Oil & Gas Leasing Trends & Legal Challenges:
Lessons from Marcellus Shale

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Executive Summary

The explosion of natural gas and oil exploration in the large underground shale play formations in various locations in the United States has fueled a boom in oil and gas rights leasing in recent years. Many areas, especially those located in the Marcellus Shale play region—which includes Pennsylvania, West Virginia, Ohio and New York, as well as smaller portions of Maryland and Virginia—that were previously economically depressed due to the loss of blue collar jobs, have experienced a new era of prosperity due to the business of oil and gas rights leasing.[1]

The largest portion of the shale underlies Pennsylvania and that state has seen the most significant growth in Marcellus Shale wells. The total number of wells in 2010 was reported at 1,368—an enormous increase from only 195 wells in 2008. The total production in Pennsylvania was reported as approximately 195 billion cubic feet of natural gas between July 2009 and June 2010.[26]

The large-scale increase in natural gas exploration has been made possible by the development of technology allowing energy companies to use horizontal drilling in conjunction with hydraulic fracturing to extract natural gas and oil from geologic shale plays. Although fracturing techniques (fracking) were first developed in the 1950s, it wasn't until the advent of horizontal and directional drilling techniques in the 1980s that fracking became commercially viable.

The Mitchell Energy and Development Corporation made large-scale shale gas production a reality in the late 1980s and early 1990s with its work in the Barnett Shale in North-Central Texas. By 2005, other companies had followed Mitchell and the Barnett Shale was producing 0.5 trillion cubic feet of natural gas per year.[1]

This success led energy companies from around the world to begin exploration in other shale plays throughout the U.S. Over the last five years shale gas exploration has become a game changer for the U.S. natural gas market. Dry shale gas production from shale gas plays increased from 1.0 trillion tons in 2006 to 4.8 trillion tons in 2010. A 2010 study revealed that only one to three percent of the technically recoverable shale gas in the U.S. has been produced, thereby underscoring the importance that shale gas will play in the future of the energy industry.[2]

Although not the only shale play in the U.S. to produce natural gas and oil, the Marcellus play has proven to be the most significant—as well as the most controversial—for the oil and gas leasing industry. Many of the states involved have not had such large scale natural gas production in many years and the influx of cases and disputes involving oil and gas leasing has exposed a number of areas of jurisprudence that have not been addressed in decades.

The issues addressed in this paper promise to persist well-beyond Marcellus. A second shale play, the Utica Shale, has been identified for its potential also to become an enormous natural gas resource. The Utica Shale exists a few thousand feet below the Marcellus Shale and extends further into New York, Pennsylvania, Ohio, West Virginia and even into Virginia, Tennessee and Canada.[24] In some parts of Pennsylvania, the Utica Shale is over two miles below sea level. However, in Ohio, the Great Lakes and Canada, the shale rises to less than 2000 feet and even has outcrop areas where it rises to the surface.

The Utica Shale will be challenging to develop because of its significant depth and the lack of information about it. Some conjecture that the Utica Shale will not be developed in the Marcellus region until the Marcellus Shale is depleted. However, in other areas, the Marcellus Shale development will serve as infrastructure in order to develop the Utica Shale. Many drilling pads, roadways, pipelines, surveying work, as well as permit preparation and relationships with landowners have already been established.[24]

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Additionally, in those areas beyond the Marcellus Shale, the Utica Shale has become a primary target and drilling has already begun in eastern Ohio and Canada.[24]

As fracking operations expand in the Marcellus region as well as in other shale plays, landowners, energy companies, and oil and gas leasing attorneys should pay heed to these disputes and to seek solutions to them in order to ensure that future development runs as smoothly and safely as possible—and is profitable for both the landowners and the energy companies.

Background

A. Fee Simple Estate

The United States is unique among most countries in the world in that it granted ownership of underground minerals to the individuals and organizations that owned the surface in a system known as "fee simple estate." Under this system, the owner controls the surface, subsurface and air above his or her property, with the right to sell, lease, gift or bequest these rights to others.[3]

When the need and technology for drilling and mining became possible, companies that wanted to purchase the coal or gas on a property, but didn't want to buy the property itself, began purchasing the rights to the resources only. These transactions also include the right by the company to take advantage of the property to remove the resource.[3]

Additionally, energy companies may choose to lease the resource rights in order to enter the property and test to see whether suitable reserves exist on the property. After exploration, the company will then decide whether to commence production or to allow the lease to expire, thus returning the rights to the property owner.[3]

B. Shale Gas Resource Development

The U.S. Energy Information Administration (EIA) began representing shale gas resource development in the mid-1990s in its National Energy Modeling System (NEMS) and energy projections.[2]

Shale gas resource production was made possible by both the development of horizontal drilling—which allows companies to turn drills sideways once underground to reach further than before—as well as hydraulic fracturing, which is commonly referred to as "fracking."[4]

Fracking is a process by which fissures or fractures in underground formations are created in order to allow the flow of natural gas and oil. The drilling operator pumps water, sand and other additives under high pressure into the formation to cause the fractures. Once the fissures are open, they are propped open by sand, allowing natural gas and oil to flow, which is then collected at the surface. Before any drilling is performed scientists will study the rock formation in order to optimize the network of fractures to keep them contained within the boundaries of the shale formation.[4]

There are 20 discovered shale plays within the U.S., both onshore and offshore. A December 2010 study by INTEK, Inc., commissioned by the EIA, showed that these shale plays contain approximately 750 trillion cubic feet of discoverable resources. Sixty-three percent of these resources are located in the Northeast, 13 percent in the Gulf Coast and 10 percent in the Southwest U.S. regions. The largest shale play by far is the Marcellus Shale in the Northeast, which contains 410.3 trillion cubic feet of recoverable resources. The next largest plays are Haynesville (74.7 trillion cubic feet) in the Gulf Coast and Barnett (43.4 trillion cubic feet) in the Southwest. These estimates are expected to change as more exploration is performed and producers drill into the geologic deposits and find out exactly how much resource is there.[2]

INTEK found that, excluding the Appalachian plays and several newly developing plays, only one to three percent of the total resources in the U.S. has actually be produced. The size of the remaining resource "underscores the importance that shale gas can play in U.S. natural gas production," INTEK said. [2]

"In order to realize this production, substantial drilling is required. As the effective lifespan of the shale gas wells is relatively short, new wells are required to maintain current production levels as well as increase them," INTEK said.[2]

In addition to the large natural gas resources that have recently been identified, four shale oil plays have been discovered. The majority of these are located in the Monterey/Santos shales in the Rocky Mountains. An estimated 24 billion barrels of oil is located within those plays over 13,000 square miles, INTEK said.[2]

The economic advantages of this increased production have been especially significant in the Marcellus Shale region. These areas had become economically disadvantaged in recent years due to the decrease in blue-collar jobs. The business of leasing oil and gas rights has become a "lifeline" supporting these rural communities.[1]

C. Gold Rush Mentality

The influx of energy companies into the Marcellus region has created what many compared to the Gold Rush in the West in the 1800s.

The frenzy of oil and gas leasing hit its peak in the late 2000s when landowners were finding that their oil and gas rights, which had been worth approximately $5 to $6 an acre several years before, had suddenly increased to $5,000 to $6,000 an acre, said Lisa McManus, an oil and gas leasing attorney in Pennsylvania.

This trend has decreased somewhat in recent years, especially in certain counties in the western part of the state, but continues to be vibrant in the area, McManus said.

The development of the Marcellus Shale began in earnest in 2004 when Range Resources drilled the first well using modern technology.[24] Soon after, a number of other energy companies entered the fray, including: Chesapeake Energy, EXCO Resources, Anadarko Petroleum Corporation, XTO Energy, Rex Energy, Cabot Oil and Gas, and EOG Resources, Inc. [23]

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These natural gas leases are typically initiated when the parties sign a five-year lease agreement under which the landowner receives a "lease bonus" or "delay rental" payment in consideration of the period in which the gas company does not actually develop the property in order to "keep the lease alive" while the company decides whether or not to begin drilling operations. These payments are often made in a lump sum covering five years, which is calculated on a per-acre basis. [1]

Additionally, the lease agreements will include a royalty payment for the resources that are recovered on the land. These percentages are often negotiable and vary from state to state. For example, Pennsylvania law requires that the landowner receive at least one-eighth the value of the gas or oil produced and sold. However, these royalty rates are sometimes much higher and can go as high as 20 percent or more, thereby increasing the windfall to the landowner. [1]

An inherent part of the oil and gas lease is the right of the producer to enter the surface of the property to drill for the sought-after resources, as well as the right to transfer the gas and oil across the property via pipelines. [1]

It is within this context that many of the competing interests arise in such gas and oil leases, as the landowner retains the fundamental right to use and enjoy the property. Often with the "gold rush" mentality under which many of these agreements are being signed, proper due diligence is not being performed on the part of the landowners or the lessees.[1]

Oil and gas leases are often defined for a limited period, much like farmland leases. However, they become indefinite if production begins and continues at an acceptable commercial rate. Often, leases contain provisions under which the lessor may extend the lease even if there is little or no production.[5]

This white paper will focus on a number of topics of current relevance to the oil and gas leasing industry in the Marcellus Shale: issues related to expiring contracts and "eleventh-hour" operations; delay rentals; minimum royalty payments; the Doctrine of Repudiation; the Accommodation Doctrine; legacy lease tax sales; the validity of lease offers; pooling of resources; standard-form contracts; Pugh Clauses; zoning issues; and the Utica Shale.

Because of the geographic location of the Marcellus Shale, many of these legal disputes involve Pennsylvania law, but this paper will also examine significant developments in other Marcellus states. Also, as Marcellus production spreads outside of Pennsylvania. Residents, organizations and attorneys of neighboring states can view the legal issues and challenges experienced in Pennsylvania as a case study for how to handle similar challenges in their states.

Legal Challenges in 2011

"As the parties and this Court are well aware, the discovery of the Marcellus Shale has revealed gaps in Pennsylvania's jurisprudence on the various legal issues that arise from natural gas drilling projects."

U.S. Judge John E. Jones III of the U.S. District Court for the Middle District of Pennsylvania in a March 8, 2011, opinion in the case Curtis E. Lauchle, et al. v. The Keeton Group, LLC, et al. *(2011 U.S. Dist. LEXIS 23102).*[14]

A. Delay Rentals

The topic of delay rentals has been a hot one in oil and gas leasing in the Marcellus Shale region recently. Energy companies have, for many years, used delay rental payments to liquidate future damages for not developing the tract. These delay rentals are normally due after each year that the company does not drill on the tract during the primary term of the lease. Given the recent explosion in development and the eagerness of both parties to sign leases as soon as possible, many companies have begun paying several years of delay rental payments in advance.[8]

By paying the delay rental, the energy company (which is also referred to as the "operator") is under no obligation to drill a well or conduct any exploratory activities. These payments are also viewed as compensation to the landowner in lieu of the royalty payment.[10]

"[For the landowner] the real money is to be made in the development of the minerals under your property and the payment of royalties to you," said Lisa McManus.[8]

In the Commonwealth of Pennsylvania, the lease carries two terms—the primary and secondary terms. Under the "automatic termination" rule, the lease terminates at the end of the primary term unless a well has been developed that produces gas in paying quantities. To address this, the industry developed several clauses: the shut-in royalty clause; the continuous operations clause; and the dry hole clause.[10]

The issue of whether payment of delay rentals can extend a gas lease beyond its primary term was addressed in the Jan. 4, 2011, Pennsylvania Superior Court opinion in *Hite v. Falcon Partners, et al.* (2011 PA Super 2; 2011 Pa. Super. LEXIS 3).[11]

In that case, the operator was the assignee of several gas leases that were initiated in 2002 and 2003, all of which carried one-year primary terms. After their expiration, the operator did not commence any drilling operations, but continued to make delay rental payments to the landowners. The landowners demanded in 2008 that the operator either begin its drilling operations or terminate the leases, which the operator refused, leading to the lawsuit.[10]

The trial court rejected the operator's argument that it could maintain the leases indefinitely as long as delay rental payments were made to the landowners. The court held that a lease cannot be construed to be perpetual unless it is clearly stated in its terms.[10]

The *Hite* decision essentially sent a message to gas operators throughout the state and the region that the automatic termination rule was alive and well and that non-producing leases would be under a greater degree of scrutiny.[10]

B. Royalty Rates

Another important issue has been the royalty rate for natural gas and resources produced on the property. Under Pennsylvania's Guaranteed Minimum Royalty Act (GMRA), all leases carry a guaranteed rate of one-eighth the value of production. However, given the recent environment for development, many of these leases are being signed for a much higher royalty rate—sometimes 20 percent or more.[8]

Controversies have arisen recently of the standard practice by energy companies of subtracting the costs of bringing the gas from the wellhead to market from the overall proceeds to the landowner.[5]

On appeal, the Superior Court noted that the payment of delay rentals was intended to encourage the lessee to develop its operations and not to reward it for inactivity. It held that the operator's interpretation did not match the historical role of the delay rental payments.[10]

The GMRA was the subject of a recent opinion by the Supreme Court of Pennsylvania in the case *Herbert Kilmer, et al. v. Elexco Land Services, Inc., et al.* (No. 63 MAP 2009; 2010 Pa. LEXIS 517). The plaintiffs in this case were challenging the "net-back" method of calculating royalties—under which the costs of taking the natural gas from wellhead to market are deducted from the sale price—and argued that it violated the GMRA and therefore voided the leases.[12] "Any owner of an interest in oil or gas lease which entitles him to share in the production of the oil and gas under such lease or the proceeds therefrom without obligating him to pay any costs under such lease."[1]

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The landowners argued that the gas company should bear all the costs necessary to market the gas, including post-production costs, and therefore the royalty should be calculated at the point of sale. They also argued that the GMRA should be read together with the Pennsylvania Oil and Gas Conservation Law (58 P.S. 402), which defines the royalty owner as "any owner of an interest in oil or gas lease which entitles him to share in the production of the oil and gas under such lease or the proceeds therefrom without obligating him to pay any costs under such lease."[14]

The energy companies argued that the landowners were attempting to invalidate their leases in order to renegotiate them at a higher rate due to the recent boom in production. Additionally, they argued that there is nothing that stops the parties from contracting for a different downstream point of measurement as long as the contract provides a minimum royalty of one-eighth at the point of removal at the wellhead.

They said that because companies sell their products at various points during the production process at various prices, by deducting the expenses, the price of unprocessed gas at the wellhead is fairly calculated.[14]

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The Court on March 24, 2010 held in favor of the energy companies. The decision effectively validated thousands of existing leases within the state that authorized a royalty rate of one-eighth after the deduction of post-production costs, as well as ratified the common method of royalty calculation that had been in continuous use for decades. An opposite finding could have had a significant monetary impact on the natural gas drilling industry in the state.[13]

The decision also resolved a number of similar cases that had been pending in state and federal courts which were challenging natural gas leases that were signed during the early days of Marcellus Shale exploration.[13]

The case may also be read as extending the one-eighth royalty to existing wells drilled on leases that were signed before the GMRA, but were deepened or reworked after the act was signed, as well as new wells that were drilled on leases that were signed before the act was ratified in 1979.[13]

C. The Doctrine of Repudiation

A number of laws and doctrines that are commonplace in oil producing states in the west and south have yet to be adopted in the state of Pennsylvania, but have been introduced through recent litigation. One of these is known as the "Doctrine of Repudiation."

The doctrine was recently argued in the federal case *Curtis R. Lauchle v. Keeton Group, LLC* on March 8, 2011 (2011 U.S. Dist. LEXIS 23102), which was brought, similar to *Kilmer*, by a group of plaintiffs that was challenging the net-back royalty calculation method under GMRA. U.S. Judge John E. Jones of the U.S. District Court for the Middle District of Pennsylvania dismissed the plaintiffs' GMRA argument in Oct. 2010.[15]

However, prior to the dismissal, the energy companies had filed a counterclaim in the case seeking an equitable extension of their leases under the "Doctrine of Repudiation." Under this doctrine, a landowner cannot profit from the wrongful repudiation of a lease. Because the gas companies voluntarily ceased production on the properties during the five-year pendency of the litigation, they argued that they were entitled to an equitable extension of their leases under the doctrine.[15]

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The doctrine, which is more commonly used in states such as Texas and Oklahoma, was essentially non-existent in Pennsylvania, with the exception of the case *Derrickheim Company v. Brown* (451 A.2d 477 [Pa. Super. 1982]), which refused to apply the doctrine to a case brought by a gas producing company.[15]

The judge in *Lauchle* found that *Derrickheim* was controlling, although it was brought by a producer and not a landowner, and refused to apply the doctrine.

"In making this determination, we are mindful of the fact that oil companies, like the Chief Defendants, wield significant, if not exclusive power in the drafting of oil and gas leases. A determination that Plaintiffs had repudiated their leases via the filing of these actions further tips the balance in favor of the oil companies. Moreover, it would likely dissuade lessors from bringing potentially meritorious actions, which the case *sub judice* unquestionably was at its inception, in the future," Judge Jones wrote in his opinion.[14]

"The *Lauchle* decision is a major setback for oil and gas companies seeking to develop the Marcellus Shale formation here in Pennsylvania," said Robert J. Burnett of Houston Harbaugh in an article.[15] "Lease challenges are not uncommon. Litigation can and does create uncertainty. When faced with such uncertainty, it is unreasonable to expect a gas producer to invest millions of dollars to drill on a property that is the subject of a lawsuit seeking a declaration that the producer has no mineral rights. The Doctrine of Repudiation seeks to balance the rights and interests of both the landowner and the gas producer. The *Lauchle* decision, however, does not take into account this balance."

D. Accommodation Doctrine

The "Accommodation Doctrine" has been introduced in many oil- and gas-producing states in order to help balance the rights of the surface owner and the interests of the mineral owner.[20]

"If the surface owner also owns the gas and minerals on that land, it's not as big of an issue as to how the surface is used," said Lisa McManus in an interview.[8] "However, where the oil, gas and mineral rights have been severed and are owned by somebody different, then the surface owner obviously isn't going to get any benefit out of his property being torn up and is going to object to it. The parties have to come to a reasonable accommodation of their interest and their rights."

This doctrine was first established in *Getty Oil v. Jones* (470 S.W. 2d 619 [Tex. 1971]) and stated that the lessor can invoke the doctrine if: 1. There is an existing use of the surface; 2. The lessee's use of the surface would preclude or impair the existing use of the surface, and; 3. The lessee has reasonable alternatives available.[21]

In *United States v. Minard Run Oil Co.* (1980 U.S. Dist. LEXIS 9570 [W.D. PA. Dec. 16, 1980]), the district court adopted its version of the doctrine. In *Minard*, the state was seeking a preliminary injunction to regulate the operations of the oil company while a permanent decision was pending in the case.[21]

As a result, the court held that the parties were required to attempt to reach a "reasonable accommodation" in order to exercise due regard for the rights of the other party. It held that although the mineral rights owner has the right to enter the property in order to extract the minerals, it is required to exercise them with recognition of surface rights and with appropriate action to prevent any unnecessary disturbance to the owner of the surface.

The court concluded that Minard Oil had the right to clear areas for pipeline and road access, to possess appropriate well sites and the right to timber only as necessary to constitute construction materials. It held that the government was entitled to realize the benefit of timber and other surface resources subject to Minard's oil and gas rights.[21]

However, in the case *Belden & Blake Corp. v. Department of Conservation and Natural Resources* (969 A. 2d 528 [Pa. 2009]), Belden & Blake, which owned the oil and gas underlying a state park, provided the Department of Conservation and Natural Resources (DCNR) advance notice of its plans for drilling, which included access routes and well sites. DCNR sought additional surface restrictions and fees and required Belden to sign a coordination agreement. Belden filed a petition for a review with the Commonwealth Court, which agreed with it and invalidated DCNR's request.[20]

DCNR appealed and the Pennsylvania Supreme Court affirmed the decision in favor of Belden. It held that the conditions that it imposed were an improper diminution of Belden's surface easement. The court did not make an inquiry into whether reasonable, alternative means of access were available, however.[20]

"The Doctrine has never been formally recognized by the Pennsylvania courts. Nor has the General Assembly passed surface owner legislation. As such, this area of Pennsylvania's oil/gas jurisprudence remains ripe for clarification. Given the increased leasing and drilling activity associated with the Marcellus Shale formation, this issue can no longer be ignored," Robert J. Burnett of Houston Harbaugh wrote in an article.[20]

New Pennsylvania senate legislation was recently proposed that would allow a three-member Coal Bed Methane Review Board—which was enacted in 2010 and has seen little use since then—to arbitrate in disputes regarding well locations and access roads between mineral rights owners and landowners. The bill (S.B. 1108) could help reduce court actions; however, the parties would retain the right to appeal the board's decision in court.[30]

E. Tax Sales

Because oil and gas exploration has been going on for over a hundred years in the Marcellus Shale region, mineral rights in many locations may have been sold in the past, as far back as the 1800s. In many instances, the owners stopped paying taxes when gas and oil production slowed down significantly in the early 1900s. As a result, these properties were sold to the highest bidder. If no bids were made, they remained in the county's Tax Claim Bureau's repository.[8]

If this is the case, the current landowners may not have the ability to lease the rights or to collect any royalties from gas or oil produced on their property and may be unable to prevent the owner of the rights from extract the gas or oil.[5]

Many times when a developer approaches a landowner about leasing oil and gas rights, the landowner may not have any idea whether he or she owns them or not. Therefore when the lease is proposed, the energy company will perform a search on the surface and subsurface rights of the property all the way back to circa 1860 to determine if there are any other leases or agreements that would impact development. If the leases are found to be clear, then development will go forward. If there are issues that occur in the chain of title, they must be addressed before any development can occur.[8]

If a tax sale had occurred on the property, the question becomes whether or not it is valid. At this point, it must be determined whether the tax sale procedures were followed properly and whether proper notice was given. The parties must also determine whether the property was listed as "seated" or "unseated"—meaning whether or not it was developed.[8]

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A decision by the Court of Common Pleas of Somerset County on Sept. 6, 2011, addressed the validity of tax sales prior to the Pennsylvania Supreme Court's decision in the case *Independent Oil and Gas Association [IOGA] v. Bd. Of Assessment Appeals* (814 A.2d 180 [Pa. 2002]). In that opinion, issued on Dec. 19, 2002, the Supreme Court found that a county cannot tax oil and gas leases under any of the state's statutes.[7]

In *Zubek*, the plaintiff was suing the county to purchase property that was listed on the county's tax claim bureau repository. The county argued that because the Supreme Court cannot tax oil and gas leases, these tax sales were invalid when they were offered to the public, although these sales were offered before the decision in IOGA.

The common pleas court ruled in favor of Zubek, holding that "when the oil and gas properties were put up for public sale and no bids were proffered, title validity passed to the County of Somerset because the oil and gas taxes at the time were valid. Therefore, The Tax Claim Bureau and County can sell the oil and gas properties at a private sale." [16]

F. Validity of Lease Offers

Recently, there has been some controversy reported regarding the validity of lease offers and whether or not an offer is binding and whether cautionary language in the contract that the lease offer is subject to approval is sufficient.[8]

An opinion on this issue was released on Aug. 23, 2011, in the case *Kerns, et al. v. Range Resources —Appalachia, LLC* (No. 1:10CV23, N.D. W. Va.; 2011 U.S. Dist. LEXIS 93920). This case is instructive as it involves one of the largest natural gas companies in the Marcellus region, Range Resources.[8]

In this case, the plaintiffs allege that they were approached by representatives from Range to discuss possible leasing of their gas reserves. The plaintiffs allege that Range provided them with a Dear Property Owner (DPO) letter, which they signed allegedly with the understanding that it was an offer of sale. Range responded, rejecting the offer, but presenting the plaintiffs with alternative terms. The plaintiffs accepted the terms and allegedly believed they were forming a binding contract with Range. Range asserted that it did not form a binding contract with the plaintiffs.

The court held that because the DPO letter contained specific language that "management approval" and "title verification" were necessary before the contract became binding, and have not shown that any oral representations were made to lead them to believe these were "mere formalities," they have not stated a plausible claim for breach of contract.[17]

G. Forced Pooling

The various states in the Marcellus Shale region have varying statutes regarding forced pooling. Under such a statute, landowners and operators in a "spacing unit" are required to jointly participate in the development of resources in that area. These statutes can help prevent landowners from delaying development by refusing to lease mineral rights to the energy company.[18]

Pooling statutes have often been opposed by small mineral owners and small leaseholders, who argue that pooling gives undue power to the drilling companies by removing the incentive to negotiate with them. They argue that pooling forces them to accept terms and conditions they would otherwise have rejected.[29]

Pennsylvania

Although many oil and gas producing states have "forced" pooling statutes, Pennsylvania does not have one that applies to the Marcellus Shale.[18]

Currently, Pennsylvania's pooling statute only applies to wells that extend 3,800 feet below the surface and penetrate the "Onondaga Horizon." The Marcellus Shale is several hundred feet above the Onondaga.

Pennsylvania House Bill No. 977 was introduced in 2009 and, if passed, would have extended the existing Oil and Gas Conservation Law into the Marcellus Shale. However, this bill lost steam when its original sponsors withdrew their support in 2010 over concerns that landowners would be forced to lease against their will.[18]

Plans to introduce a competing bill have been announced, but a draft has not yet been publicly released. Former Governor Ed Rendell had said that he would not enforce a bill that did not contain a required minimum distance between wells and did not ensure fair compensation to landowners. Presiding Governor Tom Corbett has announced that he favors forced pooling but has not yet announced his concrete plan on the issue.[18]

Under House Bill 977, non-participating operators that are forced to join the spacing unit under the terms of the order would be required to pay the "reasonable actual cost" and a "reasonable charge for supervision and for interest on past due accounts." It would also require that these parties sell their leasehold interests to the participating operators and participate on a limited basis. Any unleased landowners that are force-pooled would receive a 1/8 royalty plus additional compensation.[18]

Potential co-sponsor Representative Garth Everett commented on a newer legislative proposal called the "Conservation Pooling Act" on his website. This act might require that the operator that applies for a pooling order have leases covering a certain percentage of the land in the unit. It might also contain a 400 percent penalty for non-participating operators that participate on a carried basis, require good faith efforts to negotiate leases and protect landowners from surface impacts.[18]

West Virginia

West Virginia's law on pooling is very similar to Pennsylvania's in that it allows forced pooling in deep wells, but not in the shallower Marcellus Shale. Until recently, shallow-well drilling in West Virginia has been largely vertical, which made pooling statutes unnecessary. The state also did allow pooling provisions in the Coalbed Methane Act, which was enacted in the mid-1990s.[29]

The pooling debate in West Virginia is complicated by the relationship between the coal and gas estates. Prior pooling statutes were enacted in order to not render large portions of the coal estate unavailable for mining, whereas other states enacted them to maximize recovery of oil and gas with minimum disturbance to the surface. Currently, wells drilled in the Marcellus Shale are subject to a voluntary pooling procedure where all owners of coal in the drilling region must consent to the proposed unit. Therefore, the coal owner essentially has the right to veto a horizontal Marcellus well.[29]

New York

In 2005, New York passed the New York State (NYS) Environmental Conservation Law Section 23-0901, which contained a provision for "Compulsory Integration" or forced pooling. This law was designed to counteract the Common Law Rule of Capture, under which drilling companies could take natural gas located under a neighbor's unleased property by using horizontal drilling techniques.

When a driller applies to the NYS Department of Environmental Conservation (DEC) for a drilling permit, it must delineate a proposed spacing unit and pay royalties to all the landowners in that unit, based on their percentage of ownership of the spacing unit. The driller must show that it controls at least 60 percent of the land in the spacing unit by lease or ownership. The uncontrolled landowners are then subject to compulsory integration.

The uncontrolled owners may then elect to become an integrated royalty owner and receive a royalty equal to the lowest royalty stated in the lease, but not less than 12.5 percent. The owner is not liable for costs, has no liability and the driller cannot enter his or her property.

The owner may also become an integrated participating owner, and share the risks and rewards of the drilling operation with the driller, or become an integrated non-participating owner and share rewards from the well after a 300 percent deduction of well costs.[28]

Although compulsory integration is favorable to the drilling industry, it has been rendered largely moot recently by the moratorium on hydraulic fracturing in the state (see related section in this report) so whether or not these statutes will help to promote drilling on a large scale in New York remains to be seen.[27]

H. Zoning

A recent series of cases in Pennsylvania addressed whether local zoning ordinances are preempted by the Pennsylvania Oil and Gas Act. The cases *Huntley & Huntley, Inc. v. Borough Council of the Borough of Oakmon*t (964 A. 2d 855 [Pa. 2009]) and *Range Resources v. Salem Township* (964 A.2d 869 [Pa. 2009]) both held that, where the purposes of the ordinance go beyond the "traditional purposes" of zoning, they are preempted. These purposes are to preserve the character of various neighborhoods and to encourage "beneficial and compatible land uses."[22]

The most recent ruling on this topic was in the case *Penneco Oil Company v. The County of Fayette, Pennsylvania* (No. 18 C.D. 2010 [Pa. Commw. Ct., July 22, 2010]). In this case, the energy companies were challenging a Fayette County ordinance, which stated that while oil and gas wells are a "permitted use" in certain districts, they are a "special exception" in others.

The Fayette county ordinance held that the oil and gas well should not be located within the flight path of a runway facility of an airport; should not be located closer than 200 feet from a residential dwelling or 50 feet from any property line; the well shall provide fencing and shrubbery around the perimeter of the pump head and support frame; and that the zoning board may attach additional conditions in order to protect public health, safety and welfare.[22]

The Court held that all four of the conditions were acceptable, including the fourth "additional conditions" standard. It stated that its endorsement of this standard, however, does not provide "virtually unbridled discretion to deny permission to drill an oil and gas well even after compliance with the applicable zoning regulations."[22]

The law firm of Duane Morris commented in an article that further clarification is necessary regarding the breadth of the court's intention to allow counties to restrict drilling. "In the interim, oil and gas companies should be aware that new local government ordinances and regulations could start springing up in Pennsylvania, patterned after this Commonwealth Court–blessed Fayette County ordinance that gives a potentially wide berth to local governments to regulate Marcellus gas well installation and operation in ways that, while not well-defined, appear to go beyond location and aesthetics," the firm said.[22]

Landowner Considerations

A. Standard-Form Contracts

Many landowners who are presented with lease proposals are finding themselves in a new and unusual situation. Simply singing a "standard-form" lease document is not always in the best interest of the landowner.[5]

"It is absolutely essential as a landowner to have an attorney review the contract before you sign it," said Lisa McManus in an interview. "Once you're locked in you are locked in. You can't come back and say 'oh I didn't mean to sign that.'[1]

McManus commented that developers will not often change their contracts to meet landowner terms, but will put in additional terms as an addendum.

In the state of Pennsylvania, oil and gas companies may engage in oil and gas leasing without a license, bond, investigation or approval by a state agency. Therefore the state suggests that landowners perform due diligence regarding the drilling company, including information on the company's reputation and performance, as well as references from other landowners with whom the company has already signed leases. It is suggested that landowners save time and money by pooling their resources in performing such investigations.[5]

The company may also sell or transfer its lease agreements to other companies if it is unable to secure a large enough land for production. Through these agreements, a company can obtain a large enough area to develop a production unit. However, landowners may often find that the company they negotiate the lease with is not the same company that develops the well. Under these circumstances, the landowner may not have any say in who owns the lease and develops the well sites unless the terms of the lease specifically require the lessor to approve the transfer of a lease. The original terms of the lease will always be binding in these situations.[5]

B. Pugh Clauses

Many landowners entering into a lease agreement will add a "Pugh Clause" in order to protect their interests in case pooling or unitizing takes place. [8]

Pennsylvania gas leases allow the gas companies to combine multiple leased properties into a single production unit. The landowners in the pool then share in the royalties from the wells based on their percentage of ownership. Even though the landowner can only receive royalties from the part of the land that is included in the unit, his or her entire property is extended into the lease. This is not a favorable situation for those landowners whose properties only comprise a small portion of the production unit.[19]

Under the Pugh Clause, at the end of the primary term, the lease will expire for the remainder of the landowner's property that is not part of the production unit, thus allowing the landowner to sign a new lease for the remainder of their property and receive compensation for the property that is not included in the production unit.[19]

Although not a standard part of the gas company lease contract, some attorneys recommend that a landowner have a Pugh Clause placed as an addendum to the contract.[19]

C. Expiring Contracts

As most of the oil and gas leases carry a five-year term, as of 2011, many of the leases that were signed at the beginning of the fracking expansion in 2005 and 2006 are reaching the end of their terms. These leases vary in their terms and have varying specifications regarding how a lease could be held past the five years. In some cases, the developers have not had the opportunity to begin drilling their wells during the five years. Some landowners are now claiming to the courts that their leases have expired by their terms and are now seeking new leases at the higher rates than were available five years ago.[8]

Additionally, attorneys have seen situations in which the energy company will come in at the eleventh hour to a leased property and are commencing activities in order to perpetuate the lease. This practice raises questions about whether commencing last-minute operations constitutes bad faith.[8]

Take, for example the case *Beinlich, et al. v. Chief Exploration & Development, LLC, et al.* (No. 2011 CV-58, Pa. Comm. Pls., Sullivan Co.), which was filed on March 4 by a landowner in Elkland Township, Pa. He states in his complaint that he signed an oil and gas lease with the Keeton Group, LLC, on Oct. 24, 2005. This lease was later divided among a number of other energy companies, included Chief Exploration and Development.[9]

Beinlich says in his complaint that the lease held a five-year term, which expired on Oct., 24, 2010. During that time, Beinlich says that no drilling operations were performed on his land.[9]

However, on Oct. 21, Beinlich alleges that he received a partially executed Declaration and Notice of Pooled Unit from the Recorder of Deeds of Sullivan County, in which defendant Chief Exploration and Development purported to "unitize" the lease with leases on 23 other tracts. These tracts were to be developed from a well pad site that was located on the property of Cathy A. Castrogiovanni (the Castrogiovanni Unit).[9]

Beinlich alleges that he did not receive any notice of the pooled unit until Oct. 20, when he was informed that Chief was perpetuating its lease with him by performing operations on the Castrogiovanni Unit. Beinlich says that no operations were performed on that unit, except that Chief moved a bulldozer onto the Castrogiovanni property—which was not used in any operations—and that the company placed stakes to indicate a potential location for access onto the tract.[9]

Further, Beinlich alleges that the Castrogiovanni lease was for a horizontal drill well only and that drilling onto his property would involve directional drilling.[9]

Beinlich's complaint alleges that the refusal by the defendants to terminate the lease has caused a "cloud" on the title to his property and that he has been unable to enter leases with other companies at current market prices as a result.[9]

Conclusion

While drilling in the Marcellus region is still in its early stages, much has been learned about the potential economic impact that it can provide. If estimates about its breadth are correct, it will serve to be an enormous source of revenue for the eastern states in the U.S. for many years to come.

Landowners in Pennsylvania should become more informed of their rights involving oil and gas leases, and always consult with an attorney when they are presented with a potential oil and gas lease. Although the promise of an immediate windfall is often too tempting to pass up, they should approach such agreements with caution.

Although the laws of the states will vary on various issues, much can be learned from the recent trends in law in the area of oil and gas leasing, especially those in Pennsylvania. Like many Eastern Seaboard states, Pennsylvania's gas and oil production rose and fell almost a century ago and then was mostly forgotten. However, this sudden influx of oil and gas leasing has brought to the forefront many archaic laws and regulations that had not been visited in decades.

The state would do well to take its cues from the western states like Texas, Oklahoma, California and others that have had continued oil and gas exploration extending from the 1800s to the present. Although the landscapes of those states are drastically different than in Pennsylvania, the concepts remain the same and Pennsylvania would benefit greatly from officially endorsing the Accommodation Doctrine.

Also, issues with tax sales and forgotten oil and gas leases from the turn of the twentieth century must be dealt with in a more efficient manner in order to reserve time and resources for both landowners and companies.

The state should also push forward a pooling statute that ensures that the needs of both energy companies and landowners are met.

Landowners in Pennsylvania should become more informed of their rights involving oil and gas leases, and always consult with an attorney when they are presented with a potential oil and gas lease. Although the promise of an immediate windfall is often too tempting to pass up, they should approach such agreements with caution, as much money can be lost on a poorly executed contract. Those landowners who may not have the resources to hire an attorney on their own or to perform due diligence on the companies they are signing with should consider forming committees and pooling resources in order to get the representation they need, as well as to compare various proposals to ensure they are receiving the best contract that they can.

Finally, the other states that are just beginning to develop their shale resources should take heed of the challenges that Pennsylvania is facing. Especially those that exist in the Utica Shale play region in Ohio, which may have many factors in common with those in Pennsylvania.

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