

Explanation of Oil and Gas Leases in West Virginia

What is an oil and gas lease?

An oil and gas lease is simply a contract between a mineral owner (who may or may not own the surface of the land) and an oil and gas developer which grants the developer certain rights necessary to explore for, develop and produce oil and natural gas from subsurface geologic formations. In return for granting these rights, the mineral owner receives various forms of compensation and benefits.

Generally, the oil and gas developer is represented by a "landman" that has done title work in the county courthouse to determine the ownership of the minerals and whether or not the land is already subject to a lease. The landman will contact the owner of unleased mineral tracts, and will attempt to negotiate a lease. The landman will generally offer a preprinted lease form containing the terms he is offering. These terms are generally negotiable.

A landowner is NOT obligated to sign any lease. It is VERY important to have the lease reviewed by someone with expertise in oil and gas leases, and preferably a competent attorney with oil and gas experience before signing. (It is important to select an attorney with oil and gas experience! You don't go to an optometrist for a toothache. Lawyers, like doctors, have areas of specialization, so get an oil and gas lawyer!)

While the company may or may not ultimately drill on the property after the lease is executed, if you own the surface of the mineral lands, signing a lease may be viewed as an encumbrance on the property and could effect the property and its value. Consider these matters before signing a lease, especially if you own the surface lands:

What do these oil and gas lease terms mean?

- **Lessor** -The owner of the minerals that grants the lease.
- **Lessee** -The oil and gas developer that takes the lease.
- **Primary Term**-Length of time the Lessee has to establish production by drilling a well on the lands subject to the lease. Generally, primary terms run from one to ten years.
- **Secondary Term**-Generally, if a well is completed within its "Primary Term", the lease is extended "for so long thereafter as oil and gas is produced". That period of time after the well is completed and after the Primary Term has expired is called the "Secondary Term", although the term is not widely used.
- **Delay Rental**-Annual rental payments made by the Lessee to the Lessor for the privilege of deferring drilling, generally an amount per acre.
- **Bonus**-A payment made at the execution of the lease, which is generally computed on a per acre basis. This is sometimes in lieu of the first year's "Delay Rental", but not always.

- **Royalty**-The share of the production or production revenues payable to the Lessor. Historically in Appalachia, this was one-eighth (1/8th), or 12.5%, of the gross amount produced and/or sold from the leased premises, without deductions for any production costs. Recently, higher royalties have been paid. However, some royalty provisions in leases provide that the Lessor may deduct severance or other taxes and gathering fees from the gross before royalties are calculated. So a higher royalty percentage calculated on net may be less than a lower royalty percentage calculated on gross.
- **Shut-in Royalty**-A payment in lieu of other royalty payments required to maintain the lease in the event a well is shut in for maintenance or due to the lack of a satisfactory market. Note: If there are multiple wells on a given lease, and any remain in production, shut-in royalties may not be required depending on the specific provisions of the lease.
- **Termination**-Occurs at the end of the primary term if no production is established during the primary term or when production ultimately ceases during the secondary term. Generally, if production ceases, the lease will provide for some additional period of time for the Lessee to re-establish production.
- **Pooling (or Unitization)**-Some leases include "pooling" or unitization" provisions which allow the Lessee to designate all or a portion of land covered by one lease with all or a portion of lands covered by other leases for the purpose of creating a drilling "unit" or "pool". In that event, royalties are paid to the respective Lessors on the basis of how much acreage from each lease has been included in the total leased acreage. For example, if 40 acres of a 100 acre lease is combined with lands from other leases to form a pool or unit containing a total of 160 acres, the owners of that 100 acre lease would receive 25% (40 acres /160 acres) of whatever royalties were generated by any well drilled on the pool or unit.
- **Warranty**-A warranty is a guarantee by the Lessor to the Lessee that the title to the property is good and marketable, and clear of any title defects. There are two principal types of warranty. 1) A "General Warranty" means that the Lessor is guaranteeing the title unconditionally and forever. 2) A "Special Warranty" means the Lessor is guaranteeing that it has not done anything to encumber the title since acquiring the property. A lease does not have to contain a warranty clause.

Things to consider before signing a lease

Everything is negotiable! Some lease provisions may be even more important if you own the surface of the lands. The following are general items to consider in negotiating an oil and gas lease:

- **Location of well site, access road, and pipeline:** Ask for the right to consent to the location of all well sites, access roads and pipelines, but agree that such consent will not be unreasonably withheld. Remember that it can take between 12 and 20 tractor-trailer loads of equipment to drill a well, and that many more loads to fracture the well. The Lessee needs a large location with a good access road. The size of the location will vary,

depending on the type and depth of the well being drilled and the type of rig and fracturing equipment used to drill and complete the well.

- **Damage to crops, buildings and personal property**-The lease should require the Lessee to pay for damages to growing crops and timber, although existing West Virginia laws make the Lessee responsible for such damages. Consider specific provisions to minimize damages if you have special crops (such as Christmas trees) or livestock on the property.
- **Free gas**-Leases may provide for "free gas" for the surface owner's use. In most cases leases provide a specified (limited) amount of gas for one dwelling located on the lease. If the surface owner uses more than the amount allotted, the lease may provide that gas can be purchased at a price set forth in the lease. However, some leases provide that service can be terminated when the allotted amount is exceeded. Generally, the "free gas" consumer is responsible for installing a pipeline to the well to get the gas, and for the cost of valves, regulators, dryers, etc .. Maintenance of free gas equipment is the responsibility of the surface owner, and the Lessee is not responsible when gas is not available for any reason. (Make sure you have an alternative source of heat!) Some leases provide for a payment in lieu of free gas. Generally, this payment is at the option of the Lessee, not the Lessor, but that is negotiable. "Free gas" is great. But it is not really "free"!
- **Lease Assignment**-Leases generally provide that either the Lessor or the Lessee may assign the lease to a third party. However, most leases require the Lessor to notify the Lessee in any change of ownership to enable the Lessee to make proper payments under the lease. A Lessee cannot be expected to know every time a property subject to one of its leases is sold by one of its Lessors. However, when a Lessee assigns a lease, its Assignee is obligated to continue to make payments to the Lessor under the lease, so the Assignee will acquire payment information from the Lessee/Assignor.
- **Pooling or Unitization**-The decision to include a pooling provision should be based on the amount of acreage covered by the lease and other factors. Owners of larger tracts are less likely to benefit from pooling provisions, especially where shallow well drilling is contemplated. Consider allowing unitization only for deep (below the bottom of the Tully formation) wells or only for horizontal wells. Leases without pooling provisions can be modified in the future to add pooling if the Lessor and Lessee agree that pooling is appropriate. When wells subject to Conservation Commission jurisdiction are drilled, forced pooling can occur, even if the lease does not provide for pooling. It is possible the legislature may require forced pooling in the future. The inclusion of a pooling provision is negotiable. If a pooling provision is included, it is important to address the status of acreage covered by the lease that is not included in a unit at the expiration of the primary term. Something like the following language (a "Pugh clause") is suggested if pooling is to be included in the lease:

"Upon the expiration of the primary term hereof, Lessee shall execute and deliver to Lessor a proper surrender and release in recordable form covering any portion of the leased premises not

included within a properly designated pool or unit, it being expressly understood and agreed that only portions of the leased premises within a properly designated pool or unit shall be deemed to be held by production upon the expiration of the primary term hereof. "

- **Underground gas storage**-Some leases allow the company to store natural gas in formations underlying the lease by injecting gas into wells. It is not always necessary to have a well on the leased premises to use the leased lands for storage. Generally, a storage provision will require an annual payment to the Lessor. This can be a flat rate per year or an amount based on acreage. This provision is negotiable. It can also be negotiated at a later date, if and when an operator considers creating a storage field.
- **Reclamation**-Reclamation plans cannot be determined until a drill site and access road are selected. Surface owners will be provided with a detailed well location plat and reclamation plan during the well permitting process, which will show the location of the well and the access road. The plan will provide detailed information regarding the slope of the road, the size and location of culverts and other erosion and sediment control devices, as well as the types and quantities of lime, fertilizer, mulch and grass seed to be used for revegetation of the site.
- **Water use** -Most leases limit the right of the Lessee to use water from farm ponds and similar sources. However, each surface tract may have special conditions, and surface usage varies. If there could be problems resulting from the Lessee's use of water from the leased premises, water usage should be restricted in the lease.
- **Roads and Pipelines** -Leases generally authorize the Lessee to build roads on the leased premises for ingress and egress to and from any well drilled on the leased premises, and to lay pipelines for the purpose of transporting gas produced from the leased premises to a market. Some leases include provisions authorizing the Lessee to build roads to locations on neighboring leases and to lay lines to wells on neighboring lands. Such provisions should not be included in the oil and gas lease, but should be negotiated separately and memorialized in a separate right-of-way agreement.
- **Warranty**-Lessees should do their homework before acquiring leases, and should not rely on mineral owners to guarantee title. Without question, no one should ever drill a well without having a complete title examination performed by a competent oil and gas attorney. For these reasons, leases should certainly not require General Warranty as defined above. If any warranty is to be given, at best it should be Special Warranty. Unless the term "Special Warranty" is used, the type of warranty given is vague, at best. It is suggested that all references to title warranty be stricken, or better, that a provision stating, "Lessor(s) do not warrant title to the leased premises" be included. However, Lessees may reasonably require some level of warranty if and when they are making bonus payments or taking "paid-up" leases requiring significant up front payments.

Who regulates the drilling and operation of oil and gas wells?

The Office of Oil and Gas ("OOG") of the West Virginia Department of Environmental Protection is charged with issuing permits for drilling, re-working and plugging oil and gas wells within the

State of West Virginia. It is also charged with ensuring that wells are operated in a safe manner, and that the environment is not endangered. However, the OOG does not regulate private agreements between mineral owners and oil and gas operators. The OOG operates under rules and regulations as established by statute. Enforcement is provided by a team of OOG inspectors, with an inspector assigned to each county within the State. These inspectors review and approve reclamation plans and drilling and casing programs before a drilling permit is issued. They also monitor drilling activities and inspect reclamation after well completion. When wells are plugged OOG inspectors approve plugging procedures and monitor plugging operations. Oil and gas operators are required to post a bond with the OOG to guarantee plugging of wells and any site reclamation.

Will I know before the drilling starts?

Before drilling or any activity other than surveying can commence, an operator must obtain a permit from the OOG. To do so, the operator must prepare the following materials:

1. A surveyed plat, showing the leased lands and the specific location of the well.
2. A reclamation plan, with a detailed drawing showing the location and the road. This drawing will show the location of all culverts, as well as other soil and sedimentation control devices to be installed. The plan will specify quantities of seed, fertilizer, lime and mulch to be used in reclamation, as well as the seed mixture.
3. A statement regarding the surface owner's right to have water wells and other water sources tested prior to drilling.
4. The operator's plan for casing and cementing the well.
5. Specific, detailed instructions on how to contact the OOG to file any comments or objections regarding the permit, including the address and telephone number of the OOG inspector assigned to the county where the well is to be drilled.

Generally, a representative of the operator will contact you to discuss the location of the well, access road and pipeline before the location is surveyed and the reclamation plan is completed. This may prevent the operator from having to start over and repeat this costly and time consuming process if the surface owner has objections.

Once these materials are complete, they must be reviewed and approved by the OOG inspector before a permit application can be processed.

As part of the permit application process, the applicant must prove to the OOG that both the surface owner (including any surface owner that receives a tax ticket for the property) and any coal owner have been provided copies of the materials listed above. That proof is generally in the form of a "return receipt" card when notice is given by certified mail. Sometimes the materials are hand-delivered to the surface owner, in which case the person that made the personal delivery must provide an affidavit to the OOG, indicating the date and manner in which service was made.

No permit will be issued for at least fifteen days from the receipt of the application by the OOG unless the surface and coal owners provide waivers to the operator indicating that they have no objection to the permit being issued. A surface or coal owner has fifteen days from receipt of the application materials to file comments or objections to the issuance of a permit. Should a comment or objection be received, a permit will not be issued until the subject of the comment or objection is resolved. The OOG will arrange to review the comment or objection in the field with the surface or coal owners and the operator's representative for the purpose resolving the matter to the satisfaction of all parties, and in compliance with OOG rules and regulations. It must be noted that the review of a comment or objection is not required to occur within the fifteen-day period. It frequently takes additional time to resolve these matters, depending on the availability

of the OOG inspector and the parties involved. No well work will commence until a permit is issued.

To lease or not to lease?

This decision is much easier if you own only minerals but no surface. If you do own the surface, lease provisions must be given more careful consideration. If you only own minerals, there is much less to negotiate.

In recent months, bonuses and delay rentals have skyrocketed, with some oil and gas developers offering "paid-up" leases, with large bonuses. This means the land man may offer you as much as \$2,000 per acre payable up front for the entire term of the lease. That can be a LOT of money, and can explain why a warranty may be required.

Before these payments increased to the current level, mineral owners were typically advised to discount rentals and bonuses and concentrate on finding the Lessee most likely to drill, as royalties were generally more lucrative than bonuses or delay rentals. That is not always the case today. In some cases bonuses will exceed royalties that might (or might not) be earned over many years. Each situation must be evaluated individually, and with the advice of experienced counsel.

Some consideration should be given to collective leasing by a group of mineral owners, whether formal or informal. Where possible, owners of neighboring lands might collectively negotiate a better deal, as larger blocks of leased acreage may be more attractive to oil and gas developers, and may provide the economies of scale required to install a pipeline, etc ..

Pipelines are important to gas well development. Lessors should ask what plans or arrangements a prospective Lessee may have to get any gas produced to market. In some areas, where development has not occurred, there may not be a good answer to this question, as pipelines are far away, and will require a significant investment. That raises the "chicken and egg" question: What comes first, a pipeline or a well? In areas where significant development has already occurred, it is still important to ask how the gas is to be marketed, as not all pipelines are "open access" and available to any developer. Capacity is limited on many of the major pipelines and gathering systems today. Some of these pipeline companies require the producer to purchase "firm" transportation, and "firm" capacity is presently in short supply. Without firm transportation, a developer may be unable to get its gas to market. Although it is not always possible to answer the question of pipeline access, it is still helpful to inquire as to how a prospective Lessee plans to market its gas.

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