

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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Oil and Gas Leases Facts & Tips



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Natural Gas in West Virginia

Natural gas use is going to increase in the foreseeable future. The demand for it, both in residential and commercial applications, and improvements in drilling technology has helped spur exploration of new production areas. These areas include land in almost all counties in West Virginia, where many companies are beginning to see positive results, especially in the Marcellus Shale formation. West Virginia farmers, as owners of large tracts of land, have the potential to take advantage of these discoveries and continued exploration by granting a lease to recover these valuable resources. However, it is very important that landowners carefully read and understand any lease before signing it.

What is a gas or oil lease?

A gas lease is a contract between a landowner and a company granting exploration and development rights to subsurface oil and gas deposits to the company. In return for granting these rights, a landowner receives financial compensation. If a company is interested in leasing the rights for a specific property, a representative from the company will usually approach the landowner. This representative, whom the company has contracted to secure leases, is known as a "landman". They usually will offer a preprinted or standard lease, which represents the offer.

A landowner is in NO way obligated to sign a lease. It is VERY important to have the lease reviewed by an attorney, who is knowledgeable about the subject, before signing. While the company may not choose to drill on the property, signing a lease may be viewed as an encumbrance on the property and affect the property's value or it may impact farmland conservation easements. Consider these matters before signing a lease.

What are some important gas leasing terms that you many hear?

- **Cash Bonus-** Upfront payment- usually computed on a per acre basis- considered first year's rental
- **Primary Term-** Length of a lease- can run from one year to 10+ years
- **Delay Rental-** Annual rental payments after the first year- usually on a per acre basis- should not be deducted from royalty payments if well is drilled before expiration of lease
- **Secondary Term-** An extension of the lease beyond the primary term because it is producing oil or gas
- **Royalty-** Landowners share of gas production from property- usually expressed as a fraction of the gas value – typically is 1/8th, but currently has been as high as 1/4th - and should be on the gross, not on the net
- **Shut-in Royalty-** Payment instead of traditional royalty-paid when well is not producing due to maintenance, etc.
- **Termination-** occurs at the end of primary term or when production ceases during the secondary term
- **"Most favored nation" clause-** An optional clause that can be included in a lease agreement, which would guarantee a landowner who has signed a lease an automatic increase in their financial terms equal to that of a neighbor who has signed a lease for higher rates. This occurs within a set period, usually 30 days.

Any lease will define the terms used in the lease; if the terms are not defined, you may want to have them spelled out.

What are some things to think about before signing the lease?

Landowners have the ability to negotiate the terms of a lease. While the following are a FEW of the general items to consider prior to signing any gas lease, landowners should consult with their attorney to make sure all of their interests are protected.

- **Land disturbance from an access road and drill site-** Large amounts of equipment may be needed in the drilling process – a separate agreement should specify how much land can be disturbed, what kind of damages landowners will be paid, and the grade and location of any road to the site
- **Damage to crops, buildings and personal property-** Consider having terms in the lease making the company responsible for any damage done to crops, livestock, or property. Required fencing may also be an option
- **Free gas-** Leases can provide for natural gas for the landowner's use. Consider including that the company is responsible for the cost of the equipment installation. Sometimes, due to safety concerns, the company may simply provide monetary reimbursement instead
- **Underground gas storage-** Some leases allow the company to pump natural gas back into an empty well for storage in return for an annual payment to the landowner. This provision is negotiable and should not be in a production lease
- **Lease Assignment-** The lease may allow the company to assign or sell the lease to other firms
- **Reclamation-** Reclamation plans for both productive and unproductive wells can be spelled out in the lease to protect future land uses
- **Injection of fluids into ground –** Leases should never allow any fluids to be injected into the ground (except for fracturing the well) to ensure the safety of the landowner's water resources
- **Water use –** Much thought should be given to allowing company use of landowner's water and what kind of damages should be paid if the water supply is polluted or exhausted. *Your water should be tested before any drilling begins*
- **Sediment pond –** Careful consideration must be given to what happens with these ponds once the well is drilled. Sediment ponds and all sediment should be removed from the property, not buried, and sediment should never be applied to the landowner's property
- **Transmission lines –** Any agreement to allow transmission lines to cross landowner's property should be contained in a separate agreement, and not as part of a lease

Who regulates gas wells?

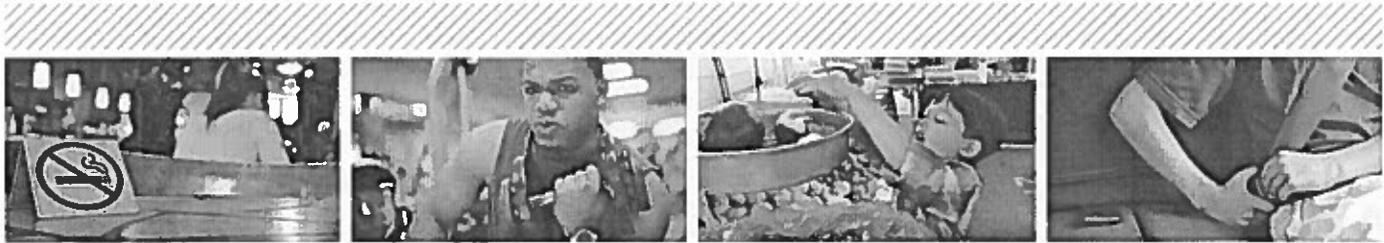
While DEP does not regulate private agreements between landowners and gas companies, DEP's Office of Oil and Gas does protect correlative rights, the environment*, and public safety. They have established rules and regulations which govern the construction of a gas well. These rules focus on protecting water quality and preventing pollution. DEP reviews all of the gas well permit applications and conducts inspections prior to, during and, after well construction. Gas companies are required to post a bond with DEP to guarantee plugging of the well and any site reclamation. **Drilling companies, however, are not subject to the same environmental standards, such as the Clean Water Act, or the Safe Drinking Water Act., since the Energy Bill of 2005 was passed by Congress.*

What is the drilling process?

Drilling of a gas well usually lasts from 2- 8 weeks, but can be even longer. During this time, depending on the well size and location, a substantial amount of land may be disturbed. If the well is productive, the well head, meters, and tanks will remain on site. If it is not productive, the well will need to be plugged in accordance with state regulations.

CONTACT A LAWYER AND RECEIVE PROPER LEGAL COUNSEL BEFORE SIGNING A LEASE OF ANY KIND.

Please call WVFB if you have additional questions or concerns at 1-800-398-4630. Information is also available on the WVFB website www.wvfarm.org. *This information contained herein is provided for informational purposes only; it is not intended to be, nor should it be considered, a substitute for legal advice rendered by a competent attorney. If you have any questions about the application of the issues raised herein to your particular situation, seek the advice of a competent attorney. This document is a "work in progress" and will be updated as new information is gathered.*



ENVIRONMENTAL HEALTH
Issue Brief

West Virginia – Leasing Tips for Natural Gas Drilling

Introduction

The Marcellus Shale is an underground rock formation estimated to contain approximately 512 trillion cubic feet of natural gas; it spans 95,000 square miles across eight states, including West Virginia. The presence of Marcellus Shale deposits in West Virginia offers landowners the opportunity to earn income by leasing the right to drill on their property. Drilling in the Marcellus Shale involves hydraulic fracturing (commonly known as “hydro-fracking” or “fracking”), which is a method of extracting natural gas from coal beds and shale gas formations by injecting large quantities of water, sand and chemicals (known as “fracking fluid”) at high pressure deep into the ground, fracturing the rock, releasing the gas and allowing it to flow to the well. West Virginia landowners need to consider a number of issues before leasing away the right to drill, including the potential impact of drilling on the landowner’s use of the land, the true value of the rights that the landowner is relinquishing, and possible environmental damage to the land and community.

General Issues

A lease is a binding contract. Most importantly, do not sign any contract unless you fully understand its terms. The landowner should carefully consider the contract, and if necessary, contact a land use attorney to review the contract. If the landowner’s neighbors have entered into leases, it is often helpful to consult those neighbors to ask about their experience. While not exhaustive, here are some issues to consider:

- Any property restriction that limits the use of property (such as an easement) should be evaluated by legal counsel before entering into a contract.
- The landowner should investigate the value of leasing rights in the area, independent of any figure that the drilling company provides.
- The contract should specify that the lease and royalty payments are for natural gas extracted from Marcellus shale only, not any other formations.
- The contract should not include any deductions to reduce the amount of the lease and royalty payments, such as any charges to process the natural gas to bring it to market.
- The landowner should pay attention to the extent of surface rights granted to the drilling company and in some circumstances restrict the drilling company’s road and well site construction on the property.

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- If tree removal is required, the landowner should receive proceeds from timber sales.
 - Be mindful of provisions that may extend the lease or automatically renew the lease.
 - Drilling and natural gas extraction may damage the surface of the land or underground water supplies. The drilling company, not the landowner, should be responsible for environmental or any other problems caused by drilling.
 - The contract should require the company to record the termination when it expires.
 - The contract should have a provision to notify the landowner of any assignment of the lease and communicate the appropriate contact information.
 - Be aware that mandatory arbitration clauses may prevent the landowner from taking the drilling company to court.

Specific Guidance for West Virginia Landowners

Gas leases provide the landowner royalty payments typically between one-eighth (12.5 percent) and one-fourth (25 percent) of the value of all natural gas extracted from the property. The royalty payment should be on the gross value of all natural gas extracted, not on the net value (which is the gross value reduced by deductions).¹ In negotiations, the landowner may want to research the formation under the land. General internet research and the West Virginia Geologic and Economic Survey are helpful resources. The thickness of formations varies greatly and is an important consideration when drilling companies evaluate land. The landowner may want to visit the Office of Oil and Gas in Charleston, WV, or contact a geologist consultant for assistance.²

The issue of forced pooling is important in West Virginia. Pooling is a possibility when a proposed well would be located in an area that includes multiple owners. The majority could force an unwilling minority owner to allow drilling; the minority owner would be compensated for his share of the land. Proposed rules for Marcellus shale drilling, introduced in the West Virginia legislature in 2012, included language to force pooling, but that legislation has been unsuccessful so far.³ This is an issue that landowners ought to watch for in any state legislation.

A contract is an agreement between two private parties. The West Virginia Department of Environmental Protection (WVDEP) Office of Oil and Gas is tasked with protecting the environment and ensuring public safety. WVDEP will not intervene in a dispute over a contract's terms. WVDEP has established rules and regulations to govern the construction of a gas well, mainly focused on water quality and pollution.⁴ In 2011, West Virginia passed the Horizontal Well Act, which requires that all permitted wells protect the quantity and quality of water in surface and groundwater systems, including quality and flow testing for all drinking water wells within one thousand five hundred feet of a permitted well, upon owner request.⁵ For lease disputes, the landowner must file suit in county court.

The landowner should be familiar with current developments. For example, the Morgantown City Council attempted to ban the use of hydraulic fracturing. However, in *Northeast Natural Energy v. Morgantown, W. Va.*, the Monongalia County Circuit Court reversed the ban, ruling that local municipalities lack the authority to regulate oil and gas development and production.⁶ Morgantown hopes to circumvent this ban and limit fracturing in Morgantown through zoning.

More Information

The West Virginia Department of Environmental Protection's Office of Oil and Gas may be a useful resource: <http://www.dep.wv.gov/oil-and-gas/Pages/default.aspx>

The West Virginia Surface Owners' Rights Organization (<http://www.wvsoro.org/>), the West Virginia Farm Bureau (<http://www.wvfarm.org/>), and the West Virginia Royalty Owners Association (<http://www.wvroa.com/>) all have resources for landowners.

The United States Environmental Protection Agency has a website on hydraulic fracturing:
http://www.epa.gov/region3/marcellus_shale/.

The Network for Public Health Law has a variety of fact sheets on hydraulic fracturing, including an overview of the health and environmental effects: http://www.networkforphl.org/network_resources/network_products/fracking_products/.

SUPPORTERS



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This document was prepared by Preston Ridinger and Paul Wierenga, student attorneys in the Public Health Law Clinic at the University of Maryland Carey School of Law, supervised by Kathleen Susan Hoke, director of the Network for Public Health Law – Eastern Region. The Network for Public Health Law provides information and technical assistance on issues related to public health. The legal information and assistance provided in this document does not constitute legal advice or legal representation. For legal advice, readers should consult a lawyer in their state.

¹ Oil and Gas Leases Facts & Tips, *West Virginia Farm Bureau*, available at http://www.google.com/url?sa=t&ret=j&q=landowners%20leasing%20natural%20gas%20west%20virginia&source=web&cd=9&ved=0CfMQFjAI&url=http%3A%2F%2Fwww.wvfarm.org%2Fdownload%2FOilGasLeasesFactsTips.doc&ei=JZK6TuqJCYX42gXKnZCwBw&usq=AF0jCNIfrh8jDI129ZrPAAb51_17W5zEj_g&cad=rja (last accessed Nov. 16, 2011).

² Information about Oil and Gas Leasing For Surface Owners Who Also Own Their Minerals, *West Virginia Surface Owners' Rights Organization*, available at http://wvsoro.org/resources/minerals_royalty/LeasingAdviceWVa2008-05-16.pdf (last accessed Nov. 16, 2011).

³ West Virginia Legislature, HB 3042 (2012), available at http://www.legis.state.wv.us/Bill_Text_HTML/2012_SESSIONS/RS/Bills/HB3042%20nr.htm.

⁴ West Virginia Department of Environmental Protection, Office of Oil and Gas, available at <http://www.dep.wv.gov/oil-and-gas/Pages/default.aspx> (Last accessed Mar. 22, 2013).

⁵ See W. VA. CODE §22-6a-8(g)(5) (2011); see also W. VA. CODE § 22-6 (1994).

⁶ W. Va. Cir. Ct. (Aug. 12, 2011), available at http://www.frackinginsider.com/Tucker_Marcellus_Order.pdf.

Royalty Owners: What You Should Know About the Cotenancy Modernization and Majority Protection Act

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The Cotenancy Modernization and Majority Protection Act (HB 4268) (hereinafter "the Cotenancy Act") was signed into law by Governor Justice on March 5, 2018, and became effective June 3, 2018. This new law overturns the 90 year old precedent established in *Law v. Heck Oil Co.*, 106 W. Va. 296 (1928), which held that an owner of an undivided 1/768 interest in the oil and gas in place could block development of the resource even though the owners of the other 767/768 undivided interest had consented to development and leased their interests to the operator. In other words, an operator must lease 100% of the owners of a parcel of land before it can be developed by conventional or horizontal unconventional drilling. This arcane law has hindered West Virginia in keeping up with its Appalachian neighbors, Pennsylvania and Ohio, in oil, natural gas and natural gas liquids production.

After June 3, 2018, if a parcel has seven (7) or more oil and gas owners, also referred to as "cotenants," an oil and gas operating company can commence developing the parcel when 75% of the ownership interests are leased. (Note: the threshold is of the *ownership interests*, not the individual owners.) If you own an oil and gas interest in one of these parcels that may be subject to the Cotenancy Act, you should be aware you will be required to make a decision as to how you will be paid for your asset, whether you want your asset to be developed or not – either as a deemed lessor or a working interest owner.

What Should You Do?

Even if you have unsuccessfully negotiated an oil and gas lease in the past or have no desire to lease or develop your minerals, you will now be subject to another negotiation with an oil and

gas operator. An operator is now required to engage in reasonable negotiations with known oil and gas interest owners in a parcel subject to the Cotenancy Act for a minimum of 45 days with hopes of concluding the negotiations with a lease consented to by both lessor and lessee. This allows you to not only ensure a lease bonus and royalty acceptable to you, but also allows you to negotiate other important terms of your lease, such as surface use, storage, pooling and Pugh clauses (provides that all lands which are not included within a producing unit when the primary term ends will revert to the lessor), delay rentals and shut-in payments, continuous operations clauses, warranty of title, and audit and assignment rights.

Before dismissing the individual negotiating process completely, it should be noted since January 2017, lessors have been able to successfully negotiate leases in West Virginia with 20% cost-free royalty provisions with bonuses ranging from \$3,000 to \$6,500 an acre. * Regardless of what you may have heard through the local rumor mill, there are still good deals to be made before conceding your interests to options outlined in the Cotenancy Act. Thus, one of the first things you should do is determine what lease terms are the most important to you.

If you own the surface as well as the mineral rights, is your land a prime location for a well pad? What type of surface protection do you need? Do you want your land to be the site of a well pad or injection wells?

Do you have a need for immediate cash rather than future royalty payments? If so, a higher lease bonus will be more important than a high royalty percentage.

Do you want the highest rate of return on your asset? If so, focus on negotiating the royalty percentage, and more importantly, the royalty terms.

Are you concerned about operators using the area as a storage field, possibly tying up your ability to benefit from your assets for years to come?

Do you want to maximize your asset by adding horizontal or vertical Pugh clauses or leasing geologic formations individually?

The next step would be to reach out to other known cotenants to inquire about their lease terms. Expand your search and reach out to owners of neighboring parcels in the area so you can get a feel for the local leasing environment. Knowledge will be the most powerful weapon in your arsenal. After knowledge, strength in numbers will be important. Try to form a consensus or leasing group among the other non-consenting cotenants to negotiate a lease for all, or at least the majority. An operator may be appreciative of the reduced workload which may result in obtaining more favorable terms and if you choose to hire an attorney or other professional to assist in negotiations, the fees should be offset between all of the cotenants.

What If I Choose to Do Nothing or be Deemed Leased?

If you are unable to reach a voluntary agreement with an operator, at the end of 45 days you should receive a written notice from the operator detailing its best and final offer. If you choose not to accept said offer, you will be deemed leased receiving the highest royalty received by other cotenants in the parcel, which will be free of post-production expenses and paid on the gross proceeds received at the first point of sale to an unaffiliated third-party purchaser, as well as the average lease bonus, delay rental and other non-royalty mineral payments. Therein lies the rub as it is not likely the operator will disclose the other cotenants' lease terms you and will be relying on the

negotiating ability of the other cotenants. Thus, it may be in your best interest to negotiate your own individual lease, by yourself or with the assistance of legal counsel or a mineral manager, because what may be best for you (such as a higher lease bonus resulting in immediate cash), may not have been most important aspect for the other cotenants.

The backstop of the Cotenancy Act is the 30 day grace period for allowance of appeal to the West Virginia Oil and Gas Conservation Commission ("OGCC"). At the conclusion of the 45 day negotiation period, if you are unsure of your decision or the operator's final offer you can appeal to the OGCC. The OGCC will review all leases in the parcel to confirm you are indeed receiving the highest royalty and average bonuses and payments, as well as benefiting from terms and provisions in the other cotenants' leases it determines to be just and reasonable. As of writing of this article, the OGCC was still in the process of determining its processes and procedures for Cotenancy Act appeals.

What If I Choose the Working Interest Option?

If you want to gamble, you can choose to become a working interest owner. Simply put, this means after the well is completed and the operator(s) have earned back two times the costs of drilling the well, the remaining working interest owners would receive their prorata share of the revenue (after royalties are paid) equal to their share of the production attributable to the tract(s) developed under the Cotenancy Act. Normally, a working interest owner would be obligated to pay a corresponding percentage of the cost of leasing, drilling, producing and operating a well or unit, but under the Cotenancy Act the oil and gas interest owner will be subject to the 200% cost recoupment penalty.

While the rewards are speculative and not immediate, the payoffs of production revenues could substantially exceed any royalty payments. As a working interest owner, you

should have the opportunity to inspect, copy and audit all production records for the well(s) in which you have an ownership interest. Further, working interest owners are often eligible for certain tax deductions based on the operating costs. A working interest is an economic interest; therefore, it is subject to depletion and deductions and an owner can deduct intangible drilling and development costs. The US Tax Code specifies a working interest in an oil and gas well is not considered a passive activity meaning, any losses act as active income incurred in conjunction with oil and gas production can be offset against other forms of ordinary income. However, one should always consult with a tax expert to determine any future tax implications.

** Lease royalty and bonus data obtained from Bounty Minerals*

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