OVERRIDING ROYALTY INTEREST (ORRI) IN OIL AND GAS PROPERTIES IN THE US

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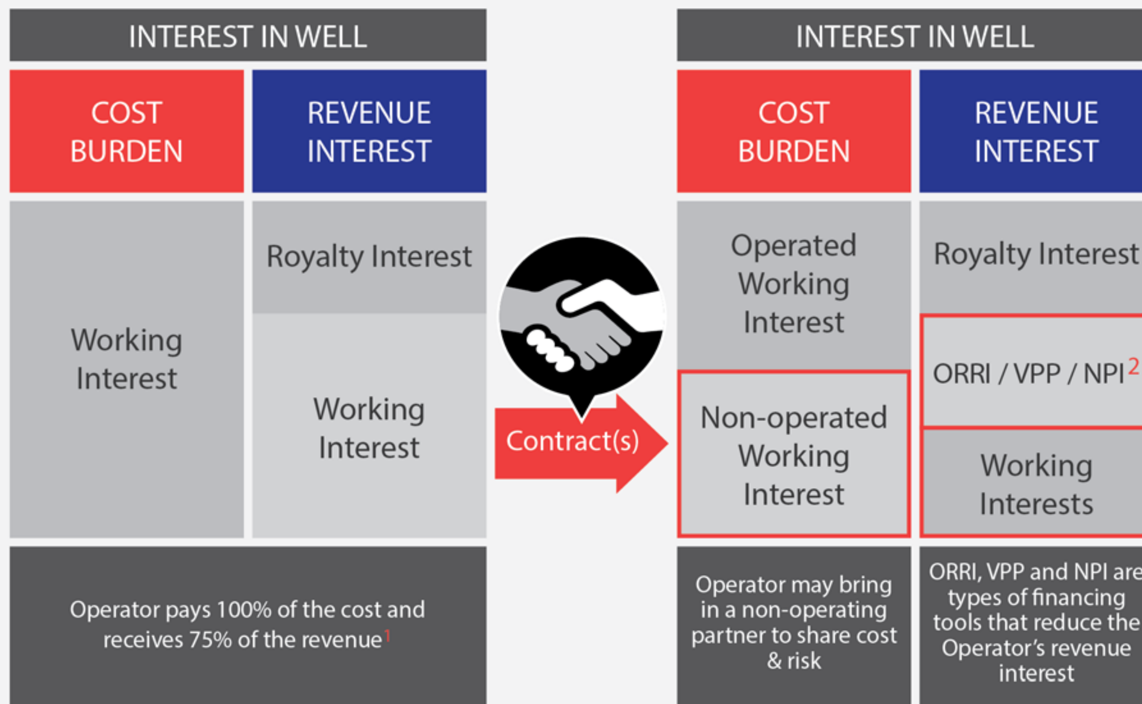
Habib Yunus: hyunus@w-advisory.com



Overview

An overriding royalty interest (ORRI), also known as a gross overriding royalty (GORR) or term royalty, is a fractional, undivided interest, derived from the working interest. It is not an interest in the actual minerals, but an interest in the oil & gas minerals production or revenue.

Creation of an ORRI

An ORRI can be created through a conveyance, but it is more commonly created by a reservation in the assignment or as a transfer of an oil/gas lease. ORRI are commonly assigned to someone that assembles a prospect, property sellers who want to retain an interest, or simply as a means of raising capital.

It is a non-possessory interest that attaches only when its share of oil/gas is produced, generally giving the owner no right to participate in decisions on the development and operations of the burdened lease. Since an ORRI is "carved out" of the leasehold interest, it is limited in duration to the term of the burdened lease.

It is possible to structure an ORRI so that it "flips" or changes to a different amount once a return hurdle is achieved. For example, some companies have invested money with operator in return for a 18% ORRI, with the ORRI reverting to 8% after payout.

Difference between Royalty Interest and ORRI

An ORRI possesses most of the qualities of a royalty. The main difference is that a royalty interest is considered a part of the mineral estate which includes ownership in the minerals. An overriding royalty does not own the minerals in the ground, only proceeds from the production of minerals. Once the lease has expired or production has ceased, the overriding royalty interest expires. On the other hand, a royalty will continue to exist even after production has ended.

Calculating the ORRI Amount

In general, the owner of an ORRI is entitled to his specified share of oil or gas produced free and clear of drilling, completing, and operating costs. However, it is commonly accepted that the ORRI owners will bear their proportionate share of production and severance taxes.

The Operator can deduct any costs to bring the production to sale. This may include transportation, treatment and marketing costs. There is no standard for the amounts of these costs. They are part of the negotiation with the Operator.

US Tax Implications

The income received from an ORRI interest is considered ordinary income.

ORRI income can be reduced for tax purposes by using either the cost depletion or the percentage depletion methods. The percentage depletion method is calculated by applying a 15 percent reduction to the taxable gross income of a royalty well.

An ORRI may also be subject to certain taxes, such as production and severance taxes levied by individual States. Since the taxes are generally paid on the ORRI owner's behalf by the working interest owner, the payment of such taxes will constitute additional income to the ORRI owner.

ORRI income is not considered unrelated business taxable income (UBTI) to tax-exempt investors.

An ORRI is considered an interest in real property for US tax purposes and would be subject to FIRPTA withholding tax when sold by a foreign owner.

US Legal Treatment as Property

In most US states an ORRI is regarded as real property. The notable exceptions are Kansas and Oklahoma, where an overriding royalty interest is considered personal property before and after it is produced.

Whether a jurisdiction classifies an ORRI as real or personal property will usually depend on how the jurisdiction classifies a landowner's royalty interest. Courts generally characterize an override as an interest in real property for purposes that affect the land involved, and as a personal property interest for purposes of payments that arise from the interest.

Since an ORRI is a non-possessory right that attaches only when the oil/gas is produced it cannot be adversely possessed or partitioned. The owner is not entitled to possessory remedies like trespass to try title. Conversely, the Operator cannot bring a partition action in an attempt to extinguish an ORRI that the lessee claims has overburdened the working interest.

Bankruptcy Implications

As long as the ORRI is considered real property, it will not be subject to creditor claims in the event of operator bankruptcy. It would not be part the bankruptcy estate and the trustee or debtor in possession (DIP) would have no power to sell, assign, or transfer the interest.

Unlike a general royalty interest, because an ORRI is generally created out of the working interest of an existing oil/gas lease it is often used as a financing tool.

Regardless, a properly structured ORRI will have the characteristics of real property.

Environmental Liability

ORRI holders have no obligation for any environmental, remediation or plugging and abandonment expenses.

W Energy Advisory	
w-advisory.com	
Phone:	+1 713-518-1126
Fax:	+1 281-617-5819
Email:	hyunus@w-advisory.com
Houston Office:	Tokyo Office:
17385 Village Green, Suite C Houston, Texas 77040 USA	Toranomon 3-18-6 Asahi Toranomon Mansion #705 Minato ku, Tokyo 105-0001 JAPAN

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