Hints on Negotiating An Oil and Gas Lease
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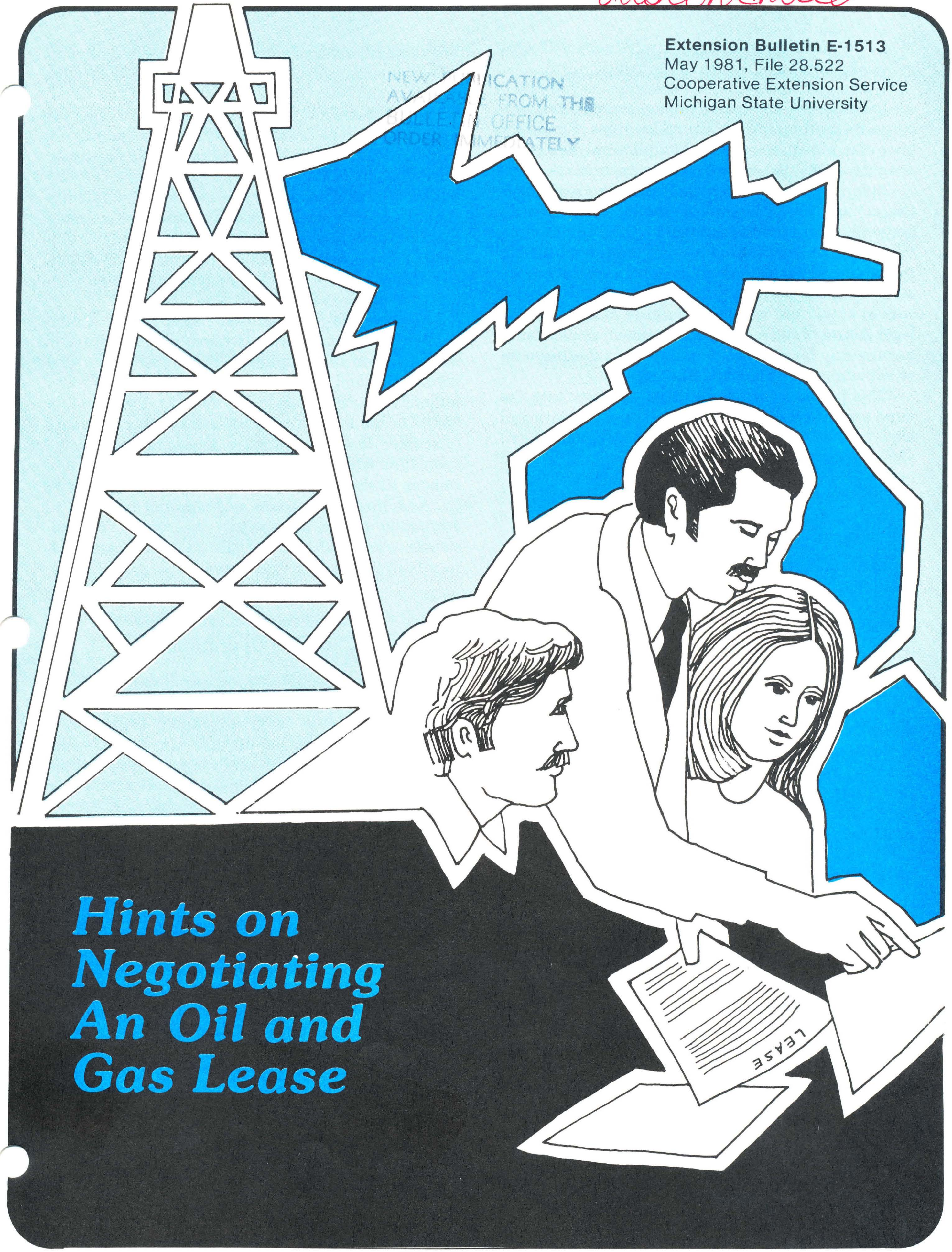

Hints on Negotiating An Oil and Gas Lease

By Judon Fambrough[1]
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Landowners are experiencing a welcomed upsurge in the exploration for oil and gas. Properties once considered marginal or doubtful now are being sought for potential commercial production.

Before any exploration can begin, the landowner (lessor) and the oil company (lessee) must agree to certain terms regarding the rights, privileges and obligations of the respective parties throughout the exploration and possible production stages. The negotiations of these terms may be landowners' first exposure to an oil and gas lease. Because of the complex legal nature of the leasing arrangement, novice landowners may be at a disadvantage when dealing with an experienced landman or oil company.

This bulletin will acquaint non-experts with the more common provisions of an oil and gas lease and explain their legal significance. It will also detail some provisions which the landowner may wish to insert for personal benefit and protection.

Leasing Provisions

There is no standard lease form universally recognized and used by the oil and gas industry. Instead, each company (or independent lessee) has a predrafted agreement which has proven suitable to them in the past. These agreements may not necessarily be in the best interest of the landowner.

Landowners should remember that all provisions of a lease are negotiable within reason. Even though the oil company representative or landman soliciting the lease may not have the authority to make changes, this does not mean certain clauses, or the complete lease itself, may not be altered. However, one's ability to negotiate more favorable terms will vary in each situation. Naturally, landowners in areas considered "hot" will have more negotiating power than landowners in areas with unproven reserves.

The Granting Clause

The opening paragraph of most leases is the granting clause. It will outline the purpose of the lease and describe the substances which can be explored and produced. Typically, the clause will state that the lease is given for the purpose of exploring, drilling, mining and producing oil and gas and all other associated hydrocarbons in whatsoever nature or kind. The more liberal leases state the agreement covers *all other* minerals and other gases and their respective vapors.

Landowners should be hesitant about entering the more liberal type lease. Their concern should not necessarily be with the production of minerals other than oil and gas, but rather with the percentage share that is allocated to them. For example, landowners should expect a greater share from the production of uranium or helium than from carbon dioxide or sulphur. If the lease is silent on this matter, the landowners will receive the same percentage for all minerals that are produced.

As possible alternatives, landowners should explicitly state the minerals covered by the lease to the exclusion of all others, i.e., all petroleum and natural gas and related hydrocarbons and no other minerals or substances in any form [3, Volume 3, p. 786]. Or, landowners may amend the royalty clause (discussed later) to explicitly denote the percentage share they will receive for the production of any substances likely to be found in commercial quantities [2]. And, finally, the lessor may consider inserting an arbitration clause to ascertain the royalty for substances other than oil and gas and associated hydrocarbons that may be discovered.

The Granting Clause and Surface Operations

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. [1]. Oil companies generally desire a much broader usage of the surface area. Consequently, most leases contain provisions permitting a wide range of surface activities.

Even though the lessee may be liable for surface damages, the inconvenience of unwanted and unwarranted structures and entries upon the surface area by the lessee may be avoided to some degree by the following:

1. Do not grant the unrestricted right to construct permanent facilities such as power stations, storage tanks, or employees' quarters. Also, do not grant an unrestricted right for the *surface* disposal of salt water if valuable agricultural land is to be preserved. Instead, state that the prior written consent of the lessor is needed for both the construction and location of such structures and sites [2].

2. Alternatively, attach a map of the proposed lease area specifying where roads, pipelines, telephone lines, salt water disposal sites and even wells may be located. For convenience sake, landowners generally do not permit wells within 200 feet (or some other stipulated distance) of a dwelling. Further, pro-

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vide that all underground transmission devices such as pipelines and telephone lines must be buried below plow depth (or a specified depth) in agricultural areas. If deviations are necessary, permit them only after securing the lessor's written consent [2].

3. Landowners wishing to cultivate or graze the area immediately above any pipelines should direct the lessee to use the double ditch method for laying pipe. This method requires the top soil be placed on one side of the trench and the subsoil on the other. When backfilling, the subsoil is replaced first followed by the top soil.

4. Specify whether the lessee's structures and equipment *must* be removed at the expiration of the lease or be forfeited.

5. Identify the parties liable for the construction and maintenance of fences and gates or similar structures around the premises, pits, drilling sites and above intersecting pipelines. The precise dimensions and characteristics of these retention devices may need to be included to avoid inadequate fences and gates from being erected.

The Duration of the Lease

Leases are divided into two separate time periods. The first period, or primary term, is a set number of years negotiated by the parties during which the lessee must commence drilling operations or pay an annual fee to the lessor. The lease 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. This sum is called a delay rental. Delay rentals must be paid on each subsequent anniversary date of the lease's primary term if drilling operations have not yet begun by that date.

Failure to receive the delay rental payment by the stipulated time automatically terminates the lease whenever the word "unless" is used in the lease to indicate the necessity of tendering the payment. Some leases contain the word "or" rather than "unless." In the latter case the lease will not terminate [3, Volume 3, pp. 8-9].

If production is not established 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 as long as substances covered by the lease continue to be produced. Generally, the full clause will read, "This lease shall remain in force and effect for a term of ______ years (or months) and as long thereafter as substances covered by the lease are produced."

For the best protection, the lessor should consider one or more of the following recommendations:

1. Strive to keep the primary term as short as possible. This should force earlier explorations.

2. If the primary term cannot be shortened, strive to negotiate a higher annual delay rental payment.

3. Make sure the word "unless" is employed in conjunction with delay rentals. Keep a watchful eye on the date by which the delay rental payments must be received. Acceptance of a late payment may be construed as a ratification and the lease will not terminate.

4. Stipulate that the lessee must identify the governing lease and the provisions necessitating any payments made to the lessor. This is an invaluable aid for landowners trying to keep track of several different leases on their land.

Extension of the Primary and Secondary Terms

The primary and sometimes the secondary terms of the lease may be extended contractually via the shut-in provisions, dry-hole provisions or cessation-of-production provisions. Most leases will contain all three.

The shut-in provisions allow the lease to remain in effect (sometimes during both the primary and secondary terms) whenever the *gas* from a producing well is not, for some reason, being sold or used by the lessee. In other words, a well which is shut-in is still classified as a producing well under the lease provisions and the lease will not terminate. Even so, a shut-in royalty (or some other stipulated sum generally approximating the value of the delay rental payment) must be paid annually to keep the lease in effect.

The dry-hole provisions, on the other hand, can only extend the primary term of the lease. Basically, the lease will provide that if oil or gas *has not* been discovered when a dry hole is struck, the lease will not terminate even though the primary term has expired in the interim — if the lessee renews drilling or re-working operations within 60 days (or some other specified period) thereafter. In the event the primary term has not expired and more than fourteen months still remain, the lessee has two *other* options available. He or she can either pay the next delay rental payment which comes due more than 60 days after the dry hole was discovered or commence drilling or re-working operations on or before the same date.

If less than fourteen months remain in the primary term when the dry hole is discovered, the lease will continue in force to the end of the primary term even though the lessee operations remain idle and no delay rentals are paid.

The cessation-of-production provisions correspond quite closely to the dry-hole provisions. The main difference is that the cessation-of-production rules apply *only after* oil or gas has been discovered. Here the lease provides that if oil and gas production should cease for any reason, the lease will not terminate if the lessee again follows one of the three options described in the dry-hole provisions. In this instance, though, there are no exceptions accorded under the fourteen-month rule.

Interestingly enough, it is quite possible for the primary term to be extended indefinitely via the dry-hole provisions. If the lessee has not discovered oil or gas and is in the process of drilling or re-working operations when the primary term expires, the lease will continue in force for so long as the lessee faithfully renews drilling or re-working operations within 60 days after striking each dry hole. However, if a producing well should subsequently be discovered and its production later ceases, the lessee must strike another producing well stemming from operations commencing within 60 days thereafter or the lease will expire. The discovery of a subsequent dry hole will terminate the lease according to its terms.

Most landowners do not have too much quarrel with the dry-hole and cessation-of-production provisions since in both cases oil and gas are being diligently sought. However, landowners may have difficulty accepting the shut-in provisions, especially where no apparent reason for the harboring of gas (or possibly oil) exists.

Due to the energy shortage and the high cost of bringing a well into production, shut-in provisions may not be used as extensively as in the past. Even so, landowners may wish to consider the following alternatives to clarify its possible usage.

1. Make sure shut-in royalties are required during both the primary and secondary terms of the lease.

2. Place a time limit on the shut-in clause — i.e., no more than three years (or some other stipulated time period) or three years beyond the primary term [3, Volume 3, pp. 448-449].

3. Escalate the shut-in royalty for each year the gas or oil is shut in.

4. As an alternative, permit the shut-in clause to continue after a stated period but only for a given number of acres immediately surrounding the well — i.e., 40 acres. The rest of the leased area will revert back to the lessor-landowner. (This provision may be qualified depending on the reasons for the shut-in).

5. Always phrase the necessity of making the payments under the shut-in provisions in optional terms (may or can) and not in obligatory terms (shall or will). In some states there is some precedence to the effect that a breach of the former terminates the lease whereas a breach of the latter does not. The only recourse left to the landowner in the latter case is to sue the producer for breach of contract [3, Volume 3, pp. 434-438].

6. Specify the circumstances when the shut-in clause may be invoked — i.e., for lack of market, available pipeline or government restrictions. As a possible alternative, permit the shut-in when, in the lessee's good faith judgment, it is economically inadvisable to produce and sell for the time being. In light of this latter suggestion, one may wish to extend shut-in provisions to both *oil* and gas.

7. Automatically terminate the shut-in provision whenever a well located on adjacent land, situated within a certain number feet of the leased premises, and completed within the same producing reservoir begins producing and selling gas in marketable quantities [2].

The Royalty Clause

Each lease contains a paragraph which allocates to the landowner a certain portion of the substances produced. These allocations may be stated in terms of market price or value, proceeds or in kind [3, Volume 3, pp. 636-637]. This is the royalty clause. From an economic standpoint, it is probably the most important clause to the landowner.

The terms of royalty clauses vary greatly from lease to lease. Consequently, this clause should receive close scrutiny by landowners. Here are some potential problems to guard against.

First, determine which costs, if any, can be deducted from the landowner's royalty payment. The costs encountered throughout the exploration, drilling, production and marketing stages are divided into two categories: (1) those borne solely by the oil company (producer) and (2) those shared by the landowner.

Generally, all expenses encountered up through the production stages are borne solely by the oil company. Expenses encountered subsequent to production can be either shared or borne solely by the oil company depending on the terms of the lease.

The shared expenses will depend partly upon where the lease fixes the royalty. If the lease is silent on this matter, the royalty is impliedly ascertained "at the well." In such cases, the landowner's royalty payment is free of production costs but bears a proportionate share of the costs incurred subsequent thereto. If the lease fixes the royalty "in the pipeline," "at the place of sale" or at other delivery points, the costs subsequent to production may be shared but there is no uniformity among the states on this point. These subsequent costs may include such items as compression expenses necessary to make the product deliverable into the purchaser's pipeline, expenses necessary to make the product salable, the expenses used in measuring production, and even transportation costs [3, Volume 3, pp. 603-606].

Another problem which the landowner should consider is determining how the royalty payment is valued or received. Three methods generally are used.

The first method is based on the market price or value of the mineral. It attempts to tie the value of the mineral to its current market value, generally at the mouth of the well. In the past, if there was no market at the well, then the market price prevailing in the field was used. And if there was no field market, then the value was determined by sales of marketing outlets comparable in time, quantity, quality and availabilities. And finally, if there were no comparable sales, the actual or intrinsic value of the substance could be used [1].

The market price method has been quite popular with landowners because it allows the royalty to follow the recent upward price trend for oil and gas. However, there are some associated problems of which landowners should be aware when using this method.

Sometimes the prices posted at wells or fields are discriminatively or artificially set and hence substantially less than the prices paid for comparable oil and gas at other locations. In such cases, it may be possible to get a higher valuation for the royalty payments but only after a difficult burden of proof has been met by the landowner in a judicial proceeding.

To avoid such problems, always try inserting some formula for determining how the market price or value will be established. For example, some leases read, "at the highest price (or percentage thereof) posted for a field within 100 miles by any of the seven major oil companies for like grade and gravity on the day the oil is removed."

The second method of evaluating royalty payments is by way of "proceeds." This method ties the value of the royalty to the actual revenue (or sales price) received from the sale of the mineral. As such, the resulting returns may or may not equal the mineral's actual market value as discussed earlier. In the past, royalties based on proceeds have been very popular. This method gave greater flexibility to the producer in marketing the product, particularly gas. By committing gas to long-term contracts, the producer could insure the landowner of a constant, dependable royalty income over time. The disadvantage was that the resulting proceeds were not immediately sensitive to a rising market price.

The third method of receiving a royalty is "in kind." This method allows the landowner to take actual possession of his or her share of the minerals' production before it is ever marketed by the producer. It presents an excellent alternative for dealing with a lease based on "proceeds." By inserting an option to take royalties either "in proceeds" or "in kind," the landowner can get the best of both worlds. Whenever, the market price rises above any long-term commitment price, the landowner can take his or her share "in kind" and seek a more lucrative market outlet. Whenever, the market price falls below any long-term commitment, the lessor's share can be taken in proceeds.

The in-kind in-proceeds alternative is quite attractive to a landowner whenever one or more gas wells or pipelines are dedicated to the highly regulated interstate market. By the landowner opting to take royalty "in kind," he or she can then seek a higher market price on the intrastate market. As a general rule, lessees are hesitant about granting this option unless the lease is in a major producing field. Otherwise, the cost of storage, accounting, delivery and other associated expenses may prove to be economically unfeasible.

Without belaboring any one point, the following is a list of factors which also might be considered when negotiating a royalty clause.

1. Detail the time, place and frequency royalty payments are to be tendered. Outline the consequences for royalty payments being missed.

2. Discuss and resolve whether royalties must be paid for wastes due to leakage, fire or other reasons which can be attributed to the lessee's negligence.

3. Reserve the option to take "in kind" if feasible.

4. Consider an extra royalty (or overriding royalty) based on a sliding scale with any one of several items as variables. For example, have one royalty based on daily or monthly production of less than (x) barrels per day (or month) and another whenever production exceeds this level. (See table 1.) Other variables upon which the scale could be based include such things as whether the substance is free flowing or having to be lifted by artificial means, the price of crude oil in the event domestic price controls are eliminated, or even upon the lessee's recoupment of

Table 1. Royalty Payment Based on Average Daily Production for Each Month

Over	*Not Over*	*Royalty*
-----(barrels)-----		(%)
	110	12.5
110	130	18.0
130	150	19.0
150	200	20.0
200	250	21.0
250	300	22.0
300	350	23.0
350	400	24.0
400		25.0

Source: U.S. Department of Interior Bureau of Land Management. Form 3120-10 (March 1965) all or a certain percentage of the production cost from the well [3, Volume 3, pp. 780-781].

5. Determine if and when the landowner should have access to free gas. Many leases allow the lessor the free usage of gas for domestic (and sometimes agricultural) purposes.

6. By the same token, decide whether the lessee should have free use of water, oil and gas produced on the leased premises.

7. As mentioned in prior sections, do not forget to include any differing royalty percentages for substances other than oil and gas which might be discovered if the landowner should opt to use this alternative.

Surface Damages

As mentioned earlier, the granting of an oil and gas lease carries with it the implied right to use as much of the surface area 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 [2].

For better protection, the landowner should insert some provisions in the lease pertaining to surface damages. For instance, a lease clause requiring compensation for all surface damages will render the lessee liable even though the injuries were incurred during the reasonable development of the mineral lease.

When compensation is required, it is commonly made "at the site" when drilling or production operations cease. In order to avoid any conflicts in this matter, the landowner should consider the following factors whenever negotiating the lease.

1. Require compensation for *all* surface damages.

2. If possible, require the lessee to restore the land to its condition prior to any operations.

3. Describe the method or methods to be employed for determining the extent of damages suffered. In the event the parties cannot agree, provide for arbitration or some other means of resolving the dispute.

4. Describe the items for which the lessee will be liable — i.e., injuries to growing crops, pastures, erosion and stagnation of the soil, growing timber, livestock, fences, ditches, canals, buildings and other structures and the pollution of any waters.

5. Determine if the compensation will be paid annually or in a lump sum. In part, this decision will depend on whether the damages are temporary or permanent in nature.

6. Resolve beforehand how payments will be distributed among the respective owners of the surface estate. This problem mainly arises whenever there is an agricultural lessee on the premises.

7. Designate the time period by which all claims or notices must be submitted to the lessee.

8. Possibly require a bond or an advance payment as security for claims against future surface damages.

9. Whenever someone enters an agricultural lease or purchases surface rights to land void of any mineral interests, he or she should always enter a contract with the owners of the mineral interests stating that a surface damage clause will be included in any mineral lease that is entered. This will insure the lessee or purchaser that any damages to crops, pasture or surface will be compensated.

Pooling

Most leases will contain some provision giving the lessee the right to consolidate the leased premises with adjoining leased tracts. The area thus formed is called a "pool" or sometimes a "unit." The rationale for establishing such pools is to unite under one operator all the landowners having an interest in a common underground reservoir. By doing so, the lessee avoids unnecessary drilling, protects the rights of the landowners in the common reservoir and prevents waste. Sometimes pooling arrangements are necessary to meet the minimum acreage requirement for a drilling permit under state regulations.

In most states, landowners may be subjected to two types of pooling arrangements. One is voluntary; the other is compulsory or statutory. The voluntary arrangement requires the free consent of the landowner and is generally found in the context of most lease forms. The statutory arrangement, on the other hand, is mandatory whenever the specified requirements under relevant state law have been satisfied. By entering either type of pooling arrangement, the landowner may find the interpretation and application of the lease provisions materially altered.

Obviously, there is very little the landowner can do to avoid compulsory or statutory pooling. But, the landowner may find it advisable to exercise caution in granting the lessee the unrestricted right to pool the leased premises. The following suggestions may be helpful in this regard.

1. If necessary, submit to voluntary pooling in the lease only to the extent necessary to get a drilling permit from the state. Otherwise, the landowner's written consent should be required to pool. Do not consent until the landowner understands the full impact of the pooling arrangement on the lease terms, the full description of the proposed pool area and the details on how the boundaries were determined.

2. In order to keep a pool from being overly extensive, stipulate in the lease the maximum number of acres a pool may contain. As a rule of thumb, limit the acreage to no more than that specified in a statutory or compulsory pool in your state.

3. Give some thought as to whether the lessee may alter or change the size or shape of the proposed pool after the landowner has consented.

4. Consider whether the pool is limited to certain producing strata or given for any and all producing formations which may be encountered. Also consider which substances may be pooled — i.e., oil and gas but not coal, valuable stones or other gaseous substances.

5. In all cases, try to negotiate the inclusion of a "Pugh" clause in the lease. A Pugh clause provides for the severance of the lease into separate tracts whenever less than all of the premises are included in a single pool or unit.

A typical Pugh clause will read, "Upon the pooling of less than all of the leased land, this lease shall be severed and considered as separate and distinct leases. The lease term and all the rights and obligations of the lessee under this instrument shall apply separately to the pooled and unpooled acreage" [3, Volume 4, pp. 40-54].

Without a Pugh clause, leases generally have language which *extends* the "leased premises" to all areas pooled with the original tract. Thereafter, if production, drilling or re-working operations are commenced on any portion of the pool (whether on the original leased tract or not), they will be construed as being undertaken on the leased land.

Caution:

By thus including a small area of a larger lease tract in a pool, the lessee can effectively eliminate the need for tendering delay rentals, reduce the proportionate share of royalties to the respective landowners and still maintain the full lease by drilling and possibly establishing production on any part of the pooled area.

6. If possible require all pooling to occur prior to drilling operations and not afterwards.

Assignment Clause

Typically leases contain a provision permitting both the lessor and the lessee the unrestricted privilege of assigning their rights under the lease. To a large extent these provisions are for the lessee's benefit.

A customary practice in the oil and gas industry is for independent landmen to lease a large area and assign (sell) it to an oil company. Consequently, the ultimate developer-producer may not necessarily be the original lessee-negotiator. At times the landowner may find the original lease tract being subdivided among several before-unknown developers. To keep better apprised of such changes, the landowner may seek to incorporate some of the following suggestions.

1. Deny the right of assignment without first securing the landowner's written consent. If this is not feasible, state that any assignment is not binding upon the lessor until he or she is duly notified in writing. The landowner should keep a record of each new assignee for his or her permanent files.

2. Do not release original lessee from liability for a default on any assigned portion of the lease or leased area. Stipulate that a default on any assigned part of the lease is a default on the whole [2].

3. Provide that accompanying each payment there must be an identification of the governing lease (or assignment thereof) and the provisions of the lease for which payment is being tendered.

Warranty Clause

Leases generally will contain provisions binding the landowners to defend their interest in, or title to, the leased premises should a dispute ever arise over ownership. This is known as the warranty clause.

To avoid any possible litigation expenses, landowners should seek to delete any language which infers they will warrant or defend title to the land. Since most oil companies or landmen generally conduct preliminary investigations as to the ownership of mineral interest prior to any lease negotiations, the warranty clause should not be needed anyway.

Lessee's Right to Free Water, Oil and Gas

Landowners should pay close attention to any provisions in a lease providing free water, oil or gas to the producer for operations. Particularly in areas where water is scarce, certain limitations should be placed on these rights. The following suggestions may be helpful.

1. Decide whether free water, oil or gas privileges will be granted to the lessee. If so, stipulate whether the substances may be used for operations conducted both *on* and *off* the leased premises. (These provisions may be incorporated into the royalty clause as mentioned earlier.)

2. Do not allow the lessee to take water from wells, tanks, ponds or reservoirs.

3. Stipulate any water usage by the lessee cannot restrict the supply of water for domestic, livestock or agricultural purposes [3, Volume 3, pp. 582-583].

4. If recovery measures are undertaken by the lessee involving floodwater operations, deny the use of

potable water. State that such water must come from non-fresh sources.

5. If water is to be purchased, state how the marked price will be determined.

Other Factors for the Landowner's Consideration

Without going into detail, the following factors may be considered by landowners when negotiating a lease.

1. If the land contains several producing formations at varying depths, lease each strata independently.

2. Always note in the lease whether the land can be used for underground storage of gas or oil.

3. Always insert provisions allowing free access to books, records, and drilling data accumulated pursuant to operations conducted on the landowner's premises [3, Volume 4, pp. 152-153].

4. If possible, negotiate some provisions whereby the landowner may assume control of the casing in the borehole when operations are abandoned. The casing can then be used to withdraw any remaining gas or extract fresh water for domestic or agricultural purposes [2].

5. Provide that if lessee does not rectify any breach of a covenant contained in the lease within 30 days after lessor gives written notice, the lessee should pay reasonable attorney fees and reasonable investigative costs incurred by lessor in preparing lessor's case for trial.

6. Require lessee to indemnify, save and hold lessor harmless from all claims, demands and causes of actions stemming from activities undertaken by lessee or lessee's assignees, their employees, agents, contractors and subcontractors during operations conducted on the leased premises. As an alternative, require the lessee to post bond and carry comprehensive liability insurance of a specified amount as added security from such claims.

Summary

Negotiating an oil and gas lease requires legal knowledge, foresight and common sense. This article has attempted to apply all three.

No landowner could possibly hope to have all these suggestions included in a lease. The number successfully incorporated depends largely upon negotiating power. Even so, the information contained herein will enlighten the landowner as to some possible alternatives, and if nothing else, foster frank discussion between the landowner and the lessee prior to signing any agreements.

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