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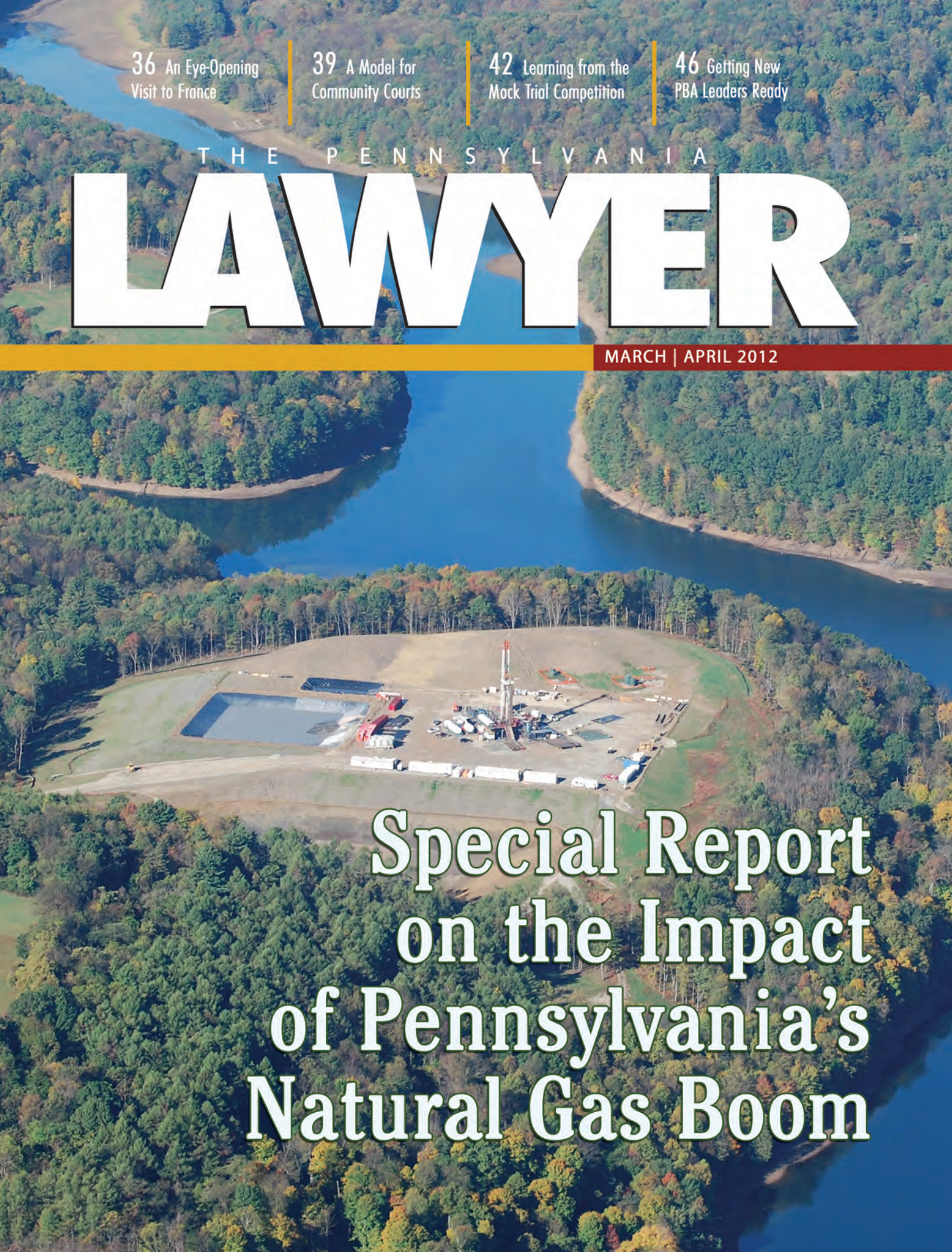

Special Report on the Impact of Pennsylvania's Natural Gas Boom

Weighing the Risks and Rewards

By Stephen W. Saunders

The impact of leases and natural gas development on real property transfers in Pennsylvania

Many Pennsylvania mineral rights owners have reaped significant financial benefits as a result of the exploding interest in the Marcellus Shale, which began in earnest in 2007. While monetary offers for paid-up lease signing bonuses — coupled with the minimum 12.5 percent royalty on production — started well below $100 per acre, lease offers from exploration and production companies and speculative land brokers increased exponentially over several years. In the sweet-spot counties of northeastern Pennsylvania the bonus money went from as much as $700 per acre in the fall of 2008 to $2,750 and higher, with royalty premiums rising to 18 percent in the span of three months.

The frenetic pace of what started as a lessor's market continued for 18 months. The attractiveness to some of group leasing spawned the formation of regional organizations with members numbering in the hundreds. Mineral acreage controlled by individual group participants ranged from several-acre parcels to tracts comprising hundreds of acres. Many of these aggregated landowners who favored the group-negotiating format ultimately leased their oil and gas interests for bonus payments of between $4,000 and $6,000 per acre and royalties above 15 percent. Some of my individual clients in Bradford County received proposals for $7,000 per acre and 21 percent as late as July 2010. While lease offers for others I have represented in the mineral and landowner aspect of my practice in central and western Pennsylvania never quite reached that level, the increases in the financial component of lease offers in those regions over time have been steady, if not as spectacular.

While it is true that development companies continue to acquire leasehold interests in oil and gas rights in Pennsylvania and brokers of varying experience are still trying to bundle landowners' leasing rights to bolster their negotiating power, the initial mineral rights acquisition phase has clearly peaked, while the leverage pendulum has swung decidedly toward the lessee. More recent internal evaluations by many exploration and production companies of their leasehold positions throughout the Marcellus Shale led to a period of lease swaps, joint ventures and outright sales of several companies to the leviathans of the energy industry (e.g., East Resources to Shell; Atlas to Chevron). With many existing leases having a primary term of five years and the supply of drilling rigs being woefully inadequate to accommodate the development boom in oil and unconventional gas shale plays throughout the United States, most exploration and production lessees in the Marcellus Shale have shifted their primary if not exclusive focus to doing what is contractually necessary to "hold by production" the leases they have already entered into.

Mineral rights owners and their legal counsel are beginning to understand that the days of multiple lease offers and suitors, lease addenda containing what have been called "landowner friendly" provisions and protracted bargaining periods yielding ever increasing bonus payments are, at least for the foreseeable future, over. For example, Pugh clauses (provisions that force termination of the acreage of a lease not included within a production unit at the end of the primary term) are virtually unobtainable or are significantly watered down, and the standard force majeure provision has turned into a get-out-of-jail card for a host of excuses bearing no resemblance to what have traditionally been understood to constitute acts of God. There is a new paradigm for negotiating the oil and gas lease that for the most part leaves prospective lessors in a weakened bargaining position. But this is in the normal ebb and flow of the leasing phase of an oil and gas practice and there is much more to oil and gas law than leasing or negotiating ancillary facility agreements. Given the production results to date, well-qualified practitioners in this field can build a career representing landowners or industry (but it is suggested not both).

As noted initially, many lessors have received a handsome quid pro quo for something that previously had at best a hypothetical value. It must be acknowledged that the potential for the occurrence of some groundwater impacts, surface spills, blowouts and vehicular accidents are unavoidable in the development of this resource. The risk of harm from operations associated with natural gas development may be significantly greater than that accompanying the building of a shopping mall, but then so too are the rewards. Pennsylvania residents expect the Legislature to enact laws that will minimize these risks by establishing sensible limitations on the aspects of natural gas development that pose a threat to the use and enjoyment of property and the resources of the commonwealth. They depend upon the state Department of Environmental Protection to police and enforce regulations and ensure that when those resources suffer adverse impacts, those impacts are negated and restoration is effected by the responsible party.

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At least in situations involving potential lessors holding mineral acreage within the 39 counties of Pennsylvania where the Marcellus Shale is located (and who own all three estates in property), they have had the power, within certain limits, to achieve compensation for and to restrict the extent of permitted development operations on their land by negotiating addenda to address surface use and damage. However, the fact remains that many landowners who already entered into leases were unaware of the pitfalls associated with the numerous variations of form oil and gas agreements, did not retain a lawyer or appropriate counsel to assist them in reviewing a lease or simply were too focused on the financial consideration and promise of royalties to press the lessee for necessary non-monetary adjustments to industry-drafted agreements. In addition, many surface owners do not own the rights to the oil and gas beneath their property and, as Pennsylvania at present has no law to compensate the surface owner for the use of his land by a mineral owner or his lessee, common law extends an implied right of access to the oil and gas owner that can threaten the surface owner's use and enjoyment of his estate.

It is anticipated that lawyers will soon be speaking with clients who have decided to sell their real estate but may be grappling with the fear that the value of the land they own has been reduced by (1) current natural gas development activities there, (2) the prospect of future operations on the property permitted under an existing lease or (3) what may be transpiring on the properties of neighboring landowners. Difficulties may arise in selling property that is subject to an existing lease where the lessor-seller intends to retain the existing or potential royalty stream rather than assigning his or her rights in the lease to the buyer. Of course value is always determined by the price that a willing buyer and seller negotiate, and in that respect the standard issues that are the key to any real estate transaction will apply the same as to a property that is the subject of an oil and gas lease: sales price, location, surrounding uses, etc. There are a number of

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unique factors associated with oil and gas properties that can affect future marketability from the perspective of the seller and the buyer. Some of these are simply beyond a lessor-seller's power to control, regardless of the terms contained in the lease he or she secured for his or her oil and gas rights.

Assume the seller of real property with an oil and gas lease has negotiated terms precluding any access to or use of the surface so that essentially the only right that has been granted to the lessee is to extract oil or gas via access from an adjacent property or by way of a subsurface horizontal well bore originating from a vertical well located on other land. Depending on the type of activity that may occur on a neighboring property by virtue of the terms of a much less restrictive lease, as well as the size and configuration of the seller's parcel, the use and enjoyment of the seller's tract to a prospective buyer may be significantly compromised. In a zoned community, incompatible uses are regulated by local ordinance, but in the case of Marcellus Shale development, decisions of the Pennsylvania appellate courts interpreting the Oil and Gas Act have severely limited the power of local governments to regulate oil and gas drilling operations. Further, under either Senate Bill 1100 or House Bill 1950 (competing versions of wide-ranging legislative amendments to the Oil and Gas Act that had not been reconciled before the end of the 2011 legislative session) further limitations on the reach of munic-

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Photo by Robert Donnan

PBI Addresses Increased Liability Risks in Oil and Gas Law Practice

An unpleasant consequence of the Marcellus Shale legal boom is the increasing cost of malpractice insurance premiums for attorneys who devote a significant portion of their practice to oil and gas law. Many attorneys are finding themselves to be "oil and gas" practitioners, confronted with an outdated or nonexistent body of law and forced to look to unfamiliar statutes, new regulations and late 19th century or early 20th century precedents (or even look outside of Pennsylvania) to find answers to their clients' questions.

Swiss Re, a global reinsurance and risk management provider, has seen an increase in malpractice claims related to quiet title actions. Prior reservations of subsurface mineral rights can be very difficult to uncover in a title search, but such failure can give rise to a malpractice claim.

Also giving rise to increasing liability for attorneys, as cited by Swiss Re, is the vast body of applicable law needed to review oil and gas leases adequately. The attorney must be knowledgeable regarding the complexities of the lease terms as well as the environmental risks associated with drilling on a client's property. Failure to keep abreast of the nuances in this highly specialized area can have significant financial consequences for clients, resulting in the potential for malpractice claims.

The Pennsylvania Bar Institute has teamed with Stephen Saunders of Saunders Law LLC in Scranton to offer "Fundamentals of Oil and Gas Law," a seminar providing a detailed overview of a variety of pressing topics, including malpractice avoidance, leasing, title, mineral rights and infrastructure development. If a significant amount of your practice focuses on oil and gas law, then this CLE presentation is for you. The program will be presented at four locations across the state in March 2012. Check PBI's website at www.pbi.org for more details.

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ipal police powers to affect natural gas drilling seem likely to result when the Legislature continues negotiations on the House and Senate versions of these bills in 2012.* The point is that a no-surface-activity lease on the seller's property may not sufficiently mitigate or buffer the impacts of adjoining development activities for the universe of potential purchasers, thus affecting value.

Another issue that has been the subject of national media attention is the relationship of oil and gas leases to mortgage regulations and the ability of a potential purchaser to secure a mortgage on real property that is subject to a pre-existing oil and gas lease. While a thorough discussion of the issue is not possible here, counsel representing owners of properties located in the Marcellus Shale region are advised to read "Rush to Drill for Natural Gas Creates Conflicts with Mortgages," published in the Oct. 19, 2011, issue of *The New York Times*, as well as the supporting documents upon which the article was based. According to the writer, bankers have expressed concern that many leases permit lessees to conduct operations on collateral property that may violate the requirements of a landowner's mortgage. These same rules require the property owner to obtain the approval of the mortgagee before a lease is signed — a fact that many landowners do not know. Since upwards of 90 percent of residential mortgages are bundled for resale on the secondary market to government institutions such as Fannie Mae and Freddie Mac, there are implications for existing loan portfolios as well as the ability of local banks to market future mortgages that may run afoul of lending regulations. While there are opposing viewpoints as to the scope and significance of the problem, the issue is one that counsel should be aware of both when representing landowners seeking leases and prospective purchasers of oil and gas properties who will require financing.

Although touched upon briefly above, further discussion of the impact of the severed oil and gas estate on transferabili-

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DEPARTMENT OF ENVIRONMENTAL PROTECTION

MARCELLUS SHALE

MARCELLUS SHALE FORMATION

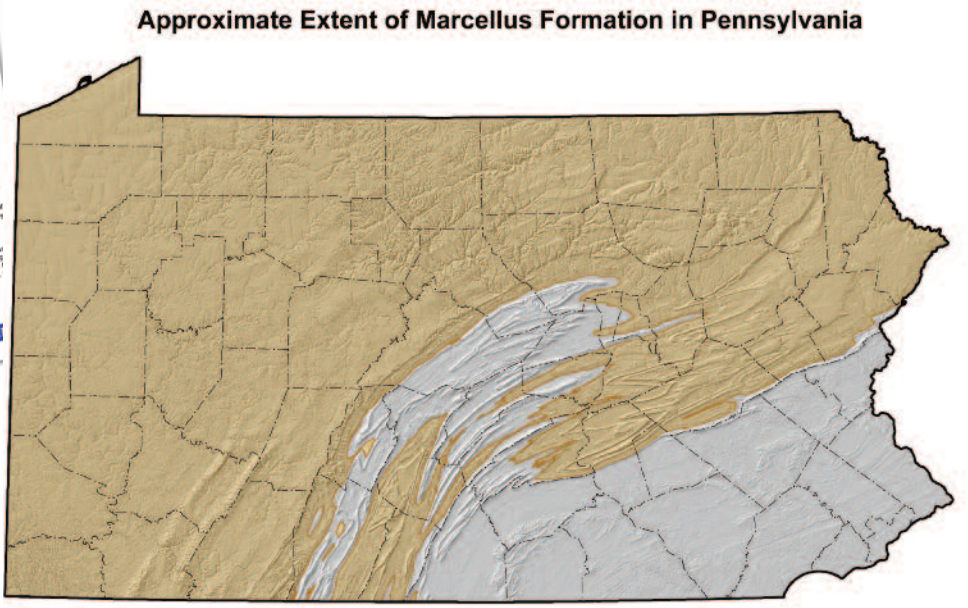
NATURAL GAS EXTRACTION FROM THE MARCELLUS SHALE

LANDOWNERS AND MARCELLUS SHALE LEASING

REGULATION OF MARCELLUS SHALE DRILLING

FACT SHE

DEP Marcellus Shale Fact Sheet



Source: Pennsylvania Department of Conservation and Natural Resources

Marcellus Formation occurs in subsurface or outcrop

**Editor's note: As the magazine went to press, compromise legislation in the form of House Bill 1950 had passed the Legislature and Gov. Tom Corbett had just signed it into law.*

ty of real property is warranted. Reference here is not to the question raised in the 2011 decision of the Superior Court in *Butler v. Charles Powers Estate* regarding whether a reservation of "minerals" should be interpreted to include Marcellus Shale and the gas it contains (which is addressed elsewhere in this issue of *The Pennsylvania Lawyer*), but the matter of the specific exception and retention of oil and gas rights by a grantor effectively creating separate ownership in the same from the grantee's surface estate and all the remaining subsurface minerals. In the case of a severed oil and gas estate, the owner of the same is understood to be dominant over the surface owner to the extent that the former is entitled to make use of so much of the subservient surface estate as is reasonably necessary to produce or extract the reserved interest. Since courts have interpreted this implied right of access to provide discretion in the lessee as to both the kinds of uses (not limited to drilling sites) and their location, the potential for conflict between the owner of the oil and gas and the surface estate are not difficult to imagine. The scope of this implied right is likely to be the subject of much litigation in the coming years.

As the maturity of the unconventional gas plays in Pennsylvania progresses and the focus of developers shifts from acquiring oil and gas rights to production, processing and transmission of the resource, the impact of existing lease provisions, actual development activities and the transfer of ownership of the land above which the Marcellus Shale sits will begin to become more of an issue for Pennsylvania landowners. In many cases lawyers were forced to learn what they could about the leasing end of oil and gas law on the fly. Counsel can position themselves to respond to the future needs of their landowner clients by preparing now to recognize and address these and other inevitable post-leasing issues. ✦

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