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MICHIGAN OIL AND GAS DEVELOPMENT: 2013 IN REVIEW

Dean Solomon, Senior Extension Educator

Michigan oil and gas drilling activity last year was still well-below pre-recession levels, and industry experts predict more of the same in 2014.

Relatively low natural gas and oil prices continued to slow oil and gas exploration in Michigan, according to the Michigan Oil and Gas News. The publication projects that final totals will show seven percent fewer wells drilled in 2013 from the previous year. Activity in the state is still much below the most recent peak in 2008.

The clear winner in 2013 was oil exploration in the Trenton-Black River formation in Jackson, Lenawee and Washtenaw Counties. Through mid-November of last year, 46 of 125 wells drilled in the state were located in those three counties. This is a huge change from 15 years ago, when a vast majority of activity was in northern Michigan's Antrim Shale formation.

Michigan oil and gas development was still in the news, despite relatively modest drilling activity. High-volume hydraulic fracturing (often called "fracking") continues to cause concern in some parts of the state, although four wells were completed this year in the Utica-Collingwood formation where this technique is used. To help address concerns and information needs, the [University of Michigan Graham Sustainability Institute](#) published [a series set of technical reports about hydraulic fracturing](#) in September that are excellent resources for local leaders, landowners and residents wishing to better understand hydraulic fracturing issues and the policy framework. These technical reports are the first [part of a project](#) to identify key strategies and policy options for managing hydraulic fracturing in Michigan. The final [integrated assessment](#) will be published in mid-2014.

Also during 2013, the Michigan Department of Environmental Quality [proposed additional rules](#) to increase water use and quality monitoring and reporting, require water withdrawal impact assessment prior to drilling, and require disclosure of chemical additives used in the hydraulic fracturing process.

Oil and gas leasing on private and public land continued, despite modest drilling in the state. Leasing companies are still seeking landowner agreements in many areas of Michigan. So, what will 2014 bring for this industry in Michigan? The Michigan Oil and Gas News predicts that 150 wells will be drilled in the state – the same as their prediction for 2013. The authors also comment that drilling in the Utica-Collingwood may “expand significantly” based on the number of drilling permits that were issued in 2013, but where actual drilling has yet to begin. Michigan State University Extension and partner organizations will continue to sponsor educational workshops during 2014 to help Michigan residents understand oil and gas leasing and other issues. Additional information is available on the [MSU Extension oil and gas information web page](#).

Southeast Michigan Continues to Draw Mineral Interest

Curtis Talley Jr. Michigan State University Extension

Southeast Michigan, including Sanilac, Lapeer and Monroe counties are all experiencing interest from the oil and gas industry to lease or purchase mineral rights. *The author made presentations at four different educational meetings from January through March with total attendance of 593.* Speakers include Michigan State University educators, private attorneys with an expertise on oil and gas leasing, the Michigan Department of Oil, Gas and Minerals and the oil and gas industry. The article in this newsletter titled “Offers to Sell Mineral Rights Should be Considered Carefully” was written as a result of the author’s educational presentation at Sanilac County in late January.

Survey of Oil and Gas Attorneys Indicates Significant Positive Results from Post Production Costs Lease Negotiations

Curtis Talley Jr. Farm Management Educator Michigan State University

During the summer of 2013, a survey was mailed to oil and gas attorneys that represent private landowners. The survey measured oil and gas lease terms “before negotiations” and “after negotiations” to determine what, if any financial or environmentally related lease terms were negotiated to benefit their clients. This is the third in a series of articles that discusses the survey results.

Each oil and gas lease contains clauses that allow the Lessee to calculate and charge what are known as post production costs from the mineral owner’s royalty. Examples of some of the

costs listed in most oil and gas lease are: “(f) sales charges, commissions and fees paid to third parties (whether or not affiliated) in connection with the sale of the gas”; “(g) any and all other costs and expenses of any kind or nature incurred in regard to the gas, or the handling thereof, between the wellhead and the point of sale”.¹

Pennsylvania mineral owners brought forth evidence of post-production costs deductions at a Senate Environmental Resources and Energy committee hearing on June 27, 2013. Bradford County Commissioners Chairman Dough McLinko said, “Our constituents have shown us evidence of extraordinary post-production costs in Bradford County, with deductions of 40 and 50% all the way up to as much as 90%.” “...we have seen checks come with zero payment. We have seen retroactive charges being billed to landowners for tens of thousands of dollars where the property owners actually have a bill sent to them and they have to go without any royalty payments until it is paid in full.”²

The article “Acting to Protect Royalty Payments” stated that five different Bradford County residents had a 12 1/2 percent royalty rate written on their lease, but, due to deductions for post-production costs, their most recent royalty payments actually ranged from 1.47 percent to 3.11 percent, according to Bradford County Commissioner Doug McLinko.³ A paid royalty of 3.11% is a reduction of 75%.

In the article “Survey of Oil and Gas Attorneys Indicates Significant Positive Financial Results from Lease Royalty Negotiations”⁴ a sample oil and gas well was used to demonstrate the royalty. For that sample well we assumed the landowner was the sole owner of 40 acres and a successful well was drilled that produced 25 barrels/day. It operated for 200 days during the year and the oil sold for \$90/barrel. This well will produce \$450,000 in gross income (25 barrels/day x 200 days x \$90/barrel = \$450,000) in the first year.

If the royalty was .167 (1/6) the leaseholder would receive \$75,150 in the first year of production (\$450,000 x .167 = \$75,150) prior to post-production cost deductions.

The post production costs portion of the survey found that 56% of the attorneys surveyed reduced potential royalty deductions from post production costs by at least 75%. Seventy eight percent negotiated at least a 50% potential reduction and Eighty nine percent negotiated a potential reduction of at least 25%.

¹ Oil and gas Lease Producers 88 2000 P-F Form Revised 8-2001

² Pennsylvania House of Representatives House Co-Sponsorship Memoranda, Representative Jesse White, June 28, 2013

³ “Acting to Protect Royalty Payments,” *The Daily Review*, 5 May 2013

⁴ Curtis Talley “Survey of Oil and Gas Attorneys Indicates Significant Positive Financial Results from Lease Royalty Negotiations”, Michigan State University News, October 17, 2013

Using the sample well, if lease negotiations reduced post-production costs charges by 50%, the savings would be \$37,525(50% of \$75,150) in the first year of production and would continue proportionally each year thereafter.

Offers to Sell Mineral Rights Should be Considered Carefully

Curtis Talley Jr., Farm Management Educator Michigan State University Extension
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Landowners and mineral owners in southeast and eastern Michigan are receiving offers to sell rather than lease their mineral rights. There are many things a seller should consider both short term and long term when evaluating the sale mineral rights.

For many landowners that also own the mineral rights (mineral property), consideration of the value of the minerals is an afterthought, particularly if there is no current mineral income. For those fortunate enough to live in an area of valuable mineral deposits, they have learned that mineral income can exceed the income from the surface if it is managed as a business enterprise.

Recently, mineral owners in parts of Michigan have been receiving offers to **purchase** rather than **lease** non-producing mineral property. These offers come in areas where oil and gas development is also beginning to occur. This article does not discuss valuation of producing mineral rights.

Defining Mineral Property

“Mineral property is real property that can have several different forms. Mineral property includes hydrocarbons (oil, gas, and coal); hard rock minerals (gold, silver, copper, and other metals); and other types of minerals (talc, bentonite, uranium, and others)”.⁵ Mineral property can also include Potassium and commercial gases and can vary from state to state.

Potential sellers may be assuming they are only selling the oil and gas rights (hydrocarbons), which could be a mistaken assumption. If the sale contract does not state only the oil and gas rights, it could include every type of mineral or gas that is considered a mineral and encompassed in the definition “all”.

There are many considerations when evaluating the sale of mineral rights. Some of these are listed below:

- Be cognizant of what “partnering together” might mean in a mineral purchase offer. It might mean the buyer plans to purchase an **undivided** interest. When you split an 80-

⁵*Mineral Rights*, State of Michigan Department of Environmental Quality Office of Geological Survey

acre tract into two 40-acre tracts, you are dividing the property. When you sell an undivided interest you are selling a portion of the whole. The offer might be to purchase a 50% undivided interest in all mineral rights for \$125/acre. This means that entity would receive 50% of all mineral income from 100% of the acres, potentially for eternity. To go one step further, in the sales contract the seller may unwittingly be assigning the legal authority to negotiate all mineral leases to the buyer.

- In the article “Survey of Oil and Gas Attorneys Indicates Significant Positive Financial Results from Lease Royalty Negotiations”⁶ the sample well produced \$450,000 in gross income (25 barrels/day x 200 days x \$90/barrel = \$450,000) in the first year. A .125 (1/8) royalty based on gross income produced \$56,250 ($\$450,000 \times .125 = \$56,250$) for the landowner from the 40-acre tract, or \$1,506.25 per acre. This indicates that if the mineral owner is fortunate enough to eventually negotiate and receive royalties that income can be substantial.
- Splitting the mineral estate from the surface estate provides no incentive for the new mineral owner to consider future mineral extraction impacts to the surface owner. Oil and gas companies often prefer dealing with a mineral owner that is also the surface owner because it reduces the number of owners they are working with.
- When a surface owner sells the mineral ownership, any control over the siting of future roads, drilling sites, tank batteries and other related facilities is lost.
- A sale is usually a “forever” transaction; once sold they are gone. A mineral lease can be long term if there is mineral production, or shorter if the acreage is not part of a drilling unit that produces royalties. Continual ownership may provide the opportunity to lease multiple times and receive multiple bonuses.
- An exception to “forever” is the Michigan Dormant Minerals Act. Under this act, severed oil or gas rights revert to the surface owner after twenty years, unless certain actions have occurred within the 20-year period since the deed was recorded.⁷ A mineral owner in Michigan should be aware of this law as it may provide an opportunity to reclaim the mineral rights if the buyer does not comply with this law.
- Who can legally sign a sales contract? How the ownership deed is structured determines who has the right to sign the sales contract.⁸ For example, if the land is held as joint tenants, all joint tenants must sign the contract. If one is unwilling to sign, no agreement can be consummated.
- Offers to purchase frequently tout the sale is “reducing” risk. It might reduce the risk of receiving no royalty income in the future, but what about the future sale of the surface without mineral rights? Will a sale of mineral rights affect future marketability of the

⁶ Curtis Talley Jr., “Survey of Oil and Gas Attorneys Indicates Significant Positive Financial Results from Lease Royalty Negotiations”, Michigan State University News (October 18, 2013)

⁷ *Mineral Rights*, State of Michigan Department of Environmental Quality Geological Survey

⁸ Curtis Talley Jr. and Trent Hilding, “Who Can Sign an Oil and Gas Lease,”? *Michigan State University Extension Fact Sheet* (February 2013).

surface? If mineral production, such as oil and gas wells are present but the surface owner is not receiving royalties, the marketability of the surface may be negatively impacted. On the other hand, intact minerals with royalty income can be attractive to certain surface buyers, as it provides additional cash flow.

- The buyer is not obligated to continue ownership after a purchase is made. As with the oil and gas lease market, whatever is purchased can be re-sold to another buyer for potentially more than the purchase price.
- Outright sale vs. a lease bonus. Mineral purchase offers may advertise that a sale produces immediate cash income. The bonus (up-front cash payment) for signing an oil and gas lease also provides immediate income. Lease bonuses can range from \$15 per acre to as much as \$6,000 per acre, depending on location and lease demand.
- Income taxes. Purchase offers may advertise that the sale proceeds will be taxed as long-term capital gains (2013 tax rates are 0% to 20% depending on taxable income vs. 10% to 39.6% for earned income.), if the property has been owned for at least one year. Taxation can be a little more complicated than that. Capital gains taxes are paid on the profit from the sale. For example, if you sell a stock share for \$150, bought it for \$100 and owned it for more than one year, the long term gain is \$50 (profit). You pay tax only on the \$50. For a mineral rights sale, the calculated capital gain will be based on the basis assigned to the mineral rights when you purchased the land, which may be “0”. If the basis is “0”, the entire amount of the proceeds would be taxed as capital gain income.
- Technology in the mineral extraction industries is constantly changing and improving. Areas that were once thought to not have economic mineral development potential are now being developed. The owner of the mineral rights at the time of development is the one receiving their portion of the income.

Because of the complexities of a mineral rights sale, MSU Extension recommends that a knowledgeable oil and gas attorney with experience working for private landowners be consulted to assist in understanding a sales contract. The oil and gas educational web page at http://msue.anr.msu.edu/program/info/oil_and_gas provides free educational materials including “Oil and Gas Expert Resources for Private Landowners,” which includes a list of attorneys that have stated they have a specialty in mineral rights. There are also other downloadable resources related to oil and gas leasing, mineral rights and links to related web pages.

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Landowner Informational Meetings

Educational meetings were held on January 30 in Sanilac County, February 17 in Ottawa County, March 6 in Monroe County, March 13 in Lapeer County and March 21 in Lapeer County. Total attendance was 579. MSU Extension personnel, private attorneys specializing in assisting landowners with oil and gas leasing, personnel from the Department of Environmental Quality and representatives of the Michigan oil and gas industry offer public meetings to educate landowners about the oil and gas industry in Michigan, which includes understanding and negotiating oil and gas leases. If you would like a meeting in your area, please contact Curtis Talley.

Please Share Your Oil and Gas Experiences

The editor is very interested in hearing both your positive and negative experiences dealing with oil and gas leasing or production. All information is kept confidential and is combined with data from other landowners to analyze the effectiveness of the educational effort. Report your experiences to the editor by phone at 231-873-2129 or talleycu@anr.msu.edu e-mail.

This newsletter is intended for landowners and other members of the public with interest in the oil and gas industry. 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 county MSU Extension Office to obtain copies of the newsletter and other free oil and gas leasing information.

MSU Extension has a web page that contains information for mineral and landowners regarding oil and gas leasing and other related informational topics at http://msue.anr.msu.edu/program/info/oil_and_gas