



House Environmental Resources and Energy Committee Update

Case Law and Regulation related to Marcellus Shale Gas Drilling in Pennsylvania

Case law:

Dept. of Conservation and Natural Resources v. Belden & Blake Corp.

Disposition: The Supreme Court decided in favor of Belden & Blake Corp. in April 2009.

Issue: Whether DCNR, as surface land owner, may condition the surface use of a state park by a gas producer by requiring additional bond and fees to repair surface damages.

Summary: Under the Oil and Gas Act, a gas driller/producer must use the surface area "in a reasonably necessary manner" for extraction and must post a bond. Because the posted bond is insufficient to repair the surface damages inflicted by the producer, leaving the taxpayers to pay for the damages, DCNR routinely imposed additional requirements, such as a performance bond and stumpage fees, through a "coordination agreement." Through this agreement, DCNR seeks to closely define, with the consent of the parties, what constitutes a "reasonably necessary" use of the surface land.

Belden argued that it met its statutory obligations as a subsurface owner and that DCNR therefore has no right to require Belden to enter into a coordination agreement that imposes extra conditions. It contends that DCNR's requirement to enter into the coordination agreement amounts to a taking without just compensation.

DCNR claimed that it is a trustee for public resources under Article I, § 27 of the Pennsylvania Constitution, under which it is authorized to condition the surface use of a state park. It maintains that, without a coordination agreement, Belden and other producers would unilaterally determine what constitutes reasonable use of the surface.

The Court held that DCNR's constitutional duty to protect public natural resources does not authorize it to impose conditions restricting the subsurface owner's rights. It reasoned that a private surface owner has no power to unilaterally impose extra conditions on the subsurface owner and that the government should not be treated differently. Under existing case law, the burden is on the surface owner to seek legal redress to prevent or restrain the subsurface owner's exercise of its rights. If DCNR finds that the surface use was unreasonable, it has the burden to challenge the subsurface owner and to seek redress in the appropriate judicial forum; allowing DCNR to impose extra conditions would shift that burden to the subsurface owner.

Comment: A remedy is necessary. Under the current practice and given the amount of bond required, it appears more cost-effective for gas producers to abandon a well and forfeit the bond than to reclaim it.

Herbert Kilmer, et al. v. Elexco Land Services, Inc. and Southwestern Energy Production Co.

Disposition: Oral argument held before the Pennsylvania Supreme Court in September 2009 under its extraordinary jurisdiction, bypassing an intermediate appeal.

Issue: Whether a royalty under an oil or gas lease may be reduced by post-production costs.

Summary: This important case of first impression is similar to the hundreds, if not thousands, of lawsuits filed and pending in state and federal courts in Pennsylvania by landowners who entered into a natural gas extraction lease with gas producers. Under Pennsylvania law, an oil or gas extraction lease is not valid if "*such lease does not guarantee the lessor at least one-eighth royalty of all oil, natural gas or gas of other designations removed or recovered from the subject real property.*" 58 P.S. § 33 ("Guarantee of Minimum Royalties").

The Kilmers, as lessor, entered into a lease with Elexco, lessee, which contained the following language: "Lessor shall receive as its royalty one eighth (1/8) of the sales proceeds actually received by Lessee from the sale of such production, less the same percentage share of all Post-production Costs, as defined below, and this same percentage share of all production, severance and ad valorem taxes." The Post-production Costs are, in part, "all costs actually incurred by Lessee from and after the wellhead to the point of sale, including, without limitation, all gathering, dehydration, compression, treatment, processing, marketing and transportation costs incurred in connection with the sale of such production."

The Kilmers claim that the lease is invalid. It does not guarantee an 1/8 royalty of the sales proceeds because it is reduced by the post-production costs. The 1/8 of the value of the natural gas must be measured at the point of sale, which occurs downstream after the natural gas has been processed and transported. Under the Oil and Gas Conservation Law ("OGCL"), a lease may not oblige a "royalty owner" to pay "any costs." Amici point out that if post-production costs are allowed, then no amount of royalty could be guaranteed because the post-production costs, determined by the gas producer, could entirely offset it.

Elexco contends that it is required only to give a 1/8 of the net proceeds—the downstream sales proceeds reduced by applicable post-production costs. Elexco insists that the Kilmers are guaranteed only the 1/8 of the value of the natural gas as measured at the wellhead and that they must pay for the additional costs associated with processing and transporting the gas to the point of sale. When the royalty provision was enacted in 1979, before deregulation, the natural gas was sold at the wellhead, and thus there were no post-production costs for processing and transporting. But now a gas producer must process and transport for sale, which costs must be recovered. The OGCL bars only production costs.

Comment: The term "wellhead" is not in the royalty provision, and states appear to vary on this issue of whether royalties may be reduced by post-production costs. Determining whether post-production costs are reasonable would be difficult and be made by the courts. Pennsylvania's provision using the word "guarantee" appears unique from other states' statutes, making it more difficult to compare with other states' approaches.

Regulation:

Permit-By-Rule (Title 25 Pa.Code Chapter 102: Erosion and Sediment Control and Stormwater Management)

Disposition: Public Comment stage as a Proposed Rule.

Summary: The proposed regulation would create a new, streamlined permitting option for qualifying projects to bypass a regular NPDES (related to wastewater discharge) or E&S (Erosion and Sediment) permit process regarding earth disturbance activity.

The permit-by-rule would be available for projects deemed to be "low-risk" with a "low-impact" design and would require the following:

- (1) Provide, at the pre-submission meeting with DEP or the conservation district, a site map containing detailed information about the proposed project.
- (2) Establish 100-foot riparian forest buffers, or 150-foot buffers if the project is near a High Quality or impaired watershed.
- (3) Limit the earth disturbance to 15 acres at a time during development of the project.
- (4) Demonstrate that the project's applicable PCSM (Post-Construction Stormwater Management) BMPs (Best Management Practices) will comply with the volume and the rate requirements of Act 167's stormwater management watershed plan.
- (5) Hire a professional engineer, geologist, or landscape architect who will prepare and seal E&S and PCSM plans, complying with the additional technical guidelines for such plans as provided in the proposed regulation.
- (6) Notify the municipality where the project is to occur.

The permit-by-rule would not be available for the following projects:

- (1) Projects that could affect an Exceptional Value (EV) watershed.
- (2) "Sensitive Areas":
 - a. Areas with "highly erodible" conditions.
 - b. Geologic formations that pose a risk to the public safety and health, such as sinkhole development, land sliding, or acid, radioactive, and arsenic bearing formations.
 - c. Wetlands or floodplains.
- (3) Currently contaminated lands.
- (4) Operators with a history of noncompliance.
- (5) Projects that could negatively affect protected species.

The permit-by-rule application would receive a 30-day review.

Comment: This permit-by-rule proposal is controversial. The permit-by-rule is available for oil and gas activities (including Marcellus Shale) with respect to the E&S permit and any applicable PCSM plan. Under the proposal, a hired professional engineer, geologist or landscape architect, rather than DEP, would be responsible for ensuring that the project would not impermissibly degrade the environment. Environmental groups have raised the concern that the proposal shifts the enforcement responsibility from DEP and the conservation district to the project applicant and that it would do away with public participation and the meaningful review of each project as required by federal law.