



Overview of Subsurface Property Rights and Related Issues

Presented to the Citizens Advisory Council

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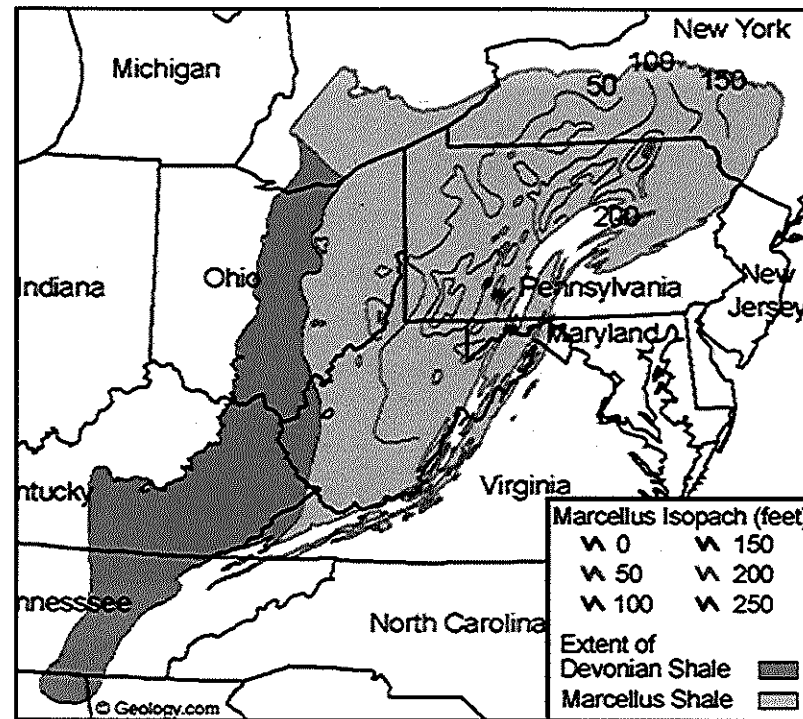
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Introduction

Why is it important to understand subsurface property rights?

Marcellus Shale:
An organic-rich shale underlying the Appalachians
Most prominently in Pennsylvania, West Virginia, Ohio, and New York

The rush to produce gas raises issues decided long ago or not previously decided with respect to property rights.



Overview

General Rules of Property Ownership

- Heaven/Hell Rule
- Three Estates in Land
- Rights of Separate Owners after Severance

Issues Peculiar to Oil/Natural Gas

- Ownership and the “Rule of Capture”
- The Oil and Gas “Lease” and Rights of Lessors and Lessees

Pooling Overview

- Definition
- Pooling under an Oil and Gas Lease and under Statutes
- Effects on Property Rights

What is the “ad coelum” doctrine?

Also known as the heaven-and-hell rule.

- Absent any conveyances, whosoever owns the surface, owns to the heavens above and the depths below.
- *Wheatley v. Baugh*, 25 Pa. 528 (1885).

What are the specific estates in property?

There are three. *Schuster v. Pa. Turnpike Comm'n*, 149 A.2d 447, 449 (Pa. 1959).

- Surface Estate – essentially the land
- Support Estate – so much of the subsurface rock, minerals, etc. that support the surface area to prevent subsidence
- Subsurface Minerals/Oil and Gas – Coal, other minerals, coalbed methane, oil and natural gas, and everything else.

Three estates in land can be severed and separately conveyed such that multiple owners can own different parts of the same “property”

What are the rights of surface owners, coal/mineral owners, and owners of the support estate?

- Property rights are created and conveyed by deed
 - Severance and conveyance of mineral estates
 - Waiver of subjacent support & corresponding right to subside

- Statutes and regulations have modified property rights
 - Exercise of police power to protect public health, safety and welfare, e.g., protected structures and features
 - Fifth Amendment protects against government taking of property without “just compensation”

- Other limitations on property rights
 - Trespass and nuisance law
 - Deed interpretation – What did the parties to the severance deed intend?

What are the rights of the surface owner versus the subsurface owner (or lessee)?

After severance of mineral/oil and gas estate (*Belden & Blake v. DCNR*, 969 A.2d 528 (Pa. 2009)):

- Implied easement on the surface to develop the subsurface estate
- Reasonably necessary to develop the surface estate (examples)
- “Due regard” to the surface owner.
- Surface owner cannot block access or prevent use.
- Surface owner cannot recover for damages to surface area as long as use is reasonable

What are some examples of “reasonably necessary” surface use?

Broadly defined in Pennsylvania. Many state courts agree on the following specifics with respect to oil and gas:

- Reasonable ***use of land for purposes of*** oil and gas exploration and production, including (a) storage tanks (b) power stations (c) other structures (d) pipes and pipelines (e) roads (f) residences for employees (g) salt water disposal pits (h) water flood programs (i) seismic testing; (j) impoundments
- Reasonable ***locations*** necessary to develop and operate the lease
- Right to ***use and consume surface or its products*** for oil and gas development, including (a) use of groundwater (b) removal of trees (c) use of clay from surface to construct access roads (d) right to store disposal water in a dry hole

What are ownership issues peculiar to oil and gas?

Consistent with heaven/hell rule, the owner of the surface owns all the oil and gas below.

- However, oil and gas is under pressure in reservoir rocks or gas bearing formation and can migrate beyond subsurface property boundary lines
- Ownership rights are therefore limited by the rule of capture:
- An owner/lessee of oil/gas who lawfully drills a well on his lease/property is not liable for drainage of the oil or gas from beneath adjacent lands. *Westmoreland & Cambria Nat'l Gas Co. v. De Witt*, 18 A. 724 (Pa. 1889).

What is an oil and gas “lease”?

An oil and gas “lease” is **not** a lease.

- A “lease” is treated as a conveyance of the oil and gas to the lessee. *Hamilton v. Foster*, 116 A. 50 (Pa. 1922).
- Typical oil and gas lease provides for a fixed primary term and a perpetual secondary term that lasts for “so long as” a specified event takes place (e.g., operations, production)
- The fee is “determinable” or defeasible because the lessee may lose the interests if it does not fulfill the requirements to perpetuate the lease. *Snyder Bros. Inc. v. Yohe*, 676 A.2d 1226 (Pa. Super. 1996).

What are the rights and property interests of lessors and lessees under an oil and gas “lease”?

Lessor's Interests:

- Royalties on production if, as, and when production occurs, free of the costs of production
- Possibility of reverter if lessee does not perpetuate the lease

Lessee's Interests

- The lessee owns all the oil/gas subject to the royalty interest (the “working interest” in the oil and gas)
- Surface rights (implied easement, right to use surface etc.)

What are the lessee's responsibilities?

Lessee's ultimate responsibility is to produce oil and gas so the lessor can receive royalties.

- During the primary term, the lessee generally must pay delay rentals or commence operations
- Before the expiration of the primary term, the lessee must be producing gas or engaging in other activities specified in the lease to keep it alive until production is obtained
- Lessee has ongoing express and implied duties during the life of the lease.

What is pooling?

Definition

- Combining multiple leased tracts to form a larger drilling and operations “unit”
- Allows the operator to develop a common source of supply and develop the oil or gas without regard to property boundaries

How does pooling affect property rights under a lease?

Pooling Clause

- Most oil and gas leases authorize the lessee to pool the leased property with other leased properties to form a unit
- Once pooled, any operations or production or other activities specified in the lease conducted anywhere on the unit are sufficient to perpetuate all the leases within the unit.
- In turn, all the lessors receive royalties whether or not a well is ever located on their property

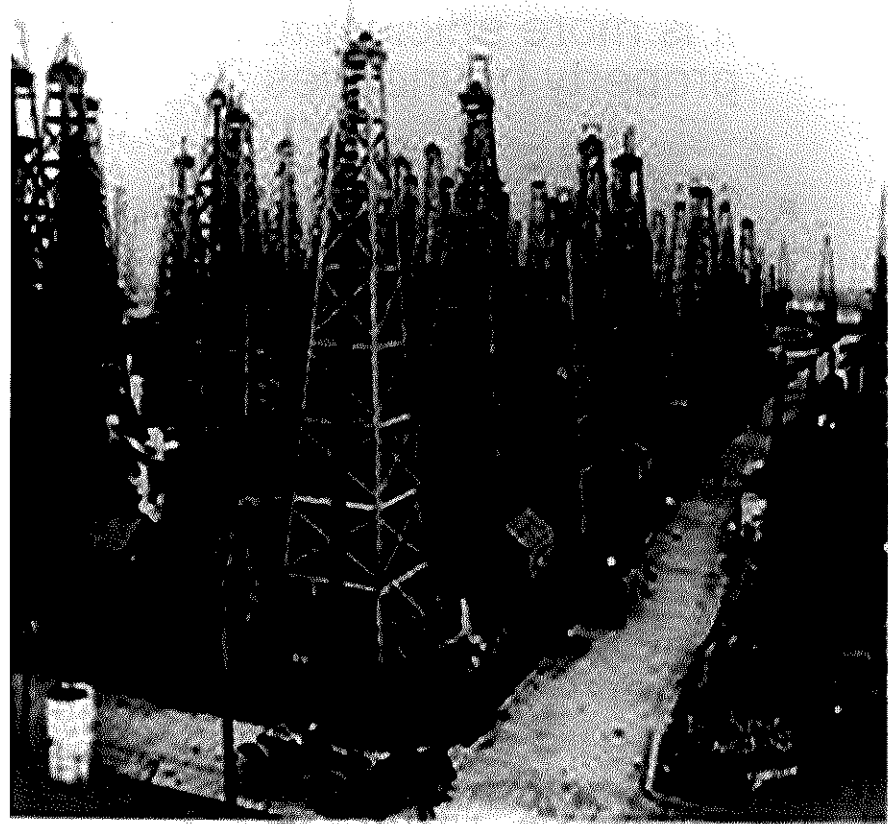
What are some potential benefits of pooling with respect to property rights?

- It is more efficient to develop the oil or gas without regard to property boundaries
- It is more economically beneficial for the lessor to receive royalties even if a well is never drilled on their property
- Significantly minimizes disturbance to surface owner's land
- Allows operator to drill fewer wells to efficiently drain the reservoir or produce gas from shale formations
- If there are fewer wells, there is less of a chance that reservoir pressures will be depleted and therefore production is maximized
- Cost effective drilling plans

What are conservation laws (pooling statutes)?

Recognizing the drawbacks of the rule of capture and the benefits of pooling, states have invoked their police powers to enact “conservation laws.”

- Designed to abolish the negative effect of the rule of capture.
- Prevent wasteful drilling and protect “correlative rights” of interest-holders whose lands overlay a common source of supply.
- Pooling statutes have been upheld as constitutional. *Hunter Co. v. McHugh*, 320 U.S. 222, 227 (1943).



How do pooling statutes affect property rights?

Integration of interests:

- The effect under most conservation laws is to “integrate” the interests of landowners and other operators in that unit and allocate among them the costs of and (eventually) the compensation from production.
- Otherwise, under the rule of capture, the oil and gas potentially would be drained from the properties by nearby operations, and oil and gas interest holders would otherwise receive nothing.
- However, integration is the most controversial part of pooling statutes because non-consenting landowners may be “forced” into a unit even if they have not leased (or don’t want to).

Questions?

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