Negotiating Oil and Gas Leases for the Lessee

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In the good old days, there was relatively little negotiation of oil and gas leases. Lessors did not understand the leasing transaction and so did not know enough to negotiate. And, at least in speculative areas, what was at stake when the lease was negotiated did not seem worth arguing about. Bonuses were modest, royalty percentages were a standard one-eighth, and oil and gas prices were low. As a result, the printed form oil and gas lease presented to the landowner by the oil company was usually executed without change.

Times have changed! The 1970s saw a great increase in oil and gas prices and, with them, a corresponding surge in the value of oil and gas leases. Lease negotiation is now the rule rather than the exception. The keys to guiding an oil company client effectively in negotiating leases are (1) appreciating the function of the lease, (2) understanding how essential lease clauses work and interrelate, and (3) avoiding interference between essential clauses and negotiated provisions.

The Function of a Lease

An oil company has two fundamental goals when it takes an oil and gas lease: (1) it wants the right to search for and develop oil and gas upon the premises without accepting any obligation to do so; and (2) if oil and gas are located, it wants the right to maintain the lease for as long as it is profitable. Both goals are tied to the inherent uncertainty of oil and gas ventures.

The lessee generally does not know for certain that oil and gas are present under the property at the time the lease is taken. If they are present, they may be drained away by other operations in the area, or the price for which they can be sold may drop so precipitously that it is not worth taking the risk of drilling. Because of these risks, the oil and gas lessee is generally unwilling to commit to drill on the property.

The second purpose of the lease—the desire to keep it as long as it is profitable—is also related to economics. Oil companies are in business to make money, and they wish to maximize their profits when their risk taking results in production. Once production is obtained on a property, how long it will be profitable to maintain it is determined by economic factors that cannot be predicted when the lease is taken, e.g., the state of the technology available to produce oil and gas, the price for which production can be sold, and tax policy, to name just a few. That is the reason that modern oil and gas leases are drafted to extend "as long thereafter as oil and gas . . . are being produced. . . ."

Key Clauses

The basic purposes of the modern-day oil and gas lease are accomplished in just three essential clauses: (1) the *granting clause*, which spells out what rights are granted from lessor to the lessee; (2) the *term clause*, which spells out the period of time for which the rights granted in the granting clause will extend; and (3) the *drilling-delay rental clause*, which makes it clear that the lease is an option agreement by negating any obligation to drill. It is particularly important that negotiated lease alterations not interfere with the functioning of these clauses.

In addition to the essential clauses, most oil and gas leases contain a group of important defensive clauses, including (1) an operations clause, (2) a *force majeure* clause, (3) a shut-in royalty clause, and (4) pooling and unitization clauses. These clauses are necessary because most states require actual production in paying quantities to maintain the lease beyond the primary term. Since that is often impractical or im-

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