



Oil & Gas Leases - Other Issues and Concerns

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Pooling and Unitization

Pooling and unitization both refer to combining multiple leases together and treating them as one for various purposes.

- Many use the terms “pooling” and “unitization” synonymously. But more strictly speaking ...
- **Pooling** refers to bringing together tracts for the purpose of drilling a single well within a particular spacing unit for primary production. (Recall that spacing rules require, by regulation, certain minimum spacing between wells.)
- **Unitization** is associated with secondary/ enhanced recovery, pressure maintenance, etc. Unitized units are typically much bigger than pooled units.

Pooling

- Pooling is largely a reaction to regulatorily created spacing units.
- Some states provide for compulsory pooling.
- Leases can have a “pooling clause” to allow the operator to pool.
- If the lease does not provide for pooling, and state law does not provide for compulsory pooling, then a lessee needing/wanting pooling will have to negotiate for it after the fact, in which case the landowner/lessor can be expected to demand additional compensation.

Compulsory Pooling

North Dakota law provides for compulsory pooling:

“When two or more separately owned tracts are embraced within a spacing unit, or when there are separately owned interests in all or a part of the spacing unit, then the owners and royalty owners thereof may pool their interests for the development and operation of the spacing unit. [In the absence of voluntary pooling, the commission upon the application of any interested person shall enter an order pooling all interests in the spacing unit](#) for the development and operations thereof. Each such pooling order must be made after notice and hearing, and must be upon terms and conditions that are just and reasonable, and that afford to the owner of each tract or interest in the spacing unit the opportunity to recover or receive, without unnecessary expense, that owner's just and equitable share.”

- N.D.C.C. §38-08-08

Compulsory Pooling

Notice that the State of North Dakota Board of University and School Lands Oil and Gas Lease (and our fake "Umberacre" lease based off of it), contemplate this:

"[I]f oil and/or gas is produced in commercial quantities from adjacent state owned mineral land leased at a lesser royalty or any other adjacent mineral land where the well is within one thousand (1,000) feet of the leased premises and where the leased premises are not entitled to an interest in such well by reason of spacing, [pooling](#), or unitization, lessee shall, within one hundred twenty (120) days after completion of such well, and subject to oil and gas conservation laws, rules, and orders, 1) diligently begin in good faith the drilling of a corresponding offset well on the leased premises, or on lands [pooled](#) therewith, and such offset well shall be drilled to such depth as may be necessary to prevent the drainage of the leased premises ..."

- §9

Pooling Clauses

Our example of the "Producers 88 Paid-Up" lease ("Ecruacre" lease) contains a pooling/unitization/reformation clause:

"Lessee, at its option, is hereby given the right and power at any time and from time to time as a recurring right, either before or after production, as to all or any part of the land described herein and as to any one or more of the formations hereunder, [to pool](#) or unitize the leasehold estate and the mineral estate covered by this lease with other land, lease or leases in the immediate vicinity for the production of oil and gas, or separately for the production of either, when in Lessee's judgment it is necessary or advisable to do so, and irrespective of whether authority similar to this exists with respect to such other land, lease or leases. Likewise, units previously formed to include formations not producing oil or gas, may be reformed to exclude such non-producing formations. The forming or reforming of any unit shall be accomplished by Lessee executing and filing of record a declaration of such unitization or reformation, which declaration shall describe the unit. " (§12)

Pooling Clauses - Ramifications

Allows secondary term to continue even when no production is taking place on lessor's land, if it's taking place on pooled land:

- “It is agreed that this lease shall remain in force for a term of Five (5) years from this date and as long thereafter as oil or gas of whatsoever nature or kind is produced from said leased premises or on acreage [pooled](#) therewith, or drilling operations are continued as hereinafter provided.” (Ecrucacre ‘88, p.2, before §1)

Allows secondary term to continue when drilling/re-working is not taking place on lessor's land, but is on pooled land:

- “If, at the expiration of the primary term of this lease, oil or gas is not being produced on the leased premises or on acreage [pooled](#) therewith but Lessee is then engaged in drilling or re-working operations thereon, then this lease shall continue in force so long as operations are being continuously prosecuted on the leased premises or on acreage [pooled](#) therewith ...” (Ecrucacre ‘88, §1)

But pooling clauses are not supposed to affect royalties ...

Unitization Clauses

- Unitization clauses are rarer than pooling clauses.
 - Historically, situations in which unitization was economically sensible for enhanced recovery were few. (But there are more these days.)
 - At the lease inception, lessees are typically focused on primary production, and many not be thinking about the need for unitization.
 - Knowledgeable landowners often object to unitization clauses, because if you have the single well of a unitized unit on your land, it is likely to be a much bigger interference with the use of the surface.
- While the need for unitization clauses may be more clear from a lessee perspective today, many leases may be quite old, and thus not contain unitization clauses.

Unitization Clauses

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Unitization/Pooling Benefits from Lessee Perspective

- Pooling allows drilling to conform to the maximum allowable under drilling spacing rules.
- Unitization allows recovery of more petroleum in a more cost-effective manner.
- The future ability to pool or unitize under a lease makes the lease more tradable/marketable, because buyers of leases want the flexibility.

Issues/Disputes Regarding Pooling/ Unitization Clauses

- Pooling/unitization rights give lessees a huge amount of power that can be used to extend leases, and royalties can be affected by the exercise of that power as well.
- Lessors generally have a cause of action against lessees who use the pooling or unitization power in a way that is not in good faith, not consistent with the goal of giving the lessee the needed flexibility to operate in an efficient manner.
- Lessors may have a cause of action against a lessees who refuse to pool when pooling would fulfill the lessors implied covenant to protect the lessor from drainage.
- Pooling/unitization clauses potentially conflict with the rule against perpetuities, to the extent they might be construed as unvested interests in real property. (A potential pitfall to watch out for!)

Revenue to Lessor

- **Bonus** - what lessor gets upon entering the deal
- **Delay rentals** - what a lessor gets paid to keep the primary term going despite drilling operations not having yet been started
- **Shut-in payment** - (a/k/a “shut-in rental”) a payment for a well that has been shut in pending a turn around in prices (it’s usually for gas, but could be used for oil); the idea is that it’s in lieu of receiving royalties on produced gas (or oil)
- **Royalties** - the share the lessor gets from the minerals produced from the land

Royalties - Basics

- A royalty is a share of production, free of the costs of production.
 - “A royalty interest is defined under well-established oil and gas law as the right to receive a share of gross production of the minerals produced under a mineral lease, free of the costs of production.” Graham v. Prochaska, 429 S.W.3d 650, 656 (Tex. App. 2013)
- This means that the royalty-interest owner doesn't have anything deducted from the royalty to account for the costs of finding the oil or gas and getting it out of the ground.

Royalties - Basics

- A royalty is not a share of the profits!
- It's much better than that!
 - (Even if you have a lot of revenue, you might never be profitable if your costs are high.)
- I.o.w., the producer/operator/lessee can lose lots of money (because drilling the well and producing was expensive), but the royalty-interest-owner/lessor could still make money.
 - Imagine this with a forest on your land: You sign a “lumberial lease” with a 1/8 royalty to a timber cutting firm. They have to pay a bunch of lumberjacks to cut down trees, road-builders, to build roads, etc. That's expensive. But you don't have to worry about that, because you get 1 out of every 8 logs.

Royalties - Amounts

- $1/8$ is a pretty standard amount
- $1/6$ has long been standard in California
- Some states prescribe $1/8$ as a minimum royalty
- Royalties can be much more these days
 - They might get as high as 40%, which is more likely in an area of proven reserves.
 - Down to $1/8$ today is more common for wildcatting (drilling with greater uncertainty about whether oil or gas will be found).
- Royalty rates might be done on a sliding scale, with royalties going to higher rates if production ends up being voluminous.

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Royalties - Disputes

- At first glance, you might think royalties wouldn't be subject to much dispute, because it's just a share of production - there's no need to argue about the costs of production.
- But in reality, royalty disputes are extremely common.
- Much of what is negotiated by sophisticated lessors may be to avoid "getting ripped off" by the lessee.
- Lessee-drafted leases with lessee-favorable terms can allow a lot of deductions for costs after production, and they can make it hard for lessors to find out about these costs or check the accounting.
 - The ProPublica article you read provides examples.

Royalties - comparing provisions

State of North Dakota Board of University and School Lands Oil and Gas Lease (and fake "Umberacre" lease), §4:

B. Lessee agrees to pay lessor the royalty on **oil** based upon gross production or the market value thereof, at the option of lessor, such value to be determined by 1) the highest posted price, plus premium, if any, paid for oil, condensate, distillate, or other liquid hydrocarbons, respectively, of a like type and gravity for the field where produced and when run, or 2) the highest market price thereof paid for the area where produced and when run, or 3) the gross proceeds of sale, whichever is greater. Lessee agrees that before any gas produced from the land hereby leased is sold, used or processed in a plant, it will be run free of cost to lessor through an adequate oil and gas separator of conventional type or other equipment at least as efficient to the end that all liquid hydrocarbons recoverable from the gas by such means will be recovered. Upon written consent of lessor, the requirement that such gas be run through such a separator or other equipment may be waived upon such terms and conditions as prescribed by lessor.

C. Lessee agrees to pay lessor the royalty on any **gas**, produced and marketed, based on gross production or the market value thereof, at the option of the lessor, such value to be based on gross proceeds of sale where such sale constitutes an arm's length transaction.

Royalties - comparing provisions

A not-untypical Producers 88 ("Ecruacre" lease), §3:

3. In consideration of the premises the said Lessee covenants and agrees:

1st To deliver to the credit of Lessor, free of cost, in the pipe line to which Lessee may connect wells on said land, the equal one-eighth (1/8) part of all oil produced and saved from the leased premises.

2nd. To pay Lessor one-eighth (1/8) of the net proceeds at the well from the proceeds received for gas sold from each well where gas only is found, or the market value at the well of such gas used off the premises.

3rd. To pay Lessor one-eighth (1/8) of the market value at the well for gas produced from any oil well and used off the premises, or for the manufacture of casing-head gasoline or dry commercial gas.

4th To pay Lessor one-eighth (1/8) of the proceeds received from the sale of any substance covered by this lease, other than oil and gas and the products thereof, which Lessee may elect to produce, save, and market from the leased premises.

Royalties - comparing provisions

American Energy Utica LLC Lease from *American Energy Corporation v. American Energy Partners, LP*

(B) ROYALTY: For all oil and gas substances that are produced and sold from the lease premises, Lessor shall receive as its royalty eighteen (18%) percent of the sales proceeds actually received by Lessee from the sale of such production, less this same percentage share of all post production costs, as defined below, and less this same percentage share of all production, severance and ad valorem taxes. As used in this provision, post production costs shall mean (i) all losses of produced volumes (whether by use as fuel, line loss, flaring, venting or otherwise) and (ii) all costs actually incurred by Lessee from and after the wellhead to the point of sale, including, without limitation, all gathering, dehydration, compression, treatment, processing, marketing and transportation costs incurred in connection with the sale of such production. For royalty calculation purposes, Lessee shall never be required to adjust the sales proceeds to account for the purchaser's costs or charges downstream from the point of sale. Lessee may withhold Royalty payment until such time as the total withheld exceeds fifty dollars (\$50.00).

Royalties - Some Means of Protection for Lessors

- Taking royalty in kind
 - “In kind” means you take the petroleum itself, rather than a check for cash.
 - Taking royalties in kind avoid possibilities for funny business.
 - In-kind royalties are generally feasible for oil, since it can be stored easily on site until picked up by truck.
 - In-kind royalties generally are not feasible for gas, which tends to leave directly by pipeline through complicated distribution schemes.

Royalties - Some Means of Protection for Lessors

- Specifying that costs cannot be deducted
- Having choice of highest market price by various definitions
- Having audit rights
- Providing for shifting or splitting of costs of audits
- Being a sovereign government with attorneys, auditors, criminal penalties, and enhanced civil remedies (It’s good to be the federal government!)

Royalties - Remedies

- The remedy is the royalty you should have gotten paid, plus interest.
 - This may not be much of an incentive to pay up in the first place. A lessee can just wait to be sued, and then be out no more money than they would have been if they had paid what they owed originally.
- In some jurisdictions, you might be able to get extracompensatory damages.
- A lessor with bargaining power could provide for remedies in the lease that make not paying more costly.
- In most states, you can't cancel a lease for failure to pay royalties.
 - Cf. delay rentals
 - But note in North Dakota, a statute authorizes courts to consider whether the equities of the case require cancellation of a lease for unpaid royalties. (This is an incentive for the lessee to pay and not hold out!)