The Marcellus Shale:

Natural Gas Leasing

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FARMING & NATURAL GAS LEASING

By: Penny Thelman

Farmers are a group that should be closely following the progress of Marcellus Shale natural gas leasing activity. Gas production from deep wells has historically been compatible with farming practices in other regions of New York in non-Marcellus Shale areas. If adequate planning and safeguards are put in place, as part of the lease negotiation process, then farming and gas production can co-exist compatibly for the duration of the production period - as long as 30 to 40 years. Some examples of items to consider are: well site, access road and pipeline locations, preferably in non-productive crop land areas, coordination of active drilling around planting and harvesting times, banking of top soil from disturbed areas, containment of well drilling fluids and safeguards to insure that on site water resources needed for irrigation and livestock are adequately protected. All such issues should be included in a lease addendum.

The amount of actively farmed land lost to drilling is likely to be very small. Initial well drilling can affect an average of five acres but a completed well site is usually less than an acre in size. When the active drilling phase is completed the land should be graded and seeded. Installation of gas collection piping and new access roads are additional areas of disturbance which should be coordinated as a function of the anticipated long term operations of the farm. The amount of disturbance will depend on the well pad location. One advantage of horizontal drilling under the proposed new DEC regulations is that multiple wells will be drilled from one well pad site. That one well pad site can service a pooling unit of one square mile (640 acres). Not every property will need to have a well site on it in order for the gas to be collected from under it.

Wells can generate income to provide farmers with the ability to lessen debt load so that the farms function economically during times of higher production costs, poor harvests or lower product values. They also provide funds to finance needed farm improvements and equipment purchases that are intended to make the overall farm operation more productive. In past years, such increased costs, poor harvests or poor prices (sometimes all of them) have caused farmers, or the landowners who own the farm parcel, to sell parcels of productive farmland for housing and other uses. Once converted for housing, commercial or industrial uses these acres are lost for valuable agricultural crop production.

As noted in the Article "Will My Property Taxes Go Up If I Sign a Gas Lease?" from the Second Quarter 2009 Newsletter, the production of gas does not cause the loss of an agricultural assessment of the entire farm parcel (only the portion of the property used for gas recovery, processing and transportation will lose its exemption). Also, "... land converted to a nonagricultural use through oil and gas exploration, or extraction activity....would be ineligible for an agricultural assessment but would not be subject to a payment for conversion."[1]

In negotiating a natural gas lease a farmer should look not only to the short term financial gain resulting from the lease bonus payment but also to the specific provisions that can be negotiated as part of a lease addendum to protect the long term viability of the farming activity for future generations.

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[1] As noted in the NYS Board of Real Property Services March 2008 publication Partial Reduction in Real Property Taxes for Eligible Farmland in New York State: You can access this information on line at: http://www.orps.state.ny.us/pamphlet/exempt/agassess.htm

Farming & Natural Gas Frequently Asked Questions (FAQs)

Q: **How much land will I lose to the well drilling activity?**

A: During the active well drilling phase the average disturbance area is 5 acres for the well drilling, pad site construction equipment storage area and for the wastewater pond. There will also be areas needed for the construction of the gas pipe lines and access road with the amount of disturbance depending upon the location of the well site.

Q: **Will I be able to farm in and around the well location when the drilling activity is done?**

A: Yes, other then an area around the finished well pad itself (about an acre) and the access road, the rest of the surface around the well location is usable. There will also be surface disturbance in areas where the collection pipes are laid but once installed the pipeline areas can be reclaimed and converted back to farming acreage. Fencing around the well pad should be addressed if livestock will be pastured around the well site. You should contact your attorney and have topsoil storage, regrading and seeding of disturbed areas and possibly fencing negotiated as part of the lease, as well as requiring pipeline to be installed below a specific depth so as not to interfere with tillage.

Q: **Will the drilling occur during planting or harvesting season?**

A: The actual drilling time for one well can take from approximately 30 to 90 days (depending upon site conditions, weather and water access). However, since multiple wells will be drilled from an individual well pad site active drilling activity can continue for up to a year of so. Noise and activity from the drilling operation and construction of the access road and well pad might be disturbing to livestock. After the active drilling period, the noise from the site is usually limited to the hum from a compressor (which can be baffled) for the gas and occasional maintenance access. As set forth in the article "Hunting For Royalties?" in our Winter 2009/2010 Newsletter, studies and empirical evidence have shown that animals apparently get used to the noise and activity. Limiting the timing of the drilling and access are items that may be able to be negotiated as part of a lease addendum.

Q: **What about being able to use some of the gas produced?**

A: Under usual provisions of a lease a landowner is entitled to some free gas produced from the well(s). Some landowners, especially farmers, may find it economically beneficial to take advantage of that right. Depending upon the well site and its proximity to the farm buildings, the gas produced can be utilized for livestock facilities, grain dryers and residences. The expense for installing and maintaining the equipment to get the gas from the well to the farm, as well as any liabilities associated with its use, need to be factored into the cost/benefit analysis. The relevant lease provision should allow the landowner to receive payment in lieu of the actual gas allotment.

ESTATE PLANNING FOR NATURAL GAS LEASING

By: Gary M. Schuster, Esq.

For many landowners, leases with natural gas companies cannot come too soon. However, it will still be some months before New York State completes its environmental review process and resumes issuing gas drilling permits. That delay should be put to good use by landowners anticipating signing leases. Receiving substantial income in the form of a lump sum signing bonus, hopefully followed by ongoing royalty payments, can bring unanticipated consequences with respect to current and future taxes, and can also stress relationships - both business and personal. It is not unusual for a large landowner to want to pass his land holdings down into future generations. That same desire should also motivate the landowner to undertake careful advanced planning so the hoped for "windfall" of bonuses and royalties will benefit both current and future generations.

Both federal and state governments tax the transfer of a decedent's "net estate". The "net" estate generally means that when determining the value of an asset you deduct from its fair market value the amount of debt on the asset. So for example, if you own real estate worth $2 million, but your mortgage is $1 million, the net value for estate tax purposes is $1 million.

The current status of the federal estate tax is actually quite odd. The estate tax expired on December 31, 2009, and will be reinstated on January 1, 2011. So you can avoid federal estate tax by dying this year! While wildly tax efficient, that is not advice we have given to any client. In any event, Congress is expected to revise the estate tax laws and try to make any such revision retroactive to January 1, 2010 to cover deaths during 2010.

Under current tax law, federal estate tax becomes payable when transfers at death are valued at $3.5 million or more. The highest tax rate was 45%. A revised tax law will probably be similar. The threshold for the New York State estate tax is lower, at $1 million.

Anyone familiar with the rates being paid by gas companies for signing bonuses and royalties knows that these thresholds might quickly be exceeded with a lease for a large parcel of land or a productive gas well. The value of the lease is not only a function of the bonus payment but also the net present value of the anticipated stream of income from the royalty payments.

There are many lawful ways that large estates can reduce estate taxes. Such estate planning frequently involves making gifts before death. These gifts take assets out of the estate. Of course, tax-free lifetime gifting is also limited, currently to $1 million. Within these limits there are many useful things that can be done.

For example, a person with substantial land holdings could gift portions to their children. The gifts could be specific acres, or undivided interests in the entire property. Contracts would be needed to enable the donor to maintain control. When a gas lease signing bonus is paid, the bonus would be apportioned among the several landowners. The wealthy donor would receive less and her estate would be smaller, reducing or possibly avoiding estate tax upon her passing.

As an alternative, rather then gifting land, the donor could gift the right to receive the bonus or royalties, either in whole or in part. Yet another alternative would be to convey the land to a limited liability company, and then convey to the heirs small interests in the LLC. When determining the value of these interests, significant discounts might be available because those small interests do not exercise control over the LLC and cannot be readily sold. This is a very common asset planning practice.

For example, suppose a parcel worth $6 million is conveyed to an LLC wholly owned by the donor. The donor then gifts to each of her two children 5% interests in the LLC. Ordinarily the value of a 5% interest would be $300,000. However, applying discounts of up to 30%, the value of the interest for estate and gift tax purposes would only be $210,000 as against the $1 million lifetime limit. That means more property and value could be moved out of the donor's estate without triggering the estate and gift tax. Naturally there are other rules and limitations that would apply, but this example illustrates the principle and value of discounted gifting.

Apart from putting land into an LLC, a landowner could assign to the LLC the right to receive a signing bonus or royalties. After gifts, portions of the signing bonus and royalties would likewise be removed from the landowner's estate at discounted rates.

For landowners contemplating a gas lease, the time to make gifts of land or LLC interests is before a lease is signed and gas starts pumping. This is because the property, and the owner's estate, will become much more valuable after the lease is signed and gas production occurs. Also, tax planning of this nature takes time - realistically, several months of discussions, analysis and drafting by attorneys and accountants. Often, executing the plan requires making numerous gifts over many years. Landowners are well advised to start planning early. Remember, when considering the monies you anticipate receiving from signing a gas lease, what really matters is not how much they pay you, but how much you keep for yourself and future generations.

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NYC WATERSHED DECISION

BREAKING NEWS

On April 24, 2010, the NYSDEC Commissioner announced that the lands within the New York City and Syracuse watersheds will not be considered as part of the DEC's ongoing SGEIS process. As a result of that decision, any applications for gas well drilling permits in those areas will need to meet special requirements relating to the unfiltered surface water supply, including conducting individual environmental reviews. The DEC announced that because of that action it anticipates completion of its FGEIS process and adoption of new regulations by late fall.

THE BIG BOYS ARE COMING TO THE MARCELLUS

It's a race to the starting line for several major energy companies:

- EXXON MOBIL CORP. announced in December 2009 that it will buy fellow Texas energy company XTO Energy Inc. for $41 billion. XTO has about 280,000 acres under lease, much of it in the Marcellus Shale area, managed by its regional office in Indiana, PA. Exxon's press release states that it believes the deal will "enhance Exxon Mobil's position in the development of unconventional natural gas and oil resources."
- In October 2009, Newfield Exploration Company and HESS CORPORATION announced the signing of a joint exploration agreement in the Marcellus Shale play. The agreement covers up to 140,000 gross acres. Hess acquired the leased areas in Wayne County, PA from Chesapeake.
- In June 2010, ROYAL DUTCH SHELL paid $4.7 billion to buy land that holds natural gas deposits in the northeast and Texas. Shell has acquired leases on more than a million acres of land. Much of that investment includes Marcellus Shale deposits.