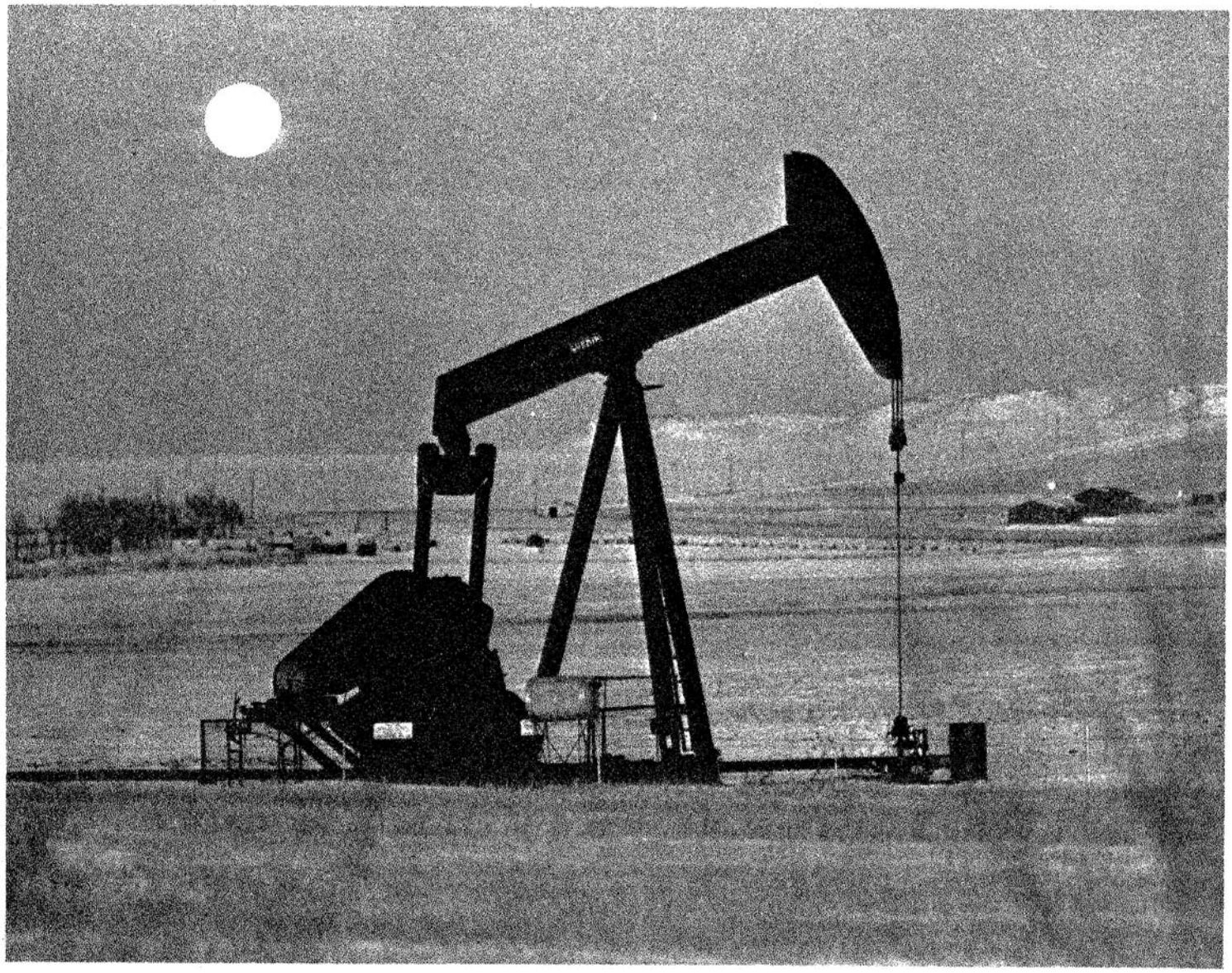
EXTENSION BULLETIN 29

NOVEMBER 1981
REVISED OCTOBER 2006



NORTH DAKOTA OIL & GAS LEASING CONSIDERATIONS

RON ANDERSON
RESOURCE ECONOMIST

COOPERATIVE EXTENSION SERVICE

North Dakota State University Fargo, North Dakota 58105

12 AECO-2

ACKNOWLEDGEMENTS

A recent editor of the Journal of Extension used the following quote by de Montaique to reflect his editorial philosophy:

> ***"And one might therefore say of me that in this book I have only made up a bunch of other peoples flowers, and that of my own I have only provided the string that ties them together."***

This quotation accurately represents my input into this publication which summarizes the experiences of others active in educational efforts and regulatory activities concerning oil and gas leasing procedures.

Extension publications from Texas, Oklahoma, North Dakota and Idaho were used extensively as source materials. The bulletin written by Judon Fambrough of the Texas Real Estate Research Center at Texas A & M University was particularly helpful in providing a number of common-sense suggestions for landowners to consider in negotiating an oil and gas lease. A complete list of all references can be found on Page 23.

A number of persons and agency representatives directly involved in evaluating various leasing provisions and situations were invaluable in clarifying leasing procedures and their application to North Dakota. Special recognition must be given to the following individuals who spent many hours reviewing the publication and suggesting revisions to improve its accuracy, quality and usefulness.

Owen L. Anderson, Assistant Professor of Law, University of North Dakota Law School, and Assistant Attorney General for the North Dakota Industrial Commission, Oil and Gas Division.

Jack Wilborn, Deputy Enforcement Officer, Oil and Gas Division, North Dakota Industrial Commission.

Erling A. Brostuen, Assistant State Geologist, North Dakota Geological Survey.

Special thanks must also be given to the following individuals. Their input throughout the writing and review process helped make this publication a more useful document for lay persons not well acquainted with the oil and gas leasing process.

David Saxowsky, Attorney and Assistant Professor, Department of Agricultural Economics, North Dakota State University.

Stephan T. Cobb, Oil and Gas Auditor, Office of the State Tax Commissioner.

Don Peterson, NDSU Extension Area Resource Development Agent, Washburn, ND.

The author takes full responsibility for any misinterpretation of recommendations received from persons reviewing all or part of this publication. Also, the recommendations outlined are not intended as a substitute for competent legal advice. Consult your attorney for the interpretation of any lease provisions that apply to your specific situation.

PHOTO CREDITS

The Washburn Leader, Jill Schramm, Photographer. Pages 5, 6, 10, 18 and 21.
The Fargo Forum, Bruce Crummy, Photographer. Cover and Pages 13 and 15.

TABLE OF CONTENTS

NORTH DAKOTA OIL AND GAS LEASING CONSIDERATIONS

INTRODUCTION

Exploration and development of North Dakota's petroleum resources is occurring at an accelerated rate. Increased prices for crude oil and the development of new technologies make it possible and profitable to drill for petroleum at greater depths. Improved methods have enabled oil companies to produce more petroleum from existing wells. Refined techniques of exploration have helped locate large areas of central and eastern North Dakota having geology favorable for discovery of new oil and gas deposits.

What does this mean for North Dakota? Many landowners who have never thought much about their mineral rights will soon have to make decisions having considerable economic consequences. Also, the "'rules-of-the-game" have changed considerably for those landowners whose current leases will soon be up for renegotiation and renewal.

PURPOSE OF PUBLICATION

Providing information to help the citizens of North Dakota better understand the oil and gas exploration and production process and related leasing considerations fits within the objectives of the Cooperative Extension Service. Oil companies will also benefit from this educational effort. An informed public is less apprehensive and easier to deal with, which should reduce the number of disagreements caused by misunderstanding the leasing process and the need for various leasing provisions to protect both the landowner and the oil companies.

Specifically, the purpose of this publication is to:

1. Serve as a general guide to the petroleum exploration and production process for those individuals not yet acquainted with the process.
2. Acquaint non-experts with the more common provisions of an oil and gas lease, relate them to the various steps in the exploration and production process, and explain their legal significance.
3. Detail specific provisions the landowner may wish to include for additional personal benefit and protection.

Because of the legal nature of the leasing process, landowners may be at a disadvantage in arranging for the future use of their mineral resources. Leasing is basically a matter of negotiation, and landowners should be aware of a number of basic factors before beginning these negotiations.

Topics selected for discussion were chosen either because they are of special concern to the landowners or because they are basic to the structure of an oil and gas lease.

NEED FOR LEGAL ADVICE

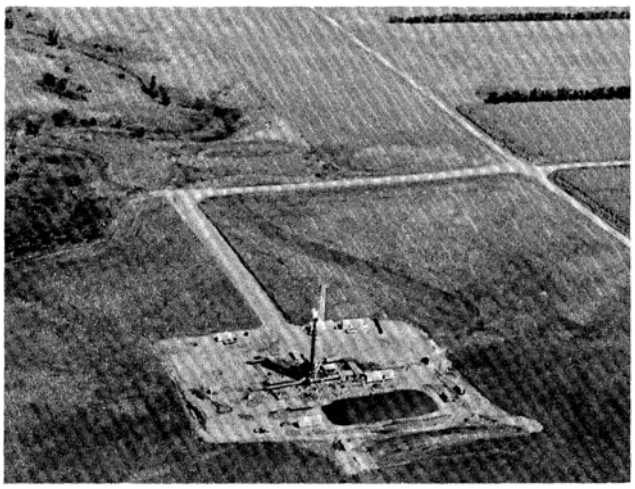
THE MATERIAL PRESENTED IN THIS PUBLICATION IS GENERAL IN NATURE AND SHOULD NEVER BE VIEWED AS A SUBSTITUTE FOR LEGAL ADVICE. Before the lease is signed, an attorney knowledgeable in the oil and gas leasing area should review the lease offered by the mineral developer to determine if it meets the specific needs of the landowner. Many landowners only seek legal advice when a problem arises after the lease is signed. At this point, the lease is a legal contract and resolution of the problem may be difficult.

Always get competent legal advice in drafting a mineral deed, royalty assignment, or deed to land containing a mineral or royalty assignment. Drafting these documents is highly technical and legal matter. Competent legal assistance can avoid possible problems and resulting disagreements and lawsuits.

EXPLANATION OF TERMS

The parties to a lease are called the lessee and the lessor. The lessee is the person or company to whom the mineral rights are leased. The lessor is the landowner and/or mineral owner who is leasing his or her property or some rights in it to another. To keep this publication in layman's terms, the lessee will be called the company and the lessor will be called the landowner.

It is assumed in this publication that the landowner owns all of the mineral rights he or she is interested in leasing. However, one person or group may own the mineral rights and another person or group the surface rights. Where these differences are pertinent, a distinction is made between the mineral owner and the surface owner.



PETROLEUM EXPLORATION AND PRODUCTION

Many residents in western North Dakota are familiar with the process of petroleum exploration and production. However, the nation's energy crisis has produced an upsurge in exploration into new areas of North Dakota where residents are not familiar with the process. Being aware of the steps involved in exploring for, finding, and eventually producing oil and/or gas will aid in understanding the need for some of the provisions which the landowner may wish to include in a future lease for his or her benefit or protection.

Steps in the exploration and production process involve (1) initial interest, (2) leasing, (3) geophysical testing, (4) drilling, and (5) well production.

INITIAL INTEREST

Before a petroleum field can either be explored or brought into production, someone must first take an initial interest in doing so. Establishing this interest can be done in several ways.

1. Research methods such as stratigraphic analysis, geophysical techniques, review of geological maps and literature, and photogeographical mapping coupled with on-site examination of rock strata out-croppings, may indicate if petroleum deposits exist in a particular area.

2. Exploration activity in a particular area is another indication a company not previously involved may invest in exploration to see if other petroleum deposits may have been overlooked.

3. Initial interest may also be established on a hunch. The hunch is research, but the decision to drill an exploratory well is based on less detailed research information than the other two methods.

LEASING

After establishing an initial interest in a particular area, the next step is to determine who owns the land and, if possible, lease the site to allow further exploration. Leases are acquired by a landman whose primary duty is to secure leasehold interest from the landowners.

County records are searched to determine ownership in a particular area. Not only must the landman determine who owns the land, but who owns the mineral rights as well. After this has been determined, the landman will negotiate the necessary leases with the landowners.

Initial compensation in the form of a bonus and a delay rental payment may be offered the landowner in return for leasing the area of initial interest. These payments will be explained later.

Leases for gas and oil are legal contracts, which for a specified sum of money give the company the right to explore for and to extract oil and gas. Each lease is negotiated and agreed upon individually.

COMPETITION FOR LEASES

The basic geological potential for oil and gas deposits exists throughout most of North Dakota. However, it is unlikely that payments for leases will become competitive until the potential exists for production that can be integrated into established transportation systems. Thus, access to transportation imposes a pattern of leasing activity that spreads outward from discoveries of significant quantities of oil and gas.

Even so, large areas in North Dakota quite distant from existing wells may be leased if they have any production potential at all. Some companies are prepared to invest in the cost of holding large lease acreages hoping that successful exploration by themselves or other companies will cause a portion of their holdings to become extremely valuable.

When a successful wildcat well is drilled a significant distance from previous production, there is likely to be an increase in leasing activity. This also may occur when new information from geophysical testing gives a favorable indication of deposits. However, while drilling information is readily available in local oil industry journals, the results of geophysical tests are seldom made known to the public.

1/ Material in this section was taken primarily from (1) **Local Government and Petroleum Development**, prepared by the Mountain Plains Federal Regional Council and available from the Federal Aids Coordinator's Office, Capital Building, Bismarck, ND 58505, and (2) **Petroleum – A Primer for North Dakota**, available from the North Dakota Geological Survey, University Station, Grand Forks, ND 58202.

These characteristics of exploration and development affect the intensity of leasing activity. However, neither distance from existing production wells nor lack of recent exploratory activity are reliable indicators of production potential. Interest in developing a particular area is best determined by consulting as many sources as possible including neighboring mineral owners, oil industry journals, and county and state officials charged with issuing permits for various phases of the exploration and production process.

GEOPHYSICAL TESTING

With initial exploration and lease acquisition completed, the company can begin more advanced phases of exploration. They can begin immediately or they may postpone additional exploration to check all information gathered and review additional data. They may want to wait in “frontier areas” to see what other activity develops. Also, on-going activities within the company may take priority over new projects.

Once the time is right, the company will begin further geophysical exploration to obtain more reliable information. Substructures of the earth are studied to localize areas where accumulations of oil and gas might occur.

PERMIT MAN

Prior to exploration, contracts are entered into between the exploration company and the surface owners (and tenants) dealing with compensation for the disruption of land and damage to personal property. Each geophysical crew has a permit man who negotiates the contract. This person also contacts the proper authorities to met legal requirements, arranges transportation and housing for the crew, and informs them of the location of streams, wells buildings and other areas designated by the surface owner as being sensitive to geophysical testing.

SEISMIC EXPLORATION

The seismograph provides the only direct way of acquiring subsurface structural information without drilling a well. Shock waves, generated at or near the earth's surface, penetrate the earth's crust and reflect back to the surface from the subsurface rock layers. There the reflected signals can be recorded and a printed record obtained on which the depth of various underground formations can be measured. Ideally, such information will reveal patterns of rock formations such as faults, anticlines and folds where oil and gas deposits have a good chance of being found.

Seismic shock waves are usually generated by detonating explosives at the bottom of shot holes 4 to 5 inches wide and drilled 25 to 200 feet in depth depending on conditions. The number of shot holes per mile varies with the type of geophysical information desired. After the explosives are detonated, a hole-plugging and cleanup crew finishes the operation

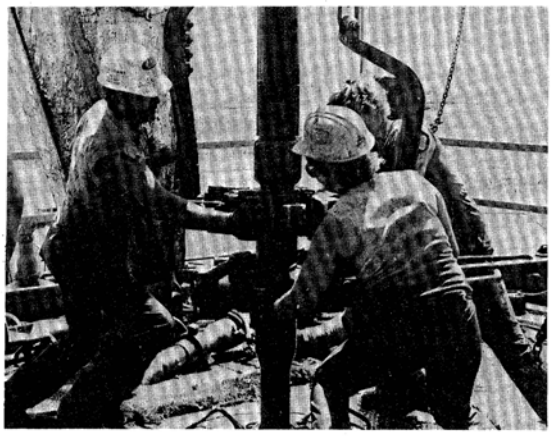
REGULATIONS

Surface owners and tenants should be aware of specific regulations pertaining to geophysical explorations (see Appendix A). If these regulations fail to cover concerns that apply to specific situations, provisions pertaining to these situations should be agreed upon. In the past, most of these agreements have been verbal. A written agreement should be used to protect both parties.

CONSIDERATIONS

While the regulations outlined in Appendix A provide considerable protection for the surface owner (and tenant), the considerations listed below will help reduce further conflicts between the parties involved:

1. Make sure the permit man is aware of areas sensitive to testing.
2. Go over the area to be tested with the permit man and suggest routes to be driven to minimize damage to range and cropland.
3. Geophysical testing companies are usually hired by oil companies to obtain a great deal of information in a short period of time. Even so, attempt to schedule operations to minimize conflicts to both parties.
4. Inform the permit man if any area to be tested is rented to others.
5. Always get the name and address of a company representative to contact if any problems have to be corrected after the testing is finished.
6. Stress the need to clean seismographing equipment before testing to minimize the spread of noxious weeds from one area to another.



DRILLING

Even though leases have been transacted and geophysical studies have been analyzed, other factors must be considered in deciding whether to drill. First, it may cost million of dollars to drill even a dry hole. Secondly, if timing is not right or drilling equipment is not available, the venture may be postponed or even cancelled. Finally, there are non-financial considerations such as potential impact on the environment.

Before drilling is started, state law requires the company to inform the surface owner in writing that the drilling process is about to start. The notice must outline the plan of work and whatever operations are planned by the company. This information is intended to help the surface owner evaluate the effect of drilling operations on the surface owner's use of the property. A form advising the surface owner of his or her legal rights and options must be included with the notice (see Appendix B).

A survey team is an essential part of the pre-drilling preparation stage. They survey the site and stake out where the drilling will take place. They also map out the location of routes to insure access to and from the drilling locations for all necessary heavy equipment and supplies.

Once the surveyors have completed their assignments, work-crews come in with earth-moving equipment to build roads, level off the location, and dig pits and trenches along with the cellar for the rig which will house some of the drilling equipment. When completed, the drilling rig and supplies can be moved in and set into operation.

TIGHTHOLE PROVISION

Landowners should also be aware of the company's right to request a tighthole provision on any well. The provision must be requested, in writing, from the Industrial Commission. If approved, all information concerning the drilling and/or production of the well is kept confidential and will not be released to anyone other than the operator of the well for six months.

WATER USE

Water is essential to the entire drilling process, especially in the preparation of drilling mud. The mud is made up of water, special chemicals and clays. It is used to clean and cool the drill bit, lift rock cuttings to the surface and maintain a constant pressure in the hole to keep the walls from caving in.

Enormous quantities of water may also be needed for injection into oil-bearing strata during secondary recovery operations. Because of the large demands for water, landowners should pay close attention to any lease provision regarding the use of water for operations (see Resource Use section on Page 18).

WELL PRODUCTION

A decision on whether a well is productive or non-productive is made when drilling reaches the precalculated producing zones. If oil or gas does not come to the surface in the drilling mud, tests can be taken to pinpoint the petroleum containing-formations. Two types of tests normally used are the **drill stem test** and **well logging.**

If further drilling does not result in the discovery of a petroleum deposit, the well is plugged with cement and abandoned. Should a well prove to be productive, well completion and production equipment is set up and the drilling rig is taken down and moved to another site.

Many wells flow naturally because of subsurface pressures. In these cases, a production devise with gauges and control valves, known as a "Christmas tree", is installed on the well head. On nonflowing wells, different types of pumps must be installed.

Once production has begun, the well's productivity is gauged, which allows hourly and daily readings on the volume of gas or oil being produced. These readings are not only important on calculating royalties, they are also important in calculating the life of a well and in prescribing what maintenance must be done to assure reaching the well's optimal productivity.

Periodically, **re-working** operations are performed to insure efficient operation of the well. Work-over crews clean the well by getting rid of fluids and sands which may have gathered in the hole. They may also refracture the well in order to open up the cracks in the formation to allow the oil or gas to flow more freely.

Several storage tanks may have to be built at the well site, and pipelines or tank trucks will be used to get the crude oil or gas to market. Both methods have good points and bad points.

Truck transportation increases traffic on rural roads and bridges which in turn increases local government maintenance costs. Some of these costs are subsidized by oil and gas production taxes, although, in new areas of development, there may be a time lag between when these funds are needed and when they are available.

Pipelines require rights-of-way which sometimes cause problems because they cross or run parallel to public roads. However, pipelines are cheaper in the long run. The size and the life of the oil field usually determines which method will be used.

RELATED LEASE PROVISIONS

The detailed table of contents in this publication points out the many factors which could be pertinent to landowners negotiating a lease. The list is by no means complete nor will all factors pertain to every landowner. However, the need for competent legal advice in evaluating the various alternative should be evident.

Before making a final decision, the landowner and his attorney should work through the possible outcome of each leasing situation. They need to select those lease provisions that will adequately protect BOTH the landowner's interest and the company's ability to carry out an effective development program.

Initially, the landowner must be concerned with how long to lease his mineral interest (Length of Lease), how much will be received in the form of a bonus, delay rental payments, and royalties (Payments Received), and what form of legal protection may be needed (Legal Liability).

A few of the lease provisions related to the drilling process include rights and restrictions on how the surface of the land may be used (Surface Use), and what happens when the term of the lease doesn't match the drilling program (Length of Lease – Drilling Operations Clause). Some of the more important provisions related to production include how to handle gas from a producing well that cannot be sold (Length of Lease -- Shut-in Clause) and how production is divided equitably when a number of wells are pumping from the same oil or gas reservoir (Pooling). Also related are provisions concerning the use of various resources by both the landowner and the company during the production phase (Resources Use).

A sample of a general oil and gas lease can be found on the State Land Department's Mineral Management website.

TERMINOLOGY AND BASIC CONSIDERATIONS

TERMINOLOGY

An understanding of mineral rights and surface rights and the implications of the separation of one from the other are necessary before any discussion of leasing provisions.

Mineral Rights may be defined as the right of ownership of mineral resources which underlie a tract of land. With the right of mineral ownership is the right to explore for, develop, and produce the mineral resource. In North Dakota, oil and gas are legally treated as minerals just like limestone and coal.

Surface Rights are the rights to use the surface for agricultural purposes, urban development, etc.

Severed Mineral Rights are mineral rights held separately from surface rights. They occur when the owner of both mineral and surface rights legally transfers all or a portion of the mineral rights he or she owns. This severed **mineral deed** is registered with the county register of deeds and becomes a part of the abstract of title to the land involved.

Severance by mineral reservation occurs when someone owning both mineral and surface rights legally transfers the surface rights of the property but retains all or a portion of the mineral rights. These reservations are also recorded and are part of any abstract of title to the land involved.

When the mineral rights are severed from the surface rights, whether by reservation or by deed, the mineral rights are dominant; that is, the owner of the mineral rights has the right to use as much of the surface as is reasonably necessary to explore, produce and transport his or her minerals. However, the mineral rights owner must consider the rights of the surface owner and is required to exercise that degree of care and use which is just consideration for the rights of the surface owner. North Dakota courts have upheld this **dominant estate** doctrine.

WHY LEASE

Any landowner who owns all of the mineral rights has the right to develop any deposits on his or her land. However, few owners attempt to do this because of the tremendous costs involved in exploration and development. Instead, most landowners lease these rights to companies which have the necessary capital and technical know-how for effective exploration and efficient production. As a result, the petroleum industry is based largely on leasing rather than outright ownership of land.

KNOW WHAT MINERAL RIGHTS ARE OWNED

Landowners may not own all of the mineral rights in all of the land they own. Because of possible previous separation of mineral rights from surface rights, it is strongly recommended that landowners put together a list of what land they own and the percentage of mineral rights remaining with each surface title. This provides a starting point for decision-making.

Compiling a list is not easy. Landowners need advice from a competent attorney to interpret the legal wording pertaining to each tract.

TYPES OF OIL AND GAS LEASE FORMS

When mineral rights are leased, the legal rights and duties of the landowners depend in large part upon the terms of the lease. Therefore, extreme care must be taken to insure that the unique needs of each landowner are met.

Each company representative or landman normally uses a predrafted agreement which has proven suitable to them in the past. Most of these lease forms are characterized by brevity and simplicity and are meant to cover most average situations. Since each leasing situation is unique, some of these predrafted agreements are not in the best interest of the landowner. Also, some companies may be using lease forms which are applicable to unique situations in other states but, if applied in North Dakota, could create problems for the landowners.

Most provisions of a lease are negotiable. Even though the company representative or landman soliciting the lease may not have the authority to make changes, this does not mean that certain clauses, or even the complete lease itself, may not be altered. However, the landowner's ability to negotiate more favorable terms will vary in each situation.

IMPLIED COVENANTS

The courts in a number of states have held that an oil and gas lease implies the company is obligated to do certain things. Significant implied covenants are duties (1) to drill an initial well, (2) to protect against drainage of oil or gas from the leased premises by wells on adjoined land, (3) to develop the lease after production by drilling additional wells, (4) to produce and market the product, and (5) to use reasonable care in the conduct of operations. However, North Dakota law is not settled as to which covenants are recognized nor have procedures been established on how to prove a case.

Compliance with these covenants is usually determined by a "prudent operator standard" which means that the company must do what a reasonably prudent operator in the same or similar situation would have done to discharge the duty. Legal interpretation of this standard would depend on the facts established in each individual situation.

STATE REGULATIONS

In North Dakota, the drilling of exploration and development wells and the producing of oil and gas is regulated by the Industrial Commission. Specifically, the Commission has the authority to regulate (1) the drilling, producing and plugging of wells; (2) the chemical treatment of wells; (3) the spacing of wells; (4) operations to increase the ultimate recovery of wells; and (5) the disposal of salt water and oil field wastes. The Commission also has the authority to limit and to allocate the production of oil and gas from any field, pool or area. Although these regulations provide considerable protection to owners of mineral rights and the related surface rights, lease negotiations are still necessary to cover unique situations not covered by statute or regulation.

No landowner could possibly hope to incorporate all of the following considerations in a lease nor should all of them need to be included. However, each situation is different, and a lease, to be effective, should contain those specific provisions that are relevant.

OIL AND GAS LEASE PROVISIONS

All parties to an oil and gas lease view development as the ultimate goal. To this end, provisions in a lease should permit the oil company freedom to carry out an efficient exploration and drilling program. However, such freedom should be tempered by the interests of society.

HOW TO LEASE MINERAL ACRES

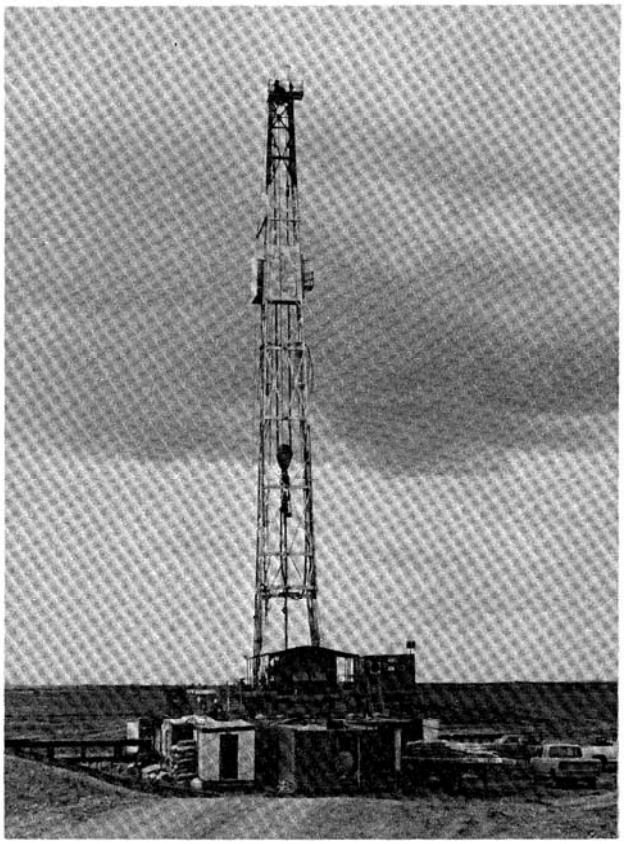
Landowners should exercise due care in deciding how the total number of mineral acres under their control should be leased. This decision, probably, more than any other, will either increase or eliminate many of the problems arising between landowners and oil companies throughout the drilling and production process.

In most cases, the following guideline should be applied in North Dakota. Regardless of how many mineral acres are leased, any land within a given surveyed quarter section (160 acres) should have its own lease. For example, if the landowner had 80 mineral acres in the south half of the northwest quarter in a given section, and another 80 acres in the north half of the southwest quarter in the same section, each quarter section should have its own lease.

This general guideline is followed by the State Land Department and it generally corresponds to the Industrial Commission's policy concerning the spacing of oil and gas wells. The guideline also eliminates many of the problems associated with various lease provisions which will be noted in following sections where applicable.

If this general guideline is followed, any reference to a general pooling clause should be deleted from the lease to keep the company from pooling all of the various leases. Additional explanation of this recommendation is contained on Page 20.

Any mention of a **Mother Hubbard Clause** or a **Coverall Clause** should also be deleted. These provisions could cause problems by allowing the company to claim adjacent acreages when mineral acres are divided and leased in small tracts. Both provisions are normally contained in leases used in Texas. However, some of these leases may be used by Texas companies leasing in North Dakota where there is no practical reason for using these provisions.



WHAT MINERALS ARE COVERED

The granting clause of an oil and gas lease outlines the purpose of the lease and describes the substances which can be explored for and produced. It is normally the opening paragraph of most leases.

North Dakota law stipulates that no mineral lease shall be interpreted as passing any interest to any minerals except those minerals specifically named in the lease. It further states that if the minerals are named, the lease also includes their compounds and byproducts, and "in the case of oil and gas, all associated hydrocarbons produced in a liquid or gaseous form so named shall be deemed to be included in the mineral named."

Many landowners prefer to lease only for those minerals the company demands and keep the rights to all other minerals for possible later leasing for an additional bonus or rental payments. Therefore, a granting clause including the statement "oil and gas and related hydrocarbons" would be the most practical statement to include and would appear to sufficiently protect the interests of the landowner.

Suggestions for evaluating the granting clause include:

1. To avoid any dispute between the surface and mineral owners, specify that the extraction method used by the company cannot strip away nor substantially destroy the surface except to build those facilities necessary for the drilling and production process. Surface owners should realize all substances lying under the surface do not necessarily belong to the mineral owner.

2. If other minerals are to be named in the lease, consideration might be given to amending the royalty clause (found on Page 12) to list the percentage share the landowner will receive for the production of all substances discovered in commercial quantities. A greater share of the production of one substance than another may be stated as going to the owner. An arbitration clause might be inserted by the owner to cover situations where agreement can't be reached on the differing percentages.

PAYMENTS RECEIVED

In return for giving the company the right to explore for and produce oil and gas, the landowner typically receives compensation in the form of a bonus and delay rental payments before the well is drilled and royalties after production begins

BONUS PAYMENT

When the lease is signed, the company usually pays the landowner an initial cash bonus in so many dollars per acre. The actual amount paid is generally not shown in the lease. Rather, only a nominal consideration is expressed as "one dollar and other valuable considerations." Bonus payments sometimes allow the company to hold the lease for a certain period of time before the company must drill or pay delay rentals.

Competition for leases largely determines the amount of bonus offered. The more intense the competition, the larger the bonus.

Sight Draft

When the landowner signs the lease, the company representative gives the landowner a 30-day sight draft equal to the amount of the bonus. Sight drafts are used to give the company time to recheck the ownership of minerals covered by the lease as well as changes in the standard lease form allowed by the landman subject to company approval.

Upon receiving the sight draft, the landowner takes it to his bank which in turn sends it to the **collection bank** (the company's bank). The collection bank then notifies the company that a sight draft has arrived and they have 30 days from that date to honor the draft. If all is satisfactory, the company sends a check in the amount of the draft to the collection bank and the draft is paid to the landowner through his or her bank. Sight drafts of more or less than 30 days are also used depending on specific circumstances.

To minimize problems associated with the practice of **short-drafting** during the time the draft is clearing, landowners should take **both** the sight draft and the lease to their bank and submit them with instructions that the lease will be released only upon payment of the draft. Short-drafting occurs when an independent landman outbids others for the landowner's lease, records it and then tries to resell it during the 30-day period. If the lease isn't resold, some excuse is given for not honoring the sight draft. When this happens the landowner not only may have missed a chance to lease his minerals to a reputable landman, he must also take the necessary legal steps to cancel the recorded lease.

A number of misunderstandings exist concerning the use of a sight draft.

1. A sight draft is not a check. The draft can only be cashed if the procedure outlined above has been followed.

2. It may take from 35 to 40 days to process a 30-day sight draft. The 30 days start when the collection bank notifies the company the draft has arrived, and it ends when the company sends a check to cover the draft on the 30th day. It may take an additional four to five days for the draft to get from the landowner's bank to the collection bank and return. To insure the collection bank promptly notifies the company that the draft has been received, the landowner should request his or her bank to forward the draft to the collection bank by "Registered Mail - Return Receipt Requested."

3. When the draft is paid to the landowner, the amount received may differ from the amount shown on the sight draft when the lease was signed. This occurs because oil and gas leases normally allow for the payment of a per acre bonus which is adjusted depending upon the amount of mineral interests actually controlled by the landowner. This can be confusing to the landowner. An alternative is a flat-sum bonus which has been used where the company is fairly sure of the amount of mineral interests controlled by the landowner.

Lease Option

If the landowner feels uncomfortable with a sight draft, an alternative might be a lease option. The option to lease would be given the company in return for an option payment (maybe 10 percent of the bonus) which would be kept by the landowner regardless of whether the company decides to lease. The company could then be allowed sufficient time to check the title, and if they decide to lease, the remaining bonus money (either a flat-sum or a per acre amount) would be paid to the landowner. Competent legal advice should be obtained before using this option.

DELAY RENTAL PAYMENT

For the privilege of delaying the start of the drilling during the primary term of the lease (explained later), the company pays the landowner a delay rental payment. The amount is stated so many dollars per acre and is paid annually. Delay rental payments offered usually stay fairly constant and may be quite low in relationship to the bonus payment.

Under the usual type of lease, the company does not pay delay rentals on a lease anniversary if the company has "commenced a well". This may mean merely digging a slush pit, building a road to a well site, or simply staking out a well location. Leases more favorable to the landowner use the phrase "commence the drilling of a well", which means "spudding in a well" or the actual start of drilling operations.

Once production is obtained and continues, the secondary term of the lease is in effect. The payment of delay rentals is no longer required and royalties are paid to the landowner for his or her share of the production.

If a flat-sum bonus is negotiated with the company, it may also be advantageous to include a flat-sum delay rental payment in the lease.

Rental Depository

A rental depository is the bank designated as the agent acting for the landowner in the handling of delay rentals. However, this bank does not have the authority to bind the owner to extend or ratify a lease by receiving and accrediting a late delay rental payment unless allowed to do so in the lease.

The owner may change this depository by notifying the company who will prepare a **Change of**

Depository to be authorized, signed and returned by the landowner to the company.

THE ROYALTY CLAUSE

From an economic standpoint, the royalty clause is probably the most important clause to the owner because it allocates to the owner a certain portion of the substances produced. The standard royalty on oil and gas for many years was 118th share. However, as North Dakota develops into a major oil producer, the 1/6th and 3/16th royalties and other fractions are used to attract mineral owners to lease.

The terms of royalty clauses vary greatly from lease to lease. However, several basic factors should be considered by the landowner.

First, specify which costs, if any, can be deducted from the landowner's royalty payment. The costs encountered throughout the exploration, drilling, production and marketing stages are divided into two categories: (1) those paid entirely by the company, and (2) those shared by the landowner.

Generally, all expenses encountered up through the production stages are paid by the company. Expenses subsequent to production can be either shared or paid entirely by the oil company depending on the terms of the lease.

The shared expenses will depend partly upon where the lease fixes the royalty. If nothing is contained in the lease on this matter, the royalty is implied to be determined "at the well". In such cases, the landowner's royalty payment is free of both production costs and costs subsequent to production. If the lease fixes the royalty "in the pipeline", or "at the place of sale" or at other delivery points, the cost of transporting the production to the point of delivery may be shared. These costs may include such items as compression expenses necessary to deliver the product into the purchaser's pipeline, expenses necessary to make the product salable and the expenses used in measuring production.

Another problem which the landowner should consider is determining how the royalty payment is valued or received. Three methods generally are used.

Determining Value of Production

Market Price

Market price or market value is based on the oil and gas value as reflected by the marketplace, generally at the mouth of the well. In the past, if there was no market at the well, then the market price prevailing in the field was used. If there was no field market, then the value was determined by sales of marketing outlets comparable in time, quantity, quality and availabilities. And finally, if there were no comparable sales, the actual value of the substance could be used.

The market price method has been quite popular with landowners because it allows the royalty to follow the upward price trend for oil and gas. However, there are some associated problems of which landowners should be aware when using this method.

Sometimes the prices pasted at wells or fields are discriminatory and are set artificially and substantially less than the prices paid for comparable minerals at other fields. In such cases, it may be possible to get a higher valuation for the royalty payments but only after a difficult burden of proof has been met by the landowner in a court proceeding.

To avoid problems, the company and the landowner should agree on a formula for determining how the market price or value will be established and this formula should be included in the lease.

Proceeds

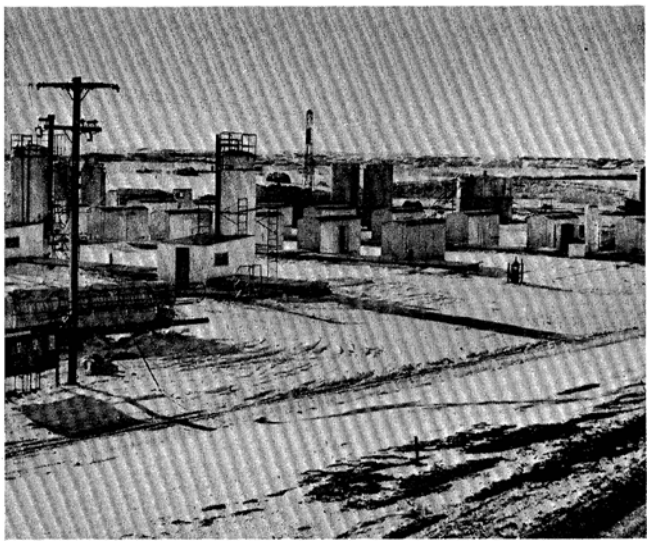
This method establishes the royalty based on the actual revenue derived from the sale of the mineral. As such, the resulting sales price may or may not equal the mineral's actual value as outlined earlier. In the past, the royalties based on **proceeds** have been very popular. This method gave greater flexibility to the company in marketing the product, particularly gas. By committing gas to long-term contracts, the company could insure the landowner of a constant, dependable royalty income over time. The disadvantage is that the resulting proceeds are not immediately sensitive to a rising market.

In Kind

This method presents an excellent alternative for dealing with a lease based on **proceeds.** By inserting an option to take royalties either **in proceeds** or **in kind,** the landowner can get the best of both worlds. Whenever the market price rises above any long-term commitment prices, the landowner can take his or her share **in kind** and seek a market outlet. Whenever the market price falls below any long-term commitment, the landowner's share can be taken **in proceeds.**

The **in kind/in proceeds** alternative is attractive to landowners when selecting a payment option for oil. It could prove to be a good bargaining point, especially if a sufficient volume of oil is involved.

If the landowner has this same option for gas and decided not to sell to the same party the company is selling to, the landowner would have to put in his own gathering line system and possibly his own processing plant. Therefore, the use of an **in kind** gas royalty would be somewhat impractical.



Parts of a Royalty Clause

The royalty clause may have three parts - an oil royalty provision, a gas royalty provision, and a royalty provision for casing-head gas from an oil well from which gasoline may be extracted. The oil royalty clause, unlike the other two, usually authorizes payment of the royalty either in kind (delivery of the royalty oil to the credit of the owner in the pipeline) or in money based on the market value of the oil. As outlined previously, costs of developing a gathering and processing system by a private individual to market his or her share of the gas produced makes the use of an in kind gas royalty impractical. Also, the alternative of having a more lucrative intrastate market for gas does not exist in North Dakota. As a result, gas royalty clauses usually provide only for payment in money.

Special care should be exercised in examining the gas royalty clause. The landowner may want to limit or prohibit the company from deducting certain kinds of costs for processing, treating, dehydrating, compressing, etc., before the company starts paying the royalty.

Cancellation of Lease for Nonpayment of Royalties

North Dakota is one of two states that have a specific statute allowing the landowner to cancel the lease for nonpayment of royalties. The statute allows cancellation, "if the equities of the case require it."

As a practical matter, the statute may not be that useful. If the company missed a royalty payment, but later acknowledged the fact and paid the royalty plus interest, an equitable situation would then exist and the lease most likely couldn't be cancelled. However, if the landowner could prove some kind of bad faith on the part of the company, he may have a case for cancellation.

Recommendations

The following list of factors might also be considered when negotiating a royalty clause.

1. Detail the time, place and frequency royalty payments are to be made. Outline the consequences for royalty payments being missed.

2. Discuss and resolve whether royalties should be paid for wastes due to leakage, fire or other reasons which can be attributed to the company's negligence.

3. Reserve the option to take in kind royalties for oil production if feasible.

4. Determine if the landowner should have access to free gas (see Resource Use section on Page 18).

5. Decide whether the company should have free use of water, oil and gas produced on the leased premises (see Resource Use section on Page 18).

6. As outlined earlier, include differing royalty percentages for substances other than oil and gas that might be included in the granting clause.

Three other factors warrant further consideration when negotiating the royalty clause.

Overriding Royalty Interest

Through negotiation, the owner who is in a strong bargaining position is often able to demand an overriding royalty in addition to the standard royalty. This interest is paid from the share of production belonging to the company and is usually free of costs of operation by the company.

An overriding (or extra) royalty is sometimes based on a sliding scale with any one of several items used as variables. For example, one royalty could be based on daily or monthly production of less than (x) barrels per day (or month) and another whenever production exceeds this level. Other variables upon which the scale could be based include such things as whether or not the substance is free flowing or having to be lifted by artificial means, or even upon the company's recovery of all or a certain percentage of the production cost from the well.

Generally, the overriding royalty interest and the royalty interests of the landowner are free from the creditors of the company who can only claim against the **working interest** (the company's share of production) unless specifically agreed otherwise.

An overriding royalty may also be created when the person or company leasing the land does not wish to develop the oil and gas and instead sells or "farms out" the lease, reserving an overriding interest. As before, this overriding royalty does not share any of the exploration or production costs.

Royalty Division Order

This document is prepared by the company buying the oil and gas produced and its outlines, in percentages, the share of production which each royalty owner is entitled to receive. When signed and returned by the royalty owner, it is acknowledged by the company to be correct.

Division orders are extremely complex and should only be signed if (1) companies won't pay royalties unless the order is signed, and (2) all the division order does is acknowledge and divide the interest, and the landowner knows that his or her interest is correctly stated. If the order requires the landowner to ratify a gas sales contract, ratify some formula on how royalties are to be paid or determined, etc., competent legal advice should be sought before signing the order.

Time Limit on Royalty Payments

A bill passed by the 1981 North Dakota Legislature requires that interest of 18 percent be paid on royalties not paid within 150 days of the sale of gas or oil produced. Oil companies can normally pay royalties within 90 days after they have sold their first oil from a well, although it may take somewhat longer with the first well in a particular field.

LENGTH OF LEASE

Oil and gas leases are generally divided into two separate time periods.

PRIMARY TERM

The first period, or primary term, is a set number of years negotiated by the parties during which actual drilling operations must begin or delay rentals must be paid. If drilling operations are not started within one year after the lease is signed, it will terminate UNLESS an agreed sum is paid to the landowner. Delay rentals must be paid on each subsequent anniversary date of the lease's primary term if actual drilling operations have not yet begun by that date.

Identification of Delay Rental Payments

Landowners should specify that with any delay rental payment, the company must identify the governing lease and the provisions necessitating the payment. This will aid the landowner in keeping track of several different leases on their land. Landowners should also keep track of the date by which delay rental payments must be received. Acceptance of a late payment may be interpreted as a ratification and the lease will not terminate.

Production Defined

Drilling must be underway or production established by the end of the primary term or else the lease will end. There have been a number of lawsuits in some oil and gas states regarding what constitutes **production** for the purposes of extending the lease beyond the primary term and continuing it during the secondary term. **Production** in general has been interpreted to mean production in paying quantities over a reasonable period of time. It has been interpreted to mean that the company must have a profit after deducting current operating expenses and marketing costs, but NOT any portion of the drilling costs. There is some question whether or not depreciation must be deducted as an operating expense.

SECONDARY TERM

If production has been established, the lease will continue into its secondary term. Generally, the full clause will read, "This lease will remain in force and effect for a term of _____ years (or months) and as long thereafter as substances covered by the lease are produced."

RECOMMENDATIONS

For the best protection of the Landowner, he or she should consider the following recommendations:

1. Try to keep the primary term as short as possible as this encourages earlier exploration. Considering the current situation, it would be unwise to sign a lease covering a period of more than five years.

2. If the primary term cannot be shortened, try to negotiate a higher annual delay rental payment.

3. Do not amend the standard delay rental clause that stipulates the lease will terminate UNLESS the company pays delay rental payments.

4. If the landowner has a small fractional mineral interest, he may consider requesting a **paid-up** lease. Such a lease benefits both the company and the landowner because both know exactly what the full term of the lease is going to be. Because there are no delay rental payments, the landowner should request a somewhat higher bonus.

EXTENSION OF PRIMARY AND SECONDARY TERMS

Even though the primary term is for a fixed period of time such as three or five years, the lease may not last that long. As mentioned previously, the term clause and the delay rental clause serve reasonably well to satisfy the interests of the company and the landowner regardless of the life of the lease. The landowner is assured that either (1) there will be prompt exploration, or (2) the landowner will receive delay rentals, or (3) the lease will terminate and the landowner will be free to lease the mineral rights to another developer. Likewise, the company is able to reserve the land during the primary term without expensive exploration and is assured of being able to continue the lease after the primary term if commercial production is obtained.

However, these two clauses fail to cover certain difficulties of concern to the company. While general leases have held up in lawsuits more often than not, various **savings** clauses meant to reduce the company's risks regarding disputes over the duration of a lease have become standard features in oil and gas leases.

The primary and sometimes the secondary term of the lease may be extended contractually by (1) drilling operations provisions, (2) shut-in provisions, (3) dry hole provisions, (4) cessation of production provisions, or (5) the Force Majeure clause.

Drilling Operations Clause

This clause is intended to protect the company in situations where a well was started before the end of the primary term but did not become a producing well until after the primary term expired. In this case, the drilling operations clause states the lease will continue and remain in effect just as though the well had been completed before the primary term of the lease expired.

A variation, called a **continuous drilling operations clause,** allows the company to preserve the lease by continuous drilling operations which lead to a producing well even though the producing well is different from the one partially completed at the end of the primary term.

Shut-in Clause

A shut-in clause allows the lease to remain in effect (sometimes during both the primary and secondary terms) whenever gas or oil from a producing well is not, for some reason, being sold or used by the company. If a shut-in well is classified as a producing well under the lease provisions, the lease will not terminate. However, a shut-in royalty or some other stated sum approximating the value of the delay rental payment should be paid each year to keep the lease in effect.

Owners may find it difficult to accept a shut-in provision, especially where no apparent reason exists. However, due to the energy shortage and the high cost of bringing a well into production, shut-in provisions are used rarely. Even so, owners may wish to consider the following alternatives to more clearly outline the possible use of this provision.

1. Make sure shut-in royalties are required during both the primary and secondary terms. Have an attorney familiar with oil and gas leasing procedures check the wording of the shut-in clause to make sure the provision allows the lease to automatically terminate if shut-in royalties are not paid.
2. Place a maximum number of years on the shut-in clause - for example, no more than three years or three years beyond the primary term.
3. Increase the shut-in royalty for each year the gas or oil is shut-in.
4. As an alternative, permit the shut-in to continue after a stated period but only for a specified number of acres immediately surrounding the well. The remainder of the leased area would then revert to the owner. This provision may be qualified depending on the reason for the shut-in. Also, initially leasing the land in smaller tracts would make this provision unnecessary.
5. Outline the circumstances when the shut-in clause may go into effect. Examples may include lack of market, lack of an available pipeline, government restrictions, or other factors mutually agreed upon before the lease is signed.
6. Terminate the shut-in provision automatically whenever a well located on an adjacent spacing unit and completed within the same producing reservoir begins producing and selling gas or oil in marketable quantities.

Dry-Hole Provisions

Suppose the company starts a well during the primary term, but abandons it as a dry hole. If the company does not commence another well within a reasonable amount of time, does the lease terminate or can the company continue the lease by paying delay rentals? If the lease can be continued, when is the next delay rental payment due? Dry-hole provisions are intended to provide answers to these questions.

Dry-hole provisions extend the primary term of the lease, but only in certain instances. Basically the lease will provide that if oil or gas HAS NOT been discovered when a dry hole is drilled, the lease will not terminate even though the primary term has expired if the company renews drilling or re-working operations of the same hole within a certain period of time thereafter. In the event the primary term has not expired and more than the stated period remains, the company may be given two other options if included in the dry-hole clause. The company can either pay the next delay rental payment which comes due a certain number of days after the dry-hole was discovered or commence drilling or re-working operations on or before the same date.

If less than a stated number of months remain in the primary term when the dry hole is completed, the lease will continue in force to the end of the primary term even though the company operations remain idle and no delay rentals are paid.

It is quite possible for the primary term to be extended indefinitely via the dry-hole provisions. If the company has not discovered oil or gas and is in the process of drilling or re-working operations when the primary term ends, the lease will continue in force for so long as the company faithfully renews drilling or re-working operations within a stated number of days after completing each dry hole. However, if a producing well should be subsequently discovered and its production later ceases, the company should be expected to commence the drilling of another producing well resulting from operations within X number of days thereafter or the lease will expire (see Cessation of Production Clause below). The completing of a subsequent dry hole will terminate the lease if the lease so dictates.

Cessation of Production Clause

Suppose production in paying quantities ceases for a prolonged period of time due to some reason other than exhaustion of the oil or gas in the ground. Reasons may include change in government regulations, breakdown of equipment, or a decline in market price. This could happen during either the primary or secondary term.

If it happens during the primary term, can the company still keep the lease in force without having to start drilling a new well or pay a delay rental? If it happens during the secondary term, does the lease terminate for lack of production? The cessation of production clause is intended to clarify the positions of the company and the landowner in these situations.

Cessation of production provisions are similar to the dry-hole provisions. The main difference is that the cessation-of-production rules apply ONLY AFTER oil and gas have been discovered. Here the lease provides that if oil and gas production should cease for any reason, the lease will not terminate if the company again follows one of the three options described in the dry-hole provisions.

Force Majeure Clause

Some leases may contain another provision meant to protect oil companies from liability and the loss of the lease whenever causes beyond their control halt operations. This provision is the Force Majeure clause. From the company's point of view, this provision has taken on added significance in recent years.

Ten years ago, the company's primary worry was complying with the rules and regulations of the Industrial Commission. Now they also have to deal with township and county zoning regulations, road permits, state bonding requirements, and a host of other factors affecting their operations. Many of these factors are beyond their control.

It appears that the general intent of the Force Majeure provision is similar to the Cessation of Production clause. However, it provides broader coverage in that cessation of drilling operations from causes beyond the company's control is included.

Because of the clause's recent vintage, few court interpretations have emerged. However, if the clause is proposed in a lease, the landowner, with the aid of his attorney, may wish to include the following considerations:

1. Avoid the inclusion of the words "force majeure." Its legal meaning remains clouded.
2. Limit the clause to simple terms. For instance, state, "If drilling, working or production operations are delayed or interrupted for causes reasonably beyond the company's control..."
3. Require a timely written notice any time a sustained work stoppage occurs. Have the notice specify whether the stoppage was related to causes beyond the company's control or to the dry hole, shut-in, or cessation of production provisions of the lease. Furthermore, have the notice contain supportive evidence of the company's reliance on the particular provision.
4. If an unavoidable stoppage should occur during the primary term of the lease, decide

whether delay rental payments are due and whether the lease term will be extended for the period of the delay.
5. Place a maximum limit on the amount of time the clause can remain in effect.
6. Determine and state the time frame in which operations must be resumed once the cause is removed.
7. Do not allow the company to use the Force Majeure provision in situations where they have failed to comply with the rules and regulations of the North Dakota Industrial Commission.

SURFACE USE

With few exceptions, the granting of an oil and gas lease carries with it the implied right to use as much of the surface area as is reasonably necessary to explore and produce the oil and gas. Leases more favorable to the company expand these implied rights and specifically permit a much wider range of surface activities.

RECOMMENDATIONS

Even though the company may be held liable for surface damages, the inconvenience of unwanted structures and entries upon the surface area by the company may be avoided to some degree by the following:

1. Do not allow the unrestricted right to build permanent facilities such as power stations, storage tanks or employee's quarters. State that the prior written consent of the landowner is needed for both the construction and location of such structures and sites.
2. Attach a map of the proposed lease area showing where roads, pipelines, telephone lines, salt water sites and even wells may be located. Depending on the circumstances, additional compensation may be in order for road right-of-way. For convenience, landowners generally do not permit a well within some stipulated distance of a dwelling (usually 330 ft.).
3. Provide that all underground pipelines and telephone lines must be buried below plow depth where cropland is involved. If exceptions to this provision are necessary, permit them only after getting the landowner's written consent.
4. Direct the company to use the **double ditch** method for laying any pipe if the area above the pipeline is to be cultivated or grazed. **Double ditching** requires placing the top soil on one side of the ditch and the subsoil on the other. When backfilling, the subsoil is replaced first.
5. Indicate whether the oil company's structures and equipment must be removed or be forfeited when the well is abandoned. If they are going to be removed, a reasonable amount of time should be allowed.
6. When a well is determined to be unproductive, procedures approved by the State Industrial Commission must be followed in plugging the well. These procedures include restoring the drill site as nearly as practical to its original condition. Similar procedures apply to pits built to contain drilling mud and the accumulation of drill cuttings during the drilling process. If these general regulations fail to cover unique individual circumstances, provisions for an agreed upon level of reclamation should be contained in the lease.
7. State regulations require that provisions must be made by the company to prevent livestock from gaining access to pits used to store saltwater liquids or brine. If additional fences, gates and cattle guards are necessary, identify in the lease who is responsible for the construction and maintenance of these items.

North Dakota law prohibits companies from allowing saltwater liquids or brines from flowing over the surface of the land or into streams. State law also authorizes the Industrial Commission to regulate underground disposal of oil field brine. Any company planning to dispose of salt water in underground formations must obtain a permit from the Commission. They must also follow accepted storage procedures and report monthly regarding amounts of salt water injected, injection pressures, etc.

CONJOINTLY OPERATIONS

The right of the oil company operating conjointly with neighboring lands is included in most standard lease forms and is sometimes abused. This provision means the company may build roads and pipelines across the landowner's land to be used to operate oil wells on an adjoining farm. Other provisions may be inserted to include any small adjoining tracts which the landowner owns, or to permit the oil company to drill oil or gas wells on adjoining land without requiring counter-drainage.

While these powers are often necessary, the landowner may wish to restrict their use to protect his or her own interest. The lease could provide that these powers be granted by separate agreement when and if they would be of interest to both parties.

DAMAGES

When the company goes beyond what is reasonably necessary in the drilling process and negligently injures the surface area, the company becomes liable to damages.

http://www.ag.nd.gov/Opinions/2007/Letter/2007-L-07.pdf

North Dakota law contains specific requirements concerning surface damages and disruption payments both for the surface owner and for others affected by the drilling process. Regulations pertaining to the mineral developer's responsibility to the surface owner include:

1. The mineral developer must pay the surface owner for loss of agricultural production and income, lost land value, and lost value of improvements caused by drilling operations.
2. The amount of damages may be determined by any formula mutually agreeable between the surface owner and the company.
3. When determining damages, consideration shall be given to the period of time during which the loss occurs and the surface owner may elect to be paid damages in annual installments over a period of time.
4. The payments shall only cover land directly affected by drilling operations.
5. Damage payments to the actual surface owner cannot be assigned to others except to a tenant of the damaged surface area.

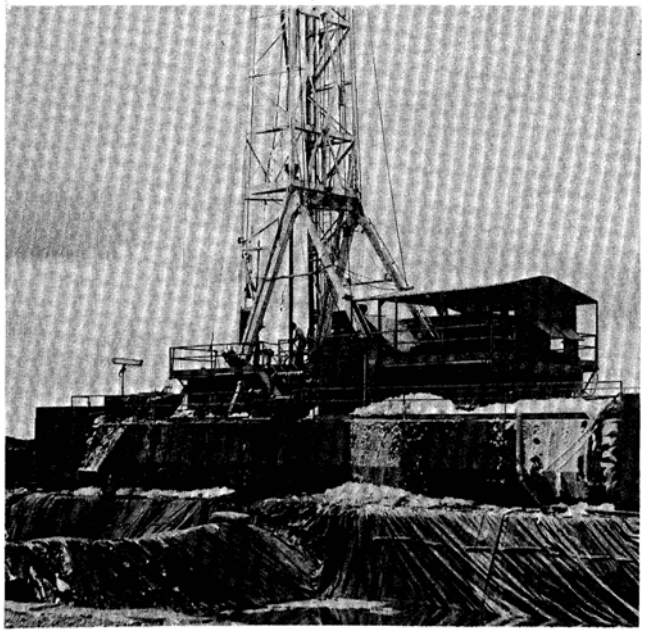
The company also has a responsibility to others affected by drilling operations.

1. The company is responsible for all damages to persons or property, both real and personal, from the lack of ordinary care by the company and from a nuisance caused by drilling operations.
2. To receive compensation, the injured party must notify the company of the damages within two years after the injury occurs.
3. Within 60 days after the company receives notice of damages, the company must make a written offer of settlement.
4. If the settlement offer is unsatisfactory or no reply is received, the injured party may bring action for compensation in court.
5. If the award offered by the court exceeds the original offer of the company, the court will award the injured party reasonable attorney fees and court costs.

In addition to the protection provided by state law, the landowner may also want to consider the following factors when negotiating the lease:

1. Describe the method to be used in determining the extent of damages suffered. In the event the parties cannot agree, provide for arbitration or some other means of resolving the dispute.

2. Resolve beforehand how payments will be distributed among respective surface owners and/or tenants of the surface area.



RESOURCE USE

COMPANY'S FREE USE OF RESOURCES

Related to the implied right to make reasonable use of the surface of the leased land, a company has the implied right to use other available resources reasonably necessary for oil and gas operations.

Water is essential to the entire drilling and production process. As outlined previously, water is used in the preparation of drilling mud. Also, modern oil production technology includes a secondary recovery technique called **water flooding.** Water is injected into a partially depleted oil bearing formation to wash the oil out of the rock into the well. Increased use of this technique could interfere with the supply of water to the owner's irrigation or domestic wells.

Because of these large demands, landowners should pay close attention to any provisions providing free water, oil or gas to the company for operations. Particularly in areas where water is scarce, certain limitations might be placed on these rights. The following suggestions may be helpful.

1. If free water, oil and gas privileges are granted to the company, stipulate whether the substances may be used for operations conducted both on and off the leased premises. You may want to limit the free use of water to just salt water. Denying the company free use of gas for on-site production may be difficult.

2. If the land should contain a central supportive device, such as an oil-gas separator, prorate the free use of oil and gas needed to run the separator according to the amount of production on the land.

3. Do not allow the company to take water from wells, tanks, ponds or reservoirs without permission or compensation.

4. Stipulate that any water used by the company cannot restrict the supply of water for domestic, livestock or agricultural purposes.

5. If recovery measures are undertaken by the company involving floodwater operations, deny the use of any water suitable for drinking. State that such water must come from non-fresh sources.

6. If water is to be purchased, state how the market price will be determined.

7. Note in the lease whether the land can be used for underground storage of gas or oil.

LANDOWNER'S USE OF RESOURCES

There may be instances where landowners can benefit from the use of equipment utilized in the drilling process or from the use of water and gas produced. Landowners might consider including the following provisions in the lease:

1. State in the lease if and when the landowner should have access to free gas. Many leases allow the owner the free use of gas for domestic purposes. Less common, but perhaps desirable for many farm operators, is a so-called irrigation gas clause, which allows the owner to receive at an agreed price such gas as is necessary to operate pumps for irrigation purposes.

2. Require the company to notify the landowner of all water-bearing formations encountered in the drill hole. If the well is not a producer of oil or gas, give the landowner the option to require the company to leave as much casing and tubing in place as is required to withdraw any remaining gas or extract fresh water for domestic or agricultural purposes. When the well can safely be used as a freshwater source, the landowner is required to write to the Industrial Commission and indicate that he wishes to use the well for freshwater and assume all liability for such use. This notice will allow the Commission to relieve the company of their legal responsibility to plug all wells not producing oil or gas.

POOLING

Pooling is a communitization or joining together of two or more surface tracts in an oil field whereby the various owners or mineral interests agree to share the expected benefits from a specific oil reservoir located under their land. In any given oil field there may be more than one oil reservoir at one level, or there may be a number of separate oil reservoirs stacked at different levels.

Pooling is necessary because much of the oil in a reservoir or related spacing unit could be removed by a single well on just one of the tracts within the unit. This would be harmful to the owners of the other tracts who may also wish to drill a well to protect their interests. However, drilling additional wells would be harmful and unnecessary. An alternative is to form a pooling arrangement whereby the owners of interest within a specific area share in the production from one or more wells according to the proportion of total mineral interests owned within the area.

Landowners may be subject to both voluntary and compulsory pooling arrangements. For example, state regulations prohibit the drilling of more than one well to the same oil reservoir on a spacing unit unless an exception is made by the Industrial Commission. However, the owners of interest in a specific oil reservoir under an area larger than the initial spacing unit, and located outside of an area that has not yet been pooled, can voluntarily agree to pool their interests and share proportionately in the production from that reservoir.

Voluntary pooling requires the free consent of the owners of mineral interests and is generally found in the context of most lease forms. The reason the pooling clause is included is to minimize any potential problems for the company when it comes time to pool.

STATE REGULATIONS

Sometimes it's impossible to get all of the interest owners to agree to a particular pooling arrangement. When this happens, any of the persons owning an interest in the spacing unit may apply to the Industrial Commission for an order that will pool all interests.

The Commission must first hold a public hearing on the matter after public notice has been given. After the hearing, the Commission will issue the pooling order which must provide for the just and reasonable division of the proceeds from production from wells in the spacing unit among all of the interest owners. Any new well drilled in this pooled area or any other pooled area must conform to the spacing authorized by the Commission. See Appendix C for a summary of minimum spacing requirements.

POSSIBLE PROBLEMS

By entering either type of pooling arrangement, the landowner may find the interpretation and application of some of the original lease provisions substantially changed. For example, it appears that a typical

pooling clause could enlarge the company's implied right to make reasonable use of the leased land to enable the company to use water from that land for the production of oil and gas from a well on other land included in the pooled unit. Also, the owner on whose land the well is situated could experience a heavy burden of surface use, yet the owner will receive only a proportionate share of the royalties. If specific damages as a result of this situation are not covered by North Dakota law pertaining to surface damages and disruption (see section pertaining to the Damage Clause on page 17), the owner may want to add specific provisions in the lease.

It also appears that by establishing a pooling arrangement, the company may be able to exercise a great deal of control over a considerable amount of leased land by drilling and establishing production on only a small part of the total pooled area. This problem will be addressed in the next section

RECOMMENDATIONS

Obviously, there is little the landowner can do to avoid compulsory pooling. However, the landowner can exercise caution in granting the company the unrestricted right to pool the leased mineral interests. The following suggestions may be helpful.

If the landowner is successful in following the general rule pertaining to leasing small tracts (see Page 9), eliminate the general pooling clause from the lease. If this isn't done, the company will be able to exercise their rights under the pooling clause and pool all of the various small leases.

General pooling provisions usually have language which allows the company to pool the mineral interests covered by the lease with other land or leases in the immediate vicinity for the production of gas and oil when in the company's judgment it is advisable to do so. The problem with granting this broad authority is that after pooling, any production, drilling or re-working operations on a well located on any portion of the pooled land could be interpreted as being undertaken on any part of the leased land.

By including the leased parcels in a pool, the company may be able to eliminate the need for paying delay rental payments, reduce the proportionate share of royalties to the respective landowners, and still maintain all of the leases by drilling and establishing production on any part of the pooled area. The "active" well need not be located on any portion of the land originally leased in small tracts, it could be located on adjacent land in a pooled unit in which the company included the leased land.

If larger acreages are leased, the landowner may want to negotiate a **Pugh Clause** which provides for the severance of the lease into separate tracts whenever less than all of the leased land is included in a single pool or unit. However, a **Pugh Clause** is difficult to negotiate, and initially leasing the mineral interests in small tracts is a suitable and much more realistic alternative.

As mentioned earlier, there may be several separate oil reservoirs stacked at different levels under the same surface area. The insertion of a **Pugh Clause** that provides for the severance of the lease into separate producing formations or levels when only one formation is included in a single pool or spacing unit could be beneficial. However, this type of clause, especially in wildcat areas, would be extremely difficult, if not impossible, to negotiate. As before, leasing the surface area in small tracts is a more realistic alternative and should take care of most of the problems a landowner might encounter.

UNITIZATION

Similar to pooling, the Industrial Commission also regulates the joining together of various mineral interests in a specific reservoir to increase the ultimate recovery of oil and gas. This process may involve pressure-maintenance or repressuring operations, cycling operations, etc.

For example, there may be four wells in a 160-acre unit. The owners of interest may agree to shut down one well, decrease production in two wells, and increase production in the remaining well if this is the best method of getting the most oil or gas from the total 160-acre unit. Another method might be for the owners of interest to agree to drill a new well in the center of the four wells and pump water into the old wells hoping to force more oil to the new well.

In general, the orders set forth by the Commission pertaining to a requested plan of unitization must protect and safeguard the respective rights of the persons affected. More specifically, the plan must prevent waste and, with reasonable probability, result in the increased recovery or more oil and gas from that reservoir than would otherwise be recovered. Also, the costs of unitization must not exceed the value of the additional oil and gas recovered.

Any owner of interest may enter a plan for unitization and request the Commission to approve it. Before the Commission will approve it, at least 60 percent of the owners of interest must sign or ratify the unit agreement.

LEGAL LIABILITY

Landowners should seek competent legal advice concerning their legal liability throughout the exploration and production process. Some specific areas of concern include:

ASSIGNMENT CLAUSE

Typically leases contain a provision permitting both the landowner and the company the unrestricted privilege of assigning their rights under the lease. To a large extent these provisions are for the company's benefit.

A customary practice in the oil and gas industry is for independent landmen to lease a large area and assign (sell) it to an oil company. Consequently, the ultimate developer-producer may not necessarily be the original company or person leasing the mineral rights. At times the landowner may find the original lease tract being subdivided among several developers. To keep better informed about such changes, the landowner may seek to incorporate some of the following suggestions in his or her lease:

1. Deny the right of assignment without first securing the landowner's written consent. If this is not feasible, state that any assignment is not binding upon the landowner until he or she is duly notified in writing. In either case, the landowner should keep a permanent record of each new assignee for his or her files.
2. Do not release the original company or person leasing the mineral rights from liability for a default on any assigned portion of the lease or leased area. State that a default on any transferred part of the lease is a default on the whole.
3. Provide that accompanying each payment there must be an identification of the governing lease (or assignment thereof) and the provisions of the lease for which payment is being made.

WARRANTY CLAUSE

Leases generally will contain provisions binding the landowner to defend interest in, or title to, the leased premises should a dispute ever arise over ownership. This is known as the warranty clause.

To avoid any possible expense in a legal action, landowners should omit any language which infers they will warrant to defend title to the land. Since most oil companies or landmen conduct preliminary investigations as to the ownership of mineral interests prior to any lease negotiations, and conduct detailed investigations before paying the initial bonus, the warranty clause shouldn't be necessary.

OTHER LEGAL CONSIDERATIONS

Time Limit to Settle Violations

The landowner may want the lease to provide that if the company does not correct any violation of an agreement contained in the lease within 30 days after the landowner gives written notice, the company should pay reasonable attorney fees and reasonable investigative costs incurred by the landowner in preparing the case for trial.

Ambiguous Terms in a Lease

Landowners should also be aware of the North Dakota Supreme Court decision which states that persons writing a lease as a normal course of their business have an obligation to avoid ambiguities about the terms of such leases. An ambiguity arising after signing cannot be interpreted in favor of the company since the landowner does not ordinarily have the specialized knowledge to avoid such ambiguities at the time of signing.

Security Against Claims

Landowners may want to require the company to give security against future loss, save and hold the landowner harmless from all claims, demands, and causes of action stemming from activities undertaken by the company or the company's employees, agents, contractors and subcontractors during operations conducted on the leased premises. If possible, require the company to post bond and carry comprehensive liability insurance of a specified amount as added security from such claims.

TOP LEASING

When oil was first discovered in North Dakota in 1951, large tracts of land throughout the Williston Basin were leased. These 10-year leases were renewed, bought and sold in 1961 and 1971. In 1981, the process is continuing, but with a major difference - top leasing.

Top leasing is a highly competitive practice whereby oil and gas minerals already legally bound under an existing lease are leased again. In general, this method of mineral leasing is used in areas where existing leases will expire in the near future.

An advance payment, usually considered part of the bonus, is offered the mineral owner when the top lease is signed. When the existing lease expires, the new lease becomes binding and the balance of the bonus money is paid. The top leasing mineral company will lose the advance payment if the company owning the existing lease decides to drill for oil or gas before the lease expires.

In areas of intense competition for leases the primary term may be as short as 18 months to three years. When negotiating these short term leases, the company may at the same time negotiate a top lease for the same tract thereby assuring the company of a longer period of time in which to develop the tract.

Top leasing benefits the landowner in that increased competition for leases enhances his or her bargaining position. Mineral companies also benefit. The practice allows them to lease certain areas showing a high potential for oil and gas production without waiting for existing leases to expire. It also allows the company's land crews to be more efficient in covering a given area in a shorter period of time.

Top leasing does not mean that the lease now in effect is automatically renewed for the new lease period. Negotiations again take place to make sure the new top lease meets the needs of the company while providing adequate returns and protection for the landowner. Input from an attorney familiar with oil and gas leasing procedures is strongly recommended in these negotiations.

OWNERSHIP PATTERNS AND MINERAL RIGHTS

CO-OWNERSHIP

If the mineral rights have been divided by either will, deed, or inheritance laws, each owner becomes a **tenant-in-common** of an individual interest in the minerals. Each **tenant-in-common** must sign a lease, but each is free to bargain for as large a cash bonus or other benefits as can be obtained. While it may be advantageous for all to lease to the same company, there is no need for them to do so.

Mineral interests held by individuals as **joint tenants with the right of survivorship** can be handled in the same way. The **joint tenants** are free to bargain separately or collectively. If three brothers owned the mineral rights as **joint tenants,** each may have a different lease pertaining to their one-third share of the minerals.

If two of the three brothers agree to the same lease, the company may approach the third brother and ask him to ratify the lease agreed to by the other two brothers. By signing the **Ratification of an Existing Oil and Gas Lease** form, the brother agrees that if he inherits the other brother's shares of the jointly owned property before the lease expires, he will accept the provisions of the lease already on that property.

When the mineral rights are owned by several persons, difficulties can arise in getting them all to execute a lease. This could happen if one person has disappeared, is a minor, refuses to execute the lease, or for some reason cannot execute the lease. North Dakota law permits the owners of one-half or more of the oil and gas, or the owners of leases covering one-half or more of the minerals under contract, to ask the court for an order allowing them to develop the oil and gas. This is done to protect the interests of the majority owners.

When this is done, all owners, both known and unknown, are made parties to the action. If the petition is approved by the court, nonsigning owners are guaranteed their proportionate benefits from the lease.

LIFE ESTATE

Leasing could become more complicated when land is subject to a life estate. Life tenants and remaindermen must usually join in executing or ratifying an oil and gas lease. They may agree to divide the proceeds in the lease or in a separate agreement. In the absence of such an agreement, the law provides a formula for computing the share of each one.

GUARDIANSHIP OR TRUSTEE

Leasing complications also arise when mineral rights are controlled by a guardian or trustee. Generally, a court order is needed to allow the guardian or trustee to execute an oil and gas lease.

WHEN AND TO WHOM SHOULD LANDOWNERS LEASE?

Landowners may incur some minor risks and inconveniences by leasing their oil and gas rights. However, if oil and gas are found, the disadvantages will likely be small compared to the royalties received. Consequently, the decision is not whether to lease but rather when and to whom.

WHEN TO LEASE?

With little or no competition for leases, the landowner must decide whether to accept the current offer or hold out until competition results in higher

delay rentals and bonuses. If the initial offer is accepted, the landowner may give up the chance of leasing at a larger bonus and higher rentals during the term of the lease. If the landowner decides to hold out for higher returns, he or she may not get an offer if competition doesn't develop in the area.

Where there is little competition, most landowners are interested in getting exploration started in the area and many of them can be expected to sign leases at the first opportunity if the lease is equitable and meets their needs.

TO WHOM SHOULD LANDOWNERS LEASE?

If there is competition for leases, landowners may have a chance to choose between two or more prospective companies. Comparing the merits of the prospective companies, the lease rates and bonuses offered, and various provisions of the lease will help decide.

However, there are other factors to consider:

1. Landowners should deal with a well-financed, well-managed company that has shown the ability to carry out an effective exploration and development program. However, this may be difficult to determine because companies often obtain leases through brokers.
2. If lease provisions are about the same, landowners should try to deal with the broker or company that has leased the most land in the area. Development may be delayed if two or more companies hold inter-mingled leases.
3. If landowners own only part of the oil and gas rights in a tract, they should try to lease to the same broker or company holding the leases from the other mineral owners. This will avoid problems that often arise when two or more companies control fractional interests in the same tract.

Once signed, an oil and gas lease becomes a binding contract between the landowner and the company. Therefore, landowners should avoid making hasty decisions. They should gather all relevant information and find out what their neighbors have been offered and what they decided to do.

When the decision can no longer be delayed, the landowner should think through the probable outcome of each decision before making a choice. They should also notify the holder of any mortgage against the land before signing the lease. Some mortgages stipulate that income from mineral leases must be used to retire the mortgage debt.

Landowners should carefully check bank references and other credentials of the broker or company representative before signing any document. They should also discuss their individual situation with their attorney, tax consultant, or credit source.

SUMMARY

This publication presents a summary of the oil and gas exploration and production process along with related leasing considerations. As mentioned before, NO LANDOWNER COULD POSSIBLY HOPE TO INCORPORATE ALL OF THESE CONSIDERATIONS IN A LEASE NOR SHOULD ALL OF THEM NEED TO BE INCLUDED. However, each situation is different and a lease, to be effective, should contain those lease provisions that pertain to each landowner's unique circumstances.

The need for and the importance of the various lease provisions outlined in this publication could change substantially because of constantly improving technology, State and Federal legislation, and future court decisions. Even so, the information presented should alert landowners to various alternatives and promote a more frank discussion between the landowner and the company before any contracts or leases are signed.

REFERENCES

Brostuen, Erling A. *Petroleum - A Primer for North Dakota,* North Dakota Geological Survey Educational Series 13, Grand Forks, 1981.

Fambrough, Judon, *Hints on Negotiating An Oil and Gas Lease*, Texas Real Estate Research Center, Texas A&M University Bulletin R-380-3M-229, March, 1980.

Grant, Douglas L., *Oil and Gas Leasing of Idaho Farm and Ranch Land,* Idaho Agricultural Experiment Station Bulletin No. 569, October, 1976.

Maynard, Cecil D., and Glenn E. Laughlin, "The Oil and Gas Lease," *OSU Extension Facts,* No. 9409, Oklahoma Cooperative Extension Service.

"Montana Attorneys Offer Primer on Oil Leasing," *Williston Basin Oil Reporter,* P22, May 31, 1981.

Mountain Plains Federal Regional Council, *Local Government and Petroleum Development,* Denver, 1980.

North Dakota Natural Resources Council, *Ever Wonder About Seismic Exploration?* Bismarck, ND, 1980.

Uchtmann, Donald L., J. W. Looney, N. G. P. Krausz, and H. W. Hannah, *Agricultural Law, Principles and Cases,* New York, McGraw-Hill Book Company, Inc., March, 1981.

Voelker, Stanley W., *Mineral Rights Management by Private Landowners In The Great Plains States,* North Dakota Cooperative Extension Service bulletin CRD-3, November, 1974.

GEOPHYSICAL EXPLORATION REQUIREMENTS
CHAPTER 38-08.1

38-08.1-01. DEFINITIONS. As used in this chapter, unless the context requires otherwise:

1. "Commission" means the industrial commission.
2. "Geophysical exploration" means any method of obtaining petroleum-related geophysical surveys.
3. "Operator of the land" means the surface owner or the surface owner's tenant of the land upon or within one-half mile [.80 kilometer] of the land on which geophysical operations are to be conducted.
4. "Permitting agent" means a person who secures a permit from an operator of the land to conduct geophysical exploration activities.
5. "Person" means and includes any natural person, corporation, limited liability company, association, partnership, receiver, trustee, executor, administrator, guardian, fiduciary, or other representative of any kind, and includes any department, agency, or instrumentality of the state or of any governmental subdivision thereof.

Source: N.D. Century Code.

38-08.1-02. ENFORCEMENT BY COMMISSION - PERSONS REQUIRED TO COMPLY WITH CHAPTER. Notwithstanding any other provision of this chapter, the commission is the primary enforcement agency governing geophysical exploration in this state. Any person in this state engaged in geophysical exploration or engaged as a subcontractor of a person engaged in geophysical exploration shall comply with this chapter; provided, however, that compliance with this chapter by a crew or its employer constitutes compliance herewith by that person who has engaged the service of the crew, or its employer, as an independent contractor.

Source: N.D. Century Code.

38-08.1-03. DEEMED DOING BUSINESS WITHIN STATE - RESIDENT AGENT. A person must be deemed doing business within this state when engaged in geophysical exploration within the boundaries of this state, and shall, if not already qualified to do business within the state under chapter 10-19.1, 10-32, 45-10.2, 45-22, or 45-23 prior to such exploration, file with the secretary of state an authorization provided under the governing statute of the organization.

Source: N.D. Century Code.

38-08.1-03.1. SURETY BOND - CERTIFICATE - RELEASE.

1. A geophysical exploration contractor desiring to engage in geophysical exploration in this state shall file with the commission a good and sufficient surety bond in the amount of fifty thousand dollars if the contractor intends to conduct shot hole operations or in the amount of twenty-five thousand dollars if the contractor intends to use any other method of geophysical exploration. Each subcontractor engaged by the geophysical exploration contractor for the drilling or plugging of seismic shot holes must file with the commission a good and sufficient surety bond in the amount of ten thousand dollars. The bond must be in a form prescribed by the commission and must indemnify all owners of property within the state, including the state and its political subdivisions, against physical damages to property which may result from geophysical exploration and the plugging of drill holes. The bond must cover all geophysical exploration and plugging operations conducted within one year of the date the bond is issued and must be automatically renewed unless the commission and the person covered by the bond receive notice sixty days before any anniversary date of the surety's intent not to renew the bond. If the surety does not renew the geophysical exploration contractor's bond, the surety's liability under the bond ceases six years from the date that geophysical exploration or reclamation covered by the bond was last conducted in the state. If the surety does not renew the drilling or plugging bond, the surety's liability under the bond ceases two years from the date the drilling and plugging covered by the bond was last conducted in this state. A person required to post a bond under this subsection may post cash or a certificate of deposit in lieu of the bond under rules adopted by the commission.
2. The aggregate liability of the surety on the bond may in no event exceed the amount of the bond.
3. Upon filing the bond required by this section and presenting a certificate of authority to transact business in this state issued under section 10-19.1-136, a certificate of incorporation issued under chapter 10-19.1, or some other certificate issued by the secretary of state showing the name of the person designated as resident agent for service of process, the commission shall issue to the person desiring to engage in geophysical exploration or plugging operations or any subcontractor of that person a certificate showing that the bond has been filed and showing the name and address of the surety company and the name of the person designated resident agent for service of process.
4. The proceeds of a surety bond become the property of the commission or the cash or certificate of deposit posted in lieu of a surety bond may not be returned to that person if the principal or person posting the bond, cash, or certificate of deposit fails to comply with this chapter and rules adopted by the commission under this chapter. This must be determined by the commission after notice and hearing in accordance with rules adopted by the commission. Notice of the hearing must be given to the principal and surety on the bond or to the person posting the cash or certificate of deposit by mailing a copy of the notice of hearing and a copy of a complaint, stating the grounds for forfeiture to them, filed by the commission. This must be done by certified mail, return receipt requested, and addressed to their last known address listed with the commission. If the principal or surety or person posting the cash or

certificate of deposit has a defense to, or otherwise wishes to contest the complaint of the commission, that person must file a written statement or answer setting forth the defense with the commission at least three business days before the commission hearing. Any defense or reason for contesting the complaint is waived if that person fails to do so. The commission may treat the failure to file a defense or reason to contest the complaint or the failure to appear at the hearing as default by the party. If the commission determines the principal on the bond or the person posting the cash or certificate of deposit as security has complied with this chapter and rules adopted by the commission under this chapter, including the proper plugging of wells and seismic holes and reclamation of the surrounding affected area, with respect to all operations secured by the bond, the commission shall release the obligation of the bond or return the cash or certificate of deposit upon its next anniversary date.

Source: N.D. Century Code.

38-08.1-04. APPLICATION FOR PERMIT TO ENGAGE IN GEOPHYSICAL EXPLORATION. Any person desiring to engage in geophysical exploration before actually engaging in the exploration, shall file an application for a permit to engage in geophysical exploration with the commission. The application for a permit for geophysical exploration must include the following:

1. The name, address, and telephone number of the person intending to engage in geophysical exploration or plugging operations and the name and telephone number of any local representative who may be contacted by the commission concerning geophysical exploration activities.
2. The name, address, and telephone number of any subcontractors, including drilling and plugging subcontractors, to be employed by the person intending to conduct geophysical exploration or plugging operations.
3. The name and address of the resident agent for service of process of the person intending to engage in geophysical exploration.
4. The date upon which geophysical exploration is to begin.
5. The approximate number and depth of any drill holes and the specific location of any drill holes or a description of the property on which the geophysical exploration is to be conducted described by township, range, section, and quarter section.
6. A fee of up to one hundred dollars.

The person making application for a geophysical exploration permit shall file an amended application whenever there is any new information or a change in the information contained in the application on file with the commission.

Source: N.D. Century Code.

38-08.1-04.1. EXPLORATION PERMIT.

1. Upon filing a complete application for permit to explore pursuant to section 38-08.1-04, the commission may issue to any person desiring to engage in geophysical exploration a "geophysical exploration permit". A person may not engage in geophysical exploration activities in this state without having first obtained a geophysical exploration permit from the commission.
2. The permit must show, at a minimum:
   a. The name of the person.
   b. The name and address of the resident agent for service of process.
   c. That an application to engage in geophysical exploration has been duly filed.
   d. That a good and sufficient surety bond has been filed by the person, naming the surety company and giving its address.
3. The permit must be signed by the director of the commission's oil and gas division or the director's designee. The permit is valid for one year.
4. Within seven days of initial contact between the permitting agent and the operator of the land, the permitting agent shall provide the operator of the land and each landowner owning land within one-half mile [.80 kilometer] of the land on which geophysical exploration activities are to be conducted a written copy of section 38-08.1-04.1 and chapter 38-11.1.
5. The permitting agent shall notify the operator of the land at least seven days before the commencement of any geophysical exploration activity, unless waived by mutual agreement of both parties. The notice must include the approximate time schedule and the location of the planned activity.
6. The permit or a photostatic copy thereof must be carried at all times by a member of the crew during the period of geophysical exploration and must be exhibited upon demand of the landowner or tenant operator or county or state official.
7. The permitholder shall notify the county auditor or the auditor's designee at least twenty-four hours, excluding Saturdays and holidays, before the permitholder commences geophysical exploration in the county. Notice must include the approximate time schedule and location of the planned activity.

Source: N.D. Century Code.

38-08.1-04.2. NOTIFICATION OF ISSUANCE OF PERMIT - REVOCATION - SUSPENSION. The commission shall immediately forward notice of the issuance of a permit to the board of county commissioners of the county in which the lands are located. The commission may revoke the permit of any person engaging in geophysical exploration upon a showing that that person has violated any applicable requirement pertaining to geophysical exploration. The commission shall notify that person, by the most effective written means, of the permit revocation. Upon notification, the person engaging in geophysical exploration may, within fifteen days, request a hearing before the commission on the matter. The commission shall either affirm, modify, or deny the permit revocation. The commission may also suspend the permit temporarily in those cases where climate and physical conditions are such as to cause harm, damage, or undue stress to roads, bridges, pastures, crops, or other physical features. For these same reasons, a board of

county commissioners, upon notice to the permitholder and the commission, also may suspend, for not longer than forty-eight hours, a permit for operations within the county.

Source: N.D. Century Code.

38-08.1-05. DUTY TO FILE RECORD SHOWING WHERE WORK PERFORMED. Within thirty days following any calendar month in which geophysical exploration is begun by any person within this state, such person shall file with the commission and shall send to the owner or occupier of any land upon which work is begun, a record showing the township, range, section, and quarter section in the county in which such work was performed and the date upon which such work was commenced. The notice also must include the actual shot point location and the amount of explosive charge, if any, in each drill hole.

Source: N.D. Century Code.

38-08.1-06. DUTY TO PLUG DRILL HOLES - PENALTY.

1. Drill holes must be plugged and abandoned as required by this section.
2. The seismic company responsible for the plugging and abandonment of seismic shot holes shall notify the commission in writing that it intends to plug and abandon the drill hole. The required notice must be received by the commission at least twenty-four hours before the time plugging activities are scheduled to begin. The notice must include the date and time the activities are expected to commence, the location by section, township, and range of the holes to be plugged, and the name and telephone number of the person in charge of the plugging operations. A copy of the notice must be sent to the landowner or lessee at the same time it is sent to the commission. The seismic company shall notify the commission in writing upon completion of the plugging operation.
3. All seismic shot holes must be plugged as soon after being used as reasonably is practicable; however, they may not remain unplugged for a period of more than thirty days unless, upon application, the commission grants an extension which may not exceed ninety days. All seismic shot holes must be temporarily capped during the period between drilling and final plugging.
4. The plug must have permanently affixed to it a durable nonrusting metal or plastic tag or plate imprinted with the name of the operator responsible for the plugging of the hole and the operator's permit number.
5. The surface around each seismic shot hole must be restored to its original condition insofar as restoration is practicable and all stakes, markers, cables, ropes, wires, primacord, cement or mud stacks, and any other debris or material not native to the area must be removed from the drill site and lawfully disposed of.

Source: N.D. Century Code.

38-08.1-06.1. PLUGGING REQUIREMENTS - RULES - LIABILITY FOR DAMAGE. All seismic holes must be plugged in accordance with rules adopted by the commission. The commission shall review and revise its rules governing plugging requirements as technology in the field evolves. The seismic company is liable for all damages resulting from failure to comply with rules adopted by the commission pursuant to this section.

Source: N.D. Century Code.

38-08.1-07. CIVIL AND CRIMINAL PENALTIES.

1. A person who violates any provision of this chapter or commission rule or order is subject to a civil penalty imposed by the commission not to exceed one thousand dollars for each offense, and each day's violation is a separate offense. A penalty imposed under this section, if not paid, may be recovered by the commission in the district court of the county in which the defendant resides, or in which any defendant resides if there is more than one defendant, or in the district court of any county in which the violation occurred. Payment of the penalty does not legalize the activity for which the penalty was imposed, or relieve the person upon whom the penalty was imposed from liability to any other person for damage caused by the violation.
2. Notwithstanding this section, a person who willfully violates any provision of this chapter or a commission rule or order is guilty of a class C felony.

Source: N.D. Century Code.

38-08.1-08. COMMISSION TO ADOPT RULES. The commission may adopt and enforce rules to implement this chapter.

Source: N.D. Century Code.

GEOPHYSICAL EXPLORATION REQUIREMENTS
CHAPTER 43-02-12

43-02-12-01. DEFINITIONS. The terms used in this chapter have the same meaning as in North Dakota Century Code chapter 38-08.1 except:

1. "Building" means any residence or commercial structure including a barn, stable, or other similar structure.
2. "Director" means the director of oil and gas of the industrial commission, the assistant director of oil and gas of the industrial commission, and their designated representatives.

History: Effective December 1, 1997; amended effective September 1, 2000; January 1, 2006.

General Authority: NDCC 38-08.1
Law Implemented: NDCC 38-08.1-01

43-02-12-01.1 SCOPE OF CHAPTER. This chapter contains general rules of statewide application which have been adopted by the industrial commission to govern geophysical exploration in North Dakota. Special rules, regulations, and orders have been and will be issued when required and shall prevail as against general rules, regulations, and orders if in conflict therewith. However, wherever this chapter does not conflict with special rules heretofore or hereafter adopted, this chapter will apply in each case. The commission may grant exceptions to this chapter, after due notice and hearing, when such exceptions will protect correlative rights.

History: Effective April 1, 2010.

General Authority: NDCC 38-08.1
Law Implemented: NDCC 38-08.1-08

43-02-12-02. CERTIFICATION TO DO BUSINESS WITHIN STATE - RESIDENT AGENT. Any person desiring to engage in geophysical exploration within this state, including a contractor and subcontractor, shall obtain from the secretary of state a certificate of authority to transact business in this state. A copy of this certificate must be filed with the commission prior to, or together with, the bond required herein and the application for permit to engage in geophysical exploration.

History: Effective December 1, 1997.

General Authority: NDCC 38-08.1
Law Implemented: NDCC 38-08.1-03

43-02-12-03. BONDING REQUIREMENTS.

1. To satisfy the obligation that a geophysical exploration contractor desiring to engage in geophysical exploration shall file with the commission a good and sufficient surety bond, the contractor, in lieu of a surety bond, may post cash or a certificate of deposit with the Bank of North Dakota. Persons desiring to file a cash bond or certificate of deposit shall file with the commission an application to deposit cash or certificate of deposit. If the applicant is currently in compliance with the statutes, rules, and orders of the commission, the commission will issue to the Bank of North Dakota a compliance statement authorizing the Bank of North Dakota to accept cash or a certificate of deposit as a bond for the applicant.

2. Geophysical exploration contractors shall file with the commission a good and sufficient bond in the amount of fifty thousand dollars if the contractor intends to conduct shot hole operations or in the amount of twenty-five thousand dollars if the contractor intends to use any other method of geophysical exploration. Each subcontractor engaged by the geophysical exploration contractor for the drilling and plugging of seismic shot holes shall file with the commission a good and sufficient bond in the amount of ten thousand dollars.

History: Effective December 1, 1997.

General Authority
NDCC 38-08.1

Law Implemented
NDCC 38-08.1-03.1

43-02-12-04. EXPLORATION PERMIT – APPLICATION - EXPIRATION.

1. Any person applying to the commission for an exploration permit must have a certificate to conduct geophysical exploration pursuant to subsection 3 of North Dakota Century Code section 38-08.1-03.1. A person may not commence geophysical exploration activities in this state without first obtaining an exploration permit from the commission. An application for an exploration permit must be submitted to the commission at least three business days before commencing operations and include the following:

    a. The name, permanent address, and telephone number of the geophysical contractor and the geophysical contractor's local representative.

    b. The name, permanent address, and telephone number of the drilling and hole plugging contractor, if different from the seismic contractor.

    c. The name and address of the resident agent for service of process of the person intending to engage in geophysical exploration.

d. The bond number, type, and amount for the geophysical company.

e. The geophysical exploration method (i.e., shot hole, nonexplosive, 2D, or 3D).

f. The number, depth, and location of the seismic holes and the size of the explosive charges, if applicable.

g. The anticipated starting date of seismic and plugging operations.

h. The anticipated completion date of seismic and plugging operations.

i. A description of hole plugging procedures.

j. A description of the identifying marks that will be on the nonmetallic plug to be used in the plugging of the seismic hole.

k. A preplot map displaying the proposed seismic source points and receiver lines and specifically identifying all source points that do not comply with section 43-02-12-05.

l. A fee of one hundred dollars.

2. The permitholder shall notify the commission at least twenty-four hours, excluding Saturdays and holidays, before commencing geophysical activity.

3. The permitholder shall immediately notify the commission of any revisions to an approved seismic permit.

4. An exploration permit expires one year after the date it was issued, unless geophysical exploration activities have commenced.

History: Effective December 1, 1997; amended effective September 1, 2000; May 1, 2004; April 1, 2010.

General Authority
NDCC 38-08.1

Law Implemented
NDCC 38-08.1-04.1

43-02-12-05. DISTANCE RESTRICTIONS - SHOT HOLE OPERATIONS - NONEXPLOSIVE METHODS. Seismic shot hole operations may not be conducted less than six hundred sixty feet [201.17 meters] from water wells, buildings, underground cisterns, pipelines, and flowing springs.

Nonexplosive exploration methods may not be conducted less than three hundred feet [91.44 meters] from water wells, buildings, underground cisterns, pipelines, and flowing springs.

Variances may be granted to this section by written agreement between the permitholder and the owner of the subject property and must be available to the director upon request.

History: Effective December 1, 1997; amended effective September 1, 2000; May 1, 2004.

General Authority
NDCC 38-08.1

Law Implemented
NDCC 38-08.1-08

43-02-12-06. NOTIFICATION OF WORK PERFORMED. The director may require progress reports prior to the completion of a project. Within thirty days following the completion of geophysical exploration by any person within this state, such person shall file with the commission a seismic completion report in the form of an affidavit deposing that the seismic project was completed in accordance with chapter 43-02-12, and incorporating a postplot map displaying the actual source point location and the location of all undetonated (loaded) holes, blowouts, and flowing holes or any other problem holes the director deems necessary. If obtained by the contractor, the latitude and longitude of each source and receiver point shall be submitted to the commission to the nearest tenth of a second.

Any person plugging a seismic hole must submit a plugging report and an affidavit of plugging detailing the line number, shot point number, hole depth, drill type, hole condition (wet, dry), bentonite used (sacks, capsules), and the depth at which the surface plug was set, and all other information necessary to describe the conditions of the shot hole.

The director is authorized to approve an operator's request to suspend a geophysical exploration project, although no suspension shall be granted beyond ninety days unless all charges are detonated.

The director is authorized to suspend operations of the entire geophysical exploration project, or any portion thereof, if further activity will cause excessive damage to the surface of the land. The geophysical exploration activity may continue upon the director approving a plan to mitigate the damage.

History: Effective December 1, 1997; amended effective September 1, 2000; May 1, 2004; January 1, 2008; April 1, 2010; April 1, 2012.

General Authority
NDCC 38-08.1

Law Implemented
NDCC 38-08.1-02,
38-08.1-05

43-02-12-07. DRILLING AND PLUGGING REQUIREMENTS.

1. Prior to commencement of any drilling or plugging operations, the director may require a field meeting with the geophysical contractor and subcontractors.

2. Except in those circumstances in which the director allows otherwise, all seismic shot holes must be plugged the same day as they were drilled and loaded. Any blown out shot holes must be plugged as soon as reasonably practicable, unless, upon application, the director grants an extension which may not exceed ninety days. All seismic shot holes must be temporarily capped until final plugging.

3. If the number of drilling rigs on a proposed project exceeds the director's capacity to provide appropriate inspection, the director may limit the number of drilling rigs.

4. Bentonite materials used in seismic hole plugging must be derived from naturally occurring untreated, high swelling sodium bentonite which consists principally of the mineral montmorillonite.

5. A durable nonmetallic plug must be set at a depth of approximately three feet [91.44 centimeters] below the surface of every shot hole. The plug must be designed to fit the hole and shall be imprinted with the mark of the operator responsible for the plugging, the mark of the permitholder, and the permitted project number.

6. Unless the contractor can prove to the satisfaction of the commission that another method will provide better protection to ground water and long-term land stability, seismic shot hole plugging shall be conducted in the following manner:

    a. When water is used in conjunction with the drilling of seismic shot holes or when water is encountered in the hole, the shot holes are to be filled with coarse ground bentonite approximately three-fourths of one inch [19.05 millimeters] in diameter from the top of the charge up to a depth above the final water level. Cuttings shall be added from the top of the bentonite to the surface. All cuttings added above the nonmetallic plug shall be tamped.

    b. When drilling with air only, and in completely dry holes, a plugging may be accomplished by returning the cuttings to the hole. A small mound must be left over the hole for settling allowance.

    c. Remaining cap leads must be cut off below ground level and any drilling fluid or cuttings which are deposited on the surface around the seismic hole will be spread out in such a manner that the growth of natural grasses or foliage will not be impaired.

d. Any markings, including lath, pin flags, flagging, or any other debris left on the project area, including the powder magazine, must be removed and lawfully disposed of.

History: Effective December 1, 1997; amended effective September 1, 2000; May 1, 2004.

General Authority
NDCC 38-08.1

Law Implemented
NDCC 38-08.1-02, 38-08.1-06, 38-08.1-06.1

43-02-12-08. BOOKS AND RECORDS TO BE KEPT TO SUBSTANTIATE REPORTS. All geophysical, drilling, and plugging contractors shall make and keep appropriate books and records for a period of not less than six years, covering their operations in North Dakota from which they may be able to make and substantiate the reports required by this chapter.

History: Effective September 1, 2000.

General Authority
NDCC 38-08.1

Law Implemented
NDCC 38-08.1-08

Oil and Gas Division
Lynn D. Helms - Director Bruce E. Hicks - Assistant Director
Department of Mineral Resources
Lynn D. Helms - Director
North Dakota Industrial Commission
www.dmr.nd.gov/oilgas

NOTICE TO SURFACE OWNERS
CONCERNING THE RIGHT OF COMPENSATION
FOR DAMAGES CAUSED BY OIL AND GAS OPERATIONS

This letter is furnished to advise you of your rights and options as a surface owner or tenant under North Dakota law. This form as well as information disclosing the plan of operations contemplated by the mineral developer are intended to assist you in evaluating the effect such activity will have on the use of your property. You are responsible for negotiating the terms of any agreements. If you need advice or assistance in making a settlement, you should consult private counsel.

North Dakota Century Code Reference

North Dakota Century Code (NDCC) Chapter 38-11.1 provides that all persons should be justly compensated for injury to their persons or property, and interference with the use of their property caused by oil and gas development.

Oil and gas development means the drilling, completion, production, or other operations associated with an oil and gas well which require entry upon the surface estate.

The law provides that surface owners and their tenants are entitled to compensation from the mineral developer for: 1) lost land value, 2) lost use of and access to the land, and 3) lost value of improvements if any, caused by oil and gas drilling operations.

Payments contemplated under this section of law cover only land directly affected by drilling operations.

Notice Requirements

Before entering your land for inspection, staking, surveying, taking measurements, or evaluating possible routes and sites the mineral developer must provide you at least seven days notice by registered mail or hand delivery. You and the mineral developer may mutually agree to waive this seven day notice requirement.

Except for geophysical exploration activities, which are governed by NDCC Chapter 38-08.1, the mineral developer must provide you notice by registered mail or hand delivery of the contemplated oil and gas drilling operations at least twenty (20) days prior to the start of the drilling operations unless notice requirements are waived by mutual agreement of both parties. If the mineral developer plans to begin drilling operations within twenty (20) days of the termination date of the mineral lease, the required notice may be given at any time prior to the start of drilling operations. This notice must sufficiently disclose the plan of work and operations for you to be able to evaluate the effect of drilling operations on the use of your property.

If a mineral developer fails to give notice as provided above, you may seek relief in the court of proper jurisdiction and you may receive punitive as well as actual damages.

Offer to settle damages

The mineral developer must make a written offer of settlement at the time the notice of contemplated drilling operations is given, unless you and the mineral developer have mutually agreed otherwise in writing. You may accept or reject any offer so made. Final agreement on the amount of compensation for damages does not have to be reached before the mineral developer begins drilling operations, and may be best negotiated after it is determined whether the well is commercial.

You may accept or reject any offer made. If you reject the offers of the mineral developer you may bring a court action seeking proper compensation. If the amount of compensation awarded by the court is greater than that offered by the mineral developer you will be awarded reasonable attorney fees, court costs, and interest on the amount of compensation from the day drilling is commenced.

Notification of Injury

Any person seeking compensation for damage and disruption or loss of production must notify the mineral developer within two (2) years after the injury occurs or would be apparent to a reasonable person.

Damage and disruption payments

The amount of compensation for damages from drilling operations may be determined by any formula mutually agreeable between the surface owner and the mineral developer. Compensation for damages caused by drilling operations must be calculated as a single sum. When determining damages you must consider the period of time during which the loss will occur.

Any reservation or assignment of payment to someone other than the surface owner or tenant is prohibited. In the absence of an agreement between the surface owner and a tenant as to the division of compensation, the tenant is entitled to recover from the surface owner that portion of the payments attributable to the tenant's share of the damages.

Loss of production payments

The mineral developer must pay you for the loss of agricultural production and income caused by oil and gas production and completion operations. The amount of compensation may be determined by any formula mutually agreeable between the surface owner and the mineral developer. When determining damages you must consider the period of time during which the loss will occur and payments must be made annually unless you elect to receive a single lump sum payment.

Any reservation or assignment of payment to someone other than the surface owner or tenant is prohibited. In the absence of an agreement between the surface owner and a tenant as to the division of compensation, the tenant is entitled to recover from the surface owner that portion of the payments attributable to the tenant's share of the damages.

Inspection of well site

You, or an adjacent landowner, may request the state department of health to inspect and monitor the well site on your land for the presence of hydrogen sulfide. If the presence of hydrogen sulfide is indicated the state department of health will issue appropriate orders to protect your health, welfare, and property.

Surface and underground water supplies

NDCC Chapter 38-11.1 further provides protection of your surface and underground water supplies for domestic, agricultural, industrial, or other beneficial use. If you own an interest in real property and obtain all or part of your water supply for any beneficial use from an underground source, you may have a claim against a mineral developer for disruption or diminution in water quality or quantity proximately caused by drilling operations. This law does not apply if water can reasonably be acquired under the changed conditions and the changed conditions are the result of the legal appropriation of water by the mineral developer.

You may have a claim for damages against the mineral developer provided that:

1) The water supply is disrupted or diminished in quality or quantity on real property you own within one-half (1/2) mile of where geophysical exploration activities are, or have been conducted, or within one (1) mile of an oil and gas well site, and
2) A certified water quality and quantity test has been performed within one (1) year preceding the start of drilling operations, and
3) A claim for damages is filed within six (6) years from the time damage was discovered or should have been reasonably discovered.
4) Damages to person or property resulted from lack of ordinary care by the mineral developer or from a nuisance caused by drilling operations.

No tract of land is obligated to receive water contaminated by drilling operations on another tract of land. The owner has a claim against the mineral developer to recover damages resulting from natural drainage of such waters onto a tract of land.

Other remedies and limitations

The remedies provided by this law do not prohibit you from seeking other legal remedies.

This law does not apply to damages resulting from the operation, maintenance, or use of a motor vehicle upon a highway.

Effective 1st day of August, 2011.

/s/ Lynn D. Helms

Lynn D. Helms
Director

43-02-03-18. DRILLING UNITS - WELL LOCATIONS. In the absence of an order by the commission setting spacing units for a pool:

1. a. Vertical or directional oil wells projected to a depth not deeper than the Mission Canyon formation must be drilled upon a governmental quarter-quarter section or equivalent lot, located not less than five hundred feet [152.4 meters] to the boundary of such governmental quarter-quarter section or equivalent lot. No more than one well shall be drilled to the same pool on any such governmental quarter-quarter section or equivalent lot, except by order of the commission, nor shall any well be drilled on any such governmental quarter-quarter section or equivalent lot containing less than thirty-six acres [14.57 hectares] except by order of the commission.

   b. Vertical or directional oil wells projected to a depth deeper than the Mission Canyon formation must be drilled on a governmental quarter section or equivalent lots, located not less than six hundred sixty feet [201.17 meters] to the boundary of such governmental quarter section or equivalent lots. No more than one well shall be drilled to the same pool on any such governmental quarter section or equivalent lots, except by order of the commission, nor shall any well be drilled on any such governmental quarter section or equivalent lots containing less than one hundred forty-five acres [58.68 hectares] except by order of the commission.

2. a. Horizontal wells with a horizontal displacement of the well bore drilled at an angle of at least eighty degrees within the productive formation of at least five hundred feet [152.4 meters], projected to a depth not deeper than the Mission Canyon formation, must be drilled upon a drilling unit described as a governmental section or described as two adjacent governmental quarter sections within the same section or equivalent lots, located not less than five hundred feet [152.4 meters] to the outside boundary of such tract. The horizontal well proposed to be drilled must, in the director's opinion, justify the creation of such drilling unit. No more than one well may be drilled to the same pool on any such tract, except by order of the commission.

   b. Horizontal wells with a horizontal displacement of the well bore drilled at an angle of at least eighty degrees within the productive formation of at least five hundred feet [152.4 meters], projected to a depth deeper than the Mission Canyon formation, must be drilled upon a drilling unit described as a governmental section, located not less than five hundred feet [152.4 meters] to the outside boundary of such tract. The horizontal well proposed to be drilled must, in the director's opinion, justify the creation of such drilling unit. No more than one well may be drilled to the same pool on any such tract, except by order of the commission.

3. a. Gas wells projected to a depth not deeper than the Mission Canyon formation shall be drilled upon a governmental quarter section or equivalent lots, located not less than five hundred feet [152.4 meters] to the boundary of such governmental quarter section or equivalent lots. No more than one well shall be drilled to the same pool on any such governmental quarter section or

equivalent lots, except by order of the commission, nor shall any well be drilled on any such governmental quarter section or equivalent lot containing less than one hundred forty-five acres [58.68 hectares] except by order of the commission.

b. Gas wells projected to a depth deeper than the Mission Canyon formation shall be drilled upon a governmental quarter section or equivalent lots, located not less than six hundred sixty feet [201.17 meters] to the boundary of such governmental quarter section or equivalent lots. No more than one well shall be drilled to the same pool on any such governmental quarter section or equivalent lots, except by order of the commission, nor shall any well be drilled on any such governmental quarter section or equivalent lot containing less than one hundred forty-five acres [58.68 hectares] except by order of the commission.

4. Within thirty days, or a reasonable time thereafter, following the discovery of oil or gas in a pool not then covered by an order of the commission, a spacing hearing shall be docketed. Following such hearing the commission shall issue an order prescribing a temporary spacing pattern for the development of the pool. This order shall continue in force for a period of not more than three years at the expiration of which time a hearing shall be held at which the commission may require the presentation of such evidence as will enable the commission to determine the proper spacing for the pool.

   During the interim period between the discovery and the issuance of the temporary order, no permits shall be issued for the drilling of an offset well to the discovery well, unless approved by the director. Approval shall be consistent with anticipated spacing for the orderly development of the pool.

   Any well drilled within one mile [1.61 kilometers] of an established field shall conform to the spacing requirements in that field except when it is apparent that the well will not produce from the same common source of supply. In order to assure uniform and orderly development, any well drilled within one mile [1.61 kilometers] of an established field boundary shall conform to the spacing and special field rules for the field, and for the purposes of spacing and pooling, the field boundary shall be extended to include the spacing unit for such well and any intervening lands. The foregoing shall not be applicable if it is apparent that the well will not produce from the same common source of supply as wells within the field.

5. If the director denies an application for permit, the director shall advise the applicant immediately of the reasons for denial. The decision of the director may be appealed to the commission.

History: Amended effective April 30, 1981; January 1, 1983; May 1, 1992; May 1, 1994; July 1, 1996; July 1, 2002; January 1, 2006; April 1, 2010; April 1, 2012.

General Authority
NDCC 38-08-04
38-08-07

Law Implemented
NDCC 38-08-04
38-08-07

North Dakota State University grants the N. D. Department of Mineral Resources, Oil and Gas Division, permission to adapt the November 1981 NDSU Extension Service publication “North Dakota Oil and Gas Leasing Considerations” for educational, non-commercial purposes.