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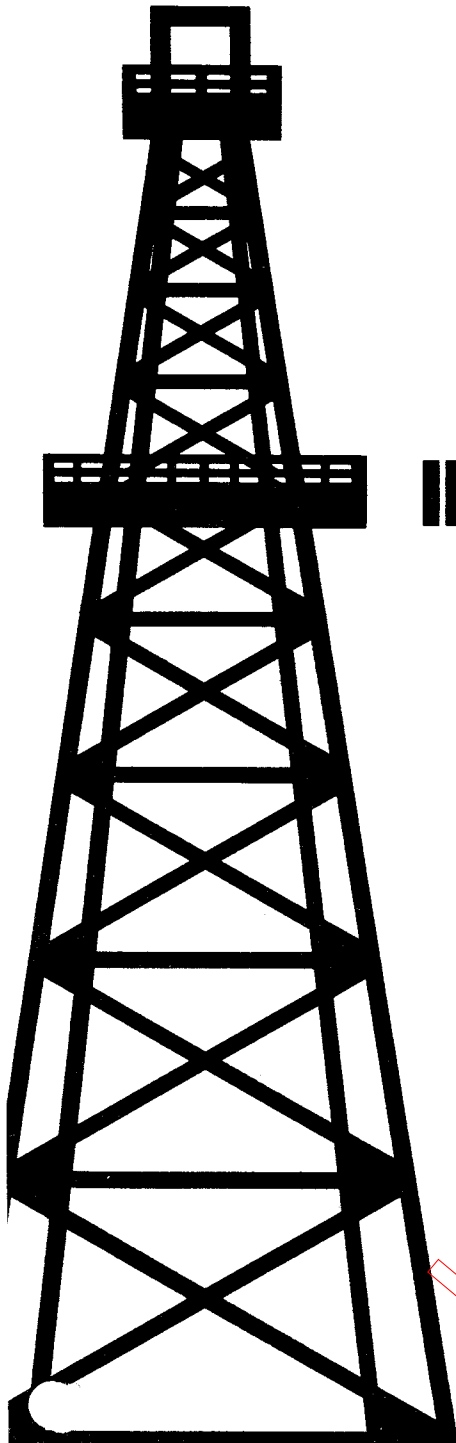
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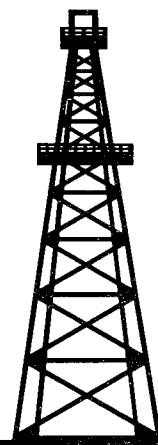
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**NEGOTIATING
OIL AND GAS
LEASES
ON
INDIANA FARMLAND**



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Negotiating Oil and Gas Leases on Indiana Farmland

by M. Owen Mohler and Gerald A. Harrison*

INTRODUCTION

Past increases and expected changes in the price of oil and gas as well as past and expected changes in technology are apparently the main forces encouraging widespread leasing activity in many areas of Indiana. Property owners in several Indiana counties in recent months have had an opportunity to lease or convey the rights to oil and gas exploration and production. Also in the south central area of Indiana, activity has been underway to lease the rights to strip mine oil shale. In south-western Indiana, activity for leasing coal mining rights has increased because of energy price considerations and expanded export outlets for Indiana's high-sulfur coal. Extra copies of this publication and EC-515, *Indiana Coal Reserves, Mining and Leasing* (\$1.00), may be obtained through your county Extension office or by writing to Mailing Room, Agricultural Administration Building, Purdue University, West Lafayette, IN 47907. Coal and oil shale mining rights leasing has several considerations in common with the leasing of oil and gas rights, but the potential property damage considerations in oil and gas exploration and production should be substantially less than for coal or oil shale strip mining.

However, the granting of rights to test drill and produce oil and gas should be viewed as a major transfer of property rights. Landowners should become fully informed about the rights and duties of oil and gas exploration and producing companies. These rights and desired limitations and the landowners compensation for delay and damages as well as for oil and gas produced should be clearly set out in the lease. The property owner must

recognize that the lease and future owners of the leasing rights have an interest in the property similar to a utility with a right of way across a farm for an electric power line.

Oil and gas leases may appear to be defined for a limited period similar to year to year farm leases, but, if production is initiated and continues at some acceptable commercial rate, the period of the lease may be indefinite. Options under a lease can extend the lessor landowner's obligations under the lease when there is little or no production.

As the discussion indicates below, if you wish to influence the timing and location of exploration and production activity, well sites, pipeline placement (including laying technique and depth), and roads (including specifics for damages to your farmland, crops and improvements), you should have written lease provisions to cover these matters.

Whether to sign an oil and gas lease with desired provisions at a given point in time, may not be an easy decision. Some people raise the concern about the possibility that production may begin on a neighbor's property that draws from your property. And if your land is not under a pooling agreement through a lease, you will not receive a share of the royalty. In a "wildcat" area (where oil and gas reserves have not been proven), other experts suggest that if production begins near your property there will be ample opportunity for leasing on the "second wave" of activity and likely on better terms than are offered during an initial leasing opportunity. The amount of bonus, delay rental, royalty, other benefits and damage provisions provided in the lease may be sufficient to convince a landowner to sign a lease rather than to wait for a better deal.

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LANDOWNERS' CONSIDERATIONS BEFORE SIGNING

1. Chances of discovering oil or gas.

If the landowners have a good estimate of any commercially available oil or gas and its cost of production, a more informed decision can be made about entering into a contract for production. With present technology a test drill site is necessary to determine the presence or absence of available oil or gas. However, existing geological information can give an indication of the possibilities of oil and gas discovery. Records and maps exist by counties of prior drill sites as well as information on current and historical production. Maps and publications may be obtained from: Publications Section, Indiana Geological Survey, 611 North Walnut Grove, Indiana University, Bloomington, IN 47405. Phone: (812) 335-7636; Bulletin 42-N, *Petroleum Industry in Indiana* (1975) is available for \$1.00. Also Bulletin 42-I, *Coal Resources of Indiana* (1973) is available for \$1.00.

2. Protection of the farmland and improvements.

Even if oil and gas are discovered and produced, cropping will continue, and landowners and tenants will benefit from minimum damage to the soil and farmland improvements. Farmers should learn the physical needs of exploration and production such as equipment used, nature of well sites, roads, pipelines and storage tanks. Learn about existing Indiana rules and regulations that govern well drilling, production, and restoration activity. Information on Indiana rules and regulations are available from: Homer R. Brown, director, Division of Oil and Gas, 911 State Office Building, Indianapolis, Indiana 46204. Phone (317) 232-4055.

3. Investigation of the leasing company.

In Indiana, companies can engage in oil and gas leasing without a license, bond or investigation or approval by a public agency. Landowners may want to seek information on the leasing company's reputation and past activity. The initial lessee may be a "landman" or broker (middleman) intending to sell leases to a drilling company. Ask the company agent for information such as several lessor and producer references and other company information that might be investigated. Farmers should be able to save time and cost by pooling their efforts in conducting an investigation. Farmers' organizations might be helpful in this regard.

Communication between landowners and perhaps negotiating as a group should be helpful. Oil and gas leases are usually preprinted forms which are likely to include terms that the lessee will adjust. However, the lessee would prefer to have a standard contract to avoid drafting costs and difficulties in evaluating the lease for subsequent assignment.

4. Evaluating your neighbors' decisions.

Farmers often follow the lead of neighbors on many important matters. Depending upon the nature of the lease and other facts, this may not be wise in the matter of signing an oil and gas lease. It is possible that a neighbor's well could draw from a reserve that flows from your property, but geologists contend that if there is a nearby "strike," the landowners with unleased land will probably obtain a more favorable oil and gas lease than those who sign early or don't bargain for detailed damage clauses or superior bonuses, rents and royalties.

However, do not overlook the influence of the time value of money. Money at an earlier date can build the same amount as a larger sum coming at a later date. But the expectation of rising oil and gas prices and higher royalties could convince a landowner that the delay will be offset by a larger sum in the future.

On the other hand, if a single lessee is unable to obtain a large enough area committed to lease, the lessee may not lease any land in a given area. Or if too few acres are under lease, the lessee may be unwilling to bear the overhead costs (risks) of exploration and test drilling. In effect, they may let the leases obtained go into default under the implied covenants of the lessee to explore and produce. This situation is likely to prevail in a "wildcat" area which may be the appropriate label for most of Indiana.

5. Seeking legal, tax and business counsel.

In evaluating the legal aspects of oil and gas leases, experienced legal counsel may be helpful in the leasing operation as well as in drafting and negotiating specific provisions.

Rental (delay or "shut-in") payments and bonuses are included as ordinary income for federal tax purposes as well as royalties. However, royalty income for oil and gas may be partially offset by the greater of a cost basis deduction or a percentage depletion allowance. For small producer lessors the percentage depletion allowance is limited to 65 percent of taxable income for the year. The percentage depletion rate is decreasing from 20 percent in 1981 to 15 percent in 1984 for primary production of oil. The 22 percent rate continues for secondary and tertiary production.

There is also a windfall profit tax on all producers of domestic crude oil. This is an excise tax on the selling price of crude oil and is imposed upon the producer, but generally administered by the purchaser through a withholding system. This tax is similar to the Indiana one percent severance tax for all petroleum products taken from the land. However, the federal tax law allows a credit against the windfall profit tax of \$1,000 in 1980 and \$2,500 in 1981. In 1982 through 1984 the credit is replaced with an exemption of two barrels per day increasing to three barrels per day in 1985 and after.

The windfall profit tax is arrived at using a number of factors and calculations. The removal price is adjusted by a base price and any state severance tax paid to give a "profit." The windfall profit is multiplied by a rate of 70 percent, 60 percent, 50 percent or 30 percent depending upon the classification of production and the producer's amount of production. For example, an independent producer of newly discovered oil would have a 50 percent rate for an average production of up to 1,000 barrels a day. The windfall profits tax is scheduled to be phased out by October 1993.

Indiana law also includes a procedure for assessing oil and gas for real property tax purposes.

Tax planning may suggest shifting the income rights to lower income family members. Further, special valuation of farmland for estate tax purposes does not apply to mineral rights.

An initial question that a landowner may need to consider is whether the oil and gas rights are already claimed by a prior lessee or grantee. In some areas of Indiana, oil and gas leasing activity existed at an earlier period when leases were granted for an indefinite period.

Also, if the land is being acquired by contract, generally neither buyer nor seller independently has the right to sign a binding lease. Mortgages may include a provision that limits the mortgagors's leasing rights.

PROVISIONS THAT MAY BE NEGOTIABLE

1. Mineral rights granted.

It may be in the best interest of the landowner to be sure that the oil and gas lease is limited in its granting clause to oil and gas and associated hydrocarbons. The lessee's initial lease form may include a grant of "other minerals." Royalties and lease provisions for oil and gas exploration and production may be inappropriate for certain other minerals.

Lessees may also attempt to cover the storage of gas in wells or underground formations. Proper compensation should be provided for storage if this is to be permitted.

2. Duration of the lease.

Oil and gas leases are drafted with a stated primary period. As long as delay rental payments are offered or made as promised, drilling or production might not have to begin before the primary period ends—for the lease to remain valid.

The lessee may suggest a primary period of 10 years which the landowner may feel is excessive for exploration or speculation. One to 3 years may be a more favorable primary period. Some landowners who are offered a nominal delay rental of \$1 per acre might favor waiting for a better offer. It is important

to recognize that the requirement to have proceeded with drilling is satisfied by drilling on land included in a pool arrangement. The lessee need not have drilled or be producing in paying quantities on a specific parcel to keep that parcel owner bound by a lease. Dry hole lease provisions may require no delay rentals in the primary term once test drilling begins and during specified lapses between dry holes.

While a landowner could insist upon a clause which stipulates that the test well(s) must be drilled within a short period of time, the windfall profit tax phase-out will add to the profit from oil production in future years except for very small producers who are exempt from the tax.

The Secondary term may continue *indefinitely* while there is production of oil, gas, liquid hydrocarbons or constituent products in paying quantities.

3. Damage to crops, farmland and improvements.

While oil and gas leases commonly include damage provisions, it is also true that the lessee has considerable freedom to go on the leased land to explore or drill and produce. Further, Indiana has certain rules and regulations for test hole drilling, dry holes, and producing wells. Indiana rules require a \$2,000 bond per test hole or well site. Indiana regulations require the drilling company to "restore the surface as nearly as possible to the condition it was prior to the drilling of the well within one (1) year from the date of completion and/or plugging." The bond secures this performance. The bond pertains only to the hole and site. It does not cover damages to fences, tile, crops, roads, soil and buildings away from the dry hole or well site nor to livestock. Improvements on Indiana rules and regulations should be in the lease. Following is a list of concerns on which a landowner might want specific provisions.

a. The landowner should reserve the right to approve the location of drill sites, tanks, access roads and pipelines.

b. Require all pipelines to be buried using the "double ditch" method below tillage depth, or at a specified depth, such as 60 inches where feasible or practical.

c. An Indiana statute requires the drilling company to be accountable to the landowner for damages "to the surface of such lands or improvements or growing crops located thereon," unless the lease provides otherwise. To make sure the lease does not limit the application of this statute, the lease should be specific in making the company liable for "all damages to growing crops, trees, fences, buildings, tile lines, drainage ditches, springs, water wells, any other improvements, livestock, and to the surface of the lessor's property.

d. Require fences around all drilling equipment to help protect livestock or children.

e. Require the company to indemnify and hold

the landowner harmless from all claims, demands and causes of actions stemming from activities undertaken by the company or its assignees. Require the lessee or drilling company to carry liability insurance as added security from such claims.

4. Bonus, rent and royalty.

A bonus is the term for the consideration provided in return for the landowner's signature on the lease. It may be the initial year's rent and comparable to the delay rental mentioned above, or it may be some amount in addition to a first year's rent. If the modern practice followed the historical practice of only a few weeks or months delay before drilling, the bonus might be the only payment before royalties begin if there is a "discovery" or before there is abandonment and termination of the lease. Modern practice and negotiations anticipate a delay of perhaps a few years before drilling and production or termination. Thus, the bonus and delay rentals may be more significant than in the past since the landowner may have to lease for a primary term of 3 to 10 years or not at all. Most landowners will feel that the nominal offer of \$1 an acre as a bonus or delay rental is not sufficient to commit their potential oil and gas reserves for an historic 1/8 royalty and risk damage to their property for which there is some chance they will not be able to readily identify or prove. Even if the damage is obvious, the landowner risks not being adequately compensated.

Reports from within Indiana and nearby states are of bonuses of \$2.00 to \$300.00 per acre and delay rentals of \$1.00 to \$45.00 per acre. Logically, the greater the expectation of a discovery, the more likely a landowner is going to get a large bonus and a commitment for a substantial delay rental as well as other favorable provisions in the lease. The higher the quality of the land for cropping purposes, the higher the bonus and delay rental ought to be.

"Royalty" has its roots in England where that was the term for the share of production from mines or quarries reserved by the crown. In the 19th century, the amount for the landowner from oil production was set at 1/8 and that is the standard offer today. Royalties up to 3/16 have been reported, but again, bargaining power for a higher than standard royalty may depend upon the expectation of a substantial discovery. Lessees who discover a large quantity available for production are in a better position to share a larger than usual percentage. Rather than engage in lengthy "haggling" one expert on leases has suggested that a landowner might agree to bonus, rental and royalty that appears to be the lessee's limit, but only after obtaining a provision in the lease that requires the lessee to provide the same higher bonus, rent or royalty that any other landowner might receive in some defined area. Landowners may want to require royalty payments on a monthly basis.

5. Access to books and records of drilling company.

The landowner should require a reasonable access mechanism to the books and records of the drilling or producing company so that he can evaluate the adequacy of the royalties received and obtain further information. This is another area where landowners might benefit from a cooperative effort to provide for an expert to inspect on their behalf.

6. Rights to free oil, gas and water.

Leases typically contain provisions for free use by the lessor of gas and water found on the premises.

The landowner should require that any water use by the company cannot restrict the supply of water for domestic, livestock, or agricultural purpose, and that the company shall not take water from wells, tanks, ponds or reservoirs of the landowner. Likewise, the landowner may want to consider provisions limiting free use of gas or other hydrocarbons. However, the landowner or a farm tenant may be able to benefit substantially from the use of a supply of gas. Lessees will likely limit lessor's free amount to that sufficient for a residence and will not pay for the pipeline from the well to the residence. A farmer may want to negotiate for the right to additional gas for livestock facilities and grain dryers at an economically advantageous rate.

7. Pooling provisions.

Most leases allow the drilling company to pool or form a drilling unit with lessor's land in combination with the property owned by adjoining landowners. Thus, when oil or gas is produced from any part of the unit all owners share in the proceeds in proportion to the amount of property they own in the unit. As indicated above, pooling provisions may also limit the need to pay a delay rental to all members of a pool when drilling is underway on one parcel in a pool, yet keep all parcels bound under their respective leases at least throughout a primary period. Indiana regulations provide 10-acre units for sandstone reservoirs, 20-acre units for limestone reservoirs, and a minimum of 160-acre units for commercial production of natural gas from a reservoir deeper than 1,000 feet.

Exercise caution in granting a company the unrestricted right to pool the leased premises, and in any event, be sure that you understand completely the effect of a pooling provision.

If necessary, submit to pooling in the lease only to the extent necessary to meet the requirements of Indiana law. In all cases, try to negotiate the inclusion of a "Pugh" clause in the lease that provides for the severance of the lease into separate tracts whenever less than all of the premises are included in a single pool or unit.

8. Consent to assignment of lease.

Require that the landowner consent to any assign-

ment of the lease or at least that he receive written notification of such assignment.

9. Warranty clause.

To avoid possible litigation expenses, landowners should seek to delete reference in the lease that infers they will warrant or defend title to the land. The initial lessee is likely to complete some type of title check and prevent payment of any bonus until he is satisfied of a lessor's rights in the mineral interest for a specific parcel. But the lessee may miss or ignore a problem. The lessor under a warranty clause could be forced to defend title at a later date.

TERMINATION OF THE LEASE

If the lessee fails to comply with the stipulations in the lease such as payment of a delay rental, a landowner, with the help of legal counsel and a court if necessary, may demand a termination of the lease because of breach. The lessee or his assignee may simply "give-up" and let the lease "automatically" terminate by the provisions of the lease. It may be useful to have a provision in the lease which requires the lessee to record a release from the lease when it is clear that the landowner is entitled to a termination.

The law also provides certain implied covenants or promises on the part of the lessee which may have been more important historically than at present.

1. There is an implied covenant to drill test wells within a reasonable time so that the purpose of the lease (production of oil and gas) can be fulfilled. If a landowner convinced a court of a lessee's failure

under this covenant, there would be grounds for termination of the lease. This covenant may be more important for lease forms used in past years providing for an extended term without provisions for payment of a delay rental. However, this covenant may still apply in Indiana even though the lease permits a delay during the primary period.

2. There is an implied consent to develop the leased premises as long as it might be done profitably. This covenant suggests that a lessee must limit the delay following a dry hole if there is reason to believe that another test drill could produce a discovery. Further, even if there is a substantial discovery the driller may be compelled to drill additional wells unless he can show that more wells could not be profitable. Of course, pooling provisions and Indiana regulations would limit the duty of the lessee-driller under this covenant.

Before attempting to terminate an oil and gas lease, the landowner should consult an attorney as to the proper procedure pursuant to Indiana Code Section 32-5-8-1. Note that if the landowner desires to cancel his lease for failure to drill test wells, he must not accept the delay rental payments, or else the lease probably cannot be terminated on grounds of failure to develop. Refusing delay rentals may be most effective when the payments are late.

After production operations are complete, drilling companies often offer a "non paying" but producing well for sale or free of charge to the landowner. When the landowner takes possession of the well, the landowner takes responsibility for plugging the well, which may be expensive. Carefully investigate all the costs and benefits before taking possession of the well.

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