Compulsory Pooling
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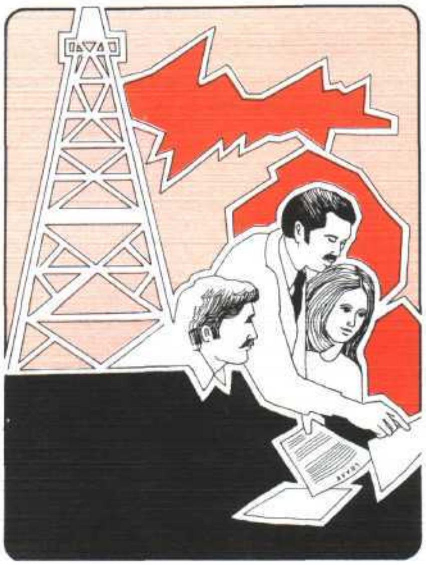

"Can a petroleum company take my oil if I refuse to sign a lease?" The answer is yes, but . . .

Recently there has been talk of a potential Michigan oil and gas boom. Many landowners have been asked to lease their mineral rights for exploration and possible development.

One such misconception concerns compulsory (or forced) pooling. What are the legal options of a landowner who does not wish to lease his or her property for hydrocarbon development?

This bulletin explains the concept of compulsory pooling and related issues. An understanding of the rights, responsibilities, and options entailed in the pooling law (R 229.1205, Act 61, P.A. 1939) should help balance the pros and cons of a leasing decision.

Pooling

Under oil and gas development regulations, small leased land parcels are combined, or pooled, to form a drilling unit. The size of a drilling unit is usually 40 or 80 acres, (although they may be set as large as 640 acres). They are strictly regulated by the Michigan Department of Natural Resources to ensure maximum recovery of any oil or gas discovered.

When the necessary acreage needed to form a drilling unit has more than one owner, separate leases must be brought together in the pooling process to establish a legitimate drilling unit.

Thus oil and gas development does not occur in a scattered, unconsolidated fashion. Pooling provisions insure that revenues

> . . . be allocated between the separately owned tracts in the unit based on each tract's proportionate share of the total surface acreage within the drilling unit. (1)

Such provisions are basically a measure to

> . . . prohibit the location of wells in a manner that would result in unreasonable drainage of oil and gas from adjacent lands. (2)

It is when this minimum acreage can not be pooled on account of one or more of the minority acreage owners refusing to lease, that *compulsory* pooling may come into play.

Petition and Hearing

When landsmen have leased a majority[1] of the acreage needed to form a unit but are unable to assemble all of the acreage required on account of a minority party, who is holding out, a petition for a pooling order may be filed with the State Department of Natural Resource's Supervisor of Wells to complete the drilling unit. Along with legal descriptions of the unleased land in question, the petition must include "certified statements indicating in detail what action the petitioner has taken to obtain a voluntary pooling agreement." (3) Within 30 days after filing the petition a hearing is held in which evidence and testimony is submitted. After due consideration, and recommendations by the Oil and Gas Advisory Board, a decision on the petition is made.

The Department of Natural Resources estimates that there are perhaps a dozen such hearings in any given year, with additional cases of landowners who were reluctant to lease but backed down when it became evident that the issue would be brought to a hearing. Generally the denial of a compulsory pooling petition is extremely rare, as the law is intended to help major owners from being denied their mineral rights by a non-leasing minority interest.

Rights and Compensation

It is very unlikely that any unleased landowners representing the minority of a drilling unit could prevent development of the tract, as there is little doubt about the outcome of a petition to force pool. Still, no drilling or trespassing will occur on the holdout's property, but the oil and gas may be drained away by a successful neighboring well. The holdout party will receive compensation for such drainage, although the financial arrangement may not be as lucrative as those received by more cooperative neighbors.

Holdout Options

Under the rules and regulations of compulsory pooling, the unleased landowner is presented with two options.

[1]The law does not specify a specific percentage of acreage that must be assembled before forced pooling can be initiated. It is assumed, however, that there must be a clear majority (more than 50 percent). In most cases there is no question in this regard, as holdouts typically represent a very small minority of a unit.

Option #1: Pay to the party authorized to drill the well his proportionate share of the cost of drilling, completing, and equipping the well, or give bond for the payment of his share of such cost promptly upon completing the well, whether it is a producer or a dry hole. (4)

This option makes the holdout a full working partner in the venture. Unlike the voluntary lessors in the pool, the working-party-holdout must pay a portion of drilling and operating costs, based on the percent of land he holds within the drilling unit. Should the well prove successful he will make out nicely, reaping his full proportionate share of the value of production. But should the drilling effort come up dry — an event more likely than not — the holdout will still be saddled with his proportionate cost of the endeavor, and none of the bonus payments or rentals that the voluntary lessors received.

Option #2: Await the outcome of the drilling of the well, and if it is a producer, allow the driller . . . to take out of the nonparticipating party's share of production, its proportionate share of the cost of drilling, completing, and equipping the well, plus such additional percent of . . . costs as the Supervisor of Wells may deem appropriate compensation for the risk of a dry hole, plus the nonparticipating party's share of operating costs. (5)

Unlike the first option, the unleased landowner that chooses option #2 pays a proportionate share of the development cost **only** if the well proves successful. In addition he is charged a risk payment, typically around 200 percent of his proportionate costs.[2] The holdout is also penalized with a share of operating costs. With the assessment of these cost burdens beginning after the completion of a successful well the unleased landowner may not begin to receive his working interest compensation for two or three years after production has commenced.

Balancing the Options

The majority of landowners who are being forced to pool choose the second option. Although the holdout's cost payments are smaller under option #1, that choice is generally less desirable because the geologic odds favor a dry hole. This would saddle the landowner with costs and no returns. The first option might be chosen, however, where the chances of success are especially high or where participation in a drilling venture as a full working partner would be a fruitful tax write-off.

Upon the issuance of an order for compulsory pooling, the unleased landowner has ten days to choose between the two options. In the event that the

> . . . nonparticipating party does not notify the Supervisor of Wells in writing within 10 days of his election, he shall be deemed to have elected alternative (2) and the party permitted to drill may proceed with the commencement of the well on this basis. (6)

With either option, the holdout ". . . will be treated as a working interest owner to the extent of ⅞'s of the total interest and as a royalty owner or lessor to the extent of ⅛ of his total interest . . ." (7) This latter royalty interest is, like that of regular lessors, free of any withholding for contributions to well costs. The arrangement is intended to keep the holdout on an equal footing with the other interests in a drilling unit. This provision may need to be updated as a ⅛ royalty figure might be below current royalties for voluntary lessors in some parts of Michigan.

[2]The risk figure varies with the estimated "failure rate" of the geologic formation where drilling is done. The figure has been as high as 300 percent.

Further Financial Considerations

It is the landowner's responsibility to be sure that whatever payments are due under the established compulsory pooling arrangement are received. This becomes especially significant with regard to option #2, whereby payments to the unleased party are not likely to begin for several years after production of a well commences. Larger petroleum companies often operate with many "in house" costs, so it is no easy matter to recognize when costs have been paid and profitable recovery has begun. It is the responsibility of the landowner to be sure he receives his just compensation. The assistance of a bank consultant or accountant may be highly valuable in this respect.

References

1. Meyers, Veryl N. "Rights and Obligations Under an Oil and Gas Lease," *Michigan Bar Journal*, July 1980, p. 437.
2. Ibid.
3. Michigan Oil and Gas Regulations, Act 61, P.A. 1939, R 299.1205.
4. Ibid.
5. Ibid.
6. Ibid.
7. Ibid.

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