Mineral Rights Issues and How to Negotiate Them in a Conservation Easement

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Part One:
Coexistence of Conservation Easements and Oil and Gas Development
What Type and Degree of Mineral Development is Allowed?

- Surface mining on the property is prohibited by Internal Revenue Service Code Section 170(h).

- However, oil and gas exploration is allowed by the Code so long as the impact is restricted to limited, temporary and localized impacts that are not irremediably destructive of significant conservation interests.

- This means oil and gas development on the property puts the IRS tax benefits of the Conservation Easement at risk, but the two can potentially coexist.
The Mineral Remoteness Letter

- Internal Revenue Service Code 170(h)(5)(ii): “With respect to any contribution of property in which the ownership of the surface estate and mineral interests were separated, subparagraph (A) shall be treated as met if the probability of surface mining occurring on such property is so remote as to be negligible.”

- A letter from an expert indicating that surface mining is a remote possibility may protect the viability of a Conservation Easement when a severed mineral owner holds rights to perform surface mining operations.
What Type and Degree of Mineral Development is Allowed?

- IRS Code 1.170A-14(g)(4):
  “However, a deduction under this section will not be denied in the case of certain methods of mining that may have limited, localized impact on the real property but that are not irretrievably destructive of significant conservation interests. For example, a deduction will not be denied in a case where production facilities are concealed or compatible with existing topography and landscape and when surface alteration is to be restored to its original state.”
How Much Oil and Gas Development is Permitted?

- Insufficient case law and regulatory rulings exist to determine exactly what constitutes a permissible level of “limited and localized impacts.”

- IRS Letter Ruling #9318027 (1993) found the designation of drill site locations constituting less than 2.6% of a property’s total acreage was sufficient to maintain tax benefits under a Conservation Easement.

- While this degree of surface usage is a benchmark, the actual threshold is unknown and will likely be judged on a case-by-case basis. The IRS also considers compatibility with topography and requirements for remediation of the surface estate.
Rights of the Oil and Gas Lessee: Reasonable Use of the Surface Estate

• Because of its dominance, the mineral estate holds an implied easement to use as much of the surface as reasonably necessary for the development of the mineral estate.

• “Reasonable Use” extends to a wide variety of oil and gas related activities, including drilling of wells and the building of roads, pipelines, electric lines, as well as storage and processing facilities and the usage of large amounts of water.
Rights of the Oil and Gas Lessee: Reasonable Use of the Surface Estate

• This right is expansive, meaning an unrestricted oil and gas lessee likely holds the power to destroy the charitable tax deduction available to the Surface Owner under a Conservation Easement.

• “This right includes the legal privilege to use the surface in a way that interferes with the surface owner’s use of the land and that significantly damages the surface, without the legal obligation to make any compensation whatsoever.”

  – Ernest E. Smith
Texas adopted the Accommodation Doctrine in 1971.

Courts require application of the accommodation doctrine when the surface owner proves “there is an existing use by the surface owner which would otherwise be precluded or impaired, and where under the established practices in the industry there are [reasonable] alternatives available to the lessee whereby the minerals can be recovered.”

Courts further require that the Surface Owner prove “there is no reasonable alternative method available to the surface owner by which the [surface owner’s] existing use can be continued.”

The bottom line: The Accommodation Doctrine is rarely applied and provides few protections.
Almost all states with extensive oil and gas development have adopted some form of legislation to protect and compensate surface owners faced with development on their property.

These statutes typically prescribe a procedure for contacting and negotiating with surface owners prior to the beginning of operations.

However, **Texas has no surface damage statute!**
Surface Damage Statutes: Typical Elements

- Required Notice to Surface Owner
- Good Faith Attempt to Negotiate Damages
- Bonding Requirements
- Payment for Damages to Land and Crops
- Prescribed Method for Determining Damages
- Penalties for Non-compliance with Statute
- Statute of Limitations for Claims
- Possible Payment for Diminution in Value of Property
Surface Damage Statutes: Compatibility with Development

- Bakken Shale (North Dakota & Montana)
- Niobrara Shale (Colorado & Wyoming)
- Permian Basin (New Mexico)
- Woodford Shale, Granite Wash (Oklahoma)
- Marcellus Shale (West Virginia, Pennsylvania)

- Statutes protecting surface owners have **no demonstrable impact upon mineral development**.
Subordination of Mineral Interest to the Conservation Easement

• The Surface Owner/Easement Donor only has the power to subordinate the mineral interest they control.

• Minerals reserved and severed from the surface estate prior to the date of the Conservation Easement are not subject to the terms of the easement.

• Subordination of severed mineral interests will require their written consent, which may be difficult to obtain or possibly require compensation.
Alternatives to Subordination: Purchase of Mineral Interest

- By performing title research in the county records and tax rolls, the identity and location of severed mineral interest owners can be determined.
- Minerals in unproductive areas can potentially be purchased in a private transaction with the mineral owner for several hundred dollars per acre.
  - The purchase of productive or prospectively productive acreage can cost thousands of dollars per acre.
- Mineral owners are often hesitant to sell what often turns out to be a valuable long-term investment.
Alternatives to Subordination: Waiver of Surface Use

- If severed mineral interest owners refuse to sell minerals or subordinate their interest, consider requesting execution of a waiver of surface use.

- When properties are pooled and/or developed with horizontal wellbores, minerals can be extracted without use of the surface estate.

- This allows both the severed mineral owner and the Surface Owner to realize the full value of their respective interests in the property.
Alternatives to Subordination: Drill Site Designations

- If the severed mineral owners refuse to sell minerals or waive usage of the surface, consider asking them to agree to designate certain portions of the surface estate for drill sites.
- Designating drill site locations of limited size near the perimeter of the property helps to balance mineral development with conservation values.
- Vertical drilling could require one pad for every 40-80 acres, depending on the particular field.
  - Horizontal drilling can develop up to 640-1,000+ acres from a single pad location!
Surface Use Agreements: The Best Form of Protection

- Surface Owners holding a sufficient percentage of the mineral interest beneath the property typically have enough power to negotiate surface use protections within the Oil and Gas Lease or in a separate SUA.

- The SUA can give the Surface Owner influence over:
  - Location and size of infrastructure and roads
  - Remediation of the surface
  - Use of surface water and groundwater resources
  - Practices designed to minimize ecological disturbance
  - Monetary damages paid to the Surface Owner
Surface Use Agreements: The “Preemptive SUA”

- The Surface Owner (if they hold mineral interest) or the severed mineral interest owners can enter into a “Preemptive SUA” before any Oil and Gas Lease is negotiated.
  - This document lists surface protections deemed necessary to preserve the conservation values of the Conservation Easement.
  - The party signing the SUA pledges to negotiation the same (or better) protections in any future Oil and Gas Lease.
Perform an Initial Evaluation of the Property

1. Are the minerals leased or un-leased?
2. What portion of the mineral estate is held by the Surface Owner/Easement Donor?
3. Who owns severed mineral interest beneath the property? How much does each party own, and how fractured is ownership?
4. Has drilling and/or production of oil and gas already occurred on the property? Is it active?
5. Has a baseline analysis of the property’s environmental condition been performed?
6. Does the oil and gas operator have a duty to remediate the property under the oil and gas lease?
Build a Record Demonstrating Intent to Protect the Conservation Values

- Create a Baseline Documentation Report.
- Be fact and science intensive.
- Identify the location of the resource(s) to be conserved and protected.
- List current and historical uses of the property – habitat compatible.
- Include reports of wildlife experts, information on habitat, wildlife corridors, flora and fauna, etc.
A Few Instructive Scenarios...
Scenario #1: Surface Owner owns all Minerals; Minerals are not Leased

- This scenario is ideal, but in Texas it is rare.
- **Surface Owner has full power to subordinate** its own mineral interest to the conservation easement.
- **Surface Owner can execute a preemptive Surface Use Agreement (SUA), or negotiate surface protections into an oil and gas lease.**
- **Low risk of losing charitable tax deduction under Internal Revenue Code.**
Scenario #2: Surface Owner owns all Minerals; Minerals are Leased

- Examine the Oil and Gas Lease to determine existing surface protections.
- Absent protections in the Oil and Gas Lease, only common law remedies are available.
  - Accommodation Doctrine; Dominant/Servient Estate
- Request a subordination of the Oil and Gas Lease to the Conservation Easement or negotiate SUA with oil and gas lessee.
- High risk of losing charitable tax deduction under Internal Revenue Code, but ownership of minerals may provide power to modify the existing agreements with the oil and gas lessee.
Scenario #3: Surface Owner owns no Minerals; Minerals are not Leased

- Mineral Owner’s ability to conduct surface mining will depend upon date and language of mineral reservation instrument.
  - Before 06/08/1983, Surface Destruction Test is applied.
  - After 06/08/1983, Ordinary and Natural Meaning applied.

- If Mineral Owner holds ability to conduct surface mining, there will be a high risk of losing charitable tax deduction under the IRC.
- To mitigate/control oil and gas development, Surface Owner should obtain subordination agreements or purchase minerals from Mineral Owner(s).
- Degree of risk to charitable tax deductions will depend upon cooperation of severed mineral owners.
Scenario #4: Surface Owner owns no Minerals; Minerals are Leased

- Examine the Oil and Gas Lease to determine existing surface protections.
- Absent protections in the Oil and Gas Lease, only common law remedies are available.
  - Accommodation Doctrine; Dominant/Servient Estate
- Request a subordination of the Oil and Gas Lease to the Conservation Easement or negotiate SUA with oil and gas lessee.
- High risk of losing charitable tax deduction under Internal Revenue Code.
Keep in mind:

Sometimes you can make it work, and sometimes you cannot.
Part Two: Implementing and Monitoring Compliance with the Surface Use Agreement
Mitigation: Planning Impacts

- The most important planning occurs **before drilling and mineral development begins**.
- Identify and map the ecologically sensitive areas of the your property.
- Note the topography, drainage and water resource locations.
- Use existing roads, facilities
- Locate “Oil Field Corridors” along existing roads. Use the SUA and consultation with the oil and gas lessee to steer mineral development operations to designated locations and routes.
Spatial Mapping
Existing Roads
Oil Field Corridor: Consolidating Development
Mitigation: Construction Phase

- Geotextile Drilling Mats
- Stockpiling of Topsoil
- Require Clean Equipment
- Bore through Sensitive Areas
Mitigation: Boring Sensitive Areas
Mitigation: Boring Sensitive Areas
Reclamation

- Redistribute topsoil
- Seed bed preparation
- Proper seed mix
- Erosion mats
- Screening techniques
- Monitoring
Reclamation: Erosion Mats
Reclamation: Native Round Bales
Location of facilities!!!!
  • Terrain
  • Natural vegetation
• Color?
• Size of tanks?
• Wall?
Reclamation: Screening Techniques
Reclamation: Screening Techniques
Reclamation: Monitoring
Development: Advantages?

- Creating more desirable habitat
- Expanding grazeable acres
- Mitigate existing erosion
“Reclamation is a process, not a project.”
Reclamation: Effects of Weather

January 12, 2013

July 6, 2013
Mitigation and Reclamation: Resources

• Surface Operating Standards and Guidelines for Oil and Gas Exploration and Development: The Gold Book (Fourth Edition, 2007)

• Environmental Best Management Practices (published by the BLM)


• www.harc.edu – Houston Advanced Research Center

• www.gpri.org – Global Petroleum Research Institute
Part Three: Land Trust Issues
Land Trust Issues

• “Who owns the minerals?” “Who owns the executive rights?” “Who has the authority to lease the minerals?” Ask the questions early in the due diligence process!

• Educate yourself on oil and gas issues, and educate your landowners.
  • Stay up on new developments in the law.

• Understand what a mineral remoteness report is – and is not.
  • When should you use it to evaluate sub-surface mineral development?
Land Trust Issues

• Don’t take no for an answer. You can be creative:
  • Specify future drill sites
  • Compensation for surface protection agreements

• Make sure you have a seat at the table:
  • Notification clauses
  • Reimbursements for reviews and approvals

• Train your stewardship staff on surface use agreements. Have an action plan in the event that your landowner is not enforcing the plan.

• Ultimately, it comes down to a risk assessment for the land trust.
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