

Emerging Issues in Pennsylvania Oil/Gas Law July 19, 2011

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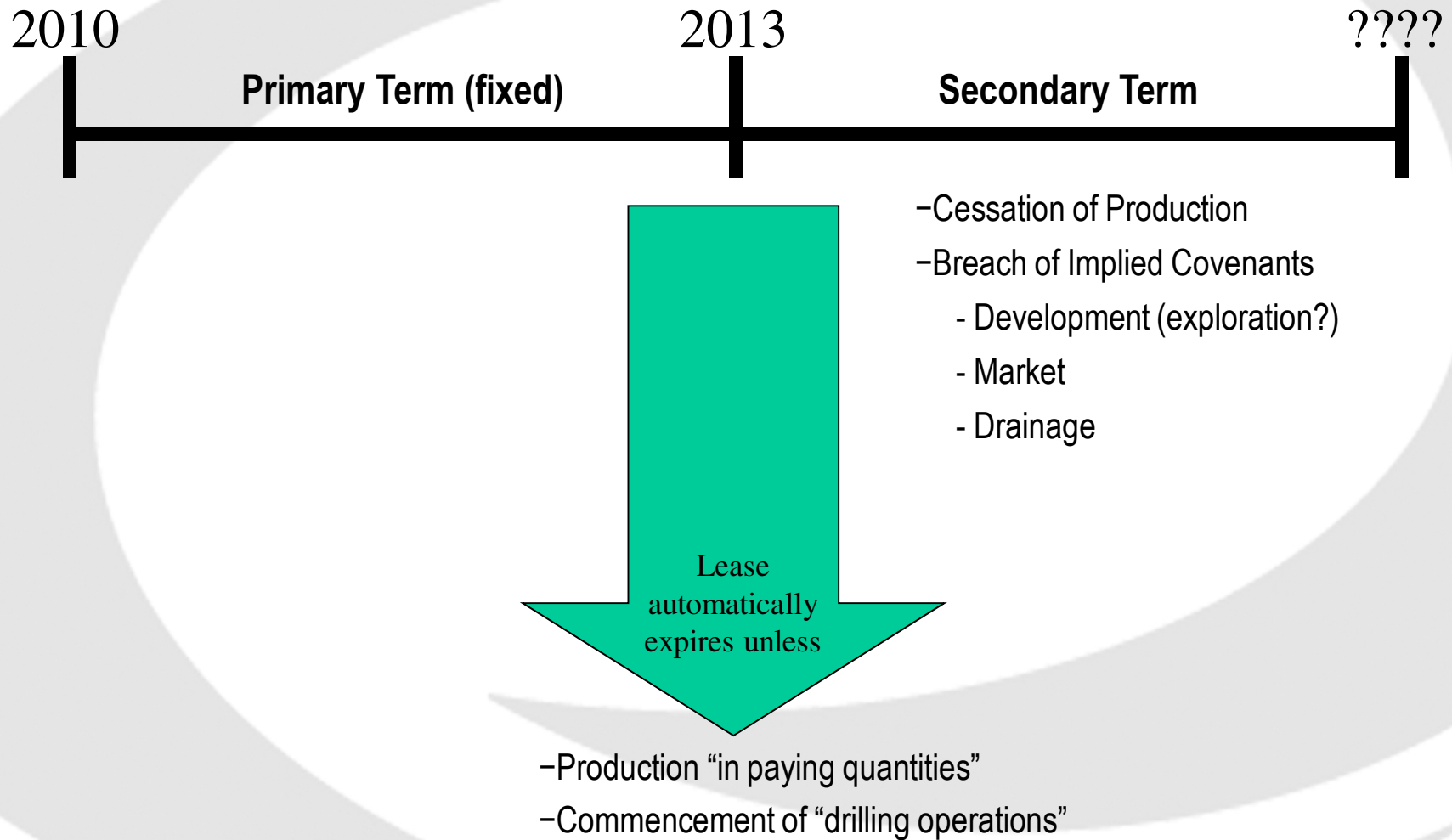
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Tonight we will briefly explore three (3) important areas:

- (i) Non-Production and Lease Termination
- (ii) Implied Covenants (i.e., reasonable development v. further exploration)
- (iii) Subsurface Trespass and the “Rule of Capture”



Termination of gas lease:

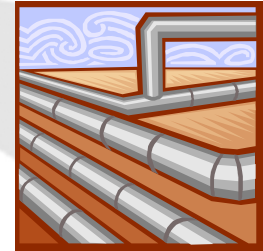


Automatic Termination Rule:

- Triggered at the expiration of the Primary Term
- Lease *automatically* terminates unless “drilling operations” have commenced or if gas is being produced “in paying quantities”
- Hite v. Falcon Partners, 2011 WL 9632 (Jan. 4, 2011):
“[F]alcon was permitted to delay production during the year long Primary Term of the Lease by the tender of a delay rental, but when that Primary Term ended and Falcon failed to commence production, the Lease expired...”

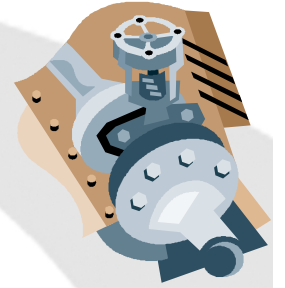


Cessation of Production: How much time does the operator have?



- General Rule: Periods of non-production during the Secondary Term automatically terminates the Lease
- To mitigate the harshness of this Rule, courts have developed and applied the “temporary cessation of production (“TCOP”) doctrine” (Texas, Ohio, Oklahoma)
- The TCOP Doctrine presumes that the parties understood that mechanical problems, reworking operations or similar other events would inevitably interrupt production from time-to-time

Cessation of Production (cont'd):



TCOP Doctrine

- i) Burden on Lessor to show actual cessation of production;
 - ii) The Lessee must then demonstrate that the cessation was due to a “sudden stoppage of the well or some mechanical breakdown of equipment...”; AND
 - iii) The Lessee must exercise reasonable diligence to remedy the defect and resume production within a reasonable period of time
- Has not yet been formally adopted in Pennsylvania

Covenants “implied” in every Lease:

- Implied covenant of Reasonable Development
- Implied covenant to Prevent Drainage
- Implied covenant to Market Gas
- Implied covenant of Further Exploration??



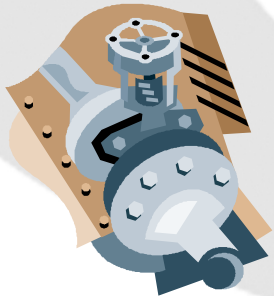
Implied Covenant of Reasonable Development:



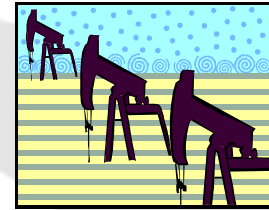
- Well-recognized in every jurisdiction for over 100 years
- Upon discovery of gas in paying quantities, the Lessee is under an obligation to drill additional wells as reasonably necessary to extract the remaining gas
- Lessor must prove that further development would be profitable
- Profitable production does not mean mere production “in paying quantities” – requires evidence that the additional well or wells would recoup a reasonable profit over and above the costs of drilling, completion and day-to-day operations. See, Kleppner v. Lemon, 35 A. 109 (Pa. 1896)

Implied Covenant of Reasonable Development (cont'd):

- Under Pennsylvania law, there is no duty to develop if the Lease itself provides the Lessor compensation (*i.e.*, delay rentals) during the period of non-production. See, Jacobs v. CNG Transmission, 772 A.2d 445 (Pa. 2001)
- Covenant only applies to proven formations (*i.e.*, known gas reserves currently producing gas)
- What about unproven formations that may lie beneath tract of land? (*i.e.*, deeper formations)



Is there an Implied Covenant of Further Exploration?



- A minority of courts have recognized an implied covenant to explore unproven formations (Colorado, Kansas)
- The covenant of further exploration has been defined as the obligation to develop “every part of the lease...whether the undeveloped portion be a single tract remote from the rest, or a considerable portion of a very large tract, or a deeper stratum...” See, Fox Petroleum v. Bocker, 253 p. 33 (Okla. 1926).
- To prove breach, Lessor must show “reasonability of the Lessee in not exploring” undeveloped formations. See, Gillette v. Pepper Tank Co., 694 P.2d 369 (Colo. App. 1981).

Implied Covenant of Further Exploration (cont'd):



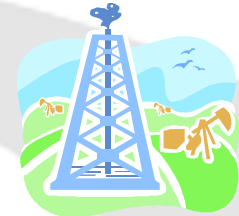
- Pennsylvania *may* recognize implied duty to explore and test unproven formations. See, Aye v. Philadelphia Co., 44 A. 555 (Pa. 1899)
- The Aye court noted that the Lessee was under an implied obligation “to proceed with the exploration and development of the land with reasonable diligence...” or risk abandonment of the lease
- Unclear in 2011 whether Pennsylvania will still recognize this implied covenant with respect to the deeper Marcellus formation

Subsurface Trespass – Can they take the gas under my property without a lease?

- Traditional vertical well vs. horizontal well
- Does the “rule of capture” apply to hydraulic fracturing?

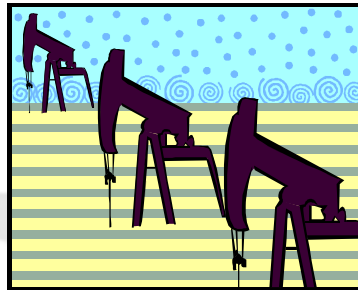


“Rule of Capture”:



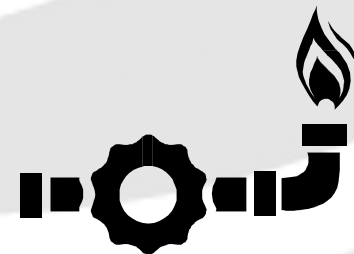
- Gas generally migrates to low pressure areas within a common reservoir
- The Rule gives the landowner title to all of the gas produced from a lawful well even if the gas “flowed” to the well from beneath another person’s tract of land
- So long as the well is within the vertical boundaries of his or her property, all gas extracted from that well is lawfully owned by that landowner and the landowner is not subject to liability for “drainage”

- “The rule of capture can mean little more than, due to [the] fugitive nature of the hydrocarbons, when captured [they] belong to the owner of the well which they flowed, irrespective of where they may have been in place originally.”
Halbouty v. R.R. Commission, 357 S.W.2d 364 (Tex. 1962)



Deviated well not protected by the Rule:

- The “rule of capture” only protects the operator from drainage liability if the gas produced has *naturally migrated* from underneath the land of another
- If the well bore “bottoms out” underneath the property of another (i.e., deviated well), the operator has committed a subsurface trespass. See, Continental Resources, Inc. v. Farrar Oil Co., 559 N.W.2d 841 (N.D. 1997)
- If the gas stayed in place, as opposed to migrated gas, the Rule does not apply



Rule of Capture and Hydraulic Fracturing:



- Shale gas is considered a “tight” geologic formation – the gas is trapped within nonporous and impermeable rock and does not migrate naturally
- Cannot be produced with hydraulic fracturing stimulation
- What happens when the subterranean fractures extend across and beyond surface boundaries?
- Coastal Oil & Gas v. Garza Energy Trust, 268 S.W.3d 1 (Tex. 2008) – fracturing created new reservoir by loosening rock formation
- Natural migration or artificially created channel?

Any Questions?



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