MEMORANDUM

FROM: Timothy D. Howell
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RE: Tanglewood Homeowners Association
Basic Oil & Gas Leasing Issues/Terminology

DATE: February 26, 2007

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1. Who is the "lessor" and who is the "lessee"?

The lessor is the landowner/mineral owner who grants the lease. The lessee is the oil and gas company acquiring the lease and the right to drill and operate wells, and is sometimes referred to as the operator

2. What surface rights does the Lessee typically acquire?

When a lease is executed, the oil and gas estate is the dominant estate. The lessee thus acquires the right to make reasonable use of the surface. However, like anything else, this point can be negotiated and limitations or complete exclusions can be placed on surface use and the location of drill sites.

3. What is a "bonus"?

"Bonus" is generally defined as "the cash consideration paid by the lessee for the execution of an oil and gas lease by a landowner." Williams & Meyers, MANUAL OF OIL AND GAS TERMS 103 (9th ed. 1994). Thus, the bonus is an up front, one-time payment to the lessor. The bonus payment would not be limited to the areas where actual drilling took place, but would be made as to each acre covered by the lease.

4. What is a "royalty"? And what is in it for the lessee - where does it make or lose its money (i.e., a "working interest")?

Perhaps the simplest way to answer these questions is by analogy. Consider the oil and gas produced from a well as a whole pie. The landowner's (i.e., lessor's) slice of the pie is the royalty it receives under the lease. A royalty is typically defined as the landowner's share of production, free of expenses of production. For this example, we will assume a ¼ royalty. The remaining ¾ of the hypothetical pie would be what is called a working interest. Under the lease, the lessee/operator would receive this remaining ¾ of production, but unlike the landowner's royalty, the working interest is subject to all costs of exploration and development. In other words, in exchange for taking on the substantial financial investment and risk associated with the drilling, the lessee is rewarded with a bigger piece of the pie. Thus, the "driller" makes money by drilling cost-efficient wells that produce a value in excess of drilling and production costs.

5. How does "pooling" work and what is it?

To begin with, pooling is generally defined as the bringing together of small tracts for the drilling of a single well for primary production on a spacing unit. A lessee's authority to pool is established by a pooling clause in the lease. The pooling clause establishes the manner and means by which the lessee may pool the leased acreage.

6. Why does the lease include oil when we are talking about natural gas?

It is true that the lessee anticipates it will produce natural gas from the well(s) it seeks to drill into the Barnett Shale formation. However, gas is oftentimes commingled with other hydrocarbons within the formation; thus, it is standard industry practice, and a necessity, for a lease to cover oil, gas and other hydrocarbons. Although the majority of production should be gas, it is likely the well(s) will also produce at least some oil and condensate. Both of these are valuable commodities. It is unreasonable to expect the lessee to return these substances into the formation. Instead, they will be sold and the lessor will receive the benefit by way of its compensation in the form of royalty payments. As a result, all hydrocarbons need to be addressed under the lease. In addition, gas condensate and/or casinghead gas fall somewhere in between what one generally thinks of as gas and oil. To avoid disputes over such issues, most leases — and all that we have seen — cover "oil, gas and other hydrocarbons."

Finally, at times oil and gas wells also may produce other valuable substances such as helium, carbon dioxide, or sulphur along with the oil and/or gas production. As a result, lessees typically want the right to anything of value that is produced with the oil and gas. This issue can be addressed and/or limited through the definition of substances covered by the lease.

7. Why doesn't the lease mention the signing bonus?

It is customary not to include bonus payments in the lease itself. Oil and gas leases are filed in the deed records. Lessees are not willing to publish the amount of bonus they pay because the highest amount on record then establishes the "floor."

As a practical matter, however, this should not be a point of concern. Remember that the bonus is "the cash consideration paid by the lessee for the execution of an oil and gas lease by a landowner." Williams & Meyers, MANUAL OF OIL AND GAS TERMS 103 (9th ed. 1994). Thus, the bonus will be an up-front payment received prior to or contemporaneous with execution of the lease. Typically, the way this works is that the lessee presents the lessor with a bank draft for the entire bonus amount along with the lease. The draft can be presented and negotiated as soon as the lease is signed.

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