

Interpreting Oil and Gas Leases in Pa.'s Shale Gas Era

BY GEORGE A. BIBIKOS

Special to the Legal

An oil and gas lease is the fundamental document through which a producer obtains rights to explore for and develop oil, natural gas and other hydrocarbons. When landowners and production companies enter into oil and gas leases, they do so with business purposes in mind in the context of a unique industry.

As Pennsylvania courts have held, it is proper to understand the nature of the industry in which the lease arises in order to interpret the parties' agreement. This is particularly important in the shale gas era given that courts may be faced with lease disputes for many years to come.

To that end, this article provides a general overview of (1) an oil and gas lease and some of its general terms; (2) the general rules of lease interpretation; and (3) some of the characteristics of modern shale gas exploration and production operations.

WHAT IS AN OIL AND GAS LEASE?

Although there are potentially infinite variations, a lease generally conveys oil and gas rights from the landowner to a producer, establishes the compensation for the lessor, sets the time frames within which the lessee must act to maintain its rights, describes the actions the lessee must undertake within those time frames and sets forth the circumstances that must exist before a lease can ever expire.

The Grant. In Pennsylvania, an oil and gas lease is a transfer of real property. See *Lesnick v. Chartiers Natural Gas Co.*, 889 A.2d 1282, 1284 (Pa. Super. 2005). The lessor transfers to the lessee a fee interest in the oil, gas and other hydrocarbons in place in exchange for a royalty interest on production. See *Brown v. Haight*, 255 A.2d 508, 510 (Pa. 1969). In addition, the lessee obtains an easement on the surface area to use for access to and development of the underlying oil and gas. The easement is either expressed in the lease or implied by law. See, e.g., *Belden & Blake Corp. v. Dep't of Conservation and Natural Res.*, 969 A.2d 528 (Pa. 2009).

The Term. A typical oil and gas lease has a habendum clause that provides for a primary term (e.g., three or five years) within which the operator must comply with certain requirements (e.g., pay delay rentals or commence operations) plus a period for "so long thereafter" as operations or production take place on the premises or lands pooled therewith. The "so long thereafter" clause creates a determinable fee in the oil and gas conveyed from the lessor to the lessee with a possibility of reverter if the lessee does not comply with the requirements of the habendum clause. See *Snyder Bros. v. Peoples Natural Gas Co.*, 676 A.2d 1226, 1230 (Pa. Super. 1996).

The Effect of Pooling. Most leases also contain a pooling clause. A pooling clause can affect the primary and secondary terms of a lease. Generally, a pooling clause authorizes the lessee to combine its leased properties in order to create a larger drilling "unit." See *Snyder Bros.*, 676 A.2d at



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1228. All lessors in the unit receive the opportunity to participate in royalties from unit production based on the amount of property they have in the unit, even if operations never take place on their particular property or a well is located somewhere else on the unit. In turn, absent lease language to the contrary, any activities required by the habendum clause that take place anywhere on the unit extend all the leases in the unit beyond the primary term. See, e.g., *Fox v. Wainoco Oil and Gas Co.*, 64 Pa. D. & C.3d 439 (Crawford County C.P. 1986).

Establishing Production in Paying Quantities. Once the lessee establishes production in paying quantities from a well, the lease lasts for as long as it takes to extract all the oil or gas. See *Balfour v. Russell*, 31 A. 570 (Pa. 1895). A well is producing in paying quantities if it consistently pays any profit, however small, over the costs of operating the well. See *T.W. Phillips Gas and Oil Co. v. Jedlicka*, 42 A.3d 26 (Pa. 2012). If the well's profitability is marginal or sporadic over some period of time, the courts may consider the lessee's good-faith judgment in maintaining the well in an effort to re-establish its profitability.

Cessation of Production. Finally, absent lease language to the contrary, a complete, permanent and intentional cessation of production during the secondary term may terminate the leasehold. If permanent cessation occurs, some courts have held that a tenancy at will is created that can be terminated by either party upon notice. See *White v. Young*, 186 A.2d 919 (Pa. 1963); *Cassell v. Crothers*, 44 A. 446 (Pa. 1899). However, a temporary cessation of production should not terminate the lease. See *Cole v. Phila. Co.*, 26 A.2d 920 (Pa. 1942).

HOW DO COURTS INTERPRET OIL AND GAS LEASES?

Given the unique characteristics of a lease and the relationship it creates, the interpretation of its terms and conditions to resolve disputes over the rights and obligations of the parties is no insignificant task. The stakes are high and valuable property rights are at issue. The courts have several tools available to them:

Intent of the Parties. The courts' fundamental goal in interpreting any contract — including an oil and gas lease — is to effectuate the intent of the parties based on the words in the agreement. See *Szymanowski v. Bruce*, 987 A.2d 717, 720 (Pa. Super. Ct. 2009). If words in the lease have acquired a special meaning in the context of an industry, as in the case of the oil and gas industry,

courts should rely on that special meaning. See, e.g., *Jacobs v. CNG Transmission Corp.*, 332 F. Supp. 2d 759, 779 (W.D. Pa. 2004).

Characteristics of the Business. Along those lines, Pennsylvania courts have interpreted oil and gas leases for 120 years "with a due regard to the known characteristics of the business." See *McKnight v. Manuf. Natural Gas Co.*, 23 A. 164, 166 (Pa. 1892); *Kleppner v. Lemon*, 35 A. 109 (Pa. 1896) ("The case must therefore depend upon the proper interpretation of the contract, aided by the necessities and usages of the business to which it relates.") In other words, in addition to the usual rules of contract interpretation, courts interpret leases in the context of the oil and gas business to determine the rights and obligations of the parties.

The McKnight Case. In *McKnight*, for example, the lessor sued the production company for breach of an implied covenant to develop after the lessee discovered gas. In that case, the lease provided for a one-eighth royalty on production from oil. If the lessee did not discover oil but discovered gas at sufficient pressures to justify marketing off the premises, the lessor would be entitled to a one-eighth royalty on the net proceeds of the sale. The lessee did not discover oil but discovered gas and produced for several years until the well broke down and the lessee abandoned the operations.

The lessor contended that the lessee had

an implied obligation to further operate the premises as a gas field given that the lessee previously discovered and produced gas. The Pennsylvania Supreme Court held that the lessee's obligations must be determined in the context of the gas business. It described the differences between oil production and gas production to explain that sinking additional gas wells may have been imprudent given that additional wells might decrease the pressures necessary to push the gas through pipelines off the lease and ultimately to market.

After describing the characteristics of gas production, the court concluded that the "well-known facts peculiar to the production of gas must be taken into account in the construction of leases for gas purposes." The court reversed and remanded the case because "the mistake of the court below was in failing to take account of, and to read into the contract between the parties, the peculiar nature and characteristics of the business of producing and transporting gas, which the parties themselves well understood, and which their contract shows were before their minds when it was entered into."

CHARACTERISTICS OF THE SHALE GAS INDUSTRY

From the perspective of parties to an oil and gas lease, some of the key characteristics of the modern shale gas industry that

Lease continues on 10

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ESCO continued from 8

ly means by which to determine that critical benchmarks in energy conservation and savings are met, and how construction and other costs are calculated. By turning to a brief discussion of what issues the EPC addresses, and a few of its critical terms, it should become apparent that a government agency or facility owner would be well advised to have both technical and legal support of their own in moving forward with projects often valued in the tens of millions.

The archetypal process starts with the selected ESCO providing a letter of intent that sets out certain general goals of the anticipated EPC, but focuses on performance of the IGA. The ESCO will insert a provision that contains a walk-away fee should the customer terminate after review of the audit. The DGS approach, and one that I urge, would not yet involve the ESCO, but rather has the EEC perform the IGA. That process then leads to the RFP.

However, more frequently, the ESCO performs the IGA, which calculates the total available energy savings as measured against the current utility tariffs. The ESCO specifies certain FIMs, breaking down the costs of each and evaluating its impact on cash flow. It also attempts to analyze some of the softer costs that it incorporates into its financial model, such

as avoided or less frequent maintenance expenses or the predicted long-term increase in the cost of electricity as measured against a load management strategy designed by the ESCO. If important to the customer, the IGA can also evaluate emissions credits, renewable energy credits, carbon offsets and sustainability goals. Lastly, the IGA presents a variety of financing options

The EPC itself provides a turn-key project guarantee that the customer will obtain savings, a guaranteed maximum price for the capital upgrades, procurements and construction, some form of gain sharing, a verification protocol and the key to the entire deal: The ESCO assumes all of the performance risk associated with its proposal. The standard upgrades include a mix of lighting improvements, HVAC modifications, shell improvements (e.g., insulation, windows), energy load management systems and generating facilities. The concept is for the ESCO to undertake a holistic evaluation of the facility's entire energy use and create a long-term vision for bringing that burdensome and variable cost to a more stable, cost-effective and reliable management system that saves the customer energy costs over time.

My view is that any agreement designed to last 15 to 25 years will contain provisions that seem attractive at first glance but after years of implementation may become crip-

pling. Long after the glow of entering into an agreement that guarantees millions in savings over that period, new management may question whether it was the best deal and how success is benchmarked over the years. Creating a separation of function between the IGA and the EPC may be a good method of generating reliable metrics, or at least providing the customer with its own representative during the audit and the system design and build process to maximize the odds of success.

The EPC itself contains many pitfalls, often starting with the definition of the "project." Because the performance guarantee is intimately tied to the project, one can be sure the ESCO will carefully define and limit its scope. Financing, especially if tax credits are available, is also extensively discussed in the EPC, and the overall deal needs to be carefully structured to ensure the availability of these credits.

The EEC can be especially helpful in evaluating the terms of the excess savings provisions. This term typically provides that once the ESCO provides the project cost, any savings it achieves inure to the customer, whether private, MUSH or government. Since the typical EPC provides that the ESCO controls the entire process of design and build, it is in the best position to negotiate the most advantageous price. But if it does not share in the excess savings, the EEC can assist the customer in evaluat-

ing whether the ESCO maximized value engineering opportunities. In one recent project discussion, the ESCO bragged that it returned \$200,000 to the customer on a \$15 million project. I could not help but think a third-party evaluator could have urged the ESCO to do better than a 1 to 2 percent savings.

The EEC can also be useful in setting the baseline of the facility's energy use, a key metric in evaluating the effectiveness of the FIMs. Moreover, helping to craft the verification method, or at least assuring the customer that the process is standardized, is another role for the EEC. Lastly, the professional can provide guidance on the schedule for the FIM implementation, operation and maintenance requirements and the feasibility of recommended building modifications (in the hope of minimizing the dreaded change orders).

Ultimately, energy efficiency projects can be a boon for facilities that drive down the bottom-line impact of energy costs. Because the EPC agreements with ESCOs are so complex and are implemented over many years, facilities should consider, as the DGS is with respect to its GESA program, whether the use of independent EECs as an owner's representative through the ESCO project can provide the customer with both the knowledge and leverage to negotiate the greatest savings on the best financial terms. •

Lease continued from 6

are important to understand include the

following:

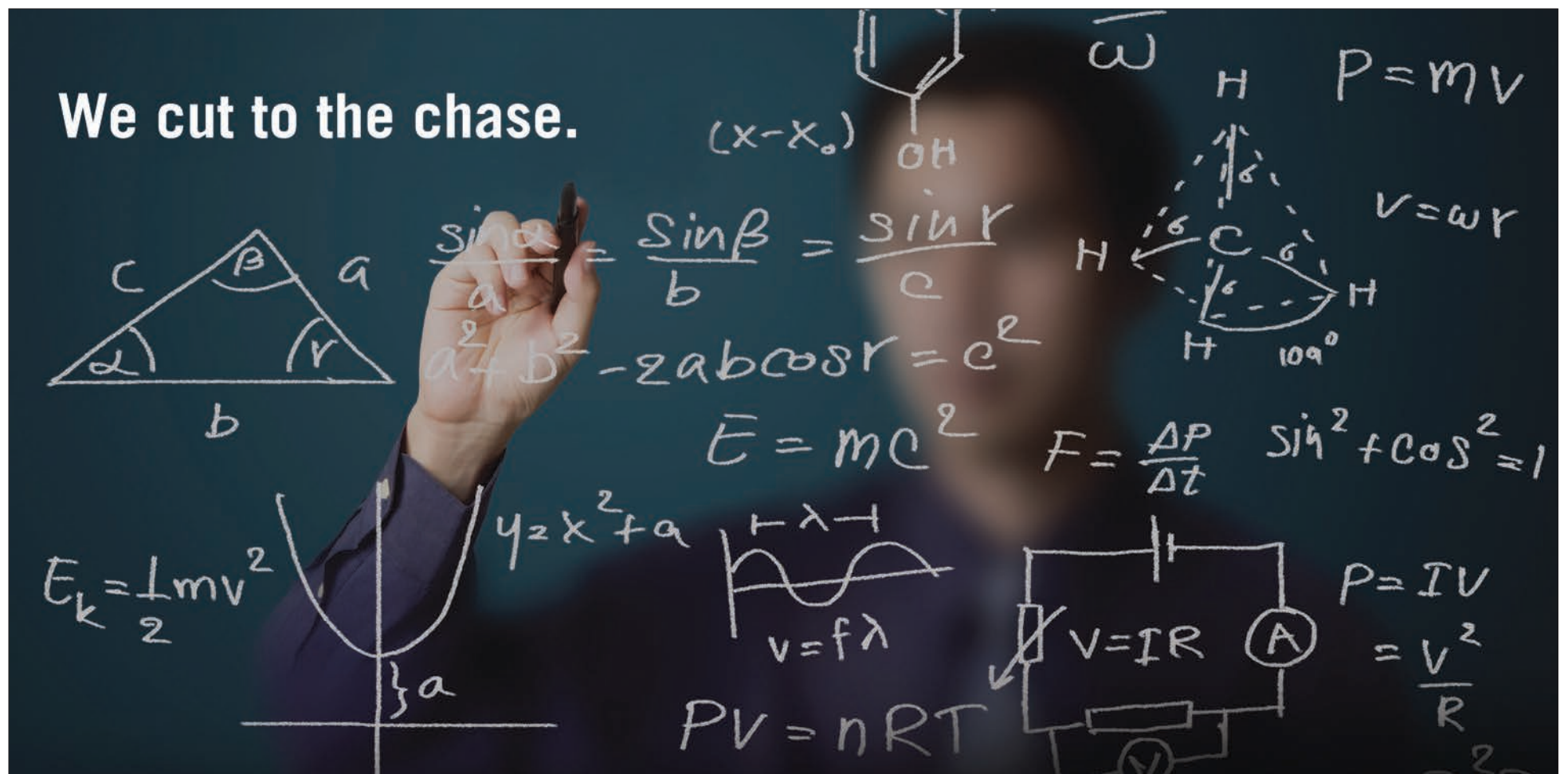
• **Preliminary Work.** The life cycle of any well targeting a shale formation begins

with preliminary work, such as conducting seismic testing to examine the subsurface of a geographic area that includes the leased

properties; obtaining necessary regulatory approvals for drilling the well and con-

Lease continues on 11

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Lease continued from 10

structing the well pad; surveying the property; siting well pad and well locations; staking well pad sites; and developing a drilling and operations plan.

• **Well Pad Construction.** Once the production company decides on the location of the wells, it constructs the well pad. That involves clearing the well pad area; mobilizing earth-moving equipment to the site; engaging in earth-moving activities to construct access roads and well pads; building impoundments for storing water; building other structures; and engaging in other

construction activities.

• **Horizontal Drilling and Hydraulic Fracture Stimulation.** The key features that set the industry apart from conventional gas operations are horizontal drilling at greater depths and the use of hydraulic fracture stimulation techniques to crack and prop open the low-permeability shale formation to release the hydrocarbons. Operations for the production of shale gas center around these activities. Horizontal drilling and well completion operations include mobilizing rigs to the site, drilling, casing and cementing operations and hydraulic fracture stimulation activities,

and other related activities that are necessary to complete a well and establish production.

• **Post-production Activities.** Given that shale gas production in Pennsylvania is still growing, the supply chain is also still growing to create support activities like gathering, compression, dehydration and transmission facilities to collect, treat, transport and market the gas. The cost and availability of the pipeline infrastructure may inform lease obligations with respect to transporting, treating and marketing production and the ability of lessors and lessees to share in those costs.

Although this is not an exhaustive list of all the characteristics of the shale gas industry, these are some of the common circumstances surrounding shale gas operations that may be considered when resolving disputes.

Fundamentally, an oil and gas lease is a business transaction entered into against the backdrop of the exploration and production industry. In light of that, the realities of the industry in the shale gas era are important to understand in order to foster the business purposes intended by both parties to the lease. •

Drilling continued from 7

from multiple parcels provides the basis for an inevitable onslaught of court challenges. *Chartiers* and its progeny are based on the principle that a property may be drilled upon as long as that activity is reasonable and there are no less-detrimental alternatives. Now, virtually every surface owner can argue that, in relation to his or her interests, there are many less-harmful alter-

natives. In fact, as to his or her property, every other viable alternative would completely eliminate detriment to the surface owner's interests.

This raises far more questions than can be answered. Does *Chartiers* require a mineral rights holder to ask permission from all surface rights holders of every adjacent property that overlies the mineral estate before picking a particular parcel to drill on? Does *Chartiers* require every other

property owner to refuse entry before drilling on a single parcel becomes necessary? If a party chooses to drill on a particular parcel, is it really optimal that one surface estate bears all of the costs, when the adjoining surface estates were equally available? Does equity require that other adjacent property owners, or the mineral rights holder, compensate the owner of the "drilled" surface estate when there is nothing about that particular parcel that makes

its use more ideal than others? Would the economic standing of a particular surface owner merit any consideration as to protect those least able to afford the burden?

As McLaughlin advised in *Minard III*, the "unique circumstances of any given case" must be considered when determining the interrelationship of these competing property rights. As future cases develop, it would appear that the "unique" will soon become the norm. •

Fracking continued from 4

cials voiced concern that the rule would create more paperwork and impose unnecessary burdens, while offering little to no benefit because states already sufficiently regulate fracking. Many states also believe that the rule-making is premature, as the

EPA has yet to complete its study.

EPA ENFORCEMENT ACTIVITIES

In addition to federal agency efforts to regulate fracking operations, the EPA and the DOJ are increasingly pursuing enforcement against oil and gas companies that violate the provisions of various environ-

mental statutes, such as the Clean Water Act. The DOJ recently filed criminal charges against seven companies in North Dakota for alleged violations under the Migratory Bird Treaty Act concerning, among other species, waterfowls, gadwalls and pintails. In addition, on May 16, the EPA and QEP Field Services entered into a proposed set-

tlement in Utah federal district court requiring the company to comply with informal policy measures mandating that oil and gas operations "aggregate" their facilities to determine whether they are subject to strict major source permit requirements under the Clean Air Act. •

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