

4. The Economic, Legal, and Tax Implications of An Oil Lease

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David Kehler is the Director/Agricultural Agent for K-State Research and Extension/Butler County, where he has worked for 31 years. Prior to that time, he was an agent in Douglas and Cherokee Counties. As an Agriculture agent, he has provided programs related to Farm Management, with a particular interest in Ag lease law and equitable lease arrangements. David is a member of the Extension Farm Management Focus Team.

Abstract/Summary

South-central Kansas has experienced a recent boom in the amount of land being leased for oil and gas production. New horizontal drilling techniques have made the area very attractive to the major oil companies. This interest seems to be spreading throughout much of Kansas.

In this session, we will discuss the types of leases you may encounter in terms of bonus payments and royalty percentages. We will also cover the significant legal provisions you should consider to be included in your lease to protect against damages to farm land, cattle grazing issues, and surface water rights.

Finally we will give you an overview of the income tax implications of an oil and gas lease bonus payment and the royalty interest you may derive from production if the drilling is successful

Oil and Gas Lease Considerations for Land Owners

Presented By: David E. Kehler
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Major Points

- Consider Seeking Legal Counsel
- Do Your Research and Ask Questions
 - Kansas Corporation Commission
 - Oil & Gas Conservation Division
<http://www.kcc.state.ks.us/conservation/index.htm>
 - Kansas Geological Survey
 - <http://www.kgs.ku.edu>

Who Are You Dealing With?

- A Land Leasing Agent working Independently
- A Land Leasing Agent Working on Behalf of an Operator / Oil Company
- An Operator / Oil Company

Components of a Lease

- Oil and Gas Lease (Paid-Up)
- Bonus Agreement (Sometimes)
- Addendum (Exhibit “ ”)

Lease Terms

- Traditionally 3 Years – Primary Term
- Some 5 Year Leases are Being Written
- Some Have an Extension Option – For Lessee
 - How Long do you Want Your Land to be Tied Up?
- Acreage Involved
 - Keep to a Minimum (240 Acres?)

Surface Use

- Payment for Drilling Pad Site
 - More for Horizontal?
- Damages Caused by Operation
- Burying Lines
- Segregation of Top Soil

Surface Use - Continued

- Landowner Permission Prior to Construction
- Cattle Guards, Gates, Fences and Locks
- Put a Limit on Substances Left on the Premises
- Barriers Between Construction and Dwellings, etc.

Surface Use - Continued

- Restriction on the Use of Freshwater and Purchase of Water
- Restoration
- Lease Road and Well Site Maintenance

Payment

- Paid Up Amount
 - Lump Sum Paid Up Front
 - Varies by Location
- Royalty
 - Traditionally - 1/8
 - Negotiable - 3/16
- Charges for Expenses

Other

- Indemnification
- Presence of Livestock
- Burning of Grass
- Grass Restoration Requirements

Other - Continued

- Drilling and/or Assignment of Water Wells
 - No By-Products Spread Without Written Permission
 - Pugh Clause
 - No Quarry Clause

Termination

- If No Production in Paying Quantities
- Non-Compliance with State and/or Federal Regulations
- Limit on Shut-In Royalty Provision

EXHIBIT "A"

ATTACHED HERETO AND MADE A PART HEREOF THAT CERTAIN OIL AND GAS LEASE DATED [REDACTED], BY AND BETWEEN [REDACTED], TRUSTEE OF THE [REDACTED] [REDACTED], AND [REDACTED], AS LESSEE.

1. Lessee is hereby given the option, to be exercised prior to the date on which this lease or any portion thereof would expire in accordance with its terms and provisions, of extending this lease for a period of two (2) years as to all or any portion of the acreage then held hereunder which would expire unless so extended. The only action required by Lessee to exercise this option being the payment to Lessor (or the Lessor's credit to the depository bank named herein) of the additional consideration as paid during the primary lease term of the lease for each acre so extended, which payment shall cover the extended term. If this lease is extended as to only a portion of the acreage then covered hereby, Lessee shall designate such portion by a recordable instrument.
2. Notwithstanding any other provisions in this lease, it is expressly understood and agreed that, after the primary term, this lease cannot be maintained in force solely by the payment of shut-in gas well royalty for any period in excess of three (3) cumulative years.
3. Lessee herein agrees that the shut-in royalty amount of \$10 per year per net mineral acre shall be substituted for the shut-in royalty payment of \$1 per year per net acre as provided in paragraph 2 of the Oil and Gas Lease to provide for a shut-in royalty amount of \$10 per net mineral acre.
4. No well shall be drilled nearer than 300 feet to the house, barn, ponds or other structure now on the premises without written consent of the Lessors.
5. Lessee shall not use surface water from the premises, water from any stream on the premises or water from any ponds located on the premises without the express written consent of the Lessors.
6. It is understood and agreed that the Lessee when constructing or preparing the well site and slush pits shall construct the same in such a manner that the top soil is removed separate from the sub soils so that the top soil and the sub soils will not be mixed when the well site is restored and/or the slush pit is filled. When restoring the well site or the slush pit to its prior condition, Lessee shall use sub soils first and the top soil last so that the well site and slush pit will be returned to or near its original condition as possible. The well site and slush pits will be constructed and filled in compliance with state regulations.
7. All pits shall be filled and leveled within ninety (90) days from the date drilling and testing or reworking operations for which such pits are used are terminated or at the option of the operator within ninety (90) days from the date that such pits have dried sufficiently to allow filling and leveling, subject to rain or other acts of God. Lessee, its agents, licensees or assigns shall keep the land of the Lessors in a tidy condition and shall not allow any debris, junk or other materials not immediately necessary for its operation to accumulate about the location or the lands of the Lessor. At the conclusion of any drilling or reworking operations, the lands of the Lessors shall be restored as nearly as practical to the condition just prior to such operations except such portion thereof as are required for the continued used in the event of production. Following the conclusion or production, all of Lessors land used by the Lessee and its operation shall be restored as nearly as practical to the condition existing on such land at the commencement of the Lessee's operations thereof. If Lessee fails to completely meet these requirements, the lessor has right to restore the land and the lessee owes lessor a minimum of \$5000.00 for the remedy of said land.
8. Lessee shall place any tanks, lease roads, pipe lines, electric lines (to be buried a minimum of [2] feet) and any other appurtenances necessitated by its operations on the lands so as to not interfere with the Lessors use of the property including the operations and movement of any irrigation equipment or the irrigation system, water wells, water pipe lines and underground electrical lines used for (he operation of the said irrigation system. Lessor reserves the right to designate the direction and location of every road or roadway on the premises and no road or roadway easement shall be constructed to or from any well location or drill site except as may be so designated by Lessor. At the request of the Lessee, the lessor shall designate the location of a road suitable in Lessee's opinion for Lessee's operations. Roadways shall be kept and maintained at Lessee's cost, in good condition and in such manner that will protect Lessor's abutting land from erosion resulting from water washing over or along the roadway and preclude

the damming of water flow over the surface of the Lessor's land by reason of the existence of the roadway. Lessee shall not allow any noxious or unsightly weeds or grasses to grow or accumulate on or along the location, tank batteries, access roads or any other parcel of ground used in the Lessee's operations.

It is understood and agreed that when any well or subsequent wells drilled on the premises are completed within 500' of any dwelling house or houses located near the vicinity, and a pumping unit is installed, the pumping unit will be powered by an electric motor so as to least interfere with the occupation.

9. Lessee shall pay for all damages caused by its operations on the leased premises. Lessee shall pay to the surface owner in advance of drilling either: A) \$5,000.00 for damages caused at each well site by Lessee's drilling operations or, B) \$2,000.00 per acre if more than 2.5 acres are used or damaged in the operation of each well site, not including access roads.
10. Lessee shall have one (1) year after the termination of this Lease to remove all of Lessee's property (including well casing) and shall at the request of the Lessor remove such property. If within one (1) year after the termination of this Lease Lessee has not removed its property and Lessor has not requested its removal, Lessee shall be conclusively presumed to have abandoned its property. However, such abandonment shall not relieve Lessee of the duty to plug any well or wells drilled on the premises in accordance with any applicable statutes, rules or regulations.
11. Lessee shall use all reasonable care and precaution so as to not in any way damage or contaminate any ponds or other fresh water supplies located on the premises.
12. In the event Lessee utilizes wellbore on the leased premises for disposal of saltwater from any well or wells from adjoining lease or leases, Lessee shall pay Surface Owner a fee per barrel disposed. The amount of this fee shall be negotiated between Surface Owner and Lessee. However, the minimum amount of said fee shall be 25 cents per barrel disposed. This fee shall be paid monthly.
13. In the event Lessee's operations require a breach of Surface Owners fencing, appropriate cattle guards and gates shall be installed and maintained at Lessee's expense and become the property of Surface Owner upon abandonment by Lessee.
14. Lessee shall fence all pits, tank batteries, drilling locations or other operations wherever cattle operations are present.
15. Upon request, Lessor shall be given a copy of all well logs at the time any well or wells are logged.
16. In the event Lessee drills any well or wells on said lease where Lessee elects not to complete or run casing in said well for production, the Lessor or its assigns may at its option take possession of said well and run casing and cement the well for production. In the event Lessor or its assigns elects to take possession of said well, Lessee shall release to the Lessor or its assigns said well and the producing zone or formation on the entire lease. In the event Lessor or its assigns elects to take possession of said well, Lessee shall provide Lessor with lien releases from the drilling contractor and its suppliers, and Lessor or its assigns agrees to pay all day work rate expenses to the drilling contractor from casing point forward and will be responsible for restoring the well site location and for covering pits. If Lessee does not complete and produce any well during the primary term of the lease or any option extension of the lease, Lessee shall release all rights in the lease to the Lessor or its assigns.
17. The terms and conditions hereof shall be considered to be covenants running with the land covered by this lease and shall be binding upon and inure to the benefit of the respective successors and assigns of the parties hereto.
18. This lease shall be terminated when the records of the Kansas Tax Commission or the Kansas Corporation Commission show non-production or non-marketing of producing in paying quantities for a period of one year or more.
19. The production of shallow gas (from a formation 1,500 feet or less) shall only extend this lease into the primary term only to the depth and wellbore of such shallow gas wells. In such case the lease shall expire at the end of the primary term as to other formations not produced.
20. It is agreed between the Lessor and Lessee that, notwithstanding any language herein to the contrary, all oil, gas or other proceeds accruing to the Lessor under this lease or by state law shall be without deduction for the cost of

producing, gathering, storing, separating, treating, dehydrating compressing, processing, transporting, and marketing the oil, gas and other products produced hereunder to transform the product into marketable form; however, any such costs which result in enhancing the value of the marketable oil, gas or other products to receive a better price may be deducted from Lessor's share of production so long as they are based on Lessee's actual cost of such enhancements. However, in no event shall Lessor receive a price that is less than, or more than, the price received by Lessee.

21. Only that acreage contained within a spaced unit shall be held by production. It is understood and agreed that if this oil and gas lease is being maintained in force at the expiration of the primary term hereof, then drilling operations or productions from drilling and spacing unit embracing only a portion of the leased premises shall maintain this lease in force only as to those portions of the leased premises included in said drilling and spacing unit. Those portions of the leased premises which are not included in said drilling and spacing unit shall be released by Lessee at that time. For purposes of this oil and gas lease, a drilling and spacing unit shall be defined as a drilling and spacing unit created by Order of the Kansas Corporation Commission of the state of Kansas, or if no drilling and spacing unit has been created by Kansas Corporation Commission, a drilling and spacing unit shall be defined as a quarter of a quarter section (i.e. 40 acres) for oil and a quarter section (i.e. 160 acres) for gas.
22. This addendum overrides any provisions contained in the body of the lease which may be conflicting.

END OF EXHIBIT "A"

EXHIBIT "B"

Attached to and made a part of that certain Oil and Gas Lease dated effective this ____ day of ____, 2011 by and between ____, of ____, as Lessor, and [REDACTED] as Lessee.

Notwithstanding anything to the contrary in the Oil and Gas Lease to which this Exhibit "B" is attached and made part of the provisions of this Exhibit "B" shall prevail wherever in conflict with the provisions of the Oil and Gas Lease.

CONSULTATION

Lessee and Lessor agree that any access roads, well sites, or pipelines to be constructed under the terms of this lease shall be done in consultation with the Lessor, provided however, the Lessor shall not attempt to prohibit said construction or make unreasonable requests of the Lessee.

PUGH CLAUSE

Production from or operations on a pooled unit or units embracing a portion or portions of the leased premises will maintain this lease in force beyond its primary term only as to those lands included within such unit or units. This lease may be maintained in force and effect as to the remainder of the leased premises in accordance with the other provisions of this lease.

USE OF WATER

Lessee agrees not to use water from Lessor's ponds and creeks for drilling purposes without the express written consent of the Lessor.

ROAD CONSTRUCTION

Following completion of a well or wells on the herein leased land(s), access to said land(s) by Lessee shall be kept to the minimum area necessary to properly maintain said well or wells. Lessee agrees to keep all surface disturbances relative to said well(s) to the minimum area necessary to conduct its operations.

RESTORATION

Lessee agrees that as soon as is reasonably possible, following completion of its operations, Lessee shall reclaim its well site, as nearly as practical, to its original condition.

BLUESTEM GRASS RESTORATION

Lessee agrees to use native Bluestem seed to restore the surface of the leased premises which was damaged as a direct result of Lessee's operations under the terms of this lease.

PRUDENT OPERATOR

Lessee agrees to be a prudent operator and will keep all surface disturbances to the minimum area necessary to conduct its operations.

INDEMNIFICATION

Lessee shall indemnify and hold Lessor harmless from any and all liability, liens, claims and environmental liability arising out of Lessee's operations under the terms of this lease.

FAIR MARKET VALUE DAMAGE ROADS AND WELLS

Lessee agrees, upon completion of its operations on the herein leased lands, it shall pay Lessor a one-time damage payment of \$2500 per well drilled.

DAMAGE TO LIVESTOCK

Lessee agrees to compensate Lessor for actual damages or injuries done to livestock, growing crops, improvements, structures, landscaping and/or other improvements located on Lessor's lands damaged as a direct result of Lessee's operations under the terms of this lease. Provided however that Lessee will not be responsible to compensate Lessor for said damages or injuries to livestock that were caused by the negligent or willful act or omissions of Lessor, its heirs, assigns, agents, employees or contractors.

ASSIGNMENT OF WELLS

In the event that Lessee drills a water well(s) on Lessor's land and Lessee desires to plug or abandon said well(s), Lessee agrees to provide Lessor with the opportunity to take over said wells(s) pursuant to the rules and regulations of the Kansas Corporation Commission. Lessor agrees to assume all liability and responsibility for the plugging of said well(s) and agrees to hold Lessee harmless from any liability associated with said well(s). Lessee shall make a good faith attempt to offer well(s) to Lessor but it is agreed that Lessee shall incur no liability under this clause should the well(s) be plugged and abandoned by Lessee.

FENCING OF PITS

Upon request of Lessor, Lessee agrees to shall place temporary fencing, or stock panels, around its drilling pits.

FENCE & GATE

Lessee agrees to shall repair or replace any fences or gates that are cut or damaged as a direct result of Lessee's operations under the terms of this lease on the lands covered by this lease.

OR

Lessee shall construct and maintain gates at all places where any roads used by Lessee cross through fences on the leased premises, and shall keep such gates locked when not in use.

OR

Upon request of Lessor, Lessee agrees to fence off its well locations on the herein-described lands. Said fence shall be constructed in a manner that does not hinder Lessee's operations and shall be constructed of equal or better quality than existing fences currently on Lessor's lands.

GATES TO PASTURES CLOSED

All gates to pastures and other lands subject to grazing by livestock shall be kept closed after passing through to prevent livestock from straying from the premises. Any damage to or loss of livestock directly caused by Lessee's failure to do so shall be paid for by Lessee as soon as is reasonably practical following ascertainment of the amount of the loss or damage. Lessee's obligation in this matter shall include such omissions by Lessee's employees, agents and contractors. Provided however that Lessee will not be responsible to compensate Lessor for said damages or injuries to livestock that were caused by the negligent or willful act or omissions of Lessor, its heirs, assigns, agents, employees or contractors.

LOCKED GATES

Lessee shall maintain locked gates where its access roads or pipeline routes intersect the Lessor's already existing fences or property boundaries on the herein leased lands. Lessor and Lessee shall maintain a double lock system with each party providing their own lock and each lock being interconnected with one-another.

BURNING LANGUAGE

Lessee and Lessor have discussed the fact that Lessor annually burns grass on lands covered hereby. Lessee agrees to make provisions in its operations for Lessor's burning and agrees to adequately protect Lessee's equipment placed upon the herein-leased lands. Lessor shall be allowed to continue Lessor's burning practices on the herein leased lands and shall have no liability to Lessee for any damages caused by said burning. Lessor agrees to notify Lessee prior to conducting burning operations and to give Lessee adequate notice if operations are being conducted upon the surface.

PROTECT LESSORS WATER SUPPLY

Lessee will test Lessor's domestic water well (as to quality and quantity) prior to the commencement of, and following drilling operations on said land in order to insure that said water well is not adversely affected by Lessee's drilling operations. In the event that it is determined that said operations of Lessee have adversely affected Lessor's water quality or quantity then Lessee, at its own expense, shall take necessary steps to return said water quality and/or quantity to as near pre-drilling conditions as is reasonably practically possible or drill Lessor a new water well.

PREVENT POLLUTION OF LAND & WATER

Lessee shall take all reasonable precautions necessary to prevent pollution of the land, air and water, including without limitation all underground fresh water zones. No drilling mud shall be spread on the surface land without the prior written consent of Lessor

NO QUARRY LANGUAGE

This lease shall not be interpreted to grant Lessee the right to develop, mine, quarry, produce or sell sand, gravel,

limestone, sandstone, building stone, aggregate or other hard rock mineral products from the herein described lands.

PIPELINE BURIAL

Lessee agrees to bury all pipelines constructed under the terms of this lease at least 36" and wherever the reference made to plow depth in paragraph #7 of this lease shall be understood to mean 36"

COMPLIANCE OF STATE AND FEDERAL REGULATIONS

Lessor agrees to abide by all current rules and regulations of the State of Kansas and the United States of America governing oil and gas development and production in the State of Kansas. Non-compliance to these rules and regulations could void this lease.