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OIL AND GAS LANDOWNER ISSUES
MONTANA STATE UNIVERSITY
Presentation of December 20, 2006
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GENERAL COMMENTS

The key to a successful relationship as a mineral owner with your Oil and Gas lessee is an understanding of the Oil and Gas lease. While understanding your Oil and Gas lease takes some work, the general concepts and principals can be understood by anyone. The Oil and Gas lease is nothing more than a contract. Yes, it is a very specialized type of contract, but a contract nonetheless. It is necessary to understand and read the document closely. Most Oil and Gas leases are fairly straight forward. Understanding certain sections depend on comprehension of terms used in the Oil and Gas business. You will have to learn these terms, but again that is not too difficult. Ultimately, if you realize that the Oil and Gas lease is your ally and not your enemy, you are on the road to protecting your legal rights.

THE SIGNIFICANCE OF THE OIL AND GAS LEASE

The fundamental contractual instrument that conveys the rights to develop oil and gas resources, as well as virtually every other type of mineral, is the lease. As such affects members of this organization, it is almost uniformly the Oil and Gas lease that defines the rights of the developer of the natural resource (the

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"lessee"), on one hand, and the rights of the owner of oil and gas ("the lessor"), on the other[3].

The conveyance or transfer of Oil and Gas rights can only be made in a writing. Oil and gas rights can never be conveyed by mere oral agreement. The real property involved must be specifically identified. While legally there exists no prohibition of the outright sale of oil and gas interests to those in the natural resources development community, such sales in this context are extremely rare, although by no means entirely non-existent.

Oil and Gas leases by their very nature can be drafted in a wide number of variations. Many are as short as a single page, while others can be voluminous. No matter the length, the thrust of this paper will include focus upon four basic subjects traditionally addressed in an Oil and Gas leases: 1) What legal rights are being conveyed by the lessor to the lessee? 2) For what period of time are development rights being granted? 3) How will the lessor be compensated for the granting of these rights, including the royalty? and, 4) Under what circumstances will the Oil and Gas Lease be cancelled?

OIL AND GAS LEASE ORGANIZATION

Most Oil and Gas leases at the beginning include what is referred to as the granting clause. There is considerable variation in granting clause language. It is thus very important that the specific language utilized in the granting clause be scrutinized very carefully. The granting clause in the Oil and Gas lease identifies the rights that are being transferred from the lessor to the lessee. The granting clause specifies the types of uses permitted and the specific substances addressed by the Oil and Gas lease.

A review of a Oil and Gas leases reveal that there are often other types of mineral and natural resources rights being conveyed beyond that of merely oil and gas. For the purposes of this paper, it is obviously important to make sure that your Oil and Gas lease contains both the terms "oil" and "gas." While this may appear to be very self-evident, the law in virtually every jurisdiction is that if rights to a given mineral or natural resource are not specifically conveyed, they remain with the lessor. Accordingly, if a type of mineral is reserved by the lessor (for instance, sand and gravel or gold), while the lessee under an Oil and Gas lease can still drill and otherwise develop

[3] (The lessor is also referred to as the grantor and the lessee is often referred to as the grantee. For the sake of uniformity, this paper will utilize only lessor and lessee, although grantor and grantee are equally acceptable).

the oil and gas resources, they cannot conduct exploration or extraction of any other minerals not specifically transferred. The granting clause thus identifies precisely what is being conveyed to the lessee.

OTHER SIGNIFICANCE OF GRANTING CLAUSE

However, the granting clause addresses more than merely what is being permitted to be developed. The granting clause typically also addresses the specific activities that can be conducted on the land in question. The granting clause will identify how resources can be developed, produced, and marketed. It is important to recall that with emerging technology and because of the potential duration of these leases there might be confusion. With the emergence of technology, resources that cannot be developed today might be subject to extraction in the future.

By way of one example only, in Colorado, Utah, and Wyoming shale oil resources and the conversion of shale into oil have been well known for well over a hundred years. In fact, oil has been already produced from shale for an extensive period of time. However, the cost of producing oil from shale has been so historically prohibitive that despite the abundance of oil shale, economics have made it unprofitable to produce oil from shale in a cost effective fashion. That is not to presume that in the immediate future as a result of development of improved technology it may be entirely possible to produce oil from shale in a cost effective and profitable fashion.

Accordingly, it is very important to pay close attention in drafting the language of the granting clause to consider the location, development, production, and marketing of the leased substances. The specific natural resources and minerals that we consider at the time of executing an Oil and Gas lease should include thoughtful consideration of events that may transpire in the future.

THE DOMINANT AND SUBSERVIENT ESTATE

Because the granting clause addresses the development of Oil and Gas interests, it is also important to note this development of Oil and Gas interests by its very nature involves consideration of what lawyers refer to as dominant and subservient estates of the land itself. This concept of land use is very counterintuitive. Many land owners incorrectly presume, particularly in instances where real property has been used in a certain way for generations (for example: ranching), that it is the surface user and not the mineral owner that has priority pertaining to the use of the land. In fact, the surface user

does not have the priority, also referred to as the dominate estate. It is the developer of the Oil and Gas resource that possesses the dominate estate and not the surface user. Hence, if there are two competing proposed uses of the same land between the surface owner and the mineral owner, the mineral owner (the lessee) prevails.

One may ask why the surface user has only the subservient estate. Although the answer is not exactly the same for every state, the simple answer is that the forefathers of virtually state placed a premium on the development of natural resources. In many states, severance taxes and other mineral related taxes were and even today are significant financial resources to the government. These oil and gas ventures also create a multitude of jobs. Particularly during the periods of time when our law was evolving through both the legislature writing laws and the judiciary interpreting the laws, the governmental priority has always emphasized creating a financial and legal environment whereby the development of natural resources would be encouraged. Through the course of time, it has always been the lessee developing the Oil and Gas interest that has received priority as to land use. Accordingly, although each state varies slightly in their interpretation of the law involving the use of property in developing Oil and Gas resources, it is almost universal that it is the lessee that has the ability to reasonably use the surface of property to develop of oil and gas. While it is true that the lessee in most instances will be required to pay for any damages caused by its operations (for instance, crop damage) it is almost always the case that it will be virtually impossible to stop the development of oil and gas on a given leased property.

RULES OF INTERPRETATION

It is also important to understand that there exist many rules of interpretation pertaining to contracts. An Oil and gas lease is merely a specific type of contract. One of the most significant rules of legal interpretation involves the emphasis that the law places on drafting documents in a clear and unambiguous fashion. All contracts are interpreted such that any ambiguity in a contract is interpreted against the person who drafted the contract. The question of who drafted the contract can often become a disputed issue of fact (as too the issue of whether a clause or term is ambiguous), but the reality is that the vast majority of all Oil and Gas leases are drafted by either landmen representing oil and gas companies or their attorneys. It is very unusual and almost unheard of that a landman will come to a prospective lessor and ask the landowner to draft an Oil and Gas lease.

THE PRODUCER'S 88

In the southwestern and western United States, many Oil and Gas leases are a variation of what is referred to as a "Producer's 88 lease." The term "Producer's 88 Lease" actually refers to a vast number of variations an Oil and Gas lease that has been in place for well more than 50 years. The significance is that all of these "Producer's 88 Leases" tend to be organized almost identically and always are biased toward the benefit of oil and gas lessees, not lessors.

EXAMPLES OF AMBIGUITIES

What otherwise might appear to be a rather simple issue of interpreting the terms of a granting clause can become very complicated. An example of this includes even the term "Oil and Gas" itself. Does "oil" include "casing head gas" produced with the well? If so, is such a "gas" or is it an "oil." Does the term "gas" include "condensate" which is formed as the gas stream is brought to the surface of the land? If so, is this correctly categorized as a "gas" or an "oil"? Does the term "gas" include non-hydrocarbon gases that often have commercial value such as carbon dioxide or helium"? Does the term "gas" include non-hydrocarbon constituents of the gas stream, an example being sulfur? Does the term "gas" include methane gas produced from a coal seam?

The potential issues created in the interpretation of the granting clause are endless. One obvious way to address these issues of interpretation would be to specifically define every term in the Oil and Gas lease. Unfortunately, few, if any, Oil and Gas leases, define these terms. Further, the attempt at defining these terms often results in as much, if not more, confusion than in not providing definitions. Because defining terms in a contract often creates more disputes than drafting definitions in the Oil and Gas lease, these type of disputes as to interpretation are typically resolved by definitions commonly used in the given industry, statutory law (to the extent statutory definitions exists in any given state) or case law where judges define a term. In an imperfect world, the key is to not try to necessarily solve every possible drafting problem in advance, but rather to be aware of the potential problem areas so as to be proactive if a problem does ultimately arise.

IMPLIED TERMS AND COVENANTS

Ambiguity exists not only pertaining to the actual words used in an Oil and Gas lease, but also in interpreting entire sections of the lease itself. To minimize ambiguity as a result of omission,

Oil and Gas leases contain not only explicit terms, but implied terms as well. There exist three broad covenants implied in an Oil and Gas lease: 1) the covenant to develop the premises; 2) the covenant to protect the leasehold; and 3) the covenant to manage and administer the lease. In addition, while it is the granting clause that typically addresses easements and related rights of the lessee as well as the resulting burdens of the lessor's land, it is often the case that an Oil and Gas lease will be silent as to these issues instead relying upon implied covenant as to the right to use the leased land.

Implied terms include the implied right to make reasonable use of the surface to explore, develop, and produce the granted minerals or natural resources. Unfortunately, "reasonable" is often in the eyes of the beholder. There are many land use conflicts that specifically involve what is and what is not reasonable. Reasonable use is easy to determine in obvious cases. Reasonable uses include activities necessary to explore, develop and operate oil and gas wells. Reasonable use includes the right to use substances associated with the surface to develop the mineral estate (for example, drilling for water).

As to uses that are not reasonable, it is never reasonable use to utilize more of the surface than necessary, to unnecessarily impair the use of the surface, to use the land in a manner that unnecessarily damage the surface, or use the land to support operations to develop other properties not part of that specific oil and gas lease. The placement of a well in the middle of a rancher’s prime grazing land may or may not be reasonable based upon other numerous criteria.

GEOPHYSICAL AND SEISMIC ACTIVITIES

There also exist a whole host of issues involving exploration activities including geophysical exploration and seismic activities. Often, the Oil and Gas lease in the granting clause does not establish whether or not these activities are permitted. It is frequently less than clear as to whether or not the lessee has the authority to conduct seismic operations on the leased land, whether the lessor retains the right to grant the authority to parties other than the lessee, whether the lessee has a right to transfer the rights to conduct such seismic or other geophysical operations and, if so, who actually "owns" the resulting data. A well written granting clause typically will specifically permit all techniques to locate oil and gas, including seismic operations. However, as oil and gas exploration becomes more intensive, there exists an ongoing dispute as to whether or not a lessor independent of a

specification in a Oil and Gas lease can contract with a third party to conduct seismic activities.

THE HABENDUM CLAUSE

It is the Habendum Clause that defines how long the interest granted to the lessee will extend. Most Oil and Gas leases provide for a primary term (the option period that establishes the period of time during which the lessee retains the right to explore, develop, and produce as to the leased property without further obligation to do so) and the secondary term (an indefinite period of time during which oil and gas is actually being produced in paying quantities). It is failure of the lessee to perform consistent with the deadlines in the habendum clause that often results in termination of the lease.

PAYMENT

Finally, issues often arise as to payment. The payment received at the time of the execution of the Oil and Gas lease is rarely an issue. The amount of royalties received can be a very contentious issue because unless the term cost is well defined, there can be significant issues as to whether the amount of money received in the royalty check by the lessee is consistent with that agreed to in the Oil and Gas lease. Even when the term cost is well defined, there can be a host of accounting and bookkeeping issues.

LEASE TERMINATION

A classic tension in Oil and Gas leases exists under circumstances where the primary term of the term has ended with no production, but the oil and gas lessee wants to keep the Oil and Gas lease in effect. It is common sense that what the lessor is ultimately looking for out of its contractual relationship is the production of either oil or natural gas so as to benefit from the royalties, which can be lucrative. On the other hand, lessees often have large inventories of other oil and gas properties and merely because the lessor has not successfully discovered oil and gas reserves on a given property during the primary term of the lease is not indicative in any fashion that the property is not valuable for future development. Development can be delayed because of time and effort being spent by the lessee on other fields or projects. The lessee might be waiting for the development of natural gas pipeline infrastructure before drilling on the property in question. There is an endless list of causes of delay. One circumstance currently causing delay is the shortage of drilling rigs. While there is ample capital available for oil and gas drilling, a significant constraint

currently delaying development is that there are more drilling projects than available drills.

EXPIRATION OF THE PRIMARY TERM

By and large, the most frequent cause for lease termination is the expiration of the primary term. If the primary term of the Oil and Gas lease as set forth in the habendum clause expires without any production in paying quantities and there are no operations being conducted as to the Oil and Gas lease in question at that time, the Oil and Gas lease terminates.

At times, this is a very confusing period because unlike the beginning of a contractual relationship when an Oil and Gas lease is signed and the commencement date is well memorialized, the expiration of the primary term often occurs with little fanfare or notoriety. As set forth below, if you believe that your Oil and Gas lease has terminated, write your lessee and request a recordable Release of Lease.

FAILURE TO PAY DELAY RENTAL

An Oil and Gas lease may also terminate as a result of a failure by the lessee to pay delay rentals or shut-in payments. A word of explanation is warranted. The objective of the lease drilling-delay rental clause is to clarify that the lessee has no affirmative obligation to drill or otherwise explore during the primary term. This clause eliminates any argument that there exists an implied obligation on the part of the lessee to test, let alone drill, upon the premises in question. Before drilling-delay rental clauses became commonly used in Oil and Gas leases, many courts held unless specifically referenced otherwise in an Oil and Gas lease, the lessee has an implied duty to drill a test well on the leased premises within a reasonable time after the execution of the Oil and Gas lease. The logic for this was that there existed an implied covenant to drill that constituted consideration for the signing of the Oil and Gas lease by the lessor and that there thus existed an affirmative expectation that the property would be tested within a reasonable time.

The utilization of the drilling-delay rental clause eliminated any implied covenant to drill a test well because such was now specifically referenced otherwise. Hence, in lieu of actually drilling, or lessee can instead elect to pay delay rentals. Lessors do not generally resist drilling-delay rental clauses because, often, they enter into Oil and Gas leases expecting any development to occur, if ever, near the end of the primary term. Courts typically hold lessors to a standard of strict compliance pertaining to the payments of delay-rentals. Courts typically

have held even minor shortages or delinquencies in payments of delay rentals to result in the termination of the Oil and Gas lease. Payments made late by mistake or not made fully made by mistake will result in termination.

THE SHUT-IN ROYALTY CLAUSE

Along similar lines, most modern Oil and Gas leases also contain a shut-in royalty clause. This provides that the Oil and Gas lease will be maintained if a well capable of production is "shut-in." Here, oil and gas has been discovered and successfully drilled, but is not being produced and is said to be "shut in". A shut-in royalty clause provides for constructive production, typically in the form of a shut-in royalty payment. The effect of the shut-in royalty clause is to provide a substitute for actual production as otherwise provided under the habendum clause. Failure to make a full and complete shut-in royalty payment is likely to result in the termination of the lease, particularly in states that follow the majority rule that "production" (as that term is used in the habendum clause) requires actual production in paying quantities.

FAILURE TO PRODUCE IN PAYING QUANTITIES

A third significant area resulting in the termination Oil and Gas leases involves the failure of the lessee to produce in paying quantities. Oil and Gas leases require "production in paying quantities" for the Oil and Gas lease to continue to be in effect after the primary term expires. Continuous operations extend the life of the lease indefinitely after the conclusion of the primary term, but only to the extent that the production is in paying quantities. Often it is fairly easy to determine whether or not there is production in paying quantities. If as the lessor you continue to receive royalty checks, such is a strong indication that the condition of production in paying quantities is being satisfied. If you were once receiving royalty payments and royalty payments are suddenly not being received, such is an indication that this topic ought to be investigated immediately.

DOES FAILURE TO PAY CORRECT AMOUNT RESULT IN OIL AND GAS LEASE TERMINATION?

Often the question is asked as to whether or not the failure to pay all royalties due under an Oil and Gas lease will result in the termination of the Oil and Gas lease. It is often the case that money is being received by the lessor, but because there exists an issue as to what are legitimate costs subject to deduction there soon occurs a dispute as to whether full payment of royalties was tendered by the lessee. Depending upon one's

theory of recovery, a breach of contract can result in the termination of the Oil and Gas lease. Overwhelmingly, the result is not termination, but damages. The remedy for default is damages defined by the actual amount due minus the amount paid, plus interest. Generally, Court's are reluctant to terminate leases for two reasons. Firstly, the structure of the Oil and Gas lease language typically does not lend itself to such interpretation. Secondly, the payment of the disputed monies plus interest makes the lessor whole. However, if your Oil and Gas lease contains terms that permit the termination of an Oil and Gas lease, such is a possible remedy.

DRY HOLE ISSUES

The final circumstance where an Oil and Gas lease may terminate is a failure to produce a well in paying quantities within a stated time after drilling of a dry hole. Typically, a lessee will be allowed to continue the Oil and Gas lease after the primary term has elapsed by conducting what is referred to as "continuous operations." If prior to the conclusion of the primary term drilling has commenced, the lessee will have an opportunity to continue to move forward with exploration even though there has not been any production at the time of the expiration of the primary term. If later drilling on the leased property is successful, then a lessor would be looking forward to the receipt of royalties in the immediate future. However, where drilling is commenced at the very end of the primary term and the primary term has already expired prior to the conclusion of drilling that results in a dry hole, the lessee will continue to maintain a grace period in which to commence drilling another well if the lessee wishes to keep the Oil and Gas lease in effect. Under virtually all interpretations of the Oil and Gas lease, the lessee can continue to drill wells indefinitely under the "continuous operations" term of the Oil and Gas lease.

Typically, one of two things happens when drilling continues after the primary term, one good and one bad. The best case scenario for all involved is that a well ultimately is successful in producing paying quantities of oil and gas so the lessor receives the benefit of a royalty check. The other alternative is not so good. Under the latter alternative, either the lessee loses interest in the property or the lessee simply runs out of money. Either way, no well in producing paying quantities results.

In the second event, the Oil and Gas lease terminates. Whether the lessor will be successful in contracting with another future lessee willing to conduct other drilling exploration on the same property is, of course, unknown.

WHAT TO DO IF YOU BELIEVE YOUR LEASE TERMINATED

If you believe that your lease has terminated, write your lessee and request a recordable Release of Lease. (A form is attached hereto.) If you receive an executed Release of Lease signed by the lessee, immediately record that document in the county records where the minerals and the leased property are physically located. This recordation will provide notice to all third parties that the Oil and Gas lease in question has terminated and the property is in such a condition to lease your property again. Always make sure to send the request for a recordable Release of Lease by certified mail, return receipt requested, or some other form of delivery where you can maintain proof that the document was received (for example, UPS or Fed Ex). If you do not receive a response in approximately 15 days, document the same with follow-up type letters, also sending these by either certified mail, return receipt requested, or other form of delivery that can be proven. Keep copies of all documents sent or received. If you receive no response whatsoever, contact an attorney or independent landman versed in Oil and Gas law to make certain that the leased interests are officially terminated.

CONCLUSION

Production of oil and gas is a business. It is very important as the lessor of oil and gas interests to make sure that you are treating your economic interest with the same professionalism as your lessee. Although such might be obvious, it always bears repeating that the property owner should make certain that he knows where his Oil and Gas leases are. It is my recommendation that individuals place these documents with other important legal documents such as wills, real estate deeds, etc. We are often amazed at how frequently our clients do not even know where their oil and gas documents are located.

In addition, it is important to have a working understanding of your Oil and Gas lease. Although not part of this presentation, it is also important to have a similar working understanding of any Surface Use Agreement. Our definition of a working understanding is not necessarily the same as the detailed understanding that one would expect of a lawyer who emphasizes oil and gas law in his or her practice. A working understanding would, however, be an understanding as to the basic terms and conditions of the most significant portions of your Oil and Gas lease. If specific issues arise, mastery of those details can be secured at that point in time. Every Oil and Gas lessor should at least be able to be conversant as to the general principals of their lease and should calendar the important deadlines and

understand the computation of compensation to which they are entitled.

THE SPLIT ESTATE

Prior to explaining specifics as to typical terms and conditions of an Oil & Gas Lease or a Surface Use Agreement ("SUA"), it is important to first understand the unique nature of the split estate as it exists in Colorado and, indeed, throughout most of the western United States.

Initially, it is important to understand some basic terminology. There exists in law what is referred to as the dominant estate and that of the subservient estate. As one might guess, the dominant estate takes priority over the subservient estate.

It is this general characteristic of dominant and subservient estates that at first confuses many people as it pertains to mineral rights. Colorado, and again most of the western United States, permits the severance of estates. For the purposes of this discussion, the two estates are referred to as those involving surface rights and mineral rights. It is important to understand that the owner of property can sell the surface rights to his property, but retain or otherwise convey to another third party the rights to the minerals. This type of transaction causes what initially is described as a unified estate to become severed. The mineral estate is said to be severed from the surface estate. These mineral rights include, when properly drafted, the rights to oil, natural gas, and many minerals, including, but not limited to coal, copper, etc.

It is the nature of these split estates that creates the dominant and subservient estate. Because both federal and state laws have always encouraged mineral and natural resource exploration since Colorado statehood in 1876, it is the mineral estate that is deemed to be dominant over the subservient surface rights. This means, in the simplest terms, that is the owner of the mineral rights that has reasonable access to the surface of the property so as to explore and develop mineral rights. Accordingly, the owner of the mineral rights has an absolute right to reasonable use of the surface to explore and develop said mineral rights, even in the event that the surface right owner has no interest in the development of such mineral rights or objects to exploration or development of the same.

Sometimes, it can be a bit confusing as to whether or not the mineral rights have been severed from that of the surface rights. Like many real property rights, this severance of mineral rights cannot be done by oral agreement alone. If you believe that the

property that you own or may purchase does not itself include mineral rights, the first place to look would be the Title Insurance purchased at the most recent time the property was conveyed. Unfortunately, in many instances title companies were not used at the time the property was conveyed and there was never title insurance secured as to that given property. Hence, no Title Commitment is available. In other instances, property rights were so long ago acquired that the underlying title abstracts are no longer available for common examination. As such, it might be necessary to secure the services of legal counsel or landsmen to conduct a title search as to the mineral interests. This title search can be conducted at the Clerk and Recorder's office of your local county government. Always be certain that you are in possession of accurate information as to the ownership of mineral rights for your property before beginning to negotiate any lease or SUA.

It is also important to understand that merely because the mineral rights are dominant to the surface rights does not mean that the beneficiary of such mineral rights has unfettered and unilateral discretion to impose upon the surface in any way they see fit so as to explore and develop mineral resources. While it is true that the mineral owners have a right to access, this right must be seen as collaborative in nature and customarily is subject to negotiation. The result of successful negotiation between the surface owner and operator as to these rights is the SUA.

THE SURFACE USE AGREEMENT

The SUA is also sometimes referred to as a Surface Damage Agreement ("SDA") or Surface Use and Damage Agreement ("SUDA"). These differences as to the name of the document are more semantic than substantive in nature and each are typically negotiated by the surface owner and a company representative, often a landman. No matter the name, SUA's in practice are an evolving document. An SUA that was negotiated ten years ago often will not adequately address all the issues currently being presently considered.

As an aside, never be shy to discuss the terms and conditions of any proposed SUA with your neighbors, your local conservation district representative, or even representatives of your local oil and gas conservation commission. If nothing else, you will quickly learn that which is reasonable and customary in your area. Please also recall that the by-word of this entire process is "negotiation". It is important not to be shy when you negotiate. This is not to suggest that it is appropriate to be overly aggressive in setting forth suggested terms and

conditions. On the other hand, those experienced in these negotiations realize that it is important to stand your ground.

Some landmen and other company representatives, although certainly a vast minority, rely upon intimidation tactics and threats in an attempt to pressure individuals or entities to execute an agreement that is not favorable to their interests. Never take such an approach personally if you experience that tactic.

The following is a preliminary outline of issues to consider when negotiating an SUA:

1. Make sure that you are working with an experienced individual with knowledge as to important issues and preparing SUA's. While it not always necessary to retain an attorney, make sure that you are, at a minimum, working with an experienced landman or other individual that understands and is conversant as to SUA's.

2. Make certain in advance of starting negotiations that surface water rights (including reservoirs and diversion systems) and ground water rights (including springs and wells) are documented by appropriate permits or other legal decrees so that there is no dispute as to ownership of the surface water rights in question are yours. Without digressing too substantially, water rights in Colorado are essentially that of appropriation, not riparian nature. This means that merely because water is located on your property or runs through your land does not mean that you possess any rights to these waters.

3. Make sure that the entity that will be actually drilling on your property has a Water Management Plan ("WMP") and, as appropriate, access to a Water Shed Management Plan (addressing drainage on your property, not necessarily drainage of the entire drainage basin). These documents will permit for a better understanding of water related issues that might impact your property.

4. When negotiating access rights, make certain that you are not merely addressing access to the property in question as a whole, but rather access to each potential well specifically. While it is common that only a single well will ever be drilled on your

property, concerns in the event that multiple wells are drilled need to be
thought out thoroughly in advance.

5. Address trans-boundary issues (i.e. impacts experienced on other properties resulting from development which occurs first on your property) that include, by way of illustration, water trespass, dust, noise, artificial light, and the like that may effect not only yourself, but your immediate neighbors. There exist a wide array of exploration and development activities that occur on your property first. It is necessary, particularly in the event that the surface owner does not actually reside upon or actively utilize their property, that they consider a "good neighbor" policy considering the rights of others, particularly those that are down stream or down wind of exploration activities.

6. As alluded to above, never hesitate to visit with your neighbors to determine the current and customary SUA terms and conditions being utilized in your area. You may find that what you believe to be customary is anything but the case.

7. Always keep in mind that some of the impacts from exploration and development do not become apparent for several years; sometimes many, many years. Make certain that your SUA provides significant latitude in addressing such future issues. For instance, the impact on water wells might not be experienced for years. Make sure to address testing as to the quality and quantity of water. Please also be aware that in the event producing quantities of oil and gas are located your property, the producer will not be expected to be responsible for the normal aging and wear and tear on facilities.

8. Understand in advance that the SUA is not "magic wand" so that every conceivable future problem of the exploration and development of oil and gas on your property will be addressed. Unfortunately, such simply is not possible. This is especially true with the impressive advancement of technology. That being said, a good SUA will address a wide variety of issues that typically arise between the producer of oil and gas and the surface owner.

9. Lastly, retain a good professional to assist you with all these considerations.

Please recall that these recommendations are not in any fashion meant to be comprehensive. No mention is made of perhaps the key issue, financial compensation for use of the surface or damages if the property is injured. Additional areas of concern include, but are not limited to, those involving surveyors, seismic activities, debris and trash, operations in mud and snow, water protection, soil protection, noise pollution, light pollution, air pollution, protection of view corridors, protection of vegetation resources, protection of wildlife resources, lost to livestock, cooperation with others as to roads and water storage, drilling operations and details thereof, impacts upon recreational uses, issues pertaining to reclamation, parking of equipment off-road, access points into areas of development, time of operations, limitations on operations, cooperation with other companies, changes in locations of roads, electric lines, and wells, cooperation and coordination with other governmental agencies, legal concerns, allocation of attorneys fees and costs in the event of breach, financial issues, damages, introduction of pipelines, compressor stations, above ground electrical lines, below ground electrical lines, service access points, and road maintenance. Those familiar with negotiating SUA's will be able to readily determine which issues impact your property.

BENEFITS OF NEGOTIATING A SURFACE USE AGREEMENT

The main benefit of entering into an SUA is that such provides an executed legal document setting forth with specificity issues and agreements thereupon. In advance, both the surface user and the development company know that if the company does not adhere to the terms and conditions of the agreement, they can be taken to court and if the surface owner prevails, the development company will typically will have to compensate the surface owner for attorneys fees and costs reasonably incurred in enforcement of the SUA.

Without an SUA, the operator still has the right to post a bond and unilaterally decide what is reasonable and necessary use of the surface. Under those circumstances, the remedies of the surface owner include litigation which is no doubt lucrative for your legal counsel, but not profitable to the surface user. Recovery of attorneys fees under these circumstances can be very difficult.

Furthermore, the negotiation of an SUA is an opportunity to focus upon issues that are important to any given property. By way of example, a surface use owner recently represented by this firm was involved in guide and outfitting operations on his property during each fall. During those weeks, it was essential that the

oil and gas developer was not on the property. Because this was a priority to that surface owner, it was identified as an issue. A compromise was reached that allowed oil and gas development to advance, on the one hand, but that successful guide and outfitting could also occur.

DRAW BACKS OF ENTERING INTO AN SURFACE USE AGREEMENT

It is almost universal that the right to claim damages for trespass upon unreasonable use of the surface is waived as a term and condition of an SUA. There are also instances where the amount of money being paid by the development company to the surface owner to enter into an SUA *vis a vis* the written concessions allowed the land user as so small that the surface user might benefit from refusing to execute an SUA.

Lastly, as referenced above, SUA's simply are not perfect written documents. No matter how much time and effort is spent in negotiating the same, it is very frequently the case that it is impossible to foresee each and every potential contingency that may occur in the future, particularly when it is sometimes the case that problems arise years after the SUA is entered into. Particularly with expanding and improving technology, many issues might exist that simply could not have been foreseen at the time the SUA was entered into.

OIL & GAS LEASE

While a surface owner should always negotiate a SUA with an operator, if you own even a fraction of the mineral rights beneath your property you will also need to negotiate an oil & gas lease. Many leases are negotiated by a landman on behalf of an oil & gas operator or by an independent landman who then sells the lease to an operator for a share of the profit. Terms of a lease deal with the financial obligations of the Lessee, such as the bonus payment, royalties in the case of production, rentals and shut-in rentals. Leases also include clauses expressing a Lessee's right to pooling, unitize and/or combine your lease with surrounding leases and both parties rights to sell, assign or transfer their interest in the lease or property, along with additional terms.

Leases are normally negotiated prior to or simultaneously with a SUA and should always be a separate contract. Occasionally, landmen prefer to include surface use conditions in the lease and forgo the SUA. Combining all terms in the lease creates complications and problems if disputes arise between the parties during the lease period. We recommend to both our operator and property owner clients that a separate contract be negotiate for

the surface and mineral property to keep the terms of use clear to all parties.

The most common form of lease offered to mineral owners is called a "Producers 88", it is a cookie cutter lease that is written to benefit the Lessee and his interest. Though it is not the intention of this paper to explain the pit falls of the Producers 88 lease it is worth noting that no lessor should sign a Producers 88 lease without first consulting with legal counsel. The most important things for a property owner to remember if you do own all or a portion of the minerals beneath your property is to:

1. Never be pressured into signing anything without carefully reading it and consulting with an experienced professional. Many landmen lead property owners to believe that the lease needs to be signed immediately and that the terms are non-negotiable, which is rarely the case.

2. If you own the surface and a portion or all of the minerals beneath the surface be sure to negotiate a SUA and lease as separate contracts. A Producers 88 lease generally addresses a few common surface use terms, such as well placement, crop damage, pipeline placement and depth, and lessee right to use water, gas or oil from the premises. However, the surface use issues addressed in a producers 88 do not sufficiently address all of the issues that need to be addressed for a piece of property where the primary residency is or where an income is made off of the land. In addition to surface use issues being sufficiently addressed it is important to create a separate SUA for clarification of the purpose of the contracts. A lease is to transfer the rights to develop minerals and a SUA is to define acceptable use of the surface of the property.

3. Make sure that any lease that you sign comprehensively addresses the uses of your property and does not have any ambagious language. The best way to assure that the lease you have negotiated is legal sound is to have, at a minimum, have an experienced professional review the lease prior to signing.

CONCLUSION

Although imperfect, it is almost universally the position from the point of view of both surface owners and those in the oil and gas industry that it is better to attempt to meaningfully address

issues in advance and successfully negotiate an SUA than to "fly blind" and hope for the best. Enforcement of legal rights is more expensive and time consuming than negotiating contract terms and, in the even of default, enforcement can be very costly. It is almost always the case that entry into an SUA is far more beneficial than no such agreement.

MONTANA LAW

The Montana legislature created the Montana Board of Oil and Gas Conservation ("MBOGC") as a consequence of the Montana Oil and Gas Conservation Act. This Board has seven members, three of whom must be selected from the oil and gas industry with two representatives consisting of land owners residing in so called oil or gas producing counties in Montana. It is the mandate of the MBOGC to, among other things, prevent waste of oil and gas related resources, encourage the maximum and efficient recovery of natural resources and the protecting of mineral owners' rights to recover a fair portion of the wells resulting from oil and gas extraction.

The MBOGC has the authority to take appropriate measures to prevent the contamination of and damage to the contiguous land resulting from oil and gas drilling operations. The mandate is quite broad and the power of the MBOGC includes, but is not limited to, the regulating of the disposal of produced salt water (referred to as "brine water") and the disposal of all waste matters commonly found in the oil patch. Under Montana law, there may be no oil or gas exploration, development, production or disposal of waste until the MBOGC first issues a drilling permit. The State of Montana has also developed special rules as to coal bed methane development, including the drilling of wells in the Powder River Basin Controlled Groundwater Area.

Montana has also followed the direction of the federal government in passing the Montana Environmental Policy Act. This requires state agencies to complete an environmental analysis along the lines of Environmental Impact Statements similar to those required under the National Environmental Policy Act ("NEPA"). The Montana Board of Environmental Review has also passed Rules and Regulations to control pollution attendant to oil and gas development. One of the more controversial Rules adopted by the Montana Board of Environmental Review essentially bans the discharge of coal bed methane water with high SAR and EC values into any Montana waters so as to prevent any significant water quality degradation.

Montana counties and municipalities also possess authority to adopt local ordinances and zoning regulations necessary to

promote the general welfare of their citizens. Interestingly, only Gallatin County has ever adopted such regulations for oil and gas. It is important to understand that Montana law vests great discretion with the MBOGC as to industry regulation. There are specific limits on "home rule" and other local regulations that can be promulgated. Specifically, Montana law excludes and prohibits local governments to pass or adopt any resolutions or rules that prevent the complete use, development, or recovery of any mineral, forest, or agricultural resource thereby eliminating governmental competition as to the regulation of the same as specifically invested in the Montana Board of Oil and Gas Conservation. This does not result in an absolute preclusion of all local regulation of mineral processing or extraction. Local governments may impose reasonable conditions and application approvals. However, land use and zoning related ordinances must allow effective utilization of mineral resources. In exceptional circumstances so as to focus upon emergency measures to promote public health, safety, moral and the public welfare, counties may adopt interim zoning or other regulations, excluding the step of absolute moratoriums on mineral development, so as to protect the general population. With more aggressive development of coal bed methane development, Gallatin County found itself as creating legal tests to determine what was and what is not acceptable local regulation.

Gallatin County was presented an application from J.M. Huber seeking a Conditional Use Permit that would have allowed that company to drill an exploratory coal bed methane well east of Boseman in the Bridger Canyon Zoning District. The Conditional Use Permit was approved, but included a long list of specific conditions that J.M. Huber believed to be unacceptable and contrary to efficient oil and gas development. J.M. Huber contested this in both State and Federal Court. Although there existed many theories pertaining to this litigation, J.M. Huber took the position that the conditions imposed by Gallatin County constitute a "taking" of their mineral rights for which compensation was required.

In 2002, Gallatin County also invoked its emergency powers establishing a two year interim emergency zoning district. This District prohibited any development of oil and gas. Areas with significant coal deposits deemed to have high potential for development were included. None of these areas were previously part of any zoning district and were not distant from the Bridger Canyon Zoning District that was the subject of litigation with J.M. Huber. Gallatin County further declared a moratorium on all permits for oil and gas wells in this emergency district such that during the moratorium period no development could occur. During the period of the moratorium, Gallatin County worked closely with the Sonoran Institute so as to develop a permanent Zoning District with established new standards for oil and gas

development in the area. Ultimately, J.M. Huber relinquished four coal bed methane leases in this area.

GEOPHYSICAL EXPLORATION IN MONTANA

As set forth above, there exists strict statutory regulations pertaining to the oil and gas development process. Any person or firm planning to conduct geophysical exploration, which includes seismic, gravity or magnetic testing, must first secure a geophysical exploration permit issued by the County Clerk and Recorder in the county where the development is being considered. Montana Code Annotated, Sec. 82-1-101 The first part of the application process is the filing of a Notice of Intent, again with the Clerk and Recorder, in each county in which the exploration will occur. The Montana Secretary of State's Office requires the designation of an authorized resident agent as a point of contact in the case of any legal action related to the exploration, much akin to a registered agent for a corporation. A Surety Bond must also be filed with the Secretary of State to indemnify property owners against potential property damages resulting from any such exploration. See Montana Code Annotated, Sec. 82-1-102 through 104.

Once a Surety Bond has been filed, the County Clerk and Recorder must issue an Exploration Permit. This is valid for that calendar year. The County Clerk also must forward a Notice of the application to the Montana Board of Oil and Gas Conservation. It is the responsibility of the MBOGC to advise the Clerk's office whether or not the applicant is in compliance with all applicable laws and rules. Prior to commencing any operations in furtherance of such exploration permit, the permit holder must notify the surface users of the land of the scheduled exploration activities. The surface user is responsible for providing the applicant with the name of a contact person. Written permission from the surface owner is required to discharge explorative shot holes within a proscribed distance from certain existing structures and water features. Within three months after any firing of shot points and seismic exploration, the permit holder must file a report with the County Clerk and Recorder. Shot holes must be plugged as specified by the MBOGC unless otherwise agreed between the surface owner and the exploring entity. When exploration is complete, the land surface must be restored. Exploration crews operating in the state must comply with crew identification requirements established by the MBOGC. See Montana Code Annotated, Sec. 82-1-101 through 108.

TYPES OF ACTIVITIES REGULATED

A Notice of Intent to explore and drill for oil and gas, including coal bed methane, on not only private, but state lands, must first be filed with the MBOGC. Permits to drill are first

required. Any wells must comply with spacing units and be operated in compliance with the MBOGC regulations, as well as with established existing pooling orders. Operators must comply with many other regulations, including those of the Montana Department of Environmental Quality and their specific water discharge regulations. Water quality permitting issues are themselves closely regulated. Interestingly, if water discharged from a well is itself put to a beneficial use, appropriation must be approved by securing a permit from the Montana Department of Natural Resources and Conservation. See Montana Code Annotated, Sec. 82-11-101, *et seq.*

Any Notice of Intention to Drill must include information specifically identifying the specific area in which the proposed activity will occur. So as to ensure compliance with state regulations, well logs must be kept and filed with the MBOGC. Any surface lands disturbed by exploration must be restored. All fresh water supplies must be protected. Wells must be drilled, cased and operated in accordance with MBOGC rules. At the conclusion of the economic life of any drill site, such must be adequately plugged. So as to avoid abandonment, a bond must be first posted to guarantee proper treatment of the well site after drilling. It is important to emphasize that no exploration or development may ever take place until after a permit is first issued. [4]

As set forth above, after a permit is issued by the County Clerk, the oil and gas operator must give advance written notice of their proposed drilling operations to all surface owners of record, as well as any purchaser under contract or deed. The owner or operator of any oil and gas well located on any state owned land must likewise notify the Montana Department of Natural Resources and Conservation in advance of any operations similar to that of private owners. An operator is further responsible for advertising a Notice of pending permit for a well in so called "wildcat" areas in the Independent Record providing statewide notice, as well as a newspaper of general circulation regularly published in the County where the well is located. Notice must follow a specific format proscribed by the MBOGC and further must advise the reader of the procedure required to request a hearing pertaining to the grant. If no request for a hearing is received within the ten day notice period, a permit may be administratively approved. The staff is required to refer an application for permit to drill to the MBOGC for notice and public hearing. In addition, part of the development of a coal bed methane well, the developer must first offer a reasonable

[4] It bears mention that the MBOGC's jurisdiction and legal authority over federal lands is absolutely limited to the authority granted to it by the United States Bureau of Land Management. The MBOGC has no jurisdiction or authority over wells drilled on lands held in trust by the United States, any Indian tribe or Indian allotees.

water mitigation agreement to each ground water right holder that possesses a well within one mile of the coal bed methane well or within one-half mile of the well that is adversely affected by the coal bed methane well. So long as the project complies with all applicable statutes, rules and regulations, a permit is issued. Operations must occur within the terms and conditions of the permit and the MBOGC administrator has the authority to impose additional permit conditions as warranted.

OPERATIONS ON STATE LANDS

The Board of Land Commissioners may also issue a Geophysical Exploration Permit on state owned lands for the purpose of prospecting and exploring for oil and gas. Any individual or entity wishing to prospect for oil and gas by geophysical methods on state lands for which no oil and gas lease is held must first submit two copies of a permit application to the Montana Department of Natural Resources and Conservation. This application must include a legal description of the areas where the exploration will take place. Description of multiple sections of state owned land are allowed. Above and beyond the same, a permit from the MBOGC is simultaneously required.

Said applicant must be registered to do business in the State of Montana and also must file a surety bond with the Montana Secretary of State. The name and permanent address of the geophysical exploration firm that will be doing the actual work must be submitted. The application must provide proof that the surface owner or lessee has been notified of the approximate time schedule of exploration activities. Permission from oil and gas lessees is also required to conduct exploration on lands covered by an oil and gas lease. The geophysical exploration permit is valid for one year, but does not grant any rights to an oil and gas lease or any other interest in the land. Typically, conditions are imposed prior to permitting exploration activities so as to protect the land surface.

It is the Montana Board of Land Commissioners that is authorized to lease any state owned minerals for the purpose of oil and gas exploration or drilling and development. This includes private or state oil and gas rights that exist beneath state surface owned land and state oil and gas rights beneath non-state owned land. Coal bed methane is part of the oil and gas estate. Corporations not incorporated in Montana must first obtain a Certificate of Authority so as to permit the conducting of business in Montana. This is received from the Montana Secretary of State's office and must be secured before applying for any lease.

Anyone wishing to lease state lands for oil and gas operations must submit an application on forms furnished by the Montana

Department of Natural Resources and Conservation. These can be picked up directly through that agency, or via the Internet. The sale of oil and gas leases are conducted approximately once each calendar quarter with the sale of such leases resulting from competitive bidding. Notice of each sale is published in the Rocky Mountain Oil Journal (formerly known as the Montana Oil Journal) or in one of the State's general circulation publications. In addition, notice is posted on the Montana Department of Natural Resources and Conservation and Minerals Management website. Interested persons may have their name placed on a mailing list.

The primary term of an oil and gas lease of this type may be no more than ten years, but no less than five years unless the MBOGC deems a shorter period appropriate. An oil and gas lease issued on state land may not exceed one section (i.e. 640 acres), except that any section surveyed by the United States containing more than 640 acres may be included under one lease. Leased lands must be generally compact and contiguous. Owners of state oil and gas leases may enter into other and further agreements as to drilling and other operations. Pooling agreements are also permitted. However, the MBOGC must first approve the assignment of any oil and gas leases and assignees must be duly qualified. The owner or operator of an oil and gas well on state owned land must notify the Montana Department of Natural Resources and Conservation in advance of any operations. The lessee is required to submit a plan for location of all facilities to all surface owner or lessee and is also required to consult with the surface owner or lessee regarding suitable location of access roads. Oil and gas operations on state lands are subject to other applicable state regulatory authorities. See Montana Code Annotated, Sec. 73-3-404, 405, 421, 429, 430 and 438.

UNDERGROUND INJECTION CONTROL

Underground injection control permits are acquired from the MBOGC for new injection wells or to convert existing wells to injection for the purposes of disposal, storage or enhanced recovery of oil and gas. Underground injection wells that inject hazardous and non-hazardous wastes below the lower-most underground source of drinking water, as well as other types of injection that are deemed to create potential public hazard must comply with the United States Environmental Protection Agency rules and regulations. Wells that inject hazardous or radioactive wastes into or above underground sources of drinking water are strictly prohibited. See Montana Code Annotated, Sec. 82-11-101, *et seq.*

CONCLUSION

Rules and regulations pertaining to oil and gas activities in Montana establish a set of codified regulations providing early

notice of all affected individuals and requiring state approval prior to moving forward with any venture. As always, if there is a property in which you have an interest that might be impacted by oil and gas development, vigilance is the by-word. It is necessary to on a regular basis keep abreast of all developments pertaining to applications for permits and the like. Also, legislation and other regulations involving oil and gas appear to be evolving quickly in the entire Rocky Mountain west. It is important one is kept abreast of legislative activities, as well as changes to the Rules of state agencies, so as to make sure that ones legal rights and property interests are being safeguarded.