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FORCED POOLING IN THE MARCELLUS SHALE: WHERE IS PENNSYLVANIA HEADED?

Compulsory or "forced" pooling statutes are common in oil and gas producing states and require landowners and/or operators in an area that has been designated as a spacing unit to participate jointly in the development of the mineral interests in that unit. Similar to an eminent domain or condemnation proceeding, forced pooling permits landowners or operators to apply directly to the regulatory body with jurisdiction over oil and gas operations in the area to compel all mineral interests in a designated spacing unit to participate in its development.

It thus prevents a landowner from hindering or delaying the unit's development by arbitrarily or opportunistically refusing to lease his mineral rights to the operator. It also prevents the operator from depriving a landowner of his right to an equitable share of the oil and gas under his land by unfairly excluding his mineral interests from the unit. Accordingly, a forced pooling statute can be an effective tool for maximizing oil and gas recovery, preventing waste and land disturbance, and providing a fair economic result to all parties.

Pennsylvania's existing forced pooling statute does not apply to the Marcellus Shale. To remedy this situation, House Bill No. 977 was introduced in the Pennsylvania legislature in 2009. The bill would have extended to the Marcellus the application of the state's existing forced pooling statute (the Oil and Gas Conservation Law), which currently applies only to wells that extend 3,800 feet below the surface and into the Onondaga horizon. The bill was referred to the Environmental Resources and Energy Committee in the spring of 2009 but was dealt a blow in early 2010 when some of its original sponsors withdrew their support, citing concerns that landowners would be forced to lease against their will.[1]

1 Anya Litvka, "Marcellus Shale Leaders to Push Pennsylvania on Drilling Rights Issues," *Pitt. Bus. Times*, Feb. 5, 2010.

Subsequently, several lawmakers have announced their plans to introduce a competing bill.[2] Although no draft of this bill has been publicly released, one of the potential cosponsors has outlined some of his ideas for a new forced pooling scheme. Governor Ed Rendell had thrown himself into the debate, announcing that he would not sign any bill that did not contain a required minimum distance between wells and did not give "full, fair" compensation to landowners.[3] Currently, however, no action can be taken regarding forced pooling until after the inauguration of Governor-elect Tom Corbett.[4] Corbett apparently favors forced pooling but has not announced any specifics of his ideas on the issue.[5]

Although there are some understandable concerns with forced pooling, the benefits of a well-drafted forced pooling statute would outweigh the drawbacks. Pennsylvania now has the opportunity to extend the application of its forced pooling statute while at the same time improving the statute by looking to the forced pooling statutes of other states to see what works and what does not. Pennsylvania lawmakers should take the time to ensure that the final legislation provides a just and efficient means to enable forced pooling in the Marcellus and not lose sight of the overall goals of such legislation, which include providing fairness to landowners and protecting the environment while fostering strong economic growth in Pennsylvania.

WHY FORCED POOLING?

The status quo is unacceptable for landowners and operators who have a stake in the Marcellus Shale because existing law fails to protect landowners' rights and the state's environment. According to the Pennsylvania Department of Environmental Protection, for a well in the Marcellus (*i.e.*, a well that is not in a coal area and not subject to the Oil and Gas Conservation Law), there are "no restrictions on well location in proximity to tract boundaries."

In addition, the Rule of Capture applies, meaning that the operator of such a well can freely drain the oil and gas from under neighboring tracts and "cannot be compelled by law to pay rents or royalties to owners of neighboring oil or gas tracts."[6] The owner of the neighboring tract could try to enter into a pooling agreement, but what if no voluntary agreement can be reached? The landowner's only recourse would be to drill an offset well, which would unfairly burden the landowner, especially those who own small tracts of land and may not have the financial or technical resources to drill a well to take full advantage of their mineral rights. People who oppose forced pooling object to the intervention of the state in the affairs of landowners and operators, complaining that such a statute "infringes upon individual property rights."[7] In order to mitigate the harsh impact of the Rule of Capture, however, some state regulation is clearly needed. This is why all major oil and gas producing states except Kansas now have forced pooling statutes.[8]

Likewise, although there are legitimate concerns regarding the environmental impact of drilling oil and gas wells, a forced pooling statute can help alleviate, not exacerbate, these concerns. Environmental groups have complained that forced pooling would serve only for "conserving the gas, not the land or the environment."[9] These concerns are misplaced. A forced pooling statute would result in the drilling of fewer wells than under existing law because it would restrict where wells could be drilled and eliminate the need for adjoining landowners to drill offset wells solely to defend their mineral rights. Drilling fewer wells protects the land and the environment because it reduces the number of locations at which a potential environmental impact could occur.

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2 Laura Legere, "'Forced Pooling' Legislation for Gas Industry Planned in Pennsylvania," *Scranton Times Trib.*, July 11, 2010.
3 Marc Levy, "Rendell Would Insist on Environmental, Compensation Requirements before Signing 'Pooling' Law," Assoc. Press, August 11, 2010.
4 Elizabeth Skrapits, "Gas 'Pooling' Law Unlikely this Year," *Citizen Standard* (Valley View, PA), October 11, 2010.
5 Amy Worden, "Corbett Inaugural to Include Gas Drilling Protest," *Inquirer* (Philadelphia), December 8, 2010.
6 *Commonwealth of Pennsylvania, Department of Environmental Protection, Landowners and Oil and Gas Leases in Pennsylvania*, Fact Sheet (November 2010), available at http://www.dep.state.pa.us/ dep/deputate/minres/oilgas/factsheets.htm.
7 *See* Rory Sweeney, "Reps Withdraw Drill Bill Support over 'Forced Pooling,'" *Times Leader* (Wilkes-Barre, PA), Jan. 27, 2010.
8 Bruce M. Kramer, "Basic Conservation Principles and Practices: Historical Perspectives and Basic Definitions, Federal Onshore Oil and Gas Pooling and Unitization," *Rocky Mtn. Min. L. Inst.* (2006).
9 Legere, *supra* note 2.

HOUSE BILL NO. 977

House Bill No. 977 would apply the existing forced pooling statute, the Oil and Gas Conservation Law, to the Marcellus Shale formation. Under the existing statute, the first step that an operator takes to force pooling in Pennsylvania is to apply to the Oil and Gas Conservation Commission for an order establishing a designated spacing unit.[10] After the spacing unit has been established, the operators in that unit can apply for a forced pooling or "integration" order covering the unit.[11] The integration order must be "just and reasonable" and be issued after 15 days' notice and a hearing.

The statute provides three choices to nonparticipating operators who may be forced to join the spacing unit under the terms of the integration order:

- to participate in the spacing unit by paying their share of the "reasonable actual cost" plus a "reasonable charge for supervision and for interest on past due accounts";
- to sell their leasehold interests to the participating operators for reasonable consideration, as agreed upon or as determined by the commission; and
- to participate on a limited or carried basis upon terms determined by the commission to be just and reasonable.

For lands that have not been leased, the owner of the land is considered an "operator" as to 7/8 and a royalty owner as to 1/8. This means that an unleased landowner who is force pooled would receive a 1/8 royalty plus compensation under one of the three alternatives described above.

PROPOSED ALTERNATIVE LEGISLATION

The draft of the bill for the newer legislation, to be called the "Conservation Pooling Act," is not yet publicly available, but it has been described by potential cosponsor Representative Garth Everett in news reports and on his web site.[12] The details of the bill are still being worked out, but the legislation might:

- require that an operator have leases covering a certain percentage of the land in the proposed spacing unit before applying for a pooling order (in the original draft of the legislation, the percentage was set at 75 percent, but Representative Everett has subsequently stated that this should be a "vast majority," *i.e.*, 90 percent to 95 percent);
- specify a penalty of 400 percent for those nonparticipating operators who elect to participate on a carried basis;
- require that an operator have made a "good faith" effort to negotiate a lease; and
- protect unleased landowners from any surface impacts.

The legislation would also change how units are drawn to ensure that the minimum necessary number of wells are drilled and no landowners are left out; provide for an appeals process for those who are force pooled; and specify minimum acreage for units and setbacks from unit borders.

ANALYSIS OF FORCED POOLING PROPOSALS

House Bill No. 977 and the proposed Conservation Pooling Act each have strengths and weaknesses. A final statute should incorporate the strong aspects of each.

Minimum Percentage Leased Requirement. Under House Bill No. 977, there would be no required minimum percentage acreage leased for an operator to file a forced pooling application. In contrast, the Conservation Pooling Act might require somewhere in the range of 75 percent to 95 percent of a unit to be leased to the same operator before that operator could force pool. A compromise somewhere in the middle of these two extremes is preferable.

Requiring a large majority, whether 75 percent or 95 percent, of land in a spacing unit to be leased to an operator before that operator can apply to force pool is an unnecessary limitation. Given the benefits that a forced pooling statute would confer, any forced pooling statute enacted in Pennsylvania should not contain requirements that result in the inability

10 58 Pa. Stat. Ann. § 407 (2010).
11 *Id.* § 408.
12 *See* Legere, *supra* note 2, and Garth Everett, "Marcellus Pooling Legislation," Aug. 30, 2010, *available at* repeverett.com/MarcellusLeg.aspx.

of an operator to use forced pooling. There is no reason to enact a forced pooling statute that has requirements so onerous that the practical reality is that almost no one will be able to take advantage of it.

Many forced pooling statutes—those in Oklahoma, New Mexico, and Wyoming, for example[13]—do not require any minimum percentage of land to be leased to an operator before it can apply to force pool. This means that an operator with only a very small percentage of ownership could force pool an entire unit. Although the lack of a minimum percentage for forced pooling may seem problematic, these statutes are beneficial to both oil companies and landowners. For example, the chairman of the Coalition of Oklahoma Surface Mineral Owners Inc. has said that the Oklahoma statute is a "good law" because "it enhances drilling opportunities."[14] He said, "We can't lose sight of the fact that if they don't drill the well, we're not going to make a dime and neither are the oil companies." (Although generally supportive of the statute, he notes that there is a concern with the ability of operators to pool large areas at one time and with the lack of clarity in defining what costs can be charged to those who are force pooled.)

Other states require a certain percentage to be leased by an operator before that operator can force pool. In Kentucky, for instance, an operator cannot force pool without the consent or agreement of owners of 51 percent of the relevant tract.[15] The Kentucky statute specifies that any landowner who cannot be located will be presumed to have consented. This 51 percent requirement would impose some burden on operators, but it is a more reasonable goal than 75 percent to 95 percent.

Risk Penalty. The proposed conservation pooling act would specify that a nonparticipating operator or unleased landowner who chose to participate on a limited or carried basis would not receive payments until 400 percent of the actual costs allocable to that operator had been recouped. In contrast, House Bill No. 977 does not specify a set "risk penalty," and under the current Pennsylvania regulations, the risk penalty is set at 200 percent.[16] A risk penalty is not a "penalty" per se but is meant to reimburse the operator for the risks that it faces in drilling, primarily the risks of drilling dry or marginally productive wells. The ideal statute would either specify a risk penalty that accurately reflects the true risks of drilling in the Marcellus or leave the risk penalty to be set on a case-by-case basis by the state regulatory authority charged with administering the law.

Bruce Kramer, formerly a professor at Texas Tech Law School, has argued that the risk penalty should be determined on a case-by-case basis. According to Professor Kramer, a "fixed risk penalty … is inconsistent with the purpose of imposing a risk penalty because the risks change from well to well."[17]

While Kramer's view makes sense, in practice it may turn out to be difficult for the state entity charged with administering the law. The Pennsylvania Oil and Gas Conservation Commission, the entity that under the statute is to issue the pooling orders, is currently nonexistent.[18] This means that the regulators charged will have no past experience in this type of analysis, and it may be preferable to have a statutory fixed rate. In addition, it is important that the statute spell out exactly what costs can be charged to those who are force pooled.

Good Faith Offer. House Bill No. 977 does not require an operator to make a good faith offer to nonparticipating lessees before applying to force pool, while the Conservation Pooling Law allegedly would require such an offer. The problem with such a requirement is that what constitutes a "fair and reasonable" or "good faith" offer is open to interpretation.

It may seem that there is no reason not to have such a requirement. After all, in a perfect world, everyone would

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13 *See* Okla. Stat. tit. 52, § 87.1(a) (2010); N.M. Stat. § 70-2-17 (2010); Wyo. Stat. Ann. § 30-5-109 (2010).
14 Adam Wilmoth, "Forced Pooling Law Boosts State's Natural Gas Economy," *Daily Oklahoman*, Feb. 17, 2006.
15 Ky. Rev. Stat. Ann. § 353.630 (2010).
16 *See* 25 Pa. Code § 79.31(3) (2010).
17 Kramer, *supra* note 8, at 266.
18 House Environmental Resources and Energy Committee Chairman Camille "Bud" George's May 2010 Update: Special Update on Severance Tax & Forced Pooling, *available at* http://www.pahouse.com/EnvResources/ documents/Forced__pooling__Severnace__tax__ERE__Committee__May__Update.pdf.

enter into voluntary agreements and no one would have to force pooling. Interestingly, though, such a requirement is present in most other states' forced pooling statutes. Texas is one of the only states to have such a requirement, and its forced pooling statute is considered "cumbersome and often ineffective."[19]

Surface and Environmental Impacts. The Conservation Pooling Law, unlike House Bill No. 977, would explicitly prohibit an operator who has forced pooled from drilling on the property of an unleased landowner. Protecting unleased landowners from surface damage is a reasonable way to make the statute more acceptable to the state's landowners, without placing unnecessary burdens on operators. The utilization horizontal drilling will also reduce surface damage.[20]

Likewise, there is no reason why a forced pooling statute could not contain other provisions to protect unleased landowners, such as an explicit requirement that drillers will provide compensation and remediate in the event that some type of contamination of the surface or the water underlying a property were to be contaminated by drilling or completion. After all, such a forced pooling statute has as one of its purposes the protection of the environment.

CONCLUSION

A good forced pooling statute should contain a clear time frame for the administrative process and avoid vague terminology that may lead to legal battles. To that end, Pennsylvania lawmakers should review carefully the forced pooling statutes of other states, taking into account not only the interests of landowners and industry, but also the environmental effects. There is, however, no simple way to determine the ideal statute, and legislators will have to make value judgments and weigh competing interests in determining the final statute. Although there is certainly room for debate, it seems that an effective statute would have the following characteristics: it would not require a large majority to be leased by an operator before that operator could apply to force pooling; it would set a risk penalty that accurately reflects the true risks of drilling in the Marcellus; it would not require a "good faith" offer to pool; and it would minimize surface impacts on unleased lands.

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19 H. Phillip Whitworth, Jr., "Pooling and Unitization before the Texas Railroad Commission, Onshore Oil and Gas Pooling and Unitization," *Rocky Mtn. Min. L. Inst.* (1997).
20 Skrapits, *supra* note 4.