Mineral Rights - Royalty Owner Info

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FROM THE DESK OF....

I want to make it clear that this is not offered as a self-promotion or to get you to sell your mineral rights short, or “give” anyone a great deal on leasing mineral rights (specifically, oil and gas.) This is not legal advice and you should consult your attorney if you have questions of a legal nature. This is just general background from the perspective of both a geologist and an appraiser that probably applies to 90% of all oil and gas leases in the U. S.

Greed makes the world go around supposedly, but buying and selling, leasing and putting together oil deals are in a class by themselves. Some people enjoy the bargaining and banter that is part and parcel with securing the mineral lease while others hate the process.

Experienced mineral owners expect, like any other unsolicited offer to buy or lease, whether it be cars, property, or minerals, a low initial offer. But the first time mineral owner who has just been made an offer often gets the “gold bug” and has visions of huge money pouring in from “his” oil well. In reality, most wells are dry or produce less than an economic amount. That big royalty check may turn out to be not so good. So the bonus plays an important part of the compensation available to the landowner. If you are betting on future income from royalty, that is a much riskier proposition than “cash on the barrelhead”. As one wag put it, “I don’t want them to ever drill and prove it to be a dry hole. I’d rather get my check every three years or so, and, heck, if there is oil there, it will still be there.”

Perfectly rational people may see the prospects differently. One, anxious to get to that royalty money, may opt to take the first bid available. The other may negociate for the highest possible rental and might even refuse initial offers. Another might opt to not lease at all and to participate in the drilling venture in hopes of achieving the highest return from a successful venture.

Risk. The reward of investment is proportional to the risk. A risky venture should be rewarded with a high return. Lower returns can be expected from less risky investments. The mineral owner is compensated by an initial lease bonus, usually a per net acre amount. Annual “rents” usually are only a perfunctory $1 per acre. The main payoff will be if the successful well is completed.

A well drilled on a single mineral owner that is successful does not necessarily relate solely to the mineral interest of that person. Adjacent owners may have property affected, and “unitization” or field rules may apply. When a large productive structure is identified, it may be a more fair distribution of the proceeds to “unitize” or “force pool” the field. The drilling unit will then divide up the royalty proceeds according to the percentage of the unit or pool that the individual owners control. The logic is that a well on one property may be draining oil or gas from adjacent owners where no well exists. To avoid unnecessary wells being drilled solely to capture the oil that is "escaping", unit operations are generally "spaced" to state specification and all affected mineral owners allocated their share based upon the whole field (pool).

Go Long? Go Short?

A "hot play" in a new area often results in competing bids for properties. Older plays, with low expectations, usually lease for modest prices. But the "new thing" may see bonus offers rapidly escalate within months and several competing leases may be available to the mineral owner. The initial "find" or idea may generate initial lease prices that are relatively low. As production is confirmed, nearby acreage may bring a premium in the market. As the play matures, prices offered may actually fall. It is not possible to predict which way things will go and conditions can change literally overnight.

Competing Offers

When competing offers are available, the mineral owner may be faced with a choice such as follows:

1	$1000 per acre	3/16th Royalty	3 yr. Term	Drilling is active
2	$500 per acre	7/32th Royalty	2 yr. Term	Will be drilling soon
3	$2000 per acre	1/8th Royalty	1 yr. Term	Does not have a rig under contract

Which offer would you take? Without knowing the geologic situation under your property, this is a real puzzle. But consider some things. The best Royalty pays the least per acre. Therefore, you stand to get a higher return but if dry, you have "left money on the table." And, if your lease merely expires in two years, you may be able to lease again. If a well is drilled, and is dry, your property is condemned and no one will be willing to pay much for the lease probably. On the other hand, if production is found, the higher royalty would pay off handsomely.

The first offer will pay intermediate and since they are drilling and offering a three year lease, it is probably going to result in a well being drilled. But if oil is found, this royalty will be less than Option 2. This may appear to be the "most sure thing." A good bonus, and reasonable royalties.

Offer 3 will pay the highest bonus, but if a well is developed, it will pay the least royalty. Perhaps the key to analyzing this option is that the term is only one year and the driller does not have a rig. It seems likely that under the current regime of rig shortages, the offer from Option 3 may face an obstacle of even being able to find a rig that can drill your well within a year. This lease is likely to expire before it is drilled.

This author might seriously consider taking the highest offer and banking on the lessee to not be able to drill that prospect. In 12 months the lease will be free to be re-leased. In fact, someone else may offer to "top lease" your land. That is they will take a lease in the future under the assumption that your lease will not be secured (Held by Production - HBP) by the holders of Option 3. In the event the high offer is from someone certain to drill, I would opt for Option 1. Better bonus than 2 and better royalty than 3.

Finally, if the area is such a lead pipe cinch, and you are certain to have production (or have already been taken into a drilling unit or pool), the highest royalty option should be taken. Alternatively, if you have the willingness and the means to, you can opt to join the operator as a minor working interest partner. You can either pay your share of expenses at the time, or, do nothing and pay a penalty out of your proceeds. In the project does not make a profit, you will not get anything, but you will still control your lease 100%. But if the project is successful, your royalty interest is now 100% less maintenance expenses. Your check will be several times the amount you would receive if you were leased.

Only a geologist can make the determination if your property is such a "lead pipe cinch" and even then, many things can go wrong. The sand may disappear, be tight, or the well can have mechanical problems. There is always geological risk. The larger the pool or unitization, the lower the risk.

The New Technology

Shale gas and coal bed methane are currently the "hot plays". The Barnett Shale of the Ft. Worth Basin is causing quite a stir, as is the "Fayetteville" Shale play in the Eastern Arkoma Basin. Bonuses in the Ft. Worth area are reportedly running $300 - $1,000 per acre, and bonuses up to $200 an acre are being reported in central Arkansas. These wells produce differently from conventional wells. The mineral owner needs to be aware that such plays often die down sooner or later. The drill bit usually does not lie. When great expectations settle down to reality, lease bonus offers tend to drop dramatically.

Any time unusually high bonuses are offered, it is time to lease. Remember a high percentage of these leases will expire without ever being tested by the drill. Waiting may only see a dramatic shift from high to low bonus money. Again, high bonus and short term often pays off better than larger royalties for longer term leases. And in risk weighted terms, this is a less risky way to lease mineral rights. 3/16th of nothing is the same as 1/8th of nothing.

My Best Advice

Study the lease offers and do not hesitate to hire a lawyer experienced in oil and gas to examine the lease. Further, there are some provisions you need to reserve.

- ☞ Limit the lease to the proposed production zone or reserve all parts of the formations which are not producing during the term of the lease. Only producing zones should be held by production. The rest of the zones should be left for someone else or tested by the operator.

- ☞ Do not guarantee title to the lease, let them do it.

- ☞ Require the lessee to pay any applicable property taxes, excess fees, etc.

And, the very best advice is to consult the National Association of Royalty Owners and get the book "Look before you Lease" from them. There are a host of lease provisions that they recommend that preserve the maximum value of the lease to you. They can be found at

www.naro-us.org

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