



STATE OF KANSAS

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June 13, 1983

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ATTORNEY GENERAL OPINION NO. 83- 90

Robert Osborn
City Attorney
The City of Stockton
Stockton, Kansas 67669

Re: Oil and Gas--Leases and Liens--Lease of Lands by
Municipal Corporations

Synopsis: Pursuant to the provisions of K.S.A. 55-211a, a city may enter into an agreement for the cooperative development of oil and gas rights, provided that such an agreement serves a public purpose. Cited herein: K.S.A. 55-211a, Kan. Const., Art. 12, §5.

* * *

Dear Mr. Osborn:

You request our interpretation of K.S.A. 55-211a. Specifically, you ask whether an agreement for the cooperative development of oil and gas rights, attached hereto as Exhibit "A," constitutes a "lease" which the city may enter into pursuant to the provisions of the aforesaid statute.

The subject agreement provides for the pooling of all oil and gas rights of certain "Landowners" (one of which is the city of Stockton) and for the drilling of a test well by the "Operator." The Operator agrees to bear all costs of drilling and completing the test well, including any damages incurred as a result of drilling operations, and further agrees to indemnify the Landowners against liability of any kind or nature as result of its operations. It is provided that the Operator is entitled to 100% of the money from crude oil runs until all expenses of the initial project,

plus interim operating expenses, are paid in full. After the costs of the original project are recovered, the Landowners (in the proportion their land ownership bears to the total unit) become entitled to a 1/2 of 8/8ths royalty interest, and the Operator retains a 1/2 of 8/8ths working interest (referred to as the Operator's "royalty interest" in the agreement). Each such interest is subject to an undivided 1/32nd of 7/8ths overriding royalty interest for a drill site, and it is provided that, after Landowner sharing in production commences, all fees and expenses of operations shall be paid from the Operator's working interest. The term of the agreement is for 1 year, and in the event oil and gas, in paying quantities, is discovered, then for so long as oil or gas, or either of them, is produced.

K.S.A. 55-211a provides, in pertinent part, as follows:

"The governing body of any municipal corporation . . . owning or having the management and control of any tract of land within the state of Kansas, is hereby authorized and empowered to lease such lands, or any part thereof, for drilling for oil or gas upon such terms as may be agreed upon: Provided, That any such lease shall contain provisions for spacing and producing wells in accordance with rules and regulations of the state corporation commission as provided by law." (Emphasis added.)

In considering whether execution of the subject agreement by the city of Stockton is within the authority granted by the above-quoted statutory excerpt, we note that the term "lease" has been defined, for purposes of oil and gas operations, as follows:

"The instrument by which a leasehold or working interest is created in minerals The most common oil and gas lease in the mid-continent area is the so-called 'Producers 88' lease. Even this does not describe a specific instrument or indicate the interests created thereby, although generally speaking Producers 88 lease forms contain an 'unless' clause rather than an 'or' clause and are executed for a term of years and so long thereafter as oil and gas is produced. . . . The principal interests arising from an oil

and gas lease are the working or leasehold interest of the lessee, and the royalty, delay rental, bonus, and possibility of reverter or power of termination interests of the lessor." (Emphasis added.) Williams and Meyers, Manual of Oil and Gas Terms (3rd Ed.) 240.

Examining the subject agreement in regard to the "principal interests" arising from an oil and gas lease, it appears that the agreement does not provide for a true landowner royalty, as such a royalty usually refers to "a share of the gross production of minerals free of the costs of production." See Williams and Meyers, Manual of Oil and Gas Terms (3rd Ed.) 240. Additionally, the agreement provides for an "operator's royalty," an interest which is an anomaly from the standpoint of the ordinary oil and gas lease. See Robinson v. Jones, 119 Kan. 609 (1925). Further, another uncharacteristic feature of the agreement is that it subjects both the royalty interest and the working interest to an "overriding royalty." Ordinarily, the overriding royalty is part of the working interest. Id. For all the above-stated reasons, it is our opinion that the subject agreement cannot be classified as an oil and gas lease.

Even though the subject agreement is not, in our opinion, an oil and gas lease, a recognized authority on the law of oil and gas has stated that municipal authority to grant oil and gas leases might properly be construed as including other powers, to wit:

"The authority to grant oil and gas leases should be construed as the authority to develop oil and gas rights by authorizing another to do so. Liberally construed, such authority would include the authority to enter into pooling and unitization agreements that do not involve participation by the municipality as an operator." (Emphasis added.) 5 Kuntz, Oil and Gas §682.

Pursuant to the above-quoted authority, it is our opinion that the city of Stockton, under the authority granted by K.S.A. 55-211a, may enter into the subject agreement, which does not involve participation by the city of Stockton as an operator and does not subject the city to any operating liabilities. Additionally, it must be recognized that even if the subject statute

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were construed as not granting authority to enter into an agreement for the cooperative development of the city's oil and gas rights, the execution of such an agreement is clearly a "local affair" which the city could authorize by ordinary ordinance adopted under home rule powers granted by Article 12, §5 of the Kansas Constitution.

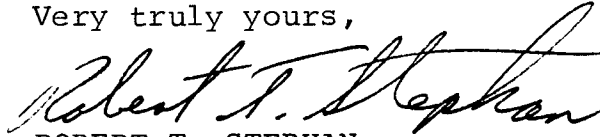
Finally, in regard to certain concerns you have expressed, we do not believe that city participation in the proposed pooling of oil and gas rights constitutes a prohibited "commercial enterprise." Many Kansas cases have held that neither the state of Kansas or its political subdivisions may engage in "commercial enterprises" wherein a public purpose is not served. See City of Geneseo v. Gas Co., 55 Kan. 358 (1895); State v. Kelly, 71 Kan. 811 (1905); State ex rel. v. Kaw Valley Drainage District, 126 Kan. 43 (1928); State, ex rel. v. City of Hiawatha, 127 Kan. 183 (1928); Glen W. Dickinson Theaters v. Lambert, 136 Kan. 498 (1932); Robinson v. Board of County Commissioners, 210 Kan. 684 (1972). However, where a public purpose is served, the court has held that a city may lawfully engage in certain commercial or business activities. See State, ex rel. v. Kansas City, 151 Kan. 2 (1940); Wendler v. City of Great Bend, 181 Kan. 753 (1957). Additionally, the tendency of courts has been to "broaden the scope of those activities which may be classified as involving a public purpose in which a municipal corporation may lawfully engage." 56 Am.Jur.2d, Municipal Corporations §210.

In our judgment, the subject pooling agreement, whereby the city may realize income from city property which was lawfully acquired for municipal purposes, serves a public purpose. In so opining, we recognize that Kansas cities have never had authority, and do not presently have authority, to commit public moneys to speculative oil and gas ventures. See City of Geneseo v. Gas Co., supra. However, no such commitment is made in the subject agreement, and all royalty owners (including the city) are indemnified against liability of any kind arising as a result of oil and gas operations. Further, as additional protection against possible claims by third parties who contract with the Operator, the city could add a clause to the agreement whereby the Operator would be required to include, in all contracts with third parties, a paragraph releasing the city of Stockton from any liability arising out of the contract or oil and gas operations. Under these circumstances, it is our opinion that, even though the

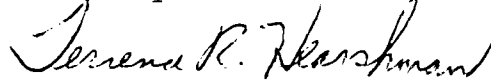
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subject agreement may have certain "business" or "commercial" motives, it serves a public purpose and is valid.

Very truly yours,



ROBERT T. STEPHAN
Attorney General of Kansas



Terrence R. Hearshman
Assistant Attorney General

RTS:BJS:TRH:ta

WHEREAS, Eric Waddell, Operator, has heretofore provided a proposal to the said Landowners which Landowners have agreed to accept, and

WHEREAS, it is the desire of all of the parties to set out in detail provisions of the said agreement for the benefit of all parties.

NOW THEREFORE, in consideration of the mutual covenants and agreements hereinafter set forth, and in the further consideration of the mutual promises between the parties and mutual considerations and cooperations between the same to promote oil and gas development, it is agreed by and between the parties as follows:

1. That Eric Waddell and Associates is hereby granted the right, power and authority to cause an oil well test to be made upon Drill Site F-2 within the City of Stockton, Kansas.

2. That the costs of obtaining said test well shall be solely and strictly that of Operator which costs include but are not necessarily limited to all legal fees and expenses, all permits required, all preparatory work of every kind and nature, all drilling, all testing, all completion work, provisions for insurance and permits as is required by the City of Stockton and the State of Kansas and any and all other expenses and charges that accrue as a result of said oil well test. That the said Landowners agree to cooperate in every manner to obtain the test well. That included in these fees, charges and expenses are all damages incurred as a result of the drilling operations, of every kind and nature.

3. Operator shall be responsible for equipping the well and shall use top quality equipment in the completion process. Operator shall use reputable firms in the drilling operation as well as testing and treating the well employing methods commonly accepted in the oil and gas industry. That Operator shall be free to commence operations when all parties have executed this agreement.

4. Operator agrees to comply in all respects with the laws of the State of Kansas pertaining to oil and gas drilling operations, and further, agrees to comply with the City Ordinances of the City of Stockton, Kansas relating thereto.

5. That in the event a dry hole occurs as a result of the drilling operations, Operator agrees to restore the surface to as nearly its original condition as possible, and shall abandon the premises and restore the same as soon and quickly as possible after the drilling operations cease, and shall pay for any and all damages as a result of the said drilling operations. None of the undersigned Landowners shall in any way be responsible for any expenses of any kind or nature incurred as a result of the dry hole drilling operations.

6. In the event oil and gas is hit in paying quantities sufficient to cause the well to be operable in commercial quantities, Operator agrees to complete the said well in a prudent like manner as soon and quickly as possible after oil is discovered. A complete and full accounting shall at all times be kept by the said Operator and the same shall be available for the inspection at any time by any of the undersigned Landowners. Upon completion in full of the oil well, all of said Landowners shall immediately be notified of the complete costs of the project, including copies of invoices and other documentation, if any, supporting the charges and expenses.

7. Landowners hereby grant Operator the right and authority to negotiate with a crude oil purchasing company for the purchase of the crude oil produced, and further grants the Operator the authority to collect 100 percent of the money as a result of said sale. Operator shall provide a monthly accounting of the income, expense, and retirement of debt to all of the undersigned Landowners as soon as practical each month after the transactions have been completed. The said Operator is hereby granted the authority to collect 100 percent of the money from the crude oil runs from the time of the commencement of the operations until all of the expenses of the initial project, plus interim operating expenses, are paid in full.

8. After payment in full of the original project cost and expense, Landowners shall immediately become entitled to an undivided 1/2 of 8/8ths royalty interests in the shares and proportions their land represents to the total unit, more particularly as set out in Exhibit "A" attached hereto. This interest may, however, be subject to an undivided 1/32nd of

7/8ths overriding royalty interest provided the Landowner for a drilling site, should the same be necessary. Operator shall likewise retain an undivided 1/2 of 8/8ths royalty interest for his use and benefit, it, too, to be subject to an undivided 1/32nd of 7/8ths overriding royalty interest to the Landowner for the drill site, should the same exist. From that time henceforth, all of the undersigned shall share proportionally in an undivided 8/8ths of the royalty interests.

9. After commencement of Landowner sharing as above stated, from that time hence forth, all fees and expenses of operations shall be paid from the Operator's 4/8ths of 8/8ths royalty interest. Landowners shall not be charged in any manner with costs, fees and expenses for operations, and the said Operator hereby agrees to hold all Landowners harmless of any liability thereon.

10. That in the event of the abandonment of the oil well for any purpose, the salvage value, less any costs and expenses for sale and liquidation of the same, shall be shared in the same shares and proportions amongst Landowners and Operator as the oil runs. In the event, however, that the costs of the initial completion have not been reimbursed to Operator, so much of the liquidation of the said equipment as is necessary to complete reimbursement to the Operator shall be made to him to complete the pay-back. Any amount over and above the pay-back to Operator for the initial cost of the project, shall be distributed amongst Landowners and Operator in the same shares and proportions as they receive oil runs.

11. The term of this agreement shall be for a period of one (1) year from the date of the last signature herein, and in the event oil and gas is hit in paying quantities, the same shall be perpetuated for so long as oil or gas or either of them is produced therefrom. Upon the abandonment of the lease, for any purpose, this agreement shall become null and void and of no further force and effect, and the rights of the Operator hereunder shall cease.

POOLING, UNITIZATION AND SPECIAL AGREEMENTS

12. Subject to the provisions of this agreement, all oil and gas rights of all of the parties in this agreement covering the lands shown in Exhibit "A" attached hereto, and all rights of the Operator obtained under this agreement in the royalties, are hereby pooled, so that operations may be conducted hereunder as one lease and one unit.

13. Nothing herein shall be construed to result in the transfer of title to the oil and gas rights, permanently, by any party thereto to any other party. The intention of this agreement is to provide for the cooperative development and operation as per the terms hereto, and upon the expiration of this agreement, all of the rights of the parties and the ownerships in the properties of the parties, shall be the same as they exist prior to entering into this agreement.

14. That the said Operator, for the benefit of all of the royalty owners in this agreement, hereby grants unto the Operator the right to inject into the unit area any substance in whatever amounts Operator deems expedient for its operations, for the benefit of everyone.

15. All oil and gas produced and saved from the unit area shall be allocated to the several tracts within the unit area in accordance with the respective tract participations effective during the period that the same were produced. The amount of oil and gas allocated to each tract, regardless of whether it is more or less than the actual production of oil and gas from the well or wells, if any, on such tract, shall be deemed for all purposes to have been produced from such tract. This allocation is subject however to the undivided $1/2$ of $8/8$ ths, subject to outstanding overriding royalties, if any, in the Operator.

16. Operator may use as much of the oil and gas as it deems necessary for its operations on this unit area, including but not limited to the injection thereof.

17. No royalties of any kind or nature, or other payments shall be payable upon, or with respect to, oil and gas used or consumed in its operations, or which otherwise may be lost or consumed in the production, handling, treating, transportation, or storing of oil and gas.

18. All of the parties to this agreement, to the extent of their rights and interests, hereby grant to Operator the right to use as much of the surface of the land within the unit area as may reasonably be necessary for its operations, except that the tank battery location shall be as specified by a separate tank battery agreement as is required by the City Ordinance of the City of Stockton, Kansas. Operator, however, shall be responsible to the parties for damages caused to the surface and surface rights as a result of the operations.

19. This agreement shall extend to, be binding upon, and inure to the benefit of, the respective heirs, devisees, legal representatives, successors, and assigns of the parties hereto, and shall constitute a covenant running with the lands, leases and interests covered hereby.

20. Any conveyance of all or any part of any interest owned by any party hereto with respect to any tract shall be made expressly subject to this agreement. No change of title shall be binding on the other parties to this agreement, other than the parties so transferring, until the first day of the calendar month next succeeding the date of receipt by Operator of a photocopy or a certified copy of the recorded instrument evidencing such change in ownership.

21. Each party hereto covenants that, during the existence of this agreement, said party will not resort to any action to partition the unit area or the equipment, and to that extent waives the benefits of all laws authorizing such partitions.

22. This agreement shall be subject to the conservation laws of the State of Kansas; to the valid rules, regulations, and orders of the Kansas Corporation Commission; and to all applicable federal, state and municipal laws, rules, regulations and orders.

23. All obligations imposed by this agreement on each party, except for the payment of money, shall be suspended while compliance is prevented, in whole or in part, by a strike, fire, war, civil disturbance, act of God; by federal, state or municipal laws; by any rule, regulation, or order of a governmental agency; by inability to secure materials; or by any other cause or causes reasonably beyond control of the Operator. No party to

this agreement shall be required against its will to adjust or settle any labor disputes. Neither this agreement nor any other instrument involved herein, if any, shall be terminated by reason of suspension of operations due to any one or more of the causes set forth in this paragraph.

24. This agreement shall become binding upon each of the parties as of the date that such party signs the instrument by which it becomes a part hereto, and, unless sooner terminated, shall become effective as to qualified tracts at the same time and date as determined herein.

25. This agreement may be terminated only by majority of the parties to this agreement after it has been determined that operations are no longer profitable or feasible. Upon the termination of this agreement, the further development and operation of the unit shall be abandoned, operations shall cease, and thereafter the parties shall be governed by the provisions of the leases and other instruments effecting the separate tracts.

26. A person may become a party to this agreement by signing the original of this instrument, a counter-part thereof, or other instrument agreeing to be bound by the provisions hereof. The signing of any such instrument shall have the same effect as if all parties had signed the same instrument.

OPERATOR'S AGREEMENT - SPECIAL PROVISIONS

27. Operator agrees, under the terms of this agreement, to cause a well to be drilled upon said land as soon as feasible, which well will be drilled to a depth sufficient to test the arbuckle structure unless oil and/or gas is discovered in paying quantities or granite, or some other impenetrable substance is encountered at a lesser depth, or unless some act of God renders drilling economically unfeasible.

28. The right of operating and managing said well shall be the sole responsibility of Operator. During the period of time of initial production before the original cost of production has been returned, all of the royalty owners signed hereto shall have the absolute right and authority to inspect the books of Operator pertaining to said well at all reasonable times and places. After the initial cost has been paid in full, and after which time royalties are being paid to the respective Landowners, under the

terms of this agreement, the operations shall be the sole and separate property of Operator. The hiring and firing of employees and the supervision shall be the responsibility of the Operator without contribution from the other royalty owners.

29. Operator agrees at all times to keep proper liability insurance upon the operations and agrees not to cause any form of lien of any kind or nature to be placed upon the operations which would be to the detriment of the Landowners, and further, Operator agrees to at all times keep the other royalty owners indemnified against liability of any kind or nature as a result of its operations. That public liability insurance shall be provided by the said Operator to comply with the state and federal laws and regulations in such respect.

30. It is agreed that Operator may assign any portions he desires of his undivided $1/2$ of $8/8$ ths royalty interest to anyone or other entity he desires. His assignees, however, shall purchase subject to the terms and conditions of this contract and shall enjoy the benefits and liabilities thereof.

31. This contract is binding on the parties hereto, their heirs, executors, devisees, trustees, legatees, administrators and assigns.

In Witness Whereof, the undersigned have hereunto set their names the day and year first above written.