Dealing with Compulsory Integration Creatively

by Sue Smith-Heavenrich

Broader View Weekly, December 12, 2008

When Robert Salvato and his brother-in-law Jamal Diboun were first approached by landmen, they didn't want anything to do with gas leases. Their families live close to each other on an old farm along Nobles Hill Road in Van Etten, a place they purchased for the beauty and quiet. Then the landmen came.

Salvato and Diboun shared their experiences with a dozen people who showed up for a meeting hosted by the Citizens Energy Coalition at Spencer Town Hall last Wednesday, December 10. After a program on closed loop drilling, presented by Nick Schoonover of the Tioga County Landowners Group, Salvato and Diboun took the floor to talk about how they dealt with compulsory integration.

It all started last winter when a representative from Fortuna informed the men that their land would be included in a drilling unit and the work would begin in March. "We began asking what are our rights? What are the possibilities?" said Salvato. They found little information to guide them.

Though they knew they would be in a drilling unit, Salvato and Diboun did not want to sign a lease. Even when one company offered $3,000/acre and an 18% royalty they left the leases unsigned. "We kind of hoped that if we ignored it, it would go away," Salvato admitted.

But it didn't go away, and in July they received registered letters informing them that their land was part of a drilling unit through compulsory integration. Three acres of Salvato's property and 15 acres of Diboun's land were included in the unit. The letter gave them 21 days to decide how they wanted to handle the compulsory integration orders.

That's when they got busy. "We drew up a dream lease," Salvato said. They listed things they would want included if they had to sign a lease. "We had provisions such as leasing only for the strata they were drilling, only for this particular well, only for five years, and no surface rights or storage."

The two had been warned that, once in a unit, they would be inundated with landmen trying to swing one last deal. "It never happened," said Salvato. Only one landman showed up, and he wasn't willing to negotiate on their terms.

So Salvato and Diboun decided to look at their options. "One option was to become a participating owner – to buy in our share of the well," Salvato said. "The cost for just my 3-acre portion would have been $23,000." Another option was to become a non-participating owner, earning a royalty only when the energy company recovered three times the cost of drilling the well.

The pressure to make a choice became overwhelming, and Salvato admitted that it got to the point where they figured it would be easier to just do nothing – to just take the 12.5% royalty. Instead, they decided to try something different: lease their acres to an acquaintance who worked in the gas industry and split the royalty.

Howard Drilling, a family-owned business from the Allegheny area, offered to lease the land, paying each landowner who invested with him $1500/acre and a 12.5% royalty until the well expenses were paid up. After that the landowners split the royalties with the company 50 – 50.

“This is something anybody could do,” said Diboun. “Create a land group and hire an investor. The reality is that they [gas companies] aren’t going to stop drilling just because one person won’t sign a lease.”

Salvato offered these words of advice: talk to your neighbors and join together in a coalition, no matter how small. Their combined acreage came to just under 50 – a reasonable risk for the small Howard Drilling company.

The other thing Salvato and Diboun did was to lease only the mineral rights for gas. Because they retain the surface rights they have an opportunity to lease to a wind energy company, should one be interested.

Fortuna began drilling the well in August, and by November everything was finished. One of the more frustrating things the brothers-in-law faced during the drilling, was finding someone in charge of the various operations – from site preparation to drilling – with whom they could talk. The workers were always good people, Salvato explained, but there was never one specific person from Fortuna overseeing the entire operation from beginning to end.

The biggest problem was traffic on the road. The trucks, loaded with oversized rigs, took up so much of the road that local drivers were concerned about safety. Not only that, Salvato said that they often had to remind the drivers to slow down. But overall, he noted, “they were very professional and focused on completing the job.”

Sidebar

Compulsory Integration at a Glance

If you don’t have a lease and you are integrated into a drilling unit, you have the following options:

- You may elect to do nothing, in which case you will receive a royalty that reflects the lowest royalty paid to landowners in the unit, but no lower than 12.5 percent for the resources extracted from your share of the unit.

- You may choose to become a participating owner, paying your portion of the drilling costs up front. If you strike gas, you receive 100 percent of the royalty for your share. If you strike a dry hole, you lose your investment.

- You may be a non-participating owner, and pay nothing. But you do not receive royalties until the well has paid for itself three times over. After that you receive your full share of production and are treated as a participating owner.

Some landowners are finding creative ways to deal with compulsory integration. Among them:

- Form an LLC, lease your land to yourself, and begin collecting royalties (though reduced) from the first year. By year three you receive 12.5 percent and the fourth year you begin receiving your full share of production royalties.

- Form a coalition and lease to an investor or small operating company under whatever terms you negotiate.