Introduction to Oil and Gas Leasing

The first sign of an oil and gas play is often the sudden appearance of lease buyers (commonly referred to as landmen) in your county, usually a team of them. They may be newcomers, but some of them will be local people you know. Even the ones from out of town may be from close by.

You'll see them buying meals in the restaurants and spending money in the dollar stores and grocery stores. They'll be staying in the local hotels. They'll be seen in the courthouse, several of them at a time, looking at land records. The word will get out fast, and it won't be long before everybody in town knows that some company is thinking about drilling for oil and gas.

These landmen will probably be independent contractors who work for a broker. The broker will have a deal with an oil and gas producer to put a team out in the field to secure leases on behalf of the producer to allow them to drill in search of oil and gas. The production company may be a huge corporation such as Exxon-Mobil, Shell, or Texaco, but more often it will be an "independent," much smaller company typically from the Southeast, maybe even from Mississippi (Isonhood, Tipton, Turner, & Ueltschey, 2013).

The landmen will search the records stored in the office of the chancery clerk of the county where the land is located to see who has mineral ownership on the land their company believes may have oil and gas deposits. If they find that you have such mineral ownership, they will soon approach you with a lease proposal asking you to give them the right to drill. If you lease your land or mineral interest, you would be the lessor, the one granting this right, and their company would be the lessee, the one being given this right.

People who work in the industry will understand the terms and conditions found in a lease, but a landowner/mineral owner, especially one who is a first-time lessee, would have no reason to know them. Don't be embarrassed to ask the landman what the terms mean. If you consult an attorney about the lease, of course you should also ask him or her.

Remember, the proposed lease will be based on the number of mineral acres you own. Even if you own the land, you may or may not own the minerals (including oil and gas) that lie below the surface. It is possible that a previous owner sold title to the surface and retained all or part of the minerals, or there may have been a separate deed that covered only a transfer of minerals (Isonhood et al., 2013).

In any event, your percentage of ownership of the oil and gas will be stated in mineral acres. For example, if the lease covers 100 surface acres and you own half the minerals, you would have 50 mineral acres. Surface acres don't count; it is possible that a surface owner has none of the mineral ownership. The owner of the oil and gas has a right to drill regardless of whether he or she owns the surface (AAPL, 2014).

The lease buyers will tell you what they believe to be the number of mineral acres you own based on their search of the land records. Their findings, although generally accurate, are not official. The true number can only be determined through a title opinion issued by an attorney.

However, there is probably little need for you to pay for an expensive title opinion, at least not if all you want to do is determine your mineral ownership. Before any future oil and gas production, more detailed supplemental opinions will be issued by expert attorneys who will verify the number of mineral acres you own. Any inaccuracies in the lease will be corrected at that time.

Even if you do not have your own title opinion done, you may still want to talk with your attorney. He or she may be able to determine your mineral ownership without preparing a complete title opinion, and may do so at less cost to you. Your attorney can also offer wording that will cover whatever special protections you may want, and you can ask that the lease be written to include them. A lease will be on a printed form; however, it can always be changed assuming the proposed changes are allowed by law and are agreed to by both parties (Isonhood et al., 2013).

There are a number of lease forms—the most common of which is called a Producers 88—and while these forms may vary in detail, some provisions are found in all of them (AAPL, 2014). For example, a lease will have a primary term, which is a time limit for a company to begin drilling. A typical primary term is 3–5 years, but the parties to the lease may agree to a longer (or shorter) term.

If oil or gas is found before this time limit is reached, the primary term will be extended to last as long as the well produces in paying quantities. A paying quantity is enough marketable oil or gas to cover the costs associated with keeping the well pumping. The time period when the well produces is the secondary term, and when a lease is extended because of the discovery of oil or gas, it is said to be held by production. Such production could last for decades (Quarles, 2014).

A lease will also cover surface damages, which are damages done to the land during drilling. The drilling of a well calls for a lot of heavy equipment, which means that trees will be cut and knocked down, fences will be broken, grasslands will be disrupted, and other damages will be incurred.

Similar clauses may be included to protect against environmental damages, groundwater and surface water contamination, protection of landmarks, and other such safeguards. Not all land is alike, and you may have specific concerns about the land you are leasing. Often the landman will be authorized to make these adjustments. You may also want to ask your lawyer about them (Isonhood et al., 2013).

The production company (lessee) will pay you a set amount per mineral acre for the right to explore for oil and gas. This per-acre amount is referred to in the lease as the bonus and is spelled out in the lease. It is a one-time payment and is paid when the lease is signed. The bonus is paid whether or not oil or gas is ever produced.

In addition to the one-time bonus, the lease will call for the payment of an annual rental per acre. The amount of the annual rental is small compared to the bonus payment—typically a dollar per acre per year. The annual rental serves to renew the lease each year, and, in the past, it was made as a separate payment each year of the lease. Today, however, the leases are typically paid-up leases in which the one-time bonus plus the annual payments for the entire primary term are made in a lump sum and paid up front (AAPL, 2014). If a well is drilled and is successful, you will be paid a percentage of the market value of any oil or gas at the time it is sold. This payment is called a royalty and is paid without regard to the company's cost of production. It is expressed as a set fraction of the price of the oil or gas.

For example, if you have a one-eighth royalty, for every eight barrels of oil, you will be paid the monetary equivalent of one barrel. This will be paid to you from the first day of production, whether or not the company has made enough to cover the cost of bringing the oil to the surface (AAPL, 2014).

Sometimes market conditions or perhaps problems with transportation can delay the selling of the product. For example, with gas, a connector pipeline may need to be built before the gas can be sold. There may be other problems, including the disruption of pipeline traffic as a result of natural disasters. In such a case, the producer may halt the extraction of the gas until the delay can be resolved. When this happens, the well is said to be shut in.

During the period a well is shut in, the producer/lessee will pay what is called shut-in royalties to hold the lease for a reasonable length of time until regular production is resumed and the original terms of the lease go back into effect. These royalties are a set amount per acre and are paid annually for the length of the shut-in period (AAPL, 2014).

Another provision found in leases is the pooling clause. Pooling is also called unitization. This clause is mainly for your information since it reflects what is required by state law. It has long been recognized that, when oil or gas is drawn from land belonging to you, it is probably draining the resources of your next-door neighbor. Therefore, no matter where a well is drilled, it affects all the contiguous properties surrounding the site. In order to protect all these nearby properties, before drilling can begin, the Mississippi State Oil and Gas Board must establish a unit that comprises the surface acreage deemed to cover the oil or gas below. These units are roughly square in shape and, the deeper the well, the larger the unit. Therefore, the lease buyer will be leasing not only from you but also from your neighbors (Section 53-3-103, Miss. Code Ann. 1972).

A well that hits oil or gas can mean a lot of money for the mineral owner, but be aware that most wells are not successful. Most of the time, the bonus payment and the annual rentals are all the mineral owner gets. Don't count on making big money, even if the prospects seem to be good.

You should also know that it takes a long time to secure the necessary rights, get the needed approvals, prepare the site, drill the well, and sell the product if the well hits. There is nothing you can do to speed up the process, and once it begins, it won't stop. Any negotiation must be done before the project begins.

Bear in mind that, once the land is leased and the unit is established, there will be activity on your land that was not there before. Crews and equipment will be brought in, and even though most of the activities are temporary, they will disrupt your use of the land while they are going on.

There are pros and cons for the landowner/mineral owner, and not all of them have been covered here. While the potential rewards may be great, you should also know the downside. You should take the time to learn the basics of the leasing process. It will help to talk with people who have experience in this area. A little preparation up front can save everybody from problems down the road.

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