



JONES DAY
COMMENTARY

PENNSYLVANIA OIL AND GAS LEASE ACT ENHANCES ROYALTY TRANSPARENCY AND AUTHORIZES LIMITED CONTIGUOUS LEASE INTEGRATION

On July 9, Governor Tom Corbett signed Senate Bill 259 into law. This legislation, which takes effect 60 days after enactment, requires specific minimum information to accompany royalty payments in Pennsylvania and authorizes the operator, in limited circumstances, to integrate contiguous leases to develop them jointly by horizontal drilling.

ROYALTIES

Titled the “Oil and Gas Lease Act,” SB 259 (hereinafter “the Lease Act”) reconstructs what is commonly known as Pennsylvania’s Guaranteed Minimum Royalty Act, 58 Pa. Stat. § 33 et seq., which requires oil and gas leases to provide a minimum one-eighth royalty. The Lease Act does not alter the minimum statutory one-eighth royalty requirement; rather, its payment information provisions mandate a level of transparency with respect to the calculation and determination of royalties. Specifically, payments for

production to interest owners must, at a minimum, include on the check stub or an attachment the following information, unless this information is otherwise provided on a regular basis:

- (1) A name, number, or combination of name and number that identifies the lease, property, unit, or well or wells for which payment is being made; and the county in which the lease, property or well is located.
- (2) Month and year of gas production.
- (3) Total barrels of crude oil or number of Mcf of gas or volume of natural gas liquids sold.
- (4) Price received per barrel, Mcf, or gallon.
- (5) Total amount of severance and other production taxes and other deductions permitted under the lease, with the exception of windfall profits tax.

- (6) Net value of total sales from the property less taxes and deductions from paragraph (5).
- (7) Interest owner's interest, expressed as a decimal or fraction, in production from paragraph (1).
- (8) Interest owner's share of the total value of sales prior to deduction of taxes and deductions from paragraph (5).
- (9) Interest owner's share of the sales value less the interest owner's share of taxes and deductions from paragraph (5).
- (10) Contact information, including an address and telephone number.

As noted above, one aspect of the new royalty disclosure requirements is the furnishing of information regarding deductions permitted under the lease. In *Kilmer v. Elenco Land Servs., Inc.*, 990 A.2d 1147 (Pa. 2010), the Pennsylvania Supreme Court rejected an attempt by landowner-lessors to void an oil and gas lease that called for the lessors to receive one-eighth of the sales proceeds after deducting the lessors' proportionate one-eighth share of post-production costs. The court deemed this "net-back" method for calculating royalties at the wellhead value to be in compliance with the Guaranteed Minimum Royalty Act, and oil and gas leases often contemplate the sharing by the lessor and lessee of post-production costs associated with bringing the gas from the wellhead to market.

LIMITED INTEGRATION OF CONTIGUOUS LEASES FOR HORIZONTAL DRILLING

In a section labeled "apportionment," the Lease Act permits the operator to integrate multiple contiguous leaseholds to develop them jointly by horizontal drilling unless expressly prohibited by the terms of a lease. For royalty calculation purposes, in the absence of an agreement, the owner of each lease is entitled to production in such proportion as the operator "reasonably determines to be attributable to each lease."

While this provision will facilitate more efficient development activities with less surface disturbance, the legislation is limited in scope in that it applies only to leased mineral interests where the lease terms are silent regarding the

right to include a particular lease with other leaseholds for development purposes. Many other oil-and-gas-producing states have compulsory pooling laws applicable to shale development activities, but the Lease Act stops far short of such a mechanism for Marcellus Shale exploration and development in Pennsylvania. While Pennsylvania's Oil and Gas Conservation Law, 58 Pa. Stat. § 401 et seq., authorizes compulsory pooling, it is limited in application to wells penetrating the Onondaga Horizon and to wells that are more than 3,800 feet deep in areas where the Onondaga is within 3,800 feet of the surface. This pooling provision has rarely been used to date, and because the Onondaga underlies the Marcellus Shale, the Oil and Gas Conservation Law is presumed not to apply to wells drilled to produce the Marcellus Shale.

DIVISION ORDERS

The Lease Act also clarifies the relationship between oil and gas leases and division orders. In the event a division order conflicts with the corresponding oil and gas lease, the oil and gas lease takes precedence. The Lease Act provides that a division order "may not amend or supplement the terms and conditions of an oil and gas lease."

Stakeholders interested in learning more about the Lease Act and its effects on oil and gas activities in Pennsylvania should contact experienced oil and gas attorneys for assistance with their questions.

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