FACTSHEET

LEASING OF OIL AND NATURAL GAS RIGHTS IN ONTARIO

(REVISED APRIL 4, 2001)

INTRODUCTION

In most of southwestern Ontario, the landowner owns the rights to minerals, including oil and gas, located beneath their property. The exploration for oil and gas is a costly, risky and technically complex enterprise, with typical costs to drill and complete a successful well between $100,000 and $500,000. Resource companies carry out most of the exploration and production in the province. In order to obtain the right to search for and produce oil and gas, companies will lease the mineral rights from the landowner.

Lease agreements are a collection of rights, grants, concessions and obligations between the landowner and the would-be developer of the oil and gas resources. The lease approach is one that best meets the requirements of both the landowner (Lessor) and the oil and gas company (Lessee). The landowner stands to gain financially from a situation in which he may otherwise not have been able to attain on his own, especially considering the risky and capital intensive nature of oil and gas exploration. For the oil and gas company, they benefit from taking risks and using technical expertise to be able to locate and produce the oil and gas. As with any agreement, the Lease must benefit all parties involved.

LEASING OF MINERALRIGHTS

The typical land acquisition procedure begins with a decision by an oil/gas company to move into a particular area. Land titles in the land registry office are searched to determine the registered owner of the mineral rights. The landowner is then contacted by an employee of the company or by an independent leasing agent acting on the company's behalf.

There is no such thing as a standard or mandatory oil and gas lease in Canada. However, every lease must deal with the same issues: what rights are granted, the obligations to drill, royalties, the length of the primary term, and numerous other issues that must be spelled out between the Lessor and the Lessee.

Companies attempting to lease mineral rights refer to the following four main points:

a) Consideration: A company wishing to acquire your mineral rights will offer monies as compensation to enter into the lease agreement. Often the consideration payment is of greatest interest to the landowner because it represents ready cash at the time of signing.

b) Royalties: A landowner is entitled to 100% of the minerals underlying his/her land. However, there are substantial risks and problems in locating and producing these resources. Exploration costs are high and there are substantial risks that a dry hole will be encountered. By leasing, rather than directly sharing the risk, landowners take a percentage share of the production value. The royalty negotiated with the company is your share of the production. Royalties are often paid on the "value of the product at the wellhead," less any transportation and processing costs necessary to deliver the oil or gas to market.

c) Length of Lease: A mineral lease grants a company the exclusive rights to drill for the minerals on the land or lands pooled with them for a specific length of time. If the company fails to perform its obligation to drill under the terms of the lease agreement within the set time frame, the lease expires and the company no longer retains a legal interest to your lands.

If the company drills within the lease period, the lease then extends for as long as production is taken from your land and royalties are paid. Upon the company establishing a producing well, the royalty payments must continue at the rate provided for in the lease, and are not subject to renegotiations.

In any given year, a company may not be in a position (either financially, technically or from a regulatory perspective) to develop all of its lease holdings. A reasonable term provides the company an adequate opportunity to explore the property for minerals. A term of five years is fairly typical. In less developed areas companies will acquire longer term leases.

d) Annual Delay Rental Payment and/or Drilling Rental: This provision permits the company to continue to lease the property by making a yearly payment to the landowner, if a well is not drilled during the first year or each subsequent year within the lease primary term.

OTHER AREAS OF NOTE

Spacing Unit/Pooling/Unitization: Spacing regulations for wells are used by the Ministry of Natural Resources for resource management to promote conservation and to prevent waste through orderly and efficient development and to protect landowner rights.

Once a company has obtained the mineral rights within a drilling tract, they can drill a well. The holdings of the landowners within the pooled tract are pooled together to make up the spacing unit. The landowners will normally participate in production, proportionate to lands contributed by their property as a percentage of the total production of a well in the pooled area.

Unitization is used when a reservoir extends beyond the original lands drilled (pooled Spacing Unit) to produce the oil or gas more efficiently and effectively by bringing together an area of lands owned by various landowners. Again, unitization is used for the purpose of resource management as governed by the Oil, Gas and

Salt Resources Act. In this way, a landowner within the area of the unitized lands are entitled to participate in production, even though no well is located on their land. Most leases permit pooling of lands to form Spacing Units, in which case you receive a portion of the royalty, based on the number of acres your lands contribute to the Spacing Unit. The lease also may permit "unitization," where in your royalty entitlement may be based on the productive lands in the unitized area.

In summary, Pooling may be required to create a legal drilling spacing unit under the industry regulations, while Unitization of a greater area removes the restrictions imposed in drilling only "on target" development wells, thereby positioning wells to more efficiently drain the oil and gas reserves. The MNR promotes the use of Unitization. The Oil, Gas and Salt Resources Act provides for compulsory pooling and unitization for resource management.

Suspended Well Payment: The purpose of this provision is to permit an extension of the lease if a well is drilled but not produced. For example, if a well is "shut-in" (drilled but not being produced), payment is made in lieu of royalties. Sometimes a company will suspend or shut-in a well. For example, the company may be evaluating or testing the viability of the well prior to spending more monies to develop; loss of gas/oil pressure to make the well feasible to operate; a well may be too far from gathering and processing pipeline systems; repairs to mechanical problems; winter or access restrictions could prevent the company from trucking out production or tying in a well.

Taxes: The landowner pays income tax on the royalties received, based on the production of his/her minerals. A T5 Income Tax Form will be sent by the company at the end of calendar year, stating the amount of royalties that have been paid out to the landowner. The landowner is responsible for filing the royalty income received from the production of minerals for income tax purposes.

Compensation & Restoration: When you are leasing your mineral rights, the lease provides the company full access to your lands, unless otherwise stated, and any surface damages incurred are to be paid in full. In many cases where companies have productive wellsites, they may take a Surface Lease Agreement to compensate landowners for use of their land on an annual basis. Upon termination of a lease, the company is obligated under strict Ministry rules and regulations to plug any abandoned well(s) and to restore the lands back to its near original condition, so far as may be practical, that existed prior to entry.

Indemnification: This provision is an acknowledgement by the company that they will assume all liability against any third-party legal action resulting from their operations while on the landowners lands and compensate the landowners for any damages or lost revenue, due to activities on the lands, unless they are caused by the landowners acts or error.

Surrender: This provision provides the company the right to surrender all or portions of the landowners land, or leased substances meaning geological zones or formations, at anytime. The company is required to remove expired or surrendered leases from title. The landowner may then chose to lease again to another company.

REGULATORY

All oil and gas activity in Ontario must be conducted in accordance with the Oil, Gas and Salt Resources Act, governed by the Ministry of Natural Resources. The Act outlines strict Regulations and Operating Standards for the industry.

STORAGE LEASE

Some depleted reservoirs might be suitable for the storage of natural gas. Companies are required to make application to the Ontario Energy Board to have the area designated as a storage facility. A Storage Lease Agreement provides for different activities than those performed under the mineral lease. Many of the terms and conditions outlined in a storage lease are similar to the mineral lease, but with modifications: a storage lease will have an expiry term that is designed to run in tandem with and to survive the term of the mineral lease. Once the pool has been designated a storage reservoir and it is active, the Storage Lease will have a renewable clause from time to time to avoid the loss of the storage reservoir. Once the Ontario Energy Board designates the formation for storage, the landowner is compensated an additional acreage rate for a Designated Storage Area. In addition to the rate, the landowner is also compensated at a negotiated rate for the residual gas still in the reservoir prior to converting to a storage facility.

SUMMARY

Companies operating oil or gas wells in Ontario must follow strict rules and regulations under the Oil, Gas and Salt Resources Act. There exists a cohesive working relationship with industry, landowners and government, such that all parties interests and safety concerns are addressed.

This document was created for landowners so they will be better informed on specific areas of concerns relating to the leasing of oil and gas. Due to the nature of the lease, prior to signing, the owner should ensure that they fully understand all terms and obligations. The owner may also consider seeking legal advice.

Recommended Resources for more information:

Oil, Gas and Salt Resources Librar y
669 Exeter Road, London, ON
(519) 686-2772
www.ogsrlibrary.com

Ministry of Natural Resources, Petroleum Resources Centr e
659 Exeter Road, London, ON
(519) 873-4644

Ontario Ministry of Agriculture, Food and Rural Affairs
publication: Oil and Gas Exploration, Production and Legislation
on Ontario Farms, August 1999, Order #99-029