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This is the third issue of our newsletter for landowners and other members of the public with interest in the oil and gas industry and how it affects landowners. Each newsletter is also posted on our website at www.msue.msu.edu/oilandgas. If you would like to be added to the e-mail list to receive this newsletter, please contact the editor. You can also contact your local MSU Extension Office to obtain copies.

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Upcoming Informational Meetings

There are no meetings scheduled at this time. If you would like a meeting, please contact Curtis Talley Jr. at 231-873-2129.

Results of the May, 2011 State Oil and Gas Auction

The state of Michigan conducted an auction of oil and gas lease rights to State of Michigan owned minerals on May 3, 2011. A total of 35,091 acres was leased with an average bonus of \$19.48/acre. The bonus is the cash amount the lessee must pay up front in order to obtain the lease. A total of 16 different entities participated in the auction. Almost 80% of the acreage that was nominated by the industry was leased. The standard minimum bid is \$13/acre. Four counties saw bidding significantly above the minimum. These were Kalkaska (\$63.22/acre average), Mecosta (\$49.11/acre average), Oceana (\$23.76/acre average) and Grand Traverse (\$23.76/acre average).

The following bidders obtained more than 3,000 acres at the auction: Houston based Flare Resources, Traverse City based KOSCO Energy, Elexco Land Services of Port Huron, MI, Meridian Energy of Haslett, MI and Rick Corman of Bridgeport, W.Va.

“Oil and Gas Leasing Resources for Private Landowners” Updated

This Michigan State University Extension (MSUE) publication is intended to help private landowners who need assistance answering questions about oil and gas leasing and information when negotiating a mineral lease (primarily oil and gas) on their property. It includes a brief listing of legal services that are available for hire as well as some informational type of resources that are available at little or no cost (i.e. through the Internet, MSU Extension etc.). With the permission of Farm Bureau, this publication has been updated by adding the attorneys from their list into this document. Most of the new additions are located in southern Michigan, which the original list was short of. It has been placed at www.msue.msu.edu/oilandgas,

Cancellation of Leases By Some Oil and Gas Companies;

The leasing boom of early summer 2010 came to an abrupt halt by August, 2010. In the midst of the boom in mineral rights leasing, landowners were negotiating and signing leases that would pay bonus payments of hundreds to thousands of dollars per acre. Starting in August, people started receiving letters stating that their signed lease was null and void. One old hand reportedly told a landowner it was the fastest boom to bust he had ever seen in the oil industry.¹ It is also the first time he ever saw oil and gas companies reject a signed, valid lease. Landowners expecting the oil and gas companies to follow through on the commitments agreed to in the lease became disappointed and frustrated. A number of them have joined together to form a class action and are planning to sue the companies to honor those signed leases.

The decision to cancel leases may be due to the failure of the Pioneer well drilled in Kalkaska County by Canadian company Encana Resource to measure up to initial expectations. The well underwent testing that initially indicated the Collingwood shale would be a new discovery for Michigan, but the longer the well was tested, the poorer the results appeared.

In regards to lease cancellations and the reasons given by the oil and gas companies for those cancellations, Susan Hlywa Topp, one of the attorneys from “Oil and Gas Resources for Landowners” provided these comments and answers the question: **Does Having a Mortgage on My Property Affect My Ability to Obtain an Oil and Gas Lease?**

The cancellation letters sent by the oil and gas company frequently state that the property has a mortgage, is outside the oil company’s target area or a deadline was missed for an agreement. Susan states “those are not legally valid reasons to cancel a signed lease. They are trying to

¹ “High and Dry,” *Traverse City Business News*, October, 2010.

justify what I think is a business decision.”² “Prior to the mass lease cancellations that occurred, having a mortgage on your property was not an issue. Most mineral lessors have mortgages on their property. The bank is usually very agreeable to a subordination agreement and welcome the fact that they have a source of revenue they can use should the landowner default on the loan. Just because certain companies have cancelled leases on properties with mortgages does not mean such action is correct. Keep in mind that for mineral rights, the standard is drillable or curable title, not perfect title.”

Since 1980, Susan Hlywa Topp has been actively involved in environmental and natural resource law in the state of Michigan. For thirteen years she was employed as a Conservation Officer with the Michigan Departments of Natural Resources and Environmental Quality, she has been in private law practice over thirteen years. Susan is a 1978 cum laude graduate of Wayne State University Law School and the principal of Topp Law PLC. She is the Chair-Elect of the Environmental Law Section Council of the State Bar of Michigan and the Program Committee Chair. Susan is a frequent speaker and published author on environmental, natural resource, and oil and gas law issues and she represents clients in both regulatory and litigation matters.

What is a subordination agreement that Ms. Topp Mentions? The editor has these comments: It is a legal document that allows (subordinates) the rights of what would be a junior lienholder (oil and gas lease) to precede the senior lien holder (mortgage company). Both a mortgage and an oil and gas lease are considered encumbrances to a property. Normally, the mortgage company is the senior encumbrance. In the case of oil and gas, the oil and gas company wants their lease to be the most senior encumbrance. Most mortgage companies do not object to this because most oil and gas leases state that if the landowner defaults on the mortgage, the oil and gas company has the right to begin paying the mortgage and deduct the payment from any royalty the landowner would receive. This allows the oil and gas company an unfettered right to continue accessing the property to produce their wells and allows the mortgage company to continue to receive payments, even though their borrower (landowner) has defaulted on the mortgage.

As a result of these cancellations what are landowners also doing? According to Joe Quandt, an oil and gas attorney in Traverse city (and also listed in MSUE Oil and Gas Leasing Resources for Private Landowners) , “landowners are consolidating into large blocks for the purpose of leasing and for the most part, they are not signing standard leases anymore”³. Besides setting lease rates and royalties, the leases can specify where wells can be drilled and how any effects on the environment are handled.

² “High and Dry,” *Traverse City Business News*, October, 2010

³ High and Dry,” *Traverse City Business News*, October, 2010

25% Royalty Negotiated in Southern Michigan

Jackson County has become an area of substantial oil and gas drilling activity. A landowner contacted the editor of this newsletter to notify him that utilizing what was learned from MSUE educational materials, their own negotiating prowess and the assistance of their oil and gas attorney, they negotiated a 25% royalty based on gross income from the well. Another words, there were no post-production costs deducted from the royalty. The only deduction from the gross income was the severance tax. This is a true cost-free royalty. They also negotiated many other changes to the lease that met their goals for the property. I confirmed this information with the oil and gas company that leased the mineral rights and the attorney that participated with the landowner. This landowner was very patient and did not lease until the area became “hot”. They waited until an oil and gas company was very interested in their mineral rights.

Hydraulic Fracturing of Natural Gas Wells in Michigan

If you have followed the oil and gas industry lately, you know that there is technology that is utilized that allows oil and gas companies to extract oil and gas from geological formations that formerly was not possible, such as tight, hydrocarbon rich shales. One of these techniques is hydraulic fracturing. The Department of Environmental Quality enforces the State of Michigan laws, rules and regulations promulgated by the legislature. The document “Hydraulic Fracturing of Natural Gas Wells in Michigan” is written by the DEQ and discusses the history, regulation and uses of hydraulic fracturing in Michigan. The document can be accessed at http://www.michigan.gov/documents/deq/Hydrofrac-2010-08-13_331787_7.pdf.

Pooling, Unitization and the Importance of a Pugh Clause

Many of the “standard” leases being offered contain significant language (almost a page in some cases) regarding pooling and unitizing of lands in the lease. These terms are very important for a landowner to understand. Scott Storey, one of the attorneys listed in the Michigan State University Extension document “Oil and Gas Resources for Landowners” was asked to provide us an education in pooling and the Pugh clause.

Scott Storey, one of the attorneys listed on the MSUE document “Oil and Gas Leasing Resources for Landowners” will answer the question below. Scott practices in the areas of oil and gas law, wind power, alternative energy, leasing, commercial litigation, construction law, employment litigation, energy and utilities, and environmental issues. He is a shareholder in Foster, Swift, Collins & Smith, P.C. located in Lansing. Mr. Storey received his undergraduate degree, with honors, from the University of Michigan and his law degree from Washington & Lee University School of Law. He is admitted to practice in the U.S. Supreme Court, U.S. Court of Appeals, 6th Circuit, and the U.S. District Courts of Eastern and Western Districts of Michigan. Mr. Storey is also a member of the Michigan Oil and Gas Association, the Ingham County Farm Bureau, and is a Licensed Residential Builder. Scott A. Storey at sstorey@fosterswift.com.

Can Pooling Language in the Lease be Used to Extend the Primary Term? If so, how? Can Pooling Language Extend a Lease Even Though the Landowner is not Receiving a Royalty?

“Pooling is the combination of leases or parts of leases for the development and production of oil and gas. To provide for more effective and efficient development, and to eliminate unnecessary wells, the State of Michigan requires that oil and gas wells be drilled on uniformly sized and spaced drilling "units". A typical well drilled into the Niagaran formation, for example, will require establishment of an 80 acre unit consisting of two contiguous quarter-quarter sections of land.

The typical pooling clause in a lease allows the developer to combine the leases of the various land owners within the proposed drilling unit. If a successful well is drilled within the unit, the royalties would be paid based on each lessor-land owner's proportional share of the leased land within the unit.

To illustrate, land owners A and B each own 40 acres, and land owner C owns 20 acres. All three land owners lease their property to Oil Company which proposes to drill a well on an 80 acre unit consisting of A's 40 acres, C's 20 acres and half (20 acres) of B's 40 acres. If each lease contained the typical pooling clause, Oil Company would be entitled to combine (pool) the leases of A, B and C to form the 80 acre unit.

If a successful well is drilled on the unit, each lessor would be entitled to a royalty based on its proportional share of acreage within the unit (regardless of on which parcel the well is actually drilled). In this illustration, A would receive a royalty based on 50% of the unit's production (40 acres of the 80 acre unit) and B and C would each receive a royalty based on 25% of the unit's production (each with 20 acres of the 80 acre unit).

Because the typical lease is extended beyond the primary term for as long as oil and gas are produced, application of the pooling clause may result in the extension of a lease beyond the primary term so long as the leased property is pooled into a producing unit. However, unless the well is temporarily shut in (e.g., awaiting construction of a pipeline, etc.), the lease extension will usually be concurrent with the lessor's receipt of royalty payments.

Many pooling clauses will operate to extend the entire leased premises even if only a portion of the lease is located within a unit. In the illustration above, only half of B's 40 leased acres were included in the unit and only the 20 acres within the unit would be generating a royalty. Nevertheless, under the typical pooling provision, the lease to B's entire 40 acres may be extended by the inclusion of part of that acreage within a producing unit. To avoid that possibility, a land owner may request inclusion of a "Pugh clause" in the lease, providing that the lease shall terminate as to all non-producing lands at the end of the primary term.”