Question 1 – February 2013 – Selected Answer 1

1) Two types of royalty interests available are a nonparticipating royalty interest, a working interest, and an outright "general" royalty. A royalty is the right to receive the gross revenues obtained from the sale of oil, gas or minerals. A royalty is the right to the gross revenues without subtracting or accounting for the cost of production. A nonparticipating royalty interest ("NPRI") is granted to an individual that is not an owner of the minerals or that otherwise has no interest in such minerals other than the interest in the royalty. The NPRI holder does not have the executive right (right to lease the minerals) or the development right (the right to develop the minerals). A working interest is the right to receive gross revenues from the sale of oil, gas or minerals pursuant to an oil and gas lease that also bears the cost of production. In contrast to an NPRI or a royalty held by a mineral owner, the holder of a working interest will have development and operating costs deducted from his interest prior to distribution of the funds. An owner of mineral rights may also be entitled to an outright royalty akin to an NPRI. Like an NPRI, the owner of the royalty in the mineral rights does not bear the costs of production and receives only his share of the gross revenues from the sale of oil, gas and other minerals pursuant to the lease.

2) No. The issue is whether the holder of a nonparticipating royalty interest is entitled to receive delay rentals. An oil and gas lease includes a habendum clause that sets forth the primary term and secondary of such lease. During the primary term, the lessee generally is not obligated to undertake any specific activities on the land. The secondary term is an indefinite term during which the lessee may hold the lease and explore and develop minerals so long as production in paying quantities ("PPQ") is obtained. The lease ordinarily ends at the end of primary term is no drilling has commenced. A delay rental allows the lessee to pay certain sums of money (the delay rentals) to extend the term of the primary lease. The delay rental may either be a condition to the lease or a covenant of the lease. Use of the word "unless" in the clause indicates that the delay rental is a condition and failure to make such rental shall automatically terminate the lease. A NPRI holder is not entitled to a portion of the delay rental since such rentals act as payments essentially for extending the primary term. Here, Lisa holds a 1/10th NPRI in the 200 acre tract. As a result, Lisa is not entitled to a portion of the delay rentals.

3) A "Pugh" clause is a clause applicable to pooling arrangements in which portions of a tract that are subject to a lease with a pooling clause but that are not pooled pursuant to that clause may be severed from the lease in the event production in paying quantities ("PPQ") is not obtained from the non-pooled portions. Under a pooling arrangement, a lessee may sign multiple leases with multiple owners of mineral rights and pool those tracts together to satisfy the obligation of production in paying quantities by obtaining PPQ from any portion of the pooled tract. By example, if Tract A and B were each 100 acres and were pooled, a well that has PPQ on Tract A would be sufficient to continue the lease on Tract B beyond the primary term assuming all of Tract B is pooled pursuant to the pooling clause. If a Pugh clause is included in Tract B's lease, however, any portion of Tract B that is not pooled pursuant to the pooling clause may be severed from the lease if PPQ is not obtained from the non-pooled portion. By way of example, if Tract A and Tract B are each 100 acres and 50 acres of Tract B are pooled with all of Tract A, PPQ for satisfaction of the secondary term of the lease with respect to the 50 pooled acres of Tract B will be satisfied by a well producing PPQ on any portion of Tract A or the 50 acres of Tract B. If, however, no well with PPQ is drilled on the non-pooled portion of Tract B (the other 50 acres) then those 50 acres will be severed from the lease and the lease will terminate by its terms.

4) A dry hole clause allows a lessee to continue the lease into the secondary term and avoid termination of the lease even if there no production in paying quantities ("PPQ") in the instance a well with no production (a "dry hole") is drilled during the primary term and good faith efforts are made to

commence drilling on a new well immediately thereafter. The habendum clause of an oil and gas lease sets forth the primary term and secondary of the lease. During the primary term, the lessee has no obligation, generally, to commence any activities. Assuming no work whatsoever has been commenced and no dry hole clause in this instance, the lease ends at the end of the primary term if there is no PPQ. The secondary term of the lease continues indefinitely and allows the lessee to remain on the land and continue exploring, developing and selling minerals so long as there is PPQ. A dry hole clause may be inserted to protect the lessee from losing the lease due to the expiration of the primary term and the lack of PPQ to continue the lease into the secondary term. If the dry hole clause is included, the lease will not terminate at the end of the primary term if a dry hole has been dug so long as the lessee has commenced operations to begin digging a new well. The dry hole clause may include a time period during which drilling on a new well and/or PPQ must be obtained before the dry hole clause expires.

5) No. The issue is whether holders of royalty interests in mineral rights are responsible for their pro-rata share of the lessee's (Oilco) production expenses. Royalties are the right to receive a portion of the gross revenues obtained from the production and sale of oil, gas, or minerals that are subject to such royalty. Royalties are generally not subject to the costs of production and instead are solely a portion of the gross revenues received from such sale. Production expenses are the expenses incurred to drill the oil, gas and minerals from the land (i.e., the cost to drill). The costs of production and drilling are borne by the lessee and those with a working interest in the well. Royalties do not bear such costs. Here, Bob and Lisa hold royalty interests in the 200 acre tract of land in Atascosa County. Lisa holds a nonparticipating royalty interest, which entitles her to 1/10th of such gross revenues from the sale of oil, gas and minerals from the land. Bob, as holder of the mineral rights and pursuant to the lease with Oilco, is entitled to a royalty of 1/3 of any production on such land. Since Bob and Lisa both hold royalty interests, neither Bob nor Lisa would be responsible for production expenses.

Question 1 – February 2013 – Selected Answer 2

<u>1. There are Royalty Interests, Nonparticipating Royalty Interests, and Overriding Royalty Interests</u>
First, there is the standard royalty interest. This is generally created when a party who has a working interest in the minerals of a tract conveys the working interest in a lease to someone else to produce. In the conveyance, the person retains a portion of all oil and gas that is produced free of production costs. Further, this person is entitled to delay rentals and bonuses. Here, Bob has a standard royalty interest.
Next, there is nonparticipating royalty interest ("NPRI"). An NPRI is conveyed out of the mineral owner's interest to a third party. This person gets to share in the gross profits of all oil and gas that is produced free of production costs. This person, however, is not entitled to delay rentals or bonuses. Here, Lisa has a nonparticipating royalty interest. Finally, there is the overriding royalty interest. This royalty interest is conveyed out of the lessees interest to a third party. This type of royalty interest will generally arise when an oil or gas company who is a lessee will convey an interest to a third-party to perform work, such as an engineer. This person will generally perform work or services at no charge to the lessee in exchange for a royalty interest that shares in the portion of all oil and gas that is produced free of production costs. Here, the facts do not state if anyone has an overriding royalty interest.

<u>2. Lisa is NOT Entitled to Any Delay Rentals</u>
The second issue is whether or not Lisa is entitled to any delay rentals. As stated above, an NPRI is conveyed out of the mineral owner's interest. An NPRI receives the gross profits of all oil and gas that is

produced free of production costs. The holder of an NPRI, however, is not entitled to delay rentals or bonuses. Here, Lisa has an NPRI. Oilco paid Bob, but not Lisa, delay rentals. Therefore, this was proper because Lisa is NOT entitled to any delay rentals because she is an NPRI.

3. A Pugh Clause Is a Clause Concerning Pooled Tracts

The next issue concerns what a "Pugh" clause is. A "Pugh" clause is an express term in an oil and gas lease that concerns pooled tracts. The clause provides that if only a portion of a tract is pooled with other tracts, production on the pooled tracts is ONLY good as to the pooled portion of the tract; there must be production in paying quantities on the remaining, unpooled portion of the tract. The lessee will have to produce on the remaining portion of the tract to keep the lease alive. Here, Bob's lease contains a Pugh clause. Therefore, if only a portion of Bob's tract is pooled, production in the pooled tracts will only be good as to the pooled portion of Bob's land and will NOT be considered production in paying quantities for the remaining portion of the tract. Oilco will have to produce in paying quantities on any unpooled tracts to keep the lease alive as to that portion.

4. A Dry Hole Clause is a Savings Clause

The next issue concerns what a "dry hole" clause is. A "dry hole" clause is an express savings clause in an oil and gas lease. The clause states that if during a valid lease a lessee drills a non-producing well (a dry hole); the lessee will have the opportunity to extend the primary term of the lease in efforts to have a producing well. The clause will generally state the amount of time the lessee will have to make a good faith effort to drill another well that will produce. Here, if Oilco drilled a well that is not producing in paying quantities, the dry hole clause will allow Oilco to extend the lease beyond the primary term and will have a certain amount of time (as described in the lease) to begin drilling another lease.

5. Bob and Lisa Are NOT Responsible for Their Pro-Rata Share of Oilco's Production Expenses

The final issue concerns whether or not Bob and Lisa are responsible for their pro-rate share of Oilco's production expenses. As stated above, a standard royalty interest and a non-participating royalty interest share in the gross profits of oil and gas produced free from production costs. Here, Bob has a standard royalty interest and Lisa has a non-participating royalty interest. Therefore, Bob and Lisa are NOT responsible for their pro-rata share of Oilco's production expenses.

Question 1 – February 2013 – Selected Answer 3

(1) Types of royalty interests: Landowner's Royalty Interest. A landowner's royalty interest is a cost-free interest in the production of oil, gas, and other minerals from the land. It is not an interest in the minerals in place, under the ground, so the owner of a royalty interest only has rights to a share of production once a well is producing. Nonparticipating Royalty Interest (NPRI). A NPRI is a type of royalty interest (as discussed above) which gives the owner a right to a cost-free share once production is reached, however, because it is nonparticipating, the owner does not have rights to participate in any other aspects of the royalty interest.

Overriding Royalty Interest. An overriding royalty interest is a type of royalty interest that lessees often reserve to themselves (or assign to a third party), that comes off the top of the royalty interest once there is production. This type of interest arises from the leasehold and terminates with the leasehold. It is also a cost-free interest in production as are all royalty interests. For example, beginning in May 2012, oil, gas or other minerals were produced in paying quantities from Bob's 200 acre tract. Thus, Bob is entitled to a payment of production - his royalty interest. Lisa also is entitled to her 1/10 NPRI. And, if

Oilco assigned the lease to a third party and reserved a fractional overriding royalty, then Oilco would also be entitled to their overriding royalty interest.

(2) Lisa, as an owner of a nonparticipating royalty interest, was not entitled to any delay rentals from Oilco. As an owner of a nonparticipating royalty interest, the owner is not entitled to any other benefits from the lease or production; merely a fractional share of production. Since delay rentals compensate a mineral interest owner for failing to reach production within the primary term of an oil and gas lease, no production was reached and thus, Lisa does not receive her fractional share of production.

(3) Pugh clause. A Pugh clause is a clause often contained in an oil and gas lease which states that if the acreage under the lease is contained in a pooled unit, the acreage that is not actually being held by production will drop off and no longer be leased. This clause essentially benefits the landowner by not keeping his land tied up in a pooled unit. When oil companies pool land, the effect is that production on any part of the pooled unit counts as production as to all the acreage contained and thus holds the land past the primary term and the lease continues regardless if the well is actually on the landowner's land or not. A Pugh clause drops off acreage contained in a pooled unit if there is no actual production from the leased land.

(4) Dry Hole Clause. A dry hole clause is a savings clause in an oil and gas lease that has the effect of extending the lease beyond the primary term or continues the lease even though no minerals are actually being produced in paying quantities. It states that if a lessee drills a well and it turns out to be a dry hole, the lessee will have additional time to commence drilling operations elsewhere in hopes to attain production. Thus, if this clause is contained in an oil and gas lease, if a dry hole is drilled, then the lease can still continue if within a reasonable time the lessee again drills elsewhere.

(5) Bob and Lisa are not responsible for their pro-rata share of Oilco's production expenses. Any type of royalty interest (as discussed above) is entitled to a cost-free fraction of production. Since this interest is cost-free, no royalty interest owner is responsible for their pro-rata share of a lessee's costs of production. Thus, Bob and Lisa, owning a royalty interest and a nonparticipating royalty interest, will owe Oilco anything to cover his expenses for drilling.