



Leasing Farmland for Oil and Gas Production

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Currently oil and gas prices are high and landowners may have an opportunity to lease their farmland for oil and gas production. Before negotiating a lease, thoroughly investigate your property title. It is a good idea to check the deed on file in the county recorder's office.

A landman, company representative, or an independent person seeking to secure oil and gas rights most often approaches the landowner. Landowners are often presented with what is commonly referred to as a "standard oil and gas lease." A lease provided to a landowner by a company will be a well-prepared document written from the company's perspective. Legal representatives for the company have written this document to protect, extend, and transfer as many rights as possible to the company.

The landowner, as well as the company wishing to lease, should seek legal counsel. This fact sheet will discuss what may be found in a standard oil and gas lease (see sample lease at the end of this fact sheet), and evaluate the meaning of the statements and terminology often seen in these documents. Remember, many of the terms in a lease are negotiable. This fact sheet should not serve as legal advice and should only be used as an educational resource. As you go through a lease with a landman or company representative, be sure to question any terms you do not fully understand.

Economic Considerations

As a landowner, you would like to earn additional money from your real estate investment. Whatever your goals for your property, an oil and gas lease can affect the use of farmland for your lifetime. From a purely economic

standpoint as a landowner, you may wish to compare the following:

Consideration or Bonus Payment	\$ _____
Delay Rental Payments	\$ _____/per acre
Gas Royalty	_____
Oil Royalty	_____
Free Gas per Well	_____
Shut-in Royalty	\$ _____

When comparing these economic components of a lease, there may be subtle differences. For instance, how is the "consideration or bonus payment" to be paid and when? Answer the following questions in regards to the bonus payment: Is this payment in lieu of the first year's delay rental payments or production royalty? If so, as the property owner do you consider this fair compensation? In addition, is the oil and gas royalty paid to you free of any deductions, such as treating, separating, etc.? The list of possible deductions from a royalty check can be long and you will not have the means to measure them, making it virtually impossible for you to evaluate the accuracy of your payments. The way production royalty is calculated can make a difference, since royalty payments can be based on quality and quantity of oil and gas production. The lease will describe the basis of your royalty payment, and this section may contain such words as "measured according to Boyle's Law for the measurement of gas under varying pressures..." This next example describes in simpler terms another basis for royalty payment: "The lessor shall receive

his royalty share free of any and all expense, and without deduction for cost of treating the oil or gas from any well to make it marketable; (B) To pay to the lessor as royalty for the gas, except casinghead gas, used on the premises and produced from each well drilled thereon, the sum of one-eighth (1/8) of field market price per thousand cubic feet of such gas so marketed and used, measured in accordance with industry standards outlined by the American Petroleum Institute.” Find the area in your lease that reads similar to the above statements. Is it different? If so, do you understand what the statements mean?

Primary and Secondary Terms

At the very top of a lease there may be a statement, “2-year oil and gas lease.” This is often referred to as the primary term or the period of time the company has before a well is drilled and found to produce in “paying quantities.” The period of time a company has to find and drill for gas is often negotiable. Drilling for oil and gas does not guarantee production. In most standard leases, there is a clause that keeps a lease in effect even if no well is found. This can be done through storage clauses or payment clauses. A property owner should clearly understand all of the different ways their lease can stay in effect. Once a well has begun production and is producing in “paying quantities,” the secondary terms of a lease go into effect. The period of time a company has to drill a well should be important to a landowner.

Next in the lease is the description of the lessor (landowner) and the lessee (company). Here a sentence may start with, “that the lessor, for and in consideration of \$_____ and other valuable consideration ...” This section of a lease describes what is being leased and for what purposes. In addition, we may find here a description of what resources (i.e. land, water, timber, other minerals, etc.) can be utilized by the company for exploration of oil and gas. Furthermore, we may find mention of items such as the storage of oil, gas, and brine. If you do not intend for your property to become a storage unit for oil and gas produced elsewhere make sure that this is clearly stated in the lease. Look for mention of formations such as “Clinton, and Berea, etc.” Realize your land is looked at as having horizons, strata, or layers. Unless otherwise stated, once a lease is signed it may allow a company to sell deep or shallow horizons without your consent unless otherwise stated in the lease. Newer leases will often mention mining or coal-bed methane. Do you want the coal resource on your land to be included in your oil and gas lease? Be certain that the coal resource was not already

leased to a different company. To avoid disputes it may be useful to specify “the extraction method used by lessee can be through borehole only.”

The delay rental is a payment to the landowner, usually paid annually on a per acre basis, and paid until a well is drilled and producing in “paying quantities.” This same payment may also be discussed in the area of a lease that deals with “shut-in.” Shut-in royalty is a payment in lieu of the production royalty. It is usually paid at the same rate and manner as the delay rental. Once a well has been drilled and is producing in “paying quantities,” the lease can remain in effect for an indefinite period and triggers the secondary terms of the lease. The term “paying quantities” is purposely vague. As a landowner, consider this term closely. Ask yourself, “How little compensation am I willing to accept to keep the lease in effect?”

Following the legal description of the land there may be a description of the minimum distance that drilling can take place from a structure. As a landowner, you may want to specify distances from houses, water wells, etc. The Ohio Division of Mineral Resource Management has set standards that govern these distances. The Division of Mineral Resource Management is a great source of information and can be accessed via the internet at <http://www.ohiodnr.com/mineral/default/tabid/10352/Default.aspx>

What Keeps a Lease in Effect?

Here are a few questions to answer in regards to keeping a lease in effect:

- What happens at the end of the primary “2–3 years” and no well has been drilled or the well is not producing?
- What happens when the well is producing very little royalty?
- In what ways can the company use the delay rental?
- Can the lease continue indefinitely for some nominal fee?
- Does the lease allow the company to store oil and gas on your property even though a well is not producing on the leased premise?

In most cases, a standard oil and gas lease will allow a company to continue the lease whether or not a producing well is found. As the landowner, state in the lease what is to occur after the primary term and secondary term. For example, “the lease terminates unless within 9 months of the end of the primary term, a well is drilled and placed in

production.” Make sure it is clear when a lease starts, ends, and the procedures to nullify the lease. If you are receiving no checks from the leasing company, but do have gas for your household, unless otherwise stated, this may keep the lease in effect. Similarly, receiving and cashing checks from the leasing company may be considered an acknowledgment of the lease. From a landowner’s perspective you would like to be in business with a reputable company, have your resources cared for properly, and keep your title work as clean as possible. From a company’s perspective, their goal is to have a lease that is an asset that can be sold, any section or part of, and does not cost much to keep. It is also convenient for the leasing company if all of their leases are the same or very similar.

Production of Oil and Gas

The lessor’s share of oil and gas production is usually one-eighth (1/8). The landowner is normally offered market price at the published rate for oil and like grade gas. This section of a lease should describe when payments are to be made, which is usually monthly. The landowner may want to ensure that “all royalties to the lessor shall be without deduction of costs of producing.” If this cannot be agreed upon in the lease, make a list of what these costs are and how much you can expect to be paid for oil and gas. If production royalties are not paid, the company usually retains a right to pay a delayed rental rate or a shut-in royalty. Keep in mind as a landowner, delay rental can be utilized in most cases to keep a low or nonproducing well lease in effect. Be sure this option fits into your objectives as a landowner. In the lease, clearly outline when and to whom payments will be made, and the consequences that are to take place if payments are not made on a timely basis. If the lease is broken for any reason, the landowner should be furnished with a “release of lease” courtesy of the leasing company. In addition, the costs associated with clearing the landowner’s title and filing should be at the expense of the leasing company. Any such agreements not in writing are not enforceable. Communication in regards to lease provisions should be documented by using registered mail.

The lease should address the use of free gas for the landowner. In most leases, the amount of gas that can be utilized by the landowner is restricted to 150,000–300,000 cubic feet. Very few leases allow for the unlimited use of free gas. In addition, the lease may limit the use of this gas for “domestic use” of one household. Free gas may be a point of negotiation. If you utilize more gas than the amount specified, be sure that you pay the same rate as

you are being paid for the gas. A landowner may want to use the free gas in more than one building. If so, it may be wise to remove the one building or dwelling clause.

Important Considerations

Other important considerations in an oil and gas lease include the right to assign, unitizing/ pooling/consolidating, burying gas lines, shut-in, and plugging or abandonment. Pooling allows the drilling company to pool or form a drilling unit with adjoining property owners. Unless you have very few acres, exercise caution in granting a company unrestricted pooling/unitization or consolidation. If your land is unitized as part of a drilling unit, you will split the 1/8th royalty with the other contributing landowners. The percentage of the 1/8th royalty you receive is based on your acreage contribution to the drilling unit. When unitized if the producing well is not on your property you will most likely not receive free gas. This particular area of a lease can be used to bind large tracts of a landowner’s farm. Likewise, after the legal description of the specifically desired tract of land it may state, “and including all lands and interest therein, contiguous or appurtenant to said described land and owned or claimed by lessor, whether or not specifically described above.” As a landowner, you may not want all parcels of your land leased for oil and gas production. Specifically state the parcel or parcels of land you want in the lease.

As a landowner you will probably not want your lease to be sublet, or assigned without your consent. Be sure to state in the lease that, “no part of the leased premise, including any and all of the geological horizons may be transferred or assigned without lessor consent.” You may see the term, “the landowner shall not unreasonably deny the right to assign.” What is unreasonable and in whose judgment? Avoid use of such vague terms.

Buried gas lines will allow the landowner to plow fields or harvest timber without damage to the lines. It may be wise to state this in the lease and the depth to bury the lines. In addition, as the landowner you may want some discretion as to how and what forages are reseeded in disturbed areas.

Most leases contain a “shut-in royalty.” This is a payment to be made to the landowner in lieu of production royalty. This payment, unless otherwise stated, may keep a lease in effect and payment will most likely be the same as the delay rental rate. As a landowner be sure this fee fairly compensates you and be aware that this clause may keep a lease in effect although you receive no royalty. Shut-in does not necessarily mean that a well is incapable of

producing; it simply means that it is not at the company's discretion.

During the process of exploring and developing oil and gas, roads may be built, water used, storage tanks located, etc. Agree to these locations in writing and mark their locations on an aerial photo. The condition of haul roads and right-of-ways is often a point of contention between the landowner and company. Unless otherwise stated in the lease, the company has great leeway as to the general condition of these roads. It may also be useful to describe in writing the condition roads are to be maintained in, who will cover this expense, and who makes this decision. Landowners may want to state in writing what happens to the roads at the end of the lease.

If a well is capable of producing, a right-of-way pipeline may need to be installed on your property for oil and gas transmission. What happens to these pipeline right-of-ways? Does your lease clearly address all structures laid upon and erected on your property? Can the transmission lines and/or tank batteries be assigned? Be sure to address these items in your lease.

Oil and gas well areas, tanks, pumps, and other equipment should be fenced off from livestock. Mark the location of these facilities on a map. The leasing company should be responsible for protecting their equipment from livestock. Be sure to state in the lease that this is the responsibility of the leasing company and that they shall keep the fence adequate to turn livestock.

Landowners who have more than one well may wish to identify from what well royalty payments are based. A well number on checks could note this. Some leases have inserted clauses that allow the landowner free access to books, records, and drilling records pursuant to operations conducted on the leased premise.

Warranty title clause on most leases states that it is the landowner's responsibility to defend the title. This clause may state, "the lessor hereby warrants and agrees to defend the title to the lands herein described." If a question of ownership arises, and you sign that you warranty the title, then burden of proof is on you and the landowner.

At the termination of a lease, "the well is not producing in paying quantities in the opinion of the landowner," you may want to purchase the well for domestic use. If you would like this option, state it in the lease and at what price, i.e. "Lessor shall have first, the option to purchase any of the wells at salvage value thereof minus cost of removal and plugging." If you do not elect to purchase the well, then specify the length of time that the lessee has to remove all equipment.

Oil and gas leasing is a complicated and long-lasting agreement. As the landowner, the decisions you make on the lease will potentially affect the property for many years. Ask questions of the leasing company, put details in writing, seek legal counsel, and investigate the leasing company.

References

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- Harrison, G.A. (1997). "Negotiating Oil and Gas Leases on Indiana Farmland," EC-564. Purdue University.
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Example of a 2-Year Oil & Gas Lease

This paper is an educational tool and not intended for use as a legal instrument. This lease example is written from a landowner's perspective. The reader should notice differences in this example and a "standard lease." These differences should raise questions. The areas in this document where blanks or "____" occur should cause the reader to consider a choice or option. A landowner's attorney and/or the leasing company representative will be helpful in explaining the terminology and intent contained in lease phrases.

2-YEAR OIL & GAS LEASE

THIS LEASE, made and entered into this _____ day of _____, 20____ by and between _____ of _____, Ohio, hereinafter called the Lessor, and _____ of _____ hereinafter called the Lessee, WITNESSETH:

That the Lessor, for and in consideration of \$_____ and other valuable consideration in hand paid by the Lessee, the receipt of which is hereby acknowledged, and the covenants and agreements hereinafter contained, does hereby lease and let unto the Lessee, for the purpose of drilling, operating for, producing and removing oil and gas ("which by definition includes coal bed methane and/or methane gas") thereof, and of storing and holding in storage, and removing (sometimes herein referred to as gas storage purposes, storage shall only pertain to oil, gas and brine produced from this leased premise), including gas lying thereunder, by pumping through wells or bore hole, in and from the _____ formation lying thereunder, and of placing tanks, equipment and structures thereon to procure and operate for the said products, and of laying pipe lines there-over to transport the same from the leased premises and "from other premises" on, over and across the leased premises. Lessor reserves all non-producing formations. Lessor reserves the right-of-way on all lands. Tanks, compressor stations, gas and oil lines shall be treated in this lease the same as the oil and gas well. These items may not be assigned, easements and/or right-of ways shall not be created without written consent of landowner. Changes to this lease may be made by adding or striking lines when initialed and dated by Lessor and Lessee.

all that certain tract of land situated in: _____ Township, Section No. _____ in _____ County, Ohio, bounded substantially as follows:

North by lands of _____

East by lands of _____

South by lands of _____

West by lands of _____

being all property owned by Lessor in Section _____ of _____ Township, containing _____ acres, more or less.

No well shall be drilled within _____ feet of the present buildings unless both parties consent thereto.

This lease shall continue in force and the rights granted hereunder be quietly enjoyed by the Lessee for a term of two years and so much longer thereafter either (1) as oil or gas or their constituents shall be found on the premises in paying quantities (in the judgement of the Lessor) or (2) as the premises shall be operated by the Lessee in search for oil or gas.

This lease, however, shall become null and void and all rights of either party hereunder shall cease and terminate unless, within _____ months from the date hereof, a well shall be commenced on the premises.

In consideration of the premises the Lessee covenants and agrees: (A) To pay of the Lessor in a royalty, free of cost, the equal one-eighth (1/8) part of all oil and gas produced and saved from the premises, at market price for such one-eighth (1/8) royalty oil at the published rate for oil of like grade and gravity prevailing on the date such oil is run into tanks or pipe lines. The Lessor shall receive his royalty share free of any and all expense, and without deduction for cost of treating the oil or gas from any well to make it marketable; (B) To pay to the Lessor, as royalty for the gas, except casinghead gas, used on the premises and produced from each well drilled thereon, the sum of one-eighth (1/8) of _____ field market price per thousand cubic feet of such gas so marketed and used, measured in accordance with industry standards outlined by the American Petroleum Institute. Payments of royalty for gas marketed during any calendar month to be on or about the 30th day of the following month; (C) To pay to the Lessor the land rental or well rental hereinafter provided for the use of the premises until a producing well is found (at rate of _____ per acre, per "month or year" on or before _____ each "month or year"); (Meter shall be located at well head or separator at lessee expense.) If rent and royalty is not paid within 10 days of Dec. 31st, the lessee shall occur interest compounded

daily at a rate of 10%, from the date above until Lessor is paid in full. The Lessor has the right to terminate this lease if after 10 days from said date, and providing written notice to the Lessee for non-compliance. At such time Lessor may assume quiet title and shall recover all cost associated with such action.

All money due under this lease shall be paid or tendered to the Lessor by check make payable to the order of and mailed to _____ Lessor at _____ above address _____ and the said named person shall continue as Lessor's agent to receive all sums payable under this lease regardless of changes in ownership in the premises, or in the oil or gas or their constituents, or in the rentals or royalties accruing hereunder until delivery to the Lessee of notice of change of ownership as hereinafter provided.

The Lessor may lay a pipe line to any one gas well on the premises, whether or not a producing well is found, and take gas produced from said well for domestic use in _____ buildings/dwellings on the leased premises, at Lessor's own risk, subject to the use and the right of abandonment of the well by the Lessee and furnished at _____ unlimited use for domestic use to the Lessor. Lessor to lay and maintain the pipeline and furnish regulators and other necessary equipment at Lessor's expense. This privilege is upon the condition precedent that the Lessor and Lessee shall both scribe to and be bound by the reasonable rules and regulations of the Lessee relating to the use of free gas and gas production, and shall maintain the said pipeline, regulators and equipment in good repair and free of all gas leaks and operate the same so as not to cause waste or unnecessary leaks of gas. In consideration for drilling, if said well does not produce gas, the Lessee shall provide gas from another line to the Lessor.

In the event a well drilled hereunder is a dry hole and is plugged according to law, this lease shall become null and void and all rights of either party hereunder shall cease and terminate from the date of the completion of the plugging of such well. Shall Lessee decide to abandon or plug any well or wells on subject land, Lessor shall have first, the option to purchase any of the wells at salvage value thereof minus cost of removal and plugging. Lessee shall give written notice to the Lessor of the intent to abandon or plug and the Lessor shall have 30 days following notification to elect to purchase. Upon the termination of this lease, Lessee agrees to cancel the same record and provide a certified copy of such to the Lessor. Once a well stops producing in paying quantities and stays at that level for 6 months the lessee shall offer the well to the Lessor as described above and if offer is rejected the Lessee shall plug the well within _____ months from offer date and remove all equipment within _____ months or plugging and such will be accepted by Lessee and Lessor as the termination of lease agreement. All equipment and lines not removed by the time described above will become the property of the landowner. The hull roads shall become the property of the landowner and shall not be removed without landowner written consent.

In the event a well drilled hereunder is a producing well and the Lessee is unable to market the production therefrom, or should production cease from a producing well drilled on the premises, the Lessee agrees to pay the Lessor, commencing on the date _____ months from the completion of such producing well or the cessation of production, a well rental in lieu of royalty a rental (\$ _____ per acre, per "month or year" as per above) under the terms hereinabove provided for rental or such well is plugged and abandoned according to law.

The consideration, land rentals, well rentals or royalties paid and to be paid, as herein provided are and will be accepted by the Lessor as adequate and full consideration for the rights described herein granted to the Lessee.

All costs for marketing, severance taxes, mineral taxes and transportation shall be paid by Lessee. All costs and assessments for installation and removal of pipelines and equipment shall be the responsibility of the Lessee even if such cost are incurred after the termination of this lease. Lessee shall have no authority to create any lien upon Lessor's interest in the premise.

The Lessee may not consolidate on this leased premise. No unitizing or pooling of lease.

This lease is to drill, store oil and gas from the well(s) drilled only on this leased property, and the Lessee may not use premises for any other purpose.

No part of the leased premise, including, but not limited to, any and all of the geological horizons, tank batteries, transmission lines may be transferred or assigned without Lessor consent.

Lessee assumes exclusively all liability associated with the execution of said practices and the maintenance of said equipment.

Premise resources may be used as to the judgement of the Lessor.

Furthermore, disturbances to the leased premise shall be restored as to the judgement of the Lessor.

The Lessee shall bury, when so requested by the Lessor, all pipe lines and electrical lines used to conduct oil or gas to and off the premises and pay all damage to growing crops caused by operations under this lease; said damage, if not mutually agreed upon, to be ascertained and determined by three disinterested persons, one thereof to be appointed by the Lessor, one by the Lessee, and the third by the two so appointed, and the award of such three persons shall be final and conclusive. The Lessor reserves the right to replant and renovate at Lessee expense ground disturbed in pursuit, transfer, or exploration of oil and gas. The Lessor must be consulted and agree as to the location of tank separator, lease road (to be geotextile & limestone base and maintained

as to Lessor's judgement) and all other facilities. Lessor reserves the right to use leased premise in support of, but not limited to, agricultural farming practices and home site buildings for the life of the lease. Lessee shall not alter drainage or pool water and shall construct and maintain well-drained haul roads as previously stated.

The Lessee shall have the privilege of using sufficient oil, gas and water for operating on the premises and the right up to one year following the termination of the lease to remove all pipe, well casing, machinery, equipment or fixtures placed on the premises. The Lessee shall have the right to surrender this lease by written notice to the Lessor. The surrender shall indicate a cancellation of all liabilities under the same of each and all parties hereto relating in any way to all of the premises indicated on said surrender, and the land rental hereinbefore set forth shall be terminated.

In the event the Lessee is unable to perform any of the acts to be performed by the Lessee by reason of force majeure including but not limited to acts of God, strikes, riots, and governmental restrictions this lease shall nevertheless remain in full force and effect until the Lessee can perform said act or acts.

All covenants and conditions between the parties hereto shall extend to their heirs, personal representatives, successors and assigns. It is mutually agreed that this instrument contains and expresses all of the agreements and understandings of the parties in regard to the subject matter thereof, and no implied covenant, agreement or obligation shall be read into this agreement or imposed upon the parties or either of them.

IN WITNESS WHEREOF the Lessors have hereunto set their hands.

Signed and Acknowledged in the presence of:

_____ X _____ (Seal)

_____ (Seal)

_____ X _____ (Seal)

(*) See attached Exhibit "A" for additional terms and conditions.

STATE OF _____ On this _____ day of _____ A.D. 20 _____

County of _____ before me, a _____ in and for said County

personally appeared the said _____

who acknowledged that _____ did sign and seal the foregoing instrument and that it is _____ free act and deed.

WITNESS my hand and _____ seal, the day and year aforesaid.

_____ (Seal)

Notary Public, Justice of the Peace

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