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Gas Leasing & Development update

Pennsylvania Enacts New Oil & Gas Lease Act

By Jonathan Samel, Esquire

On July 9, 2013, Governor Corbett signed into law the Pennsylvania Oil and Gas Lease Act (the "Act"). This legislation, which takes effect 60 days after enactment, provides that specific minimum information must now be provided with royalty payments made to landowners in Pennsylvania, and also allows producers, in limited circumstances, to develop contiguous gas and oil leases jointly by horizontal drilling without the landowners' agreement.

The Act amends the Pennsylvania Guaranteed Minimum Royalty Act ("GMRA") which has required gas and oil leases to provide a minimum one-eighth (12.5%) royalty. The Act does not change this minimum royalty percentage requirement, but rather now also requires a minimum level of disclosure from producers with respect to the calculation and determination of royalties.

In the case of Kilmer v. Elexco Land Services, Inc., 990 A.2d 1147 (Pa. 2010), the landowners contended that in calculating royalties, the GMRA prohibited the gas company from deducting the costs of transporting, processing, and marketing natural gas (collectively referred to as "post-production costs") after it was captured from the gas well. The landowners argued that the deduction of the post-production costs caused their royalty payments to effectively fall below the statutory minimum of one-eighth (12.5%). However, the Pennsylvania Supreme Court held that deducting post-production costs from the gross sale proceeds before calculating the royalties did not violate the GMRA.

Neither the GMRA nor the courts in Pennsylvania have required that producers itemize and share information about post-production costs with landowners. Landowners have been requesting more detailed accounting information with respect to how their royalties are being calculated, seeking disclosure of the amounts of post-production costs that were being deducted in calculating their royalties. These requests appear to have prompted the Pennsylvania legislature to pass the Act, joining several other states that have passed similar laws requiring more detailed royalty reporting, despite the lack of provisions in gas and oil leases requiring such reporting.

The royalty reporting requirements under the Act apply to payments to all "interest owners." The Act defines an "interest owner" as a person who is legally entitled to payment from the proceeds derived from the sale of gas or oil from a well located in Pennsylvania. Because of this broad definition of "interest owner," it appears that the Act may apply not only to

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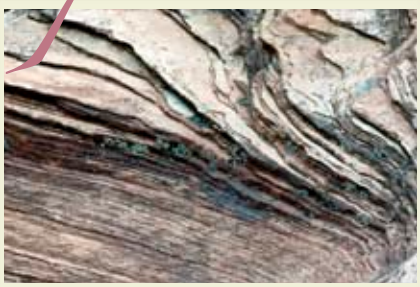

A MINERAL BY ANY OTHER NAME IS NOT NATURAL GAS

By Mark F. Himsworth, Esquire

As many predicted, the Pennsylvania Supreme Court, in Butler v. Charles Powers Estate, has decided there is no need for scientific evidence to determine whether shale and the natural gas contained within it fall under the definition of "minerals" for the purposes of interpreting deed reservations.

Relying upon the Dunham Rule, named after the 1882 Pennsylvania Supreme Court case Dunham & Shortt v. Kirkpatrick, the Court found that they were not since they are not "metallic" in nature.

Justice Max Baer, writing for the Court, said, "the common, layperson understanding of what is and is not a mineral is the only acceptable construction of a private deed," and that, "notwithstanding different interpretations proffered by other jurisdictions, the rule in Pennsylvania is that natural gas and oil simply are not minerals because they are not of a metallic nature, as the common person would understand minerals."

Accordingly, parties drafting deeds should clearly state that if it is their intention to reserve natural gas rights, they must specifically say so.

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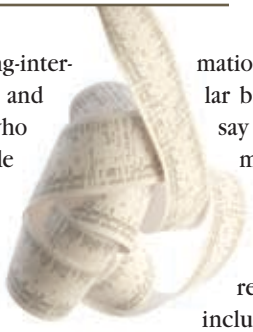

royalty owners, but also to working-interest owners, joint-venture partners, and any other individual or entity who shares in the proceeds from the sale of gas and oil.

The Act requires producers to disclose either on a check stub or an attachment to the form of payment, a statement that lists, at a minimum:

1. A name, number or combination of name and number that identifies the lease, property, unit or well or wells for which payment is being made; and the county in which the lease, property or well is located.
2. Month and year of gas production.
3. Total barrels of crude oil or number of Mcf of gas or volume of natural gas liquids sold.
4. Price received per barrel, Mcf or gallon.
5. Total amount of severance and other production taxes and other deductions permitted under the lease, with the exception of windfall profit tax.
6. Net value of total sales from the property less taxes and deductions from paragraph (5).
7. Interest owner's interest, expressed as a decimal or fraction, in production from paragraph (5).
8. Interest owner's share of the total value of sales prior to deduction of taxes and deductions from paragraph (1).
9. Interest owner's share of the sales value less the interest owner's share of taxes and deductions from paragraph (5).
10. Contact information [of producer], including an address and telephone number."

Under the Act, producers need not provide the above mentioned information on a check stub or attachment form if "the information is otherwise provided on a regular basis." The Act, however, does not say how frequently such information must be disclosed in order to be considered being "provided on a regular basis."

In addition to the royalty reporting requirements, the Act also includes a section entitled "Apportionment," which has created controversy, and which reads as follows:

"Section 2.1. Apportionment. Where an operator has the right to develop multiple contiguous leases separately, the operator may develop those leases jointly by horizontal drilling unless expressly prohibited by a lease. In determining the royalty where multiple contiguous leases are developed, in the absence of an agreement by all affected royalty owners, the production shall be allocated to each lease in such proportion as the operator reasonably determines to be attributable to each lease."

Section 2.1 is limited in scope in that it applies only where the lease terms are silent regarding the right to combine a particular lease with other leases for development purposes. Other states have compulsory pooling laws applicable to shale development activities in which a drilling company can force landowners to accept drilling if surrounding landowners have agreed to leases. The Act stops short of such "forced pooling" for Marcellus Shale exploration and development in Pennsylvania. The Act does not grant a producer the right to drill beneath non-leased properties, nor does it permit drilling through properties leased by other producers.

However, concern has been expressed that this new "apportionment" provision may be interpreted to allow producers to force the owners of traditional vertical well leases signed many years ago to accept horizontal shale gas drilling. The result has been analogized to forced pooling since the Act may allow these old leases that do not have a pooling provision (but do not expressly prohibit pooling) to be included in a pooled production unit that will be developed with horizontal drilling – without the lessor's agreement to amend the lease to allow Marcellus Shale pooling. As a result of this new provision, the ability of an owner of one of these old leases to negotiate beneficial terms, or a higher royalty in exchange for amending the lease could be effectively eliminated.

The apportionment section of the Act also states that, absent agreement, production and royalties among contiguous leases are to "be allocated to each lease in such proportion as the operator reasonably determines to be attributable to each lease." This provision appears to grant producers, under certain circumstances, the subjective right to determine which affected lease will receive a greater share of the royalties where there is no unit or other landowner royalty agreement in place. Concern has been expressed that this language is vague and has the potential to invite abuse by producers.

The Act also provides that a division order may not amend or supplement the terms and conditions of a gas and oil lease. A division order is an agreement signed by a landowner with the gas company directing the distribution of the proceeds from the sale of gas and oil from a well. The terms of the gas and oil lease will now control where there is a conflict between a division order and the lease.

There are unanswered questions relating to the interpretation of the new Pennsylvania Oil and Gas Lease Act, and differences between landowners and producers are likely to occur relating to the application of the Act. If you are interested in learning more about the Act and its effects on gas and oil leasing and development, please contact our office for assistance.

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