Managing Mineral Interests

Solving the "Fractionalization" Puzzle

A Joint Publication Developed by:
The National Association of Royalty Owners and The National Association of Division Order Analysts

What Is Fractionalization?

Fractionalization. . . . . .Sounds like new math, right? It's not! "Fractionalization" and "dilution of interest" are buzz words frequently used to describe the transfer of mineral interests (and working interests, too) into smaller and smaller pieces, sometimes to the point where owners end up with a zero interest. A large interest can, through several generations, become of little or no value to its owner.

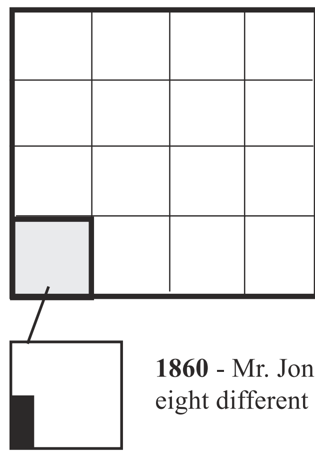
Unfortunately, many interest owners have not taken the fractionalization problem into consideration and have assumed that the interests will be passed along for the benefit of their heirs. As a result, the continued "fractionalization" of mineral interests into smaller and smaller portions is a growing concern to all parts of the oil and gas industry in the United States.

In order to better understand "fractionalization" and to develop solutions to this growing problem, an industry group, led by the National Association of Royalty Owners (NARO), was formed in 1994. This industry group has investigated a wide range of possible solutions, from aggregate payments to legislative changes. However, it is believed that, by far, the most effective solution to "fractionalization" is the proper management of mineral interests.

This brochure has been developed to highlight the problem of mineral "fractionalization" and to provide some alternatives to consider in managing your interests. As an interest owner, you are a vital member of the oil and gas industry and have the opportunity to help ensure future generations enjoy the benefits from owning mineral interests.

Consider becoming part of the solution. By working together, royalty owners and oil companies can build a stronger oil and gas industry.

"The Shrinking Interest"



1840 - Paul Jones acquires 640 acres, including mineral rights.

1860 - Mr. Jones sells 40 acres in 5 acre lots to eight different families.

1890 - One family, the Charles Smith family, passes their interest in the 5 acres to 10 children (1/2 acre each).

1930 - One of the 10 children, Jacob Smith, executes a lease reserving a 1/8th royalty. The lease is included in a 160 acre oil unit
(1/2 acre x 1/8 divided by 160 acres = **0.0003906**).

1940 - Jacob Smith gives the royalty interest of 0.0003906 to his 5 children
(0.0003906 divided by 5 = **0.0000781**).

1960 - One of the 5 children, Adam Smith, passes his interest 1/2 to his wife and 1/2 to their 4 children.
(0.0000781 x 1/2 = 0.0000391 and
0.0000781 x 1/2 divided by 4= **0.0000098**).

• **1990** - One of the 4 children, Daniel Smith, passes his interest 1/2 to his wife and 1/2 to their 3 children (0.0000098 x 1/2 = 0.0000049) and
(0.0000098 x 1/2 divided by 3 = **0.0000016**).

2010 - One of the 3 children, Jane Smith Wilson, passes her interest to her 2 children
(0.0000016 divided by 1/2 - **0.0000008**).

Payments from“Fractionalized”Interests

As interests become fractionalized, oil and gas payments also become smaller. Below is a common example of a “fractionalized” payment:

Oil Production:
30 barrels/day = 900 barrels/month
Sales Price:
$60.00/barrel
Sales Value:
900 barrels x $60.00 = $54,000.00
Owner’s Decimal:
0.0000016
Owner’s Share:
$54,000 x 0.0000016= $0.09.

While the above example is calculated using typical production of 30 barrels of oil per day, many wells in today’s oil industry are marginal producers, producing an average of less than 3 barrels per day.

Of the total 120,000 producing wells in Oklahoma in 1995, over 70,000 were marginal producers. In Texas, the situation is similar, where almost 70% of the oil production comes from marginal wells, producing an average of 2.4 barrels per day.

Payments from marginally producing wells for fractionalized interests are often non-existent. With production of 3 barrels per day, an owner’s decimal interest must be over 0.0000050 for the owner to receive a payment of just 1 penny a month!

On the other extreme, for the rare well that produces $1,000,000.00 in monthly sales, an owner with a decimal interest of 0.0000016 would only receive $1.60 of revenue.

How Does This Affect Royalty Owners?

In many areas, promising mineral prospects are saddled with many fractionalized” unleased mineral interests. As a result, companies often pass over these prospects with fewer, consolidated mineral ownerships.

In areas where companies do decide to lease properties with “fractionalized” mineral interests, the owners often have substantially less negotiating power in determining favorable lease clauses.

As mineral interests become “fractionalized” over time, it is not unusual that the owner’s address becomes lost or unknown to the producer or lease operator. As a result, several states have already passed legislation to deal with “fractionalized” and/or “missing owner” interests.

In Kansas, for example, mineral owners are required to “register” their non-producing property ownership in each individual county within a 20 year period, or else risk forfeiting their interest in the property forever. The Texas legislature considered similar legislation in 1995, which proposed that “dormant” mineral interests would automatically revert to the surface owner. With these types of issues facing mineral owners, it is even more important for the oil and gas industry to work together to solve the “fractionalization” problem.

In today’s competitive industry, it is increasingly common for oil and gas purchasers to either refuse to purchase production or offer to purchase it at a reduced price from properties with many “fractionalized” interests. Even with tax incentives, the sheer number of owners for a property can often be one of the determining factors which keep a marginal well producing. While producers’ overhead costs may not seem to be a concern of the mineral owner, it does become the mineral owner’s problem when wells are plugged and abandoned due to administrative and operating costs exceeding income. Once a well is plugged, income and royalty payments stop forever, even for future heirs of the mineral owner!

Some Options For Managing Minerals

There is a wide range of possible solutions to “fractionalization”. Listed below are some options you may want to consider for your minerals:

CONSOLIDATE THROUGH TRUSTS AND PARTNERSHIPS:

Trusts and partnerships offer a wide variety of benefits. Rather than “fractionalizing” minerals interests, some families choose to convey their interests into a trust or partnership to centralize the administration of their assets, which may also provide tax benefits and lessen probate expenses. In addition, larger consolidated interests may provide additional leverage for future oil and gas leasing negotiations.

RE-CONSOLIDATE FAMILY-HELD INTERESTS:

As families examine their oil and gas mineral holdings, it often becomes evident that past “fractionalization” of interests have weakened the family’s assets. This situation can be remedied by re-consolidating small interests to that they can be managed by a trustee, attorney-in-fact or appointed agent.

DONATE SMALL INTERESTS TO CHARITIES:

Donating small mineral interests to charitable organizations may offer an attractive alternative to “fractionalizing” interests. Transferring small interests to charities may also reduce well operating costs, as most producers already make monthly payments to the major charitable organizations. For mineral owners, the timing of the donation could provide valuable tax deductions.

APPOINT AN AGENT: Appointing an agent to receive oil and gas proceeds offers many of the benefits realized from a trust, larger consolidated interests can also provide leverage in negotiating with potential lessees. In addition, if a bank or trust company is appointed as agent to account for and disburse proceeds, the mineral owners may qualify for estate planning and financial services from the agent’s company.

TRANSFER WHOLE INTERESTS:

Another alternative to “fractionalizing” minerals into smaller and smaller interests is to transfer ownership in some specific leases (or geographical areas) to one heir and interests in other specific leases to another heir. Leases can be grouped together based on historical revenue or potential reserves to “equalize” assets to each heir.

ACCEPT ROYALTY BUY-BACK OFFERS:

To reduce operating costs of marginal wells, many producers have established small royalty buy-back programs. These programs typically offer the royalty owner some multiple of the annual revenue received from the oil and gas property in exchange for the right not to make further production payments to the interest owner for the remaining life of the property. Royalty owners benefit by receiving a one-time “prepayment” for future revenues and are relieved of the hassle of dealing with small, infrequent checks.

SELL HIGHLY FRACTIONALIZED INTERESTS:

Selling minimal-reveue producing or small non-producing minerals to a professional royalty company and placing larger interests in a trust or partnership to prevent further reduction by fractionalization has proved a good solution for many families. This maintains a reliable revenue stream for future generations while removing the "headache" properties.

A Message to Mineral and Royalty Interest Owners from NARO & NADOA

You are a vital member of the oil and gas industry. To ensure future generations enjoy the benefits of owning mineral interests, please consider one of the many alternatives to mineral "fractionalization"

The alternatives discussed in this brochure are only a few of the many options available. For assistance in selecting the correct option for your specific circumstances, we urge you to contact your local oil and gas attorney or your bank's oil and gas trust department or other qualified professional counsel.

To receive more information on this important topic, you may also contact the National Association of Royalty Owners toll free at: 1-800-558-0557.

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