Oil and Gas Leasing Basics

by
Trent A. Echard, Esq.
Strassburger McKenna Gutnick & Gefsky
Co-Chair of Oil and Gas Practice Group

Oil and Gas leases are contracts between an Oil and Gas owner (the "**OWNER**") and a leasing company (the "**LEASING COMPANY**"). Typically, the main purpose of an Oil and Gas lease is to allow the LEASING COMPANY to "produce" or "extract" the Oil and Gas from the property. In exchange, the OWNER receives some form of payment, typically a royalty and an up front bonus. This section discusses:

1. **The Parts Of An Oil And Gas Lease**
2. **The Oil And Gas Production Rights That Are Conveyed By A Lease**
3. **The Additional Rights An Oil And Gas Lease May Convey**
4. **How An Owner Is Paid**

❶ THE PARTS OF AN OIL AND GAS LEASE

Modern Oil and Gas leases have five parts: (1) a Standardized Lease Form; (2) an Addendum; (3) a Memorandum; (4) a Payment Document; and (5) an Affidavit signed by the OWNER. Most often, LEASING COMPANIES will present an OWNER with a lease proposal that includes a Lease, a Memorandum, a Payment Document, and an Affidavit. The LEASING COMPANY may or may not provide the OWNER with an Addendum. If the LEASING COMPANY does offer an Addendum, the Addendum may not address all of the OWNER'S concerns. If the OWNER wants to address additional issues, he or she should first try to address the terms in the Addendum. However, it is important to review all of the parts of a Lease carefully.

Standardized lease form: Most LEASING COMPANIES provide a landowner with a lease form that contains the standard terms of the Lease. Most OWNERS consider the standardized lease form to be a starting point for negotiations. Typically, LEASING COMPANIES will not allow any written changes to be made directly on a Standard Lease Form document. Instead, modifications to the lease can be addressed through the Addendum. Occasionally, some terms may be stricken out and initialed.

Addendum: Most LEASING COMPANIES prefer that any modifications to the standard lease be made in a document called an "Addendum." Typically, the Addendum will include a list of provisions that modify the standard lease form. The Addendum will often indicate that it controls over the lease if they conflict. This is typically the place to address virtually any concerns.

Here are some examples of the topics that Addendum clauses can address:

- restrictions on the LEASING COMPANY's right to use the surface
- well pad construction and related payment rights
- pipeline construction and related payment rights
- access roadway construction and related payment rights
- gate construction, maintenance, and access
- royalty payments
- taxes / Clean and Green rollback penalties
- mechanics' liens
- indemnification
- warranties and representations made by the OWNER
- timber cutting procedures and payment rights
- other issues important to the OWNER

Memorandum: In order to protect its investment in a property, a LEASING COMPANY may want to make a public record of the fact that it has obtained a lease. On the other hand, the LEASING COMPANY may not want the general public to know the specific terms of the lease that it has negotiated with each OWNER. Therefore, the LEASING COMPANY may file a short document called a "Memorandum" with the Recorder of Deeds for the County. The Memorandum will let the public know that the LEASING COMPANY has obtained a lease, but the Memorandum does not specify all of the details of the lease.

Payment Document: Generally, a LEASING COMPANY will not pay an OWNER for an Oil and Gas lease until the LEASING COMPANY verifies that the OWNER is the person who owns the Oil and Gas rights. Typically, a LEASING COMPANY will negotiate the terms of an Oil and Gas lease and then perform a "title search" to verify that the OWNER is the correct person to pay for the lease. Often times the LEASING COMPANY will agree to conduct this title search and pay the OWNER in 90 days to 120 days. The terms of this payment are often detailed in a document called an "Order of Payment." Some LEASING COMPANIES use other forms of payments such as "Bank Drafts" or Wire Transfers. Importantly, any documents that contain the payment terms could have important terms related to the LEASING COMPANY's payment obligations. The payment documents might spell out the OWNER's rights in the event that the Oil and Gas Company does not pay in the time specified.

Affidavit: Some LEASING COMPANIES require OWNERs to sign an affidavit along with their lease. Affidavits may require an owner to make a variety of representations about: (1) his or her ownership of the property; or (2) his or her knowledge of Oil and Gas drilling activity on the property. If an OWNER makes a representation in an Affidavit and that representation turns out to be false, the LEASING COMPANY might attempt to seek the return of its payments. Therefore, it is important to review these representations very closely.

❷ THE OIL AND GAS PRODUCTION RIGHTS THAT ARE CONVEYED BY A LEASE

The Basic Right Conveyed: An Oil and Gas lease is a contract. Every lease can be different. From a legal standpoint, each lease can have different consequences to an Oil and Gas OWNER. Generally speaking, most leases will give the LEASING COMPANY two main rights:

(1) the right to ***search*** for Oil and Gas; and

(2) the right to ***produce (extract)*** Oil and Gas if a productive well is drilled.

As discussed below, most leases will also provide the LEASING COMPANY with additional rights.

The Primary Term or Period for "Searching": In most leases, the LEASING COMPANY has the right to "search" for Oil and Gas during for an initial predetermined period of time. "Searching" typically means conducting scientific tests, surveys, or even drilling wells. The initial period of time that is open for searching is called the "primary term." The primary term is typically a specific number of years that the OWNER and LEASING COMPANY agree upon to allow for initial searching before a well starts to produce Oil and Gas. The primary term typically lasts anywhere from 5 years to 10 years.

Extending the Primary Term: Some leases provide the LEASING COMPANY with flexibility to increase the initial searching period by paying additional money before an agreed upon deadline. This is often called an "option" to extend the primary term. Lease provisions governing the extension of the primary term are often strict when it comes to payment requirements and deadlines. OWNERS should review these clauses very closely. Sometimes a LEASING COMPANY's attempt to extend a primary term creates a question as to whether the correct amount was paid and whether it was paid by the correct date. This can result in a dispute placing large amounts of money and important Oil and Gas rights at stake. The OWNER may take the position that the lease has expired because payment was not made in strict accordance with the terms of the extension provision. The OWNER may want to negotiate new, more favorable terms. Meanwhile, the LEASING COMPANY may take the position that the lease is still valid under the previously negotiated terms. (See the DISPUTES chapter for more information). It is critical to evaluate these situations closely.

An OWNER may be required to make important decisions very quickly, and attorneys can be helpful in navigating these situations.

The Secondary Term: The vast majority of leases can be carried over from the primary term into a "secondary term" once gas has been produced by a well. During the secondary term, the LEASING COMPANY will typically have the right to produce gas from a well that it has drilled. In many leases, the LEASING COMPANY will continue to have the right to search for Oil and Gas.

Most leases allow the secondary term to last "as long as" gas is being produced in sufficient quantities to be profitable. That can translate into decades or even longer. Importantly, leases may be carried into the secondary term by engaging in other activities aside from actually extracting oil or gas. Each lease will specify exactly which activities are sufficient to convert the lease from the primary term into the secondary term. In some leases, these activities could be as minimal as surveying the property, applying for a permit, or excavating ground for a well site. Other activities that might extend a lease into the secondary term could include storage of gas under an OWNER's property (for which the OWNER might not receive lucrative production royalties). Importantly, a LEASING COMPANY may try to rely on these activities to hold a property under lease for a very long time. However, many of these activities might not result in the payment of royalties to the OWNER. OWNERS should review all lease terms closely to ensure that they are acceptable and consistent with their personal objectives.

It is very important to review leases carefully to see what conduct could extend a lease into the secondary term. These terms are important when entering a lease. Once a lease is in place, it is not always clear whether the secondary term has been triggered or whether it has expired. That analysis can require a detailed review of: (i) the entire lease; (ii) the drilling and production history for the property; and (iii) the related legal rules governing Oil and Gas leases.

❸ OIL AND GAS LEASES MAY TRANSFER MORE THAN OIL AND GAS RIGHTS

Importantly, an Oil and Gas Lease may give a LEASING COMPANY more than the right to drill for Oil and Gas. Many lease proposals contain "standardized" provisions. If those standardized provisions remain unchanged, they often provide the LEASING COMPANY extensive rights. Some of those rights are discussed below.

Surface Use Rights: Of course, a LEASING COMPANY needs to drill a well to extract Oil and Gas. With modern horizontal drilling techniques, however, the well does not necessarily need to be on an OWNER's property. Therefore, not every lease needs to include the right to conduct "surface operations" on the OWNER's property.

OWNERS should know that the standard provisions in many leases may allow LEASING COMPANIES to construct well pads, access roadways, pipelines, pits, ponds, power lines, drainage facilities, compressor stations, and many other types of facilities. Typically, LEASING COMPANIES are willing to pay more in exchange for the right to conduct these activities on an OWNER's property. However, if these types of activities would interfere with the OWNER's use of the property, then the OWNER should review these clauses with particularly close attention. The OWNER should be prepared to accept less money in exchange for restricting the LEASING COMPANY's rights to use the surface of the property.

Underground Storage Rights: LEASING COMPANIES may also seek the right to store gas underground. Natural gas is typically found in underground rock formations. Once all of the gas has been removed from a rock formation, it leaves empty spaces. A gas company can pump gas back into those spaces for storage. The storage process typically works in a cycle like this:

(1) during the summer months, gas is extracted from rich shale reserves (like the Marcellus Shale);

(2) gas is then stored in depleted sandstone reserves (i.e., old shallow wells);

(3) when cold winter months arrive and gas is needed, it is pumped out of the storage areas.

Importantly, under some leases, underground storage activity can go on for a very long period of time without the OWNER receiving lucrative production royalties. OWNERS should carefully review which underground storage rights, if any, they convey in a lease. OWNERS should consider what benefits they receive in return for underground storage rights.

Pipelines and Waterlines: Some Leases include language that would give the LEASING COMPANY the right to construct pipelines and waterlines. It is important to review these terms for important issues, like:

- Which gas can be moved through the pipelines? (i.e., Is the pipeline being used for the benefit of ***this*** property?)
- How big will the pipeline right of way be?
- Where will the pipeline right of way be located?
- How will the pipeline right of way be maintained?
- What compensation will be paid for the right of way?
- How long will the LEASING COMPANY have the right to use the right of way?

OWNERS will often prefer to exclude a general right to construct pipelines from their Lease. They will often attempt to negotiate the terms of a pipeline right of way in a separate agreement.

Injection Wells: Many standard lease forms allow for the right to drill brine injection wells. This activity causes some OWNERS concerns with regard to property value, potential liability, and potential environmental impact. Again, OWNERS should be careful to review which rights they give and which benefits they receive in return.

4 PAYMENT FOR OIL AND GAS LEASES

Modern Oil and Gas leases typically provide for three types of payments:

1. an upfront bonus payment;
2. royalties;
3. other payments for the use of the property.

Upfront Bonus Payments are typically negotiated with the lease. After the LEASING COMPANY confirms that the OWNER actually owns the Oil and Gas, then it will pay the upfront bonus. The procedure for making an upfront bonus are usually set forth in a document called a Memorandum of Payment. The document will state that the LEASING COMPANY has a set period of time (usually 90 days to 120 days) in order to confirm that the OWNER actually owns the Oil and Gas. After that period, the LEASING Company will pay the bonus by check or wire transfer. There are other methods for paying bonuses, but this method is the most common.

The amount of the upfront bonus payment can depend on a variety of factors. For example, if a lease gives the LEASING COMPANY the right to use the surface for drilling, the upfront bonus is typically higher. Other factors that can push bonus payments up include: a strong oil and gas market; nearby wells with established production histories; and several landowners with adjoining properties who are willing to work together to negotiate a lease. Some factors that can push bonus prices down include: local laws that restrict drilling activities; a lack of access to pipelines; or a poor market for oil and gas.

Royalties are paid as a percentage of the value of the oil and gas produced. Importantly, costs are associated with producing oil and gas. There are costs necessary to bring the Oil and Gas to the surface of the ground. These are known as “preproduction costs.” They usually include the costs for drilling a well. Many leases do not deduct preproduction costs from royalties.

There are also costs associated with getting the Oil and Gas from the surface to the point where it is sold. These are called “postproduction costs.” Many leases allow a LEASING COMPANY to subtract postproduction costs from the royalties that are ultimately paid to an OWNER. These postproduction costs can include the costs of separating gas from water, compressing the gas, and transporting it in a pipeline to where it is ultimately sold. Once the gas is ultimately sold, the LEASING COMPANY may subtract its costs in order to determine what the gas was worth when it came out of the ground. The LEASING COMPANY may pay the OWNER royalties minus the postproduction costs.

It is important to review a lease and evaluate what costs can be deducted. It is also important to review the manner in which a LEASING COMPANY is entitled to account for its costs. There are many different ways of accounting for costs. It is important to understand what protections the lease provides and what protections the law provides.

Other payments are often made for use of the property. For example, when a LEASING COMPANY installs a well pad or an access road, it will often pay the person who owns the surface for the damage to the property. Sometimes the amount of the payment is negotiated beforehand in the lease. Sometimes, the parties agree that they will negotiate the amount later.

Trent A. Echard is admitted to law practice in PA, OH, and WV. He is the Co-Chair of the Oil and Gas Practice Group at Strassburger McKenna Gutnick & Gefsky. Trent can be reached by email at techard@smgglaw.com or by phone at (412) 281- 5423 (Pittsburgh) or (724) 836-5423 (Greensburg). This article is for informational purposes only. If you have questions about an oil and gas matter, you should consult a lawyer.