Bulletin 732
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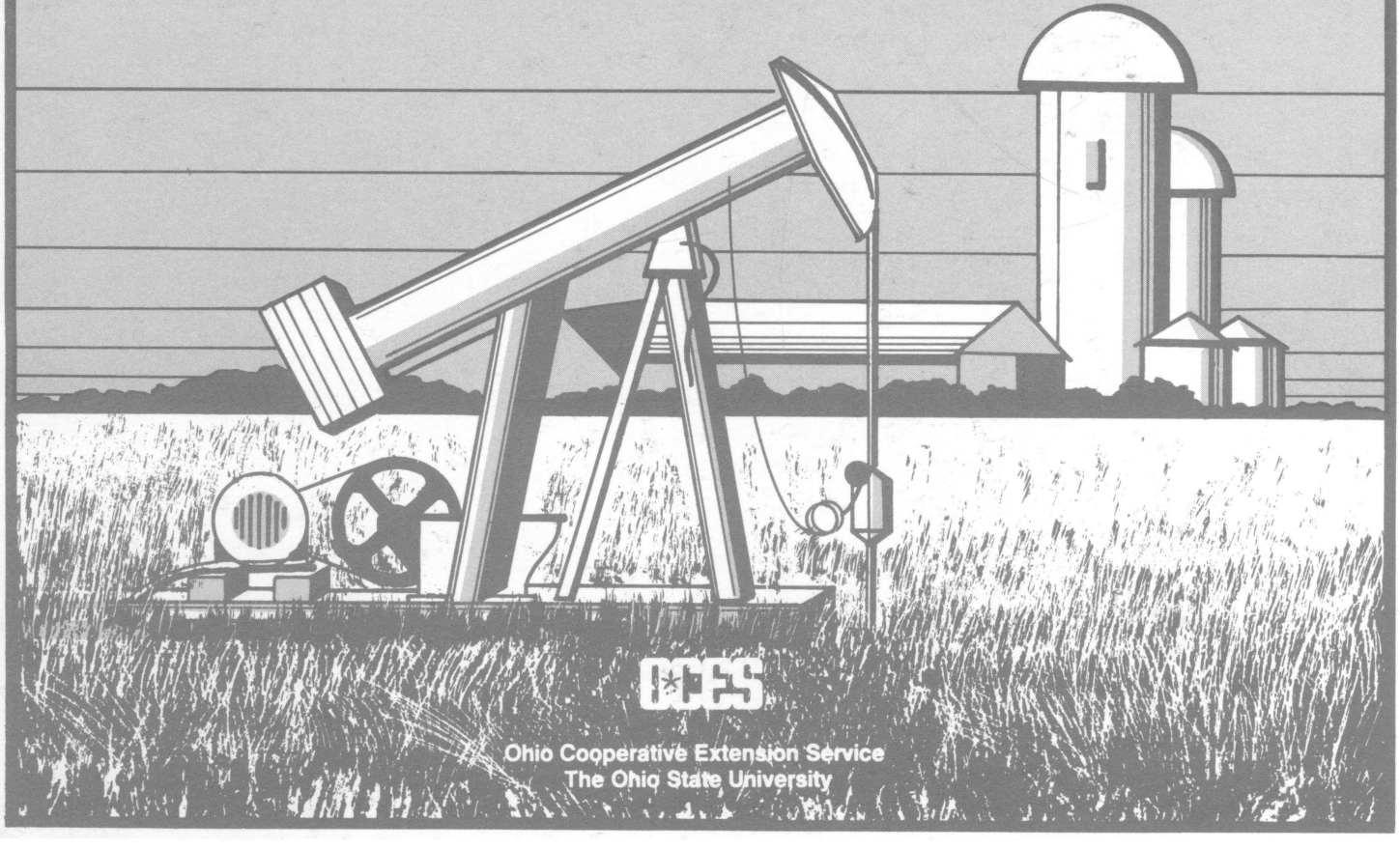
OIL AND GAS LEASES IN OHIO

Legal, Tax and Environmental Considerations



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OIL AND GAS LEASES IN OHIO

Legal, Tax and Environmental Considerations

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INTRODUCTION

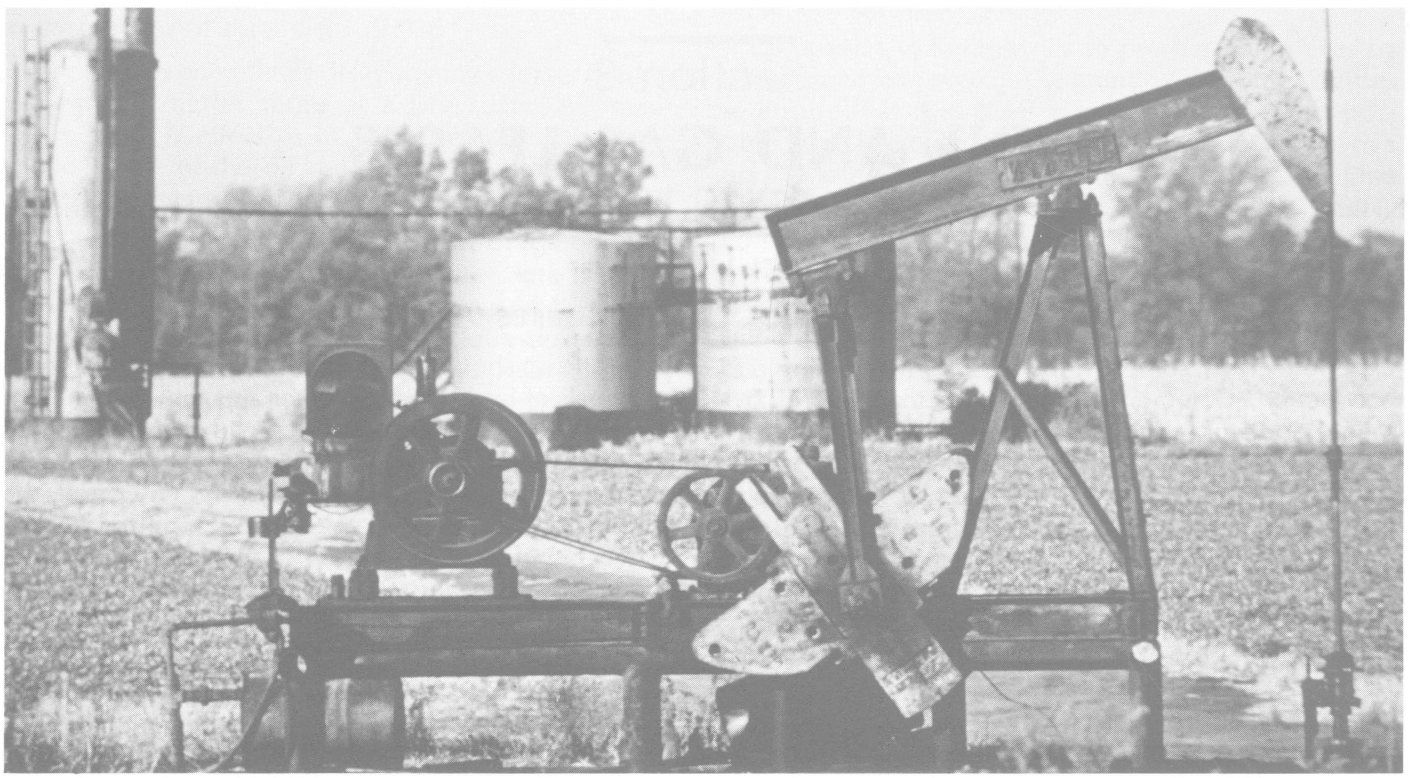
The need for decreased dependence on foreign oil has made oil and gas production within the United States a priority issue. This dependence and its economic impact have been felt by most Americans. As the demand for nonimported fossil fuels has increased, the value of Ohio's oil and gas resources has increased correspondingly. The result is that new wells are being drilled, and old wells are being reworked. With this trend continuing, landowners are increasing their resource awareness and becoming more involved in drilling and production activities.

Likewise, oil and gas companies are contacting landowners, seeking leases that will allow the company to explore for and produce oil and gas on the property. During the negotiation of a lease, the company will offer the landowner economic benefit in exchange for the right to develop the property's oil and gas resources. However, negotiating and drafting such a lease is not necessarily easy or simple. An oil and gas lease that is equitable to both parties—the landowner and the company—can contain many negotiated clauses.

In addition, after an oil and gas lease is signed, a continued sound business relationship between the mineral owner and the leasing company must be pursued. A key factor in this is good communication between the involved parties. But, if there is a communication breakdown, and one party substantially infringes on rights of the other, legal remedies are available to the damaged party.

The Division of Oil and Gas, Ohio Department of Natural Resources (ODNR), is responsible for enforcing provisions of Chapter 1509 of the Ohio Revised Code (ORC). Chapter 1509 contains the laws relating to oil and gas exploration and development. A situation bothersome to one of the lease parties, or to property neighbors, may be covered within this chapter of the ORC and thus enforceable by the division.

The principal objective of this bulletin is to provide basic information to landowners interested in leasing their property for oil and gas production. Also, the bulletin seeks to provide information to landowners that have already leased their land.



Drill rigs, pumps and storage tanks can be expected on land leased for oil and gas drilling and production. Impact on the land and production benefits for both the lessor and lessee should be determined in the oil and gas lease.

The information presented herein is intended to familiarize the reader with situations encountered during oil and gas leasing and production. *This information is not intended as a substitute for legal assistance.* Rather, legal help should be sought from attorneys well-versed in Ohio oil and gas concerns.

Throughout the publication, the terms "lessor" and "lessee" are used. *Lessor* refers to the mineral owner; *lessee* refers to the company leasing, or desiring to lease, the mineral rights. The lessor usually is the owner of the land, although it is possible for a lessor to own mineral rights without surface rights.

Section 2

OHIO'S OIL AND GAS INDUSTRY

Geologic and geographic circumstances have given Ohio a valuable and marketable reserve of oil and gas. Historically, Ohio's oil and gas exploration and production have recorded periods of increase and decline. For example, in the late 1970's and early 1980's, the oil and gas industry experienced a dramatic increase in activity; in 1984, 5,179 reported new wells were drilled. This was the third highest number in the past ten years.[1] In total, as of December 31, 1984, there were 55,681 oil and gas wells in operation in Ohio.[2]

Many of Ohio's oil wells are "stripper wells." That is, their production is less than 10 barrels per day. The average production of an Ohio oil well is less than two barrels per day.[3] The commercial life expectancy of an average oil or gas well is 15 to 18 years, depending on the well site and its management. However, producing small amounts of noncommercial oil and gas for residential use is possible beyond the commercial life.[4]

The Division of Oil and Gas, ODNR, issues drilling permits, inspects drilling activities and enforces state laws pertaining to oil and gas exploration. Any oil or gas well to be drilled, plugged or reopened requires a permit from the division.

Section 3

OIL AND GAS LEASES

Prior to any well drilling, a lease must be signed between the property (or mineral) owner and the oil and gas company, unless the mineral owner is to conduct the activity. Landowners considering signing an oil and gas lease should be aware of the problems experienced by some landowners during drilling and production. Common problems are inadequate payment for damages to crops and land, unsatisfactory methods of storage and disposal of brine (a concentrated saltwater byproduct), unacceptable restoration of the land and unnecessary and improper use of the land. To lessen the risk of these problems and to write a more equitable lease agreement, landowners should be aware of the definitions and terms of a typical lease. However, not all oil and gas leases are alike, and there is no such document as a standard, or Ohio-approved, lease.

All Leases Are Negotiable

Each lease should be written to fit the specific needs and goals of both the landowner and the oil company. Landowners, of course, should read and understand every term and phrase in the lease before signing. If certain terms or phrases are unclear or unwanted, the landowner should have these terms omitted or the lease amended or rewritten. If there are terms that the landowner wants to insert into a lease, he or she should negotiate to add them to the basic document or a document addendum.

[1]Theodore A. DeBrosse, *Summary of Oil and Gas Developments in 1984,* Ohio Department of Natural Resources, Division of Oil and Gas, 1985.
[2]Theodore A. DeBrosse, *Summary of Oil and Gas Developments in 1984,* Ohio Department of Natural Resources, Division of Oil and Gas, 1985.
[3]*Ohio Oil and Gas Industry,* Ohio Oil and Gas Association.
[4]*Ohio Oil and Gas Industry,* Ohio Oil and Gas Association.

Parties to a lease should not rely on verbal commitments; that is, if a subject is worth talking about, it is worth writing into the lease. Verbal commitments made before a contract is written usually are not enforceable. Once the lease agreement is signed, it is a binding contract for both parties and can only be changed by mutual consent, unless fraud or duress is proved. A lease can be enforceable for many years. Therefore, the landowner should thoroughly review a lease before signing.

Landowners thinking of entering an oil and gas lease agreement also should carefully consider the agreement's impact on their property. When the producer begins drilling, landowners should expect roads, pipelines and some land disturbance from drilling and marketing activity. The producer has the right to use reasonable and acceptable methods in the drilling operation. In return, the landowner can receive benefits in the form of a bonus payment, delay rental payments, royalties, free gas and land improvements such as upgraded roads or reclamation.

The extent and amount of oil and gas under a given parcel of land is only a guess, even for experienced drillers. The probability of hitting oil and gas in certain geologic formations and geographic areas can be high due to favorable information from surveys and previous drilling. However, this does not guarantee a productive well. From 1974 to 1984, the average success rate for finding productive wells in Ohio was 90 to 96 percent of total wells drilled.[5]

Landowners sometimes delay signing a lease, hoping to negotiate better terms at a later date. Although this method is effective in some instances, the economic nature of the oil and gas industry may limit or reduce the negotiating power of the landowner.

On the other hand, some landowners sign the first lease presented to them, then at a later date become dissatisfied. They may fail to look beyond the compensation they receive toward the long-term effect the lease will have on their property. Before signing an oil and gas lease, landowners should review it with a knowledgeable attorney and a tax expert or accountant. An attorney can suggest possible changes for the landowner's benefit. A tax consultant or accountant can explain the tax consequences resulting from receipt of bonus payments, delay rental, royalties and free gas.

The following sections deal with the major clauses of oil and gas leases. Some clauses likely will be added or omitted during negotiations. Negotiating a lease is a bargaining situation, and a certain amount of give and take is necessary from both sides.

Lessor and Lessee

The first paragraph in an oil and gas lease usually consists of the designation of the involved parties: the lessor is the mineral owner, and the lessee is the company interested in obtaining the rights to drill and produce the oil and gas. As noted previously, the lessee is not always the company that actually develops or drills at the site. Sometimes, these activities are subcontracted or assigned to other companies.[6]

Granting Clause

The granting clause includes reference to the *consideration payment* (which is usually but not necessarily $1.00). Generally, the granting clause defines the interest in the landowner's property that is granted to the lessee. The consideration payment, also called *bonus,* is a negotiable figure and should be sufficient to cover the direct and indirect expenses of the landowner that result from entering the agreement. The consideration payment can be very important. If a lease is unsuccessful, this payment may be the only benefit the landowner receives from the lease.

The granting clause usually provides the company the exclusive right to drill and produce the oil and gas from the property. In addition, the clause can include the right to maintain pipelines, storage tanks, roads and other facilities necessary to explore, produce and transport the oil and gas.

Companies sometimes try to protect themselves by using broad language in the granting and other clauses to ensure that they have gained the most rights possible. This language can cause the landowner to give up rights he or she did not intend to transfer. One common method is the use of the phrase, "... and all other minerals." An oil and gas lease should not be designed for anything other than the drilling and production of oil and gas. Thus, it should be limited accordingly.

Many leases state permission to transport "from, across and through" the lessor's land the oil and gas from the subject land and all other lands by any means, usually by laying pipelines and developing access roads. This language creates an easement for transporting oil and gas anywhere on the lessor's land. As noted, the easement can be for oil and gas found on the owner's property and also other properties. Restricting pipe laying to routes approved by the lessor is a good practice. The lessor may negotiate the right to approve the placement of access roads, and within limitations, the well sites and associated equipment. To be effective, these rights must be written into the lease.

[5]Theodore A. DeBrosse, *Summary of Oil and Gas Developments in 1984,* Ohio Department of Natural Resources, Division of Oil and Gas, 1985.

[6]"Assigned" is defined as sold, transferred, gifted, bequeathed, traded or otherwise transferred.

Finally, the mention of storage" in the granting clause possibly can be interpreted as storage of any oil and gas or brine, none of which must be from the leased property. In this case, the storage clause can extend the lease agreement beyond the designated term and will provide the landowner with no royalty income. As a result, this phrase should be clearly defined (see page 15, Addendum clause 29, "Storage of Gas or Brine").

It is important to remember that the granting clause lists and limits the property rights to be conveyed to the company. Landowners should know exactly what is being granted.

A typical granting clause paragraph in a lease reads:

"WITNESSETH, That the said lessor, in consideration of the sum of one dollar, the receipt of which is hereby acknowledged, and of the covenants and agreements herein contained, does hereby grant unto the Lessee all of the oil and gas and/or the constituents of either, in and under the lands hereinafter described, together with the exclusive rights to drill for product and market oil and gas and their constituents and also the right to enter thereon at all times for the purpose of drilling and operating for oil, gas and water and to transport from, across and through said lands oil and gas and their constituents from the subject and other lands and to possess, use and occupy so much of said premises as is necessary and convenient in removing or transporting across said lands the above named products by pipe lines or otherwise for a term of ten (10) years and so much longer thereafter as oil, gas or their constituents are produced in paying quantities thereon, or operations are maintained on, all of that certain tract of land situated in . . ."

Leasing Clause

The leasing clause usually is the second or third major paragraph in the lease and covers the description of the leased property. This can include all of the landowner's property or a portion thereof. The acreage leased should be specified to determine delay rentals and other incomes.

Another encompassing clause, commonly called a "Mother Hubbard clause," can combine the leased unit with any parcels of land owned by the lessor that were inaccurately described in the legal description. If this clause is in a lease, landowners should be sure it does not automatically add unintended lands to the contract. It is wise to put a legal description of the property in the lease or as an attachment, although this is not required by law. Ohio Amended House Bill 186, which applies to recordings after December 31, 1984, requires that the county permanent parcel number or sectional index be placed on a recorded lease or any assignment of a lease. This legislation applies to all counties where permanent parcel numbers or sectional indexes are maintained.

Habendum or Term Clause

Whereas the first part of the typical lease defines the rights of the lessee, the next section usually determines the length of time the lessee retains these rights. This clause is the "habendum" or term clause. Leases have two possible points of termination: one refers to the end of the primary term, and the other refers to the end of the production, or secondary, term. The *primary term* defines the length of time and the compensation the company is to pay the landowner in order to retain the exclusive right to explore without obligation to drill on the land. The compensation during this term usually is in the form of consideration or bonus payments and delay rentals. These are discussed in following sections.

The primary term of an oil and gas lease is a predetermined time period with a definite termination date. This period usually is two to five years but can range from a few months to 10 years or more. The primary term is established by negotiation. The company, upon the commencement of operations—drilling a well, establishing storage, constructing pipe lines or unitizing—can void the primary-term termination date. This moves the lease into the secondary, or production, term. There is a legal question of whether unitizing alone, without having commenced a well somewhere on the unit, moves a lease into the secondary term. Unitizing is discussed on page 9.

The *secondary term* has no limiting time period. It runs indefinitely while the well is active or until the occurrence of an event stipulated in the lease. Commonly, leases provide that the primary term runs for a specific number of years, with a continuation of the lease "for as long thereafter" as oil and gas are produced in paying quantities.

Phrases such as "commencement of a well," "paying quantities," "completion of a well," and "operations," all must be clearly understood and should be defined within the lease. Determining "paying quantities" has been interpreted by Ohio courts to be the lessee's decision. The total costs of producing a well need not be covered by production in order for it to be determined by a court to be producing in paying quantities. If a lessor is dissatisfied with the court definition, then he or she may want a satisfactory definition in the lease. (see page 16, Addendum clause 40, "Definitions").

"Commencement of a well" can be a rather broad term that may include activities other than actual drilling. For example, some landowners have been convinced that an action such as dumping a load of gravel is adequate to be declared commencement of a well (see page 16, Addendum clause 40, "Definitions").

Delay Rental

Delay rental payments commonly are paid on a per-acre basis and hold the lease in force until a set time period passes or an event occurs that puts the property into the secondary term. Typically, payments range from $1 to $10 per acre or more, depending on competition and the anticipated productivity of wells on the property.

Landowners also should consider the timing of payments. Most leases state that delay rental payments start after a fixed period of time, such as three months. A landowner might negotiate advanced rental payments on his or her property or shorten the length of time until the first payment.

Royalties

The *royalty* is the amount of payment landowners receive as a result of a well's production. Usually, the royalty is one-eighth the proceeds from the oil and gas produced, based on well-head value. With additional saleable products from the well, such as casing-head gas, the landowner should make sure there is one-eighth royalty compensation from those products as well.

Royalty levels have been one-eighth the oil and gas produced from the well for almost a century. Thus, negotiating a royalty payment other than one-eighth is very rare, although it sometimes is possible. If the landowner is in a competitive area, he or she might be able to negotiate an override—that is, a fraction of the proceeds above the one-eighth royalty (for example, a 1/64 override).

A seldom-used royalty option provides for a minimum dollar amount that the lessee must pay to the landowner, regardless of the quantity of oil or gas produced.

Landowners should state where, when and to whom royalty payments are to be made. They also should consider remedies for delinquent payments (see page 13, Addendum clause 3, "Late Payments"). Additionally, landowners can require the company to provide production and sales records of the barrels of oil or cubic feet of gas produced for each royalty payment. Some landowners are uneasy about the reports of production they receive; providing some form of assurance is recommended to companies to increase confidence in reports.

Dry Hole Provision

In drilling a well, a company can invest many thousands of dollars. With an unsuccessful well, the dry hole provision gives the company time to consider if a second well should be drilled on the property, without termination of the lease. This clause protects the company's investment after a good-faith attempt has been made. If not already indicated in the lease, landowners may consider including a lease clause that states if a second well is not drilled in a predetermined amount of time, the lease terminates.

Shut-in Well

A *shut-in well* is a well that is capable of production, but for reasons such as inadequate transportation facilities or lack of a market, it is not in production. Generally, once a well is commenced, the landowner does not receive delay rental. However, if the well is not producing, the landowner does not receive a royalty. One possibility is for the landowner to receive a stated amount of money—possibly a payment equal to the delay rental—during the period a well is shut in. The landowner still receives royalties if and when the oil and gas is produced and sold.

A clause usually is included in leases relating to shut-in well payments. The lease should answer questions on the amount of payments, how much time should pass before the payment begins and how long the shut-in period should continue without additional compensation or termination of the lease (see page 15, Addendum clause 23, "Shut-in Wells").

Storage

Generally, through the granting clause or a special provision, the company acquires the right to store oil and gas. Landowner concerns are that the property might be used for storage of products not produced on the premises, with little or no payment for such use. Some landowners have had their property used for storage of gas for several years, even though no wells were ever drilled. Continuing storage is permitted under the basic lease.

Some leases also allow for the disposal of brine and other subsurface wastes coming from subject property and other properties. These wastes possibly can be injected into a well on the lessor's property. If the landowner grants the right of storage or disposal in the lease, there should be a payment for this right negotiated at the time storage is to take place.

Storage of on- or off-site oil and gas products or wastes need not be part of the lease. These can be considered under a separate business agreement. Also, the storage clause or a separate agreement can address the possibility of changing the amount of payment

Oil storage tanks. "Storage" usually is outlined in the lease's granting clause or a special provision in the lease.

received over time in relationship to a changing economy (see page 15, Addendum clause 29, "Storage of Gas or Brine").

Free Gas

Leases often provide that if gas is produced, the landowner on whose property the well is drilled is entitled to gas for a private residence at no cost (excepting the cost of running pipelines from the well to the residence). Many leases limit the amount of free gas to be used in one dwelling. However, the amount of gas used, the number of households or other structures in which it is used and the laying of the pipelines are negotiable. Leases may be negotiated so that the landowner also can use gas for farm purposes. A concern of oil and gas companies in this regard is that a peak usage of gas, such as for grain drying, might reduce well pressure and damage long-run production.

For estimating gas needs, natural gas is assumed to contain 1,000 British Thermal Units (BTUs) per cubic foot, and oil, 38,500 BTUs per gallon. Thus, 3,850 cubic feet of gas can replace 100 gallons of oil and vice versa. A two-story, insulated wood-frame house uses an average of 160,000 cubic feet of gas per year.[7] Typically, a lease provides for 200,000 to 400,000 cubic feet of free gas (see page 15, Addendum clause 24, "Free Gas").

If more than the stated amount of free gas is used, the landowner should negotiate a payment for the overage based on the well-head price, like any other first purchaser, and not the retail rate. (Most leases, as first presented, indicate overage at the retail price.) Likewise, it is possible, but very rare, to negotiate a payment from the company to the mineral owner for unused "free" gas. Some producers do not meter the landowner's gas. Payment for unused gas requires a meter that the landowner may have to purchase.

Landowners also should check their liability within the free gas clause. Some leases state that landowners are liable for any damage or injury resulting from the landowner's or the company's equipment or operation. Landowners should not be held responsible for the company's negligence, so the statement pertaining to the company's activities should be deleted. There is risk with the use of free natural gas, especially if

[7]East Ohio Gas Company.

the gas has not been treated to give off a detectable odor in case of a leak.

A typical free gas paragraph in a lease reads:

"Lessor may lay a line to any gas well on said lands and take gas produced from said well for use for light and heat in one dwelling house on said land at Lessor's own risk, subject to the use and the right of abandonment of the well by the Lessee. The first two hundred thousand (200,000) cubic feet of gas taken in each year shall be free of cost, but all gas in excess of two hundred thousand cubic feet taken in each year shall be paid for at the current published rates in the town nearest the premises above described and the measurements and regulations shall be by meter and regulators set at the tap on the line. This privilege is upon condition that Lessor shall subscribe to and be bound by the reasonable rules and regulations of the Lessee relating to the use of free gas."

Lessor Acquiring a Commmercially Unproductive Well

When a well is no longer commercially profitable, the company has the legal responsibility for its plugging. However, the landowner can consider purchasing the well. This can be done with a clause in the lease indicating that the landowner has the option of purchasing the well at the time of abandonment.

One formula for the purchase of a well is the salvage price of the well equipment, minus the costs of equipment removal and the costs of plugging. Landowners who purchase wells are responsible for costs of plugging and all other future liabilities (see page 14, Addendum clause 19, "Purchase of Abandoned Well by Lessor"). Sometimes, well purchases can be accomplished without the protection of a specific clause in the lease.

Lessee's Right to Oil, Gas and Water

In most leases, usually within the granting clause, the company's right to utilize a reasonable amount of oil, gas and water during the drilling operation is stated. The use of these products, especially water, is necessary during the drilling phase. In some cases, the landowner, due to domestic or business water needs, might limit the company's right to surface or subsurface water or ask for compensation for the use.

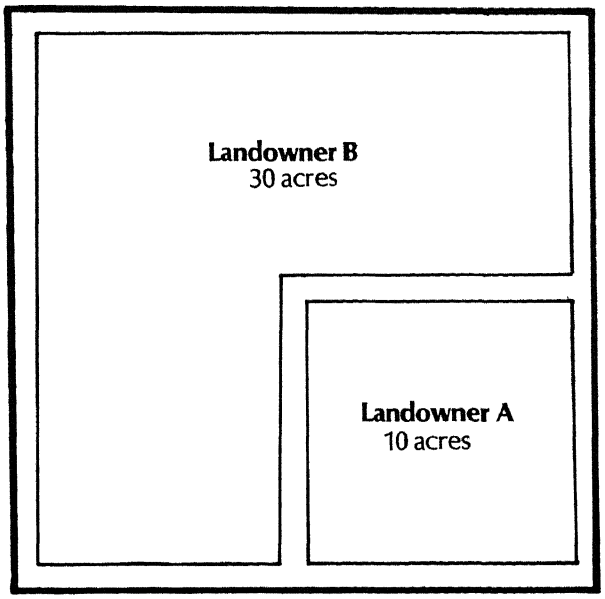
Pooling and Unitization

One of the most difficult to understand and most complex lease clauses concerns *pooling,* or *unitization.* The purpose of a pooling or unitization clause is to allow the company the right to consolidate separately owned lands into a single drilling unit. The reasons for forming this type of drilling unit under one operator are: (1) efficiency of production, (2) prevention of undue drainage of oil and gas from adjacent lands, and (3) the necessity of meeting minimum acreages required under Ohio regulations.

If a lessor gives the lessee the right to pool or unitize his or her land, the lessee can join all or part of the property with adjoining landowners to form a "drilling unit." The result is that all owners share in the oil and gas proceeds in proportion to the geographic area each contributes to the unit.

For example, in Diagram 1, Landowner A contributed 10 acres to a 40-acre drilling unit. His proportion of well proceeds are one-fourth of the one-eighth royalty received. Landowner B receives three-fourths of the one-eighth royalty.

Diagram 1
40-acre Unit

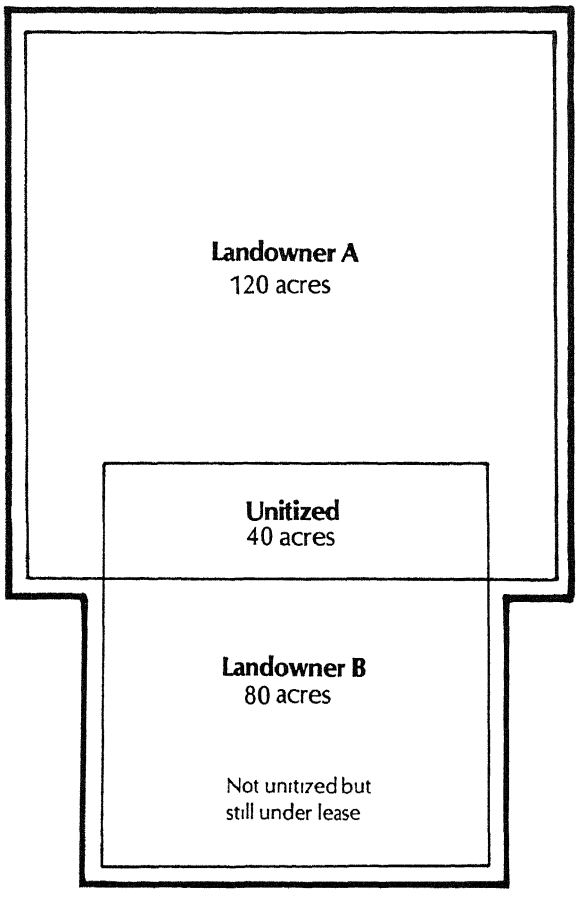


Landowner A: 10 acres/40 acres = ¼, or 25%, of the ⅛ royalty

Landowner B: 30 acres/40 acres = ¾, or 75%, of the ⅛ royalty

Diagram 2

160-acre Unit



In Diagram 2, Landowner A contributed 120 acres to the 160-acre unit. Landowner B also has 120 acres and contributed 40 acres to the unit. When the 160-acre unit was formed, the remaining 80 acres of Landowner B were not part of the drilling unit, yet still are under lease while producing no income. Landowner A receives three-fourths of the one-eighth royalty, whereas Landowner B receives one-fourth of the one-eighth royalty. It should be remembered that each landowner receives royalties in proportion to the amount of property they contribute to a drilling unit, not necessarily in proportion to the total acreage they lease. Also, land not part of the drilling unit, but leased, does not generate income (not even delay rentals) and can be tied up for as long as a well produces.

In some cases, unitization is beneficial in that it allows small-acreage landowners to enjoy the benefits of oil or gas on their property. The disadvantages of unitization to the landowner also are worth considering. One landowner might have all the roads, pipelines and wells on his property, yet must share the royalties with neighbors who have incurred no drilling impacts.

In most leases, the parcel where the well is located has the right to free gas, whereas parcels without the well, but unitized, do not have this right.

In general, large-acreage landowners may not favor unitizing with adjoining landowners because they have sufficient acreage to support a well under minimum acreage requirements. On the other hand, small-acreage landowners may favor unitization because it is the only way they can enjoy the benefits of this natural resource.

If the lessor elects to enter into a pooling agreement in the lease, he or she should consider a clause that provides for the severance of the lease into separate tracts whenever less than all of the land is included in a single pool (see page 15, Addendum clause 30, "Unitization or Pooling" and page 15, Addendum clause 31, "Severance of Land Not Unitized or Pooled").

A typical pooling and unitization paragraph in a lease reads:

"The Lessor hereby grants to the Lessee the right to consolidate the leased premises, or any part thereof, with other lands to form an oil and gas development unit of not more than six hundred forty (640) acres for the purpose of drilling a well thereon, but the Lessee shall in no event be required to drill more than one well on such unit. Any well drilled on said development unit, whether or not located on the leased premises, shall nevertheless be deemed to be located upon the leased premises within the meaning and for the purposes of all the provisions and covenants of this lease to the same effect as if all the lands comprising said unit were described in and subject to this lease; provided, however, that only the owner of the lands on which such well is located may take gas for use in one dwelling house on such owner's lands in accordance with the provisions of this lease, and provided further that the Lessor agrees to accept, in lieu of the ⅛ oil and gas hereinbefore provided, that proportion of such ⅛ royalty which the acreage herein leased bears to the total number of acres comprising said development unit. If said development unit shall thereafter be used for gas storage purposes, the well rental or land rental hereinbefore provided for such use shall be payable to the owners of the parcels of land comprising said unit in the proportion that the acreage of each such parcel bears to the entire acreage of said unit."

Voluntary and Mandatory Unitization

Landowners can be subject to voluntary or man-

datory pooling and unitization. *Voluntary pooling* allows landowners to freely agree to pool tracts to form a drilling unit. The right for this type of unitization often is granted to the lessee. This right also can be set forth by a separate agreement—an agreement that is not part of the original lease. The provision for voluntary pooling or unitization is set forth in ORC Section 1509.26.

Mandatory pooling states that if a tract of land is of insufficient size or shape to meet state requirements, and the company is unable to voluntarily pool landowners, the company can apply to the Division of Oil and Gas for a mandatory pooling order. There is a review process involved, and affected landowners are notified. Details on mandatory pooling are contained in ORC Sections 1509.27 and 1509.29.

Assignment

The *assignment clause* in a lease gives the lessee the opportunity to sell, trade, sublet or otherwise transfer the lease to another firm. Law takes the approach that contracts are freely assignable. If any restrictions are to be placed on assignments, they must be included in the written lease.

Often, the company originally negotiating and signing the lease with the landowner is not the firm that actually drills the well and markets the oil and gas. The original company or independent leasing agent might be primarily in the business of obtaining leases and selling them to producers. For this reason, most leases include a subletting or assignment provision.

Landowners should consider the need for a written right of approval before the lease, or a portion of it, can be assigned. This adds a degree of protection to landowners by allowing them to determine if the company to whom the lease will be assigned is reputable and has a good business record. This approval cannot be arbitrarily withheld by the lessor.

Company References

It is recommended that landowners make a thorough check of references on a company before signing a lease. One way to accomplish this is to obtain a list of landowners whose property the company has leased and drilled. Landowners can then contact these parties for comments regarding the company. Questions to ask other landowners include:

(1) Have delay rental and royalty payments been made on time?

(2) Has the company and its employees and subcontractors treated the property with respect, especially in regard to access roads, crops, amount of land taken for drilling, fences, reclamation procedures and water supply?

(3) Was topsoil separated during site preparation and replaced during restoration?

(4) Have there been questions or concerns about accurate reporting of gas and/or oil production?

(5) Was there any say in the location of wells, access roads, storage tanks, separators and pipelines?

(6) How soon did the company drill after signing the lease?

(7) What were the agreements under the free-gas clause, delay rental per acre and up-front bonus?

(8) How does the company dispose of brine or saltwater?

(9) What are the plans of future oil and gas development of the property?

(10) Were any liens placed on the oil and gas company assets located on the property that required a description of the real estate?

(11) Have you had any concern about the financial stability of the company?

(12) Have you had any difficulty communicating with company personnel? Were you able to resolve differences?

(13) Have there been extended periods of delay in operation or production? If so, why?

(14) Has your property been unitized or pooled with other properties? If so, why?

If a thorough reputation check has been made of the original lessee, then the lessor may reserve the right to check on future assignees or lessees. If the lease that is in place does not have a clause giving the landowner the right to approve future lessees, there is some help in the ORC. ORC Section 1509.31 states that the current holder of the lease—the lessee—must notify the holders of royalty interests of any assignment by certified mail within 30 days of the assignment. However, the statute does not give the lessor the right to approve the assignment, only the right to notice.

Oil and gas companies have reason to resist a negotiated clause that restricts any assignment on their part. One reason is that many times, the company needs outside investors to adequately fund the drilling operation. In return for the investment, these individuals can acquire part ownership in a well. This transaction can be regarded as an assignment. Another frequently used assignment is to a business entity held by the leasing company owners. The negotiated assignment clause should allow these assignments but place restrictions on assignments to entirely new lessees (see page 13, Addendum clause 6, "Limitations on Assignments").

Indemnification or Damage Clause

The granting of an oil and gas lease implies the right of the company to use as much of the surface area as is reasonably necessary. Roads, pipelines, and noise are part of this activity. These disturbances are the natural and expected consequences of drilling and production.

However, there can be damages beyond reasonable limits for which a landowner should recover. A typical lease states that the lessor will be reimbursed for crop damages but makes no statement regarding payment for other damages. Landowners may negotiate a statement providing payment for all damages caused by operations under the lease.

Damages can occur to crops, drainage systems, water supplies, fences, timber and soil. Landowners should be able to recover losses regardless of the type of damage. However, unless stated in the lease, the lessee is under no obligation to restore the land to its original condition. It can be stated in the lease that any damages not mutually agreed upon shall be determined by arbitration or court decision. A lessor may negotiate the posting of a bond by the lessee to help ensure that damages are paid.

Often, the lessor rents the surface to a tenant farmer. Sometimes, a portion of the damage payment due the landowner also is due the tenant. The responsibility for collecting damage payment rests with the landowner, because he or she has the contract with the lessee. After a damage payment has been received, the portion due the tenant should be paid to him or her by the landowner (see page 13, Addendum clause 7, "Damage Payments").

Warranty Clause

Generally, the company insists in the lease that it is the landowner's responsibility to defend title to the property. The landowner guarantees that he or she owns the property, is not under lease to another company and is willing to take legal action to prove this. Sometimes, a person is a joint owner with others, and this fact is not readily available without studying deed records. Often, the land can be held by a land contract that requires the legal owner to sign the oil and gas lease. The property can be held by a life estate, in which case, remaindermen also must sign the lease. Also, mineral rights can be "severed" from surface rights and owned by a third party. If a landowner is in doubt as to the ownership of mineral rights under the land, the deed should be checked.

Force Majure

Another clause generally found in the lease is the force majure clause. It stipulates that drilling or production can cease temporarily without danger of the lease terminating, if the delay in drilling or loss of production is a result of factors beyond the company's control. Examples of such factors are civil disturbances, strikes or acts of God.

Entire Contract Clause

The last clause in the lease usually is the statement that the entire agreement is included in the contract and nothing else is binding. This means that no matter what the landowner was told during lease negotiations, the company is not bound to those agreements unless they are put in writing in the contract.

Therefore, all agreements should be written; avoid oral promises. Again, lease parties should remember that if something is worth talking about, it is worth writing into the lease. Also, landowners must not feel obligated to sign a lease. The lease is a negotiated business transaction that *both* parties must understand and agree on before signing.

Checklist of Leasing Considerations

It is difficult to develop a model lease that applies to all lease holders. Many factors must be taken into account to develop a lease tailored to a landowner's and a company's specific goals and property. The following section mentions clauses that can be added to a lease. The headings of these clauses can be used as a general checklist for evaluating and negotiating a lease.

PREPARING AND EXECUTING ADDENDUM TO OIL AND GAS LEASES

Upon receipt of an oil and gas lease, a landowner should take time to study and become aware of all provisions contained within. Often, some provisions must be changed and new ones added in order to reflect negotiated terms of the parties.

A recommended method of effecting the negotiated terms is to prepare an *addendum* to the basic lease. The addendum can be legally effective by referencing it within the basic lease, even though it is a separate document. Also, changes often are made by striking or adding words within the lease and initialling by the parties.

The signed lease and addendum are important documents and should be kept in a safe place with other valuable papers. The recorded lease and addendum should only be used for reference; the signed copy is vital in enforcing contract terms. Ideally, leases and addendums should be executed, signed, witnessed and notarized in duplicate so that both parties have copies.

There is no standard oil and gas lease form in use in Ohio, because the desires of the parties of a lease differ in each situation. Likewise, the development of a standard addendum form is impractical.

Following is a sample addendum with a list of clauses used in its development. Not all of these clauses are necessary in a lease. Instead, parties to a lease should choose those that are most useful for their situation. These clauses reflect general concepts and can be altered to fit the desires of either party. Also, parties can negotiate additional clauses beyond those listed here.

Oil and Gas Lease Addendum

A typical addendum begins with the following statement:

"This is an addendum to the oil and gas lease executed by and between _____ (lessor) and _____ (lessee) on ____ day of _____, 19____. This addendum is to become a part of the lease. If there should be any inconsistency between the terms and conditions set forth in the basic lease and those in this addendum, the provisions of this addendum shall prevail."

The following clauses then should be considered for inclusion in the addendum:

1. Property Description

A full description of the subject property of this lease shall be recorded with the lease and this addendum.

2. Strata Leased

This lease shall only apply to the producing zones (strata) of _____, _____ and _____. The lessor shall retain full ownership and control of other strata to be developed or leased at his or her discretion.

3. Late Payments

Any delay rental, royalty or other payment not made when due shall accrue interest compounded daily at the rate of ____ percent.

4. Notice for Nonpayment of Delay Rental

If the lessor does not receive a delay rental payment by the stated due date, then the lessor, after giving 10 days written notice to the lessee and noncompliance by the lessee, at his or her election without notice to the lessee shall have the right to terminate this lease.

5. Removal of Equipment

All equipment, property and fixtures belonging to the lessee, his or her agents or to contractors shall be removed by said lessee within ____ days of the expiration of this lease. Any equipment, property or fixtures not so removed shall, at the lessor's option, become the property of said lessor. Expenses incurred by the lessor in removing such property in excess of value received shall be paid by lessee.

6. Limitation on Assignments

Lessee shall not make an assignment of the operating responsibilities existing under this lease without first receiving written approval of the lessor.

7. Damage Payments

Lessee shall pay for all damages caused by oper-

ations under this lease. Any damages not mutually agreed upon shall be determined by a board of arbitrators: one member to be appointed by the lessor, one by the lessee and the third by the two so appointed. The award of such three persons shall be final and conclusive. Each party shall pay the cost of the one arbitrator selected, and the cost of the third arbitrator shall be shared equally.

8. Override

Lessor retains unto themselves ____ (fraction) of the 7/8 share as an overriding royalty interest.

9. Lessor Payment of Charges

All costs for marketing, severance taxes, mineral taxes and transportation shall be paid by the lessee. The lessor shall receive 100 percent of the one-eighth royalty payment provided; however, a deduction shall be permitted for the lessor's share of any windfall profit taxes.

10. Pipeline Crossing Public Highway

All costs and assessments for the installation and removal of pipelines that cross public roadways placed there by operations permitted by this lease shall be the responsibility of the lessee, even if such costs are incurred after the termination of this lease.

11. Locating Wells and Associated Activities

The final location of well sites, tank batteries, meters, separators, access roads and pipelines shall be approved by the lessor in writing before drilling is started, equipment is set and operations begun. All sites shall be kept to a mutually agreeable size set forth in a separate writing signed by the parties hereto.

12. Plat Map

The lessee shall provide the lessor a plat map showing the location and depth of all buried pipelines.

13. Fencing

After drilling is completed, all well sites and tank batteries shall be fenced by the lessee, and if livestock are run in the field surrounding a well site or tank battery, a fence adequate to turn such livestock shall be constructed and maintained.

14. Abandonment of Lease Roads

All roadways installed by lessee shall be restored to facilitate normal surface operations of the lessor within ____ (days/months) of abandonment of the operations that required such roadway. The lessor may elect by written request to lessee to have specified roadways or portions thereof remain.

15. Removal of Marketable Timber

After locating a proposed site for well(s) and other associated operations a written notice shall be given to the lessor setting forth the proposed location(s). The lessor shall have ____ days after receipt of notice to remove marketable timber from the identified area(s). After the specified number of days has passed, the lessee shall have the right to develop the well site and associated operations.

16. Facilities Serving Other Properties

Only pipelines, tanks, equipment, roadways and other operations servicing the wells on the lands covered by this lease shall be installed.

17. Burying of Pipelines

All pipelines shall be buried at a depth specified in writing by lessor, which shall in all cases be below tillage and drainage tile depth.

18. Recording and Certified Copies of Documents

The lessee shall be solely responsible for the recording of pertinent documents under and related to this agreement. The lessee shall provide lessor with a certified copy of the recorded lease and addendum thereto.

19. Purchase of Abandoned Well by Lessor

Should lessee decide to abandon any existing well or wells on subject land, lessor shall have the option to purchase any of the wells at the salvage value thereof minus cost of removal and cost of plugging. Lessee shall give written notice to lessor of the intent to abandon, and lessor shall have a period of ____ days after the receipt of such notice to elect to purchase. Notice of said election shall be given by lessor to lessee in writing.

20. Cancellation of Recorded Lease

Upon the termination of this lease, lessee agrees to cancel the same of record and provide a certified copy of such cancellation to lessor. In the event that lessee fails to cancel this lease upon its termination, then lessor may proceed to quiet title as to said lease and shall recover all the costs, including attorney fees, incurred in such action from lessee.

21. Burying of Utility Lines

Any utility lines used by lessee in the conduct of its operations shall be buried upon the written request

of lessor. All said utility lines shall be removed by lessee upon termination of this lease, unless lessor elects in writing delivered to the lessee to have such kept in place.

22. Future Laws and Regulations

Notwithstanding anything to the contrary herein contained or implied by law, all present and future rules and regulations of any government agency pertaining remotely or directly to any portion of this agreement shall be binding on the parties hereto with like effect as though incorporated herein at length, provided, however, any provisions contained herein that set forth stricter requirements than present or future rules and regulations shall remain in effect.

23. Shut-in Wells

If a well shall be shut in, the lessee shall from date of shutting in until date production is started, restarted or until date of termination of lease, whichever shall occur first, pay lessor an amount equal to the delay rental. The payment amount and schedule for a shut-in well shall be the same as the one for delay rental payments.

24. Free Gas (alternative clauses)

(A) The lessor shall be entitled to _____, cubic feet of free gas for the following named uses: _____, _____, _____ and _____. If lessor exceeds the agreed-upon amount, then he or she shall pay the wellhead price for the excess.

(B) The lessor shall be entitled to _____cubic feet of free gas. The gas allocated to the lessor under the free-gas clause shall become the sole property of the lessor to be used by him or her in any manner so desired. Should lessor not use the entire yearly allotment, lessee shall purchase the seven-eighths share of the unused free natural gas allotted to lessor at the wholesale well-head price. Should lessor use more than the yearly allotment, he or she shall pay lessee the wholesale well-head price for seven-eighths of the excess amount. Any payments required by this paragraph shall be made within ____ days of the close of the calendar year.

25. Termination of Lease

If this lease has not terminated within ____ (days/months/years) from the signing, then it shall terminate, unless a well (wells) is (are) currently producing in paying quantities or there is no shut-in well on subject property. Once a well stops producing in paying quantities and stays below that level for ____ months, and there is no shut-in well, the lessee shall have ____ (days/months) to plug the well and remove all equipment.

26. Time of Delay Rental Payment

Delay rental shall become payable quarterly, in advance, from the date of signing this lease and addendum until production begins.

27. Record of Production

The lessee shall provide the lessor a monthly record of the quantities of oil and gas produced on subject property at the time royalty payments are made.

28. Prevention of Unreasonable Damage

In no event shall drilling operations under this lease be performed if unreasonable damage will result to the property.

29. Storage of Gas or Brine

The provision(s) in the lease permitting the subject property to be used for storage of gas or brine shall be null and void, and the property shall only be used for storage of gas or brine, upon execution of a separate written agreement with the lessor.

30. Unitization or Pooling

The provision(s) in the lease permitting unitization or pooling of subject property with any other property shall be null and void, and the property shall only be unitized or pooled, upon execution of a separate written agreement with the lessor and following the provisions of state law.

31. Severance of Land Not Unitized or Pooled

Upon the unitization or pooling of less than all of the leased land, this lease shall be severed and considered a separate and distinct lease. The lease term and all the rights and obligations of the lessee under this instrument shall apply separately to the unitized (pooled) and ununitized (unpooled) acreage.

32. Development of Property After Completion of Well

If within ____ (months/years) after completion of a well, the lessee does not commence a new well, the lease on the undeveloped land shall be terminated, and lessor shall have the right to release the undeveloped land or to hold it free of lease. The lessee shall be entitled to continue the lease on so much of subject property as required to support a well of the actual depth as specified under the rules and regulations of the Division of Oil and Gas, Ohio Department of Natural Resources.

33. Method of Giving Notice

All notices provided for herein are to be delivered either personally or by certified United States mail.

34. Copy of Documents to Lessor

A copy of all documents filed with Division of Oil and Gas, Ohio Department of Natural Resources, pertaining to this lease shall be delivered to the lessor within 10 days of filing with the division.

35. Mechanics Lien

The lessee shall have no authority to create any lien for labor or material upon the lessor's interest in the demised premises, and neither the lessee nor anyone claiming by, through or under the lessee shall have any right to file and place any labor or material lien of any kind or character whatsoever upon the demised premises, and the buildings and improvements therein located so as to encumber or affect the title of the lessors in said land and the buildings and improvements thereon located, and all persons contracting with the lessee, directly or indirectly, or with any person who in turn is contracting with the lessee, for the creation, construction, installation, alteration or repair of any improvements or for the destruction or removal of any leasehold improvement upon the demised premises, including furnishing and fixtures, and all materialmen, contractors, mechanics and laborers, as heretofore stated, are hereby charged with notice that as and from the date of this instrument they must look to the lessee and the lessee's interest only in and to the demised premise to secure the payment of any bill for work done or materials furnished or performed during the term hereby granted.

36. Reclamation/Restoration

In addition to the provisions of the Ohio Revised Code, the reclamation and restoration practices to be utilized on any well sites, access roads and other disturbed areas shall be as follows: during the drilling period and any time prior to completed reclamation, erosion shall be controlled by the lessee through temporary or permanent measures. The drill site shall be restored to the slope not to exceed ____ percent. A drill site shall be seeded with a mixture of _____, _____ and _____ at a rate of ____ pounds per acre. The lessee shall be responsible for establishing a seeding and controlling erosion on a drill site for a period of _____ _____ after the spud date unless the lessor assumes control of reclaimed area prior to that time. If lessor assumes control of a portion of the reclaimed area, the lessee responsibilities shall end as to that portion. During the reclamation, the lessee shall obtain a soil test analysis through The Ohio State University soil test laboratory or other soil test laboratory agreed upon by both parties to this agreement and shall fertilize and lime the site to be reclaimed as indicated on the analysis. As a well site is prepared, top soil to a depth of ____ inches shall be stockpiled, then as reclamation is performed, said topsoil shall be placed on top of the reclaimed area. Any site reclamation plans to be submitted to the Division of Oil and Gas shall be approved and initialed by the lessor prior to being submitted. All restoration and reclamation plans shall be approved by the local Soil and Water Conservation District Office.

37. Arbitration

The parties hereto agree to submit to arbitration all differences that may arise under this agreement that they cannot resolve themselves. Such arbitration shall be by a board consisting of one chosen by the lessor, one chosen by lessee and a third chosen by the arbitrators that were selected by the parties. The decision of a majority of the arbitrators shall be final and binding upon all parties to this lease and addendum except if a question of law. Each party shall pay the cost of the arbitrator he or she selected, and the cost of the third arbitrator shall be shared equally between the parties.

38. Timing

Time shall be of the essence in the conducting of all activities and meeting all the terms related to this lease and addendum.

39. Duty of Extraordinary Care

The lessee shall exercise extraordinary care and precaution in conducting all operations related to this lease.

40. Definitions

The following definitions shall control the term of the lease and this addendum.

Commencement: commencement of a well shall be considered to have been achieved the instant actual drilling begins and is diligently pursued to completion.

Operations: only activities that are in active pursuit of developing a new well or continuing production from existing wells shall be regarded as operations.

Paying Quantities: a well shall be considered to be producing in paying quantities only if the income from the well exceeds the cost of operating the well and marketing the product and shall be considered to be producing in paying quantities only if the royalties received by the lessor exceeds the delay rental provided for in this lease. The royalties received by

the lessor shall be permitted to drop below the delay rental for a period of ____ (days/months/years) before the well shall be declared not to be producing in paying quantities, except that a shut-in well shall permit the lease to continue for a period of up to ____ (days/months/years).

Section 5

POST-LEASE RIGHTS AND RESPONSIBILITIES

Good Communications

The relationship between the owner of the minerals (the lessor) and the oil and gas company (the lessee) after a lease has been signed is of utmost importance. The lessor should know and have periodic contact with a person of responsibility in the company.

As development activities take place, the lessor must protect his or her interests. No one knows the terms of the lease agreement, especially those that affect the lessor, better than the lessor.

Much of the well site work is done by subcontractors of the lessee. It is unlikely that these individuals know of any unique clauses that have been placed in a lease. If work by subcontractors goes adverse to the lessor's interests, then he or she needs to inform the subcontractor(s) of those contract terms. If satisfaction cannot be achieved, then contact should be made with the responsible people in the lessee's company.

Once production is underway, the lessor should check production reports. The ORC provides that royalty holders in a gas well have a right to reports of production. These reports should be provided to the royalty holder as often as royalty payments are made. The reports must contain the volume of natural gas being paid for, the price per 1,000 cubic feet and the volume of natural gas that has passed through the meter if the well is metered.[8] This statute relates only to gas. The lease, usually by an addendum clause, can give the lessor the right to production records of both gas and oil. Also, the lessee, to advance good relationships, can provide oil production records even though they are not mentioned in the lease or statute.

Some lessors say that they do not understand the records provided by the lessee. If records are not understood, contact should be made with the lessee for assistance. If satisfaction cannot be gained through the lessee, then other knowledgeable people in the industry should be consulted. A lessor usually requires assurance that he or she is receiving a fair share of the income from production.

A troublesome clause in most oil and gas contracts requires that the lessor notify the lessee if a delay rental payment is not received. Typically, the clause reads: "This lease shall become null and void for failure to pay rental for any period when same becomes due and payable, provided, however, that Lessee or his or her assigns is given ____ days written notice of failure to pay said rentals and they are not paid within said ____ days."

Worth noting in this is the possibility of lease termination if a delay rental payment is not received. However, there usually is a responsibility placed on the lessor to notify the lessee before a termination can occur. It is recommended that such notice be sent by certified mail with guaranteed receipt back to sender. This practice provides evidence to the sender that the notice was received. Page 13, Addendum clause 4, "Notice for Nonpayment of Delay Rental," also relates to this concern.

Often, it is not the desire of the lessor to terminate a lease, but instead to receive the agreed-upon delay rental until a well is commenced or the primary term of the lease passes. To help enforce payment, a clause in the agreement is recommended that provides for a penalty if payments are late (see page 13, Addendum clause 3, "Late Payments").

If a lease has been terminated for some reason, the lessor usually makes certain that the lease is marked "terminated" in the county recorder's office. Reasons for lease termination include:

(1) Expiration of the primary term with no operations or production activities occurring and no delay rental payments being accepted;

(2) During the primary term, delay rental payments are not being received;

(3) The specified time period set forth in the lease

[8]Ohio Revised Code, Section 1509.30.

has passed after the drilling of a dry hole;

(4) A well is not producing in paying quantities; or

(5) Production and operations have ceased.

It is suggested that an addendum clause be inserted in the oil and gas lease that places a responsibility on the lessee to have the terminated lease so marked in the recorder's office. This frequently is overlooked, and the lessor is left with the question of how to make courthouse records show that termination has occurred (see page 14, Addendum clause 20, "Cancellation of Recorded Lease").

The ORC sets forth a procedure that will help in getting termination recorded.[9] The steps are:

(1) Send a certified letter to the lessee indicating that the lease is considered terminated;

(2) If the letter is answered, then the lessor should present the letter to the county recorder so the proper entry can be made in the records;

(3) If no answer is received from the lessee, then the lessor must publish notice of such termination once in a local newspaper;

(4) If no response is received within 30 days after publication of the notice, the lessor must file an affidavit of forfeiture with the recorder; and

(5) The lessee now has an additional 30 days to rebut the affidavit filed by the mineral owner, and if it is not rebutted, the lease can be officially terminated.

If a lease is not terminated on the public records, then there remains a question whether the lease is continuing. This question is important to future oil and gas companies interested in leasing, potential land buyers, potential mortgage holders and others. A lease not marked terminated creates a "cloud" on the title.

Lessees interested in acquiring land with an old oil lease that has not been marked terminated often are willing to rely on a statement of the lessor in order to expedite the execution of a new lease. The interested company might ask the mineral owner to sign an "affidavit of nonproduction and nonperformance." In this, the mineral owner states that even though there is a lease on public record that is not marked terminated, there is no production or activity on the property that would continue an old lease. This can expedite a new lease, but it does place the burden on the lessor of the minerals in case a question is raised by the previous lessee.

Another way to have a lease terminated is to initiate a legal action against the previous lessee. This is known as a "quiet title action." In such a case, the court decides if the old lease is terminated, and this decision then is placed on the county records.

[9]Ohio Revised Code, Section 5301.332.

Responsibilities of the Division of Oil and Gas

The Division of Oil and Gas, ODNR, is responsible for enforcing Ohio's oil and gas laws. These laws are set forth in Chapter 1509 of the ORC. Sometimes, concerns of the lessor as well as other interested parties must be dealt with through the division. It is recommended that the wording of the lease or addendum set forth as many of the desired contract terms as possible rather than relying entirely on state statutes. The lease agreement should provide that parties adhere to the state laws (see page 15, Addendum clause 22, "Future Laws and Regulations"). Following these recommendations gives the parties a right to private contract enforcement in addition to the assistance of the Division of Oil and Gas. The topics covered by Chapter 1509 of the ORC include:

(1) Granting of permits for drilling, reopening, converting a well to a use other than the prior permitted use or plugging a well (ORC Sections 1509.05 and 1509.06).

(2) Obtaining financial assurance from oil and gas companies for compliance with statutes and regulations. Financial assurance is given through bonding, money deposits or a showing of financial responsibility by a financial statement that indicates a net worth of twice the amount required by bond (ORC Section 1509.07).

(3) Restoration procedures (ORC Section 1509.072).

(4) Procedures for drilling in a coal-producing area (ORC Section 1509.08).

(5) Well location and spacing requirements (ORC Sections 1509.09 and 1509.24).

(6) Requirements for a drilling log (ORC Section 1509.10).

(7) Filing of annual production records (ORC Section 1509.11).

(8) Plugging and abandonment of wells (ORC Sections 1509.12 through 1509.19).

(9) Preventing waste of oil and gas (ORC Section 1509.20).

(10) Permits for secondary recovery operations (ORC Section 1509.21).

(11) Limitations on brine management (ORC Section 1509.22).

(12) Regulating safety practices (ORC Section 1509.23).

(13) Procedure for pooling tracts of land. The statute provides for either voluntary or mandatory pooling (ORC Sections 1509.25 through 1509.29).

(14) Reporting gas production to royalty holders (ORC Section 1509.30).

(15) Procedure for notifying a royalty owner of a transfer or assignment of a lease (ORC Section 1509.31).

(16) Establishment of a board of review to hear disputes arising from orders of the Division of Oil and Gas and a technical advisory council (ORC Sections 1509.35 through 1509.39).

(17) Municipal regulations (home rule) (ORC Section 1509.39); statutes not to be constructed as a limit on production (ORC Section 1509.40); statutes not to be constructed as permitting antitrust activities (ORC Section 1509.41); and penalties (ORC Section 1509.99).

The Division of Oil and Gas main office is in Columbus; regional offices are in Millersburg, Dellroy, Marietta and Newark. One of these offices should be contacted if a situation arises that the division regulates.

The division publishes a notebook listing Ohio's oil and gas laws, rules and regulations. It provides quick access to this material. Information on purchasing the notebook is available from the Ohio Department of Natural Resources, Division of Oil and Gas, Fountain Square, Columbus, Ohio.

Court Remedies

The courts can provide remedy whenever parties to a lease have had their rights infringed. For example, one landowner felt a well had been shut down too long and took the question to court. The well had been shut down because of an equipment breakdown, and the repair work had been delayed for approximately 18 months. The court found this an unreasonable length of time and held the lease terminated.[10]

If concerns exist, and no resolution is found through good communications, or the problem is outside the jurisdiction of the Division of Oil and Gas, then landowners must rely on the court system. The terms of a private contract, in this case the lease agreement, are enforceable through court actions.

Also, *implied covenants* developed through the years relate to oil and gas leases. These covenants have been given effect by the courts. Implied covenants are contract terms that arise out of the oil and gas lease, even though they are not stated specifically. Five classifications of implied covenants have been developed by Ohio and other state courts. They are:

(1) To drill an initial exploratory or test well.

(2) To protect the leased premises from drainage by wells on adjoining property.

(3) To conduct lease operations that affect the lessor's royalty interest with reasonable care and due diligence.

(4) To market the product.

(5) To reasonably develop the leased premises by drilling additional wells.

These implied covenants do not give assurance of a court remedy, but with the proper facts, they can be helpful. If there are legal questions that affect the rights of the parties to an oil and gas lease, an attorney should be contacted. A remedy obtained through negotiation or through a court can be helpful to the injured party.

Section 6

THIRD-PARTY OWNERSHIP OF MINERALS

A general conveyance of land, absent any exceptions or reservations, includes all of the minerals therein. The law recognizes the right of a landowner to exclusive possession of the earth, minerals and other substances below the surface. The landowner can keep the minerals for his or her own use or grant the mineral rights to another; one person can own the land surface while another person owns all or part of the underlying minerals. For example, one person might own the surface, another the oil and gas, and a third the coal.

Ownership of the minerals in a land tract can be severed from the ownership of the surface by:

(1) A conveyance of the minerals only;

(2) A conveyance of the surface only; or

(3) A conveyance of the land with a reservation or exception of the minerals.

Rights of the Mineral Owner

Bare mineral rights without the right to use any of the land surface are a nullity. The surface must be removed or penetrated before the minerals can be extracted, and roadways must be constructed to gain access and to remove the minerals.

[10]See court case, Wagner v. Smith, 1982. 8 Ohio App. 3d 90.

A conveyance of minerals carries with it the right to enter upon the land and remove the minerals as well as the right to use as much of the surface as is *reasonably necessary,* unless the language of the deed expresses otherwise. The courts apply the maxim, "When anything is granted, all the means of obtaining it and all the fruits and effects of it also are granted." Following an absolute conveyance, the mineral owner receives an estate in fee (unconditional ownership) with an easement to the surface for as long as the land contains the minerals that were granted.[11]

It should be clear that the terms of the conveyance need not expressly grant access to the minerals over and through the surface. This right of entry is implied as an incident to the conveyance of the mineral estate.

The mineral owner only can use so much of the land surface as is reasonably necessary for proper mineral development operations and can use all reasonable means and equipment necessary to remove the minerals.[12] This can include constructing well sites, setting storage tanks, developing access roads, putting in pipe lines and using water.

The incidental right to use the land surface is determined by the degree of necessity in a particular case and can change with the circumstances or conditions. Such uses must be necessary as opposed to merely convenient or arbitrary.

The mineral owner also can use some of the land surface as a dumping area for materials or waste immediately above the minerals, as is strictly and reasonably necessary. Adjoining property, however, cannot be used as a dump absent an agreement to the contrary.[13]

The mineral estate exists until the specified mineral is exhausted, and at that time, the right to use the land surface no longer exists. *Note:* a surface owner can seek to reacquire mineral rights that have been severed. It is possible for the mineral estate to be conveyed back to the surface owner before all or any of the minerals are mined.

Rights of the Surface Owner

When the ownership of minerals in land has been severed from the ownership of the surface or the remainder of the land, the surface owner has a separate estate carved out of the whole, which constitutes an estate in itself.[14] The surface owner has the right to use and enjoy his or her land free from annoyance except such as reasonably arises from the mineral development operation. This includes the right to build a house and make other improvements to a location that do not interfere with the mineral estate.[15]

One important right of the surface owner in the case of underground mining is the right of subjacent and lateral support. The surface owner is entitled to expect all mineral development to be conducted in such a manner as to leave sufficient support for the land surface in its natural state, either by allowing enough ground to remain or by the substitution of artificial supports.[16]

The surface owner's right to absolute support is a property that passes with conveyance of the surface without regard to express language to that effect.[17] This right can be relinquished or waived by the surface owner if such intent is manifested by clear language. However, the grant of all minerals underlying a tract of land does not constitute such a release.[18]

[11]See court case, Moore v. Judian Long, 80 NE 6.
[12]See court case, Frandlier v. Collcost, 119 NE 2d 688.
[13]36 *American Jurisprudence* 403, Mines and Minerals SS 179.
[14]See court case, Yoss v. Markley, 68 NE 2d 399.
[15]See court case, Harper v. Jones, 74 NE 2d 397.
[16]See court case, Ohio Collieries Co. v. Cocke, 140 NE 356.
[17]See court case, Chartiers Coal Co. v. Curtiss, 1006 NE 1053.
[18]See court case, Burgner v. Humphrey, 41 OS 340.

Section 7

RESTORATION AND RECLAMATION OF OIL AND GAS SITES

Throughout Ohio, landowners should be concerned about the damage to property and the loss of soil from inadequate restoration of the oil and gas drilling site and surrounding areas.

A landowner's greatest opportunity to prevent damage and excessive erosion and to ensure proper reclamation of the site occurs before the lease is signed. At this point, the landowner can negotiate into the lease or addendum specific restoration plans aimed at reducing potential development hazards (see page 16, Addendum clause 36, "Reclamation/Restoration").

Communication is a key process in a successful reclamation plan. Landowners should know and communicate with the oil and gas company personnel, so if something is not being done properly, a responsible person can be contacted. Meeting with those installing the road and well site is advisable. This should be done both before and during installation.

The concern is, if the lessee does not complete restoration as planned, how does the lessor cause restoration to be completed? Remedies that have been explored include: lessor completes restoration and is indemnified by lessee; performance bond is given to lessor; or a penalty is payable to the lessor.

State Law on Restoration

ORC Section 1509.072, Restoration of Land Surface

"No oil or gas well owner or his or her agent shall fail to restore the land surface within the area disturbed in siting, drilling, completing and producing the well as required in this section.

"A. Within five months after the date upon which the surface drilling of a well is commenced, the owner or his agent shall, in accordance with his restoration plan filed under division L of Section 1509.06 of the Revised Code fill all the pits for containing brine, other waste substances resulting, obtained or produced in connection with exploration, drilling or production of oil or gas, or oil that are not required by other state or federal law or regulation, and remove all concrete bases, drilling supplies and drilling equipment. Within nine months after the date upon which the surface drilling of a well is commenced, the owner or his agent shall grade or terrace and plant, seed or sod the area disturbed that is not required in production of the well, where necessary to bind the soil and prevent substantial erosion and sedimentation. If the chief of the Division of Oil and Gas finds that a pit used for containing brine, other waste substances or oil is in violation of Section 1509.22 of the Revised Code or rules adopted or orders issued thereunder, the chief may require the pit to be emptied and closed before expiration of the five-month restoration period.

"B. Within six months after a well that has produced oil or gas is plugged, or after the plugging of a dry hole, the owner or his agent shall remove all production and storage structures, supplies and equipment and any oil, saltwater and debris and fill any remaining excavations. Within such period the owner or his agent shall grade or terrace and plant, seed or sod the area disturbed, where necessary to bind the soil and prevent substantial erosion and sedimentation.

"The owner shall be released from responsibility to perform any or all restoration requirements of this section on any part or all of the area disturbed, upon the filing of a request for a waiver with and obtaining the written approval of the chief, which request shall be signed by the surface owner to certify the approval of the surface owner of the release sought. The chief shall approve such request unless he finds upon inspection that the waiver would be likely to result in substantial damage to adjoining property, substantial contamination of surface or underground water or substantial erosion or sedimentation.

"The chief may, by order, shorten the time periods provided for under division A or B of this section, if failure to shorten the periods would be likely to result in damage to public health or the waters or natural resources of the state.

"The chief may, upon written application by an owner or his agent showing reasonable cause, extend the period within which restoration shall be completed under divisions A and B of this section, but not to exceed a further six-month period, except under extraordinarily adverse weather conditions or when essential equipment, fuel or labor is unavailable to the owner or his agent.

"If the chief refuses to approve a request for waiver or extension, he shall do so by order."

Technical assistance and suggestions on temporary

and permanent erosion control and reclamation practices can be obtained from the Soil and Water Conservation District office and the office of the Soil Conservation Service. The Ohio State University, Ohio Cooperative Extension Service, provides educational assistance for landowners in restoration and reclamation. Several oil and gas companies are working with these offices as plans for restoration and reclamation are developed.

Considerations in the Restoration Plan

The following points should be considered in a reclamation plan:

Lease Road

(1) Where will the lease road be located?

(2) Will the lease road be left on site or removed after operations cease?

(3) Has the location and design of the lease road been decided?

(4) Will slope and natural contour be considered?

(5) Has soil stability of the lease road location been investigated?

Restoration and reclamation are important lease concerns. This access road, for example, can be left on-site after production, regraded or removed — depending on provisions of the lease and addendum.

(6) Have surface drainage ways been considered?

(7) Has the flow capacity of culverts under the lease road been determined?

(8) Is erosion control of road cuts planned?

(9) Are stream and water courses considered in the planning?

(10) Has the access point to the public road been discussed with county or township officials regarding visibility and road ditch considerations?

(11) Will the lease road be elevated?

(12) What materials will be used to construct the road?

(13) Will the lease road be supplied with gates?

(14) Will water bars and other conservation practices be used on the site?

Well Site

(1) Have temporary and permanent management practices for dealing with surface water flow at the well been determined?

(2) Have temporary and permanent seeding mixtures at the well site been determined?

(3) Has the removal and disposal of trees at the well site been determined? Is any of the timber marketable?

(4) Has the design of surface water control structures and erosion control structures, depending on whether they are temporary or permanent, been determined?

(5) Will all topsoil be stockpiled and placed back on top during reclamation?

(6) Has a topographic map been prepared indicating a final slope and contour of the site?

(7) Has the final fertility level of the site been agreed upon, including pH, phosphorous and potassium?

Other Considerations

(1) Is there a complete understanding of site development considerations and construction procedures to be followed by the cat skidder, driller and pumper?

(2) Will the area be fenced? What type of fence?

(3) Will all pipelines and utility lines be buried and if so, how deep?

(4) Will damage to subsurface drainage, including field tile, be repaired?

In the lease, a landowner should not ask that a site be restored to its original condition unless that is exactly what is wanted. Sometimes, the original condition is not the desired condition for present or future purposes of the property.

Soil erosion is a continuing problem for many landowners. The road culvert shown here represents one alternative for drainage and flow. Erosion control, flow capacity, soil stability and existing waterways are among the concerns that should be addressed in the restoration plan.

Section 8

FLARING AND VENTING GAS IN OHIO

In Ohio, all owners or lessees drilling or producing crude oil or gas must use every reasonable precaution to prevent its waste. Any well that has sufficient quantities of natural gas to justify utilization shall be unitized or shut-in within 10 days of completion of the well. The owners of wells that produce both oil and gas can burn the gas in flares if it is lawfully produced and there is no economic market for the gas.

Flares must be a minimum of 100 feet from the well, a minimum of 100 feet from oil-production tanks and all other surface equipment, a minimum of 100 feet from existing inhabited structures and in a position so that any escaping oil or condensate cannot drain onto public roads or toward existing inhabitant structures or other areas that could cause a safety hazard. All gas vented into the atmosphere must be flared, with the exception of gas released by a properly functioning relief device or gas released by controlled venting for testing, blowing down and cleaning out wells. (ORC Chapter 1509.20 and Ohio Administrative Code, Oil and Gas Rules, Chapter 1501:9-9-05).

BRINE DISPOSAL

On January 10, 1985, Governor Richard F. Celeste signed into law Amended Substitute House Bill 501, a brine disposal law. The legislation took effect on April 12, 1985, and provides stringent regulation of the storage, transportation and disposal of brine waste.

Brine is concentrated saltwater that is trapped in underground formations and brought to the surface during oil and gas production. It is toxic to plant and animal life and can threaten human health if it enters a water supply.

The brine law addresses the major problem of previous legislation—inadequate regulation of transportation from well to disposal site. The law now requires registration of persons transporting brine by vehicle and makes brine haulers responsible for proper disposal. Vehicles must be clearly marked, and haulers must keep a daily log to aid the state in monitoring. The log must contain at a minimum the name of the well owner whose brine is being transported, the date and time the brine was loaded, the driver's name, the amount loaded at each collection point, the disposal location and the date, time and amount of brine disposed of at each location.

To obtain a registration certificate, a business must:

(1) File a plan for compliance with all applicable statutes and rules and a list of all prospective disposal sites;

(2) Post $30,000 bond that can be ordered forfeited to pay damages to an injured party;

(3) Provide a certificate of insurance including at least $300,000 bodily injury and $300,000 property damage coverage; and

(4) Pay a $500 fee.

The law establishes procedures for the division chief to follow in issuing orders and provides for the appeal of orders to the Oil and Gas Board of Review or the Court of Common Pleas. The law prohibits the issuance of registration certificates to anyone with outstanding liability for road damage or whose disposal plan does not provide for compliance with applicable statutes and rules. The chief also can suspend registration if he believes a transporter has engaged in a pattern of violations of the law or the terms and conditions of the certificate.

The law also specifies permissible methods of disposal. The law first lists disposal of brine by injection into an underground formation and second by annular disposal if approved by the chief, Division of Oil and Gas, ODNR. Brine can be disposed of by underground disposal in association with enhanced recovery of oil and gas reserves.

The law also permits surface disposal for ice and dust control on roadways by counties, townships and municipal corporations. A political subdivision can allow surface application by adopting a resolution to that effect following at least one public hearing. If the resolution is adopted, it remains in effect for one year. The subdivision must obtain the approval of the chief within 30 days after adopting the resolution, the terms of which must be at least as stringent as the requirements of the oil and gas law.

Other methods of permissible disposal include the construction of pits for spillage control that are maintained to prevent the escape of brine, with the reservoir within the pit kept reasonably free of brine and other oilfield waste. Earthen impoundments also can be used for temporary storage in association with saltwater injection wells, enhanced recovery projects or solution mining projects.

In action for illegal contamination of a domestic water supply where annular disposal is used, there exists a rebuttable presumption that the annular disposal caused the violation if the well is located within a one-quarter-mile radius of the violation site. The law requires improved standards in constructing pits, on-site storage units and the disposal of drilling mud and other wastes.

Much stiffer civil and criminal penalties are also established. Civil penalties range from $2,500 to $4,000, and criminal penalties range from $100 to $20,000 and two years imprisonment.

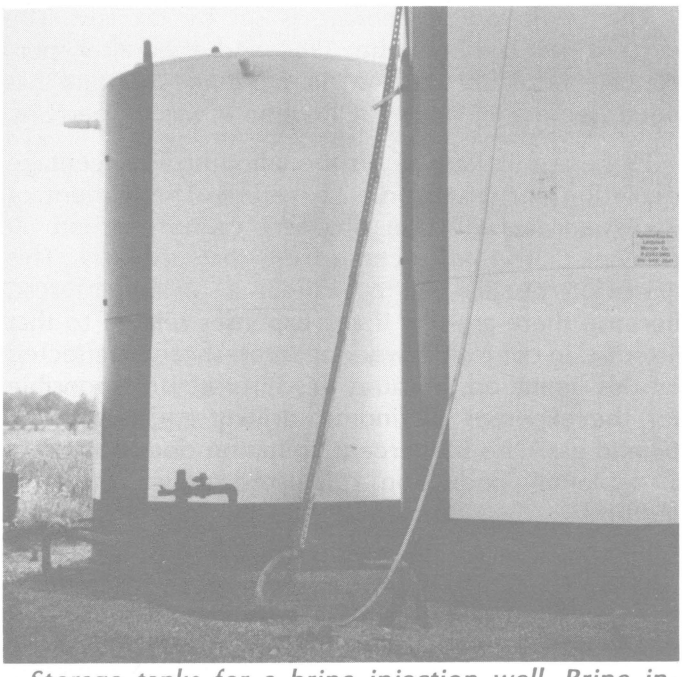
The law reduces to six months the time period in which all pits must be filled after the commencement of surface drilling. It further provides that if a pit is in violation of pollution and illegal placement provisions, the chief can order the pit emptied and closed before the expiration of the six-month surface restoration period.

In addition, the law requires that a well owner whose operations substantially disrupt a water supply by contamination, diminution or interruption replace that water supply and reimburse the injured party for reasonable costs incurred. Anyone violating an owner's disposal plan, a transporter's disposal plan or a

surface application plan, or who knowingly engages an unregistered transporter, is liable for any damage or injury proximately caused by the violation. The law also establishes joint and individual liability for multiple offenders.

Revenues to operate the program come from increased oil and gas permit fees. The law charges an additional $50 fee to fund research on the effects of annular disposal and surface application on public health and safety. Civil penalties assessed are paid to the Oil and Gas Permit Fee Special Account of the Division of Oil and Gas, ODNR. Criminal fines obtained by prosecuting attorneys are paid to the county treasury where the violation occurred.

This legislation has been amended to provide exemptions for certain shallow wells in designated geographic areas. Qualifying wells are those that were drilled before January 1, 1980; are located in an unglaciated part of the state; are located in the Berea or Big Injun formation; and primarily provide gas for domestic use. Wells that meet these requirements, however, are not free to discharge brine directly into the waters of the state nor endanger the health, safety or environment.



Storage tanks for a brine injection well. Brine injection for enhanced oil and gas recovery is one permissible disposal method under the 1985 brine disposal law.

Section 10

TAX CONSIDERATIONS

There are several tax concerns for the lessor and lessee of oil and gas. These concerns relate to income tax, windfall profits tax (WPT), severance tax and a mineral tax paid to the county auditor. The material in this bulletin primarily relates to lessor tax issues.

Income Tax

The sources of oil and gas income that lead to income taxation are bonus payments, delay rentals, royalties, damage payments, shut-in well payments and payments from granting easements. The free gas available to the lessor is not subject to income tax. Following is an indication of how each of the sources of income are taxed. (At the end of this bulletin are examples of 1040 Schedule E; Form 6783, Qualified Royalty Owner's Exemption Certificate; 6248, Annual Information Return of Windfall Profit Tax; and 6249, Computation of Overpaid Windfall Profit Tax.)

Depletion Allowance

Royalty payments for oil and gas qualify for a *depletion allowance* as a deduction against gross royalty income. Landowners should be sure the royalty payment used for calculation of percentage depletion reflects the gross royalty payments. Deductions such as marketing charges, severance taxes and windfall profit taxes are a part of gross royalty payments and must be added back before calculating the depletion allowance.

One of two types of depletion allowances is permitted by tax law—cost or percentage depletion. A taxpayer is permitted to use the method that results in the highest deduction.

Cost depletion is based on the capitalized cost a taxpayer has in the oil and gas. The cost depletion deduction in one year equals the capitalized cost multiplied by the units of oil and gas produced in that year divided by the total units estimated to be recoverable. A lessee can use the cost depletion method, but most lessors do not have an identified capitalized cost allocated to the mineral interest in their property.

The *depletion percentage* is set by tax law. The current tax law sets the 1984 and thereafter percentage depletion rate at 15 percent. This rate has been decreasing since 1980, when it was 22 percent.

There are limitations on the amount of percentage depletion permitted on a tax return. The amount of depletion for any one property cannot exceed 50 percent of the net income from that property. This limitation usually will not affect a royalty interest, because there are few if any expenses related to that interest. In contrast, a working interest can be affected by this limitation, because this interest is responsible for the expenses of finding, drilling and producing oil and gas. This 50-percent limitation does not affect a depletion deduction calculated under the cost method.

Another limitation is that a taxpayer's aggregate deduction for percentage depletion cannot exceed 65 percent of taxable income for the year after considering certain adjustments. These adjustments include the adding back of any percentage depletion other than on qualifying gas, any net operating loss carryback and capital loss carryback and any distributions of certain trusts to their beneficiaries. Any amount that is disallowed by reason of this 65-percent limitation can be carried over to subsequent tax years.

The percentage depletion was drastically changed in the 1975 Tax Reduction Act. In the act, the rates of depletion were reduced, the 65-percent limitation was established, and percentage depletion was eliminated for large producers. A large producer is defined as one producing over 1,000 barrels of oil per day. Gas is substituted for oil in this 1,000-barrel limitation at the rate of 6,000 cubic feet (MCF) per barrel.

Windfall Profits Tax

The windfall profit tax (WPT) is an excise tax on the production of crude oil. The tax is collected and paid to the government by the first purchaser of the oil. The first purchaser provides a report to the producer and affected royalty holders showing the amount of tax withheld. This tax is temporary and will be phased out between 1990 and 1993.

In 1980, tax legislation passed that granted a credit to offset the WPT for royalty owners. That credit was changed in 1981 to an exemption for certain levels of a royalty owner's oil production. The exemption level in 1984 was two barrels of oil per day, and in 1985 and thereafter, three barrels a day. This exemption has eliminated the WPT tax concern for many

Oil and Gas Lease Income Tax Information

Source of Income	Tax Classification	Where Reported on Federal Tax Return
Bonus	Ordinary, not subject to self-employment tax.	1040 Schedule E, Part 1, Rent Income.
Delay Rental Income	Ordinary, not subject to self-employment tax.	1040 Schedule E, Part 1, Rent Income.
Royalty Payments	Ordinary, subject to depletion allowance, not subject to self-employment tax.	1040 Schedule E, Part 1, Royalty Income and Depletion Allowance.
Damage Payments Real Property	Reduction of basis or capital gain, not subject to self-employment tax.	1040 Schedule D, Part 1 or 2 (depending on time property has been held).
Damage Payments Crops	Ordinary, subject to self-employment tax.	1040 Schedule F.
Seismographic Tests	Ordinary, not subject to self-employment tax.	1040 Schedule E, Part 1, Rent Income.
Shut-in Well Payments	Ordinary, not subject to self-employment tax.	1040 Schedule E, Part 1, Rent Income.
Easements	Reduction of basis or capital gain.	1040 Schedule D, Part 1 or 2 (depending on time property has been held).

Windfall Profit Tax Rates

	Royalty Owners and Integrated Producers	Independent Producers
Tier-one oil	70%	50%
Tier-two oil	60	30
Tier-three oil	30	30

royalty owners. Royalty owners must file an IRS Form 6783 to qualify for this exemption (See Sample Form 1, page 32).

For royalty owners experiencing production above exemption levels, WPT rates for oil classes are shown at the top of the page.

Tier Descriptions

Tier-one oil: Production from a property that began producing before 1979. This classification includes taxable oil other than tier two or three.

Tier-two oil: Crude oil produced from stripper wells (low-production wells for a specific period) and production from the Naval Petroleum Reserve.

Tier-three oil: Oil discovered in 1979 or later, heavy oil (high-viscosity crude) and incremental tertiary oil (the increase in production over a base period caused by pumping water or gas into the well). This classification does not include tier-two oil.

Oil production by *independent producers* is less than 1,000 barrels per day; independent producers do not refine oil or sell it at retail.

The WPT is applied to the difference between a base price of crude oil in May 1979 (adjusted quarterly for inflation) and the current price. The formula also recognizes increases in state severance tax that are possibly due to increased oil prices. Ohio's severance tax is set at a fixed rate per barrel and is not related to market price, so it is not deductible.

Three IRS windfall profit tax forms are included in this bulletin: Form 6248, Annual Information Return of Windfall Profit Tax; Form 6249, Computation of Overpaid Windfall Profit Tax; and Form 6783, Qualified Royalty Owner's Exemption Certificate. (See sample forms 1, 2 and 3.)

Example calculations of WPT for a royalty owner follow:

1) 1,500 barrels of production
−1,095 barrels exempted (365 days X 3 barrels)
405 barrels subject to tax

2) $30 current market price
−$20 adjusted base price
$10 windfall profit

3) $10 windfall profit
× 60% rate (assumed to be tier-two oil)
$6 per barrel

4) 405 barrels x $6 = $2,430 WPT

Severance Tax

A State of Ohio severance tax is levied on the production of oil and gas and other minerals. The rate of this tax, as enacted by House Bill 291 on July 1, 1983, is 10 cents per barrel of oil and 2.5 cents per 1,000 cubic feet of gas. Usually, this severance tax is paid by the lessee. However, some leases are written so that the company has a right to charge the lessor his or her pro rata share of the tax. The first one million dollars collected under this tax go to the oil and gas well plugging special account. All other monies collected are credited to the oil and gas permit fee special account.[19]

The well plugging special account is expended to plug wells or properly restore the land surface where security bonds for doing such have been forfeited; on abandoned wells for which no funds are available; and, upon authorization by the Division of Oil and Gas Controlling Board, to use abandoned wells for the injection of oil or gas production wastes.[20]

Funds in the oil and gas permit fee special account are used for expenses of the Division of Oil and Gas associated with the administration of the Natural Gas Policy Act of 1978 and other functions.[21]

Mineral Tax

The county auditor's office collects a mineral tax from oil and gas production. The producer is responsible for annually reporting to the auditor's office the production from each property. Formulas for calculating this tax follow.

[19]Ohio Revised Code, Chapter 5749.
[20]Ohio Revised Code, Section 1509.071.
[21]Ohio Revised Code, Section 1509.071.

This tax is the lessee's responsibility, unless the lessor owns a part of the working interest in addition to the royalty interest.

Oil:

Average daily production in barrels
×1,250
×The working interest percentage
×The millage of the well site township
=The oil tax.

Gas:

Average daily production in MCF
×180
×The working interest percentage
×The millage of the well site township
=The gas tax.

Section 11

SECTION SUMMARIES

The right to develop mineral land raises unique issues. Ohio law seeks to protect the interests of all real property owners. Case law and state statutes define the rights and duties of both surface owners and mineral owners so that they can coexist.

Oil and Gas Leases

Prior to any well drilling, a lease must be signed between the landowner and the producer. This lease lists the conditions of the contract. Lease length, delay rental payments, royalties, dry-hole provisions, shut-in well provisions, storage, free gas, purchase of unproductive wells, pooling, assignments and damages are among many conditions to consider before signing a lease.

To lessen the risk of problems and to write an equitable agreement, landowners should be aware of the many possible lease clauses. There is no standard lease, nor is there an "Ohio-approved" lease. An ideal lease is written with the best interests of both the mineral owner and the company in mind.

Preparing and Executing Addendum to Oil and Gas Leases

Upon receipt of an oil and gas lease, a landowner should study all the provisions of the lease. Often, provisions must be changed or new ones added. A recommended way to incorporate these changes is through the use of a lease addendum. Lease parties should choose those addendum clauses that reflect their agreement.

Post-lease Rights and Responsibilities

The relationship between the mineral owner (the lessor) and the company (the lessee) after a lease is signed is of utmost importance. The lessor should have periodic contact with a person of responsibility within the company.

If concerns exist, and (1) there is no resolution found through good communication; (2) the concerns are not addressed in the lease; and (3) they are outside the jurisdiction of the Division of Oil and Gas, the lessor can rely on implied covenants. These are contract terms that are derived out of an oil and gas lease, even though they are not specifically stated.

There are five covenants generally recognized in Ohio: (1) To reasonably develop the leased premises; (2) to conduct operations with reasonable care; (3) to protect the leased premises from drainage by wells of adjoining property; (4) to market the product; and (5) to reasonably develop the leased premises by drilling additional wells.

Additional lessor relief can come from the Division of Oil and Gas. The division is responsible for enforcing Ohio's oil and gas laws. These laws are set forth in Chapter 1509 of the Ohio Revised Code and Chapter 1501 of the Ohio Administrative Code.

Third-party Ownership of Minerals

A conveyance of minerals carries with it the right to enter upon the land and remove the minerals as well as the right to use as much of the surface as is reasonably necessary. Following an absolute conveyance, the mineral owner receives an estate in fee with an easement to the surface for as long as the land contains the minerals that were granted. This right of entry is implied as an incident of the conveyance and need not be stated explicitly in the deed.

The incidental right to use the land surface is de-

termined by the degree of necessity in each particular case. The mineral owner also can use some of the land surface above the minerals as a dumping area for materials or waste.

When ownership of the minerals is separate from ownership of the land surface, the surface owner has a separate estate in and of itself. The surface owner has the right to use his or her land free from annoyance except as reasonably arises from the mineral development operation.

Restoration and Reclamation of Oil and Gas Sites

Throughout Ohio, landowners should be concerned about the damage to property and the loss of soil from inadequate restoration of drilling site areas. A landowner's greatest opportunity to prevent damage and excessive erosion and to ensure proper reclamation of the site occurs before the lease is signed.

State laws on restoration set forth minimum standards for oil and gas sites and provide specific points to consider in developing a reclamation plan prior to the signing of the lease.

Flaring and Venting Gas in Ohio

All owners, lessees and drillers of crude oil and gas must use every reasonable precaution to prevent waste of the resource. All wells with sufficient quantities of natural gas to justify utilization shall be utilized or shut in within 10 days of well completion.

The well owner can burn natural gas in flares if there is no economic market for the gas and the flares are at least 100 feet from the well, 100 feet from oil-producing tanks and 100 feet from inhabited structures. All vented gas must be flared, except for gas released by a properly functioning relief device or by controlled venting for testing, blowing down or cleaning out wells.

Brine Disposal

Ohio oil and gas wells typically generate three products—oil, gas and saltwater brine. The oil and gas produced at the well are marketable, but the saltwater brine is a disposal problem. The chief of the Division of Oil and Gas, ODNR, has legal authority to make rules concerning brine disposal. Currently, there are three approved methods of disposing of brine in Ohio: (1) deep-well injection, including annular disposal; (2) use of brine for dust and ice control (with the permission of local officials); and (3) enhanced recovery methods.

Regulations for the disposal of brine from oil and gas wells have been prepared by the Division of Oil and Gas. 1985 legislation has granted relief from these regulations to wells primarily used for domestic purposes and those located in unglaciated parts of the state.

Tax Consequences

Income tax, windfall profits tax (WPT), severance tax and mineral tax are areas of concern for the lessor and lessee.

Bonus payments, delay rental payments, royalty payments, damage payments, shut-in well payments and easement payments are subject to income tax.

Percentage and cost-depletion allowances qualify as deductions against taxable income. The amount of depletion for any one property cannot exceed 50 percent of the net income from the property if using the percentage-depletion allowance method. In addition, the deduction can not exceed 65 percent of taxable income for the year.

Crude oil production also is subject to the WPT. This is an excise tax paid by the oil's first purchaser. The WPT is temporary and will be phased out between 1990 and 1993. Most lessors receiving royalties do not have to pay WPT because of the exemption of 3 barrels per day.

Sample Form 1

Form **6783**
Department of the Treasury
Internal Revenue Service
(December 1981)

Qualified Royalty Owner's Exemption Certificate

OMB No. 1545-0615
Expires 9-30-84

Name | Taxpayer Identifying Number

Number and street

City or town, State and ZIP code

Part A—Royalty Owner's Exemption Certificate.

I certify that I am a qualified royalty owner (as defined in section 6429(d)(1)) and that all of my production from the property(ies) listed below qualifies for exemption from the withholding of windfall profit tax.

The total qualified royalty production from these property(ies) (plus qualified royalty production from other properties that I have certified) does not exceed my share of the maximum amount exempt for qualified royalty owners. (Attach additional sheets, if needed).

Property #1
Full lease name | Identifying number, if applicable
Location

Property #2
Full lease name | Identifying number, if applicable
Location

Property #3
Full lease name | Identifying number, if applicable
Location

Property #4
Full lease name | Identifying number, if applicable
Location

Part B—Revocation of a Previously Filed Certificate.

I am revoking my previously filed certificate with respect to the property(ies) listed below. (Attach additional sheets, if needed.)

Property #1
Full lease name | Identifying number, if applicable
Location
Date original certificate was filed

Property #2
Full lease name | Identifying number, if applicable
Location
Date original certificate was filed

Please Sign Here

Under penalties of perjury, I declare that I have examined this exemption certificate and to the best of my knowledge and belief, it is true, correct, and complete.

Signature | Date

For Paperwork Reduction Act Notice, see back of this form. Form **6783** (12-81)

Sample Form 2

Form **6248**
Department of the Treasury
Internal Revenue Service

Annual Information Return of Windfall Profit Tax—1984

OMB No 1545-0224

Copy A—File with the IRS

Producer or Other Recipient	**Filer**
Name, address, and ZIP code	Name, address, and ZIP code
Employer identification no. (EIN) / **Social security no., if no EIN**	**Employer identification no. (EIN)** / **Social security no., if no EIN**

If you have received a Form 6248 from another person concerning oil reported on this Form 6248, enter the name and employer identification number of that person below.

Name	**Employer identification number**

Part I Producer or Other Recipient

1 Type of Producer (check all applicable boxes):

1 ☐ Individual 2 ☐ Partnership 3 ☐ Trust 4 ☐ Estate 5 ☐ Corporation 6 ☐ Resident of U.S. Possessions 7 ☐ U.S. citizen or entity, or resident alien 8 ☐ Foreign citizen or entity, or non-resident alien

2 Producer Status (check all applicable boxes):

1 ☐ Independent producer 2 ☐ Integrated oil company 3 ☐ Member of "related group" 4 ☐ Producer with no withholding 5 ☐ Royalty owner 6 ☐ Working interest 7 ☐ Trust beneficary 8 ☐ Operator

Part II Exempt Oil

		a. Tier one	b. Tier two	c. Tier three (1) Newly discovered	c. Tier three (2) Incremental tertiary	c. Tier three (3) Heavy
1 Number of barrels of exempt oil (do not include exempt stripper well oil)	1					

2 Total (add amounts on line 1, columns a through c(3)) 2

3 Type of exempt oil (check applicable boxes): 1 ☐ Qualified governmental interests 2 ☐ Exempt Indian oil 3 ☐ Qualified charitable interests 4 ☐ Exempt Alaskan oil

4 Total barrels of exempt stripper well oil (see instructions) 4

Part III Exempt Royalty Owner Oil

	Total number of certified barrels	a. 1st quarter	b. 2nd quarter	c. 3rd quarter	d. 4th quarter
1 Barrels removed in calendar quarter	1				
2 Total (add amounts on line 1, columns a through d)	2				

Part IV Taxable Crude Oil Removed During 1984

		a. Number of barrels	b. Tax liability
1 Tier one, other than Sadlerochit oil, taxed at 70%	1		
2 Tier one, other than Sadlerochit oil, taxed at 50%	2		
3 Tier one Sadlerochit oil taxed at 70%	3		
4 Tier one Sadlerochit oil taxed at 50%	4		
5 Tier two oil taxed at 60%	5		
6 Tier two oil taxed at 30%	6		
7 Newly discovered oil	7		
8 Incremental tertiary oil	8		
9 Heavy oil	9		
10 Total barrels of oil (add amounts in column a)	10		
11 Amount of windfall profit tax liability for oil removed during 1984 (add amounts in column b)	11		
12 Amount of windfall profit tax withheld with respect to oil removed during 1984	12		
13 If line 11 is greater than line 12, subtract line 12 from line 11. This is the amount of underwithheld windfall profit tax	13		
14 If line 12 is greater than line 11, subtract line 11 from line 12. This is the amount of overwithheld windfall profit tax	14		

Part V Amount of Windfall Profit Tax Withheld from Payments Made in 1984

1 Windfall profit tax withheld from payments made in 1984 (regardless of when windfall profit tax liability arose)	1	

For Paperwork Reduction Act Notice, see the instructions on back of Copy A. Form **6248** (1984)

Sample Form 3

Form **6249**
(Rev January 1985)
Department of the Treasury
Internal Revenue Service

Computation of Overpaid Windfall Profit Tax

▶ See separate instructions.

OMB No 1545 0226

80

Name

Taxpayer identifying number

Part I Type of Return to Which Form 6249 Is Attached

- ☐ Form 720
- ☐ Form 843
- ☐ Form 1040 (and Form 1040NR)
- ☐ Form 1040X
- ☐ Form 1041
- ☐ Form 1120 or Form 1120-A
- ☐ Form 1120F
- ☐ Form 1120X
- ☐ Other Form 1120 (Form 1120-DISC, Form 1120L, Form 1120M, 1120S, etc)
- ☐ Form 990-C or Form 990-T
- ☐ Other ▶

Part II Overpayment Due to a Withholding Error.—For calendar year ▶

1 Please check the applicable box for the status that resulted in a withholding error
- ☐ Exempt qualified governmental interest (section 4991(b)(1))
- ☐ Exempt qualified charitable interest (section 4991(b)(1))
- ☐ Exempt Indian oil (section 4991(b)(2))
- ☐ Exempt Alaskan oil (section 4991(b)(3))
- ☐ Exempt royalty owner oil (section 4991(b)(5)) (trusts do not qualify)
- ☐ Exempt stripper well oil (section 4991(b)(6))
- ☐ Independent producer oil (section 4992)
- ☐ Trust beneficiary credit or refund (section 6430)
- ☐ Other (attach explanation)

2 Amounts withheld for oil removed during the calendar year (attach Form(s) 6248)	2	
3 Correct amount of tax (see instructions)	3	
4 Overpayment due to a withholding error (subtract line 3 from line 2)	4	

Part III Overpayment Resulting From the Net Income Limitation

5 Enter amount from line 19 (Part V)	5	

Part IV Combined Overpayment of Windfall Profit Tax

6 Total amount of credit or refund (add lines 4 and 5) (see instructions)	6	

For Paperwork Reduction Act Notice, see page 1 of the instructions. Form **6249** (Rev 1-85)

Sample Form 4
Supplemental Income Schedule

SCHEDULE E
(Form 1040)
Department of the Treasury
Internal Revenue Service (O)

(From rents and royalties, partnerships, estates, and trusts, etc.)
▶ **Attach to Form 1040.** ▶ **See Instructions for Schedule E (Form 1040).**

OMB No. 1545-0074
1984
13

Name(s) as shown on Form 1040 | **Your social security number**

Part I Rent and Royalty Income or Loss

1 Did you or a member of your family use for personal purposes any rental property listed below for more than the greater of 14 days or 10% of the total days rented at fair rental value during the tax year? . . . . . ☐ Yes ☐ No

2 **Description of Properties** (Show kind and location for each)

Property A .....
Property B .....
Property C

Rental and Royalty Income		**Properties** A	B	C	**Totals** (Add columns A, B, and C)
3 a Rents received					3
b Royalties received					
Rental and Royalty Expenses					
4 Advertising	4				
5 Auto and travel	5				
6 Cleaning and maintenance	6				
7 Commissions	7				
8 Insurance	8				
9 Interest	9				
10 Legal and other professional fees . .	10				
11 Repairs	11				
12 Supplies	12				
13 Taxes (Do **not** include Windfall Profit Tax here. See Part III, line 37.) . . .	13				
14 Utilities	14				
15 Wages and salaries	15				
16 Other (list) ▶					
.....					
.....					
.....					
.....					
.....					
.....					
.....					
.....					
.....					
17 Total expenses other than depreciation and depletion. Add lines 4 through 16	17				17
18 Depreciation expense (see Instructions), or depletion	18				18
19 Total. Add lines 17 and 18	19				
20 Income or (loss) from rental or royalty properties. Subtract line 19 from line 3a (rents) or 3b (royalties) .	20				
21 Add properties with profits on line 20, and write the total profits here					21
22 Add properties with losses on line 20, and write the total (losses) here					22 ( )
23 Combine amounts on lines 21 and 22, and write the net profit or (loss) here					23
24 Net farm rental profit or (loss) from Form 4835, line 49					24
25 Total rental or royalty income or (loss). Combine amounts on lines 23 and 24, and write the total here. If Parts II, III, and IV on page 2 do not apply to you, write the amount from line 25 on Form 1040, line 18. Otherwise, include the amount in line 39 on page 2 of Schedule E					25

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