PENN ROAR

Pennsylvania's Royalty Owners Action Report

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NARO-PA & FRACKNATION THE TRUTH RUNS DEEP see page 2

NARO-PA Drafts Press Release Defining Improper Royalty Deductions

By: NARO-PA Legislative Committee

Chesapeake takes deductions for costs coded on royalty owners' check stubs as gathering and "third party." As this practice applies to leases with the market-enhancement royalty clause, it is an unlawful attempt to apply the net-back method of calculating royalties in contravention of the language of the leases. *Kilmer v. Elexco Land Services Inc.*, 605 Pa. 413, 900 A.2d 1147 (2010), does not govern this situation. *Kilmer* merely holds that applying the net-back method to one-eighth-royalty leases does not violate the Guaranteed Minimum Royalty Act.

In Pennslyvania, parties are free to contract as they please. Here, the parties have agreed to change the contract from the default net-back regime to a first-marketable-product regime. Under a first-marketable-product regime, *Mittelstaedt v. Sante Fe Minerals*, 1998 OK 7, 954 P.2d 1203 (1998), and its related cases, control. *Mittlestaedt* holds that gathering is required to transform the product into marketable form. Thus, deductions for these costs are disallowed.

"Third party" costs are also disallowed, because the implied duty to market the gas requires fixing the sales price on the first sale to a non-affiliated party. *See generally*, *Direct Sales: Royalty Problems for the Producer*, 46 Okla.L.Rev. 235 (1993). Otherwise, the lessee has the burden of proving that the price paid by its marketing affiliate was the best possible price obtainable.

In light of the foregoing, the language of the market-enhancement clause is unambiguous. But even if the language was ambiguous, all the rules of contract interpretation align in favor of the lessors: interpretation in favor of rationality and reasonableness, which is to change the default treatment of post-production costs; construction against the drafter, which was Chesapeake; construction in favor of the layman, which is the royalty owner; and construction according to the parties' intent, which was to prevent the deduction of the costs specifically enumerated in the market-enhancement clause. The idea that the parties to an oil and gas lease would negotiate into a lease a clause confirming the net-back method of calculating royalties—which was already irrefutably established under Pennsylvania law and by the plain language of the printed lease—mere surplusage—is untenable.

This is more than a contract-interpretation issue. It is a matter of applying common sense: lessors' obvious intent in negotiating modifying the lease with the market-enhancement clause was to prevent deductions for gathering, transporting, marketing, and the other charges enumerated in the

Continued to page 2

Inside This Issue

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market-enhancement clause. Landmen actively promised royalty owners that the market-enhancement clause barred all post-production costs except for the costs of actually transforming the product produced through the wellbore into different chemical compounds, e.g., cracking wet gas; at the least, landmen knowingly allowed royalty owners to be influenced by a fundamental misunderstanding of what was being negotiated.●

HELP BRING THE *FRACKING TRUTH* TO PENNSYLVANIA!

NARO-PA will be hosting a screening tour of

FRACKNATION

THE TRUTH RUNS DEEP

Bethlehem, PA	June 17th	Lehigh Univ.'s Zoellner Arts Center	6:30 pm
Harrisburg, PA	June 18th	Harrisburg Hilton	7:00 pm
Williamsport, PA	June 19th	Genetti Hotel & Suites	7:00 pm
Towanda, PA	June 20th	Keystone Theatre	7:00 pm
Tunkhannock, PA	June 24th	Shadowbrook Inn & Resort	7:00 pm

Fracknation is feature documentary that will tell the truth about fracking for natural gas. We need help to bring this important documentary to Pennsylvanians statewide!

Royalty Accounting Standards Bill

NARO-PA Legislative Committee

Information required to be included with Oil and Gas payments to Interest Owners

- Notwithstanding any other applicable terms or arrangements, every payment of proceeds derived from the sale of Oil, Gas or NGL shall be accompanied by a statement setting forth the following:
  - The name of the Lessor;
  - The Lessor's identification number (being the account number or payee number utilized by Producer);
  - The lease number, property name, well name and API Number used to identify the lease, and well,
  - The month and year during which the sale occurred for which payment is being made;
  - The total volume of Oil represented by the payment, measured in barrels;
  - The total volume of Gas represented by the payment, measured in MMBtu;
  - The total volume of NGL represented by the payment, measured in gallons or barrels;
  - The price per barrel of Oil sold or MMBtu of Gas sold or the price per barrel, (or price by gallon, if applicable) of NGL sold, as applicable;
  - Lessor's interest in the sale expressed as a decimal;
  - Lessor's share of the sale before any deductions or adjustments;
  - Lessor's share of the sale after deductions or adjustments;
  - Specific deduction code to account for any deduction shown (including, without limitation, transportation, tax, line loss, compression, processing, treatment, marketing, gathering, third party charges)
  - An address and telephone number for which additional information may be obtained and questions answered
- Any escrow account(s) established by the Lessee to accumulate funds payable to Lessors shall be a Qualified Escrow Account. Administrators of Qualified Escrow Accounts shall deliver to the Lessor or potential owner (s) or if ownership is in dispute, an annual statement with the same information as if a proceeds check had been issued, as well as the rate of interest for said account.
- Unless otherwise prohibited by applicable law, (i) payments of proceeds derived from the sale of Oil, Gas, or NGL shall be paid by a Lessee to a Lessor commencing no later than 120 days after the end of the month in which production is first sold, (ii) payments thereafter shall be made on a monthly basis no later than sixty days for Oil and sixty days for Gas and NGL following the end of the calendar month in which subsequent production is sold and (iii) payments may be made annually if the aggregate sum due a Lessor for twelve consecutive months is one hundred dollars or less. The Lessee and Lessor may provide, in a valid lease or other written agreement, for terms or arrangements for payment that differ from those set forth herein.
- Following the first payment, if there is any month in which a payment is not made, the Lessee shall provide Lessor with a statement explaining why such payment was not made.
- Any delay in determining whether or not a Lessor is entitled to an interest in proceeds shall not delay payments to all other Lessors so entitled.

Continued to page 4

- Upon written request by the Lessor, submitted to the Lessee by certified mail (or other means producing a receipt confirming that the correspondence was received), the Lessee shall provide to Lessor within sixty days a written explanation of those deductions or adjustments, whether or not identified with the payment, and, if requested by the Lessor, such meter calibration testing and production reporting records that are requires to be maintained by the Lessee.
- If a Lessee does not make payment to Lessor within the time frames specified in this section, the Lessee shall pay to the Lessor an amount of damages equal to double the aggregate amount of the royalties due plus interest on that sum from the date due and reasonable attorney's fees incurred by Lessor in attempting to collect any past due payment(s). Lessee shall pay the damages to Lessor set forth herein regardless of the cause for the original failure to pay royalties.
- Any circuit court of this state shall have jurisdiction to determine the following:
  - The date on which payment of proceeds is due a Lessor
  - The existence or nonexistence of an occurrence which would justifiably cause delay in payment
  - The amount of the proceeds plus interest, if any, due a Lessor by a Lessee
  - Whether the prevailing party is awarded reasonable attorney's fees and costs
- As a prerequisite to seeking relief under this section for the failure of a Lessee to make timely payment, a Lessor shall give the Lessee written notice by certified mail (or other means producing a receipt confirming that the correspondence was received) of such failure and the Lessee shall have twenty days after receipt of the written notice in which to pay the proceeds, plus any interest due thereon, in accordance with the provisions of this section or to respond in writing explaining the reason for nonpayment.

<u>Inspection of Records</u>

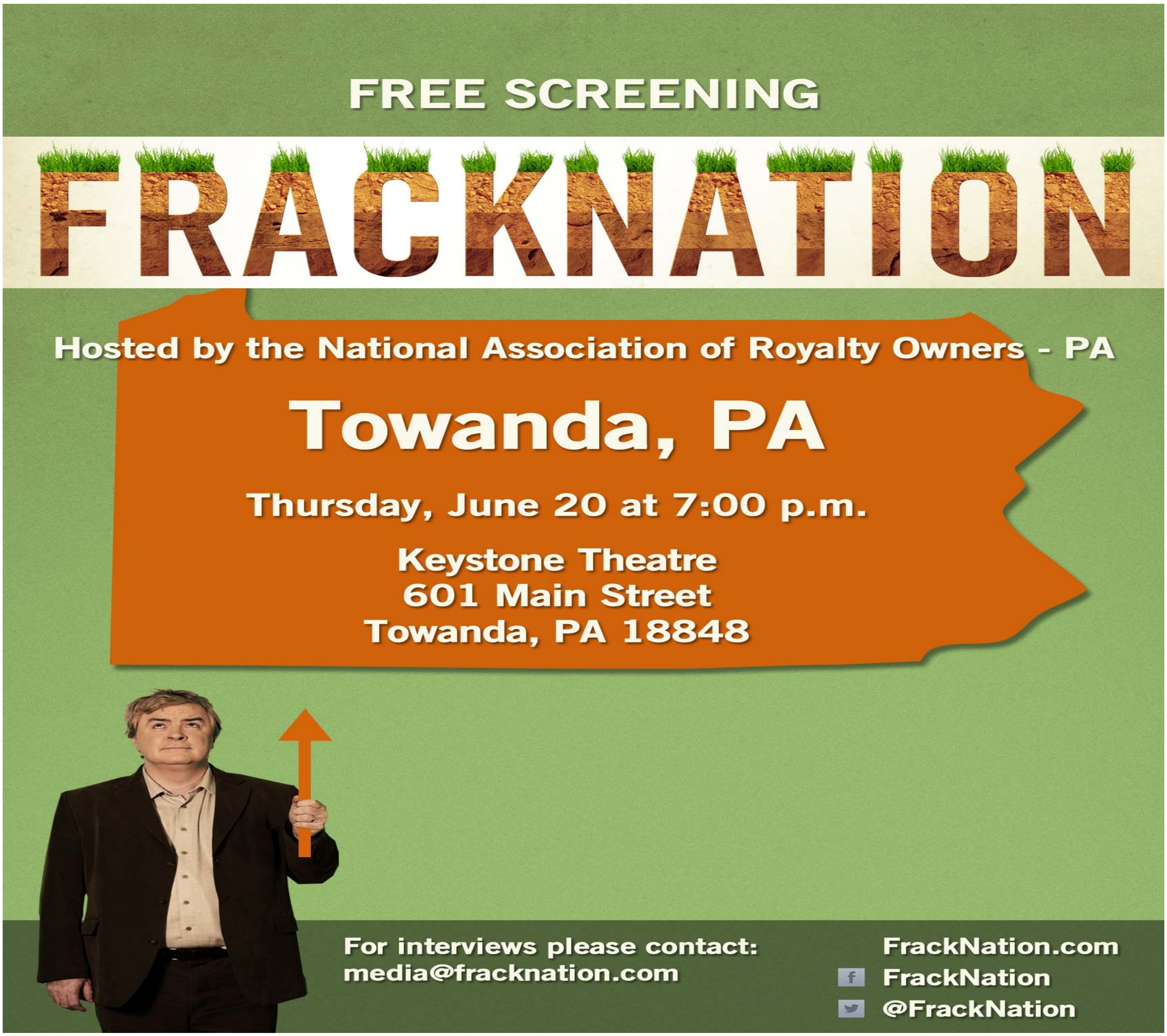
- Any Lessor or its contracted associates may inspect the records of a Lessee to verify proper payments,
  - Lessor can make a written request for inspection with regards to one or all of the properties for which Lessor is being paid for the previous five years.
    - The Lessor shall notify the Pennsylvania Department of Revenue of any inconsistencies and or reporting errors and provide such additional records as requested by the Pennsylvania Department of Revenue.
  - Lessee, upon receipt of formal request has thirty days to respond with the location at which the necessary records are maintained proposed dates, which shall be sufficient to permit Lessor to complete an inspection of the requested records. Unless otherwise mutually agreed, the proposed dates must be within sixty days following the date of Lessee's receipt of notice from Lessor.
  - Lessee shall provide copies of not less than the following for all requested periods:
    - Statements from sale of Gas, Oil and NGL
    - Transportation Contracts
    - Purchase Agreements and Marketing Agreements
    - Master meter(s) and well head charts
    - Meter Calibration reports
  - If any items to be produced by Lessee are not in the possession of Lessee, it shall be the responsibility of Lessee to acquire copies of such items, at the sole cost and expense of Lessee, prior to the commencement of Lessor's inspection.
  - Lessee shall make available a knowledgeable person who is able to answer any questions pertaining to accounting issues regarding a well (s) that are the subject of the Lessor's request for inspection.
  - Lessee shall make available the current Well Tender for the well(s) that are the subject of Lessor's request for inspection to assist the Lessor or his contracted associates in making a physical inspection of the well(s), including but not limited to the well site, pipelines, metering equipment and any other equipment necessary for production of the well. The Lessee shall cause the Well Tender to be able to respond to inquiries regarding the production and maintenance of well(s), included but not limited to:
    - Meter Calibration
    - Gas flow rates
    - NGL processing
    - Pipeline Maintenance
  - Except as otherwise provided herein, all information provided to Lessor will be confidential in nature and cannot be disclosed to any other persons.

Continued to page 5

Royalty Accounting Standards Bill **continued from page 4**

- o If an error is found during the inspection performed by the Lessor and or its contracted associates, Lessee shall pay to Lessor as damages an amount equal to double the amount of royalties due but unpaid plus 18 % interest on that sum from the date due, plus reasonable attorney's fees incurred by Lessor in attempting to collect, plus any fees and expenses of third parties engaged to assist in the inspection. On petition of the Lessor, a court may dissolve the lease.
- o The Lessor shall notify the Pennsylvania Department of Revenue of any inconsistencies and or reporting errors and provide such additional records as requested by the Pennsylvania Department of Revenue.

- Nothing set forth herein shall limit the powers of the Pennsylvania Department of Revenue to inspect the tax returns of any Lessee. If, following any inspection or audit of a Lessee by the Pennsylvania Department of Revenue t, it is determined that a Lessee did not accurately report the production of any well(s), the Pennsylvania Department of Revenue shall notify the Lessor(s) whose payments are affected by the inaccurate reporting. ●



The Invisible Hand is Absent:
Building the Case for Legislative Intervention

***By:** T. Walczak, VP, NARO-PA*

In general, if any branch of trade, or any division of labour, be advantageous to the public, the freer and more general the competition, it will always be the more so.

Adam Smith, *The Wealth Of Nations*, Book II, Chapter II, p.329, para. 106.

While much is written on the topic of free markets and consumerism, there is little attention paid to the moral philosophy of procurement, specifically regarding natural resources from private ownership. Procurement from private ownership can absolutely be conceived of as an American concept since the majority of natural resources are held in private ownership. Regardless, the same principles of free markets and consumerism can be easily adapted to apply.

As with all facets of effectively practiced capitalism, the pendulum swing between extremes eventually passes temporarily over equal advantage for all. Typically, this equilibrium is best achieved through the injection of competition and the most effective system is that which can prolong those competitive forces to bring the greatest good to all for the longest sustained time. Equilibrium cannot be attained outside a fluid system which allows movement in either direction.

Economical horizontal drilling, coupled with gathering and transportation costs dictates a leasemap which is homogenous to singular operators. This leads to a narrowing of the choices mineral owners can make as a partner to produce their resource. This territorialism, in conjunction with the falling field price for natural gas, has led to a free-fall in lease offers to mineral owners in bonus money, royalty percentage, and quality of terms in that lease. Conversely, as the field price for natural gas increased from its March 2012 low, the recent lease offerings have not reflected this resurgence. This can wholly be attributed to the absence of free-market forces in the procurement of leases.

It was the early leases, which pre-dated the Marcellus rush that allowed for post-production costs to be deducted from royalty percentages. Unfortunately, the only tool we have for cost examination is by comparison, producer vs. producer. These comparisons have yielded our deduction that these costs are very subjective across the spectrum of producers. Therefore, while we agree this is excepted practice under these early leases, it is the moral philosophy of each company that is evident as they determine what value per mcf that deduction may be. It was the introduction of competitive forces which allowed mineral owners to later strike sharing of post-production cost provisions from leases they were presented, but much of the early production we are currently seeing is production under these type leases, so these deductions are commonplace. It was competition and education that solved this problem for many mineral owners.

Consumption is the sole end and purpose of all production; and the interest of the producer ought to be attended to, only so far as it may be necessary for promoting that of the consumer.

The Wealth Of Nations, Book IV Chapter VIII, v. ii, p. 660, para. 49.

The Market Enhancement Clause is certainly a provision which is advantageous to both the mineral owner and the producer since it has the opportunity to increase the value of the resource and, with increased supply, increase the quality of the product offered. However, the misuse of the clause

Continued to page 7

by producers can partially be attributed to the lack of affordable remedies by mineral owners to contest the deductions.

The lack of that "invisible hand" of a free market to nudge operators into again treating mineral owners fairly will continue without dramatic changes to the market, as well as the laws.

The ability of the industry to self-regulate through its trade associations may quiet the call for the drastic changes needed, but we have not seen a public reprimand or a curtailment by the major offenders as yet. If the industry fails in an effort at self-governance, other solutions must be sought.

> *To widen the market and to narrow the competition, is always the interest of the dealers…The proposal of any new law or regulation of commerce which comes from this order, ought always to be listened to with great precaution, and ought never to be adopted till after having been long and carefully examined, not only with the most scrupulous, but with the most suspicious attention. It comes from an order of men, whose interest is never exactly the same with that of the public, who have generally an interest to deceive and even oppress the public, and who accordingly have, upon many occasions, both deceived and oppressed it.*
>
> *The Wealth Of Nations*, Book I, Chapter XI, Conclusion of the Chapter, p.267, para. 10.

Solutions to the problem currently include arbitration on an individual basis, but specific legislation to broadly correct future abuse can be accomplished with the combination of three legislative maneuvers:

First, the PA House of Representatives needs to pass the language included in NARO-PA's Royalty Accounting Standards Bill, which begins to build a framework that entitles the mineral owner to a system of navigable, affordable recourse coupled with pressure on a producer to come to the table.

Second, well meters need to be certified by PA's Bureau of Weights and Measures to ensure PA's mineral owners, and the state under Act 13, are paid correctly. We certainly can build on the framework created under Act 13 to enforce this certification of meters and payment.

Thirdly, competition needs to be reintroduced into many regions of the Marcellus. The primary vehicle for this would be the introduction of "Lease Integration" to the Marcellus. *Conservation Law* is applicable to horizons below the Onondaga, but it is a poorly crafted law, from the perspective of the mineral owner. A new "Lease Integration" rule should be crafted in favor of the mineral owner, using NARO-PA's suggestions, given the potential for lost opportunity for the mineral owners if producer-favored rules are crafted.

In truth, many operators have the opportunity to take advantage of their poorly crafted leases and have not. That is a Pennsylvania Marcellus story which is re-solidifying America's faith in the free-market. Conversely, the action of the single largest producer has gained statewide attention for their exploitation of mineral partners. Now it is imperative that the hands of lawmakers act on behalf of the people to swing the pendulum back.

Certainly, a rediscovered moral capitalism would begin to solve problems currently fracturing some mineral owners' partnership in the gas industry, but until then, we may have to help guide them a bit. The industry, the legislature, and the mineral owners should work together to ensure these new rules are to the advantage of all. ●

Introducing Compulsory Integration

By: Lester Greevy & John Shoemaker, Greevy & Associates

Editor's note:
Compulsory Integration, Forced Pooling and Conservation Law are all terms for pooling laws which involve gas companies "pooling" unleased mineral owners into production units. While this is a rule the industry has expressed they would eventually like enacted, they have chosen to "piecemeal" it into place by first introducing it as a rule through "Lease Integration," which is the forced pooling of properties which are already under lease to a competing company. This is a way of achieving more efficient surface use and gas recoverability by forcing otherwise unwilling companies, in a region being developed, to participate in a specific well. Much of the following information about Compulsory Integration, in the next few pages, applies similarly in concept to lease integration, except instead of referring to "non-consenting lessors" (mineral owners), simply substitute terminology which refers to incorporating leases of "non-consenting Lessees" (gas company) only. The concept of this rule resembles legislation proposed by Senator Yaw's "Company to Company Pooling," although we have not seen the industry's specific proposal. We thought it would be helpful to reprint this information which originally appeared in Sept 2011's *PennROAR*.

"Forced pooling", sometimes called "compulsory integration" has become a hot-button—and emotionally charged—issue among Pennsylvania's royalty owners. In the state, the only mechanism for forced pooling is the Oil and Gas Conservation Law, 58 Pa.C.S.A. §§ 401 et seq. (the "Law"). But despite the Law, forced pooling is practically non-existent in Pennsylvania. This issue of PENN ROAR will summarize the Law, explore the advantages and disadvantages of a broadened forced-pooling statute, and present the characteristics of such a broadened statute which would be advantageous to royalty owners.

Summary of the Oil and Gas Conservation Law

The purpose of the Law is to protect the *correlative rights* of owners of oil and gas interests. Correlative rights are the rights of such persons "to have a fair and equitable opportunity to obtain and produce his fair and equitable share of the oil and gas" underlying a particular spacing unit (think production unit), "without being required to drill unnecessary wells or incur other unnecessary expense…". 58 Pa.C.S.A. § 402(2).

The Law contemplates production from "pool[s]" or underground reservoirs—conventional plays. The Marcellus Shale contains "tight gas", trapped in the shale and not accumulated in vast, hollow, underground reservoirs—it is an *un*conventional play.

The Law applies only to wells which do penetrate the Onondaga horizon—or where the Onondaga is not present, wells which exceed a depth of 3800 feet beneath the surface. Since the Marcellus Shale lies above the Onondaga horizon, Marcellus wells are exempt from the Law. Hence the severely limited applicability of the Law.

Any operator or unleased royalty owner having an interest in the proposed spacing unit may initiate proceedings to force pool tracts within that unit. Thus, operators may force pool other operators, and not just royalty owners. Similarly, an operator with an interest within a spacing unit to which that operator has not been voluntary pooled may force its hand as against the dominant operator.

The Law provides for notice and a hearing before a tract becomes force pooled to any spacing unit. The purpose of the hearing to attempt to reach agreement among consenting and non-consenting operators and royalty owners as to the terms and conditions of the operation of the proposed spacing unit, including which party will operate the unit. If no agreement is reached, a state bureaucracy makes a determination.

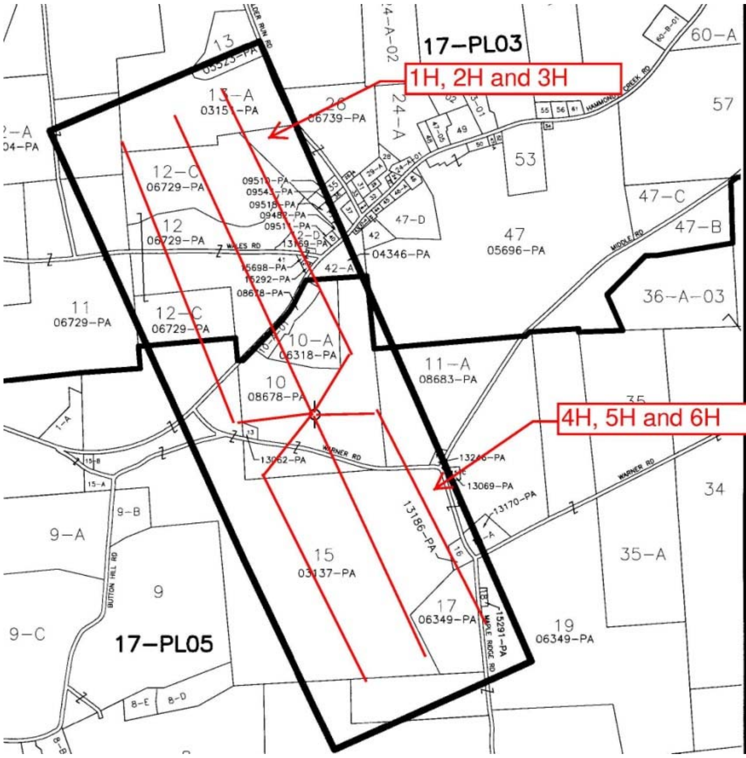
If a non-consenting lessee (gas company) becomes force pooled, the operator of the unit is entitled to seven-eighths of that non-consenting lessee's share of production from the unit until its share of the cost of drilling, equipping, and operating the well(s) is recouped. After the non-consenting lessee's share has been recouped, it is entitled to 100% of its proportional share of production. Of course, nothing in the Law relieves any lessee of its duty to pay the agreed-upon royalties to its royalty owners.

If a non-consenting lessor (royalty owner) becomes force pooled, it to is entitled to seven-eighths of its share of production from the unit until its share of the cost of drilling, equipping, and operating the well(s) is recouped, whereupon it is entitled to 100% of its proportional share of production.

The Oil and Gas Division of the Department of Mines and Mineral Industries of the Commonwealth of Pennsylvania administers the Law. ●

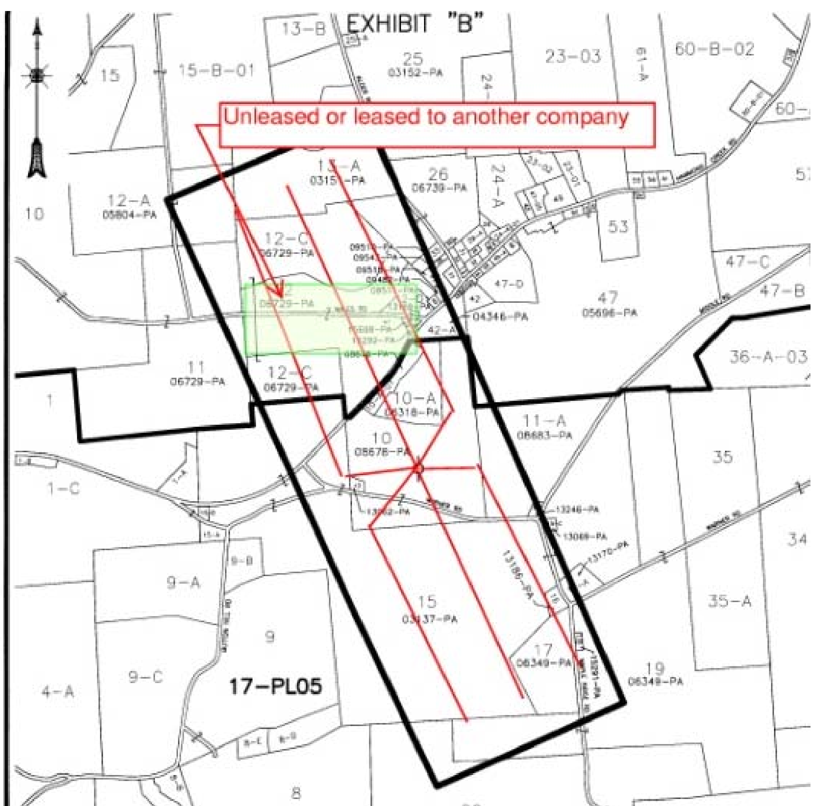
Q: Why is it Called Conservation Law?

Jacqueline Root, NARO-PA Chapter President, R&R Energy Consulting



Scenario #1:

Company A drills 6 horizontal wells and all Lessors receive royalties based on their fractional interest.



Scenario #2

Current Law	Compulsory Integration
3 horizontal legs deleted and no trespass is allowed	All 6 horizontals are drilled
40 un-leased and 110 leased acres excluded from the unit and potential for future development is limited	Well bore may travel under the 40 acres but no surface use is allowed
150 mineral acres receive no royalty income	Royalties paid to un-leased owner based on law
If the 40 acres is leased to Company B: Unless A&B choose to partner no royalties will be paid to the 150 mineral acres	If the 40 acres is leased to Company B: Company B is force pooled and the lessor receives royalties based on the lease agreement with Company B

***A:** Conservation is using best practices to maximize a resource without waste. Stranding of gas, as a result of incomplete leasing, leads to diminished potential yield from the field.*

Legislative Considerations for Forced Pooling

By Dale Tice, Esq, Marshall Parker & Associates

Oil and gas leasing and Marcellus development are often perceived as controversial and divisive issues in Pennsylvania. While the large majority of landowners in the Marcellus fairway have been amenable to leasing their property for gas drilling, there is a vocal minority of landowners who vehemently oppose Marcellus development and have refused to proceed with an oil and gas lease for their property.

Readers of the PENNROAR are by now familiar with the operation of the pooling provision found in the gas leases used by Marcellus operators. It is readily apparent that these holdout landowners will make it difficult or impossible for the gas companies to proceed with development of a production unit in the area where the un-leased land is located. For the gas companies, the solution to this problem has been forced pooling – also sometimes referred to as "fair pooling" or compulsory integration.

Pennsylvania has previously enacted a forced pooling law known as the Oil and Gas Conservation Law, but as discussed in the analysis by Les Greevy, the current law does not apply to the Marcellus shale. As a result, there has been an ongoing, heated discussion among the various stakeholders about the possibility of drafting a new version of the Conservation Law that would allow compulsory integration of the Marcellus. At this time, it appears that forced pooling may be such a hot topic that legislators will refuse to touch it, but the issue is likely to resurface in future legislative sessions.
It is not the purpose of this article to advocate for adoption of a new forced pooling law in the Commonwealth. Rather, the discussion below highlights a number of issues that should be addressed in the legislative discussion about a forced pooling law, in the event that such legislation is introduced in Pennsylvania.

Good Faith Offer

Texas has enacted a forced pooling law. However, the law requires that the oil and gas company first make a good faith lease offer to a holdout landowner before proceeding with a forced pooling proceeding. As a result, the forced pooling law has been rarely used in Texas. Pennsylvania legislators may consider including such a requirement in any forced pooling proposal.

Minimum Leased Acreage

Some states with forced pooling laws have included a requirement that the operator have a certain minimum amount of acreage leased in the area of the proposed pooled unit. This type of requirement forces the gas company to lease some percentage of the landowners in the area intended for drilling before proceeding with compulsory integration. The percentage of land required to be leased may vary anywhere from 51% to 95%. Obviously, as the minimum percentage required increases, it will be increasingly difficult for the gas company to utilize forced pooling.

Risk Penalty

When an oil and gas company drills a well, there is always some risk that the well will be unproductive and the operator will be unable to recoup its drilling costs. The amount of risk will vary from well to well and will also vary depending on the target formation being drilled.

The concept of the "risk penalty" recognizes that the non-participating landowner who is being forced-pooled should share in the risks involved in drilling. Forced pooling laws accomplish this risk sharing by providing that the non-participating landowner will not receive gas production payments until the gas company has recouped the landowner's proportional share of the costs to drill the well, plus some additional percentage of the costs as compensation to the operator for undertaking the risk of drilling.

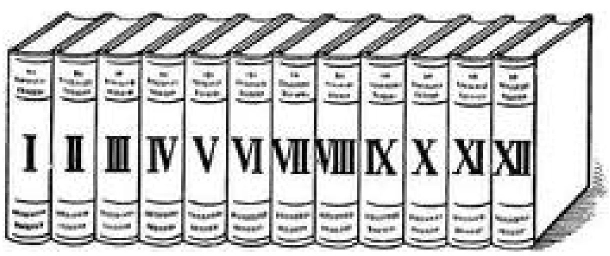
Pennsylvania's current Conservation Law sets the risk penalty at 200% of the landowner's proportional share of the drilling costs. Until the gas company recoups double the landowner's share of the costs, the un-leased landowner will receive a royalty payment of 1/8 (12.5%) of his or her proportional share of production. After 200% of the landowner's share of costs is recovered by the gas company, the non-participating landowner is then entitled to his or her entire proportional share of the total gas production. Legislators may also address the specific types of drilling costs that may be charged against the landowner's share.

The most recent forced pooling proposal discussed here in Pennsylvania set the risk penalty at *400%*. It may be questioned whether the risks involved in Marcellus drilling justify a risk penalty in that range.

continued on page 11

Landowner Surface Protection
A forced pooling law should explicitly provide that the surface of the land of a non-participating landowner may not be used for drilling operations. Legislators may also consider a provision requiring that the operator provide compensation to the landowner in the event that there is some inadvertent impact on the un-leased landowner's property or water supply.

Conclusion
This author does not intend to suggest that forced pooling is either good or bad for Pennsylvania landowners. But clearly, Pennsylvania royalty owners must understand that when evaluating any future forced pooling proposal, the devil is in the details. ●



Forced Pooling, Compulsory Integration, or Eminent Domain?

By Jacqueline Root, R & R Energy Consulting

The Pennsylvania debate on this topic can quickly become very emotional. Should unleased mineral owners be subject to forced pooling? Is compulsory integration the equivalent of eminent domain? Will the unleased mineral /surface owner be forced to give up surface rights? Does compulsory integration have the potential to maintain a competitive leasing environment? Does compulsory integration already exist in PA? When this is bantered about in the media that last two questions rarely enter into the discussion.

Forced pooling already exists in PA under the Conservation Law and applies to formations below the Onondaga Horizon or below 3800' where the Onondaga is not present. Wells drilled in the Utica formation will be subject to the Conservation Law and it is clear to me that the law should also apply to the Marcellus. The Conservation Law includes the following as its "Declaration of Policy:" *It is hereby declared as an expression of policy to be in the public interest to foster, encourage, and promote the development, production, and utilization of the natural oil and gas resources in this Commonwealth, and especially those which may exist in the Lower Devonian Series and the Silurian and Cambro-Ordovician Geological Systems or from any formation below the Onondaga horizon, in such manner as will encourage discovery, exploration, and development without waste; and to provide for the drilling, equipping, locating, spacing and operating of oil and gas wells so as to protect correlative rights and prevent waste of oil or gas or loss in the ultimate recovery thereof, and to regulate such operations so as to protect fully the rights of royalty owners and producers of oil and gas to the end that the people of the Commonwealth shall realize and enjoy the maximum benefit of these natural resources, it being recognized, however, that the uninterrupted exploration and development of Pennsylvania and Mississippian Systems and the Upper and Middle Devonian Geological Series, being sands and strata above the Onondaga Horizon, both of a primary and subsequent methods have been carried on exhaustively since the discovery of oil in the Drake Well in 1850 without regulatory restriction or control to such an extent that <u>at the present stage of development it would be impractical and detrimental to the operation of such shallow horizons to impose regulations under this act, particularly in view of the facts that the</u>*

continued on page 12

Forced Pooling, Compulsory Integration… from page 11

production therefrom, whether of primary or secondary nature is carried on without appreciable waste and that the methods of exploration, discovery, development and production above the Onondaga Horizon and in shallow horizons at a depth of less than three thousand eight hundred feet differ from methods of exploration, discovery, development and production below the Onondaga Horizon or below three thousand eight hundred feet in cost, methods, operating problems, and other important characteristics. Development of the Marcellus does not differ from that of formations below the Onondaga and so, the same reasoning pertaining to elimination of waste and protection of correlative rights should apply to the Marcellus and any other similar formation.

The Conservation Law should be updated not only to include the Marcellus but also to reflect new techniques and better protect the rights of mineral owners subject to compulsory integration.

The law does require that proposed units be based on geology but is rather vague in the details. Spacing requirements would further eliminate waste of the energy resource as well as surface disturbance.

Marcellus unitization is far from uniform and there is no protection other than a legal battle if the operator opts to include your acreage based on lease expiration rather than geology. If an operator wished to force pool an unleased mineral owner, the operator should have to control 80% or more of the proposed unit. The mineral owner should have clear guidelines to participate as an operator if that is their choice. What is a fair cost recovery percentage, should it be different depending on the formation, it is currently 200%. Should it be 150%? If you as a mineral owner chose to take a royalty percentage rather than participate should that number automatically be 12.5% or should there be a mechanism to arrive at a higher rate?

Okay, so you have made the decision not to lease. If you are force pooled does that give the operator access to your surface for roads, well pads or pipeline?

The answer is no. However, it does give the operator the right to drill under and frac' under your property and establishes rules under which you would receive compensation. If you decided not to lease because you believe this is the devil's work and you want nothing to do with oil and gas development, you certainly will feel that your rights have been compromised.

On the other hand, if you haven't leased because the Lessee is unwilling to meet your lease terms and monetary requests, you may find that a well written Conservation Law could be your best friend.

Once an operator has significant leasehold in your area, Marcellus development can be fast, efficient, and most desirable if you are leased. The downside is reduced leasing competition for the unleased mineral owner, particularly those with small parcels. Whether leased to a third party or unleased, they risk be excluded from the unit and there is no protection under current PA law. Compulsory integration offers opportunity to the mineral owner who chooses to either take a personal risk or to lease to a third party willing to meet their terms.

The governor's Marcellus Shale Advisory Commission made the recommendation in July that the Oil and Gas Conservation Law be updated to reflect new technology and include the Marcellus formation. There have been whispers that the industry would like to see this outcome.

Mineral owners need to be part of this discussion to ensure that our rights are protected.●

Some Thoughts on Compulsory Integration:

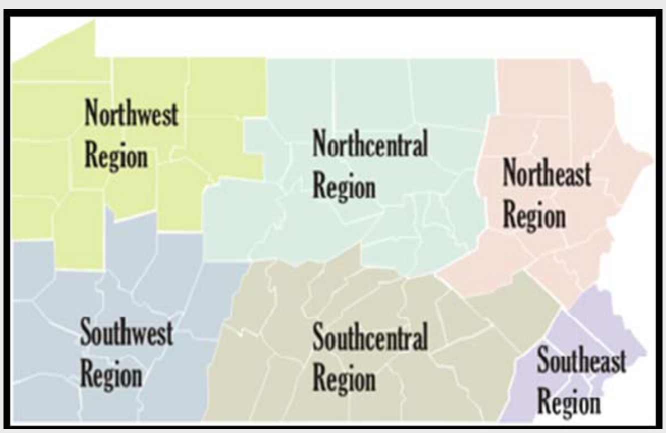
The race to lease property is over and the leasemap is a checker board of competing companies. No company has a dominant leasehold prolific enough to make horizontal drilling of 6 or 8 wells from one pad optimal. So the Lessors begin to work together or trade leases until one company controls the region. This is also beneficial to help reduce costs of infrastructure to produce natural gas from the area, as well as reduce surface disturbance from pipelines.

But with the competition out of the way, unleased property owners have only one company left to negotiate with. Lease rates and royalties offered begin to fall. The quality of lease provisions also diminishes. These unleased landowners want to engage in the exploration but now fear they have missed their opportunity to maximize their benefits. Under current law, they may have…

With Compulsory Integration, a small competing company could begin leasing in the area. Not to drill, but for the expressed goal of being forced pooled or petition to be included in the production units of the dominant company exploring the region. With this unique opportunity, the unleased landowners have a chance to negotiate a better deal with a company eager to get in on the game.

The key is drafting a Conservation Law that does not treat all unleased landowners as recalcitrant individuals who are standing in the way of natural gas development.

Do you have some thoughts on Compulsory Integration you'd like to share with the legislative committee? Your thoughts are needed as we draft a NARO-PA policy on forced pooling. Send them to pennroar@yahoo.com



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Additional Protections Give Royalty Owners Equal Footing in Forced Pooling

By Bill Wilson, NARO-PA, NE Regional Board Member

In his recommendation to The Economic and Workforce Development Subcommittee (Marcellus Shale Advisory Commission, Terry Engelder noted that, "rock splitting by hydraulic pressure is known to travel as much as 2000 feet from a horizontal well. Some gas may come from distances up to 2000 feet although the volumes from this distance are very low." Further he says, "Fractures opened by hydraulic pressure generally drain a swath of a "PRODUCTION UNIT" about 300-500 feet either side of a well – This is a common drainage distance even under unleased land."

Other industry reps have stated that they think the effective economic recovery distance from a horizontal well is as little as 130-150 feet, a number that is bolstered by the decreasing well spacing to 250 feet in parts of the Barnett Shale.

With the preceding in mind, if there is to be mandatory integration, wouldn't it make sense to structure the law so that a property could only be forced into a "PRODUCTION UNIT" for an individual well whose bore will pass directly beneath the property? If that well is to be part of a larger "POOLED UNIT" for other wells, it should not be assessed for the cost of the entire "POOLED UNIT", but only for proportionate share of the costs of that well's "PRODUCTION UNIT". The costs of the entire "POOLED UNIT" should be allocated to each "PRODUCTION UNIT" on the basis of the percentage that the "PRODUCTION UNIT" represents to the whole "POOLED UNIT".

A property should not be forced into a planned "PRODUCTION UNIT" until 6 months prior to the planned date for drilling the well. Should the well not be drilled (by a drilling rig capable of drilling the entire planned total depth including horizontal component with bit turning) within that 6 months time frame, the royalty rate should increase by 1% for each month that the date is delayed.

Shouldn't a "PRODUCTION UNIT" be limited to 500' feet either side of the well bore, then a "POOLED UNIT" could be defined as a planned area including several "PRODUCTION UNITS" that can be drilled from the same drilling pad.
Further, if a property is forced into a "PRODUCTION UNIT" against the desires of the royalty owner and if the well is drilled but is not able to achieve the planned length, the property past the end of the actual well bore should be released.

The property to be integrated should be completely surrounded by leased property if the owner of the rights being forced into a "PRODUCTION UNIT" objects to the integration and a no surface use lease should be used.

If the property owner (owner of the Oil and Gas Rights) wishes to be leased and cannot reach agreement because of "Low Ball" offers and a company controls the surrounding acreage or 70% or more of the acreage in the township, then the property owner can apply to the Bureau of Oil and Gas Management to be integrated utilizing a state assigned arbitrator. The arbitrator should choose from 2 leases, one submitted by the property owner and one submitted by the company, thus forcing each side to put forth their most realistic offer for consideration.

If production company "A" controls 70% of the area in a given township and production company "B" has property interspersed within that acreage, then company "B" or the Lessor to company "B" can petition the Bureau of Oil and Gas Management to be integrated into "POOLED UNITS" of Company "A"

Once a property is integrated, the "PRODUCTION UNITS" should not be changed unless the well in that "PRODUCTION UNIT" does not reach the planned total depth or the well is abandoned. In no case should a company be allowed to redesignate "POOLED UNITS" or "PRODUCTION UNITS", when such redesignation would create circumstances requiring forced integration of a property not otherwise meeting the criteria.

Should an unleased property owner be integrated then the property owner should be given the option of being a participating operator, a nonparticipating operator or a Lessor under the terms of a lease approved by the arbitrator. Should a leased property owner petition the Bureau for integration, the property should be integrated under the terms of the existing lease.

Any integration hearings should be held within 75 miles of the property being integrated.●

MARCELLUS GAS IS NOT A MINERAL:
WHAT DOES THIS MEAN FOR LEASE HOLDERS?

by: Robert J. Burnett, Esquire, Houston Harbaugh Attorneys at Law

On April 24, 2013, the Pennsylvania Supreme Court issued its much anticipated decision in *Butler v. Charles Powers Estate* ("*Butler II*"). At issue in *Butler II* was whether a reservation of "minerals" in an 1881 deed included the Marcellus Shale gas. For more than 130 years, Pennsylvania law had long recognized that such a reservation did not include the oil and gas formations.[1] However, the 2011 decision of the Pennsylvania Superior Court in *Butler* suggested that the Marcellus Shale gas should be treated differently. *See*, *Butler v. Charles Powers Estate*, 29 A.3d 35 (Pa.Super. 2011) ("*Butler I*"). In *Butler I*, the Superior Court implied that since the Marcellus Shale is, in essence, a rock formation it should be treated as a "mineral" just like coal, iron and limestone. Relying on Pennsylvania's treatment of coal bed gas as precedent, the Superior Court further opined in *Butler I* that a reservation of "minerals" in a deed may possibly include the underlying shale formations and the natural gas trapped within the shale. Not so, said the Supreme Court. In *Butler II*, the Pennsylvania Supreme Court re-affirmed the long-standing principle of Pennsylvania law that a reservation of "minerals" in a deed does not include the oil and gas. The *Butler II* panel stated that:

"[W]e hold that the Superior Court erred in ordering the remand, and further that Marcellus Shale natural gas cannot, consistent with the *Dunham*'s Rule, be considered a mineral for private deed purposes."*See*, *Butler v. Charles Powers Estate* (p. 21, J-118-2012).

The Supreme Court expressly rejected the analogy of coalbed gas. Since the early 1980s, Pennsylvania law has recognized that the owner of a coal seam owns the coalbed gas trapped within the seam. This rule was adopted by the Pennsylvania Supreme Court in the *United States Steel v. Hoge*, 468 A.2d 1380 (Pa. 1983). In considering which party possessed the right to the coalbed gas, the *Hoge* court noted "as a general rule, subterranean gas is owned by whoever has title to the property in which the gas is resting..." *Hoge*, 408 A.2d at 1283. The *Hoge* court further observed that "such gas as is present in coal must necessarily belong to the owner of the coal..." *Id*. In the *Butler I* decision, the Pennsylvania Superior Court was persuaded by this reasoning and suggested that the logic of *Hoge* should apply to the Marcellus Shale formation and the gas contained within the shale.

On appeal, the Pennsylvania Supreme Court in *Butler II* distinguished the rationale of *Hoge* on several grounds. First, the Supreme Court noted that the mineral reservation at issue in *Hoge* concerned specific coal rights and the related right of ventilation. Commercial exploitation of coalbed gas is "very limited and sporadic" because it is generally viewed as a dangerous waste product of coal mining. As such, it had to be vented from coal seams to allow the coal to be safely mined. As these issues are not present in connection with the extraction of hydrocarbons from the Marcellus Shale, the Supreme Court concluded that the Superior Court's reliance on Hoge in *Butler I* 0was therefore misplaced.

continued on page 16

Marcellus Gas not a Mineral continued from page 15

Second, the Supreme Court noted that the *Hoge* panel inherently recognized a "legal distinction" between coalbed gas and the natural gas found in other non-coalseam horizons. Given this historical distinction, the Supreme Court in *Butler II* concluded that the *Hoge* decision was, and is, limited to coalbed gas and cannot be read as broadly as the Superior Court did in *Butler I*. The Supreme Court found "no reason" to apply *Hoge* and held that:

> "[W]e therefore find no merit in any contention that because Marcellus Shale natural gas is contained within shale rock, regardless of whether shale rock is or is not a mineral, such consequentially renders the natural gas a mineral..."*See, Butler v. Charles Powers Estate* (p. 24, J-118-2012).

By rejecting *Hoge* and reversing the Superior Court's *Butler I* decision, the Supreme Court re-affirmed *Dunham's* Rule as controlling law in Pennsylvania.

Under *Dunham's* Rule, a reservation of "minerals" in a deed will not include the oil and gas unless there is "clear and convincing evidence" that the parties intended to include such hydrocarbons. "[T]he rule in Pennsylvania is that natural gas and oil simply are not minerals because they are not of a metallic nature..." *See, Butler v. Charles Powers Estate* (p. 21, J-118-2012). Most states, unlike Pennsylvania, include oil and gas in a mineral reservation. However, as Justice Baer noted in the 6-0 majority opinion in *Butler II*, *Dunham's* Rule has "formed the bedrock for innumerable private, real property transactions for nearly two centuries." Given this longstanding history, the panel in *Butler II* was reluctant to overturn this well- established principle of Pennsylvania law and invalidate hundreds, if not thousands, of Marcellus Shale leases. ●

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[1] The rule in Pennsylvania that the term "minerals" includes only metallic substances is known as *Dunham's* Rule and is derived from the 1882 decision of the Pennsylvania Supreme Court in *Dunham v. Kirkpatrick*, 101 Pa. 36 (Pa. 1882)

Dueling Fracking Documentaries in Pennsylvania

By: Magdalena Segieda, PRESS RELEASE | June 6, 2013

Hollywood, CA—Pennsylvania is set to be the center of the fracking wars in mid-June as two rival documentaries on the subject are being screened on the same night in three towns!

FrackNation, the controversial "pro-fracking" documentary, and *Gasland 2*, the sequel to the HBO documentary that started much of the anti-fracking movement, are going head to head every night June 17 through 19.Sparks are sure to fly as the rival documentaries screen nearby and the filmmakers answer questions about their work.*FrackNation* and *Gasland* are being screened simultaneously in Bethlehem, Harrisburg, and Williamsport on consecutive nights.

Magdalena Segieda, co-director of *FrackNation*, said she was delighted to bring the film to Pennsylvania. The screenings are being hosted by the National Association of Royalty Owners - Pennsylvania.

"*FrackNation* is a film by the people, for the people," said Segieda. "Unlike the corporate-funded *Gasland*, our film was crowdsourced through Kickstarter by fracking supporters whose story wasn't being told."

FrackNation, which debunks many of the major scares of the anti-fracking movement, has been praised by the *New York Times* as "meticulously researched" and "provocative."

According to *Variety*—the showbusiness bible—*FrackNation* "makes a good case against [*Gasland*]" and "debunks the famous *Gasland* scene of a fracking 'victim' setting his tap water on fire."

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Magdalena Segieda is available for interviews. To schedule, please contact susanboliver@me.com or call (703) 216-4078

The National Association of Royalty Owners PA Chapter Hosts FrackNation Screening Tour

NARO-PA PRESS RELEASE | June 7, 2013

This week the National Association of Royalty Owners Pennsylvania Chapter (NARO-PA) announced they will be hosting a screening tour crossing Pennsylvania in support of the documentary "FrackNation. The movie will be shown at a free screenings, which are open to the public, starting in Bethlehem June 17th, Harrisburg June 18th, Williamsport June 19th, Pittsburgh and Towanda June 20th, and finishing the tour in Tunkhannock on June 24th.

"This movie is our story. The people in the Marcellus region know what a revolution the drilling has created for our economy and energy security, but sometimes we don't realize how fragile our rights are. Just east of all this activity, the drilling has been cut-off and the people have been stripped of their property rights by the Hollywood elite. We need to share this movie to help educate the public about the facts surrounding natural gas drilling. The silent majority needs to start being a vocal advocate for reality." says chapter vice-President, Trevor Walczak.

"When Gasland premiered four years ago, it played on people's fears. Intellectually, it was empty, but it effectively scared a lot of people who don't live in the middle of this great energy revolution. When I'd tell them the real gas country of Pennsylvania was nothing like the one Josh Fox created, they were skeptical. Now, four years later, none of Fox's fear-mongering has come true, and people outside the Marcellus region are curious to finally hear the truth."

John Shoemaker, a lawyer and member of NARO-PA noted "FrackNation is a random act of journalism—a refreshing look at the real facts instead of the usual environmental radicalism."

Josh Fox and Gasland 2 will also be making a screening tour of four Pennsylvania cities: Bethlehem, Camp Hill, Williamsport and Pittsburgh. In an effort to

continued on page 19

FrackNation Screening Tour continued from page 18

balance the scale, NARO-PA will also be hosting screenings in those cities, as well as additional stops in Towanda and Tunkhannock.

"When we heard he made a sequel, we knew it was time to fight back head-to-head," says Mr. Walczak. "I vowed we'd be there in every city Josh Fox stopped in to bring people the truth about fracking. How it saved our farmlands, our families and honestly, our way of life. Phelim's facts vs. Fox's fiction."

In the wake of the original Gasland movie, the Delaware River Basin Commission (DRBC) shut-down all natural gas drilling within the watershed of the Delaware River. This moratorium restricted development in most of Wayne County, PA, where the Walczak family has owned land for three generations. Like many property owners in the Delaware River Basin, Mr. Walczak feels his property rights have been violated by the moratorium and he feels people all across the state should have an opportunity to hear the facts about natural gas drilling.

"It's sickening to think how the people who don't know the truth, and I think in some cases, don't want to, are the ones shaping public policy in regards to shale gas." Mr. Walczak continued. "FrackNation does a very effective job of interviewing experts to explain the truth about fracking, explore it's value to the entire world's economic system, and explore how anti-fracking has become the latest celebrity fad. There is no way someone could watch this movie and not come to the conclusion that Josh Fox is a liar. On behalf of all of Pennsylvania's mineral owners, NARO-PA is proud to share this story with the people of Pennsylvania, because everyone deserves the truth."

Joseph Zuber, another NARO-PA member from Montrose added, "At NARO we strive to inform and educate the royalty owner. What better way to achieve this than by sponsoring screenings of FrackNation."

The ***National Association of Royalty Owners*** (NARO) is the only national organization representing, solely and without compromise, oil and gas royalty owners interests.

"The mission of NARO is to encourage and promote exploration and production of minerals in the United States while preserving, protecting, advancing and representing the interests and rights of mineral and royalty owners through education, advocacy and assistance to our members, to NARO chapter organizations, to government bodies and to the public."

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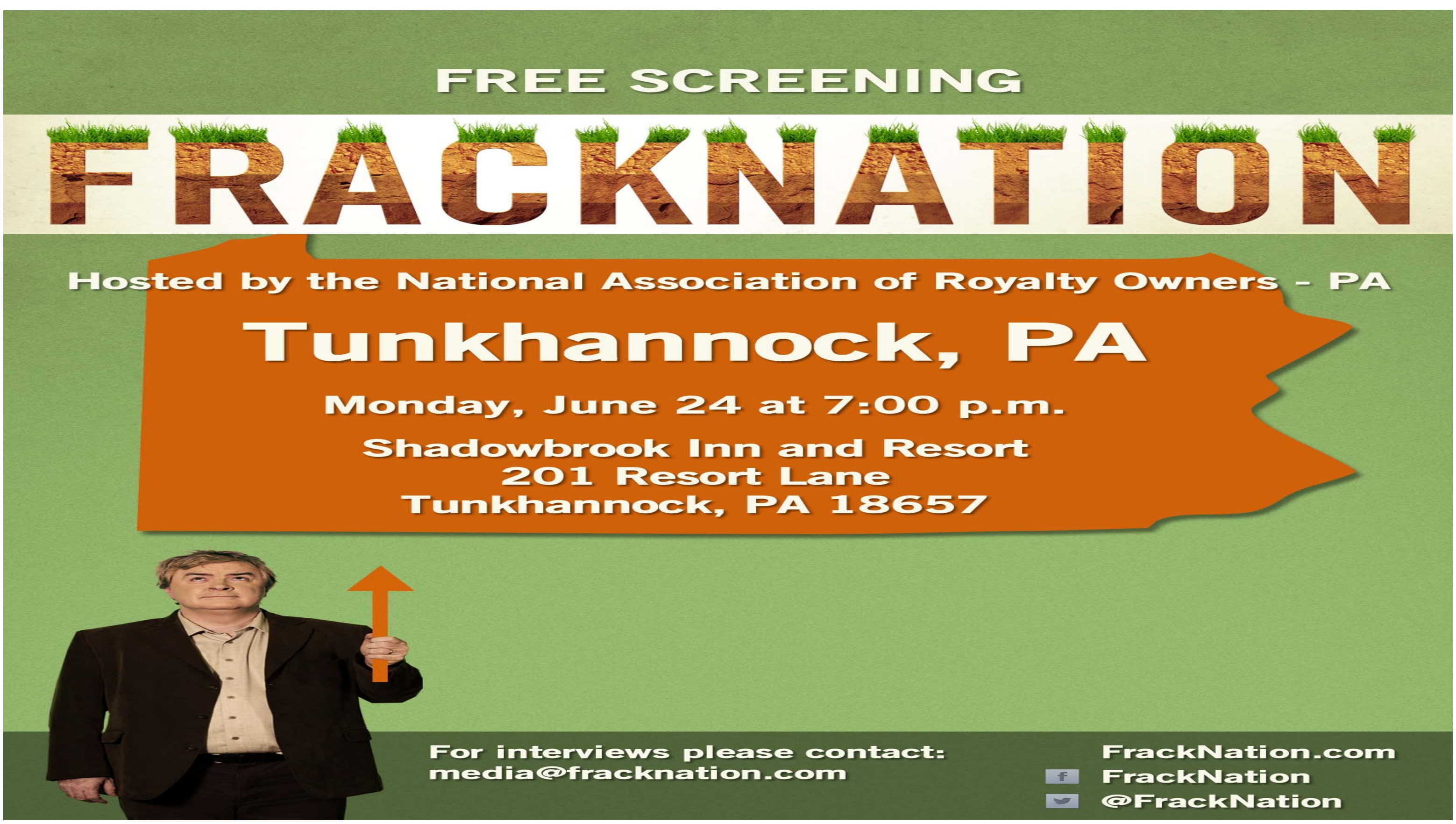

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