



NORTHWEST
INVESTMENT & TRUST SERVICES
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Oil and Gas
Management Issues
for Pennsylvania
Municipalities



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Introduction

- Founded in 1896, Northwest is headquartered in Warren, PA
- 180+ branches in 4 states: PA, OH, NY, MD
- OGM Division formed in 2010
 - Manage royalties (in western states as well as in Appalachia) on hundreds of thousands of acres
 - Help owners with 10-10,000+ acres
 - 1 well or hundreds
 - Traditional or shale
- My background
 - Private practice before joining the bank
 - Wore many hats, including solicitor for Municipalities and municipal authorities



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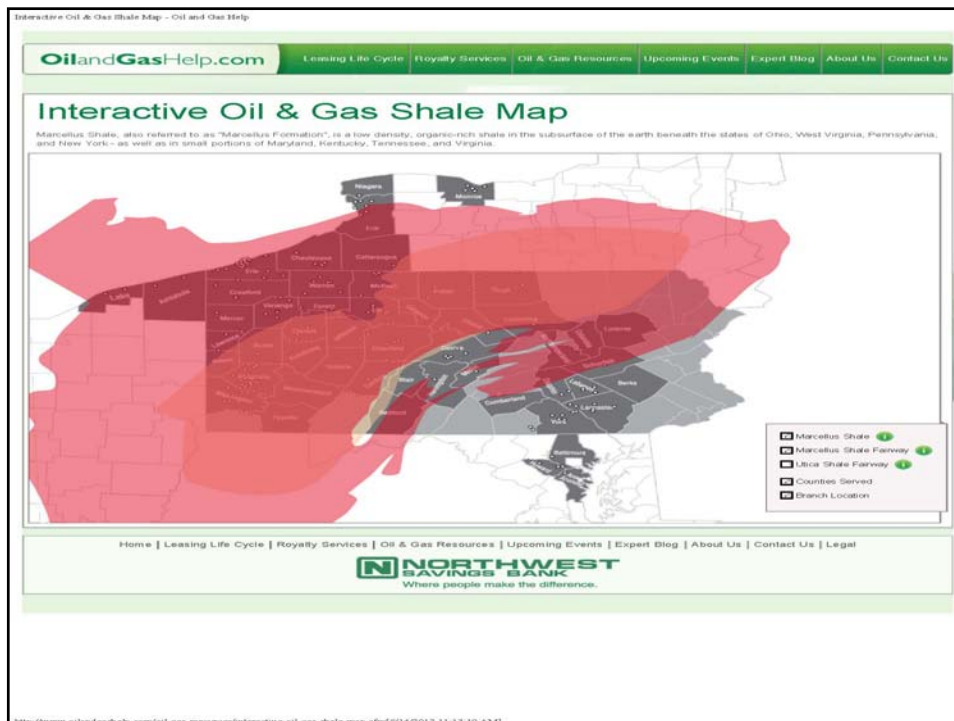
Today's presentation

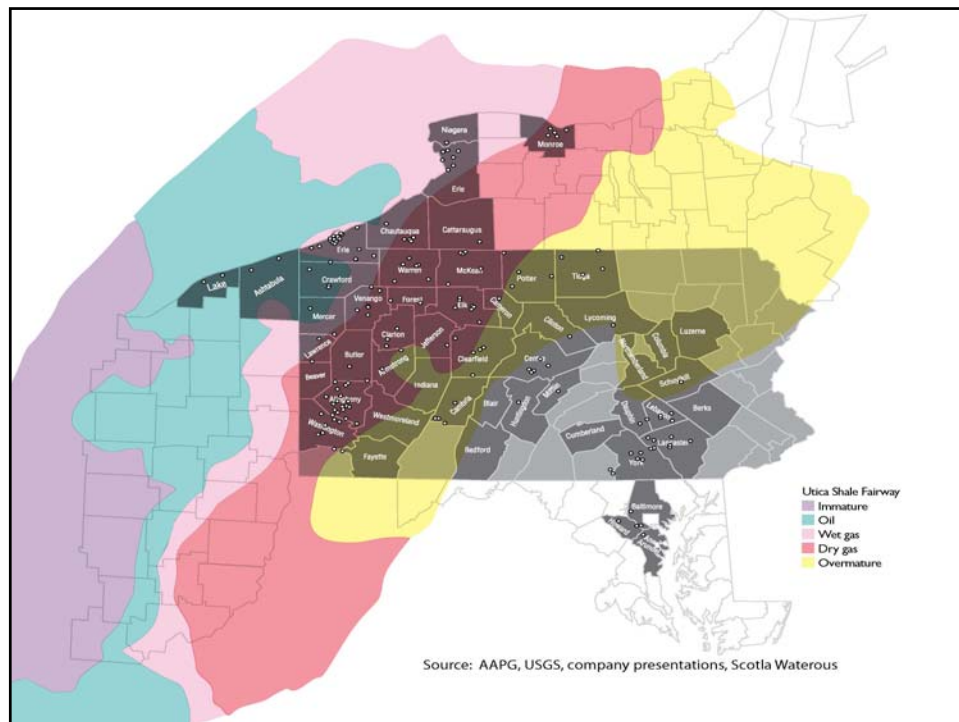
○ What it isn't

- A discussion of pros and cons of oil and gas development
- A discussion of the impact of *Robinson Township* on the duty of local municipalities to regulate this industry

○ What it is

- A discussion of the duty owed by public officials to manage publicly held oil, gas and mineral interests





Current Trends in PA

- Early Marcellus exploration and productivity activity was in the southwest and northeast
- Exploration and productivity activity has moved west and into other formations
 - Oil=\$\$\$
 - Wet gas/rich gas=\$\$
 - Dry gas=\$

Current trends (cont'd)

- Oil and wet gas represent significant premium profit potential over dry gas (for now...)
- Parts of the Marcellus in southwestern PA have wet gas, but there is a more significant oil and wet gas component of the Utica in eastern OH/western PA
- Additionally, industry is exploring other formations with wet gas potential
 - Geneseo shale in north/central PA
 - Rhinestreet shale in northwest PA
 - Burket and other shales in western PA
- Has the dust settled?

Pre-Lease Issues

- Seismic testing agreements
 - Should I sign?
 - Historically producers had to get a lease to conduct exploration activities, including seismic testing
 - Pre-lease seismic testing can give them a “peek” under your land for much less than a lease would cost...
 - Is it a producer looking for a “sweet spot” or a seismic mapping company looking to build a valuable database on the cheap?

Pre-Lease Issues (cont'd)

○ Who owns the mineral rights?

- Severance could have occurred decades ago
- May NOT show up in a current surface estate title search; you must do a search of the separate OGM chain back to roughly August 1859 (\$\$\$)
- Subsurface estate is “dominant” over the surface

○ Common myths:

- I must own the OGMs because
 - I had the title searched when I bought the property
 - My deed doesn't say anything about the OGMs
 - I must own the OGNMs because they asked me to sign a lease



Leasing - Process

- Landmen obtain signatures on leases
- Executed leases are forwarded to abstracting companies
- Leases and abstracts are then forwarded to the oil and gas company's attorneys for title review/opinions
- Payment is typically made to landowner only after title opinion is issued confirming title



Leasing – Process (cont'd)

- If the title search shows a defect or lack of title, the lessee may pay less or not at all depending upon your actual ownership
 - Warranty of title provisions in the lease
- The lease may be assigned before or after production commences
 - The landman/company you liked so well when you signed may not be around later
 - The lease is your only protection

Leasing: early problems

- Most PA landowners STILL don't have their leases reviewed by an attorney before signing
- Most have already conducted negotiations and just want their lawyer to “bless” the proposed lease...!!!
 - Rural Pennsylvanians...
- Landmen:
 - Agent? Broker? Employee?
 - How compensated?
 - You are unlikely to know!!!

Leasing – Use of Addenda

- Landowner attorneys negotiating on behalf of their clients typically propose changes to the lease through the use of an addendum
- Some gas companies are now offering their own form of addendum with the lease
 - Sometimes offered as “non-negotiable”
- Enable expedited negotiation BUT
 - You still have to review the lease and make sure that the addendum adequately addresses your UNIQUE needs

When should I sign?

- What landowners are really asking is “How much should I sign for?”
- Early leases are generally not the best
- BUT if the landowner waits too long...

Economic terms are important, but are NOT all-important...

Indefinite secondary term...

Leasing Update



Oil and gas leases may affect you and your property for years to come.

Leasing Pitfalls

- “Middle men” vs. actual E&P companies
 - Marketers, “flippers”, consultants: hidden fees
- “Willy Wonka” logic
 - Standard form of contract...
 - “Producers 88”
 - Can change weekly!!!
- Landowner “groups”
 - Grass roots organizations
 - Other – formed by individuals with pecuniary interest
 - “Wal-Mart” logic
 - “Three Musketeers”

Leasing Pitfalls (cont'd)

- Overly expansive pipeline easements with appurtenances
 - Three little words...
 - Practice tip: negotiate these separately
- Gas storage clauses
 - Little economic benefit to the landowner
 - Can hold the lease open even if no production (i.e. the landowner is not receiving any royalties)
 - Negotiate storage rights separately

Leasing Pitfalls (cont'd)

- Overly expansive “Mother Hubbard” clauses
 - Original purpose was to permit production even in the event of dispute between adjoining landowners concerning boundary lines, title disputes, etc.
 - Have been expanded to include “all other lands of lessor whether or not herein described and whether or not contiguous with the herein described parcel”
A good clause gone bad...
- Injection disposal wells...
- “Other” deductions...

Leasing Pitfalls (cont'd)

- Royalties: “net” vs. “gross”
- Depth horizon limitations
- “Pugh” clauses
- Unit sizes
 - 640 vs. 1280 vs. unspecified
- Unitization language
- Compensation for drill site
- Shut-in provisions
- “Force Majeure” clause

Leasing Pitfalls (cont'd)

- Contractual efforts to eliminate implied covenants, limitations on forfeiture
 - e.g. covenant to actually produce the lease
 - Forfeiture in the event of non-performance
- Expanded secondary term language
- Renewal rights
- Rights of First Refusal
- Warranty of Title (General vs. Special)
- Multiple parcels=multiple leases
- And many more

Leasing – Other documents

- If you are asked to sign a lease, make sure your attorney sees ALL the documents:
 - **Memorandum of Lease** – make certain that relevant addendum provisions are reflected in the memorandum
 - Will cause title NIGHTMARES in the future
 - Lenders are already shying away from properties so encumbered...concern is diminution in value of surface estate
 - Without the actual lease, lenders cannot properly evaluate the impact of the lease on the value of the surface estate

SIGNED LEASE COPY!

Leasing – other documents (cont'd)

- **Order of Payment**
 - Legitimate purpose...title review
 - **READ CAREFULLY** in conjunction with the underlying lease
 - “Payment obligations are mere covenants and not conditions”
 - If the gas company doesn't pay [the bonus...a delay rental payment...a timber damages payment...a well site damages payment], then it loses the lease automatically, right?
WRONG!

Leasing Pitfalls - example

○ Medora Resources

- leased (tens of?) thousands of acres in Northwest PA from 2010 through 2013
- Claimed to be “shallow” producer (but had never drilled a well in PA)
- As such, “couldn’t afford” shale gas lease terms (bonus, royalty, etc)
- Excluded the Marcellus and the Utica
- Medora’s target? The Upper Devonian
- Who were they really working for?
 - (how to know?)

The lease has been negotiated....

- Whew! We’re done now, right? We can just look forward to our “mailbox money” – right?
- WRONG!
 - Just because you negotiated certain provisions into your lease does not mean that the lease is being followed in practice
 - You have to verify compliance with the lease by the producer

Post-lease/post-production concerns

- Although a common practice in western producing states, “mineral management” is new to Appalachia; HOWEVER:
 - **TAT!!!**
 - Western mineral management formula: **land r^2**
 - PA = the oddball in oil and gas law
 - **In PA the “mineral” estate does NOT include oil, gas or coal**
 - BUT when is gas not gas?
 - one of only 3 oil and ga producing states to follow the “apportionment” rule...
 - PA was one of the last producing states to enact a version of the model Oil and Gas Conservation Act
 - No well spacing, questionable forced pooling, little case law, little statutory or regulatory guidance...

Interpreting Royalty Check Stubs

- Key: Understanding what **is** and **isn't** on there
 - **What is:** *reading* royalty check stubs
 - [Chesapeake Check Stub Example](#)
 - **What isn't:** *interpreting* the data to verify/support the math
 - **Lease data:** net mineral acres, royalty percentages, method of royalty payment (net vs. gross)
 - **Declaration of pooling and unitization:** size of unit, number of acres in the unit
 - **Price data**
 - **Production data**
 - Other issues
 - [Related entities?](#)
 - Deductions authorized outside the royalty provision of the lease
 - “Free Gas” clause
 - Joint marketing issues

Mineral Management Basics

$$R = V * P * DI - D$$

R = Royalties

V = Volume

P = Price

DI = Decimal Interest

D = Deductions (if allowed under the lease)



Beyond the Basics

$$DI = AOIU / TAIU * RPFL$$

DI = Decimal Interest

AOIU = Acres Owned In Unit

TAIU = Total Acres In Unit (unit size)

RPFL = Royalty Percentage From Lease

Example:

640 acre unit, 110 acres in unit, 1/8 royalty

$DI = 110 / 640 * .125 = .02148438$



Beyond the Basics

- It all starts with the LEASE
 - And addenda, including but not limited to contemporaneous and subsequent writings
 - “amendment”; “ratification”; “memorandum”; “order of payment”
- Other required documents:
 - Division Order(s) (if any)
 - Declaration(s) of Pooling and Unitization
 - Unit Map(s)
 - Check stubs or royalty information statements (in the case of direct deposit)
- Other required data:
 - Price data
 - Production data

Beyond the Basics

- **Net vs. Gross Royalties**
 - A gross royalty lease provision is no guarantee against deduction for post-production expenses
 - Incorrect “market enhancement” clause
- **Deductions authorized elsewhere in the lease**
 - Operator “Free Gas” clause
- **Joint marketing issues**
- **Incorrect decimal interests**
 - Wrong acreage
 - Wrong royalty percentage
- Without verification, you may not be paid what you are owed!

Deductions

- There is no standard format for royalty statements.
 - Stay tuned, legislation has been proposed...
 - GMRA
 - Uniform deduction language/disclosures/codes
 - Past legislative efforts in this area have been...misguided
 - Act 66 of 2013: "Readability" of statements but...
 - Mark Twain said it best...
- Deductions with the same deduction code can mean different things
- You MUST understand each producer's unique deduction codes.

Other Elements

- Price – what price is being paid?
 - **Oil**
 - **NGLs**
 - Lumped together or sold separately?
 - BTU upcharge?
 - Refused ethane
 - **Methane**
 - Appalachian hub price issues
 - Hedging (some or all)
 - Futures contracts/swaps/collars

Other Elements (cont'd)

○ Production

- Oil
- NGLs
 - Blending with other units...from how far away?
- Methane

○ **Best answer:** audit clause in lease gives the royalty owner the right to audit production data

- Without an audit clause: royalty owner's Options are more limited BUT now we can compare production reported to landowners with the production reported to the Commonwealth

“Dry” vs. “Wet” Gas: which is better?

- Short answer: when?
 - Crawford County 1984
 - Potter County 2015
- 2016:
 - Oil = \$\$\$
 - Wet Gas = \$\$
 - Dry Gas = \$
- 2017: ???
- Supply vs. Demand, Price

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Comparative “Ease” of Verification

- Oil = easiest
- Dry Gas = moderately difficult
- Wet Gas = Hardest
- Why?
 - Lack of supporting detail from producers
 - Price volatility
 - Blending of liquids from multiple units
 - Varying values of NGL's
 - \$ value depends on BTU value
 - What is the mix in your unit?

“Wet” Shale Gas Formations in PA

- Know what formation is being produced
- Know what is being produced from each formation
- Not all formations are created equal:
 - Marcellus
 - Utica
 - Rhinestreet
 - Geneseo
 - Burkett
- Double/Triple Play

Special Issues for Municipalities

- Good news: no tax considerations
- Perpetual existence
- Bidding requirements? Sale vs. lease of real property interest OR a sale of personal property?
- “Choice” to not lease...spoliation (abandonment)?
- Surcharge?
 - Could arise where a taxpayer alleges negligence in the management of a specialty asset
 - Timber, oil and gas rights etc.
- (CONSULT YOUR SOLICITOR!!!)



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