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Legal Affairs

Negotiating Oil and Gas Leases on Indiana Farmland

Gerald A. Harrison

Contents

Introduction1

Considerations Before Signing2

Chances of Discovering Oil or Gas2

Protection of Farmlands and Improvements2

Investigation of the Leasing Company3

Evaluating Your Neighbors' Decisions3

Seeking Legal Counsel3

Tax and Estate Planning Considerations4

Provisions That May Be Negotiable4

Mineral Rights and Other Rights Granted4

Duration of the Lease4

Damage to Crops, Farmland, and Improvements5

Bonuses, Rents, and Royalties6

Access to Books and Records of the
Drilling Company6

Rights to Free Gas and Water6

Pooling Provisions6

Consent to Assignment of a Lease7

Warranty Clause7

Termination of the Lease7

Failure of Implied Covenant to Drill7

Failure of Implied Covenant to Develop7

Seeking Legal Counsel Before Termination8

Taking Possession of a Well8

Disclaimer: This paper is intended for educational purposes only. Individuals with legal interests at stake should consult an attorney who is informed on these matters.

Introduction

Besides the discovery of new accumulations, changes in the price of oil and gas, and advances in technology and deregulation are forces that encourage widespread leasing activity in southern Indiana. Landowners in several Indiana counties continue to have an opportunity to lease or convey the rights to oil and gas exploration and production. Granting of rights to test-drill and to produce oil and gas is an important transfer of property rights.

One might say that the oil and gas producer/lessee becomes a "partner" in business. Landowners should control this relationship through the lease. Landowners should also become fully informed about the rights and duties of oil and gas exploration and producing companies. These rights and desired limitations and the landowners' payments for delays and property damages, and for the actual oil and gas produced should be clearly stated in the lease. Lawyers experienced in dealing with both the landowner and lessee relationship and the production of oil and gas may offer many lease drafting suggestions that may benefit a landowner.

Talk to other landowners (lessors) and learn more about their experiences with exploration and production and the royalties they received. Seek legal counsel experienced in these matters before signing an oil and gas lease. A standard form lease offered by a landman may not offer all that can be negotiated by a lawyer experienced in protecting the landowner interests.

A lawyer can clarify your rights, responsibilities, and risks under a gas and oil lease. For example, the landowner should be concerned about the potential for his or her liability for oil and other types of pollution under federal and state law. Individual landowners with small parcels may join together with neighbors in order to pool resources for hiring lawyer with oil and gas lease and production experience.

The property owner must recognize that the lessee and future owners of the leasing rights have a long-term interest in the property similar to a utility with a right-of-way for an electric power line.

Oil and gas leases are defined for a limited period similar to farmland leases. However, if production is initiated and continues at some acceptable commercial rate, the period of the lease is indefinite. In fact, options under the typical lease can extend the period of the lease when there is little or no production.

In order to have a say about 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 farmland, crops, and improvements), one should have lease provisions to cover these matters.

However, signing an oil and gas lease with the desired provisions may not be an easy decision. For example, individuals may be concerned about the possibility that production may begin on a neighbor's property that draws from your property.

If land is not under a pooling agreement through an oil and gas lease, the owner of the land will not receive a share of the royalty. In a "wildcat" area (where oil and gas reserves have not been proven), experts suggest that if production begins near your property, there will be a chance for leasing on the "second wave" of activity. With a second wave of activity, lease terms may improve compared with an initial leasing opportunity. The amount of signing 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. Current and alternative uses for the land to be covered by the lease may be a deciding factor.

Considerations Before Signing

Chances of Discovering Oil or Gas

If the landowner has a good estimate of commercially available oil or gas underlying his or her land and the cost of its production, a more informed leasing decision can be made. With present technology, a test drill site is necessary to detect the presence or absence of available oil or gas. However, existing geological information can show the possibilities of oil and gas discovery. Records and maps exist by counties of prior drill sites and information on current and historical production. Geological consultants or petroleum engineers may review records and maps to develop an understanding of production possibilities and the potential for profitable production.

Maps and publications may be obtained from: **Indiana Geological Survey, 611 North Walnut Grove, Indiana University, Bloomington, IN 47405. Phone: 812-855-7636; Bulletin 42-N, Petroleum Industry in Indiana (1995) is available for \$4.00. Also Bulletin 42-I, Coal Resources of Indiana (1973) is available for \$1.50. Postage and sales tax are extra. Additional detailed information is available from individual test well records. Information is available from John A. Rupp, Head, Energy Resources Section, Indiana Geological Survey, phone: 812-855-1323.**

Protection of Farmland and Improvements

When oil and gas are discovered and produced, cropping can 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. Farmers and landowners may wish to learn about existing Indiana rules and regulations that govern well drilling, production, and restoration activity. Information on Indiana rules and regulations is available from: **Division of Oil and Gas, Indiana Department of Natural Resources, 402 West Washington St., Rm. W-293, Indianapolis, Indiana 46204. Phone: 317-232-4055.**

Investigation of the Leasing Company

In Indiana, companies can engage in oil and gas leasing without a license, bond, or investigation or approval by any Indiana agency. Landowners may want to seek information on the leasing company's reputation and performance. The initial lessee may be a middleman (landman or broker) 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 can save time and cost by

pooling their efforts in conducting such an investigation--perhaps with the assistance of an attorney. A farmers' organization might be helpful in this regard.

Oil and gas leases are usually pre-printed forms which are likely to include terms favorable to the lessee. The lessee would prefer to use a standard-form contract to avoid drafting costs. Further, if leases are not similar, there may be difficulty in evaluating leases for subsequent sale or assignment to a drilling company. However, the lessor should know that any lease form can be modified, perhaps with provisions important to the lessor.

Evaluating Your Neighbors' Decisions

Landowners 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 a gas and oil lease. While it is possible that a neighbor's well could draw from a reserve that underlies your property, 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 do not bargain for detailed damage clauses or superior bonuses, delay rents, and royalties. A customary royalty is one-eighth (1/8) of the "value of the production."

It would be wise for the landowner to get an explanation of how the value of production is determined, for example, in the case of natural gas production, what costs may be subtracted before the rate of the royalty is applied. In the case of natural gas, the value of the proceeds may be taken at a point remote from the land to which the lease is applicable. In short, processing and transportation or pipeline costs may be subtracted in arriving at the "value of production."

However, do not overlook the time value of money. Money at an early date may be equivalent to or more than a larger sum at a later date. But an outlook of rising oil and gas prices and higher royalties could convince a landowner that a delay could result in a larger sum in the future.

On the other hand, if a single lessee is unable to obtain a large enough area committed to leases, the lessee may not lease any land in a given area. If too few acres are under lease, the lessee may be unwilling to bear the overhead costs 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 much of Indiana.

Seeking Legal Counsel

In some areas of Indiana, oil and gas leasing activity existed during an earlier period when leases were granted for an indefinite period. Therefore, a landowner may need to check to see if his or her property is not already under an oil and gas or mineral lease. It is possible that a lease already exists that has not been recorded. A lawyer can assist in clearing up any doubt about prior oil and gas leases. However, the leasing company may take steps to check the landowner's title once a lease is signed. Provisions exist in Indiana law to help clear a landowner's title of dormant mineral leases.

In evaluating the legal aspects of oil and gas leases, experienced legal counsel may be helpful in drafting and negotiating specific provisions. Many of the ideas shared in this publication were obtained from the writings of lawyers and other professionals experienced in gas and oil leases and especially with the problems that may arise once the lease is in place and production begins. This publication does not discuss all the concerns that a property owner may have and that a lawyer could help alleviate by drafting provisions into an oil and gas lease for a particular situation. Legal counsel may be helpful after drilling

and production operations begin, but covering the major issues in the lease is the best way to handle problems that may arise.

Tax and Estate Planning Considerations

Rental (delay or "shut-in") payments, bonuses, and royalties from gas and oil production are included as ordinary income for federal income tax purposes. However, net royalty income from oil and gas production is reduced for federal income tax purposes by the *greater of* a **cost basis deduction** or a **percentage depletion allowance**. Unless a landowner allots some of the purchase price of his land to oil and gas deposits, there is no cost basis assigned to oil and gas that may be produced. For the lessor, the **percentage depletion allowance** is limited to 65 percent of **taxable income** for the year. The **depletion allowance** for oil and gas is 15 percent. The depletion allowance cannot exceed 100% of the **actual taxable income from the property before the depletion deduction**.

For example, a lessor/landowner has \$10,000 of royalties, taxable income from the oil and gas property of \$9,000 and total taxable income of \$30,000. The **tentative depletion allowance** is \$1,500 (15% of \$10,000). The **taxable income limitation** is \$9,000 (100% x \$9,000) and the **overall taxable income limitation** would be \$19,500 (65% x \$30,000). Neither **limitation** is a factor in this example, so the **depletion deduction** would be \$1,500. In this example, there was no cost basis for newly discovered oil and gas, so the cost basis deduction is zero. Thus the depletion allowance, as calculated, would be the applicable deduction--\$1,500 in this example.

Indiana law provides for a severance tax on the value for all oil and gas. The tax is levied at the greater of one percent or \$0.24 per barrel of oil and one percent or \$0.03 per thousand cubic feet of gas.

Also, Indiana law includes a special procedure for assessing oil and gas for real property tax purposes. Landowners should find out how an oil and gas lease may affect their property taxes. Increases in real estate tax due to gas and oil production may be an item the landowner will want to assign to the lessee.

Both income tax and estate planning may suggest shifting the income rights (if not full ownership rights) of oil and gas deposits to lower income family members. Further, special valuation of farmland for federal estate tax purposes does not apply to mineral rights.

Also, if the land is being acquired under an installment contract, it is likely that neither buyer nor seller independently has the right to sign a binding lease. Mortgages may include a provision that limits the landowner/mortgagor's leasing rights.

Landowners must be cognizant of the fact that once a gas and oil lease is signed, the lessee's mineral rights take on an independent nature. The lease will be recorded at the courthouse in the county where the land is located, establishing an ownership interest in the landowner's chain of title.

Provisions That May Be Negotiable

Mineral Rights and Other 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 standard 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. It is advisable to negotiate each mineral separately. Likewise,

underground storage rights for natural gas should be separately negotiated.

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. The landowner may demand a separate payment for lessee pipelines running across his or her property--\$10 a rod may be attainable.

Duration of the Lease

Oil and gas leases are drafted with a stated **primary period** (before production begins). 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 long primary period, perhaps 5 to 10 years, which the landowner may feel is excessive for exploration or speculation. One to 2 years may be a more favorable primary period. 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 provisions** in a lease may require no delay rentals in the primary term once test drilling begins or during specified lapses between dry holes. Landowners can insist upon a clause which stipulates that the test well(s) must be drilled within a short period of time.

Typically, the **secondary term** (starts with beginning of production) may continue indefinitely while there is production of oil, gas, liquid hydrocarbons, or constituent products in paying quantities. Landowners may seek a lease without a secondary term or other delays rather than a long term lease.

Damage to Crops, Farmland, and Improvements

While oil and gas leases commonly provide payment for damages, 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 rules and regulations for well drilling, dry holes, and producing wells. Indiana rules require a \$2,000 bond per test hole or well site. Alternatively, there may be a blanket bond of \$30,000 for all wells drilled by the person for the duration of the bond. Indiana regulations require the drilling company to restore the surface as nearly as practicable to the condition it was prior to the drilling of the well after completion and/or plugging.

The bond is subject to forfeiture should an operator of the well fail in adhering to Indiana oil and gas laws. Funds from forfeited bonds are used to clean up sites on an environmental priority basis. It does not cover damages to fences, tile, crops, roads, soil, and buildings away from the dry hole or well site or to livestock. Additions to the Indiana rules should be in the lease. Following is a list of specific provisions a landowner may consider.

a. Reserve the right to approve the location of drill sites, tanks, access roads, and pipelines. You may desire that a drill site to be a minimum distance from buildings and property lines. The reservation of location of a drill site is important to the landowner in order to maintain the value of his or her property. In fact, the landowner may be wise to limit the lessee to one drill site at a time--with consideration of the operator's performance from a preceding location.

b. Require all pipelines to be buried using the "double ditch" method and below tillage depth, or at a

specified depth, such as 36 inches--safely below all possible tillage depths.²

c. Require 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. 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." The Indiana law makes the driller liable to the state of Indiana for various damages, but not necessarily to the landowner.

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

e. Require the company to indemnify and hold the landowner harmless from all claims, demands, and legal problems and law suits stemming from activities undertaken by the company or its assignees.

f. Require the lessee or drilling company to carry liability insurance as added security from claims by neighbors government entities and others. Examples of problems that may arise include environmental law violations and interference with agricultural drainage systems.

Bonuses, Rents, and Royalties

A **bonus** (a one-time payment) is the term for the money provided to the lessor 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 a few years before drilling and production or termination. Thus, the bonus and delay rentals may be more significant than in the past, because 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 one-eighth (1/8) royalty and risk damage to their property. Even if the damage is obvious, the landowner risks not being adequately compensated. Past reports from within Indiana and nearby states are of bonuses ranging from \$2 to \$300 per acre and delay rentals of \$1 to \$45 per acre. Logically, the greater the expectation of a discovery, the more likely a landowner may get a large bonus and a commitment for a substantial delay rental as well as other favorable provisions in the lease. Also, 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 1/8th, 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," a landowner might agree to a bonus, rental payment, 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 a defined area. Landowners may want to require royalty payments on a monthly basis.

Access to Books and Records of the Drilling Company

The landowner should require a reasonable access mechanism to the books and records of the drilling or producing company so that he or she 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 examine books and records on their behalf, because many landowners may not feel competent to audit lessee information. However, the landowner may find that "division orders" from crude buyers and other industry reports may provide satisfactory proof of the volume or quantity of production from his or her land.

Rights to Free 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. However, because of safety issues, lessees may be unwilling to grant a right to a gas supply for a property owner directly from the production on a given parcel of land.

Lessees will likely limit the 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.

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 a drilling 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 drilling units for sandstone reservoirs, 20-acre drilling units for all other reservoirs, and a minimum of 40-acre drilling units for commercial production of natural gas from a reservoir deeper than 1,000 feet. Petitions to modify spacing can be filed with the Division of Oil and Gas.

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 is included in a single

pool or drilling unit.

Consent to Assignment of a Lease

Require that the landowner consent to any assignment of the lease or at least that he or she receive written notification of such assignment. The landowner may also wish to reserve a right to consent to the change of an operator.

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 or she 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 proceedings, if necessary, may demand a termination of the lease because of breach. The lessee or his or her 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.

Failure of Implied Covenant to Drill

The law provides implied covenants or promises on the part of the lessee. First, 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 convinces 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 payment of a delay rental. However, this covenant may still apply in Indiana even though the lease permits a delay during the primary period.

Failure of Implied Covenant to Develop

Second, there is an implied covenant to develop the leased premises as long as it might be profitable. 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, lease pooling provisions and Indiana regulations limit the duty of the lessee driller under this covenant.

Seeking Legal Counsel Before Termination

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. If the landowner desires to cancel his lease for failure to drill test wells, he or she must not accept delay rental payments or else the lease may remain

in force and not be terminated on grounds of failure to develop. Refusing delay rentals may be most effective when the payments are late.

Taking Possession of a Well

After production operations are complete, drilling companies may 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; and there may be increased exposure to environmental liabilities. Carefully investigate all the costs and benefits before taking possession of the well.

¹ This publication was revised by a co-author of the 1982 version, Gerald A. Harrison, Extension Economist, Agricultural Economics Department, Purdue University. Owen Mohler, deceased, was lead author of the 1982 draft. Mohler was legal consultant to the Indiana Farm Bureau. John A. Rupp, Head, Energy Resources Section, Geological Survey in Bloomington and a staff reviewer, Division of Oil and Gas, Indiana Dept. of Natural Resources provided numerous suggestions for this revision. Others who supplied useful suggestions or were reviewers include: Ray Ballard, Extension Educator, Floyd County; Jay Ritter, Gallagher Drilling, Inc., Evansville, IN; Marian Percy, Attorney, Corydon, IN; David Frette, CPA, Washington, IN and Tom Tucker, CPA, New Albany, IN. A special thanks for professional editing by Laura Hoelscher. Gerald Harrison's address is: Agricultural Economics Department, 1145 Krannert, Purdue University, West Lafayette, IN 47907-1145. Phone: 765-494-4216; Fax: 765-494-9176; E-mail: < harrison@agecon.purdue.edu >.

² The "double-ditch" method refers to the practice of separating the top soil and subsoil back and replacing it into a trench in the same profile that naturally occurs. The top soil will be placed on the surface above the subsoil when the trench is filled.

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