptation to landowners, especially those in financial need. With rental rates for subsequent years usually low, and with the chances of hitting a producing well on your property typically "less than good," the bonus may be the only real benefit you receive from your lease.

At the same time, however, the bonus should not be overemphasized at the expense of royalty rates or the duration of the contact. "Essentially, it boils down to balancing the 'sure' bonus payment against the chance of a successful well and the high royalty returns a producing well can bring" (6). A producing well could easily yield royalty payments 10 to 20 times the bonus payment in the first producing year alone.

Royalties

Every lease allocates to the landowner, or mineral owner, some portion of any hydrocarbons produced. Terms of this apportionment constitute the royalty clause. In those lucky cases where production occurs, royalties usually comprise the crucial portion of the lease. Most leases traditionally provide the lessor with a 1/8 royalty share. "However, royalty payments can be any percentage that the landowner is able to negotiate, and he or she should not accept arguments that oil companies will refuse royalty percentages higher than 1/8" (7). But remember that by choosing to negotiate for a higher royalty rate you may have to do so at the expense of your bonus payment, and vice versa.

Several points are worth mentioning concerning the royalty clause of a lease.

1) Be sure that it is clear exactly what costs, if any, can be deducted from the landowner's royalty payment. Generally all expenses incurred through production are born solely by the lessee, but this issue should be clear. Royalty shares should be based on gross proceeds or market value "at the wellhead." Especially with gas, "The language 'at the wellhead' is of considerable significance since in numerous instances the cost of gathering and processing the gas and transporting it to a point of sale at a gas transmission line may be considerable" (8).

2) "Sometimes the prices posted at wells or fields are discriminately or artificially set and hence may prove to be substantially less than the prices paid for comparable oil and gas at other locations" (9). Such adjustments of value will obviously affect royalty returns. "To avoid such problems, always try inserting some formula for determining how the market price or value will be established" (10).

3) Another option is to receive your royalty "in kind". This arrangement lets the lessors take actual possession of their share of the physical product of their lease, thereby eliminating valuation problems.

Duration of the Lease

Leases specify the number of years that the agreement shall remain in effect. This is called the primary term. They will generally state that "... if drilling operations are not commenced within one year after the lease is entered, the lease will terminate unless an agreed sum is paid the lessor" (11). This sum is the rental, which "... must be paid on each subsequent anniversary date of the lease's primary term if drilling operations have not yet begun by that date" (12).

If the lessee begins to drill a well before the primary term has expired, the lease will be extended for as long as diligent efforts to find oil or gas continue. Exactly what constitutes such "due diligence" has been a matter of considerable legal contention, however, when lessees appear to procrastinate on the development of their lease tracts.

If exploration or production has not commenced by the end of the primary term, the lease will end. "If production has been established, the lease will continue into its secondary term and last so long as [hydrocarbon or other] substances covered by the lease continue to be produced" (13). Therefore, it is to the landowners advantage to:

1) Keep the primary term as short as possible. "The sooner the lease can be completed, the sooner the lessor has the commitment on his or her property removed" (14). In general, a five-year term might be considered a fair arrangement for both parties in the lease; it allows a reasonable amount of time for drilling, but at the same time encourages exploration to start.

2) Strive to negotiate a higher annual delay rental payment (15).

3) Consider placing a time limit on the shut-in clause. A gas well may be "shut-in," or production legally postponed until gas pipelines are extended into the area, but you can limit this, too.

4) Insert a clause in the lease specifying that if oil is discovered on the leased property, the company will drill on remaining land under the lease or relinquish it at the end of the primary term of the lease (16).

Surface Damages

Oil and gas leases carry the implied right to use as much surface acreage as is reasonably necessary for the development of the mineral interest.

Only when the lessee goes beyond what is reasonably necessary and negligently injures the surface area will the lessee become liable for damages to the holder of the surface estate. Likewise, the lessee is under no legal obligation to restore the surface area to its condition prior to the commencement of operations (17).

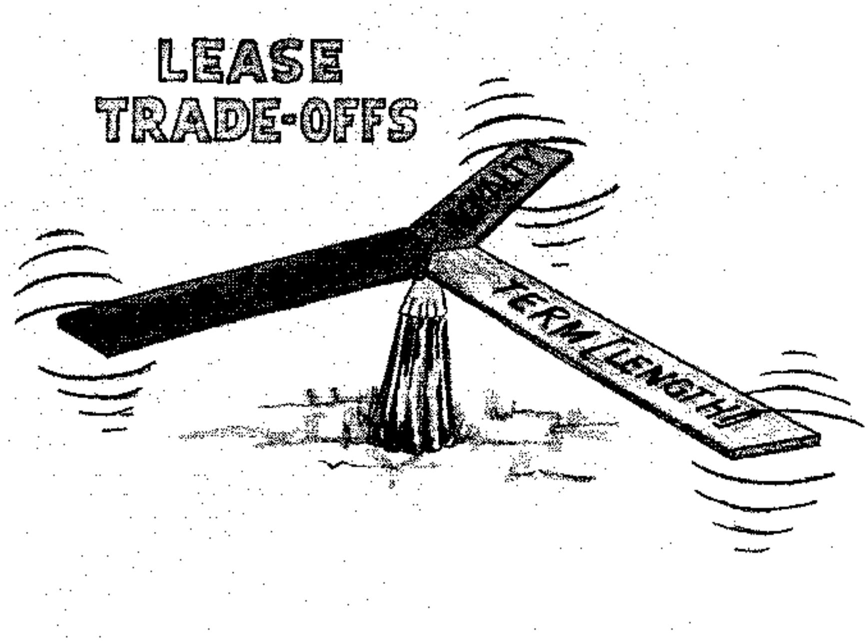
For protection, landowners are advised to insert specific provisions in their leases regarding surface damage. Texas oil and gas lease specialist Judon Fambrough suggests:

1) Full compensation for all surface damages.
2) A requirement for the lessee to restore the property to its condition prior to any development operations.
3) Designation of specific items for which lessees will be liable, and the manner by which costs will be assessed, in the event of any damages (might include crops, livestock, structures, pollution of water, etc.).

Conclusion

This bulletin is not the final word in oil and gas leasing. Instead, it should be a first step in the landowner's prudent effort to take the best possible advantage of what may be a once-in-a-lifetime opportunity. Be sure to carefully think through the "big three" trade-offs of bonus, royalty, and term of lease, and how they can best work for you.

It's a matter of give and take, benefits and concessions. The points discussed, and a great many others that haven't been, are all worth considering before the landsman "comes knocking." Once you've received that first offer, it's time for you to knock on the door of a good oil and gas lawyer and start working out the details of what will best serve your needs.



Considering the major point of an oil and gas lease may seem like trying to balance a three-way teeter-totter.

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Issued in furtherance of Cooperative Extension work, acts of May 8 and June 30, 1914, in cooperation with the U.S. Department of Agriculture. Gordon E. Guyer, Director, Cooperative Extension Service, Michigan State University, East Lansing, MI 48824.

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