

Barnett Shale Expo  
Fort Worth Convention Center  
March 11, 2009

Royalties-Understanding your lease

Presented By: Jerry R. Simmons, Executive Director  
National Association of Royalty Owners (NARO)

[www.naro-us.org](http://www.naro-us.org)

March 11, 2009

# Short Commercial about NARO



The ONLY national organization representing, solely and without compromise, oil and gas royalty owners interests.

- What does this statement mean?
- Who are we?



The ONLY national organization representing, solely and without compromise, oil and gas royalty owners interests.

- NARO was founded in 1980
  - Due to Windfall Profits Tax
- We have grown into an educational/advocacy organization
- NARO has two “parts”
  - The Association a 501 c (6)
  - The NARO-Foundation a 501 c (3)



## NARO State Chapters

Arkansas-NARO

Appalachia-NARO KY, OH, PA, TN, NY, WV

NARO-Rockies CO, MT, ND, NM, UT, WY

OK-NARO

NARO-Texas



The ONLY national organization representing, solely and without compromise, oil and gas royalty owners interests.

## Annual Convention

Educational Opportunity for Mineral/Royalty Owners

Two days of seminars

2009 Will be held in Las Vegas, NV

October 1, 2, 3

NARO-TX May 27, 28 & 29, 2009 Horseshoe Bay,  
TX

# Mineral Management 101

## Program Outline

- Ten Duties of Mineral Owners
- Four Major Events for Mineral Owners
  - Ownership
  - Leasing
  - Division Orders
  - The Royalty Check

# 10 Duties (Responsibilities) of Mineral Owners

1- **KNOW** what you own

2- **KNOW** what information you need and where to get it

3- **KNOW** what is going on in your area of interest

# 10 Duties (Responsibilities) of Mineral Owners

4-**KNOW** what the future impact the small print in the oil and gas lease/division order will have on your royalty payment

5-**KNOW** who has it (your lease, your well, your production)

# 10 Duties (Responsibilities) of Mineral Owners

6-**KNOW** what questions to ask and to whom to ask them

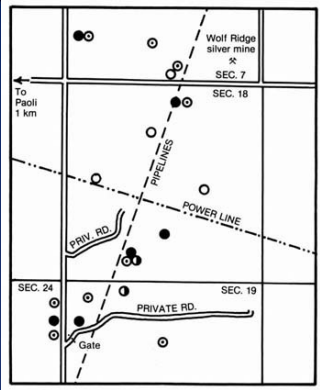
7-**KNOW** your limits

# 10 Duties (Responsibilities) of Mineral Owners

8-**KEEP** copies/originals of everything and organize it

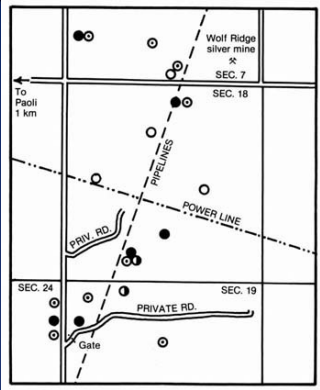
9-**KNOW** that you must remain vigilant and **DO** something

10-**PLAN**



# 4 Major Mineral Owner Events

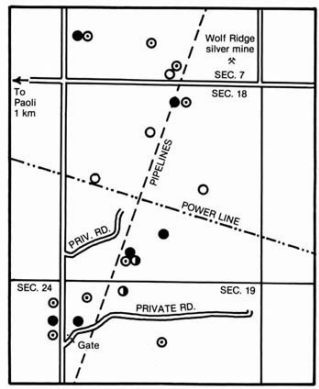
- **OWNERSHIP**
- Leasing
- Division Orders
- The Check



# Types of Ownership

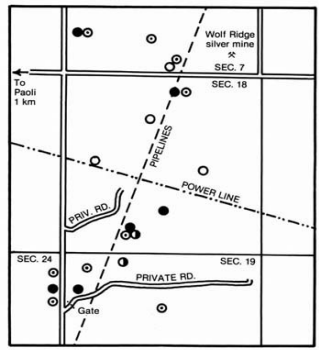
- **Non-Producing**
  - Mineral Ownership
- **Producing**
  - Overriding Royalty Ownership
  - Working Interest
  - Royalty Ownership

# Mineral Ownership



- Rights of Mineral Ownership
  - Enter the land to explore, drill, produce and otherwise carry on mining activities.
  - Lease those ownership rights to another party.
  - Ownership exists in perpetuity. **EXCEPT H.B. 834**
  - The minerals sit “in place” until developed; most mineral owners cannot afford to drill a well.

# Types of Ownership: Producing



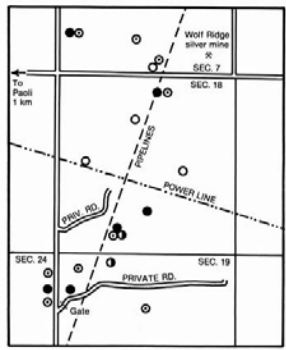
## Working Interest (WI)

Investors in the well who share the actual costs incurred in drilling, completing and producing  
Production income is distributed proportionately

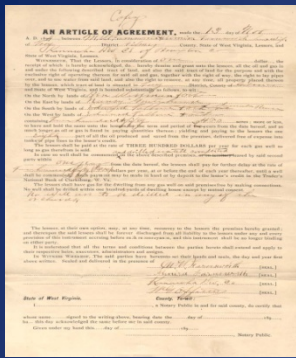
## Overriding Royalty Interest (ORRI)

Carved from the WI; non-cost bearing

# Types of Ownership: Producing

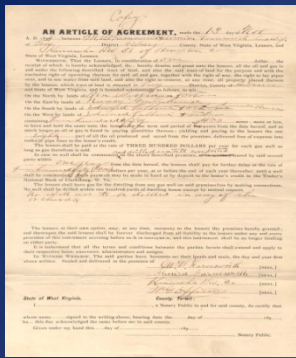


- Royalty Ownership/Interest (RI)
  - Begins with Production
  - Ends with Production
  - Does not have to be owned by the “Mineral Owner” but it usually is
  - Is based on the fraction retained in the lease and your ownership
  - Gets you the checks in the mail



# 4 Major Mineral Owner Events

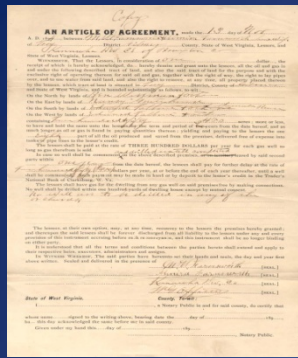
- Ownership
- **LEASING**
- Division Orders
- The Check



# Leasing

Many printed forms are available but

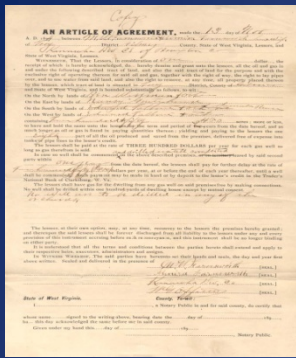
THERE IS NO SUCH THING  
AS A  
“STANDARD LEASE” FORM



# Leasing

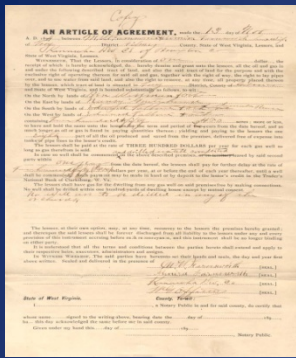
## The Oil and Gas Lease is

- the basic instrument in oil and gas development
- a legal instrument executed by a mineral owner granting the exclusive right to another to explore, drill and produce oil and gas from a particular piece of land



Leasing

VIRTUALLY ALL  
LEASE TERMS ARE  
NEGOTIABLE



# Negotiations

- The Lease Bonus

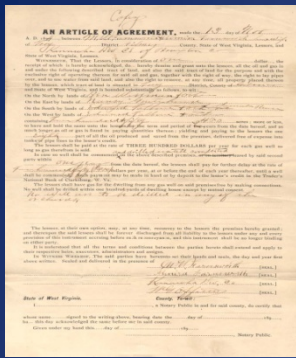
Paid by the Lessee at the time the lease is executed

Usually is calculated on a per acre basis

Usually is paid by separate draft or check

Is not recited in the lease

Example: Ownership	=	10 NMA
Lease Bonus	=	<u>\$50 per acre</u>
Total Bonus Paid	=	\$500



# Negotiations

- Retained Fraction (Royalty Rate)  
If production is established

the Fraction agreed upon

will be the royalty rate paid on production

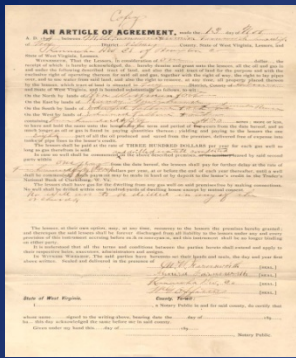
Example: Retained Fraction

$$1/8 = 12.50\%$$

$$3/16 = 18.75\%$$

$$1/5 = 20.00\%$$

$$1/4 = 25.00\%$$



# ase Clauses that can Bite Your Pocketbook

“To pay Lessor for gas (including casinghead gas) and all other substances covered hereby, a royalty of  $\frac{3}{16}$  of the proceeds realized by Lessee from the sale thereof, less a proportionate part of the compressing, dehydrating, transporting, and marketing or otherwise making such gas or other substances ready for sale or use, said payments to be made monthly.”



# 4 Major Mineral Owner Events

- Ownership
- Leasing
- **DIVISION ORDERS**
- The Check



## Division Orders

- Issued by the Company AFTER production is established
- States the decimal interest on which you will be paid
- Is the link to information on your check stub



# Division Orders

NADOA Model Form Division Order (Adopted 9/95)

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**DIVISION ORDER**

To: \_\_\_\_\_ Date: \_\_\_\_\_

Property Number: \_\_\_\_\_ Effective Date: \_\_\_\_\_  
Property Name: \_\_\_\_\_  
Operator: \_\_\_\_\_  
County and State: \_\_\_\_\_  
Property Description: \_\_\_\_\_  
Production: \_\_\_\_\_ Oil \_\_\_\_\_ Gas \_\_\_\_\_ Other: \_\_\_\_\_

Owner Name and Address: _____	OWNER NUMBER: _____
	Type of Interest: _____
	Decimal Interest: _____

The undersigned certifies the ownership of their decimal interest in production or proceeds as described above payable by \_\_\_\_\_ (Payor).  
(Complete Name)

Payor shall be notified, in writing, of any change in ownership, decimal interest, or payment address. All such changes shall be effective the first day of the month following receipt of such notice.

Payor is authorized to withhold payment pending resolution of a title dispute or adverse claim asserted regarding the interest in production claimed herein by the undersigned. The undersigned agrees to indemnify and reimburse Payor any amount attributable to an interest to which the undersigned is not entitled.

Payor may accrue proceeds until the total amount equals \_\_\_\_\_, or pay \_\_\_\_\_ whichever occurs first, or as required by applicable state statute.

This Division Order does not amend any lease or operating agreement between the undersigned and the lessee or operator or any other contracts for the purchase of oil or gas.

In addition to the terms and conditions of this Division Order, the undersigned and Payor may have certain statutory rights under the laws of the state in which the property is located.

Special Clauses: \_\_\_\_\_

Owner(s) Signature(s): \_\_\_\_\_

Owner(s) Tax I.D. Number(s): \_\_\_\_\_

Owner Daytime Telephone #: \_\_\_\_\_

Owner FAX Telephone #: \_\_\_\_\_

Federal Law requires you to furnish your Social Security or Taxpayer Identification Number.  
Failure to comply will result in 28% tax withholding and will not be refundable by Payor.

## NADOA Model Form Division Order



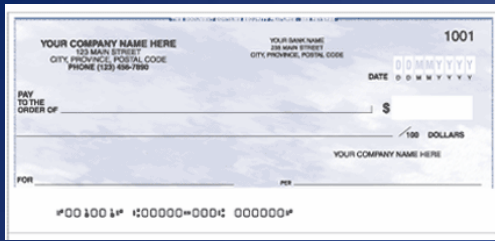
# Decimal Interest

$$80 / 640 \times 3/16 = .0234375 \text{ RI}$$

**Net Mineral Acres Owned**

**Drilling and Spacing Unit Size (in acres)**

**Royalty retained from the Oil & Gas  
Lease**



# Major Mineral Owner Events

- Ownership
- Leasing
- Division Orders
- **THE CHECK**

YOUR COMPANY NAME HERE  
123 MAIN STREET  
CITY, PROVINCE, POSTAL CODE  
PHONE (532) 555-1234

YOUR BANK NAME  
234 MAIN STREET  
CITY, PROVINCE, POSTAL CODE

1001

DATE DDMMYY

PAY TO THE ORDER OF \$

100 DOLLARS

YOUR COMPANY NAME HERE

FOR PER

#001001# H00000=0004 000000#

# The Royalty Check

1	2	3	4	5	6	7	8	9	10	11	12	13	14	15
PROD DATE	P C	PRICE	T	GP	VOLUME	TAX	LEASE DEDUCT	NET VALUE	PAYMENT DECIMAL	VOLUME	GRS VALUE	TAX	LEASE DEDUCT	NET
16														
111111-CHK WELL #5-1 STATE: OK COUNTY: GARVIN LEGAL: SW/4 SECTION 27-4N-4W														
502	2	3.864	2	01	898.08	249.77	.00	3220.43	.00173611	1.56	6.02	.43	.29	-29
602	2	3.604	2	01	863.51	224.05	.00	2888.76	.00173611	1.50	5.40	.39	.00	5.01
702	2	3.600	2	01	881.00	228.34	.00	2944.06	.00173611	1.53	5.51	.40	.00	5.11
802	2	3.533	2	01	673.00	172.12	.00	2219.14	.00173611	1.17	4.15	.30	.00	3.85
902	2	3.767	2	01	853.00	231.30	.00	2982.38	.00173611	1.49	5.58	.40	.00	5.18
1002	2	4.070	2	01	1239.00	362.97	.00	4680.12	.00173611	2.15	8.76	.63	.00	8.13
1102	2	4.530	2	01	1331.00	434.01	.00	5596.25	.00173611	2.31	10.47	.75	.00	9.72
1202	1	29.042	2	02	-155.65	-325.56	.00	-4194.90	.00173611	-.27	-7.85	-.57	.00	-7.28
1202	1	29.043	2	02	178.43	377.10	.00	4805.10	.00173611	.31	9.00	.65	.00	8.35
1202	1	29.042	2	02	155.65	325.56	.00	4194.90	.00173611	.27	7.85	.57	.00	7.28
1202	2	4.679	2	01	1436.00	483.63	.00	6236.22	.00173611	2.49	11.67	.84	.00	10.83
103	2	5.409	2	01	1013.00	394.40	.00	5085.83	.00173611	1.76	9.51	.68	.00	8.83
203	2	6.233	2	01	807.00	362.00	.00	4668.17	.00173611	1.40	8.73	.63	.00	8.10
303	2	.000	2	01	.00	137.89	.00	1778.72	.00173611	.00	3.33	.24	.00	3.09
403	2	5.166	2	01	726.00	269.94	.00	3480.90	.00173611	1.26	6.51	.47	.00	6.04
LEASE TOTAL											94.64	6.81	.00	87.83
OWNER TOTAL											94.64	6.81		
INTEREST TYPES (IT)					PRODUCT CODE (PC)					DEDUCT CODE				
1-WI 2-ROY. 3-ORRI					2-GAS 1-OIL					BW-BACKUP WITHHOLDING EV-SEV TAX KC-KS CONSERVATION NE-NETTING EXPENSE NM-NM WITHHOLDING SB-OK WITHHOLDING SV-SEV TAX TC-LA CENT FAC GAS TR-LA CENT FAC OIL				
17 CHECK TOTAL											87.83			
OWNER NUMBER 000001					CHECK NUMBER 000001					CHECK DATE 1/1/1900				



# Record Keeping

- YOUR FILES
  - Evidence of Title (Ownership)
    - The instrument showing your ownership
  - Leases and Offers
  - Division Orders
  - Correspondence
  - Check Stubs or Check Skirts

According to EIA 2007 452,768 gas wells in the U.S.

Most wells are in rural areas

Location of meters

Number of meters

Location of BTU sample

Location of price points

Where are Royalties and Taxes  
Paid?

# NARO's 2006 10K Report

## Conclusions

1. Apache Corporation was the only top producer that was part of this study that did not appear to use midstream affiliates or subsidiaries to transfer income or expenses. The price reported by Apache Corporation appears to be the actual arm's length sale price received by Apache Corporation.
2. Southwestern Energy Company disclosed the highest price for arm's length sales due by selling directly to consumers in Arkansas. Their arm's length sale recouped them a price per mcf of 85.57% higher than their publicly disclosed price and 124% higher than the price reported to the private royalty owners.
3. Southwestern Energy Company reported the highest post-production costs of \$.91 per mcf at the private royalty owner level. They also collected post-production costs of \$2.80 per mcf from the consumers in the form of distribution charges. This amounts to charges in excess of \$3.50 per mcf being reported and collected for post-production costs.

# NARO's 2006 10K Report Conclusions

4. **The average wellhead price publicly reported by all the companies combined was 3.56% higher than the wellhead price reported to private royalty owners. This could be due to differing btu factors of the averages reported. ConocoPhillips reported the best exploration and development price to the private royalty owners.**
5. For those producers disclosing post-production costs to the private royalty owners, the amount disclosed to the private royalty owners was an average of 43.41% higher than the publicly disclosed rates. This amounts to the company recouping an average profit of 43.41% from private royalty owners.
6. **Only Apache Corporation (\$6.54/mcf) and EOG Resources (\$6.56/mcf) reported their wellhead prices as being collected by Exploration and Production and could be considered the standard for arm's-length sales prices for 2006.**

# NARO's 2006 10K Report

## Conclusions

7. The highest wellhead price reported was \$6.69 per mcf by Chesapeake Energy Corporation and the lowest was \$5.24 per mcf by Williams Companies, Inc., with both companies selling to affiliate midstream companies at a higher value. However, EnCana corporation reported a netback price of \$4.67, which would place them with the lowest price reported with \$1.68 of post-production costs against \$6.35 per mcf wellhead price. EnCana also reported selling to affiliate midstream companies at a higher value.
8. The largest profit reported by sales to midstream affiliates was 69.47% by Williams Companies, Inc.
9. **The average profit of the 8 companies that used sales to affiliates was 15.32%. This was actually 16.21% higher than the prices reported to private royalty owners. 15.32% profit in the midstream represents a significant amount of income not reported to royalty owners and taxing authorities.**
10. **9 of 10 of the top producers in Texas, Oklahoma, Arkansas and Colorado use affiliates and subsidiaries to reduce income to royalty owners and taxing authorities.**

# Why Are Royalty Owners Concerned?

The volume of evidence that shows States, Federal Government, Tribes and Private Royalty Owners have found, proven and collected millions for underpayment of Royalty and Tax

# Some of the cases

- OK has collected millions from underpayments, price manipulations and volume underreporting from at least 15 companies
- CO has recouped \$23 million in underpaid severance tax
- WY has conducted audits since 1981 and has collected millions
- AL found underpayment of royalty due the state more on this in a minute

# Some of the cases

- Through court challenges private RO's have collected:

\$200 million in CO

\$405 million in WV (Settlement not disclosed)

\$Tens of millions in OK

\$2 + million in AR

# Alabama v Exxon

- State entered into 22 leases with Exxon (Now ExxonMobil)
- Leases PROHIBITED deducting many of the “usual” costs from royalty payments and required Exxon to provide reports documenting the basis for royalty

# Alabama v Exxon

- On appeal the circuit court reduced punitive damages to \$3.5 Billion and left the compensatory damages at \$102.8 Million
- In 2007 AL Supreme Court threw out all punitive damages and reduced the compensatory damages to \$51.4 Million + interest for breach of contract

# Alabama v Exxon

## The memo

Memo sent to Exxon Senior VP from another Exxon Executive argued that Alabama's "inexperienced regulatory staff and (auditing) processes" were unlikely to detect underpaid royalties, and Exxon planned to go ahead and take the deductions prohibited in the oil and gas leases. The memo further argued that Exxon's exposure, if caught, would only be the underpayment plus 12% interest.

# Railroad Commission of Texas

## General Information Pertaining to Leases and Royalties

- The Commission maintains records regarding the reported production and disposition for all oil and gas produced from wells in the State. Additionally, the Commission also maintains records regarding the permitting of wells.
- If you have internet access you can obtain all reported production information from January 1993 to present and any online permitting records at the Commission's website [www.rrc.state.tx.us](http://www.rrc.state.tx.us). There is no charge for access to these records.
- The Railroad Commission cannot advise you whether you should enter into a lease or any other agreement, or whether an operator is in compliance with the terms of a lease. Since these are private contractual matters, you may want to consider contacting an experienced oil and gas attorney. State Bar of Texas P.O. Box 12487 Capitol Station Austin, Texas 78711  
(800) 252-9690
- The State Comptroller oversees the payment of oil production taxes. Producers, first purchasers and subsequent purchasers all must file certain reports with the Comptroller. These reports outline in detail the amount of oil and gas produced monthly, counties and leases where the oil was produced, the price received or paid for the oil, and other information.
- State Comptroller L.B.J. State Office Building 111 E. 17th Street Austin, Texas 78701  
(512) 463-4000 (800) 252-1384

# Texas Natural Resources Code

- The statutes outlining the rights of royalty owners may be found in the
- **Texas Natural Resources Code Section 91 Subchapters J and L**
- These requirements include:
  - When to pay royalties, when royalties can be suspended, and what interest rate to pay when interest is due
  - What should be reported with a payment
  - The statutory components of a division order
  - What kind of notice to provide royalty owners when you buy a working interest or when the payor changes
  - What information a royalty interest owner can request
-

# Texas Natural Resources Code

- **ROYALTY PAYMENT REQUIREMENTS IN TEXAS**  
**Sections 91.401(2) and 91.501**
- As a working interest owner in a well or property, you have the responsibility to pay or cause to be paid any royalties due under the lease agreement from which you derived your working interest. This is true even if you are not the operator of the well or property.
- Sections 91.401 to 91.406 of the Natural Resources Code concern the timely payment of royalties.
- 91.406 provides for minimum damages and recovery of attorney's fees in a successful action to recover past due payments.
- Section 91.501 to 91.506 outline the information to which royalty owners are entitled from their payor.

# Texas Natural Resources Code

- **WHEN TO PAY**  
**Section 91.402(a) and (f)**

Initial payment

- 120 Days after end of month of first sale

- Ongoing payments

- 60 days after end of calendar month in which oil production sold
- 90 days after end of calendar month in which gas production sold

- Payments must be paid when the payment reaches \$100, or
  - If payments do not reach \$100 within 12 months and are greater than \$10, the aggregated amount must be paid
  - Amounts that do not aggregate to \$10 must be paid upon the sale or plugging of the property or at the owner's request
  - If an owner requests payment more frequently, only aggregate to \$25

# Texas Natural Resources Code

- **WHAT YOU HAVE TO REPORT WITH A PAYMENT (amended effective 9/1/2002)  
Section 91.502**
  - Property Identification (Name, Number, or both; and County and State)
  - Sales month and year
  - Volume sold
  - Price per barrel or Mcf
  - Severance or other taxes deducted
  - Windfall profit taxes (repealed 1989)
  - Other deductions or adjustments
  - Net value
  - Owner decimal interest
  - Owner gross value
  - Owner net value
  - Address and phone number where additional information can be obtained

# Texas Natural Resources Code

- **ROYALTY OWNER REQUESTS**  
**Section 91.404(b)**
- If a royalty owner notifies you in writing of failure to make timely payment, you must either make payment or respond in writing within 30 days of receipt of the notice.
- **Section 91.504 (amended effective 9/1/2002)**
- Requests sent by certified mail for information regarding itemized deductions, adjustments, the heating value of gas, or the Railroad Commission of Texas identification number for the lease, property, or well must be responded to within 60 days of receipt of the request.
- **Section 91.505 (amended effective 9/1/2002)**
- Additional requests sent by certified mail for information not covered by Section 91.504 must be responded to within 30 days of receipt of request.

# Texas Natural Resources Code

- **CHANGE OF PAYOR**  
**Section 91.407 (a), (b), and (c)**
- If there is a change of payor, the new payor must notify the payee in writing of the change at the payee's most recent known address. The notice must include property name and number, effective date (month and year), and payor's address and phone number.
- A division order, check detail, or other written communication that includes all of the above information will satisfy this requirement.

# Texas Natural Resources Code

- **SUSPENDING PAYMENTS**  
**Section 91.402(b) and (f)**
- Payments can be suspended without interest (provided the lease does not provide otherwise) if:
  - A dispute concerning title exists that would affect distribution of payments
  - A reasonable doubt exists that the payee has sold or authorized the sale of its share of the oil or gas to the purchaser
  - A reasonable doubt exists that the payee has clear title to the interest in the proceeds of production
  - A title opinion requirement placing the title, identity, or whereabouts of the payee at issue remains unsatisfied after a reasonable request for curative has been made.
  - Payments are aggregated as provided by statute

# Texas Natural Resources Code

- **WHEN INTEREST IS DUE**  
**Section 91.403 and 91.407(d)**
- Late payment interest is due at a rate of 2 percentage points above rate charged on loans to depository institutions by New York Federal Reserve Bank when:
  - Payment is late and the title is clear
  - Payment is late, a division order is offered that does not comply with statutes, and the division order is not signed
- Late payment Interest is due at a rate of 4 percentage points above the rate charged on loans to depository institutions by the New York Federal Reserve Bank when:
  - Payment is late and notice that you are the new payor has not been provided

# Texas Natural Resources Code

- **ANNUAL NOTICE TO ROYALTY OWNERS (effective 9/1/2002)**  
**Section 91.504(e)**
- At least once every 12 months, a payor shall provide the following statement to each royalty interest owner to whom the payor makes a payment:
- Section 91.504, Texas Natural Resources Code, gives an owner of a royalty interest in oil or gas produced in Texas the right to request from a payor information about itemized deductions, the heating value of gas, and the Railroad Commission of Texas identification number for the lease, property, or well that may not have been provided to the royalty interest owner. The request must be in writing and must be made by certified mail. A payor must respond to a request regarding itemized deductions, the heating value of gas, and the Railroad Commission of Texas identification number by certified mail not later than the 60th day after the date the request is received. An owner of a royalty interest in oil or gas may obtain information regarding production that has been reported to the Railroad Commission of Texas by contacting the oil and gas division of the commission or accessing the commission's website and providing the identification number of the lease and the county in which the lease is located.

# Texas Natural Resources Code

- **DIVISION ORDERS**  
**Section 91.402(c) through (i)**
- As a condition for the payment of proceeds, a payor may require a signed division order from the payee containing certain provisions. These provisions include:
  - Effective date of division order
  - Property description and type of production
  - Payee's fractional and/or decimal interest
  - Payee's type of interest (Royalty, Override, etc.)
  - Certification of title to the share of production being claimed
  - Unless otherwise agreed to by the parties, agreement to notify payor at least one month in advance of effective date of any change of interest
  - Agreement to indemnify and reimburse the payor for payments resulting from failure of title
  - Authorization to suspend payment to payee for title dispute or adverse claim
  - Name, address, and taxpayer identification number of payee
  - Provisions for valuation and timing of settlements of oil and gas production to the payee
  - Notification to the payee that other statutory rights may be available to a payee with regard to payments
- The statute also provides an example model form oil and gas division order that complies with the statute. Division Orders do not amend any lease or operating agreement between interest owner and lessee.



The ONLY national organization representing, solely and without compromise, oil and gas royalty owners interests.

[www.naro-us.org](http://www.naro-us.org)

Web site with current NARO information

Also link to NARO Message Boards