THE BOON AND BANE OF MARCELLUS SHALE

I grew up on a farm in Washington County. We never had much money, but most people thought we did because we owned property. Farmers understand that their land is often worth more than their farm business. A common joke among farmers is that if they come into some money they will just keep farming until it's all gone. Now that the exploration and extraction of natural gas from the Marcellus shale has become profitable, many farmers and property owners are benefiting financially.

Companies such as Range Resources, EOG and Halliburton are bringing an army of experienced drilling people into Washington County to develop our natural gas resources. All this is good for our local economy and landowners may be particularly excited about the possibility of significant financial gains from signing a natural gas lease. The problem is that it is hard to find trustworthy, nonbiased information about leasing and payments.

In this article, we will focus on financial issues you should consider surrounding natural gas leasing.

The gas lease is a legal document and as such should be reviewed by an attorney. The lease agreement usually lasts for about five years. It could lead to a secondary term that could last as long as the production is active on the property.

A typical leasing agreement will give the energy company a fair amount of leeway as to surface rights. You may want to limit those rights within the agreement. For example, you may want to stipulate where a well is to be located on your property or where the drilling company can build access roads. You can also ask for protection in the event there is damage to livestock, crops or buildings.

The types of income available through a natural gas lease may include a signing bonus, land rental fees and/or royalty payments. You should ask for a written description of how you will be paid and what payments you might receive in the future. Additional revenue opportunities may be associated with pipelines, gas storage, well-siting fee and selling resources from your land, such as stone, timber or water access.

Potential expenses may include legal fees, property tax increases and other expenses. When negotiating a lease you may want to include a provision to require the gas company to indemnify you for any liability you might incur as a result of drilling. You should be indemnified if you are pulled into litigation. One example might be if your neighbor's water supply is contaminated from the drilling. Another could arise if someone is injured on your property as a result of coming into contact with drilling equipment.

There may be other contingencies to consider, not the least of which is your future financial management. The income you may derive from a gas lease may require a new approach to tax planning, estate planning and wealth management.

The income you receive from natural gas leasing is subject to federal and Pennsylvania state income taxes, but not local taxes. If you receive an upfront payment, that amount will be considered ordinary income and is subject to regular income tax. As a result, you may need to file a quarterly estimated tax return to avoid penalties.

As a landowner, you have to consider the "cost basis" in your property. The only time you can recover your basis is either when you sell the property or sell resources from the property. Tax law on natural gas royalties allows you to deduct annually from your basis as the gas is depleted, thus saving you taxes. This is called a depletion allowance.

In addition, property taxes may be affected, especially if you have enrolled in Pennsylvania's Clean and Green program. You may have to reimburse the state for the lower real estate taxes you paid prior to the gas exploration and drilling on your land. Consulting with a certified public accountant (CPA) regarding these tax planning matters is definitely advisable.

Also, it might be wise to consider planning for the transfer of your estate after your death. With recent tax law changes the amount of assets in an estate that can pass to others before incurring estate taxes will increase to $5 million per person ($10 million for couples). The estate tax rate has been reduced to 35% for estates with assets above the exemption level. Most estates will continue to be subject to the Pennsylvania State Inheritance tax and other administrative and probate costs.

When planning your estate, you will want to consider all of your assets, including the potential assets that may relate to natural gas. The rights to natural gas and royalty income streams should be viewed separately from the surface land itself when assessing a value.

A financial windfall or "sudden wealth" is almost always a welcome event, but a certain amount of stress comes with the territory, especially if you have never had to manage a large sum of money. This is why many people seek out a professional – someone they can trust to help them. A certified financial planner (CFP) typically has a process for managing your money that is based on your personal goals and lifestyle. Look for an advisor who takes a comprehensive approach to money management, who has knowledge of the financial implications of natural gas income sources and years of practical financial management experience.

If you would like more information regarding natural gas exploration in this area please call our office and we will send you a free copy of "A Landowner's Guide to Leasing Land in Pennsylvania" and "A Landowner's Guide to Financial Management" provided to us through Penn State Extension.

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