

Land Negotiation Texas and Oklahoma

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GLG Presentation 04.21.2017

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OVERVIEW– MINERAL INTEREST AND ACQUISITION OF DEVELOPMENT RIGHTS - LEASE PROVISIONS

Acquiring Right to Drill and Develop

- Most Mineral Interest owners do not have the technical expertise or capacity to explore for, drill for, produce and develop oil and gas reserves.
- Mineral Interest owners will “lease” these rights to an exploration and development company via an oil and gas lease agreement (a “Lease”).
- Leases are negotiated and provisions may vary. Common Lease components:
 - The Mineral Interest owner receives a bonus (cash consideration paid for the lease) and royalty (the right to receive a share of future production).
 - Energy Company receives the right to explore for, drill for, produce and develop oil and gas for a specified term and as long thereafter as oil and gas is produced on the lands covered by the lease. Energy Company also receives the net revenue, after deducting the royalty, from the sale of the oil and gas production from the Lease.
- Mineral interests owned or administered by state governments or the federal government, are leased by competitive bid at public sales or auctions. State and Federal leases have pre-set lease forms and are typically non-negotiable.
- In the U.S., land is measured in “acres” and a company’s acreage position is often referred to as “leasehold”.

The Oil & Gas Lease

- Multiple forms used across the United States
- Basic deal terms:
 - Bonus
 - Primary Term
 - Royalty
 - Delay Rental (if any)
 - Shut-in Royalty (and term)

Special Provisions

- More sophisticated and savvy owners:
 - Minimum annual royalty
 - Well commitment requirements - May provide for liquidated damages for failure to drill
 - Increased royalty after well payout
 - Continuous drilling obligations

How are deal terms determined?

- Oil & Gas company will evaluate prices based upon own economics
- Bonus generally market driven
- Royalty rate generally market driven
- Primary Term: Market driven and operational plans of lessee or anticipated drilling activity by others

Significant Lease Provisions

- Royalty Clause
- Prohibition or limit deductions of post production costs: transportation, compression, dehydration, treating and marketing costs: Can dramatically impact costs to Lessee/Operator
- Sale of production to affiliates – royalty should be paid on the higher of gross proceeds or market value at the point of sale
- Provide for interest on payments when royalties are paid late. There are often statutory provisions that affect this as well.

Significant Lease Provisions

- Operations
- Clearly define what is necessary to constitute drilling operations, and when drilling is completed
- Define what operations will maintain the lease beyond the primary term absent operations

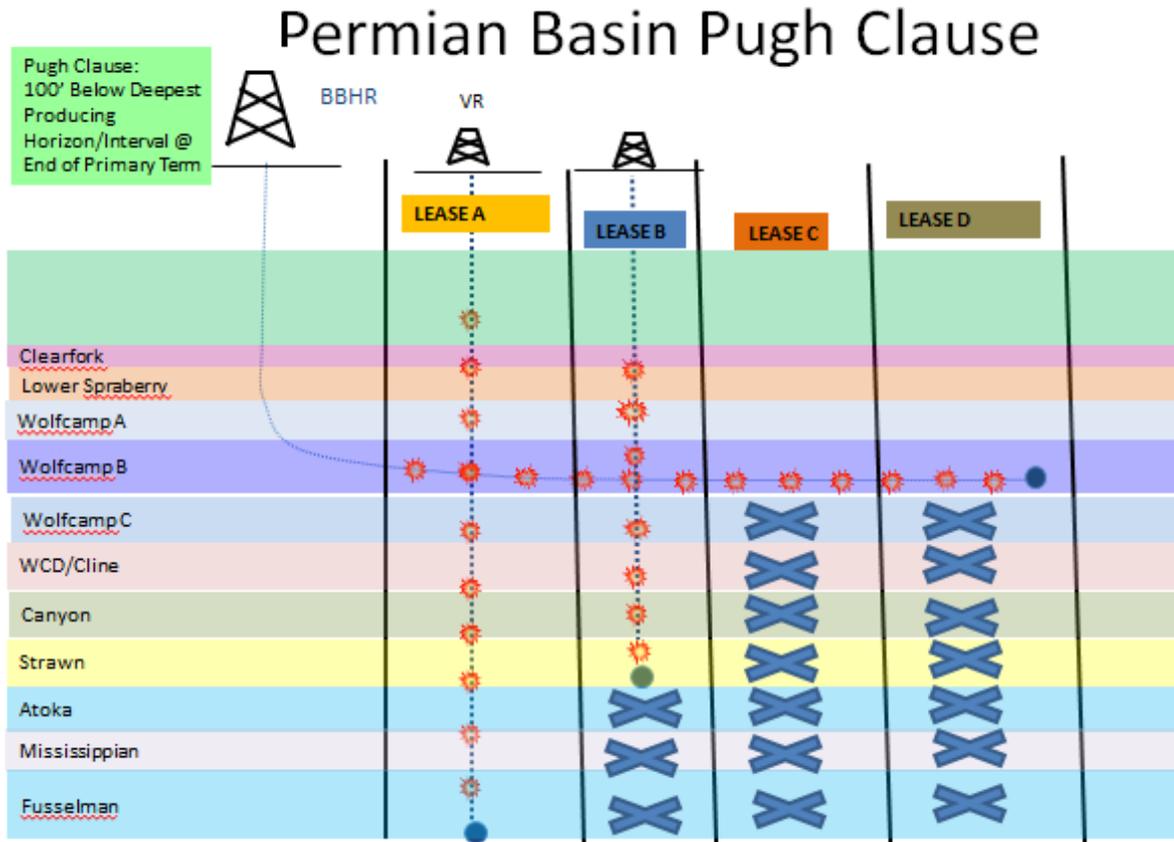
Significant Lease Provisions

- Pugh Clause and Depth Severances
- Examples – Horizontal and Vertical Pugh Clauses
- **Horizontal Pugh Clause**
- Notwithstanding anything to the contrary, it is agreed that should Lessee exercise his option to pool or combine any portion of the land covered hereby with other lands, lease or leases as hereinbefore provided, then such operations and production on and in any such pooled unit as herein provided, shall continue this lease in force and effect during or after the primary term as to that portion of the lands covered by this lease, included in such unit or units as hereinabove provided, but not as to such portion of said lands covered by this lease and not included in any such unit. This lease maybe kept in force and effect as to such remainder in any manner elsewhere provided in this lease not inconsistent with this paragraph.

Significant Lease Provisions

- **Vertical Pugh Clause**
- It is understood and agreed that one (1) year after the expiration of the primary term of this lease, upon the expiration of any extension or renewal, or after cessation of operations as provided herein, whichever occurs last, Lessee shall release all rights lying below the stratigraphic equivalent of one hundred feet (100') below the base of the deepest producing formation in any well drilled on the leased premises or on lands with which the leased premises has been pooled or unitized.

The Pugh Clause at Work



Significant Lease Provisions

- Pooling – In Texas, this is a critical provision of the oil and gas lease.
- Consider whether the tract is large enough to develop without pooling with other lands
- If pooling clause is needed, negotiate a maximum size for pooled units

Significant Lease Provisions

- Surface and surface rights
- Protection of surface
- Surface damages
- Surface use agreements

Regulatory and Jurisdiction

State and Federal Agencies

- Each state has a regulatory body that governs oil and gas operations, production and taxation.
 - Texas Railroad Commission
 - Kansas Corporation Commission
 - Mississippi State Oil & Gas Board
 - Louisiana Office of Conservation
 - Bureau of Indian Affairs, U.S. Department of the Interior
- The Federal government also has jurisdiction over oil and gas operations as it relates to environmental issues such as air emissions, water quality, protecting wildlife and endangered species and operational safety.
 - Environmental Protection Agency
 - U.S. Fish & Wildlife
 - Occupational Safety & Health Administration

Texas Railroad Commission

RRC is the Agency That Regulates Drilling and Production of Oil and Natural Resources

TRRC's authority is more limited than some other states' conservation agencies

- Many important issues addressed by regulatory units in other states like Oklahoma are not resolved by RRC actions
- RRC issuance of a drilling permit or acceptance of a proration unit does not bind or pool all interests in these units
- Prevents waste and protects correlative rights

Oklahoma Corporation Commission

OCC is the Agency That Regulates Drilling and Production
of Oil and Natural Resources

OCC is distinctively different than Texas

- Many important issues addressed by regulatory units are resolved by OCC, most significantly the establishment of drilling and spacing units, forced-pooling (unitization) and increased density wells.
- OCC issuance of a pooling order binds all interests in these units
- Prevents waste and protects correlative rights

Oklahoma Shale Development Act

- **Basis:**
- **Section 1:**
- “The Legislature finds that advances in horizontal drilling techniques for wells drilled and completed in shale formations in Oklahoma have advanced beyond the historical statutory spacing scheme found in Section 87.1...of Title 52 of the Oklahoma Statutes, in particular to the use of extended lateral lengths....”
- “The Corporation Commission...is constrained in its ability...by the limitations placed upon it by the existing statutory scheme.”
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- **Section 2:**
- New law creating “The 2011 Shale Reservoir Development Act” and includes associated definitions (i.e. “Allocation Factor”, “Completion Interval”, “Multiunit Horizontal Well”, etc.)

Shale Development Act

- Authorizes jurisdiction of Corporation Commission to permit drilling, completion and producing of multiunit horizontal wells or create a horizontal well unitization, if Commission finds either will prevent waste and will protect correlative rights.
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- **Section 4:**
- Allows for drilling of horizontal wells in shale reservoirs across existing unit boundaries of two or more existing 640-acre units subsequent to application, notice and hearing:
- The portion of the completed horizontal lateral in each unit will be treated as a separate well for that unit.
- “The allocation factor for each unit shall be determined by dividing the length of the completion interval located within the affected unit by the entire length of the completion interval in the multiunit well.” Drilling and production costs to be allocated similarly.
- Provides for pooling interests of owners
- Provides for commingling of production
- Subject to Oklahoma Production Revenue Standards Act

Shale Development Act

- **Application/Hearing requirements:**
- Approximate location of proposed multiunit well
- Notification of all owners with a right to share in proceeds/production
- Map or maps indicating location of existing well(s)
- Proposed allocation factors
- Expert testimony that proposed multiunit well(s) will prevent waste, protect correlative rights and aid in “full and efficient development of affected units”

- **Section 5:**
- Allows for Horizontal Well Shale Unitization for Shale Reservoirs, subsequent to application, notice and hearing.
- These units shall be two governmental/640-acre sections **but may be expanded to include a maximum of four governmental sections.**

Shale Development Act

- **Application/Hearing Requirements:**
- Same as 4 above AND
- Must include a Plan of Development for full and efficient development of shale reservoir

- **Primary differences between (Section 4) Multiunit Well(s) and (Section 5) Horizontal Well Shale Unitization:**
- The latter requires the express written consent of 63% of working interest owners and 63% of royalty owners.
- Allocation will be on a unit basis rather than an allocation based upon perforated length of lateral lying within each unit.

Texas Pooling

- **General Statement Regarding Pooling**
 - Units for wells are voluntary and unit size is subject to the terms of the leases and other agreements and are often based on field rules or statewide rules.

Statewide (Field) Rules

- Apply to all fields with no special field rules
- Spacing rule: 467'/1200'
- Density rule: 40 acres (both oil and gas)

Horizontal Wells

- Rule 86 – Statewide Rule
 - Applies to all horizontal wells unless superseded by Special Field Rules
 - Even when special field rules adopted, some portions of SWR 86 may apply, e.g., table/formula for assignment of additional acreage for allowable
 - Allows more acreage to be assigned to proration unit depending on length of lateral(s)
 - May also allow more acreage to be pooled/held under oil and gas lease provisions

“Standard” Spacing Rules

Chart

Acres	Spacing	Max Diag.
640	1867' / 3735'	8500'
320	1320' / 2640'	6500'
160	933' / 1867'	4500'
80	660' / 1320'	3250'
40	467' / 933'	2100'
20	330' / 660'	1500'
10	233' / 467'	1000'
5	165' / 330'	1100'
2	150' / 300'	500'

- Usually adopted without need for evidence
- For non-standard, need evidence, *e.g.*,
 - Faulting
 - Land issues, *e.g.* small tracts
- Smallest optional unit *usually* determines spacing rule
- In “horizontal” rules, common to see less than standard, *e.g.*, 320 acres with 467' or 330' lease line rule

Special Field Rules – Horizontal Wells

- Typical rules adopted for horizontal wells
 - 0' between well
 - Take-point, with and without “NPZ”
 - Off-lease penetration
 - Stacked laterals
 - Box rule
 - Formula for additional acreage assigned for allowables

Rule 37 (Spacing)

Well Spacing:

Where can I drill on my lease?

Rule 37 Spacing Issues Unique to Horizontal Wells.

- Rule 37: No well may be drilled nearer than 467' (if SWR's) from the nearest property line.
- Rule 86: Rule 37 applies to all points along a horizontal drainhole.

Statewide Rule 37 (Spacing)

- Statewide spacing rule
 - Not a surface-location rule
 - Property Line : 467'
 - Between Well: 1200'
 - Applies only to wells on same lease or pooled unit and completed in same field.
- Special field rules modify statewide rules.

Statewide Rule 38 (Density)

DENSITY OF DRILLING:

HOW MANY ACRES DO I NEED FOR A DRILLING PERMIT?

Rule 38 Statewide Density Rule

- Minimum number of acres for permit = 40
- Same requirement for oil and gas wells
- Special field rules modify

Voluntary Pooling

MANY DIFFERENT KINDS OF UNITS IN TEXAS: CAUTION!

- Voluntary Pooled Units
- Force Pooled Units
- Drilling Units
- Proration Units
- Fieldwide/Enhanced Recovery Units
- Specially Defined Units in the Lease Instruments

VOLUNTARY POOLING

- Why Pool?
 - Avoid drilling unnecessary wells
 - Protect each owner's correlative rights to share in production
 - Comply with RRC spacing and density regulations and obtain increased allowable
 - Obtain the best geological location
 - Maintain leases for future drilling

Authority to Pool

- Pooling authority must be granted in the lease or by separate contract.
- Texas courts are liberal in recognizing conveyance of pooling authority and in concluding such pooling clauses should not be construed in a narrow or limited manner.
- Always start with the lease.

REMEMBER FUNDAMENTAL DISTINCTION

- RRC rules (for spacing, density, allocation) do not alone create pooling authority.
- But RRC rules can impact pooling authority
 - “governmental authority” clauses – may pool to larger size if necessary for regular permit or full allowable as provided in lease

O&G Lease Pooling Provisions

- Many different pooling provisions even in “standard” form leases
- Events necessary to trigger pooling authority; e.g.
 - for conservation
 - avoid unnecessary drilling
 - proper development
- **Don't assume**: read your lease pooling provision and all riders carefully!

Pooling with Governmental Authority

- Example language: “If larger units than any of those herein permitted . . . are required under any governmental rule or order, for the drilling or operation of a well at a regular location, or for obtaining maximum allowable . . . any such unit may be established or enlarged to conform to the size required by such government rule or order.”
- What is the difference between “prescribed” and “permitted” ?

“Governmental Authority” Pitfalls

- Prescribed by governmental regulation (*Jones v. Killingsworth*)
- Size required to obtain a regular location or maximize allowable
- Size prescribed or permitted by governmental regulation

Unpooled Undivided Interests Within Pooled Unit Boundaries

- No equitable pooling in Texas – regulatory drilling/proration units do not pool those interests that the operator has no authority to pool from leases
- Cost-bearing interests
 - Unpooled interests in a drillsite tract share as cotenants
 - A cotenant may pool his undivided interest in a non-drillsite tract without the consent of the other cotenants
 - Ratification of pooled units by non-drillsite cost-bearing interests

Horizontal Wells

RRC Regulation of Horizontal Rules

- Statewide Rule for Horizontal Wells = Rule 86
 - Adopted in 1990 when horizontals were drilled open hole
 - Permits assignment of additional acreage to horizontal wells
 - Longer drainhole=greater drainage area=larger proration unit=increased allowable.
 - Some fields have alternative special rule
 - E.g., Hawkville (Eagle Ford Shale): $A = (L \times 16249) + 320$
 - Provides that spacing rules apply to all points along a horizontal drainhole.

RRC Rule 86(d)(1)

Maximum Acreage Allocable to Each Horizontal Well

Additional Acreage Assignment for Fields
With a Density Rule of 40 Acres or Less

Horizontal Drainhole Displacement, ft.	Additional Acreage Allowed, acres
100 to 585	20
586 to 1,170	40
1,171 to 1,755	60
1,756 to 2,340	80
2,341 to 2,925	100
2,926 to 3,510	120
Etc. – 585 ft. increments	Etc. – 20 acre increments

Additional Acreage Assignment For Fields
With a Density Rule Greater Than 40 Acres

Horizontal Drainhole Displacement, ft.	Additional Acreage Allowed, acres
150 to 827	40
828 to 1,654	80
1,655 to 2,481	120
2,482 to 3,308	160
3,309 to 4,135	200
4,136 to 4,962	240
Etc. – 827 ft. increments	Etc. – 40 acre increments

- Drainhole measured from penetration point to terminus.
- Density rule for subject field determines which table applies.
- Acreage assigned under RRC rules is not necessarily acreage held under applicable leases.
- Caveat: This rule does not necessarily mean that the operator may legally pool/retain such additional acreage. Leases must allow such pooling/acreage retention.

Rule 86 Add On Acreage Is Permissive, Not Mandatory

- Rule 86 doesn't require additional acreage assignment
 - BUT more acreage usually entitles well to greater allowable
- Application of Rule 86 is critical in interpreting lease provisions that tie pooling and/or retained acreage to RRC rules
 - Pooling – how much acreage may be pooled
 - Retained acreage – how much non-pooled acreage may be maintained after expiration of lease's primary term

Permitting Horizontal Wells

As Production Sharing Agreement (PSA) Wells

- Where no pooling authority for tracts to be crossed by horizontal well(s)
- Operator obtains PSA from these owners
 - Same field rules as previous slides
 - Existing pooled units and/or lease tracts are without pooling authority to form unit necessary to drill commercial horizontal well(s)
- PSA Wells Necessarily Require Rule 37 Exceptions.
 - As wells cross the lease line, they violate lease line spacing rule.
- RRC Form PSA-12 Allows For Administrative Approval of These Permits Where Operator Owns/Controls In Each Drillsite Tract:
 - 65% of royalty interest
 - 65% of working interest

Permitting Horizontal Wells As Allocation Wells

- Where no pooling authority for tracts to be crossed by horizontal wells
- Where there is no PSA or <65% sign up to PSA
- Must comply with spacing/density and no dual assignment of acreage requirements
- Permit does not pool or determine allocation of production for any party who has not so authorized by lease or other agreement