

Natural Gas Lease Forms and Addendum

Presented for informational and educational purposes only.

Consult with an attorney familiar with gas law before signing any lease.

OVERVIEW

Understanding what is in a natural gas lease and WHAT IS NOT in the lease is of great importance to any land owner considering leasing land for gas exploration and production. The lease is a registered legal document and you will be bound by the terms set forth in that document and any addendum attached with it.

Most, if not all, standard leases presented by landmen representing a broker or drilling company will heavily favor the company. It is YOUR responsibility to identify the issues that are most beneficial to your circumstances and NEGOTIATE the terms that are also in your best interest. The end result is a win/win situation for both you and the company. We do not here even begin to attempt to cover all of the parts of leases and addenda but some items that have been commonly found to be of importance of landowners who have been through the experience of leasing land for natural gas exploration and production. It cannot be stressed enough to seek qualified legal guidance before signing any gas lease.

LEASE or CONVEYANCE

In the simplest terms a LEASE gives RIGHTS to the gas, oil, or minerals from under your land as specified by the lease, for a specified period of time.

A CONVEYANCE is a complete transfer of OWNERSHIP of your mineral estate to a company. In other words, you have sold everything under your surface land to the company. You have no rights to it from that point on.

BONUS

The BONUS is the amount of money you are entitled to receive within a certain period of time upon signing a lease. The payment method is specified in the lease agreement. The safest in our opinion is the PAID UP BONUS. That is, the entire amount due over the entire term of the Primary Lease is paid up front. This eliminates the chance that the company “pulls out” 2 years down the road and still owes you the balance.

In areas that have no track record for productive gas wells, or new areas that are speculative, bonuses offered could be \$25 an acre or less. In 2006, \$25 an acre was a good bonus in Northern Wayne County, PA. But by November 2007, the bonus that was being offered, right up front was \$500 an acre. By unifying as a block of land owners, groups began successfully negotiating \$750 an acre bonus.

The area you are in, and the amount of leasing interest by the gas/oil drilling companies determines the level of the bonus that landowners might be able to negotiate. It is a supply and demand market. Making yourself aware if the land you own is in a “play”, such as the Marcellus Play in NE PA, will give you knowledge to negotiate the best bonus payment possible. Contact your local Ag Extension and find out what sort of gas leasing activity is going on in your area.

LENGTH OF LEASE TERMS

How long is the PRIMARY TERM of the lease? 3yrs? 5yrs? 10yrs?

While you are counting your newly found wealth, look at the primary term of your lease. \$500 an acre might sound great, but does that represent payment for 10 Years? If so, that would mean that your real income would represent only \$50 an acre per year... And your mineral estate is tied up for a very long time. A 10-year term is great for the company, because they don't have to do anything for a very long time and account the potential pools of gas as assets... Which makes the company books look great and the stockholders very happy.

In the Texas/Oklahoma areas, a 3-year primary term is standard, while currently in PA, 5 and 6 years are more the norm. And there are still 10-year “boiler plate” leases that are signed by folks who just haven't done their homework.

AUTOMATIC EXTENSION

If you read the Extension above, you will see that the company can extend the lease for an additional 5 years under the same terms and conditions. That means that if, at the end of the primary term of your lease, prices have jumped to over \$1000 an acre, or royalties have increased, you will still be locked into being paid at the old prices. Great deal for the Company. Bad for you.

Rather than an extension of the original terms, your addendum should replace this with giving the company something like the "right of first refusal". What that means simply is if another company offers you better terms to lease, you are giving the company you are already leased with, the opportunity to MATCH or better, the new offer.

THE ADDENDUM

OVERVIEW

There are many agreements and covenants (promises) made in the main lease document and we only covered a few of the major items above. In the Addendum section here, we will again cover some of the major issues that have been negotiated by informed lessors. There are many more than are described here, but this will give you an idea of the complexity of leasing and the importance of understanding everything before signing anything.

Rather than re-writing the lease to balance the scales a little more in your favor, an Addendum can be attached to the lease to identify and include items that may be unclear, or not agreed to in the lease itself. The addendum should be written in a way that it clearly identifies itself as superseding anything written in the lease itself.

WHAT ARE YOU LEASING?

What minerals are being leased? Did you mean to include Uranium, Coal, or Gold, if it were to be discovered? If you are leasing gas, oil, methane and hydrocarbons, spell it out explicitly AND EXCLUDE everything else.

How deep are you leasing to? There is a possibility that in some areas, there may be more than one geological formation that may produce gas. Are you leasing for the Marcellus formation only? Or are you leasing right down through the Marcellus into another gas producing formation... if it is found to exist?

Keep in mind that you can limit the depth of your lease.

WHAT ARE YOUR TERMS?

What lease terms do YOU want? The company has shown you what terms it would like. Your addendum tells the company what you would like to include for your benefit.

- Bonus – Maybe \$500 an acre is fine with you, but not for 10 years. So write it to reflect only 3 or 5 years on the primary term. The reason for the 10-year terms is because landowners have not made a better lease length a condition for signing.
- Royalty – Again, 12.5% is the state minimum for PA. Why isn't the rate above minimum? Unless you take the step to negotiate a better royalty it will just stay at the minimum level.
- Lease Extension – Get rid of it. Have your attorney write an equitable lease renewal so when your Primary Lease expires, you are recompensed at the market rate at the time of renewal. One option might be a "right of first refusal" to give the company holding the primary lease the opportunity to match the offer of a competing company.

STORAGE

If the company decides that a well isn't producing, and decides it wants to pump gas into it to store it there, do you want to let them do it for free?

Your addendum can specify that storage is not included in the lease agreement and that any storage will be negotiated as a separate agreement.

PIPELINES

You will probably see in your lease that the company has given itself permission to run pipelines through your land to get gas from outside of your “pool” to market. This means that even if you have no well on your property, a gas line can run through it for free. Your addendum can specify that ONLY pipelines taking gas from a well on your property is allowed for free. Any other pipelines must be negotiated under separate agreement. Remember. These types of pipelines do not carry the weight of “eminent domain” and the company can not run them without your consent.

SHUT IN CLAUSES

A well may be drilled, but for one reason or another, it is capped and not used to produce gas. As an active well, under most leases, it causes the lease to continue indefinitely under what is called the Shut In. Typically while the well is shut in, a minimal fee, like \$5 an acre is paid to the landowner, since there are no royalties... But since the well is there, the lease continues under the shut in rate. No Bonuses for renewals and No Royalties.

Put an expiration limit for shut in wells.

INDEMNIFICATION

Spell out how the company will protect you AT IT'S OWN EXPENSE from any lawsuits, damages or deaths on your property. Spell it out that you are to be named as an additional insured on their liability policy and be sure that they provide you with a certificate of insurance for liability, workman's comp, and disability insurance.

LAND USE / STRUCTURES

- A well site needs access, and access roads will need to be constructed. Are you going to allow the company to just run amok and build their roads anywhere they want to? Are you going to let them use your roads? If so, who is responsible for keeping them in repair?
- How close do you want them to be able to put a drilling rig to your home?
- Do you want gates built to keep your cows from escaping from their access points?
- Do you want to keep your privacy private by requiring entrance gates to your property?
- Are you going to allow them to drill a well to get water to “frac” the shale?
- Do you want to be notified if water producing strata or other minerals are discovered?
- Where is the drilling refuse like mud and salt water going to go?
- What kind of buildings will you allow to be constructed and how long after everything is finished will you allow drilling equipment and debris to remain?
- Since drilling is a 24/7 operation, if drilling is within a close proximity to your house, there are lights pointing right at your bedroom window will you have the rights to request shields to be installed? Or if the drilling noise keeps you up all night can you stipulate noise barriers to minimize the disruption to your life?
- What about the barbed wire that was accidentally broken? Are you going to fix it or are you expecting the company to fix it?

WATER

What if drilling damages your domestic water? Who is responsible to fix it?

A good addendum will include the requirement that water is tested both before and after drilling by a certified lab AND you are provided with a copy of the documentation.

Make sure that your addendum stipulates that if the domestic water supply is compromised, that the company does whatever is necessary to restore the quality of the water to pre-drilling conditions.

If you own a dairy farm, you might even want to have a clause to make sure your dairy herd is not deprived of clean water for more than a specified length of time.

LOSS OF RESOURCES

If trees have to be cut, or crops need to be removed from production due to the space needed to build roads and set up drilling platforms, who pays for that loss.... And how will the payment calculations be determined? If there is a dispute about the calculations, how will it be settled?

TITLE WARRANTY

Make sure that you specify that you are only saying that the title to your land is good to the best of your knowledge and that the Lessee (The company leasing your land) agrees that no claim will be made pertaining to warranty of title.

Why? Because the company may withhold royalty payments until the warranty is cleared by the judicial system, which may go all the way back to when the Pilgrims landed. All it takes for that to occur is for ANYONE to tell the company "there might be a title problem" on your property.

FREE GAS

Since the gas that may be found will most likely be coming out of the ground at a very high pressure, it is virtually unusable unless you spend a ton of your own money to get it safely from the well to your house. Better to just stipulate that you want to get paid annually a sum equal to the amount of gas that is being offered, in lieu of the gas itself.

HUNTING SEASON

Add a restriction for drilling operations to be minimized during your deer hunting season.

PRODUCTION COST DEDUCTIONS

Some natural gas leases have a clause to deduct from the royalty paid, the costs to "make the gas more marketable". The question that has to be clarified in your addendum is "will what I receive due to making the gas more marketable, increase the dollar amount of my royalty? Or can my royalty payment for enhanced gas be less than my check for un-enhanced gas?"

PUGH CLAUSE

If only a small portion of your land is included in a pool, you only receive royalties on the acreage in that pool. Without a Pugh Clause the balance of the acreage outside of the pool would not be included to calculate royalty payments, yet would still be under the original lease.

The Pugh Clause provides that production from a pooled unit can not hold the portion of the leased land outside of the unit.

Look at a "pool" as a pond underneath the ground (though it actually isn't). Your neighbor's entire 60 acres is over that pond, but only 5 acres of your 300 acres is over it. Thus, you have 5 acres in the production unit, and your neighbor has 60 acres. When the royalties are calculated, Your neighbor will get paid on 60 acres, and you will get paid on 5 acres... But your other 295 acres produces \$0, because it is not included in the pool.

By insisting on a Pugh Clause, that 295 acres must be released from the lease and you are free to lease it to another company. Without the Pugh Clause, the 295 acres is locked into the lease and cannot be broken free.

ACCESS TO INFORMATION

Make sure that you have access to be able to audit the records to verify the accuracy of the records etc., and checking the amount of payments due on an annual basis.

EASEMENTS / TAXES

- Have you considered who pays the extra real estate taxes if, due to gas production your taxes are increased? If you are getting a 1/8 royalty, then make sure the drilling company is paying the other 7/8th.
- Consider that it is the drilling company that wants you to remove your land from programs like Clean and Green, etc. in order to drill for gas. Put it in writing that

they will cover 100% of the costs of removing that land from the easements and paying the difference in the tax liability.

MOST FAVORED NATION

Here is one that you might have a hard time making it fly. A most favored nations clause basically says if the amounts I contracted for at the time I sign my lease, are lower than an amount paid to a neighbor, the company agrees to pay me the higher amounts. You really need to discuss this one with your attorney.

SURFACE DAMAGES

Each time a well is drilled, a landowner experiences surface damages. An area has to be leveled, liners or whatever is needed to fulfill containment requirements will create damage to the land. Best to just negotiate those damage costs up front and write in a surface damage clause for each well drilled. Typical amounts in PA average from \$15,000 to \$25,000 for each gas well drilled. Your attorney will be able to assess an appropriate amount for your location.

RESTORATION

When all the work is finished what are you going to require to restore your property to pre drilling conditions? For example, if you are a crop farmer do you want the top soil separated from the clay and stone and put back on top of the working areas? Do you want extraneous work roads removed and the land restored to its original contours and planted with alfalfa or timothy? This needs to be clearly spelled out in your addendum. What about a dry well, or a well that can no longer produce gas? Who is going to plug it and when?

DISPUTES / ARBITRATION

So... You think you've pretty much covered everything? How are you going to handle the situation when you and the company leasing your land get into a dispute? Take them to court? I doubt it. Remember these are the guys that are, according to current estimates, spending over a billion dollars in the region, just to acquire leases. Do you honestly believe you have the money or staying power to fight them in court? Consider an arbitration clause in your addendum. Perhaps the gas company picks an arbitrator to represent them, you pick an arbitrator to represent you and the 2 arbitrators pick a 3rd person as a type of unbiased arbitrator. Also include a location where the arbitration should be conducted (Perhaps your local county) When the arbitration is done, the dispute is resolved. Yes, there may be some compromises, but in most cases the decision will be equitable and the closest thing to a win-win for all. The added benefit is that arbitration is a fraction of the cost of a court decision... which can be strung out for years.

CONCLUSION

We have only covered some of the basic clauses that are often used in addenda. The key to writing a beneficial addendum is by identifying and then

Then consult with an attorney familiar with gas law. He/she will include the things that will protect your interests. You need to let him/her know wh

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writing down those things that are MOST IMPORTANT TO YOU and your family or your landowners group.

at other things are personally important to you and what your plans are for your land, and those who will inherit the decisions you make today.