<u>Round 1: Oil & Gas Lease Negotiation</u>

General Facts for Both Sides

The primary goal of this meeting is to negotiate several specific terms of an Oil, Gas, and Mineral Lease between Kruger Industrial Smoothing (hereafter "***Kruger***"), as lessor, and Munson Petroleum LLC (hereafter "***Munson***"), as lessee.

Kruger is a large landowner in Baytown, Texas, an industrial town located east of Houston and northwest of Trinity Bay in western Chambers County. Kruger owns the surface and minerals comprising a 2,750 acre tract of land along the Grand Parkway (Texas Route 99) in the southeastern portion of Baytown. The captioned land is comprised of five lots. A diagram of the land is provided on the last page. The Grand Parkway, when completed, will be the outermost of the multiple beltways that encircle Houston and will have a diameter of over 50 miles. The area around the captioned land is still primarily used for agriculture, but many commercial buildings similar to the headquarters of Kruger are planned or are being constructed along the Grand Parkway. Real estate prices are climbing and more commercial development is imminent.

Kruger currently has one large permanent building on its tract—the Kruger headquarters. To the south of the headquarters building is a large parking lot used for employee and customer parking and for parking the vehicles and equipment used for smoothing. The remainder of the property is currently undeveloped. The entire tract is zoned by the city of Baytown as five north-side oriented rectangular tracts, all of which are categorized for commercial or retail use.

Mr. Kruger, president of Kruger, has recently noticed multiple oil and gas companies slowly acquiring leases and conducting "wildcat" activities across the Trinity Bay in eastern Chambers County. The companies are using horizontal drilling and hydraulic fracturing ("fracing") technologies to prospect for highly speculative reserves. Kruger's tract and its immediate vicinity, however, are still untouched by exploration activities.

Munson was founded in 1977 by Roy Munson and is now directed by his nephew Lucas Munson. Its company headquarters is located in downtown Edmond, Oklahoma, but it has significant assets in eastern Texas.

Two weeks ago, Munson contacted Mr. Kruger requesting a meeting between representatives of the two companies to discuss leasing part of Kruger's property. Based on Munson's research, it believes oil may be located under both Kruger's property and to the north under the Grand Parkway right-of-way. Munson cannot drill on the Grand Parkway itself or any part of the Parkway's state-owned right-of-way, of course, but would like to use directional drilling techniques to drill from the captioned land into the mineral acreage to the north.

Mr. Kruger is largely unfamiliar with the oil and gas industry and is not comfortable negotiating a lease alone. He has hired experienced local counsel to represent him at the meeting. Munson will be represented at the meeting by two attorneys experienced in conducting leasing negotiations for the company.

While preliminary emails and phone discussions have finalized some terms of the potential lease, the following issues still need to be addressed at the meeting:

A. Primary Term and Extension Clause

The parties should determine the length of the primary term of the lease and whether any extension clause will be included to possibly extend the primary term. The starting date of the lease will be April 1, 2016.

B. Royalties and Deductions

The parties need to agree upon the fractional amount of lessor's royalty to be paid to Kruger by Munson for oil, natural gas, and other minerals. Munson and Kruger have previously agreed that no overriding royalty interest will burden the leasehold. No non-participating royalty interests (sometimes called "freestanding royalties") currently burden the property. The captioned land is not subject to the Texas Relinquishment Act.

The parties also need to consider what deductions Munson can make from the lessor's royalty for processing, transportation, and/or marketing.

C. Initial Bonus Payment

Both parties understand that a bonus payment, payable to the lessor immediately upon executing the lease, is standard for the industry. However, the parties need to determine the amount of the one-time payment.

D. Delay-rental Clause and Payments

If, during the primary term of the lease, the lessee does not commence drilling an initial well within a certain time, the parties need to consider if either (a) the lessee should be required to pay the lessor an annual fee—"delay rentals"—during the period where no drilling activity is promulgated or (b) if the lease will be a "paid-up" lease where the delay-rentals are considered to have been included in the bonus payment. If the former, the parties need to consider what the annual delay rental amount will be. If the latter, a lump sum amount may be added to the bonus.

E. Shut-in Royalty

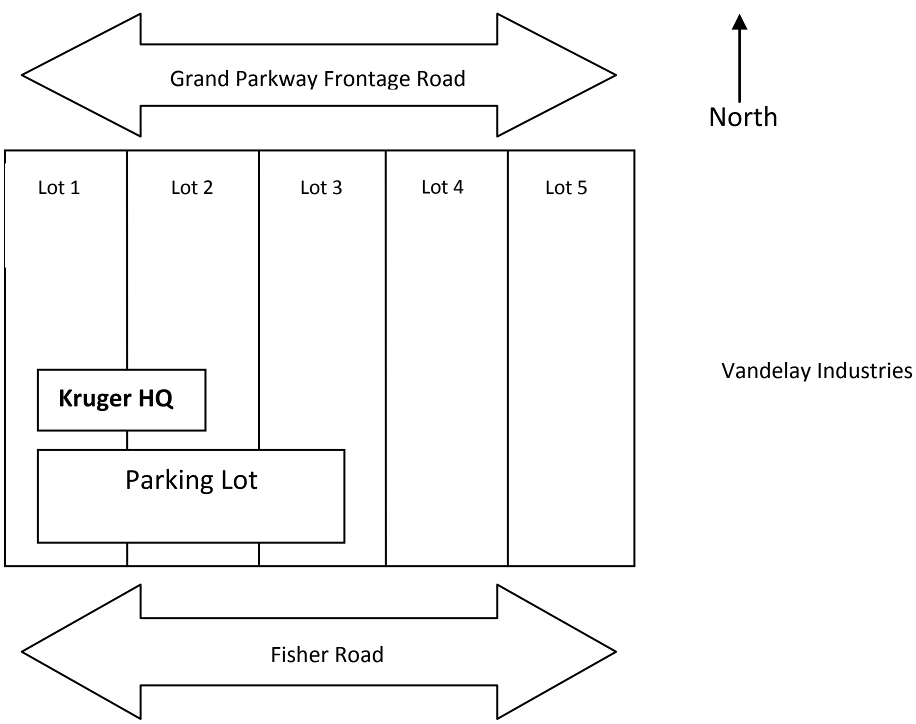
Texas typically requires wells to produce in paying quantities in order to maintain a lease during the secondary term unless the lease itself provides otherwise. Therefore, leases often contain a shut-in well clause, allowing a lessee to maintain a lease during the secondary term provided that a well capable of producing in paying quantities is located on the leased acreage (or lands pooled therewith) with, usually, an annual payment of shut-in royalty made to the lessor in return. Such shut-in royalties are payments to royalty owners under the terms of a lease that allow the lessee to defer production from a well that is capable of producing but that is turned off—"shut-in"—for lack of a market or other reason. The parties must decide if the lease will include a shut-in well clause and, if so, what the shut-in royalty will be.

F. Pooling Clause

Both parties understand that inclusion of a pooling clause in a lease is very common for the industry. The parties must first determine whether to include a pooling clause. If included, the parties must determine if the pooling clause will be limited by other terms such as a "Pugh Clause" or a minimum-acreage pooling requirement.

G. Location of the Drill Site

The parties must decide if Munson can drill anywhere on the lease (as curtailed by state and local drilling regulations) or if Munson will be limited to drilling within certain areas.



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<u>Confidential Facts: Attorneys for Kruger Industrial Smoothing</u>

Mr. Kruger has been eyeing the recent oil developments in the area. He has also done some research on the intricacies of oil and gas leasing. Mr. Kruger was obviously very excited when Munson personnel contacted him, but concealed it well from the Munson landmen. Mr. Kruger has remained realistic, and understands that Kruger may not initially make much royalty off this lease, particularly with low oil prices. Still, Kruger knows that if prices increase again, royalties will increase as well.

Based on his communications with other commercial landowners in the area, Mr. Kruger knows that oil companies employ experienced attorneys to negotiate leases. He has asked you to negotiate some of the more difficult terms in a lease with Munson's lawyers and has given you the authority to approach the following issues accordingly.

A. Primary Term & Extension Clause

Kruger wants to initially ask for a two-year primary term, but will accept up to a four-year primary term. Kruger will not agree to a primary term of *more* than four years. Kruger knows that oil companies sometimes wait as long as possible before they begin drilling. While Kruger wants to minimize the time before possible drilling, he realizes that prices are low and companies are currently reluctant to do much drilling.

Kruger knows that, with the current low price of oil, lessees want more time to drill and therefore want "extension clauses"—clauses that provide for an extension of the primary term if a stated consideration is paid. Kruger would prefer a one-year extension option, but will accept a two-year extension option if the compensation for activation of the extension clause is higher. Kruger will not accept an extension clause longer than two years. For a one-year extension, Kruger will expect at least $1,500 per acre upon activation by lessee of the extension clause. For a two-year extension, Kruger will expect at least $2,500 per acre upon activation by lessee of the extension clause.

B. Royalties and Deductions

The captioned land is wildcat acreage (meaning there has been no previous production). Ideally, Kruger would like a 1/5th royalty. However, if counsel is able to secure the below-described royalty calculation in Kruger's favor, Kruger is willing to accept down to 1/7th royalty, but no lower.

Mr. Kruger has researched common issues with the calculation of royalties. Some companies deduct the lessor's proportionate share of post-production costs from their royalty. Texas case law generally stipulates that where the lease is silent, the lessor's pro-rata share of all post-production costs past the wellhead is deductible from the lessor's royalty. Therefore, Mr. Kruger would like to add language to the lease to prevent Munson from deducting these costs from the lessor's share of royalty. The three post-production deductions that will need to be addressed are processing, transportation, and marketing. Mr. Kruger prefers that none of the costs from these be deducted. In the spirit of negotiation, however, he will authorize either a marketing **and/or** transportation deduction as processing tends to be the most costly of the three.

C. Initial Bonus Payment

Kruger would like a signing bonus of $1,400 per acre, but will settle for $900 per acre. The bonus is of particular importance to Kruger. If no well is drilled or the well does not produce, this may be the only income Kruger receives. Kruger wants Munson to understand that other companies may soon be vying to obtain a lease for this property and other properties in Chambers County. It is possible that other companies might offer Kruger more. Mr. Kruger views the bonus as compensation for taking this risk.

D. Delay-rental Clause and Payments

Mr. Kruger has heard stories about lessees securing leases and then not drilling. He also knows that, in the event of production, royalty will be Kruger's largest source of income from mineral development. Therefore, if Munson does not drill in the first year of the primary term, Kruger would like to receive some consideration for the delay. Kruger is ambivalent about whether the lease will be a "paid-up" lease or whether it will contain a delay-rental clause requiring annual payment. If the lease is to be a "paid-up" lease, then Kruger wants to add to the initial bonus payment (see (C) above) a lump sum of at least $25,000. If the lease will instead require an annual delay-rental payment, Kruger would like to receive at least $5,000 annually in the event Munson does not drill. In either case, more delay-rental income is always welcome to Kruger.

E. Shut-in Royalty

Kruger is not opposed to the inclusion of a shut-in well clause. If Munson wants to include a shut-in well clause, however, Kruger wants to receive a shut-in royalty. Kruger wants $150 per acre leased per year, but will settle for down to $120 per acre leased per year.

F. Pooling Clause

While Mr. Kruger has no problem including a voluntary pooling clause in the lease, he has heard about "bad faith" pooling where oil companies pool a small portion of a lease (that contains a typical lessee-drafted form pooling clause) and using that constructive production to maintain the entire lease into the secondary term in the case of an off-tract well. Kruger would like to include a "Pugh Clause" so that only that portion of the lease that is pooled is considered to be held by constructive production into the secondary term. Kruger is willing, however, to settle for language that requires Munson to pool at least half (50%) of the total acreage of the lease when it activates the pooling clause.

G. Location of the Drill Site

Kruger cannot allow drilling and production from Lot 1 or Lot 2. Furthermore, it wants to eventually sell Lot 5, meaning it does not want drilling and production on that lot. Drilling and production from Lot 3 is acceptable as long as Munson agrees to not disrupt the parking lot. Drilling and production from anywhere on Lot 4 is acceptable.

Confidential Facts: Attorneys for Munson Petroleum LLC

Munson is an established regional company in the oil and gas industry. It has maintained a relatively small and successful business for over 35 years. Munson is currently well positioned for the trough of hydrocarbon prices because it sold significant mineral properties during the summer of 2014 when prices were still high. Because of these sales, while the company maintains many productive oil and gas properties, it is sitting on significant cash reserves. It would like to position itself for a possible rebound in prices by cheaply acquiring leases covering newer, more speculative acreage so it can evaluate such new prospects while the price of contractor services is relatively low. If it finds new targets, Munson will then develop the new assets when prices rise. Therefore, leasehold portfolio growth is still a goal for Munson. Munson has a few productive wells located in other properties north of Baytown, and this past success has prompted it to look for other opportunities in the region.

Since drilling wells is cheaper during periods of low prices, Munson would like to take this opportunity to look for more speculative targets. With the cash the company has on reserve and the recent promise of renewed oil production in the span between Houston and Beaumont, the opportunity for growth by booking reserves through wildcat drilling is promising.

The key factor for this growth is securing leases. Munson has not negotiated many leases with corporate lessors similar to Kruger; most of Munson's previous lessors have been absentee landowners involved in agriculture. Corporate lessors are typically more worried about how drilling might impact their future uses. Perhaps because of this, Munson has struggled to win the leases it wants closer to Houston.

Munson has given you authority to approach the following issues accordingly.

A. Primary Term & Extension Clause

According to Mr. Munson, the longer the primary term, the better! Munson intends to drill on Kruger's property as quickly as possible, however, geology and geophysical exploration work first needs to be completed before operations begins. Due to low prices, plenty of rigs and workers are available. For these reasons, Munson would like a four-year primary term, but longer is better. Munson will not accept a primary term of less than three years.

Munson needs an extension clause of at least one year, preferably two. Munson is willing to make a payment in an amount of $1,300 to $2,600 per acre to activate the extension clause. If Kruger allows the two-year extension, the payment can be on the higher end. If Kruger agrees only to the one-year extension, the payment should be on the lower end.

B. Royalties and Deductions

Before addressing the amount of royalty, counsel may need to explain how Munson usually calculates royalties. Depending on the language in the lease, companies may deduct the lessor's proportionate share of post-production costs—those costs incurred past the wellhead—from their royalty. Lessors have started adding language to recent leases that prevent oil and gas companies from deducting post-production costs from their royalty. Munson does not like this. It forces the lessee to pay more to produce the same amount of oil and gas, and it believes the lessor should pay its share of costs to make the oil and gas marketable. After all, Texas case law generally stipulates that where the lease is silent, the lessor's pro-rata share of all post-production costs is deductible from the lessor's royalty.

The three post-production deductions that will need to be addressed are processing, transportation, and marketing. Munson would prefer for all three to be deductible. However, it recognizes that this goes against the current trend. Counsel should be aware that processing is the most expensive cost, and transportation is more expensive than marketing. Therefore, a processing or transportation deduction would be acceptable to Munson.

The standard royalty interest found in Munson wildcat leases is $1/8^{th}$. Munson is willing, however, to create an exception for Kruger. If Kruger is willing to agree to a transportation **or** marketing deduction allowance, Munson will agree to a $1/7^{th}$ royalty. If Kruger agrees to all post-production deductions, Munson will agree to a $1/6^{th}$ royalty.

C. Initial Bonus Payment

Munson understands that leasing is competitive and bonus payments can often be a deciding factor lessors use to choose a lessee, particularly one in need of immediate money. Munson knows, however, that no other companies are currently leasing in the immediate area. If possible, Munson counsel should try to limit the payment to $700 per acre but Munson has authorized up to $1,100 per acre.

D. Delay-rental Clause and Payments

Munson is requiring that the lease be a "paid-up" lease because delay-rental clauses requiring annual payments are more difficult to manage. To that end, Munson is willing to add to the initial bonus payment (see (C) above) a lump sum of not more than $30,000 in return for Kruger agreeing to a "paid-up" lease. Munson wants, of course, to pay as little as possible, but realizes a hefty addition to the bonus payment may be necessary to secure Kruger's agreement for a "paid-up" lease.

E. Shut-in Royalty

Munson wants the lease to include a shut-in royalty clause. In return, Munson is willing to a pay an annual shut-in royalty of up to $140 per acre per year, but less is always better.

F. Pooling Clause

Munson requires a voluntary pooling clause in the lease. Munson recognizes that landowners are becoming increasingly wary of "bad faith" pooling that may occur when oil companies pool a small portion of a lease (that contains a voluntary pooling clause) and thereafter use that constructive production to maintain the *entire* lease into the secondary term, as the typical lessee-drafted form pooling clauses provide. While Munson would accept inclusion of a "Pugh Clause" that provides that only that portion of the lease that is pooled is considered to be held by constructive production into the secondary term by an off-tract well, Munson would rather have language that only requires it to include in the pool a certain percentage of the total acreage of the lease when it activates the pooling clause. In the latter instance, any percentage of acreage-inclusion between 20% and 60% is ultimately acceptable, but lower is at least theoretically better for Munson.

G. Location of the Drill Site

Munson, not surprisingly, would like the right to drill anywhere on the lease. It realizes, however, that Kruger has existing buildings and parking lots that it would not want to be disrupted with drilling and production. At a minimum, Munson would require the lease to allow for drilling and production on Lot 4 or Lot 5 or both.