



Underground, Out of Mind

Oil prices are edging higher. What about royalty streams? Many mineral rights owners are in the dark.

When Woody Guthrie penned “This Land Is Your Land,” he overlooked a hefty chunk of what was “made for you and me.” The wheat fields, the redwood forests — all well and good. But what about the bounty below the surface: the gold and silver, the oil and gas? Now it may well be that drilling and mining simply flew in the face of Guthrie’s aesthetic and political sensibilities. Or perhaps the singer discovered just how complicated mineral rights can be.

Even the basic issue of who owns what underground can be perplexing, in part because of the history of land

rights in the United States. “A hundred years ago a property’s surface rights and its mineral rights were usually controlled by the same person,” says Dick Sadler, national executive of the Oil, Gas and Minerals Group of U.S. Trust. “But today that’s actually the exception. One parcel of land may well involve dozens of mineral owners.” What’s more, he adds, “they all may have leased their rights to an oil and gas corporation.”

MOW LAWN. DRILL BOREHOLE?

Letting a drilling company do all the heavy lifting has long been standard practice. But this is not to say that

rights holders have it easy. Indeed, mineral leasing involves deeds and contracts that, as Sadler puts it, “can be extraordinarily complicated legal documents with certain clauses — royalty clauses and pooling clauses among them — that can change the mineral owner’s share of production dramatically. The documents can also identify multiple postproduction expenses, such as for compression, dehydration and transportation.” Each type of interest, moreover, has varying property rights and participates differently in the exploration process. Little wonder, as Sadler suggests, that some individuals struggle to understand

which kind of rights they own. (See the box next page.)

One particularly involved contractual relationship is the working interest. In contrast to a royalty contract, it obliges the rights owner to take into consideration certain expenses, such as drilling and equipment, as well as monthly operating costs. These are usually presented in an Authorization for Expenditure (AFE).

As Bob Maxwell, senior vice president and petroleum engineering manager with the Oil, Gas and Minerals Group, explains, “the AFE is a complex document that operators send out for certain well operations, such as drilling new wells or applying new technology to old wells. They prepare AFEs based on what their engineers propose regarding operations on the lease. For exploratory drilling, the goal is to find and develop the oil and gas reserves under a lease. For a lease that already produces oil and gas, the intent is to improve its profitability by increasing revenues or reducing operating expenses.” A full analysis of an AFE can

take time. “But under some joint operating agreements, nonoperating working interest owners may have as little as 15 days in which to choose to participate in an operation,” says Maxwell. “If they fail to respond in that time, they stand to lose the right to take part.”

As for royalties, any shortfall stands to be greater when oil, for instance, is at or near a price peak. During the past two years, the cost of a barrel of

global competition for resources is already intensifying. Over time, America seems almost certain to rely more heavily on domestic oil and gas production, alternative energy sources notwithstanding. And that will almost surely have an effect on energy prices.

MINING THE (MINING) DATA

Well-informed mineral owners are out there, says Maxwell, “yet over the years

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crude has fluctuated widely. In 2008 it hit a high above \$130, fell to \$30 for a while and then climbed again, to a mid range of about \$80 for much of 2009. At the end of the year, a barrel was going for \$76.¹ Keep in mind, of course, that these numbers reflect energy usage today. With China and India now modernizing in earnest,

we have found that a surprising number of rights holders are hard-pressed to answer a few important questions. Do you have a complete inventory of your interests? Are you getting paid for all the products from your producing properties? Are you getting a reasonable price for these products? What deductions are coming out of your royalty

Interests in Oil, Gas and Other Minerals

MINERAL INTEREST Ownership of the right to mine or produce all minerals – including hydrocarbons – beneath the surface of a property.

ROYALTY INTEREST Ownership of a percentage of production, or production revenues, made from leased acreage, bearing no cost of exploration, drilling, etc.

WORKING INTEREST Owners are obligated to pay a percentage of the cost of leasing, drilling, producing and operating a well or unit. After royalties are paid, the working interest also entitles its owner to share in production revenues with other working interest owners, based on the percentage owned.

NET PROFIT INTEREST A share of net proceeds from production paid solely from the working interest owner’s share. It is sometimes granted in lieu of a royalty interest.

OVERRIDING ROYALTY INTEREST Ownership in a percentage of production or production revenues, free of the cost of production, created by the lessee, company and/or working interest owner and paid by the lessee, company and/or working interest owner out of revenue from the well.

NONPARTICIPATING ROYALTY INTEREST Ownership in a share of production, paid to an owner who does not share in the right to explore or develop a lease or does not receive bonus or rental payments. It is free of the cost of production and is deducted from the royalty interest.

NET REVENUE INTEREST A share of production after all burdens, such as royalty and overriding royalty, have been deducted from the working interest. It is the percentage of production that each party actually receives.

stream?” No surprise, perhaps, that “all too many individuals — as well as foundations — simply cash their royalty checks with little or no awareness of how big the dollar amount should actually be,” says Sadler.

But it does not have to be that way. After all, most people with sizable stock and bond portfolios routinely hire professional managers to run them. They can certainly do the same for their oil, gas and mineral portfolios. And yet, both Sadler and Maxwell acknowledge, many are reluctant to do so. Why would that be? “Perhaps they are not sure what we do,” both managers say.

Sadler explains the role from his perspective. “We strive to help mineral owners by scrutinizing lease rights, contracts, projected oil prices and information from a database of well histories,” he says. “We have specialists on our staff, such as petroleum landmen, title analysts, division order analysts, geologists and petroleum engineers. We believe these professionals are essential to properly manage an oil, gas and mineral portfolio.”

“Without the proper expertise, clients may be losing a lot of money over the lifetime of a well,” Maxwell adds. “So we aggressively negotiate with the


oil and gas companies in order to obtain favorable terms for our clients. Beyond that, as part of Bank of America’s Specialty Asset Management (SAM) group, we can serve our clients even more effectively — by partnering with other SAM divisions, such as Timberland, Farm and Ranch Services and Real Estate.”

In other words, they can offer expertise above ground and below, in most states. From California to the New York Island and beyond. ■

By Ian Prior, U.S. Trust

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