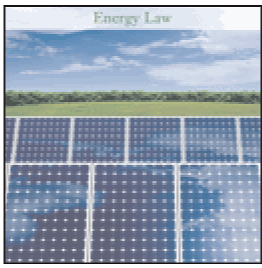
The Legal Intelligencer

Interpreting Oil and Gas Leases in Pa.'s Shale Gas Era

July 31, 2012
By George A. Bibikos



George Bibikos

An oil and gas lease is the fundamental document through which a producer obtains rights to explore for and develop oil, natural gas and other hydrocarbons. When landowners and production companies enter into oil and gas leases, they do so with business purposes in mind in the context of a unique industry.

As Pennsylvania courts have held, it is proper to understand the nature of the industry in which the lease arises in order to interpret the parties' agreement. This is particularly important in the shale gas era given that courts may be faced with lease disputes for many years to come.

To that end, this article provides a general overview of (1) an oil and gas lease and some of its general terms; (2) the general rules of lease interpretation; and (3) some of the characteristics of modern shale gas exploration and production operations.

What is an Oil and Gas Lease?

Although there are potentially infinite variations, a lease generally conveys oil and gas rights from the landowner to a producer, establishes the compensation for the lessor, sets the time frames within which the lessee must act to maintain its rights, describes the actions the lessee must undertake within those time frames and sets forth the circumstances that must exist before a lease can ever expire.

The Grant. In Pennsylvania, an oil and gas lease is a transfer of real property. See *Lesnick v. Chartiers Natural Gas Co.*, 889 A.2d 1282, 1284 (Pa. Super. 2005). The lessor transfers to the lessee a fee interest in the oil, gas and other hydrocarbons in place in exchange for a royalty interest on production. See *Brown v. Haight*, 255 A.2d 508, 510 (Pa. 1969). In addition, the lessee obtains an easement on the surface area to use for access to and development of the underlying oil and gas. The easement is either expressed in the lease or implied by law. See, e.g., *Belden & Blake Corp. v. Dep't of Conservation and Natural Res.*, 969 A.2d 528 (Pa. 2009).

The Term. A typical oil and gas lease has a habendum clause that provides for a primary term (e.g., three or five years) within which the operator must comply with certain requirements (e.g., pay delay rentals or commence operations) plus a period for "so long thereafter" as operations or production take place on the premises or lands pooled therewith. The "so long thereafter" clause creates a determinable fee in the oil and gas conveyed from the lessor to the lessee with a possibility of reverter if the lessee does not comply with the requirements of the habendum clause. See *Snyder Bros*. v. *Peoples Natural Gas Co*., 676 A.2d 1226, 1230 (Pa. Super. 1996).

The Effect of Pooling. Most leases also contain a pooling clause. A pooling clause can affect the primary and secondary terms of a lease. Generally, a pooling clause authorizes the lessee to combine its leased properties in order to create a larger drilling "unit." See *Snyder Bros*., 676 A.2d at 1228. All lessors in the unit receive the opportunity to participate in royalties from unit production based on the amount of property they have in the unit, even if operations never take place on their particular property or a well is located somewhere else on the unit. In turn, absent lease language to the contrary, any activities required by the habendum clause that take place anywhere on the unit extend all the leases in the unit beyond the primary term. See, e.g., *Fox v. Wainoco Oil and Gas Co.*, 64 Pa. D. & C.3d 439 (Crawford County C.P. 1986).

Establishing Production in Paying Quantities. Once the lessee establishes production in paying quantities from a well, the lease lasts for as long as it takes to extract all the oil or gas. See *Balfour v. Russell*, 31 A. 570 (Pa. 1895). A well is producing in paying quantities if it consistently pays any profit, however small, over the costs of operating the well. See *T.W. Phillips Gas and Oil Co. v. Jedlicka*, 42 A.3d 26 (Pa. 2012). If the well's profitability is marginal or sporadic over some period of time, the courts may consider the lessee's good-faith judgment in maintaining the well in an effort to re-establish its profitability.

Cessation of Production. Finally, absent lease language to the contrary, a complete, permanent and intentional cessation of production during the secondary term may terminate the leasehold. If permanent cessation occurs, some courts have held that a tenancy at will is created that can be terminated by either party upon notice. See *White v. Young*, 186 A.2d 919 (Pa. 1963); *Cassell v. Crothers*, 44 A. 446 (Pa. 1899). However, a temporary cessation of production should not terminate the lease. See *Cole v. Phila. Co.*, 26 A.2d 920 (Pa. 1942).

How Do Courts Interpret Oil and Gas Leases?

Given the unique characteristics of a lease and the relationship it creates, the interpretation of its terms and conditions to resolve disputes over the rights and obligations of the parties is no insignificant task. The stakes are high and valuable property rights are at issue. The courts have several tools available to them:

Intent of the Parties. The courts' fundamental goal in interpreting any contract — including an oil and gas lease — is to effectuate the intent of the parties based on the words in the agreement. See *Szymanowski v. Brace*, 987 A.2d 717, 720 (Pa. Super. Ct. 2009). If words in the lease have acquired a special meaning in the context of an industry, as in the case of the oil and gas industry, courts should rely on that special meaning. See, e.g., *Jacobs v. CNG Transmission Corp.*, 332 F. Supp. 2d 759, 779 (W.D. Pa. 2004).

Characteristics of the Business. Along those lines, Pennsylvania courts have interpreted oil and gas leases for 120 years "with a due regard to the known characteristics of the business." See *McKnight v. Manuf. Natural Gas Co.*, 23 A. 164, 166 (Pa. 1892); *Kleppner v. Lemon*, 35 A. 109 (Pa. 1896) ("The case must therefore depend upon the proper interpretation of the contract, aided by the necessities and usages of the business to which it relates.") In other words, in addition to the usual rules of contract interpretation, courts interpret leases in the context of the oil and gas business to determine the rights and obligations of the parties.

The *McKnight* Case. In *McKnight*, for example, the lessor sued the production company for breach of an implied covenant to develop after the lessee discovered gas. In that case, the lease provided for a one-eighth royalty on production from oil. If the lessee did not discover oil but discovered gas at sufficient pressures to justify marketing off the premises, the lessor would be entitled to a one-eighth royalty on the net proceeds of the sale. The lessee did not discover oil but discovered gas and produced for several years until the well broke down and the lessee abandoned the operations.

The lessor contended that the lessee had an implied obligation to further operate the premises as a gas field given that the lessee previously discovered and produced gas. The Pennsylvania Supreme Court held that the lessee's obligations must be determined in the context of the gas business. It described the differences between oil production and gas production to explain that sinking additional gas wells may have been imprudent given that additional wells might decrease the pressures necessary to push the gas through pipelines off the lease and ultimately to market.

After describing the characteristics of gas production, the court concluded that the "well-known facts peculiar to the production of gas must be taken into account in the construction of leases for gas purposes." The court reversed and remanded the case because "the mistake of the court below was in failing to take account of, and to read into the contract between the parties, the peculiar nature and characteristics of the business of producing and transporting gas, which the parties themselves well understood, and which their contract shows were before their minds when it was entered into."

Characteristics of the Shale Gas Industry

From the perspective of parties to an oil and gas lease, some of the key characteristics of the modern shale gas industry that are important to understand include the following:

• **Preliminary Work.** The life cycle of any well targeting a shale formation begins with preliminary work, such as conducting seismic testing to examine the subsurface of a geographic area that includes the leased properties; obtaining necessary regulatory approvals for drilling the well and constructing the well pad; surveying the property; siting well pad and well locations; staking well pad sites; and developing a drilling and operations plan.

• **Well Pad Construction.** Once the production company decides on the location of the wells, it constructs the well pad. That involves clearing the well pad area; mobilizing earth-moving equipment to the site; engaging in earth-moving activities to construct access roads and well pads; building impoundments for storing water; building other structures; and engaging in other construction activities.

• **Horizontal Drilling and Hydraulic Fracture Stimulation.** The key features that set the industry apart from conventional gas operations are horizontal drilling at greater depths and the use of hydraulic fracture stimulation techniques to crack and prop open the low-permeability shale formation to release the hydrocarbons. Operations for the production of shale gas center around these activities. Horizontal drilling and well completion operations include mobilizing rigs to the site, drilling, casing and cementing operations and hydraulic fracture stimulation activities, and other related activities that are necessary to complete a well and establish production.

• **Post-production Activities.** Given that shale gas production in Pennsylvania is still growing, the supply chain is also still growing to create support activities like gathering, compression, dehydration and transmission facilities to collect, treat, transport and market the gas. The cost and availability of the pipeline infrastructure may inform lease obligations with respect to transporting, treating and marketing production and the ability of lessors and lessees to share in those costs.

Although this is not an exhaustive list of all the characteristics of the shale gas industry, these are some of the common circumstances surrounding shale gas operations that may be considered when resolving disputes.

Fundamentally, an oil and gas lease is a business transaction entered into against the backdrop of the exploration and production industry. In light of that, the realities of the industry in the shale gas era are important to understand in order to foster the business purposes intended by both parties to the lease.

George A. Bibikos *is a senior associate in the Harrisburg, Pa., office of* ***K&L Gates*** *and an adjunct professor of oil and gas law at Widener University School of Law. He represents major oil and gas companies, large independents and midsize producers operating in the Marcellus and Utica shale plays. He can be reached at 717-231-4577 or* ***george.bibikos@klgates.com***