

## **Facts for Appraisers about Mineral Rights**

Appraisers in South Arkansas and in the Arkansas River Valley, roughly from Ft. Smith to Russellville have always had to contend with issues surrounding mineral rights. Mineral rights for rural properties are often found separated (severed) from the surface rights in areas where coal, oil, or gas are found. Since the mid-1980's activity has been at relatively low levels and leasing prices have been low as well.

With the recent upsurge in oil and gas pricing, exploration has suddenly increased. It has begun in places where such activity was dormant or non-existent. Recent changes in drilling technology has made production of gas from shale rock feasible. SEECO (Southwestern Energy Exploration Co.), which is associated with Arkansas Western Gas Co., recently began a drilling project in Van Buren, Cleburne, Conway and surrounding counties which touched off a "boom" in leasing and drilling activity. As of November of 2005, 85 wells have been drilled or permitted. SEECO has 10 special rigs under construction to develop the gas they have found. Other companies are accumulating leases and tens of thousands of acres are affected.

That boom has spread into Eastern Arkansas where drilling was almost non-existent. White, Woodruff, Cross, Jackson, Prairie, Lonoke, and Monroe counties are experiencing the most interest as petroleum landmen offer up to \$400 per acre for mineral rights leases to drill oil and gas wells.

The appraiser now faces an additional burden in identifying such value and determining if a comparable is influenced by the presence of a lease, the lack of mineral rights or the owners desire to sell the surface but retain the mineral right, or, the value that such leasing activity has either added or subtracted to the fee simple. The competency provisions of USPAP require an appraiser to obtain competency by experience, study or association with an appraiser who is competent.

While few appraisers may elect to become mineral appraisers, the average rural appraiser in the central Arkansas region, needs to become knowledgeable on the basics of mineral rights. Perhaps the first lesson is simply to define the mineral right.

The state Oil and Gas Commission offers a good Surface and Mineral Owners manual at their website - [www.aogc.state.ar.us](http://www.aogc.state.ar.us)

Mineral rights are not an easement. They are real property rights and like surface rights have a bundle of rights associated with them. The mineral owner can Sell, Lease, Use, Give away, Enter (ingress/egress), or Refuse to do anything. In fact, mineral rights are dominant rights over surface rights. Unless the mineral owner has waived that right, they can enter the surface over the mineral right in order to exploit their mineral. The surface owner cannot prevent a mineral owner or their lessee from drilling on their property. In Fee Simple, any deed which does not specify that the mineral rights are retained or severed, implies that the mineral right is intact and part of the fee simple.

If the mineral rights are severed, correctly, the surface rights should no longer be Fee Simple, but Fee in Surface. Fee in Surface is the term used by mineral professionals, but that term is rarely encountered in the appraisal literature and there is no check box on the URAR form for it.

Severed mineral rights complicate the valuation of the surface because this right of entry may detract from the value of the property or the ability of the owner to have the “quiet enjoyment” of their property. Conflicts between surface owners and mineral owners or drilling companies are legendary and people have been killed in such confrontations. Appraisers need to be aware that when mineral rights are absent, whoever owns the mineral right can, if they so desire, enter the property. The impact on the value of the surface might not be apparent until the drill rig appears.

This raises liability issues for the appraiser, even though they did not appraise the mineral right. It is not hard to imagine a situation where a new rural property buyer, confronted by a drilling rig within a few hundred feet of their home, sues the appraiser for not revealing the negative impact of such an occurrence. Realtors and lenders may face the same suit.

Mineral leases have three general elements.

-A cash bonus is paid up front for a primary term. The primary term is typically 3 to 5 years. If drilling does not discover production during the primary term, the lease expires.

-An annual rental is paid, usually a perfunctory \$1 per acre, to hold the lease during the primary term.

-A royalty interest. Arkansas requires a minimum royalty of 1/8th. The mineral owner gets 1/8th the production from the well. The royalty may be higher in many areas. The cost of drilling the well and producing the gas is borne by the lessee. The owner only pays their part of transportation costs from wellhead to the destination (pipeline or refinery.)

The Secondary term of the lease occurs if production is found. A lease is said to be “held by production” (HBP) if gas or oil is produced. So long as production continues, the lease remains in effect.

With the current boom in central Arkansas being so recent, little market data is available to make adjustments for the absence of mineral rights. The appraiser may be forced to rely upon polling owners and Realtors for their best “guess” while accumulating as many sales as possible in affected areas that have both minerals intact and minerals severed.

Likewise, many sellers now want to retain their mineral right. Appraisers may be asked to value the mineral separately. And many a sales negotiation may be complicated by the unwillingness of the seller to part with the minerals and likewise the buyer unwilling to buy without. With 5 year lease bonuses running to \$400 per acre, it is understandable.

However, like most petroleum plays, this one has a life cycle. The first leases taken in the Central Arkansas area were \$25 - 50 per acre whereas some of the most recent ones are

\$300-400. The middle of 2005 saw a rapid escalation in offering prices. Now there are signs the oil companies are taking a “wait-and-see” approach. They want to see some of the more remote wells start production before leasing additional land. This chaotic market makes the appraisers job most complex.

Even once the current mania runs its course, the residual effect likely is to complicate the appraisal process for years to come. More landowners will want to retain mineral rights in the play areas. Unrealistic values may be set upon current leases or mineral rights. Geologists who have studied the area realize that there is a limited area where the current play is seeking leases. Properties miles away may be completely out of the lease area, but will be affected by the owners or the non-professional petroleum investors perception, rather than the facts. The principle of anticipation is the perception that value is created by anticipation of future benefits. The reality of oil and gas in the ground may not be as important as that perception in the general land buying public that oil and gas is nearby.

The appraiser needs to educate themselves on the mineral right, to identify the right and deal with it appropriately. Accumulating sales with and without mineral rights is the best way to determine the actual market reaction, but such sales are rare and difficult to determine since most lease information is closely held by the lessee and lessor. Rapid changes in the mineral rights values will be driven by results. High drilling activity and good production will drive up prices. Prices driven by a short term “mania” will likely fall rapidly to a more normal level once production and producing areas are established.

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