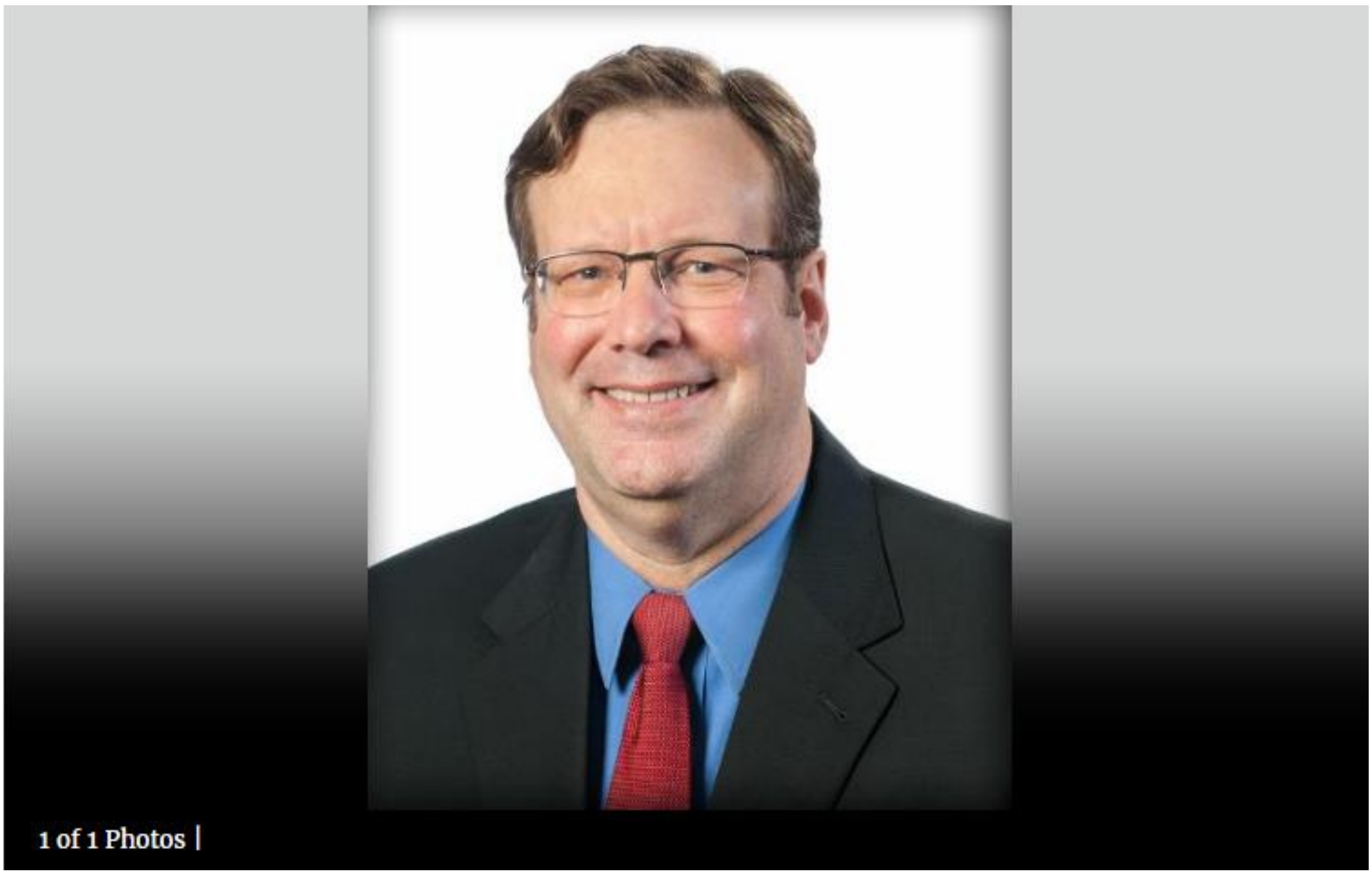
Ohio Gas&Oil

Negotiating extending undrilled shale leases

By David J. Wigham | Attorney Published: April 4, 2016 10:05 AM



For more than six years, areas of eastern Ohio have experienced the largest oil and gas boom in Ohio's history. New technologies in the oil and gas industry have opened up development of the Utica Shale formation, using directional drilling and staged fracking. During this time, thousands of landowners have signed oil and gas leases containing provisions specifically geared for shale development. The majority of these leases contain an initial five-year primary term (which is the time measured from the lease date within which the producer must commence drilling operations). Quite often, landowners received lucrative bonuses upon signing a shale lease. roducers pay out signing bonuses based on the number of leased acres owned by the landowner. Bonus payments have ranged from $500 per acre to more than $6,000 per acre, depending on when the lease was signed and the location and desirability of the leased property.

Once a well is drilled within a unit containing a portion of the leased property, the lease will continue to run indefinitely for so long as oil and gas are produced in paying quantities. Where the producer has not drilled a well in the initial five-year term, most shale leases also contain an option for the producer to extend the lease beyond the primary term, typically for an additional five years. These extensions became effective upon the producer's payment of another bonus payment, usually in the same amount as the initial bonus payment.

Since the end of 2014, oil and gas prices have fallen at an alarming rate and now stand at 17-year lows. Where oil was once trading at around $100 per barrel or more, now prices are hovering just under $40 per barrel, and natural gas prices have fallen under $2 per MCF. Despite falling prices, Utica Shale production volumes in 2015 doubled from 2014.

This price collapse has already financially impacted the oil and gas industry. Rig counts have diminished nationwide (and in Ohio), drilling permit applications have slowed, and drilling programs have been scaled back, or in some cases, eliminated altogether, as many producers cannot operate profitably in the current pricing climate. There are even reports of some producers shutting-in wells until prices rebound. Many producers are verging on bankruptcy, while others have already filed. Consequently, producers are looking to cut costs however they can.
This environment also created a dilemma for shale producers holding large blocks of undrilled acreage held by leases still in their primary term. With the drilling slowdown, many five-year primary-term leases are set to expire before wells can be started, and can only be extended upon payment of the original signing bonus. Many producers do not have the cash to pay another round of bonus payments to extend these leases. Thus, they face the choice of either losing large blocks of undrilled acreage or investing large sums of money to hold the acreage for another five years, without knowing when and if prices will rebound so as to make development profitable again.

[See also - *Read leases carefully for an 'implied requirement'*]

Faced with this problem, producers are approaching landowners and attempting to renegotiate their leases. Most often, producers ask landowners to amend their leases to allow the producer to make bonus payments in five one-year increments, instead of one lump sum payment at the beginning of the five-year extension term. Some producers are even trying to seek an extension for a reduced payment, or in certain cases, for no payment at all. From the producers' perspective, producers are simply trying to hold on to their acreage positions. They have already invested substantial resources in acquiring acreage and developing acreage positions and drilling sites, beyond the payment of signing bonuses. For example, producers must invest in geology and engineering, hire land men to negotiate leases and pipeline rights of way and have title work run to ensure good title to the minerals. Producers will lose all of this investment if they simply allow leases to expire. If a lease expires, another producer will be free to lease the acreage. However, the next producer must also sink these development costs into re-building leased acreage blocks. Thus, there is a benefit to the producer to try to hold on to acreage positions.

From the landowners' perspective, there are both pros and cons to this approach. For example, if a landowner agrees to an extension-payment plan with the producer, it will help ensure the landowner receives some payment for the extension term of their lease, rather than nothing at all if the lease is allowed to expire. Also, since the land will remain under lease, there is a greater chance that it will be developed in the next five years. On the other hand, the landowner may not receive the full five-year extension payment if the producer drills a well on the leased property during the extension period. In addition, the landowner may be able to re-lease the property to another producer after the lease expires. However, because signing bonuses have fallen since the price collapse, there is no guarantee that a landowner will receive a signing bonus in the same amount the landowner received during the height of the boom.

These complicated issues make it essential for landowners to engage a knowledgeable and experienced oil and gas attorney to guide them through these negotiations with producers to help make the right decision whether to extend a lease, and if so, to maximize the payments they will receive for such an extension.

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[See also - *Ohio Supreme Court holds form that leases are enforceable*]