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NEGOTIATING MINERAL
LEASES WITH
DEVELOPERS

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Public Affairs

The escalating petroleum prices of recent years have prompted a wave of oil and gas exploration in previously unexplored places.

This newsletter issue is written to provide South Dakota landowners with perspective on some of the "rules of the oil exploration game". It is not uncommon for landowners, in their eagerness to get into the oil business, to hastily give someone the right to explore their land and later find their farming or ranching activities have been greatly affected in ways they did not expect.

South Dakota law protects some of the rights of landowners (to be described later), and is designed to guard against the most common type of abuses. Special or unusual circumstances, however, must be dealt with on a one-by-one basis.

The principal agreement between the landowner and the oil producer is the mineral lease. When an oil company representative comes to a farm, he or she will usually have a sample lease for the landowner to sign. It may or may not have terms favorable to the landowner. The landowner should examine the lease carefully and have an attorney examine it before he decides whether to sign it.

The South Dakota Board of Minerals and Environment (formerly Oil and Gas Board) is responsible for issuing mineral exploration permits and enforcing laws pertaining to mineral development. To obtain a permit from the Board, a driller must certify that an agreement has been or is being negotiated with the landowner regarding compensation for damages to livestock and surface land resulting from drilling operations. The driller must also post a bond to ensure that each dry and abandoned well is plugged. If the landowner is not a party to the drilling agreement (mineral rights owned by someone other than the landowner), the driller must also post a bond insuring that insofar as possible the surface will be restored to its original condition.

According to law, a landowner and driller may negotiate agreements concerning the plugging of a well or the restoration of surface cover that are different from the provisions of the law. If an oil or gas well is converted to a water well instead of plugged, a landowner must comply with all statutes regarding groundwater contamination and development.

A mineral lease should state specifically the minerals to be sought. A lease which confers the right to explore and develop minerals might legally also allow strip mining.

A typical lease covers six major points for negotiation: the lease payment per acre; the amount of royalty to be paid per cubic foot of gas or barrel of oil, if such minerals are found in profitable quantities to produce; the length of time the lease will be in effect; conditions under which the lease may be terminated; the

amount and conditions under which delay rentals (if any) will be paid; and provisions for the surface use of the property during and after drilling operations. Another point for negotiation, but usually not included in the lease, is the amount of possible bonus payments. Additional points may be included to cover special circumstances.

Lease rates and royalties

The lease rate per acre and royalty payments for minerals produced are determined by the "going rate". An examination of leases ~~already recorded in the office of~~ the Register of Deeds can indicate the going rate. An alternate bid from a competing firm (if any) can be a more current indicator of the going rate. Lease rates vary depending upon the amounts of other cash payments as explained below.

Lease duration

A typical lease provides for a specific period of time for the lessee to explore and produce gas and/or oil. This period is called the "primary" term. If commercial quantities of oil or gas are produced, the lease is automatically extended to the "secondary" term which remains in effect as long as production continues. If oil and/or gas are not produced during the ~~"primary" term, the lease expires.~~

Conditions for terminating leases

When the lease is signed, the driller has the legal right to enter the property to commence operations. If the landowner is not satisfied with the manner in which his property is used, he has no recourse as long as the terms of the lease are fulfilled. If the terms stipulate payment for damages to property or excessive waste only, settlement of such claims may be difficult and costly to prove. The right to terminate the lease, unless such claims are

settled fairly and promptly, might prevent abuses of the property or costly and time-consuming litigation.

Other conditions under which a lease might be terminated include late payment of delay rentals and royalties, and failure to observe existing easements which might be attached to the property.

Delay rentals

Delay rentals are annual penalties for not drilling. They provide incentives to drillers to explore property without delay. ~~Since royalties from producing wells are generally much greater than the annual lease payments, landowners usually find it advantageous to try to negotiate low lease rates and high delay rentals.~~

If the landowner is negotiating a lease on a large tract of land, he or she should consider dividing the land and negotiating separate leases for each tract even though the leases may be identical. If one well is drilled on a large tract, it may relieve the driller of the responsibility to pay delay rentals on the remainder. As an incentive for the landowner to lease a large tract of land, however, the lessee may be willing to make a bonus payment based upon the number of acres. ~~Bonus payments are paid at the~~ time leases are signed, although for tax reasons the landowner may want the payment spread over several years. If the owner of a large tract is negotiating with more than one company, he may be able to divide the property into several tracts for separate lease and bonus payment negotiations.

Surface use of the land

The landowner should keep in mind desired possible future uses of the property when negotiating for the rights to the surface use of the property. The landowner,

for example, may want to specify the location of roads, gates and cattleguards. The driller will need water for drilling operations and storage space for drilling equipment and supplies, some of which may involve hazardous chemicals. The lease should stipulate that storage areas be fenced and that no fresh water from the land may be used for drilling unless a payment is negotiated for its use.

If oil or gas is found, it is likely there will be a need for pipelines and storage tanks, all of which will require additional space. The lease should state the depth pipelines should be buried; the number, spacing, and fencing of storage structures; and payments for use of the land.

The landowner may want to include a clause in the lease permitting the right of free use of the gas produced. The purchase and installation of the required equipment might be a trading point for other rights given to the drilling firm.

To prevent possible contamination, the landowner should specify that wells should not be located near streams and water impoundments. The driller should also be required to comply with all government regulations and honor any easements which may be attached to the property.

In any drilling operation there will be unavoidable damage to the land at the site. The lease should state the specifications for repair of damages and the amount of the "location damage payment".

Unforeseen circumstances may arise which may make changes in the terms of the lease desirable. The lease should state that any changes in the agreement must be in writing and that subsequent

changes in part of the lease agreement will not void the remainder. Because verbal agreements are subject to misunderstanding and are exceedingly difficult to prove in court, should litigation become necessary, they should be avoided.

In conclusion, the execution of an oil and gas lease is a very complex legal transaction. Most South Dakota landowners have not had experience with such leases and usually they are dealing with experienced professionals. Before entering into any agreement which gives the right of exploring and developing one's property, landowners should seek professional advice and give the matter serious attention. Otherwise, what may seem like a "little point" at the time that a lease is negotiated may unexpectedly result in future consequences adverse to the landowner.

Postscript

A committee of the Legislative Research Council will be offering several bills for consideration by the 1982 Legislature which would substantially modify the present mining statutes. The proposed bills (as yet unnumbered) may expand the rights of private landowners in situations where the mineral rights have been separated. Persons interested in the provisions of the proposed laws might want to contact their legislator and possibly attend the appropriate committee hearing when the provisions are discussed.

Plan now to attend the Economics Department Agri-business Day Program on April 1, 1982. You will receive a detailed program at a later date.

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