MINERAL RIGHTS, WORKING, AND OVERRIDING/NET PROFIT INTERESTS

Katrina LaRocque, CET, APA

July 8th, 2019

In the oil and gas industry, there are several types of ownership. These ownerships can generally be categorized as operating and non-operating. While operating interests are actively involved in the development and operations of the property, non-operating interests are passive and do not generally participate in these matters. Economic interests considered to be non-operating include mineral-right royalties and overriding/net profits interests.

In oil and gas, all ownership types originate from mineral rights. The mineral rights owner can lease the rights to another party thereby allowing the lessee to explore, develop and produce oil and gas from the leased rights. In return for the lease, the lessee agrees to pay the lessor a mineral-rights royalty. The lessee may retain the lease or may assign all or part of the lease to yet another party.

If the lessee is not interested in exploring or developing the lease, they may transfer the rights to another party in exchange for an overriding royalty interest. If the lessee wishes to actively develop the lease but wishes to reduce the financial risk, they may sell a portion of the lease to other parties. These other parties then become working interest partners in respect of the lease operations.

Any of the working interest partners may further assign a part of their ownership to others via an overriding or net profit interest. This is typically done as a form of compensation (such as to the landman who negotiated the prospect) or simply to raise capital.

Mineral Right Interests

In Canada, the majority of mineral ownership is held by provincial governments (i.e. Crown) whereas a much smaller amount is held by corporations or individuals (i.e. freehold). As the highest form of ownership is that of mineral owner, the mineral rights must be either leased or purchased from the mineral owner prior to the commencement of any exploration or production activities. A royalty is a preferential ownership of production reserved to the owner of land for permitting another to use the property and mineral royalty owners receive their share of production revenue before working interest owners. Royalties may be revenue-based or profit-based.

Revenue-based royalties are assessed on the value of production received by the operator with defined deductions as specified by the royalty contract. Furthermore, revenue-based royalties have no responsibility for exploring, drilling or maintaining the leased land and, therefore, do not share in the accompanying financial burdens. The manner by which revenue-based royalties is calculated is mandated by the specific governmental jurisdiction or by specific royalty agreement in the case of freehold royalties.

Working Interests

Working interest refers to an ownership in an oil and gas lease granting its owner the right to explore, drill and produce oil and gas from a tract of property. The working interest owners collectively bear the entire financial responsibility in respect of leasing, drilling, producing and operating the property on a cash, penalty or carried basis. In return, the working interest owner is entitled to a share of production from the property. This interest may be assigned to another party or may be divided into other special property interests such as overriding royalties or net profits interests.

The working interest owners of a property will designate an operator (usually, but not always, the party that has the largest working interest). The operator supervises, manages and conducts the day-to-day operations of the property. The non-operating working interest owners participate in the decision-making process in respect of the property but are not involved in actual operations. For example, all working interest owners of a property would have a vote in the annual operating budget of a property including the authorization of the expected expenditures. They would not, however, actually conduct or perform any of the activities necessary under that budget.

The rights and responsibilities of working interest owners are typically governed by a Joint Operating Agreement (“JOA”) which provides the terms and conditions under which the property is to be developed and operated. Oftentimes, the JOA will include an accounting procedure which sets forth the types of costs which are allowed to be charged to the working interest owners and the basis by which they will be shared. In the oil and gas industry, it is commonplace for standardized accounting procedures to be used in respect of joint venture agreements, such as the PASC Accounting Procedure. When the PASC Accounting Procedure is referenced, some agreements may reference a particular version of the Accounting Procedure whereas others may reference that the latest, most current version shall apply.

Overriding Royalties (ORR) and Net Profit Interests (NPI)

Both overriding royalties and net profit interests are created out of a working interest in a property and both represent a fractional, undivided interest with the right to participate or receive proceeds from the sale of oil and gas. It is important to note that an ORR or NPI is not an interest in the minerals but, rather, is an interest in the proceeds from the oil and gas sold. The interest is limited to specific lands and is bound by the terms and limits of the lease. Specifically, once the lease has expired or production has ceased, the ORR or NPI expires. The primary difference between an ORR and an NPI is how the owner’s share of revenues is determined.

Unless the grant or reservation of the interest provides otherwise, an ORR interest does not participate in drilling, completing or operating costs though they generally participate in transportation, treatment and marketing costs. The ORR is paid immediately once the well produces and the products are sold and there is no deferment of revenues as a result of capital or operating cost recoveries by the originating working interest owner.

An NPI, on the other hand, shares in the costs associated with the exploration, development, production and operation of the property. Generally, an NPI is calculated by deducting the cumulative capital costs and operating expenses from the revenues associated with the production of the lease. Operating costs are the costs incurred to keep the property operational after the wells have been drilled and completed and include, but are not limited to, costs for repairs and maintenance, salaries and wages, automotive expenses, chemicals and consumables, utilities and a myriad of other cost types. Payment to the NPI holder will only occur when there is a cumulative positive balance and, unlike working interest owners, the NPI holder is not required to pay for any losses. As a result, payment to the NPI holder is deferred until the prescribed costs are recovered by the originating working interest owner.

Generally speaking, the level of control an interest-holder has in respect of a property reflects the level of risk in terms of having to pay for upfront costs and the possibility of paying out-of-pocket costs should the property incur a loss.

Net Profit Interest Agreements

In the oil and gas industry, a farmout agreement is an agreement entered into by the owner of a mineral lease (the “farmor”) and another party that wishes to obtain a percentage of ownership of that lease in exchange for providing services (the “farmee”). A farmout agreement differs from conventional transaction because the primary consideration is the rendering of services rather than the simple exchange of money.

Farmout agreements typically occurred when the farmor wished to assign an interest in the lease to the farmee based on the condition that the lease would be developed in a certain fashion. This arrangement allowed the farmor to maintain an economic interest in the lease while transferring the associated economic risks to another party. The consideration provided to the farmor by the farmee was typically either an overriding royalty or a net profit interest.

Overriding royalties were generally negotiated when the farmor wished a to have an expedient and reliable revenue stream as payments were assessed on the value of production rather than net profits. Net profit interests, on the other hand, were usually negotiated at a higher percentage interest due to the risk that revenues would be delayed due to the recovery of capital and operating costs and may not be received at all if the property did not generate a net profit. While NPIs were commonplace in the late 1970’s and 1980’s, they have become less so and overriding royalties are now more prevalent.

While royalty and working interest ownerships have well defined accounting procedures, there is no generally accepted method of calculating net profits interests. Each particular NPI is the product of the negotiations when the interest was established and, therefore, the governing NPI contract is the only document which governs which expenses and revenues should be included in the net profit calculation.

About the Author:

Katrina LaRocque is the president of Petrotech Consulting Services Ltd., an international company which provides accounting, audit and advisory services to the oil and gas industry. Ms. LaRocque has written numerous articles, papers and essays related to oil and gas accounting and has lectured on various industry matters.