

Welcome!

Minerals: excepting and insuring; Water Rights
by John Rothermel

Note: Materials for the February webinar are available
at www.stewarttexas.com

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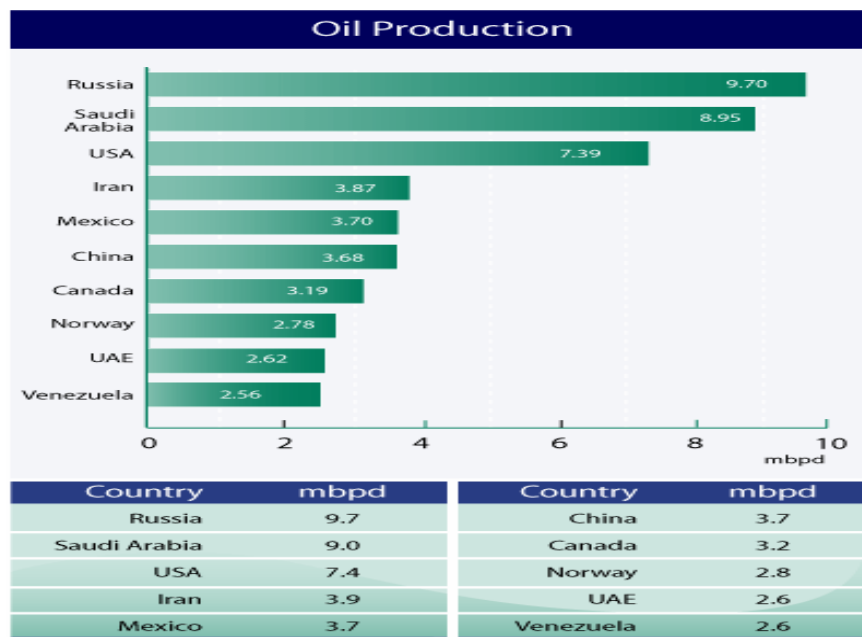
Minerals: excepting and insuring; Water Rights

Stewart Title Guaranty Company
March 2008 On-line TIPS
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There have been oil wells in Texas since 1866

- The first oil well was drilled in Texas in 1866.
- Texas still has nearly $\frac{1}{4}$ of the known oil reserves in the United States.
- As an oil producing nation, Texas would rank in the top 15 (were we still independent!) at about 935,493 bbls/day

World Oil Production



The extent of production remains fairly constant and fairly high

- Oil Production over the years:
 - 1937-77,565 wells
 - 1957-176,705 wells
 - 1977-163,826 wells
 - 2006- 151,832 wells
- Gas production over the years
 - 1937-2717 wells
 - 1957-13,681 wells
 - 1977-31,434 wells
 - 2006-83,218 wells

Oil and gas are part of the mineral estate

- Texas early on recognized that the fee simple estate can be divided or severed into a surface estate and a mineral estate.
- Once severed, the estates can pass through many different hands and have totally separate chains of title.
- Unless all of the mineral interests are acquired by the surface owner, the estate remains severed forever

What are minerals?

- The answer to this question has geological, legal and practical dimensions.
- Ultimately, after a series of landmark decisions by the Texas Supreme Court, minerals are those substances found more than 200 ft below the surface of the soil. Surface is from 200' below the surface to the surface.

What are minerals?

- Oil, gas and some kinds of coal are minerals.
- Lignite coal (surface mined) is surface
- Gravel is surface.
- Caliche is surface
- "Dirt" is surface
- If you have specific questions about another substance, contact a Texas underwriter who will have to research that particular substance

How are minerals severed?

- Minerals are severed from the surface by a mineral deed.
 - The deed must contain a legal description
 - Ironically of the surface
 - May sever at specific depths
 - May be all or a fractional interests
 - $\frac{1}{2}$
 - $\frac{1}{4}$
 - $\frac{1}{6}$
 - $\frac{1}{8}$

What rights does a mineral owner have?

- The main rights a mineral owner has is the right to explore for minerals and the right to produce and sell those minerals.
- These rights are superior to the rights of the surface owner.
 - The mineral owner has the right to use as much of the surface as is reasonably necessary to exercise his mineral rights.

How do we know that minerals have been severed?

- The mineral deed must be executed by the proper parties, contain a proper legal description and be recorded in the proper county records.
- Mineral deeds will typically be found in title plants and will be indexed to the land.

What is the appropriate search period for the title company?

- The search period varies by county.
- Since we have had production since 1866, in some areas, 1908 in others, 1920s and 30s in other and 1950s in still others, no hard and fast rule applies.
- **BUT, JUST BECAUSE YOU HAVEN'T HAD ANY PRODUCTION IN THE LAST 25 YEARS YOU STILL HAVE TO SEARCH FOR MINERALS**

What is the appropriate search period for the title company?

- If you have ever had minerals in your county, or if anyone ever thought you had minerals in your county, there have been mineral severances.
- Since the estates when severed become permanent ownership, those severed minerals exist for ever.

Oil Prices going up have caused lots of new exploration

- **Newark, East (Barnett Shale) Field
Discovery Date – 10-15-1981**
- **As of January 23, 2008, there are a total of 7,170 gas wells entered on RRC records.**
- **In addition, there are 4,350 permitted locations**

Barnett Shale

- This field produces in eighteen (18) counties:
- Bosque, Clay, Comanche, Cooke, Denton, Eastland, Ellis, Erath, Hill, Hood, Jack, Johnson, Montague, Palo Pinto, Parker, Somervell, Tarrant, and Wise

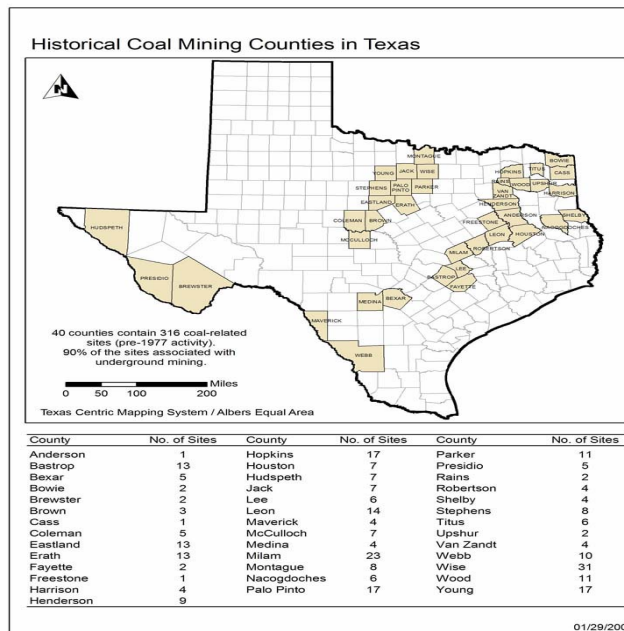


Barnett Shale

- **Gas Well Gas Production –**
- **January 2004 through December 2004 = 380 Bcf**
- **January 2005 through December 2005 = 501 Bcf**
- **January 2006 through December 2006 = 698 Bcf**
- **January 2007 through November 2007 = 768 Bcf**

Barnett Shale

- For 2007 production accounts for 15% of Texas
- (this amounts to about 3.75% of US known reserves...15% times 25%)
- Production
- • Drilling Permits Issued –
- January 2004 through December 2004 = 1,112
- January 2005 through December 2005 = 1,630
- January 2006 through December 2006 = 2,514
- January 2007 through December 2007 = 3,679
- • There are a total of 191 operators in the
- Newark, East (Barnett Shale) Field.



History of Texas regulation of Coal Mining

- The first account of coal mining in Texas was written in 1819. Most of the coal extraction consisted of small operations until the 1880s.
- Three classes of coal have been mined in Texas: bituminous, sub bituminous, and lignite. Most of the coal mining done from the 1800s to the 1940s used underground methods, where vertical shafts or sloped adits (tunnel entrance) provided access to the mine workings. Surface mining methods (strip mining) to extract coal were used starting in the 1950s.
- The major coal mining areas or regions have been identified through several inventories. Coal mining activity has been verified in 32 localities within 18 coal mining areas/regions (click on the upper right thumbnail map for a higher resolution version). The current tally of historical coal mine sites stands at 316. Historical coal mining activity took place within 40 counties (click on the lower right thumbnail map for a higher resolution version).
- All coal mining as of August 1977 has been regulated under the federal Surface Mining Control and Reclamation Act (SMCRA). The mine sites included in the two maps were all in operation and abandoned prior to passing the SMCRA legislation; therefore the mining companies were not required to reclaim them. Source Texas Railroad Commission

How are the minerals brought to market?



- Many times by pipeline
- Pipeline companies will have easements or rights of way recorded in the public records
- How do we know if they are still active?
- <http://www.rrc.state.tx.us/divisions/gs/permitting/index.html> has a list of all active pipeline companies in Texas

How does the mineral owner get his minerals produced?

- Most of the time, the drilling company will approach the mineral owner for a lease of the minerals.
- Technically, a mineral lease in Texas is a deed with a condition subsequent. What this means is that the lessee owns his rights until something happens that divests him of his rights.

Leases

- First although some old-timers still talk about the producers 88 lease, there really isn't such a standard form. But most leases do contain some standard features:
 - Parties
 - Legal description
 - Royalty payment: usually 1/8th or 1/6th
 - How the lease is held

Leases

- Leases are held in several ways:
 - The initial term of the lease perhaps 3 years based on the payment of a “bonus” per acre and then perhaps an additional amount for each of the 2nd and 3rd years.
 - Held by production
 - Held by shut in royalties
 - Held by payment instead of drilling

How long can the lease last?

- If there is production, the lease will last for as long as there is production
 - Some wells have been producing since the 1920s and 1930s. See Luling and Kilgore and the East Texas Oil Field.

What other kind of mineral interests are there?

- In addition to the mineral interest sometimes called a working interest, other common rights are royalty and non-participating royalty interests.
 - These royalty interests are simply a right to receive part of the production or money paid for the production. They do not have the right to participate in the decisions about whether to lease, where to drill or how much the payments are.
 - Neither do they bear any part of the expense of drilling.

Mineral Interests come in fractions

- Title companies avoid setting out how much of the mineral estate a particular person owns because of the complexity of the fractional interests.
- Let's say that a person owns $\frac{1}{2}$ of the minerals and that owner and the owner of the other $\frac{1}{2}$ interest enter into an oil and gas lease. They negotiate a $\frac{1}{6}$ th royalty.

Mineral Interests come in fractions

- Owner A conveys a $1/8^{\text{th}}$ overriding royalty to his friend C. Later A dies and leaves his mineral interest to his wife and 3 kids.
- D wants to buy the interests from them. Who owns what?

Mineral Interests come in fractions

- A owns $1/2$; B owns $1/2$ of the mineral
- There is a $1/6^{\text{th}}$ royalty and a $1/8^{\text{th}}$ ORR so at this stage A owns $(1/2 \times 1/6)$ or $1/12^{\text{th}}$ less $1/8^{\text{th}}$ of the $1/12^{\text{th}}$.
- $1/12 = 7.29\% \times 87.5$ (the remainder after taking out the $1/8^{\text{th}}$ ORR and thus owns 7.29% of the royalty.
- When he dies and leaves the property to his wife and kids equally, the ownership is

Mineral Interests come in fractions

- $(1/2 \times 1/6) - (1/8 \times 1/12) / 4 = 1.8225\%$ each or slightly less than $1/50^{\text{th}}$ of the royalty.
- Although they still own $1/8^{\text{th}}$ or 12.5% of the minerals.
- It's just too much math for the amount of premium we receive!

Law of Capture

- Texas follows the law of capture when dealing with oil and gas.
- This means that the oil under ground may be pumped out by whoever can get a well into that pool of oil.
- Texas only allows wells as distinct distances from one another. Usually 40ac for oil and 640 ac. for gas.
- Unless all of the owners of the 640 ac. can get leased in the same pool, only the owner of the 10 ac drilling tract will get all of the production.
- To avoid this unfairness and to prolong the productive life of the well, all of the owners will be put into a unit or pool. Units are usually gas and pools are usually oil.
- You have to do the arithmetic that we did for the other slide for all of the owners in the pool/unit in order to know how much of the production each owner, mineral or royalty, will get. Usually expressed as the fraction that their mineral ownership bears to the entire pool. So if you own 120 ac of a 640 ac pool you own 18.75% of the production; which is then multiplied by your royalty.

The law of capture



- The law of capture is based on the old Roman hunting concept that you could follow your prey where ever it went and drag it off the neighbors land when it died.

Price Does Matter

- In 2006, Texas oil well produced an average of 535,114,593 barrels per month or 17,832,153 barrels per day.
- The average well produced 6.12 barrels of oil per day.
- When the price of oil was \$20/ barrel = \$122.40 per day or \$3,672/mo.
- At \$101/pbbl = \$621.15 per day or \$18,630/mo.
- A significant difference of nearly \$15,000/mo.

Price Does Matter

- At \$15,000 per month difference in the value of a typical well, it is easy to see why places that haven't seen exploration or production in years or even decades are being looked at again. \$180,000 per year difference is real money.
- In areas where exploration and production have been non-existent, title practices may have gotten a little forgetful or even sloppy.

Don't search/Don't care

- If we have been insuring only the surface estate, we really don't need to do much to avoid claims. We simply show surface only in item 3 of Sch. A, and in the legal description and take exception to the deeds where the minerals are severed in Sch. B. We don't need to show all of the leases, assignments, royalties or further conveyances of the minerals.

Don't search/Don't care

- But, we are creating a claim waiting to happen if we insure fee simple on Sch. A, don't limit the legal description and don't show the mineral deeds on Sch. B.
- We have then insured fee simple title to the minerals and if they have been severed, the insured has suffered a compensable loss.

Do search/Do care

- On the other hand, we can't just except to all oil, gas or other mineral that may be produced from the land UNLESS we show the deeds conveying the minerals.
- P-5 prohibits general exceptions without the consent of the insureds. With some share of \$611 per day at risk, many buyers are no longer agreeing to general mineral exceptions.
- Thus we have to search and care

TIPS for handling mineral interests

- #1:
- Avoid setting out exact fractional interests. If required by the insured to set out such interests, preface them by inserting the word “stated” as in a stated 1/8th interest. That way we are simply saying what the parties to the instrument said.

TIPS for handling mineral interests

- #2
- If insuring just the surface, do not show assignments of leases, leases, royalty and NPPR instruments and the like.
- Do say, “All oil, gas and other minerals appear to have been conveyed by [set out deed reservations by at least Vol/Pg]. These interests have not been traced since such reservation/conveyance”

TIPS for handling mineral interests

- #3
- To the extent possible, put the surface language in the estate, the legal description and exception.

T-19/T-T19.1

- The T-19 series endorsements insures against loss caused by damage to structures (present or ((after 4-1-08)) future) caused by exploration or production of minerals.
- If examination of the file determines the existence of severed mineral interests, the form allows this paragraph to be deleted.
T-19 3b and T.19.1 2b

T-19/T-T19.1

- Many lenders and some owners are reluctant to have their coverage limited by removal of this language.
- What are we to do?
- Fortunately, for both residential and small rural tracts, we have some help.

T-19/T-T19.1

- Urban tracts: many cities and many sets of restrictions prohibit drilling oil or gas wells within residential subdivisions. Such drilling ordinances or restrictions will allow us to issue the T-19 series intact.
- Rural tracts: since most of these properties are outside of the city limits and are unrestricted, we have to look elsewhere for help. Fortunately, the Texas Rail Road Commission has provided a valuable aid:

T-19/T-T19.1

- **RULE §3.37 Statewide Spacing Rule**(a) Distance requirements.
- (1) No well for oil, gas, or geothermal resource shall hereafter be drilled nearer than 1,200 feet to any well completed in or drilling to the same horizon on the same tract or farm, and **no well shall be drilled nearer than 467 feet to any property line**, lease line, or subdivision line; provided the commission, in order to prevent waste or to prevent the confiscation of property, may grant exceptions to permit drilling within shorter distances than prescribed in this paragraph when the commission shall determine that such exceptions are necessary either to prevent waste or to prevent the confiscation of property.

T-19/T-T19.1

- $467' \times 467' = 218089 \text{ sq ft} / 43560 \text{ sq ft} = 5.007 \text{ ac.}$
- So, unless you have some indication (like a well shown on a survey) that the RRC has given special permission, it is safe to issue the intact T-19 series whenever you tract is less than 5 acres.

Insuring Minerals

- Since the mineral estate in Texas is clearly a real property interest it is at least theoretically possible to insure it.
- As has been pointed out in this presentation, oil and gas law is complicated and the fractional interests can get very difficult to compute.
- Thus, insuring mineral estates must be treated differently than insuring dirt.

Insuring Minerals

- We would require that the title agent search the surface and the minerals; creating at a minimum a run sheet showing all of the documents affecting the minerals: deeds, leases, royalties, NPPRs, rights of way, etc.
- We would then require a 2nd opinion from a reputable oil and gas attorney whose credentials have been approved by Jim Gosdin, Jim Kletke or John Rothermel. This opinion must be paid for by the parties and is not part of the title insurance premium.

Insuring Minerals

- Finally, to justify the time, trouble and expense of this additional effort, we will not consider a mineral policy in a policy amount of less than \$500,000
- Note however: our strong preference in Texas is that the policy exceed \$5,000,000 – Premium for which is currently \$23,209.

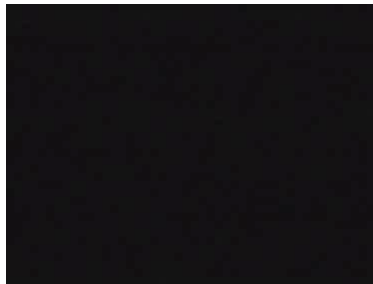
Insuring Guidelines

- There must be a **sovereignty search of title**: (a) a **plant search by the title insurance agent** in jurisdictions where title plants are maintained by title insurance agents, and (b) a **courthouse search by a landman** or experienced attorney approved by the examining attorney.
- A **copy of the run sheets and all documents** must be provided to the examining attorney to prepare a title opinion.
- The opinion must certify (a) that the attorney conducting the examination has examined a sufficient abstract or search of title to allow an **unqualified opinion as to the ownership of the mineral rights interests being insured**, subject to any requirements, and (b) that the **search of title commenced with the sovereignty** of the soil.
- The **examining attorney must (a) have been licensed for a minimum of 10 years, (b) have a reputation as a reliable, experienced and respected minerals/oil and gas title examiner, (c) be licensed in the state in which the subject mineral rights interests are located, (d) be approved by state counsel, and by a senior underwriting counsel** in the Stewart Legal Services department.
- The title opinion must be reviewed by and deemed satisfactory to state counsel and also must be approved by a senior underwriting counsel in the Stewart Legal Services department.
- Stewart Title Guaranty Company will not issue on mineral rights unless the minimum policy amount is **\$500,000**. **Stewart will directly issue the title policy** with the coordination of state counsel or National Title Services personnel where allowed by law.
- Stewart must be provided with a satisfactory deposit for issuance of the policy. The Company should file (1) a separate rate of 150% of the basic rate in each state where filing is appropriate, and (2) include a requirement for direct issue with a deposit that can be offset against the issuance of a policy.
- At this time, a separate policy should not be filed. **Stewart will use the standard policies and add (a) standardized exceptions, and (b) exceptions based upon state law, the specific title search and examination, and standard exceptions recommended by the title examiner.**
- The issuance of any policy is **subject to any reinsurer's acceptance**, and Stewart's acceptance of any reinsurer's conditions and fees.
- The issuance of any policy insuring mineral rights interest will be in compliance with applicable state rules and regulations.
- **The examining attorney will identify any unique statutes, pending legislation, or regulations affecting the interest to be insured.**
- The examining attorney will identify whether unrecorded documents exist and will obtain or take exception.

Insuring Water

- Stewart Water is the exclusive entity that handles water rights insurance in Texas.
- We use standard forms and standard rates but with special exceptions
- We insure groundwater (underground) not lakes.
- Contact Joe.Knox@stewart.com for information.

The whole idea of this presentation
is to get us speaking the same
language



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