

Institution of Oil and Gas Reservation in FDIC Owned Real Estate Sales



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TABLE OF CONTENTS

Executive summary 2
Background 4
Types of interests 4
Surface Rights Issues..... 8
Lending 11
Conclusion 11
ORE Accomplishments 2011-2012 12

EXECUTIVE SUMMARY:

The Division of Resolutions and Receiverships (DRR) Owned Real Estate (ORE) plans to reserve mineral interests for most marketed and sold ORE Assets. This report addresses key issues and concepts for DRR Management to understand how and why reserving mineral interests enhances asset recoveries. It also provides background on the various types of mineral rights, particularly oil and natural gas, as well as offering a better understanding of rights associated with this reservation. By reservation of minerals, FDIC will own a Royalty Interest wherein no liabilities are incurred. Royalty Interests and other interests will be explained further. DRR ORE will use an Addendum to the Purchase and Sale Agreements for initiating this mineral reservation. Special language will be added to the Special Warranty Deeds (SWD) for reserving mineral interests on all ORE sales.

- **For rural ORE properties:** Oil, Gas, and Other Minerals will be reserved and excepted from the Sale of ORE. Language inserted into the SWDs, notwithstanding anything in the Contract to the contrary, allows the FDIC as mineral owner and seller to retain bonuses, rents, and royalties relating to any existing and future oil and gas leases. In addition, FDIC will retain the perpetual right to enter upon the property by ingress and egress, to search for and develop oil, gas, or other minerals as well as to remove, transport, and dispose of such products. FDIC will retain the exclusive right to negotiate, procure, sell, and convey oil, gas, and mineral leases.

- **For ORE properties located in incorporated cities:** Oil, Gas, and Other Minerals will be reserved and excepted from the Sale of ORE. The difference between rural properties and properties located in incorporated cities is that FDIC will waive all rights to utilize the surface of the property for the purpose of mining, producing, transporting, storing, drilling, and exploring for oil, gas and other minerals. FDIC will continue to retain the right to lease, develop and/or produce oil, gas and other minerals in, on, or under, or that may be produced from the property, by pooling or unitization of the property with other lands or by utilizing directional or horizontal drilling from well sites located on lands other than the property or

by any other development method that *does not involve utilization of the surface of the Property*.

- **The mineral interest reservation:** It would apply to all types of ORE properties with the exception of condominiums and ORE valued at \$50,000 or less. For Louisiana ORE properties, an FDIC Legal acceptable separate SWD will be used applicable to state law.

Failure to reserve mineral interests by FDIC on most ORE properties means missed opportunities for an added return to the Receivership or Corporate through lease bonuses, production, and the subsequent liquidation of these mineral interests. .

BACKGROUND:

One of the missions of DRR is to maximize asset returns through liquidation in a timely fashion for both Receiverships and the Deposit Insurance Fund. Reserving mineral rights today could provide the opportunity to increase future revenues to FDIC. When applied to the area of oil and gas interests an example of this would be where an oil company is leasing the minerals rights in an area or a drilling company paying FDIC for its royalty rights out of successful production from an oil or gas well on property owned or previously owned when mineral interests were retained.

The most common and most valuable mineral rights are petroleum rights, typically oil and natural gas; however, other rights could include water, coal, gold, silver, or other precious metals. Royalty and Mineral Interests sales to this point have been from properties where either the failed bank retained the mineral rights or where the FDIC did the same in prior years. To more fully capitalize on this potential recovery for the Receivership, DRR ORE is initiating 1) a purchase and sale agreement addendum to be used when putting ORE under contract for sale and 2) Special Warranty Deeds (SWD) for the reservation of mineral interests to be used in the closing documents. There will be various SWD's to encompass all ORE sales in the United States and its territories.

Oil & Gas mineral interests fall into five categories as noted below:

A **Non-Producing Mineral Interest** is a mineral interest ownership not currently being produced, mined, or sold.

A **Royalty Interest** is established when an oil and/or natural gas lease gives the mineral interest owner the right to receive a portion of the production from the leased acreage (or proceeds of the sale thereof). Generally, the owner is not required to pay any portion of costs for drilling or operating the wells.

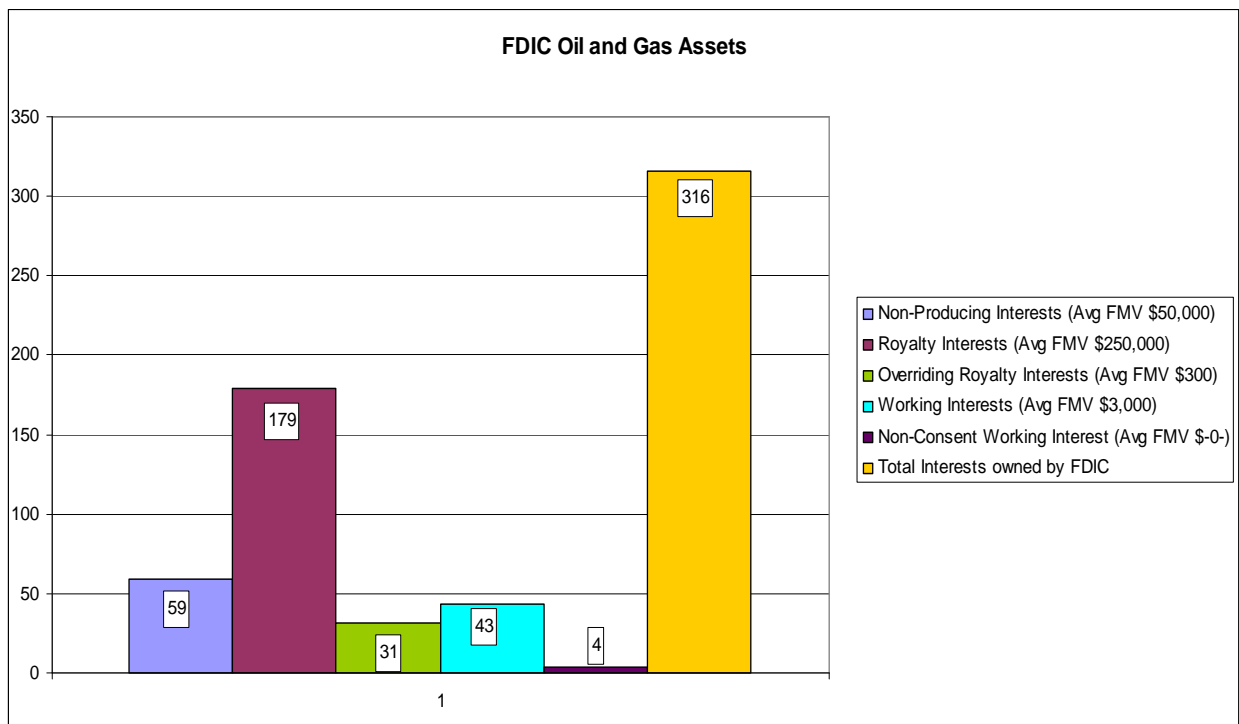
An **Overriding Royalty Interest** owner has the right to receive revenues, in addition to the basic royalty, from the production of an oil or gas well without paying any drilling or monthly operating expenses from the well. Owners of overriding royalty own only proceeds from the production of minerals and not the minerals themselves. An Overriding Royalty Interest expires concurrently when the lease expires and production stops, whereas, minerals and royalty owners maintain their ownership even after production stops.

A **Working Interest** gives the owner of the interest in an oil or gas lease the right to drill and produce oil and gas on the leased acreage. It requires the owner to pay a share of the costs of drilling and production operations. The owner's entitlement share of production in a working interest will always be smaller than the share of costs the owner is required to bear with the balance of the production revenue accruing to the owners of royalties. For example, the owner of a 100% working interest in a lease burdened by a landowner's royalty of 12.5% would be

required to pay 100% of the costs of a well but would be entitled to retain only 87.5% of the production.

A Non-Consent Working Interest is when a Working Interest Owner elects not to participate in a proposed operation. The owner becomes a “non-consenting party,” and may be subject to a “non-consent penalty”. It involves a temporary relinquishment of the interest owner’s share of production revenue from the project to the consenting parties. Once the consenting parties recoup their investment costs and receive this limited return on the investments, the non-consenting parties share in production revenues in proportion to their ownership interests.

The chart below depicts FDIC’s inventory of oil and gas mineral assets as of 2012 within each of the five categories as defined above.



There are several ways to own mineral interests. A mineral interest owner is not always the landowner or surface owner. Surface owners may sell the minerals with the surface, sell the minerals separate from the surface, deed the minerals to family, or sell the surface and retain all or part of the minerals also known as severance.

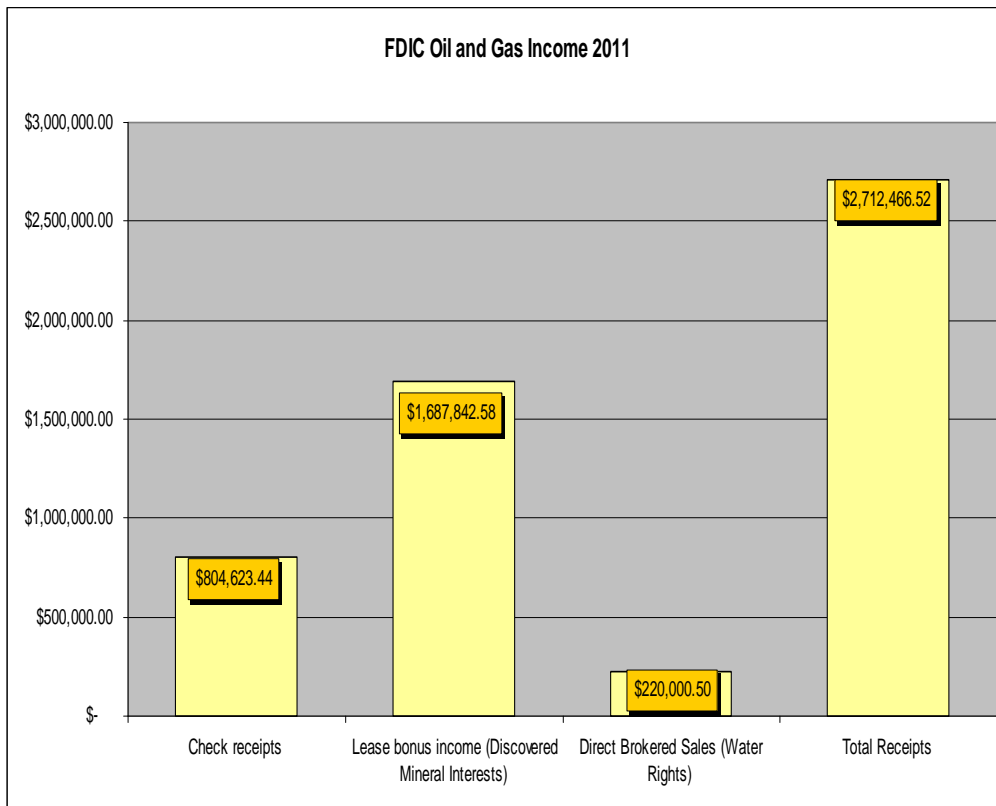
Severance by mineral reservation occurs when a party owning both surface rights and mineral rights sells, or grants by deed, the surface rights of his/her property but retains all or a portion of

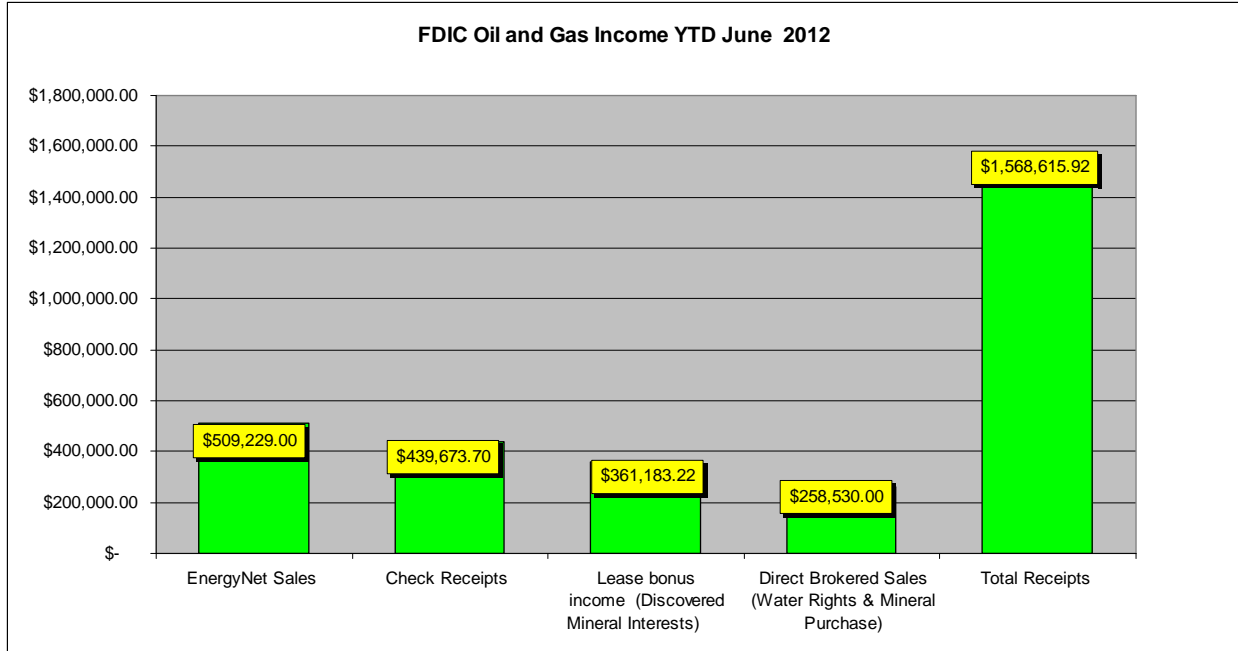
the mineral rights. From a historical perspective, severance of minerals by mineral reservation is widely practiced by federal and state governments, land-grant railroads, lending institutions, as well as by individuals. Mineral reservations are recorded with the county register of deeds and are generally not included in any abstract of title to the land involved.

Bonus money is a lease bonus paid to mineral interest owners by an exploration and production company desiring to lease mineral interests for acreage believed to have oil and/or gas reserves. Landmen hired by these exploration and/or production companies research county courthouse records to find the recorded deeds in which mineral interest reservations are cited and trace these reservations to the current mineral owner.

During the recent energy exploration boom, DRR ORE received income from discovered mineral interests reserved by U.S. banks which failed as many as 75 years ago. Lease bonuses paid to FDIC from discovered mineral interests range from \$150 to \$2,600 per net mineral acre. A majority of mineral interest inventory is corporately owned since the reservation and the receivership was over 15 years old when discovered. Since 2010, FDIC has received income from mineral interests in states such as California, Colorado, Louisiana, Oklahoma, Texas, and Pennsylvania, when it was discovered that failed banks had made mineral reservations in areas where drilling was found to be advantageous.

The following Charts show income sources and amounts for 2011 and YTD thru June 2012 respectively:





On all discovered mineral interest assets, FDIC utilizes procedures for maximizing income. When a drilling company wants to lease the Corporation's mineral interests, FDIC ORE negotiates a 20-25% Royalty Interest on mineral interests on the production of wells after they are drilled and completed, as well as, lease bonuses on all the non-producing acreage to be leased. FDIC Engineering Contractors make Fair Market Evaluations of non-producing properties and producing properties. Subsequently, FDIC ORE sells all types of mineral interests through its online auction contractor, EnergyNet, Inc. EnergyNet's website is energynet.com. Most of the assets are sold via online auction.

Individuals may also purchase a mineral right or interest when they purchase the surface property from the FDIC. The first step by the prospective buyer is to contact FDIC or its contractor at the time the purchase and sale agreement is completed and make a request to purchase the mineral interests along with the surface. FDIC in turn will request a separate mineral evaluation by an FDIC Engineering Contractor to establish the mineral interest's appraised value. The valuation process can take up to three (3) weeks. Valuation expenses can cost \$17,000 or more in some cases; these expenses may be passed on to the purchaser. This evaluation will then be used to negotiate with the potential purchaser of the surface for the additional purchase of the mineral rights with it.

A Title Opinion or Policy can identify mineral interests previously deeded. Since Real Estate appraisals do not value mineral rights or acknowledgement of ownership, mineral interests must be evaluated by a Professional Engineering Oil & Gas firm.

SURFACE RIGHTS ISSUES:

There are several surface rights issues to discuss. To protect the interests of FDIC, the Legal Department has prepared two types of Special Warranty Deeds to be utilized for the reserving of mineral interests. One reserves mineral interests which include the right to control surface access; this SWD would be used in rural areas. This would allow FDIC to maximize leasing opportunities to deal directly with drilling companies on well sites in larger land properties. The second SWD excludes the right to control surface access in incorporated cities. This will be utilized when it is determined that the property is in an incorporated city which may have restrictions and the land size is not large enough for drilling locations away from improvements. On these properties, the SWD would allow for an oil or gas exploration company to negotiate with the surface owner (purchaser) the right to set up drilling operations and subsequent restoration of the area. In both instances, time considerations must be made for leveling the immediate area, constructing the pad site, possibly building roads to transport equipment, and preparing for the drilling rig. Once preparation is complete, the crew will begin the drilling process, which includes casing, cementing, and completing the well. The surface owner would not receive proceeds from production of oil and gas minerals, only the mineral owner or owners.



ILLUSTRATION A

Illustration A shows the layout of a typical drill site.

Real estate professionals, including attorneys, title agents, and county recorders responsible for filing property deeds often use the words “ingress and egress”. These terms are usually associated with easements. An easement is a legally binding arrangement, which can both protect or restrict the right(s) of use on a property. Details surrounding the ingress and egress of

a real estate parcel will be listed under property easements on the property deed. Common types of ingress and egress easements allow adjoining properties shared use of a driveway, the right to walk across a designated portion of the property, or the use of a private road to reach the property. Property easements will detail the specifics of the ingress and egress guidelines, as well as, note if the arrangement can be altered, or provide a time frame in which the easement is valid and legally binding.

Allowing ingress and egress rights to the property increases mineral value. In rural areas, drilling is much easier because the acreage is greater. In urban areas, lots are small with little acreage. DRR/ORE recommends using the right of ingress and egress and preserving that right in the SWD in only rural areas. With no surface access, and no ingress and egress rights to the property, an oil company would have to lease up large portions of land. The normal acreage leased for drilling gas wells (units) is 640 acres or a square mile, while 320 acres is the norm for oil drilling units. Texas requires minimum spacing for oil wells of 40 acres. Other states have different requirements.

In Texas, if someone owned fewer than 20 acres and the oil company did not have access to the surface; the oil company would have to institute a pooling arrangement wherein large acreage would be leased and several mineral owners would be pooled together and receive their percentage of production. On the average, if fewer than 40 net mineral acres is leased, 5-10% of the mineral value could be lost. More than 80 acres must be leased for gas and more than 20 acres leased for oil in order for an oil company to drain the oil or gas from the proposed acreage. Oil companies cannot drill within 300 feet of a residence. Only authorized personnel are allowed on site to avoid hampering drilling operations and to prevent distractions. New or proposed construction must be at least 75 feet away from a residence, unless measures are taken to mitigate noise and reduce the chance of contamination from spills. That distance is cut to 10 feet if a drilling site has been abandoned in compliance with local safety requirements. An engineering assessment establishes minimum distances from petroleum product wells. Today, horizontal drilling is common to reach an area to be drilled from another location.

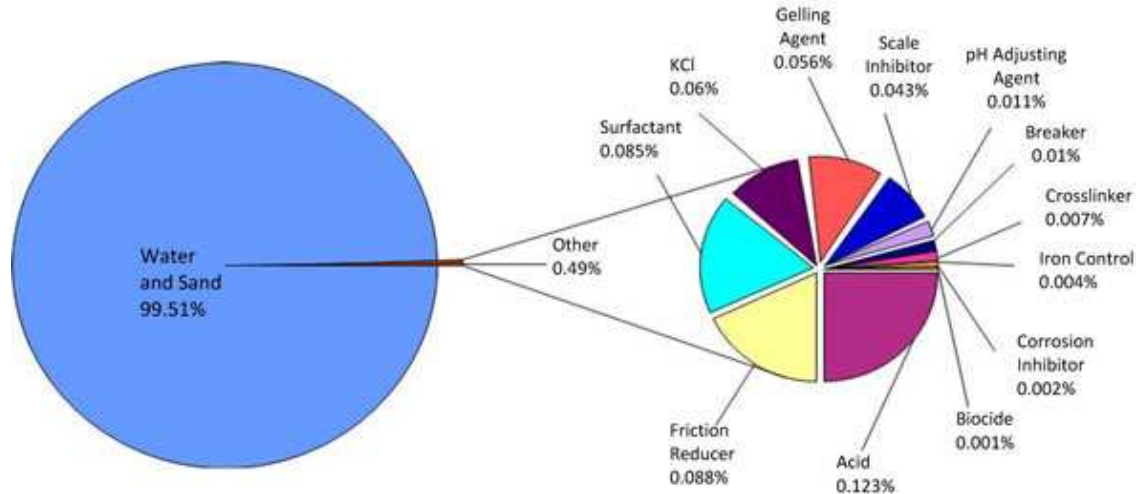
Chemicals used during Hydraulic Fracturing represent another issue for mineral owners. Reserving minerals in SWD is a Royalty Interest which does not bear liability. Consequently, damages fall on the individual oil company. **Illustration B** on the next page displays the typical layout of a site prepared for hydraulic fracturing. This produces an idea of what happens at the well site. The hydraulic fracturing job involves many facets including blending and pumping of fracture fluids; pumping solid material, usually sand, into fractures to hold them open; and even how the rock formation responds to the fracturing. Chemicals are needed to ensure that the fracturing job is effective and efficient. Chemicals can limit growth of bacteria and prevent corrosion of the well casing. The number and types of chemical additives used in a typical fracture treatment depend on the conditions of the specific well to be fractured. Each component serves a specific, engineered purpose. For example, the predominate fluids currently used for fracture treatments in the gas shale plays are water-based fracturing fluids mixed with friction-reducing additives called slickwater.



ILLUSTRATION B

Fluids create fractures in the formation and carry a propping agent (typically silica sand), which is deposited in the induced fractures to keep them open. In response to public concerns about hydraulic fracturing the oil and gas industry has set up www.fracfocus.org to inform residents near their wells of the chemicals used in the fracturing process. Again this website does not contain fluids perceived to be trade secrets. The industry also relies on scientific study in order to try to alleviate public concern. It is the position of the oil and gas industry that some of the fracturing fluids and chemicals do indeed stay in the reservoir. However, because the reservoir is typically thousands of feet below aquifers, those aquifers are required to be protected by casing and cement, and the impermeable nature of the rock above the reservoir; chances of aquifer contamination are miniscule at best. All hydrocarbon reservoirs require an impermeable seal to keep the lighter hydrocarbons from migrating to the surface. Were this seal not intact, the reservoir would long ago have been depleted. A comprehensive study by the EPA is expected to be released in 2012. While this will in no way be the definitive report on hydraulic fracturing, it is expected that a lot of future policy will be based on the study's findings. The proposed rules require companies, once drilling is complete, to disclose the chemicals used during hydraulic fracturing, or fracking. About 90% of wells drilled on federal and Indian lands use this drilling process, which blasts chemical-laced water and sand deep below ground to release oil and natural gas trapped in rock formations. The makeup of fracturing fluid varies from one geologic basin or formation to another.

The chemicals are composed of some or all of the following as shown on the next page:



Concern over groundwater contamination resulted in action being taken to protect mineral owners. Water wells typically range from 3 to 18 m deep, but in some areas can go deeper than 900 m or 2,952' and wells are drilled at depths of 5,000' to 20,000'. In general, the casing of oil and gas wells, whether vertical or horizontal, is accomplished in multiple phases from the largest diameter casing to the smallest. In most states, cement is required to protect the water table. Casing strings provide isolation of fresh water zones and groundwater from the inside of the well thus helping protect groundwater resources. In this regard, surface casing is the first line of defense. Production casing provides a secondary layer of protection for groundwater. Proper sealing of the annular spaces with cement creates a hydraulic barrier to both vertical and horizontal fluid migration. The quality of the initial cement job is a critical factor in the prevention of fluid movement from deeper zones into groundwater resources. Again, *reservation of minerals gives FDIC only a Royalty Interest which would not subject FDIC to liabilities of oil companies*. States such as Alaska, Michigan, and Ohio, require an additional verification method using geophysical logs such as Cement Bond Logs and Variable Density Logs. Most states have monitored requirements for casing and cementing. As shown above, water and sand make up over 99.51% of the fracturing solution.

LENDING:

Currently, no rules or lender restrictions exist for Sellers retaining mineral rights on real estate properties sold. However, certain states require borrowers to receive permission from their mortgage lender before signing a lease of their mineral rights. Upstate New York now requires gas companies to agree to pay for damage caused by drilling that may lead to devaluation of its mortgaged properties. Many times the cost of restoration greatly exceeds the value of the land. Under the market value rule, however, property damages can never exceed the fair market value. For instance, restoration of the land after strip mining coal or lignite will exceed the value of the land prior to operations. In addition to loss of market value, another recovery, known as punitive damages, may be obtained in certain circumstances. A growing concern for lenders exists regarding leases, allowing drillers to conduct operations that may violate the landowner's mortgage.

CONCLUSION:

DRR ORE plans to initiate the reservation of minerals rights on all ORE sales transactions. Exceptions would be condominiums and ORE properties valued at \$50,000 or less. Since a surface right is not owned by a condominium owner, DRR ORE would use SWD's without mineral reservation for these sales transactions. In addition, FDIC would not reserve minerals on any ORE sales of \$50,000 or less or when conveyance is by quit claim deed.

DRR ORE will begin reserving mineral rights in all FDIC ORE except those as discussed. DRR ORE will institute reserving mineral rights and maintain the right of ingress and egress except within incorporated city limits. For the reasons shown above, FDIC should reserve the right to control the surface and allow access by an easement or access road to the property located in rural areas. Landmen will likely continue to find mineral rights from past failed institutions to which FDIC owns interest. If mineral rights are reserved, then like any other rightful party, FDIC should exercise its right and title. It is in the best interest of FDIC, and consistent with its mission, to institute these changes.

The failure to reserve mineral interests would be a decision to not take advantage of the lease bonus, production and subsequent liquidation of these other owed assets which have come into our possession mostly through discovery.

Recent large lease or mineral income completed in 2011 through June 2012 by the ORE / OOA / Oil and Gas Section are:

- Anadarko Petroleum paid FDIC \$1,024,000 in 2011 on 640 Net Mineral Acres (NMA) in Adams County, Colorado, from a mineral reservation from Silverado Banking, Savings and Loan Association, Denver, Colorado which failed in 1988;
- FDIC was paid \$130,000 in 2012 from a FirstTier Bank mineral interest reservation in 2008 on 141.8/NMA in Larimer County, Colorado;
- Seneca Resources paid FDIC \$300,000 in 2011 from a mineral reservation by Coudersport Trust Company, Coudersport, Pennsylvania on 111.95/NMA from 1937.
- Venoco paid FDIC \$76,240 in 2010 and 2011, with \$114,360 lease bonus to be collected over the next three years, from a reservation by United States National Bank, who reserved minerals in 1980 in Kern County, California, on 818.3/NMA.
- EnergyNet.com sales 2012– San Joaquin Basin, Leased Minerals Rights 157.50/NMA – Kern County, California \$113,400
- EnergyNet.com sales 2012 – San Joaquin Basin, Leased Mineral Rights 319.00/NMA – Kern County, California \$236,250
- EnergyNet.com sales 2011– Strawn Basin – Barnett Shale Non-Producing Minerals 107.663/NMA – Tarrant County, Texas \$745,500

2010 sale:

- EnergyNet.com sales – 1Q 2010 – Lowell Williams 4H & 6H (Royalty Interest) Hill County, Texas \$975,000