

Colorado Landowner's Guide

Essential Elements of a Protective Oil and Gas Lease

or... why you should never sign a standard industry lease.

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For most landowners, the investment in their home and property is one of the largest investments they have. Yet, far too often, landowners threaten that investment by signing a lease or surface use agreement without consulting an oil and gas attorney.

Like any business deal, both parties signing an oil and gas lease are hoping to receive some benefit from the transaction. The landowner (mineral owner) wants to receive maximum return for the extraction of his minerals, the oil and gas company wants to get access to those minerals as cheaply as possible with the least number of restrictions to drilling and development.

The standard 88 lease is the oil and gas companies' opening offer. It is the minimum they think they can offer without being insulting to the mineral owner. If you do not negotiate for better terms in the lease, you will be leaving money on the table, as well as possibly jeopardizing the value of your land.

Leverage in Negotiating with the Oil and Gas Industry

What the industry does not want landowners to know is that **landowners do have significant leverage in these negotiations**. If you own your mineral rights, you have something of value that the oil and gas company wants. You can negotiate the bonus payments, royalties, the protections for your land... nearly EVERYTHING IS NEGOTIABLE.

The ways to increase your leverage are: educating yourself about your rights and how much they should pay to access your minerals, joining together with your neighbors to increase the acreage you have in the negotiations, and obtaining legal counsel.

Working with your Neighbors: Landowners with mineral rights have the ability to negotiate fair compensation and protection of their land. Landowners can increase their leverage by banding together with their neighbors to negotiate better compensation and surface protections for their entire neighborhood. More acreage = more leverage.

Legal Counsel: Landowners often feel overwhelmed or helpless when first approached by the industry. Industry representatives can leave the landowner feeling like they have no option but to give the industry access to their minerals, or permission to drill on their land. To have equal footing in these negotiations, it is often helpful to have the assistance of an oil and gas attorney who has experience representing land and mineral owners.

Oil and gas law is a specialized area of the law. An attorney that has experience representing landowners and mineral owners in oil and gas transactions will have a better sense of what fair compensation is for mineral rights in the area and may be able to "shop around" your lease to a number of oil and gas companies to find the best terms. An oil and gas attorney will also know the clauses of the lease that must be removed, or added, to protect you and your property.

Negotiations as a Land and Mineral Owner

When the oil and gas industry believes that there is oil and gas under a property, the mineral owner for that property may be approached by a landman to sell or lease those mineral rights. Landmen are professionals that research mineral ownership and negotiate the purchase or lease of mineral rights from willing owners. Some landmen work for the oil and gas operators directly, some work for independent subcontractors who will then transfer the leases they negotiate to oil and gas companies for a profit.

Landmen have a code of ethics but experience has shown that it is not always upheld in practice. One questionable tactic that a landman might employ is to attempt to play one mineral owner against another. A landman may tell a mineral owner that the bonus payments and royalty rates they are offering are much higher than they are offering anyone else. A landman may also state that other neighbors have already signed leases. These statements may be untrue and can build mistrust among neighbors. Landmen may also threaten to “force pool” mineral owners who are unwilling to lease or sell their mineral rights. These are often empty threats that are only meant to intimidate mineral owners who do not immediately sign the first lease presented to them.

Selling mineral rights is a dangerous proposition for any landowner. Landowners who sell all of their mineral rights have sold away their ability to be able to place conditions on how the minerals are extracted, and have forfeited their share of any monetary benefit from the resource extraction. A more common approach is to **lease** the minerals to an oil and gas operator.

The oil and gas landman’s standard industry lease should be rejected outright. The industry’s standard leases and surface use agreements are not specific to the needs of the landowner and are written to protect the industry, not the landowner.

A Protective Lease

A “protective lease” is one that gives 1) fair compensation for access to your minerals, 2) fair lease terms, and 3) protection of your land through a surface use agreement. Below is a list of clauses in a standard lease as well as other clauses that you will want to consider to make your lease a “protective lease”. This is a *partial* list of issues a landowner should consider when negotiating a lease. Again, it is extremely helpful to have the assistance of an experienced *oil and gas* attorney when negotiating a lease.

1) Fair Compensation

Note: The going rate for bonus payments and royalty rates are very dependent on location and market. If there are some very productive wells nearby, the value of your minerals will rise. If the price of oil continues going up, even marginally-producing areas may be attractive. On the other hand, if a well drilled near your property is a dry hole, then the value of your minerals will drop precipitously. The price of gas is so low that even high-producing wells are being shut in.

STANDARD LEASE PROVISIONS

- **Bonus payments for signing the lease** - A bonus payment is money paid as an incentive for simply signing the lease. The bonus payment is set to an amount of money per mineral acre. Bonuses in Colorado over the past few years have ranged from \$6,000 / acre to \$150 / acre – depending on the location, market price, and number of acres being leased. The more acreage that is being leased— the higher the bonus payment. The money is typically paid within 60 to 90 days of signing a lease.
- **Royalty payments** - Royalty payments are a percentage of the production that comes from a well. A mineral owner who has 10 mineral acres within a 100-acre drilling unit has a 10% interest in that well. The lessor will receive a percentage, in the form of a royalty, of that interest. Thus, if the lessor has negotiated a royalty of

18.75% the amount they will receive will be 18.75 % of their 10% interest in the well... or 1.875% of the profits from that well. The royalties are paid without accounting for the costs of drilling the well or most production costs. The lowest rates in Colorado are 15% (on the eastern plains) but can go as high as 20% (1/5).

MODIFICATIONS TO REQUEST

- **Removal of “post-production costs” clause** – Lessors need to be careful about provisions in standard leases that permit royalty payments to be reduced based on post-production costs including treating, processing and transporting the gas taken from their property. This provision can reduce the effective royalty rate by 5%. There is usually no post production costs associated with oil production – just gas.
- **Request Independent Audits** – Mineral owners with a lot of acreage should attempt to negotiate the right to have a third party confirm the gas company's actual production figures for each well. The lessor should at least have the right to review the oil and gas company's records related to production and operations under the lease.
- **Request payments for pipelines placed over or under your property** – An oil and gas company is allowed to place pipelines on a lessors property for gas produced on that land. But if the oil and gas company is attempting to place pipelines over land that serves other mineral interests on adjacent properties, the landowner should be provided additional compensation.

2) Fair Lease Terms

- **Length of your lease** - The length of time that an oil and gas lease remains in effect can have a significant impact on the lessor's ability to negotiate and receive market-rate compensation. The typical oil and gas leases provide for a *primary term* and a *secondary term*. The *primary term* is the initial fixed term (usually three to five years). This is the period of time during which the industry must drill a well. If a well is not drilled during this time, the lease expires. The mineral owner is then free to negotiate a new lease – including a new bonus payment. The *secondary term* is the period of time the land is in production. This term lasts as long as the wells on the property are still producing in paying quantities.
- **Renewals of your lease, and rates for renewal** - There are a variety of ways for a lessee to extend or renew the primary term, whether automatically or through an option. These provisions in the lease must be read and negotiated carefully. The typical renewal provision is one to two years in length and requires repaying the original bonus amount.
- **Warranty Clause** - The warranty clause of the oil and gas lease obligates the lessor to defend title to the mineral property leased if it is questioned. The lessor could incur substantial legal expenses in the event of such title disputes. The oil and gas industry employs legions of landmen to search title records. Mineral owners should avoid legal exposure by removing the language or adding a provision that expressly states the mineral owner gives no warranty of title.

3) Surface Protections

*The standard industry lease will contain a provision that give the oil and gas operator the right to, “unimpeded ingress and access to the leased lands, and the **right to use so much of the surface, and at such locations, as may be necessary or convenient for lessee's oil and gas operations.**” TRANSLATION: under the standard industry lease, the operator may use as much of your surface as they wish. To avoid that, you should consider adding the items in a SURFACE USE AGREEMENT that is attached as part of your lease. Once the lease is signed, you have lost much of your leverage to demand protections of your surface. If the operator is unable or unwilling to negotiate a surface use agreement at the time the lease is signed, a provision should be added that states, “Any entry or location of facilities on the surface property is forbidden without permission granted through a separate surface use agreement.”*

Here is a sample of issues a landowner may want to include in a surface use agreement:

- **Location of the well(s)** – Does the well *have* to be on your property? Directional or horizontal drilling technologies allow the drilling rig and well pad to be placed several thousand feet away from the

underground target the operator wants to produce. If the well or other oil and gas facility must be located on your property, consider the truck traffic, noise, and odors of the industrial facility. Choose a location that will be least obtrusive to yourself, and your neighbors.

- **Multi-well pads** –If there will be multiple wells in the area, operators have the ability to co-locate wells on a single well pad – thereby minimizing the impacts to the surface. However, these facilities are larger, and create more air emissions and nuisance (noise, traffic, light) and longer drilling times. If allowed, multi-well pads should be located far away from homes. I recommend at least 2,000 feet.
- **Location of roads and vehicle access** – Can the well be drilled near an existing road? Are there places where you would like the industry to build a road?
- **Transportation plans** - It may take over 2,000 round trip truck trips to drill a well. Once the well is drilled, the industry monitors the well at least once a week. In some cases, this monitoring can be accomplished remotely through supervisory control and data acquisition (SCADA) systems.
- **Additional equipment and facilities** - Will you allow additional production facilities such as oil and gas processing, compressor engines, or temporary worker housing on your property? Will you allow regional pipelines on your land? You should charge extra for regional facilities to be placed on your land.
- **Limiting surface disturbance** –How much acreage will you lose access to? Using an existing surface well site location or access road can avoid the impacts of new construction. Operators may be able to reduce the size of the well pad or to limit the width of the access road.
- **Interim reclamation** – What will the land look like when they are done? Operators should prepare a plan to control noxious weeds and undesirable species in disturbed areas. When the drilling is complete, the well site should be reduced to the minimum needed to maintain the well. All other areas should be reclaimed with native species or a seed mix recommended by the landowner. It is a good idea to take pictures of the land before the oil and gas company clears the land and moves in equipment.
- **Pits** – Will you allow waste or production pits on your property? All pits eventually leak into ground water and should be avoided if at all possible. The best operators have gone to “pitless drilling” systems that use holding tanks rather than pits to hold drilling fluids and flow-back from fracking or produced water.
- **Waste disposal** – How will liquid and solid waste be disposed of? Will you allow waste pits or require closed-loop systems? Some operators try to convince landowners to allow them to “land farm” their drilling muds. This is generally a bad idea because even drilling muds approved from such use come out of the hole with naturally occurring petroleum and other drilling products that are toxic to soil.
- **Ground water impacts** – Are you on a water well? Collecting and analyzing water and gas samples from existing water wells or springs before and after drilling is now required in most cases.
- **Noise impacts** - Will the facility create noise? Most noise can be reduced through the use of electric motors, mufflers, locating or orienting motors or compressors to reduce noise, or installing insulated buildings or sound barriers.
- **Dust impacts** –Industry is usually willing to water roads to control dust during drilling operations.
- **Visual impacts** – Are there views you would like to protect? Would you prefer that the well is screened behind a berm? Will there be lights during drilling and after the well is drilled?
- **Water rights** - Will the operator be using water taken from the property?
- **Fencing** –Installing security fencing around wellheads and production equipment can help protect residents or livestock and contain surface impacts to a limited area.
- **Damages** – How will the landowner be compensated for damage to the property?
- **Timing** – Will the timing of the operations disrupt agricultural uses for the property? Is the area used by wildlife during certain times of the year?
- **Current use** – Are there current or future uses of the land that must be accommodated by the operator?
- **Other requirements** – Absolutely anything can be added in a surface use agreement. What makes your land special to you?

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