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Royalty and Surface Owner Information Brochure

INTRODUCTION

The purpose and mission of the Arkansas Oil and Gas Commission (Commission) is to serve the public, prevent waste, encourage conservation, and protect the correlative rights of ownership associated with the production of oil, natural gas, brine and associated products through the enforcement of the laws of Arkansas.

The following is an overview relating to some of the more common mineral and surface owner questions that are asked of the Commission. It is not intended to answer legal questions pertaining to the natural gas and crude oil industry. Instead, it should be used as a research tool to help both the mineral owner and the surface owner make well-informed decisions.

The Commission cannot negotiate contracts, lease agreements or surface damages for a mineral or surface owner. With regard to legal questions concerning these issues, it is suggested owners consult an attorney to assist the owner in the decision making process.

THE MINERAL LEASE

When a company desires to develop the mineral resources in an area, the company will need to secure mineral lease agreements from the mineral owners. The mineral lease is a legal binding contract between the mineral owner (Lessor) and an individual or company (Lessee), which allows for the exploration and extraction of the minerals covered under the lease.

The mineral lease is an agreement between two parties, and although there is a standard lease form utilized by most companies, there is no "one size fits all" lease agreement, and specific terms and conditions contained in the lease are subject to negotiation by the Lessee and Lessor. Following are explanations of some of the major components of a mineral lease:

- **Cash Bonus**

The **cash bonus** is also known as a **lease bonus** or **bonus consideration**. It is money paid up front to a Lessor by a Lessee as an incentive to sign a mineral lease. The dollar value of the **cash bonus** is paid on each mineral acre owned by the Lessor. The price paid per acre can vary between geographic regions and although many factors influence the price paid, generally the value of the mineral rights is relative to the potential for resource development in that area.

- **Primary Term of the Lease**

The **primary term** of the lease is the duration of time a lease agreement will be in effect. A common industry standard for **primary term** is three to five years, although depending on circumstances, terms of less than three years are not uncommon. This window of time is intended to allow a Lessee to explore for mineral resources before the leased mineral rights transfer back to the mineral owner. The duration of the mineral lease is automatically extended if the drilling operations are commenced before the **primary term** expiration date, or if a successful well has been completed during the time covered under the **primary term**.

- **Held by Production (HBP)**

If a successful well is drilled during the primary term of the lease agreement and production has occurred, the lease is automatically extended and is considered to be “**held by production (HBP)**”. The mineral lease will remain valid as long as the production royalties are paid to the Lessor as outlined in the mineral lease agreement.

- **Shut-In Royalty**

If a successful gas well is drilled during the primary term of the lease agreement and production has not occurred, the lease agreement will remain valid if a yearly **shut-in royalty** is paid to the Lessor. The annual payment of **shut-in royalties** can also be used to extend an existing lease. For example, a gas well that at one time produced but has now ceased production and has not yet been plugged and abandoned, the payment of an annual shut-in royalty can extend the lease term.

- **Royalty Payment**

Royalty Payment, Royalties, Lease Royalty and **Production Royalty** are a few of the more common terms used to describe routine payments to the Lessor for their proportionate share of the produced minerals. The Arkansas statute provided royalty is 1/8th. However, **royalties** greater than 1/8th may be paid, if agreed upon during the lease negotiation process.

- **Surface Operations**

When a well is drilled, the drilling pad and the production facilities will require the use of a limited amount of surface property. If a Lessor does not want the land surface disturbed a “**No Surface Operations Clause**” may be negotiated and included in the mineral lease agreement. This clause may be used to limit or restrict the use of the property for drilling activity or long-term production operations.

SURFACE DAMAGES

In today’s environment, it is not uncommon for the mineral ownership to have been severed from the surface ownership at the time of the land sale. When purchasing a piece of property, it is the buyer’s responsibility to be aware of any mineral lease agreements associated with the property and how those agreements may directly affect the property owners obligation to allow entry onto the property.

It is important to realize that under the laws of conservation in the State of Arkansas the mineral rights are dominant over the surface rights. Therefore, the surface owner is compelled to allow a reasonable portion of their land to be used for the development and production of the minerals unless the mineral owner added a “**No Surface Operation Clause**” to the lease agreement.

The Lessee holding the lease has a legal authority to enter the property for exploration and production even if the non-mineral owning surface owner objects to the intrusion on the property. That does not mean the surface owner will be without compensation. The amount and type of compensation is strictly a matter of negotiation between the surface owner and the company entering the property. If a mutual agreement cannot be reached, the surface owner always has the right to seek the advice of an attorney and relief through the court system.

The only surface owner’s protection under State law is the requirement to have the surface, where the drilling operations occurred, returned to reasonable condition after the drilling and production has ceased. Commission regulations ensure the proper plugging of the well; however, an attorney can be consulted for other surface damage claims.

DIVISION ORDER

After a well has been successfully drilled, the Lessee will forward the Lessor a document called a **Division Order**. It usually contains information such as the legal description of the Lessor’s name and address, legal description of the property, tax identification number and decimal interest based on the amount of mineral ownership.

The information on the **Division Order** will need to be verified and a federal tax identification number will have to be included. Otherwise, federal law requires 31% of your royalties to be paid directly to the IRS by the Lessee holding the lease. For most individuals, the person’s social security number is the tax identification number. The **Division Order** needs to be signed and returned to the Lessee.

TRANSFER ORDER

In the State of Arkansas when a person sells a piece of property the mineral rights automatically transfer with the surface rights, unless otherwise stated in the deed.

When there is a change in mineral ownership resulting from an inheritance, survivorship, purchase of minerals, marital status or any other form of revision, **it is the responsibility of the individual who is to receive royalty payments to notify the Lessee of the change.** A certified letter to the Lessee stating what changes have occurred along with copies of the supporting documents will expedite the process and eliminate unnecessary delays.

STATE INTEGRATION OF INTERESTS

The Commission, in accordance with State statute, has established drilling units consisting of a set amount of acreage for the purpose of protecting correlative rights. Given oil and gas resources are mobile within a reservoir during the production process, the establishment of drilling units, of a specific acreage size, ensures all mineral owners potentially impacted by the producing well will receive proper compensation for the oil and gas produced from a unit. A company desiring to explore for and develop oil and gas resources is required to pay production royalties to the mineral owners in these established drilling units. When a mineral owner does not enter into a mineral lease with a company wanting to produce the oil and gas from a drilling unit, Arkansas statute provides for an integration of the unleased mineral interest in order to allow the well to be drilled to recover the oil and gas resources. The Integration provisions contained in Arkansas State statute, as administered by the Commission, were adopted to ensure all mineral owners receive proper payment of production royalties.

It is the expectation of the Commission that entities desiring to drill and operate an oil or gas well in Arkansas will attempt in good faith to negotiate a satisfactory mineral lease with mineral owners before resorting to the integration provisions of Arkansas statute. However, if the company or individual desiring to develop the oil and gas and the mineral owner cannot agree on acceptable lease terms, the company or individual (Applicant) can make application to the Commission for an Integration Order.

The process begins with an application submitted to the Commission by the company or individual seeking an Integration Order. All interested parties are given notice of when and where the Commission will hear the integration application. Commission Hearings are held monthly, generally the fourth Tuesday of each month, alternating between the Commission's El Dorado and Ft. Smith offices. The exact meeting dates can be found on the Commission's web page at www.aogc.state.ar.us.

At the hearing the Commission will take testimony from the Applicant and any other interested party concerning the application. After hearing the testimony presented, the Commission will decide whether or not to grant the integration application and what terms should be granted to the unleased mineral royalty and leasehold working interest owners. If an Integration Order is granted, the unleased mineral royalty owners and leasehold working interest owners will be afforded various options for integration of the unleased interests. For purposes of this brochure, however, only the options pertaining to royalty mineral interest owners will be presented.

The majority of Integration Orders will contain three active options and one passive option. Unleased mineral owners will have a 15-day election period from the date the order is signed to select one of the options. Although the options may contain variances on a case-by-case basis, the following is a summary of the common options:

LEASE - Sign a lease for the bonus and royalty specified by the Commission, which is usually the highest amount offered and accepted by other mineral owners in the unit before the integration application was submitted to the Commission. A lease signed during the 15-day election period has a term of one year, or as long thereafter as production is occurring from the unit.

PARTICIPATE - Participate in the unit by signing an operating agreement, which generally follows the Model Form Operating Agreement, A.A.P.L. 610-1989 with COPAS 1984 Accounting Procedure. Under this option the mineral owner will receive the proportionate share of the 1/8th royalty, and in addition will also pay the proportionate share of the well cost, whether the well is successful or not. If the well is successful, the mineral owner will receive the proportionate share of the well proceeds.

ELECT NON-CONSENT - This option is similar to the PARTICIPATE option, with the exception that the costs of participation in the well are carried by the operator. Under this option, the unleased mineral owner will receive the proportionate share of the 1/8th royalty, but will not receive the lease bonus. In addition, the unleased mineral owner will receive the proportionate share of the production revenue from which the operator will withhold the necessary proceeds to pay the operator for the drilling cost plus any risk factor deemed appropriate by the Commission. The risk factor or penalty is variable based on the potential risk of drilling a successful well, but is commonly 400% - 600%. As an example, if an unleased mineral owner were to elect the non-consent option in a well with a 400% penalty factor, the operator would automatically withhold the unleased mineral owners production revenue (excluding the 1/8th royalty) until four times the mineral owners percentage of the drilling, completing and well equipping costs, plus 100% of operations expenses are recovered by the operator. If and when, the drilling cost obligations have balanced, the mineral owner would receive the proportionate share of the production revenue, less operation expenses, from that time forward in addition to the continued 1/8th royalty payments.

NO RESPONSE - All of the above options require the unleased mineral owner to notify the operator of the selected choice. The "NO RESPONSE" option requires no action on the part of the mineral owner. If the unleased mineral owner does not notify the operator and select one of the above options within the election period specified in the Integration Order, the unleased mineral interest will be deemed integrated and the mineral owner will receive a lease bonus and royalty amount specified by the Commission. Under the "NO RESPONSE" option, the mineral owner will lose the option to elect participation in future wells drilled within the unit.

At this time, the law in Arkansas is unclear as to what rights an operator of an integrated unit has, relative to surface access necessary to drill a well, on the unleased mineral interests, under the "ELECT NON-CONSENT" or "NO RESPONSE" options above. The operator will, however, have the right to drain oil or gas from all the integrated interest acreage. It is important to note, however, that if another party owns a fractional interest in the minerals under a property, the owner of the partial minerals **may** have the right to give an oil and gas company access to drill a well, whether or not the current surface owner and partial mineral owner execute a lease.

FREQUENTLY ASKED QUESTIONS

Q. I have inherited mineral rights. How do I transfer the royalty payments over to me?

A. Send a self-explanatory, certified letter to the well operator and include the following information:

- A copy of the death certificate or other relating documents.
- A copy of the Last Will and Testament.
- If the estate was probated through the courts, then send a copy of the Final Decree, Court Order or an Affidavit of Heirship.
- A list of the legal names, addresses and tax identification numbers of the heirs who are to receive royalties.
- The operator may require additional information.

Q. I have purchased a piece of property and the mineral rights were included. How do I transfer the royalty payments over to me?

A. Send a self-explanatory letter to the operator and include the following information:

- A copy of the deed showing that mineral ownership was transferred during the land sale.
- The legal name, address and tax identification number of the entity who is to receive the royalties.

Q. A company has approached me about drilling a well in my section. What options do I have?

A. If the property owner owns the minerals, an unleased mineral interest owner has three basic options, 1) voluntarily negotiate a mineral lease agreement with the company, 2) request to participate in the well, or 3), in the absence of an agreement, be subject to an integration proceeding before the Commission, at which time the options discussed under the "State Integration of Interests" section of this brochure will be offered.

Q. How do I know the cash bonus and conditions that are being offered are fair?

A. The terms and conditions of the mineral lease agreement are negotiable and can vary from one geographical region to another. The price paid per acre can also vary between geographic regions, and although many factors influence the price paid, generally the value of the mineral rights is relative to the potential for resource development in that area. It is always a good practice to check with neighbors, friends, real estate agents and individuals within the oil and gas industry to compare what cash bonuses are being offered.

Q. I've been told that our minerals are being force integrated. What does that mean?

A. Forced integration is a process that is used to ensure the orderly development of the crude oil and natural gas resources in the State of Arkansas. There are times when a mineral owner cannot be located or the mineral owner chooses not to participate or sign a lease agreement. When this situation occurs, the operator may ask the Arkansas Oil & Gas Commission, whose mission is to protect the correlative rights of all parties, to integrate all unleased mineral owners. The process of integration was discussed earlier in this brochure.

Q. I don't own the mineral rights to my property and a company wants to drill on my land. Can I stop them? What are my options?

A. It is not uncommon for part or all of the mineral ownership to have been severed from the surface ownership at the time of the land sale. In the State of Arkansas, the mineral rights are dominant over the surface rights, and state law requires the surface owner allow a reasonable portion of their land to be utilized for drilling and production. Unless the mineral owner, prior to the sale of the surface, negotiated a mineral lease agreement that specifically states “No Surface Operations”, then the company holding the lease can enter the property for exploration and production. Most operators will negotiate payment for surface damages; however, law does not require damage payments. If the Lessee’s activities are excessive of those activities reasonably required to explore for and produce oil and gas resources or the Lessee is negligent or fails to restore the surface area, the surface owner can seek the counsel of an attorney and relief through the court system.

Q. A new gas well has been drilled in my section or there is a gas well in my section that has been producing for some time. When can I expect my royalty check?

A. At the end of a well’s initial month of production, a grace period of six (6) months and twenty days is allowed before the royalty payments are to be made to the mineral owners. As an example, if gas was first sold in January the company has until August 20th to begin paying royalties.

There is an exception. The royalty payment may be postponed until the royalty revenue reaches a minimum of one hundred-dollars (\$100) or, until the end of the calendar year, when royalties total less than one hundred dollars.

Q. I’m not getting a royalty check. What should I do?

A. There are many reasons an individual may not receive a royalty check. The first step is to confirm that you own the minerals by researching your property deed. If you own the minerals, contact the operator and inquire as to why royalties are not being paid. The operator will research the issue and make the necessary corrections. The AOGC can provide contact information if necessary by contacting one of the Commission offices with the legal description (section, township and range) of your property.

Q. How do I find out if I own the mineral rights to my property?

A. In the State of Arkansas, the mineral rights are considered part of the sale with the surface rights unless they have been specifically reserved. A review of the property abstract should indicate if the mineral rights were reserved by a former property owner. A review of the warranty deed at the Circuit Clerk’s office will also indicate mineral ownership. In addition, an attorney, abstract company, or a land man may be contacted for assistance.

Q. The company that operates the well I’m receiving royalty from has sold the well to another company. Will this affect my royalty checks?

A. Oil and gas wells are property that can be bought and sold. It’s not uncommon for a well to have changed hands several times during the course of its life. You may notice a different looking revenue statement, payment schedule, or some other visual change. However, the

responsibility for royalty payments is still intact and is passed on to the new operator. You will still receive royalty payments; it will just be from the new company.

Q. I have recently changed my marital status. How do I make that change to my royalty account?

A. Send a self-explanatory letter to the company that operates the well, and include the following information:

- A copy of a past revenue statement with your identification number listed,
- A copy of your marriage license, and
- Legal name, address and social security number of the entity that is to receive the royalty.

Q. I need to change my name due a court proceeding. How do I make that change to my royalty account?

A. Send a self-explanatory letter to the company that operates the well and include the following information:

- A copy of a past revenue statement with your identification number listed.
- A copy of the court order.
- The legal name, address and social security number of the entity who is to receive the royalties.

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