

GETTING TO YES:
HOW A COMPULSORY POOLING
STATUTE FACILITATES FAIR
NEGOTIATIONS AMONG INTEREST
HOLDERS

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Getting To Yes: A Proposal for a Statutory Approach to Compulsory Pooling in Pennsylvania

- What Can We Learn from Other States?
- What is Best for Pennsylvania?
 - West Law:
 - 41 ENVLRNA 11044
 - Lexis:
 - 41 ELR 11044



Drilling is Underway



What Will Harrisburg Do?



Pooling a Critical Piece of the Puzzle

- Common Misconceptions About Pooling
- Constitutionality of Compulsory Pooling
- Options for Cost and Profit Sharing:
Learning From Other States
- Likely Scenarios Where Pooling Would Be
Advantageous to Unleased or Leased
Landowners

According to some, Compulsory Pooling . . .

- . . . is “a policy to force some property owners to lease their land.”
 - Pittsburgh Tribune-Review. July 23, 2011.
- . . . is a violation of personal property rights.
- . . . is an exercise of “eminent domain for private use.”
 - Pittsburgh Times-Tribune Op/Ed August 7, 2011.
- . . . forces landowners to accept the state minimum royalty rate of of 12.5% and get no bonus payment.

The Basic Elements of a Pooling Statute

- Four Elements:
 - 1) presupposes the existence of established drilling or spacing unit;
 - 2) permit the owners of separate tracts to VOLUNTARILY pool their interests
 - 3) require notice and public hearing before pooling is ordered; and
 - 4) are based on the principle that interest owner is entitled to his JUST & EQUITABLE share of oil & gas...

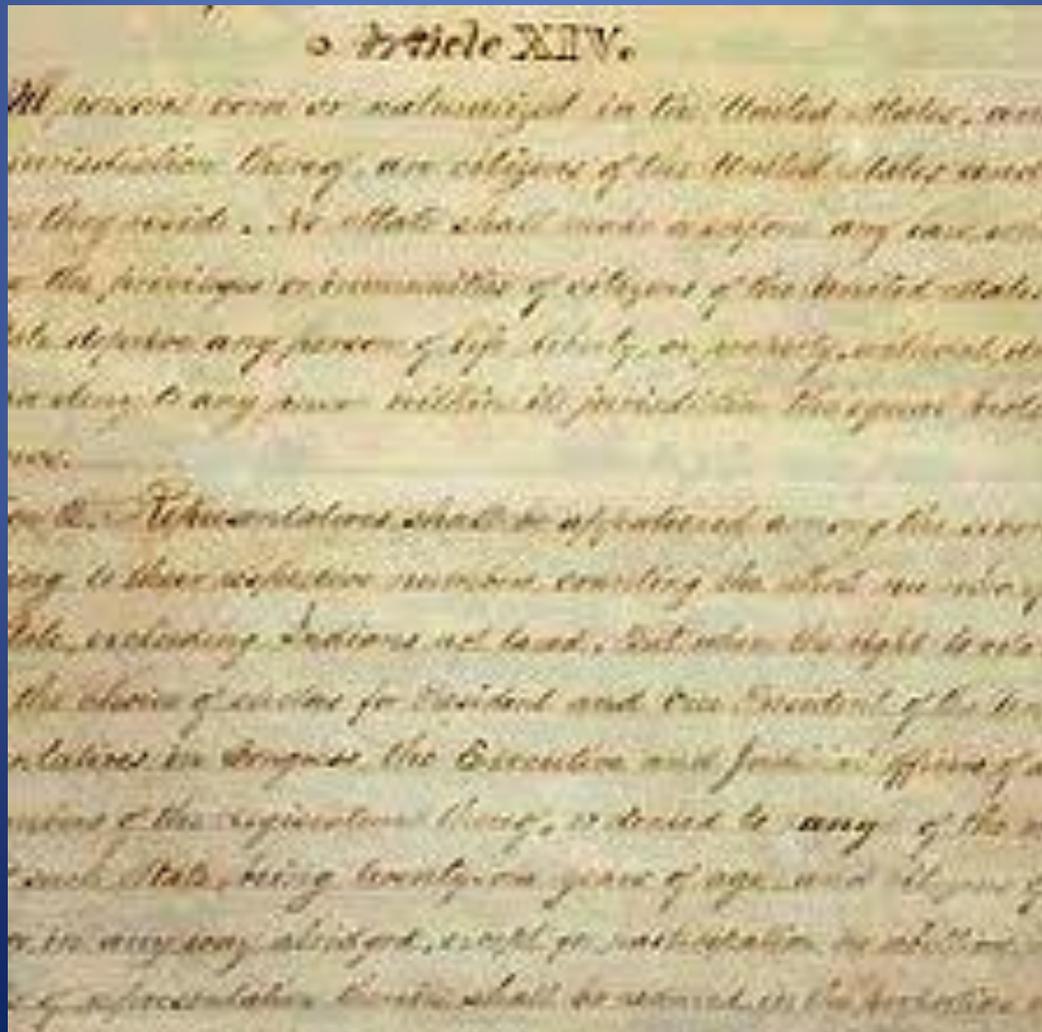
The Two Prong Purpose of Pooling

- (1) Pooling prevents WASTE
 - Oil and Gas are special: we depend upon these resources
 - The more domestic oil and gas the better
- (2) The protection of CORRELATIVE RIGHTS
 - By protecting each property owner's right to produce from a common source of supply, POOLING PROTECTS THE PROPERTY RIGHTS OF INDIVIDUALS

Basic Elements of a Pooling Statute

- Four Essential Components:
 - (1) they presuppose the existence of established drilling or spacing unit;
 - (2) they permit the owners of separate tracts to VOLUNTARILY pool their interests;
 - (3) they require notice and public hearing before pooling is ordered; and
 - (4) they are based on the principle that interest owner is entitled to his JUST and EQUITABLE share of production

Pooling Does NOT Violate the 14th Amendment



Pooling is a Constitutional Exercise of the State Police Power

- In reviewing Oklahoma's pooling statute, the state's high court found it did NOT violate 14th Amendment
- The police power to prevent waste is "beyond successful contradiction"
- On appeal, the Supreme Court of the United States upheld the Oklahoma high court's reasoning and dismisses the appeal
 - *Patterson v. Stanolind Oil & Gas Co.*, 77 P.2d 83 (Okla. 1938).

Foundation for *Patterson*

- Two Supreme Court Cases:
- “Every person has the right to drill wells on his own land and take from the pools below . . . but the right to take and thus acquire ownership is subject to the reasonable exertion of the power of the state to prevent unnecessary loss, destruction, or waste.”
 - *Champlin Refining Co. v. Corporation Comm.*, 286 U.S. 210 (1932).
- In other words: the rule of capture applies BUT is limited by the POLICE POWER to prevent waste

Patterson Foundation Cont'd

- SCOTUS identifies and describes the correlative rights of property owners in a common source of supply AND the right of the legislature to protect those rights
- The UNIQUE properties of oil and gas create the need for the protection of correlative rights: one person's right to extract can destroy an adjacent owner's right to exploit his share of the common source of supply
 - *Ohio Oil Co. v. State of Indiana*, 177 U.S. 190 (1900).

Cost & Profit Sharing: Two Situations

- **Leased:**
 - Where the owner of the mineral estate has already contracted to develop the resource and, presumably, has received compensation.
- **Unleased:**
 - Owner of the mineral estate has not conveyed the right to develop the resource in exchange for compensation.

Situation #1: Leased

- Three Approaches
 - a.) Free Ride
 - b.) Risk Penalty
 - c.) Surrender of Working Interest

Situation #1: Leased

- a.) Free Ride
 - Non-consenting interest holder's share of the production costs are carried by the operator.
 - Successful well - only responsible for proportionate share of costs to drill.
 - Dry-hole – the holdout owes nothing to the operator
- State's featuring a free ride:
 - Alaska, Arizona, Indiana, and Missouri

Situation #1: Leased



- b.) Risk-Penalty
 - Holdout must compensate operator for proportionate share of costs plus an additional percentage as a penalty for holding out.
 - If total cost of drilling is \$1 million
 - Holdout's owns 50% of the acreage in unit, share of cost is \$500,000
 - Risk penalty of 200% = \$1 million.

Situation #1: Leased

- Model Oil & Gas Conservation Act of IOGCC suggests 300%.
 - Colorado: No penalty for “equipment beyond the wellhead connections,” 200% for costs of drilling
 - Texas: 200% for drilling & completion costs, only
 - Wyoming: 300% for traditional costs, 200% of any new equipment purchased
- Other States featuring Risk-Penalty:
 - Alabama, Louisiana, Michigan, Mississippi, Montana, Nebraska, Nevada, New Mexico, &

Situation #1: Leased

- c.) Surrender of Working Interest
 - Interest holder assigns working interest to the drilling party in exchange for a bonus payment, royalties, or both.
 - Avoids risk penalty.
 - Creates an overriding interest, but the conservation commission dictates the terms.
 - Oklahoma features Surrender of Working Interest as one of three “Options”

Oklahoma's Options Approach

- Non-consenting working interest holder may:
 - 1) participate in the cost of drilling and completing the well (second change to voluntarily pool)
 - 2) be treated as a carried interest, subject to a risk penalty
 - 3) surrender working interest in exchange for compensation
- Other states providing the options approach:
 - Arkansas, Idaho, Illinois, South Dakota, and West Virginia.

Situation #2

- Treatment of Unleased Interests
 - Must share in cost of production
 - Treated as a royalty interest until the costs are recovered from landowner's share of profits
 - Then receives a full 8/8's (100%) of profits from gas extracted
 - Value of gas substitutes for bonus payment

Situation #2

- Treatment of Unleased Interests

Colorado: Pays $1/8$ “royalty” to unleased landowner until costs of production are recovered. Then paid full $8/8$ share of production

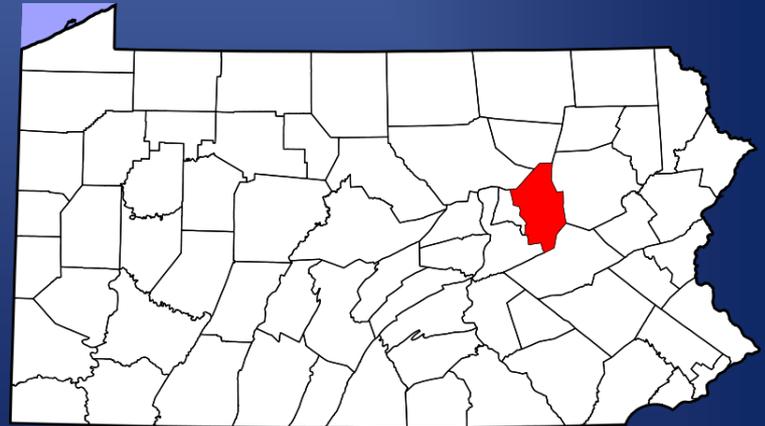
Utah: Pays the average royalty of other royalty owners in the unit until costs are recovered. Then pays full $8/8$ share of production

Other Important Points to Consider

- Who May Petition to Pool?
 - Mineral interest owners, neighboring interest holders, unleased landowners?
 - Minimum Acreage Required?
- To Whom do they Petition?
 - Texas Commission on Environmental Quality
 - Oklahoma Corporation Commission, Oil and Gas Division

Advantages for Landowners

- Snee Family of Columbia County, PA
- Unleased Landowners
- Neighbors have signed with Nat'l Fracture Corp. (NFC)
- NFC plans to drill along Snee's property line
- Rule of Capture allows NFC to send fractures across the border without signing lease with Snees
- Without compulsory pooling, Snee family has no recourse



Advantages for Landowners

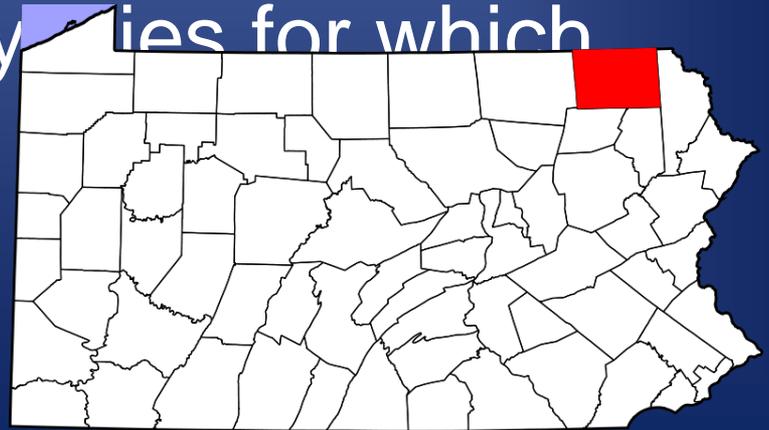
- With a compulsory pooling statute, the Snee family can petition the state to create a unit and pool the Snee interests with neighbors.
- If well is productive, Snees will get payments of $1/8$'s interest until their share of drilling costs are repaid out of the other $7/8$'s interest.
- Once repaid, Snees will get 100% of their proportionate share of the profits.

Advantages for Landowners

- Hynoski family from Susquehanna County, PA has leased their land to NFC.
- Hynoski family sacrificed maximum bonus payment for higher royalty: Value in the Gas!
- Neighbors leased to AFC. Well already spudded
- NFC will not drill because right next door.
- NFC & AFC, in the midst of a rivalry, refuse to work together.
- Under PA law, the Hynoskis have no recourse.

Advantages for Landowners

- Were there a compulsory pooling statute, the Hynoskis, as royalty owners, could petition the state to pool their land with their neighbors
- AFC & NFC would be forced to cooperate
- Hynoskis realize the royalties for which they negotiated.



Pooling is Controversial but . . .

- . . . is NOT policy to force some property owners to lease their land. ***Unleased landowners don't have to lease.***
- . . . is NOT a violation of personal property rights.
- . . . is an NOT exercise of “eminent domain for private use.”
 - ***Fair & just compensation must be provided.***
 - ***Patterson***
- . . . does NOT forces landowners to accept the state minimum royalty rate of of 12.5% and get no bonus payment.

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