Compulsory Pooling and the Landowner That Has Not Signed an Oil and Gas Lease

How does Compulsory Pooling Occur and How is the Un-Leased Landowner Paid?

Leasing oil and gas mineral rights is a choice, not an obligation. Some landowners are anxious to lease because the potential for cash royalty payments is present. Other landowners may not want to enter into an oil and gas lease because the potential impacts to their existing business interests are not compatible with their long term financial, emotional, and resource protection goals. However, Under some circumstances, a landowner may not prevent the development of oil and gas resources that may underlie their property; those interests may be Compulsorily pooled with neighboring acreage to permit drilling. Compulsory pooling is allowed under R 324.304 of the State of Michigan oil and gas regulations in order to allow for equitable and efficient development of oil and gas, while preventing the drilling of unnecessary wells.

Let's use an example. You own 160 acres and your neighbor owns 80 acres. Your neighbor has leased his mineral rights, but you choose not to. The drilling company needs 40 acres of your land and an adjacent 40 acres of the neighbor's land to obtain a drilling permit for the depth and geologic formation they are targeting to develop. Without your being under some type of lease or compulsory pool, it prevents your neighbor from receiving any royalty because the oil company does not have the 80 acres to obtain the permit to drill the well from the Supervisor of Wells. (insert a table)

To allow the oil and gas development and drilling of the well, the oil and gas production company can apply to the Supervisor of Wells for a Compulsory Pooling order. The compulsory pooling order is the remedy, so that the oil company can drill the well, the neighbor can obtain their royalty and even though you are not under a lease, you will receive what the state considers is *fair compensation.*

http://msue.anr.msu.edu/uploads/files/Greening/Pooling_of_Properties_DEQ.pdf. The compulsory pooling order may include two options for the un-leased mineral owner.

1. Within 10 days of the Order to elect to become an investor in the well (working interest owner) and within 10 days of such election to pay a sum which the Order stipulates as the up-front investment required to drill, equip and complete the well (predicated upon figures supplied by the Petitioner) or
2. Elect to be carried by the company. "The Pooled Owner is considered to hold a 1/8 royalty interest which shall be free of any charge for drilling, completing,

equipping the well, or for compensation for the risks of the well or operating the proposed well, including postproduction costs".[1]

i. In addition, the Order will deal with only the well in question. Your 40 acres, not the entire acreage you own, will be compulsory pooled so the well can be drilled.

ii. It will be a non-development order. It will not establish any right for the operator to operate on your surface lands to place a well site, tanks, roads, etc.

iii. You will receive no lease bonus because there will be no lease signed.

Compulsory pooling, depending on your goals and objectives, is an option that some landowners have indicated works for them if they cannot negotiate changes to the oil and gas lease that meet their environmental, income and business goals. They receive a royalty based on gross income, not net income. They do not have to be obligated to a lease and there are no development or surface activities on their land because all of the mineral harvesting is occurring underground by means of directional or horizontal wells.

How does an un-leased compulsory pooled mineral rights owner get paid?

Compulsory pooling does not happen often because it is an expensive process for the oil and gas development and production company to ask for compulsory pooling. A company would much prefer a signed lease. A win-win lease agreement that has better terms than the compulsory pooling order can also be better for the landowner. In conversations with landowners, the author has learned that the threat of compulsory pooling is not uncommon if the mineral owner is unwilling to sign the initial lease (standard lease) and accept the signing bonus, ordinarily dollars per acre leased, offered by the company. Statements made by the company representative may give some the impression that if they do not sign the lease offered, they will be forced to lease anyway by the state and it will be years before a royalty is earned. They feel they have no choice, so they give up and sign the standard lease. Numerous oil and gas attorneys that represent landowners believe the basic terms of a compulsory pooling order for the un-leased mineral owner that chooses to be carried by the company are preferable to the standard lease. For more information on pooling see "Pooling of Properties

[1] Order of the Supervisor of Wells 05-2012, July 23, 2012

for Oil and gas Production" on the Michigan State University Extension oil and gas information web page http://msue.anr.msu.edu/program/info/oil_and_gas.

The State's regulations require that the compulsory pooled mineral owner receives a cost-free 1/8 royalty. In our example, if the landowner owns 100% all of the mineral rights, what happens to the cash flow that represents the other 7/8? It goes to the oil and gas company, but not as it would if there were a lease. There is no lease, it is an order from the Supervisor of wells for one well. The un-leased landowner is **treated like a working interest owner.** Working interest is a very important concept.   A working interest owner is a partial owner of the well. Investors can buy an interest in the well, say 10% and pay 10% of the drilling, equipping and operating costs and receive 10% of the company's share of the income.

Under compulsory pooling, because the company is paying all of the costs to drill and develop the well, and they have the risk of a dry hole, the mineral owner is assessed a penalty. For example, in addition to the actual costs, it may add 300% of the costs of drilling, 200% of the costs of completing, and 100% of the costs of equipping the well. These costs come out of the 7/8 stream of income the owner would have gotten as a **working interest owner**. After the well is paid for, the pooled mineral owner receives the 1/8 cost free royalty, plus their proportionate share of the income and expense based on their ownership in the well.

For example, if it takes 10 years of cash flow to reimburse the development company and pay for the drilling, development, equipping and penalty, in year 11 the mineral owner receives the 1/8 plus their share of the working interest. Because the mineral owner can eventually receive a royalty plus the working interest income, if the well is a good producer and long lasting, it is likely that a compulsory pooled mineral owner over the lifetime of the well could earn significantly more than signing the standard lease that offered a 1/8 royalty based on net income and its associated deductions for post-production costs. To see how this might play out, let's look at an example oil and gas well.

Example oil and gas well:
In addition to the royalty, the un-leased landowner is **treated like a working interest owner.** In this example I am making the following assumptions:

1. The un-leased mineral owner owns 40 of the 80 acres needed for a well and owns 100% of the mineral rights on his 40 acres.

2. Cost to drill, equip and complete well = $400,000. In this example, the mineral owner has 40 acres (50%) of the 80 acres needed for the drilling permit, so his share of drilling costs are $200,000.
3. Well revenue of oil and gas combined is $10,000/month.
4. These calculations demonstrate the working interest principle. Actual well income will vary each month.

The un-leased mineral owner receives a 1/8 cost free royalty. $10,000/mo x .125(1/8) = $1280/mo royalty x 50% (40 acres of the 80) = $640/mo royalty to un-leased landowner
$10,000 - $1280 = $8,720/ month to the oil and gas production company (the other 7/8).
If the 50% mineral owner had been a working interest owner (investor) and not a leased mineral owner and had 50% ownership, his revenue would be: $8720 x 50% = $4,360/mo income.

The compulsory pooled un-leased mineral owner in this case must pay a 200% penalty for drilling, equipping, etc. = $200,000 (his ½ of well costs) + $200,000 x 2 = $600,000
The $600,000 is paid off over time by the $4,360/month, so it takes $600,000/$4360/month/12 mos./yr, or 11.4 years to pay off the drilling penalty.

After the well is paid off, the landowner gets the 1/8 ($640/mo) + $4,360/mo theoretically. By then the oil and gas production from the well may be significantly lower, so it will probably not be $4,400/mo. In any case, once the Penalty is paid, if the well is still producing, the subsequent revenue and total value to the landowner may be substantially more than the landowner would have received had he accepted the initial 1/8th lease with an up-front signing bonus.

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