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## SHORTCOMINGS OF THE 2013 AMENDMENTS TO PENNSYLVANIA'S GUARANTEED MINIMUM ROYALTY ACT AND THE NEED TO BETTER PROTECT ROYALTY OWNERS' RIGHTS

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# SHORTCOMINGS OF THE 2013 AMENDMENTS TO PENNSYLVANIA’S GUARANTEED MINIMUM ROYALTY ACT AND THE NEED TO BETTER PROTECT ROYALTY OWNERS’ RIGHTS

Wesley S. Speary\*

## I. INTRODUCTION

In the summer of 2013, the Pennsylvania General Assembly (“General Assembly”) passed Senate Bill No. 259 (“S.B. 259”), also referred to as Act 66 of 2013 (“Act 66”), which amended Act 60 of 1979, also known as the Guaranteed Minimum Royalty Act (“GMRA”). Former Pennsylvania Governor Tom Corbett signed Act 66 on July 9, 2013.<sup>1</sup> It became effective on September 9, 2013.<sup>2</sup> While Act 66 partially addressed reporting issues regarding Pennsylvania’s natural gas royalty payments,<sup>3</sup> the Act did not do enough to solve the ongoing royalty payment

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\* J.D., 2015, *magna cum laude*, Order of the Coif, Environmental Law Certificate, William H. Eckert Writing Award, Second Place: *ISIS and Its Failed Claim of Pre-Modern Governance*, University of Pittsburgh School of Law. M.P.A., 2015, Dean’s Award Co-recipient, Council of Scholars, University of Pittsburgh Graduate School of Public and International Affairs. Sincere appreciation and thanks to my grandfather, Floyd Williamee, for long discussions on social and environmental issues, and to my mother, Mary Jackson, for her steady support throughout everything. Additional thanks to my legal writing professor and academic advisor, Teresa Kissane Brostoff, and to Associate Dean of Students, Kevin Deasy, for helping me to navigate through and succeed in law and graduate school.

<sup>1</sup> *Pennsylvania’s New Pooling Law*, STATEIMPACT: PA., <http://stateimpact.npr.org/pennsylvania/tag/pooling> (last visited Jan. 20, 2014).

<sup>2</sup> Michael L. Krancer & Margaret Anne Hill, *Shale Gas Leasing—Achieving Clarity, Transparency and Conservation: Recent Actions of the Pennsylvania Supreme Court and Legislature*, 84 PA. B. ASS’N Q. 93, 96 (2013).

<sup>3</sup> 58 PA. CONS. STAT. ANN. § 35.2 (West 2013).

problem.<sup>4</sup> In addition to its inadequate remedy to the royalty issue, Act 66 also created new concerns by allowing the pooling of natural gas leases.<sup>5</sup>

Under both the original<sup>6</sup> and amended GMRA,<sup>7</sup> in order to be valid, a gas lease must guarantee that a lessee will pay a lessor “at least one-eighth royalty of all oil, natural gas or gas of other designations removed or recovered from the subject real property.”<sup>8</sup> Partially in response to interest owners’ concerns regarding lack of clarity in natural gas lease royalty payments, the General Assembly amended the GMRA to provide clearer definitions and to require lessees to provide explanations of payment determinations.<sup>9</sup> Specifically, the Act 66 amendments to the GMRA “add[ed] definitions; provid[ed] for payment information to interest owners for accumulation of proceeds from production, for apportionment and for conflicts; and ma[de] editorial changes.”<sup>10</sup> However, the amendments do not define the term “royalty,” nor do they prevent lessees from making deductions that effectively reduce royalty payments below the expected one-eighth minimum.<sup>11</sup> Instead, Act 66’s language statutorily recognizes the ability of gas companies to make deductions through leases.<sup>12</sup> Specifically, subsection 5 of section 35.2 only requires lessees to regularly report total deductions.<sup>13</sup> Additionally, the

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<sup>4</sup> Compare 58 PA. CONS. STAT. §§ 33.1–35.4 (West 2013), with *Senate Bill No. 259, Session of 2013, Royalty Stub Transparency Issues and Post-Production Costs from the Development of Natural Gas: Hearing Before the Pa. S. Envtl. Res. and Energy Comm.*, 197th Gen. Assemb., Reg. Sess. (Pa. 2013) [hereinafter *SEREC Hearing*], available at <http://environmental.pasenategop.com/2013/06/27/public-hearing> (hearing testimony regarding excessive and unclear deductions from royalty payments) (video recording).

<sup>5</sup> *Pennsylvania’s New Pooling Law*, *supra* note 1 (citing 58 PA. CONS. STAT. ANN. § 34.1 (West 2013)) (quoting the National Association of Royalty Owners’ (“NARO”) Pennsylvania Chapter (“NARO-PA”)).

<sup>6</sup> 58 PA. CONS. STAT. ANN. § 33 (West 1979), *repealed by* Act 66 of 2013, P.L. 473, No. 66, § 1, 58 PA. CONS. STAT. ANN. §§ 33.1–35.4 (West 2013).

<sup>7</sup> 58 PA. CONS. STAT. ANN. §§ 33.1–35.4 (West 2013).

<sup>8</sup> *Id.* § 33.3.

<sup>9</sup> See *SEREC Hearing*, *supra* note 4.

<sup>10</sup> S.B. 259, 197th Gen. Assemb., Reg. Sess. (Pa. 2013) (enacted) (capitalization removed), available at <http://www.legis.state.pa.us/CFDOCS/Legis/PN/Public/btCheck.cfm?txtType=PDF&sessYr=2013&sessInd=0&billBody=S&billTyp=B&billNbr=0259&pn=1290>.

<sup>11</sup> See 58 PA. CONS. STAT. ANN. §§ 33.1–35.4 (West 2013).

<sup>12</sup> See *id.* § 35.2(5).

<sup>13</sup> *Id.*

amendments contain no provisions for legal consequences or remedies if lessees fail to report the deductions.<sup>14</sup>

This Note discusses whether Act 66 properly and adequately protects royalty owners' rights and expectations. Further, this Note focuses primarily on the royalty payment issue, providing a slightly less detailed review of the lease pooling issue. Part II provides a brief overview of gas rights and leasing, the Marcellus Shale formation, and Pennsylvania's regulation of the natural gas industry. Part III discusses the original GMRA, relevant case law, and royalty owners' concerns regarding royalty payments. Part IV analyzes the shortcomings of Pennsylvania's legal decisions and developments regarding property owners' interests. Part V discusses proposals to improve legal protection of royalty owners' interests, including proposed and suggested definitions for natural gas royalties. Finally, Part VI provides a brief summary and conclusion.

## II. NATURAL GAS PRODUCTION: RIGHTS, MARCELLUS SHALE, AND PENNSYLVANIA

### A. *Regulatory Changes to the Structure of the Natural Gas Industry*

Before the 1980s, natural gas producers explored for natural gas, maintained gas wells, and sold gas at the wellhead to pipeline companies at federally regulated prices.<sup>15</sup> Pipeline companies then refined the gas into a marketable form, transported that refined gas to market, and sold it to local distribution companies at value-added prices that accounted for refining and transportation costs.<sup>16</sup> Producers calculated landowner royalty payments based on the price they initially received at the wellhead, not the price at which pipeline companies sold the marketable gas.<sup>17</sup> As a result, when the General Assembly passed the GMRA in 1979, the sale at the wellhead served as the only point of sale for calculating royalties.<sup>18</sup> In the 1980s, fears of pipeline monopolies led the federal government to require pipeline companies to decouple transportation services from sales services "and, in effect, provide common-carriage services to others, including gas producers, who wished

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<sup>14</sup> *See id.* §§ 33.1–35.4.

<sup>15</sup> *Kilmer v. Elexco Land Servs., Inc.*, 990 A.2d 1147, 1155 (Pa. 2010).

<sup>16</sup> *Id.*

<sup>17</sup> *Id.*

<sup>18</sup> *Id.*

to transport natural gas.”<sup>19</sup> That change to the gas industry’s structure impacted how lessee producers currently calculate natural gas royalty payments.<sup>20</sup>

*B. Gas Rights and the Role of Leases in Natural Gas Production*

The United States is unique in the fact that people privately own mineral rights.<sup>21</sup> In most other countries, the government owns and engages in mineral extraction.<sup>22</sup> Typical U.S. landowners do not conduct gas extraction or production because they lack the necessary expertise and resources, instead leasing their rights to people who have the requisite expertise and resources.<sup>23</sup> Because of the structure of U.S. mineral rights and the private nature of leases, leases take on “potentially infinite variations.”<sup>24</sup> When discussing lease variations, attorney and practitioner George A. Bibikos once described a gas lease as the “heart of [the] relationship” between a property owner and a lessee and a means to realize royalties.<sup>25</sup>

Under both the old, regulated structure of the natural gas industry and the current, deregulated structure, the lessee natural gas company bears one hundred percent of the production costs, essentially consisting of everything needed to extract the gas from the wellhead, and one hundred percent of the risk of loss during production.<sup>26</sup> After deregulation of the natural gas industry, production companies began investing in infrastructure and midstream, or post-production, activities.<sup>27</sup> Post-production costs, consisting of everything needed to get the gas from the wellhead to the point of sale, became subject to contract and negotiation.<sup>28</sup> Natural gas companies began including special royalty provisions in leases to

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<sup>19</sup> *Id.*

<sup>20</sup> *See id.*

<sup>21</sup> *SEREC Hearing, supra* note 4 (statement of G.A. Bibikos).

<sup>22</sup> *Id.*

<sup>23</sup> *Id.*

<sup>24</sup> *Id.*

<sup>25</sup> *Id.*

<sup>26</sup> *Id.*

<sup>27</sup> *Id.*

<sup>28</sup> *Id.*

account for post-production costs.<sup>29</sup> In Pennsylvania, production costs remained non-deductible.<sup>30</sup>

According to Bibikos, the practice of deducting post-production costs recreates the previous Pennsylvania practice of providing a one-eighth royalty payment at the wellhead.<sup>31</sup> His theory asserts that, by allowing gas companies to deduct one-eighth of post-production costs from the valuation of gas at the point of sale, gas companies pay a royalty that is equivalent to a one-eighth royalty that landowners would have received had the old, regulated structure of gas production still existed.<sup>32</sup> Bibikos then added that gas companies do not deduct Act 13 impact fees or regulatory costs that occur during the production phase.<sup>33</sup>

### C. *The Marcellus Shale Formation*

The Marcellus Shale Formation is a large, underground rock formation rich in natural gas that underlies several states, including much of Pennsylvania.<sup>34</sup> Natural gas proponents promote Pennsylvania's Marcellus Shale gas reserve as a clean, safe alternative to coal and a key to U.S. energy independence.<sup>35</sup> The Marcellus Shale reserve is the second largest natural gas reserve in the United States and potentially holds 168 to 500 trillion cubic feet of natural gas.<sup>36</sup> In 2012, unconventional gas resources like Marcellus Shale made up fifty percent of U.S. natural gas production.<sup>37</sup> Estimates value Marcellus Shale natural gas at over \$1

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<sup>29</sup> *Id.*

<sup>30</sup> *Id.*

<sup>31</sup> *Id.*

<sup>32</sup> *Id.*

<sup>33</sup> *Id.*

<sup>34</sup> *Kilmer v. Elexco Land Servs., Inc.*, 990 A.2d 1147, 1149 (Pa. 2010) (citing TIMOTHY CONSIDINE ET AL., AN EMERGING GIANT: PROSPECTS AND ECONOMIC IMPACTS OF DEVELOPING THE MARCELLUS SHALE NATURAL GAS PLAY (2009)).

<sup>35</sup> Kristen Allen, Note, *The Big Fracking Deal: Marcellus Shale—Pennsylvania's Untapped Resource*, 23 VILL. ENVTL. L.J. 51, 54 (2012).

<sup>36</sup> Stephanie Scott, Note, *Who "Shale" Regulate the Fracking Industry?*, 24 VILL. ENVTL. L.J. 189, 189–90 (2013).

<sup>37</sup> Jeffrey B. Jacquet, *Landowner Attitudes Toward Natural Gas and Wind Farm Development in Northern Pennsylvania*, 50 ENERGY POL. 677, 677–78 (2012).

trillion.<sup>38</sup> By 2012, natural gas accounted for twenty-two percent of Pennsylvania's installed energy generation capacity.<sup>39</sup>

In order to extract natural gas from rock pores, vertical fractures, and mineral grains, gas companies utilize hydraulic fracturing (“fracking”) and horizontal drilling.<sup>40</sup> Extractors began fracking for natural gas in the 1940s.<sup>41</sup> Today, extractors mix millions of gallons of water with sand and chemicals, inject it thousands of feet below the surface, and fracture the rocks.<sup>42</sup> By holding fractures open, sand allows gas to escape more quickly.<sup>43</sup> Horizontal drilling allows extractors to remove more gas from a single well site, reducing negative surface impacts.<sup>44</sup> Waste, flowback, and produced waters from fracking contain radioactive materials and chemicals and must be handled and treated properly in order to avoid water contamination and health issues.<sup>45</sup> Because fracking and horizontal drilling have made the Marcellus Shale reserve more accessible, gas companies have offered landowners more profitable leases over the past few years.<sup>46</sup> In response, the increased compensation in new leases has corresponded with some landowners reviewing and questioning the validity of their old leases under the GMRA.<sup>47</sup>

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<sup>38</sup> Scott, *supra* note 36, at 198.

<sup>39</sup> PA. PUB. UTIL. COMM’N & PA. DEP’T ENVTL. PROT., 2011 ANNUAL REPORT: ALTERNATIVE ENERGY PORTFOLIO STANDARDS ACT OF 2004, at 18 (2012).

<sup>40</sup> Allen, *supra* note 35, at 56.

<sup>41</sup> *Id.*

<sup>42</sup> *Id.* at 61.

<sup>43</sup> *Id.* at 57.

<sup>44</sup> Scott, *supra* note 36, at 196.

<sup>45</sup> *Id.* at 200; Allen, *supra* note 35, at 58.

<sup>46</sup> V. Finkelstein, *Marcellus Shale Drilling Projects Increase Following Pennsylvania Supreme Court Decision*, CONSTRUCTION L. SIGNAL (Aug. 31, 2010), <http://www.constructionlawsignal.com/by-state/pennsylvania/marcellus-shale-drilling-projects-increase-following-pennsylvania-supreme-court-decision>.

<sup>47</sup> *Kilmer v. Elexco Land Servs., Inc.*, 990 A.2d 1147, 1150 (Pa. 2010).

### III. DEVELOPMENTS IN NATURAL GAS ROYALTY PAYMENTS IN PENNSYLVANIA

#### A. *Kilmer v. Elexco and the Net-Back Method for Determining Royalty Payments*

In *Kilmer v. Elexco Land Services, Inc.*, the Pennsylvania Supreme Court interpreted the GMRA as allowing gas companies to use the “net-back method” to apply post-production cost deductions to royalty payments under natural gas leases.<sup>48</sup> Passed by the General Assembly in 1979, the original GMRA provided that a lease or similar

agreement conveying the right to remove or recover oil, natural gas or gas of any other designation from lessor to lessee shall not be valid if such lease does not guarantee the lessor at least one-eighth royalty of all oil, natural gas or gas of other designations removed or recovered from the subject real property.<sup>49</sup>

The royalty owners in *Kilmer* claimed that their “lease violated the one-eighth royalty requirement of the GMRA because the net-back method resulted in a royalty less than one-eighth of the value of the gas.”<sup>50</sup> Central to the case was the absence of a definition of “royalty” in the GMRA.<sup>51</sup> While the General Assembly considered such absence, it did not rectify the situation with its recent GMRA amendments.<sup>52</sup>

At the time of *Kilmer*, many Pennsylvania natural gas leases, including the one at issue in *Kilmer*, “calculate[d] the royalties as one-eighth of the sale price of the gas minus one-eighth of the post-production costs of bringing the gas to market.”<sup>53</sup> That calculation, called the “net-back method,” aims to determine the gas’ value at the wellhead “by deducting from the sales price the costs of getting

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<sup>48</sup> *Id.* at 1158.

<sup>49</sup> 58 PA. CONS. STAT. ANN. § 33 (West 1979), *repealed by* Act 66 of 2013, P.L. 473, No. 66, § 1, 58 PA. CONS. STAT. ANN. §§ 33.1–35.4 (West 2013).

<sup>50</sup> *Kilmer*, 990 A.2d at 1150.

<sup>51</sup> *Id.* at 1149. *See also* 58 PA. CONS. STAT. ANN. § 33 (West 1979).

<sup>52</sup> *See generally* SEREC Hearing, *supra* note 4. *See also* 58 PA. CONS. STAT. ANN. §§ 33.1–35.4 (West 2013) (lacking a definition for the term “royalty”).

<sup>53</sup> *Kilmer*, 990 A.2d at 1149.



the natural gas from the wellhead to the market.”<sup>54</sup> The *Kilmer* court adhered to the gas industry’s definitions of production costs as the “expenses of getting gas to the point it exits the ground” and post-production costs as the “expenditures from when the gas exits the ground until it is sold.”<sup>55</sup> Importantly, the *Kilmer* lease expressly stated that the lessee would deduct one-eighth of the post-production costs from the sales proceeds while expressly defining the costs within its terms.<sup>56</sup>

Applying Pennsylvania’s rules of statutory interpretation, the *Kilmer* court sought to determine the General Assembly’s intent by first looking at the “plain language of the GMRA.”<sup>57</sup> Although the GMRA expressly required lessors to receive a one-eighth royalty, the GMRA did not define the term “royalty,” nor did it contain key terms at issue, including “‘at the wellhead,’ ‘post-production costs,’ or ‘point of sale.’”<sup>58</sup> The *Kilmer* court reasoned that, because the point of sale occurred at the wellhead at the time of the GMRA’s enactment, the General Assembly intended that royalty calculations occur only at one instance: the point of sale at the wellhead.<sup>59</sup>

However, because the point of sale no longer occurs exclusively at the wellhead, the *Kilmer* court had to determine “which valuation point [was] most consistent with the language of the statute” and the definition of the term “royalty.”<sup>60</sup> Following Pennsylvania’s legislative rule for interpreting technical words, phrases, and the like with their “peculiar and appropriate meaning” acquired through use, the *Kilmer* court rejected the plain meaning of “royalty” and adopted the gas industry’s definition of the term.<sup>61</sup> Accordingly, the gas industry has defined “royalty” as a portion of the proceeds from sale in which the royalty owner

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<sup>54</sup> *Id.* at 1149 n.3 (citing 30 C.F.R. § 206.151 (2010); HOWARD R. WILLIAMS & CHARLES J. MEYERS, MANUAL OF OIL AND GAS TERMS § N (Patrick H. Martin & Bruce M. Kramer eds., 2009)).

<sup>55</sup> *Id.* at 1149 n.2.

<sup>56</sup> *Id.* at 1150 (citing the lease between Kilmer and Elexco Land Services, Inc., dated Oct. 15, 2007).

<sup>57</sup> *Id.* at 1156 (citing 1 PA. CONS. STAT. ANN. § 1921(a)–(b) (West 1972); 58 PA. CONS. STAT. ANN. § 33 (West 1979), *repealed by* Act 66 of 2013, P.L. 473, No. 66, § 1, 58 PA. CONS. STAT. ANN. §§ 33.1–35.4 (West 2013)).

<sup>58</sup> *Id.* at 1157. *See also* 58 PA. CONS. STAT. ANN. § 33 (West 1979).

<sup>59</sup> *Id.* at 1157 (citing 1 PA. CONS. STAT. ANN. § 1921(c)(2) (West 1972)).

<sup>60</sup> *Id.*

<sup>61</sup> *Id.* (quoting 1 PA. CONS. STAT. ANN. § 1903 (West 1972)).

does not share the production expenses but may share the post-production expenses.<sup>62</sup>

Stating that landowners can receive royalties in-kind (i.e., receive a portion of the gas in lieu of receiving a payment), the *Kilmer* court concluded that the “General Assembly [did] not intend to create a situation where one landowner would receive a dramatically increased royalty when the product [was] valued at the point of sale when the neighbor who took the royalty in-kind would have a reduced royalty based on the wellhead value.”<sup>63</sup> The *Kilmer* court based this conclusion on the fact that companies sell natural gas at different levels of processing, potentially resulting in “dramatically” different royalty payments.<sup>64</sup> It then concluded that “[t]he use of the net-back method eliminates the chance that lessors would obtain different royalties on the same quality and quantity of gas coming out of the well depending on when and where in the value-added production process the gas was sold.”<sup>65</sup>

In addition, the *Kilmer* court rejected concerns about gas companies potentially inflating post-production costs in order to reduce royalty payments.<sup>66</sup> It reasoned that, because gas companies pay seven-eighths of the post-production costs, these companies maintain a strong incentive to minimize costs.<sup>67</sup> The *Kilmer* court also stated that if landowners suspect fraudulent cost reporting, “landowner[s] can seek a court ordered accounting.”<sup>68</sup>

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<sup>62</sup> *Id.* at 1157–58 (citing HOWARD R. WILLIAMS & CHARLES J. MEYERS, *MANUAL OF OIL AND GAS TERMS* § R (Patrick H. Martin & Bruce M. Kramer eds., 2009); George A. Bibikos & Jeffrey C. King, *A Primer on Oil and Gas Law in the Marcellus Shale States*, 4 *TEX. J. OIL GAS & ENERGY L.* 155, 168–69 (2008–2009); RICHARD A. LORD, 17 *WILLISTON ON CONTRACTS* § 50:60 (4th ed. 2009)).

<sup>63</sup> *Id.* at 1158.

<sup>64</sup> *Id.*

<sup>65</sup> *Id.* (citing *Bice v. Petro-Hunt, LLC*, 768 N.W.2d 496, 502 (N.D. 2009); *Garman v. Conoco, Inc.*, 886 P.2d 652, 661 (Colo. 1994)).

<sup>66</sup> *Id.*

<sup>67</sup> *Id.*

<sup>68</sup> *Id.*

*B. Post-Kilmer v. Elexco: Pennsylvania Senate Environmental Resources and Energy Committee Hearing and the Calls for Leasing Reform*

On June 27, 2013, the Pennsylvania Senate Environmental Resources and Energy Committee (“SEREC”) conducted a public hearing regarding transparency issues with royalty payments, check stubs, and deductions of natural gas development post-production costs from royalty payments.<sup>69</sup> A number of state senators, representatives, and other interested parties attended the hearing.<sup>70</sup> All testifying parties supported the natural gas industry and Marcellus Shale development.<sup>71</sup> However, their testimonies highlighted several issues, including: lack of uniformity in gas leases; lack of uniformity in post-production deductions; lack of explanations of and clarity in post-production deductions; applications of retroactive deductions and charges to royalty payments by at least one company following the *Kilmer* decision; unequal bargaining power between landowners and gas companies; costs to lessors for challenging lease violations and/or post-production deductions; and the need for a legislative definition of the term “royalty.”<sup>72</sup>

1. Specific Issues with Royalty Payments

a. Excessive Deductions

The National Association of Royalty Owners (“NARO”) represents about 8.5 million royalty owners and educates them about royalties and deductions.<sup>73</sup> The average owner is over sixty years old, widowed, and receives less than \$500 per month in royalty payments to supplement his or her income.<sup>74</sup> The royalty payment

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<sup>69</sup> See *SEREC Hearing*, *supra* note 4.

<sup>70</sup> See *id.* The following people testified: Joel Rotz, Senior Director of the Pennsylvania Farm Bureau (“Farm Bureau”); Mike Evanish, Manager of MSC Business Services Division, providing accounting for 5,000 Farm Bureau members; George A. Bibikos, a partner at K&L Gates, LLP, representing the Marcellus Shale Coalition; Bradford County Commissioners Doug McLinko and Daryl Miller; Christopher D. Jones, an attorney with Dawsey, DePaola and Jones, PC, representing lessors and property owners in Bradford County, Pennsylvania; David Sikes, CMM, President of NARO; and Jackie Root, CMM, President of NARO-PA. *Id.*

<sup>71</sup> *Id.*

<sup>72</sup> *Id.*

<sup>73</sup> *SEREC Hearing*, *supra* note 4 (statement of D. Sikes).

<sup>74</sup> *Id.*

situation in Pennsylvania is atypical among gas-producing states, as royalty owners in other states do not see the same deductions.<sup>75</sup> Furthermore, within Pennsylvania, large deductions are not typical among all producers, either.<sup>76</sup> According to David Sikes, President of NARO, a lull in Pennsylvania's gas production activity left the legal framework behind, and "litigation did not keep up with the technology."<sup>77</sup> Importantly, not all gas companies are to blame for the current situation, as some companies take no deductions.<sup>78</sup> However, excessive deductions still remain a major issue, even for some operators who worry that large deductions will ruin the industry's reputation.<sup>79</sup>

Royalty deductions have ranged from zero to one hundred percent of royalty payments.<sup>80</sup> Some royalty payments reported at the SEREC Hearing totaled \$40,000 per month, while other payments had zero-dollar value.<sup>81</sup> In some cases, deductions even exceeded payments.<sup>82</sup> Chesapeake Energy Corp. ("Chesapeake") appeared to be the biggest perpetrator, with deductions in two examples ranging from twenty-seven to one hundred percent per well per month.<sup>83</sup> One example from Chesapeake had at least fifteen possible deductions.<sup>84</sup>

The absence or presence of inter-company cooperation and pipeline sharing explains some of the disparate costs and deductions.<sup>85</sup> In one example, a single well had four companies involved, and each company calculated different post-production costs.<sup>86</sup> According to one Pennsylvania state representative, Tina

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<sup>75</sup> *Id.*

<sup>76</sup> *Id.*

<sup>77</sup> *Id.*

<sup>78</sup> *Id.* (statements of M. Evanish and D. McLinko).

<sup>79</sup> *Id.* (statement of J. Rotz).

<sup>80</sup> *Id.* (statement of M. Evanish).

<sup>81</sup> *Id.*

<sup>82</sup> *Id.* (statements of M. Evanish and D. McLinko).

<sup>83</sup> *Id.* (statement of M. Evanish).

<sup>84</sup> *Id.* Note that the lack of information made available at the time of the SEREC Hearing made it impossible to determine an exact number.

<sup>85</sup> *Id.*

<sup>86</sup> *Id.* (statements of M. Evanish and C.D. Jones).

Pickett, post-production cost deductions come mostly from gathering line systems, and multiple companies use the same gathering line system.<sup>87</sup>

In addition, and post-*Kilmer*, select companies have been taking retroactive deductions from royalty checks.<sup>88</sup> Some retroactive deductions have equaled tens of thousands of dollars, and some companies have stopped paying royalties to landowners until all retroactive bills have been paid.<sup>89</sup> According to Doug McLinko, Bradford County Commissioner, his conversations with commissioners in other states indicated similar concerns, particularly with one company.<sup>90</sup>

#### b. Lost State Revenue

In 2012, gas companies paid \$731 million in total royalties that were divided among tens of thousands of taxpaying royalty owners in Pennsylvania.<sup>91</sup> Unfortunately, the excessive royalty deductions deprive the entire Commonwealth of tax revenue.<sup>92</sup> Daryl Miller, another Bradford County Commissioner, loosely estimated that in the last six months of 2012, Pennsylvania missed out on about \$10 million that would have circulated through the local economy and generated tax revenue.<sup>93</sup> In addition to lost revenue from excessive deductions, out-of-state attorneys are offering to represent landowners for a portion of landowners' royalty fees over the course of several years.<sup>94</sup> Diverting royalty payments as income to out-of-state attorneys further deprives Pennsylvania of tax revenue.<sup>95</sup> In fact, Jackie Root, President of NARO-PA, described royalty payments as a finite resource that requires preservation.<sup>96</sup>

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<sup>87</sup> *Id.* (statement of Rep. T. Pickett).

<sup>88</sup> *Id.* (statement of D. McLinko). *See also id.* (statement of C.D. Jones) (testifying that, starting in January of 2012, Chesapeake began listing a "miscellaneous recoupment PA" deduction that Jones speculated is a retroactive deduction that Chesapeake implemented following *Kilmer*).

<sup>89</sup> *Id.* (statement of D. McLinko).

<sup>90</sup> *Id.*

<sup>91</sup> *Id.* (statement of J. Root).

<sup>92</sup> *Id.* (statement of D. McLinko).

<sup>93</sup> *Id.* (statement of D. Miller).

<sup>94</sup> *Id.* (statement of D. McLinko).

<sup>95</sup> *Id.*

<sup>96</sup> *Id.* (statement of J. Root).

## c. Leases Signed in Good Faith

When Bradford County, Pennsylvania residents signed their leases, lessees advised residents that they would receive the full royalty payments without deductions.<sup>97</sup> Even those residents who have protective, no-deduction addenda in their leases still see deductions.<sup>98</sup> According to attorney Christopher D. Jones, gas companies themselves, not the landmen who first negotiated the leases, are breaking promises and lease addenda.<sup>99</sup> In particular, at the time of the SEREC Hearing, Chesapeake had been deducting costs from leases that contained protective market enhancement clauses.<sup>100</sup> The deductions reflected a payment arrangement Chesapeake had with one of its own subsidiaries.<sup>101</sup>

The deduction issue centers on the fact that most Pennsylvania natural gas leases are older leases signed in good faith pre-*Kilmer*.<sup>102</sup> Mike Evanish, business manager for a firm providing accounting to 5,000 Farm Bureau members, stated that the “idea of deductions was never on the table at any meeting” he attended, nor was it part of any discussion that he had with attorneys regarding gas production.<sup>103</sup> Under the circumstances, royalty owners continue to feel betrayed.<sup>104</sup> They and witnesses at the SEREC Hearing think that the GMRA was meant to address the current royalty deductions issue and that the Commonwealth has failed to protect landowners’ financial interests.<sup>105</sup> According to McLinko, royalties lost to deductions could have helped retirees and others who need the income.<sup>106</sup> As such, he wants those who signed their leases in good faith pre-*Kilmer* to have their guarantees restored.<sup>107</sup>

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<sup>97</sup> *Id.* (statement of C.D. Jones).

<sup>98</sup> *Id.*

<sup>99</sup> *Id.*

<sup>100</sup> *Id.*

<sup>101</sup> *Id.*

<sup>102</sup> *Id.* (statements of D. McLinko and D. Miller).

<sup>103</sup> *Id.* (statement of M. Evanish).

<sup>104</sup> *Id.*

<sup>105</sup> *Id.* (statements of D. McLinko and D. Miller).

<sup>106</sup> *Id.* (statement of D. McLinko).

<sup>107</sup> *Id.*

#### d. Self-Reporting of Gas Production Volumes

During the SEREC Hearing, other concerns arose regarding Chesapeake's royalty payment deductions. Jones explained that on a single accounting spreadsheet that listed six landowners with interest in a single well, under each landowner, Chesapeake listed different per-month gas production volumes from that well.<sup>108</sup> Chesapeake also listed a different gas price for each landowner.<sup>109</sup> Additionally, some of the per-month gas production volumes repeated in a noticeable pattern.<sup>110</sup> Based on the production reports, Jones could not determine how much gas Chesapeake actually produced per month at the well.<sup>111</sup> Pennsylvania Department of Environmental Protection ("DEP") records did not help to clarify volume reports.<sup>112</sup> According to Jones, the DEP website only listed total days and total volumes of production, not daily, weekly, or monthly amounts.<sup>113</sup> Even if the DEP website listed more incremental volumes, the self-reporting of production volumes without independent verification would continue to leave doubts about actual production.<sup>114</sup>

### 2. Limitations Under the Current Legal Framework to Address the Issues

#### a. Lack of Statutory Definition of "Royalty" in Pennsylvania

As several parties testified to at the SEREC Hearing, and as the *Kilmer* court addressed, Pennsylvania lacks a statutory definition of the term "royalty."<sup>115</sup> The absence of a statutory definition has contributed to the lack of uniformity among royalty payments and deductions and will likely limit the ability of land and royalty owners to pursue legal redress.<sup>116</sup> As happened in *Kilmer*, in disputes over

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<sup>108</sup> *Id.* (statement of C.D. Jones).

<sup>109</sup> *Id.*

<sup>110</sup> *Id.*

<sup>111</sup> *Id.*

<sup>112</sup> *Id.*

<sup>113</sup> *Id.*

<sup>114</sup> *Id.*

<sup>115</sup> *Id.* (statements of M. Evanish, D. Miller, J. Root, and D. Sikes); *Kilmer v. Elexco Land Servs., Inc.*, 990 A.2d 1147, 1149 (Pa. 2010).

<sup>116</sup> *SEREC Hearing*, *supra* note 4.

royalties, courts may continue to side with the general practices of the natural gas industry and not with the reasonable expectations of landowners.<sup>117</sup>

#### b. Shortcomings of Self-Help

Some landowners worry that openly expressing their concerns will adversely affect production.<sup>118</sup> Additionally, although landowner organizations retain accounting services, only lawyers, not accountants, can attempt to reconcile paystubs with lease agreements.<sup>119</sup> Retaining legal services on top of accounting services would increase the expenses to royalty owners, some of whom may not have the financial resources for either service.<sup>120</sup> Moreover, landowners who have simply tried reaching out to companies have had no success receiving explanations for deductions.<sup>121</sup> Reportedly, some companies' employees simply did not know what the deductions were.<sup>122</sup> Furthermore, Root stated that she only received clarification of financial statements because her gas lease included special provisions, and without those provisions, she might have received no information at all.<sup>123</sup>

#### c. The Expense of a Legal Accounting and Prohibitive Contract Clauses

At the SEREC Hearing, State Senator Gene Yaw brought up the idea that royalty owners could seek a legal accounting to define and determine the propriety of royalty payment deductions.<sup>124</sup> In Pennsylvania, although no longer a procedural action in equity, an accounting is available as a civil action that can provide equitable relief.<sup>125</sup> In an accounting action, when one party "allege[s] that an opposing party has received moneys . . . in any . . . capacity in which he or she is

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<sup>117</sup> Compare *id.* (statement of D. Sikes) (asking the General Assembly to not allow the industry to define "royalty"), with *Kilmer*, 990 A.2d at 1149 (accepting the gas industry's definition of royalty).

<sup>118</sup> *SEREC Hearing, supra* note 4 (statement of D. Miller).

<sup>119</sup> *Id.* (statement of M. Evanish).

<sup>120</sup> *Id.* (statement of D. Sikes) (testifying that many leaseholders are single, older adults who depend on royalty payments to supplement their income).

<sup>121</sup> *Id.* (statement of D. McLinko).

<sup>122</sup> *Id.*

<sup>123</sup> *Id.* (statement of J. Root).

<sup>124</sup> *Id.* (statement of Sen. G. Yaw).

<sup>125</sup> 14 STAND. PA. PRACTICE 2d § 81:1 (2013) (citations omitted).



bound to account, or where the” first party cannot cite the precise amount due because the opposing party has failed to account to the first party, the first party has the right to an accounting.<sup>126</sup> A plaintiff may establish the right to an accounting by showing that a valid contract between the parties existed and that the defendant breached his or her contractual duty.<sup>127</sup> When a right to an accounting exists, Pennsylvania courts will recognize an accounting as the sole relief sought.<sup>128</sup> Unfortunately, the added expense of legal accountings effectively prohibits their use. Additionally, leases with arbitration clauses prevent court action, including an accounting, and have prohibitive costs—filing for arbitration can cost up to \$10,000.<sup>129</sup>

#### d. Hesitancy and/or Inability to Litigate

Although NARO and the Farm Bureau provide gas lease education for members, those organizations do not provide legal representation.<sup>130</sup> Additionally, the agricultural community generally tends to be non-litigious,<sup>131</sup> and royalty owners tend to lack the financial resources to pursue legal action against large corporations.<sup>132</sup> Because of high litigation costs, the main avenue for recovering improper deductions would arguably be a class action lawsuit. However, in a successful class action, class representatives and their law firms, rather than the majority of class members, receive most of the benefits.<sup>133</sup> While many royalty owners might be able to protect themselves through non-deduction clauses in new leases, not all companies have honored these clauses.<sup>134</sup> Furthermore, the same

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<sup>126</sup> *Id.* § 81:3 (citations omitted).

<sup>127</sup> *Id.* § 81:5 (citing *Berger & Montague, PC v. Scott & Scott, LLC*, 153 F. Supp. 2d 750 (E.D. Pa. 2001); *Haft v. U.S. Steel Corp.*, 499 A.2d 676 (Pa. Super. Ct. 1985)).

<sup>128</sup> *See Hook v. Hook & Ackerman, Inc.*, 117 A.2d 714, 715 (Pa. 1955) (affirming an order of accounting where the “plaintiff brought a suit in equity for an accounting for royalties due under a licensing agreement” and the plaintiff had a right to recover the amount due as shown by the accounting).

<sup>129</sup> *SEREC Hearing*, *supra* note 4 (statement of C.D. Jones).

<sup>130</sup> *Id.* (statement of D. Sikes).

<sup>131</sup> *Id.* (statement of J. Rotz).

<sup>132</sup> *Id.* (statement of M. Evanish).

<sup>133</sup> *Id.* (statement of D. Sikes).

<sup>134</sup> *Id.*

arbitration clauses that create a barrier to legal accounting would likely bar other avenues of litigation, including traditional and class action lawsuits.<sup>135</sup>

According to Root, companies that violate market enhancement clauses do so because they face little to no risk.<sup>136</sup> If these companies go to arbitration, they may or may not have to pay the royalty.<sup>137</sup> Even if they are forced to pay the royalty, they still may not have to pay interest or penalties.<sup>138</sup> Additionally, companies play the odds that royalty owners will not sue, in which case those companies will not pay anything at all.<sup>139</sup>

Although royalty owners often do not sue gas companies,<sup>140</sup> some royalty owners did file a class action lawsuit against Chesapeake alleging underpayment of gas royalties.<sup>141</sup> On September 3, 2013, news reports stated that Chesapeake “agreed to pay \$7.5 million to settle” the dispute.<sup>142</sup> Thousands of leaseholders had joined together to sue Chesapeake’s subsidiary, Chesapeake Appalachia, LLC, for allegedly “wrongly charging fees related to process[ing],” refining, and transporting natural gas.<sup>143</sup> The federal lawsuit named fourteen representative plaintiffs from one New York county and five Pennsylvania counties.<sup>144</sup> “[T]he settlement appl[ied] to anyone in Pennsylvania with a Chesapeake lease that specifically prohibits [post-production] deductions.”<sup>145</sup> Under the settlement, royalty owners were reported to receive different payouts based on their deductions.<sup>146</sup>

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<sup>135</sup> *Id.* (statement of C.D. Jones).

<sup>136</sup> *Id.* (statement of J. Root).

<sup>137</sup> *Id.*

<sup>138</sup> *Id.*

<sup>139</sup> *Id.*

<sup>140</sup> *Id.* (statement of C.D. Jones).

<sup>141</sup> Marie Cusick, *Chesapeake Energy Agrees To Pay \$7.5 Million To Settle Royalty Lawsuit*, STATEIMPACT: PA. (Sept. 3, 2013, 9:49 AM), <http://stateimpact.npr.org/pennsylvania/2013/09/03/chesapeake-energy-agrees-to-pay-7-5-million-to-settle-royalty-lawsuit>.

<sup>142</sup> *Id.*

<sup>143</sup> *Id.* (citing Michelle O’Brien, lead counsel for the class action lawsuit).

<sup>144</sup> *Id.*

<sup>145</sup> *Id.*

<sup>146</sup> *Id.* Note that when this story broke, the settlement still needed court approval.

Shortly after the settlement was announced, former Governor Corbett released a statement purporting that his “first and foremost interest [was] in ensuring that the landowners of Pennsylvania [were] treated fairly and with respect.”<sup>147</sup> Corbett claimed to have personally relayed royalty owners’ concerns to Chesapeake’s President and CEO, Doug Lawler.<sup>148</sup> According to former Governor Corbett, Lawler had a “personal interest” in resolving the matter.<sup>149</sup> Although Corbett acknowledged ongoing issues regarding royalty payment deductions, he still perceived “the proposed settlement [as] a significant step forward in protecting the interests of Pennsylvania’s landowners.”<sup>150</sup> After the settlement, Pennsylvania’s State Attorney General began investigating Chesapeake for potential royalty payment fraud.<sup>151</sup>

3. Suggested Recommendations from the SEREC Hearing to Improve the Legal Framework of the GMRA
  - a. The Pennsylvania General Assembly Needs to Statutorily Define “Royalty”

Several interested parties at the SEREC Hearing asked the General Assembly, in accordance with the *Kilmer* court’s statement,<sup>152</sup> to statutorily define the term “royalty.”<sup>153</sup> In general, advocates supported a statutory definition based on gross revenue without deductions.<sup>154</sup> At the SEREC Hearing, such a definition received support as both the traditional<sup>155</sup> and common sense<sup>156</sup> interpretation of the term.

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<sup>147</sup> *Id.* (quoting former Pennsylvania Governor Tom Corbett).

<sup>148</sup> *Id.*

<sup>149</sup> *Id.*

<sup>150</sup> *Id.*

<sup>151</sup> Marie Cusick, *Pa. Attorney General Investigating Complaints Against Chesapeake Energy*, STATEIMPACT: PA. (Feb. 20, 2014, 3:01 PM), <http://stateimpact.npr.org/pennsylvania/2014/02/20/pa-attorney-general-investigating-complaints-against-chesapeake-energy/>.

<sup>152</sup> *Kilmer v. Elexco Land Servs., Inc.*, 990 A.2d 1147, 1157 n.14 (Pa. 2010) (“We note that the General Assembly is the branch of government best suited to weigh the public policies underlying the determination of the proper point of royalty valuation in the deregulated gas industry. However, until the General Assembly acts to specify the point of valuation, we must interpret the statute as written, prior to deregulation.”).

<sup>153</sup> *See SEREC Hearing, supra* note 4.

<sup>154</sup> *See generally id.*

<sup>155</sup> *Id.* (statement of D. Sikes).

Sikes requested that the General Assembly prohibit producers from defining the term “royalty.”<sup>157</sup> A Bradford County solicitor also asked legislators to define the term “valuation.”<sup>158</sup> The SEREC Hearing elicited a common concern about the constitutional applicability of a statutory definition to old leases, but the only answer that emerged was that any definition would apply to future leaseholds.<sup>159</sup>

b. The Pennsylvania General Assembly Needs to Improve Reporting and Oversight

Joel Rotz, President of the Pennsylvania Farm Bureau, discussed the need for a common sense approach to promote transparency in royalty paystubs and the deduction of post-production costs.<sup>160</sup> That approach seeks disclosure on check stubs of additional, purportedly non-proprietary information.<sup>161</sup> According to Rotz, providing more information on paystubs “maintains credibility and trust with royalty owners,” especially since the deduction of post-production costs undermines the trust and support that the natural gas industry has earned among royalty owners.<sup>162</sup> The common sense approach dictates that if companies are allowed to make deductions, companies should do so prior to determining the minimum one-eighth royalty payment, not after.<sup>163</sup> At the very least, Pennsylvania legislation should promote such transparency.<sup>164</sup>

Jones advocated increased uniformity and better verification of production volume reporting, including mandatory gas volume metering at the wellhead.<sup>165</sup> Jones requested that the General Assembly expand the Pennsylvania Unfair Trade Practices and Consumer Protection Law to empower landowners to better protect themselves and to empower the State Attorney General to take legal action on

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<sup>156</sup> *Id.* (statement of J. Rotz).

<sup>157</sup> *Id.* (statement of D. Sikes).

<sup>158</sup> *Id.* (statement of one Bradford County solicitor).

<sup>159</sup> *See id.* (statement of G.A. Bibikos).

<sup>160</sup> *Id.* (statement of J. Rotz).

<sup>161</sup> *Id.*

<sup>162</sup> *Id.*

<sup>163</sup> *Id.*

<sup>164</sup> *Id.*

<sup>165</sup> *Id.* (statement of C.D. Jones).

behalf of citizens.<sup>166</sup> In order to offset the costs of such additional industry oversight, Pennsylvania could enact a severance tax on natural gas production.<sup>167</sup>

#### IV. SHORTCOMINGS OF POST-KILMER LEGAL DEVELOPMENTS TO PROPERLY PROTECT LESSOR/ROYALTY OWNER INTERESTS REGARDING ROYALTY PAYMENTS

##### A. *Kilmer v. Elexco in Light of the SEREC Hearing*

The 2013 SEREC Hearing on royalties highlights several aspects of the *Kilmer* court's reasoning that do not hold up in light of recent circumstances in Pennsylvania.<sup>168</sup> First, many residents' leases differ from the *Kilmer* lease. According to Jones, many of the residents' leases lack clearly defined deductions, whereas the *Kilmer* lease clearly explained the deductions.<sup>169</sup> Second, Root argued against the "in-kind" royalty argument found in *Kilmer*, contending that people cannot take gas at the wellhead like they can oil and that producers no longer sell oil at the wellhead.<sup>170</sup> Third, and perhaps most importantly, the *Kilmer* court's conclusions regarding equitable payouts and gas companies' conduct fall far short of actual practice.<sup>171</sup>

Contrary to the *Kilmer* court's conclusion that allowing the deduction of post-production expenses would ensure equitability among royalty payments, the variability of deductions has resulted in vastly differing—and at times highly inequitable—royalty payments.<sup>172</sup> If the 1979 General Assembly had truly intended the GMRA to ensure relatively equal royalty payments as the *Kilmer* court asserted, then the actual implementation of the net-back method in Pennsylvania

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<sup>166</sup> *Id.*

<sup>167</sup> *Id.* (stating that North Dakota uses severance tax funds to pay for monitoring natural gas extraction).

<sup>168</sup> Compare *Kilmer v. Elexco Land Servs., Inc.*, 990 A.2d 1147 (Pa. 2010), with *SEREC Hearing*, *supra* note 4.

<sup>169</sup> Compare *Kilmer*, 990 A.2d at 1150 (citation omitted), with *SEREC Hearing*, *supra* note 4 (statement of C.D. Jones).

<sup>170</sup> Compare *Kilmer*, 990 A.2d at 1157–58 (citing WILLIAMS & MEYERS, *supra* note 62), with *SEREC Hearing*, *supra* note 4 (statement of J. Root).

<sup>171</sup> Compare *Kilmer*, 990 A.2d at 1158, with *SEREC Hearing*, *supra* note 4.

<sup>172</sup> *Kilmer*, 990 A.2d at 1158.

has not met that intent.<sup>173</sup> Instead, deductions among similarly situated royalty owners range from zero to \$40,000.<sup>174</sup>

In addition, the excessive deductions that Chesapeake has taken indicate that the *Kilmer* court erred in reasoning that gas companies do not have an incentive to inflate post-production cost deductions.<sup>175</sup> The accepted economic theory of a firm states that a firm's primary objective is to maximize profits, and a firm maximizes profit, in part, by reducing the costs of inputs.<sup>176</sup> In the current situation, inputs would likely include production and post-production costs that a gas company (or a gas "firm") incurs in order to bring its gas to the desired point of sale, as well as royalty payments to lessors. A gas firm can reduce input costs—that is, production and post-production costs—by shifting them to landowners.<sup>177</sup> Because the GMRA has prevented gas firms from shifting production costs to lessors, gas firms have turned to deducting post-production costs as a means of offsetting input costs.<sup>178</sup> By deducting post-production costs from royalty payments, gas firms can reduce both their input costs and their royalty payouts, thus resulting in larger profits. As the check stubs from one company illustrate, a firm that seeks to maximize profits will shift as many input costs as possible, in the form of royalty payment deductions, to royalty owners.<sup>179</sup> Although the *Kilmer* court correctly recognized a firm's incentive to reduce costs, it incorrectly reasoned that a firm could not achieve that end by adding excessive costs as deductions to royalty payments.<sup>180</sup>

### B. *The Improper Distinction Between Production and Post-Production Costs*

An inherent flaw lies within the distinction between production and post-production costs, allowing the gas industry to improperly claim deductions under

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<sup>173</sup> Compare *Kilmer*, 990 A.2d at 1159 (citations omitted), with *SEREC Hearing*, *supra* note 4.

<sup>174</sup> See *SEREC Hearing*, *supra* note 4 (statements of M. Evanish and D. McLinko).

<sup>175</sup> Compare *id.* (statement of M. Evanish), with *Kilmer*, 990 A.2d at 1158.

<sup>176</sup> ROBERT S. PINDYCK & DANIEL L. RUBINFELD, 5 MICROECONOMICS 201–02 (8th ed. 2013).

<sup>177</sup> See 58 PA. CONS. STAT. ANN. § 33 (West 1979), *repealed by* Act 66 of 2013, Pub. L. No. 2013–66, § 1, 58 PA. CONS. STAT. ANN. §§ 33.1–35.4 (West 2013); *Kilmer*, 990 A.2d at 1157–58 (citations omitted).

<sup>178</sup> See generally *Kilmer*, 990 A.2d 1147; *SEREC Hearing*, *supra* note 4.

<sup>179</sup> *SEREC Hearing*, *supra* note 4 (statements of M. Evanish and D. McLinko).

<sup>180</sup> *Kilmer*, 990 A.2d at 1158.

the net-back method.<sup>181</sup> According to the reasoning of Bibikos and the gas industry (both of which the *Kilmer* court accepted), production applies only to the process of getting the gas out of the ground and to the wellhead.<sup>182</sup> However, after examining the extraction and production processes for what they truly are, it appears that some members of the industry and their advocates have convincingly substituted the term “production” for “extraction.”

Oxford Dictionaries defines “extraction” as “[t]he action of taking out something, especially using effort or force” and lists “mineral extraction” as an example of that definition.<sup>183</sup> Extraction, not production, should be the term that defines the process of getting the gas out of the ground and to the wellhead. Even assuming *arguendo* that “extraction” should not have the common dictionary definition but rather the accepted definition from industrial practice,<sup>184</sup> the gas industry uses the term “extraction” to refer to the process of getting gas out of the ground and to the wellhead.<sup>185</sup> As *Kilmer* and the SEREC Hearing illustrate, the production process is not uniform between and among members of the natural gas industry.<sup>186</sup> Because the production process is not uniform, the term “royalty” should not depend on the seemingly arbitrary distinction between production and post-production costs, nor should it ignore the plain meaning of the term “extraction.”

In reality, production continues until the producer (in many modern circumstances, the extractor) generates a final product for sale and actually sells the product.<sup>187</sup> In other words, production stops at the point of sale of the produced

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<sup>181</sup> *Id.* at 1157–58.

<sup>182</sup> *Id.* at 1149 (citations omitted); *SEREC Hearing, supra* note 4 (statement of G.A. Bibikos).

<sup>183</sup> *Extraction*, OXFORD DICTIONARIES, [http://www.oxforddictionaries.com/us/definition/american\\_english/extraction](http://www.oxforddictionaries.com/us/definition/american_english/extraction) (last visited Mar. 4, 2014).

<sup>184</sup> See 1 PA. CONS. STAT. ANN. § 1903 (West 1972); *Kilmer*, 990 A.2d at 1157–58 (quoting 1 PA. CONS. STAT. ANN. § 1903 (West 1972)).

<sup>185</sup> See *Natural Gas > Production Processes > Drilling*, MARCELLUS SHALE COAL., <http://marcelluscoalition.org/marcellus-shale/production-processes/drilling> (last visited Mar. 12, 2014) (stating that horizontal drilling “allows for the extraction of larger quantities of natural gas from a single wellhead”).

<sup>186</sup> See *Kilmer*, 990 A.2d 1147; *SEREC Hearing, supra* note 4.

<sup>187</sup> I recognize my generous use of the root word “produce,” but I find such overuse necessary to emphasize the simplicity of the reasoning as opposed to the convoluted argument used by the gas industry to distinguish between the terms “production” and “post-production.”

product.<sup>188</sup> As *Kilmer* and the SEREC Hearing testimony explain, the first point of sale of natural gas in Pennsylvania originally occurred at the wellhead.<sup>189</sup> All production costs for producers/extractors occurred up to and stopped at that point, and producers/extractors had their end product.<sup>190</sup> Presently, the production of a saleable end product continues well beyond the wellhead.<sup>191</sup> Although different producers sell their products at different points along a line, these producers continue to refine and transport gas until they produce a marketable product.<sup>192</sup> The keyword here is “*product*.” How can a company incur post-production costs if they have not yet finished producing the product that they intend to sell? Common sense says that they cannot.<sup>193</sup>

### C. *Limits to the GMRA Amendments on Royalty Payment Information*

The payment information amendment to the GMRA set a minimum standard for providing information that lessees must meet.<sup>194</sup> The newly added section 35.2 states:

Whenever payment is made for oil or gas production to an interest owner, all of the following information, at a minimum, shall be included on the check stub or on an attachment to the form of payment, unless the 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.

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<sup>188</sup> See *Kilmer*, 990 A.2d at 1157; *SEREC Hearing*, *supra* note 4 (statement of G.A. Bibikos).

<sup>189</sup> *Kilmer*, 990 A.2d at 1155; *SEREC Hearing*, *supra* note 4 (statement of G.A. Bibikos).

<sup>190</sup> *Kilmer*, 990 A.2d at 1155; *SEREC Hearing*, *supra* note 4 (statement of G.A. Bibikos).

<sup>191</sup> *Kilmer*, 990 A.2d at 1155–57.

<sup>192</sup> See *Kilmer*, 990 A.2d at 1155.

<sup>193</sup> *Id.*

<sup>194</sup> See 58 PA. CONS. STAT. ANN. § 35.2 (West 2013).



- (5) Total amount of severance and other production taxes and other deductions permitted under the lease, with the exception of windfall profit 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.<sup>195</sup>

Although a positive step toward protecting royalty owners' interests, the GMRA amendments fall short of fully addressing royalty owners' concerns. Admittedly, section 35.2 *does* address the lack of clarity in check stub reporting by requiring more detailed reporting.<sup>196</sup> However, the reporting requirement appears to be severely limited. Additionally, the GMRA amendments do not prevent the deductions that lie at the heart of the current issue, nor do they define the term "royalty."<sup>197</sup> Had the General Assembly adequately responded to royalty owners' concerns, the GMRA amendments would have included a definition of the term "royalty" that, at the very least, applied proactively to new leases.<sup>198</sup>

Regarding clarity in reporting, the GMRA amendments do not address concerns that check stubs do not explain or define the nature of individual deductions.<sup>199</sup> Subsection 5 only requires gas companies to report to royalty owners the "[t]otal amount of severance and other production taxes and other deductions permitted under the lease."<sup>200</sup> However, check stubs and payment reports to royalty owners already disclose the "total amount" of deductions. Instead, problems arise when royalty owners attempt to decipher the individual components of the total

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<sup>195</sup> *Id.*

<sup>196</sup> *See id.*

<sup>197</sup> Compare 58 PA. CONS. STAT. ANN. § 35.2 (West 2013), with *SEREC Hearing*, *supra* note 4.

<sup>198</sup> Compare 58 PA. CONS. STAT. ANN. §§ 33.1–35.4 (West 2013), with *SEREC Hearing*, *supra* note 4 (statement of G.A. Bibikos).

<sup>199</sup> Compare 58 PA. CONS. STAT. ANN. § 35.2 (West 2013), with *SEREC Hearing*, *supra* note 4.

<sup>200</sup> 58 PA. CONS. STAT. ANN. § 35.2(5) (West 2013) (emphasis added).

deductions but, even with the aid of accountants and lawyers, are unable to do so.<sup>201</sup> Subsections 6 through 9 provide no further help in deciphering individual deductions because those subsections also appear to apply only to total interest, sales, and deductions.<sup>202</sup> Royalty owners specifically requested that the General Assembly require gas companies to provide clear, understandable explanations of individual deductions,<sup>203</sup> but the amendments to the GMRA fail to require such explanations.<sup>204</sup>

*D. Contradictions in the GMRA Amendments Regarding Lease Pooling*

Admittedly, section 34.1 *does* impose an element of reasonableness for apportioning payment, that “the production shall be allocated to each lease in such proportion as the operator reasonably determines to be attributable to each lease.”<sup>205</sup> When gas producers choose to develop Marcellus Shale gas underneath multiple properties from which the producers have leased the natural gas rights, such producers cannot arbitrarily or capriciously apportion royalty payments to owners.<sup>206</sup> However, absent an apportionment agreement among and between the producer and leaseholders, the producer has the statutory right to unilaterally decide what constitutes a “reasonable” apportionment.<sup>207</sup> Given the excessive and obscure royalty deductions that at least one gas company has been making,<sup>208</sup> it seems dubious to exclude royalty owners from the determination of reasonable apportionment and to assume that all gas companies will unilaterally provide reasonable apportionments.<sup>209</sup>

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<sup>201</sup> *SEREC Hearing, supra* note 4 (statement of C.D. Jones).

<sup>202</sup> *See* 58 PA. CONS. STAT. ANN. § 35.2(6)–(9) (West 2013).

<sup>203</sup> *SEREC Hearing, supra* note 4 (statement of D. Sikes).

<sup>204</sup> *See* 58 PA. CONS. STAT. ANN. § 35.2 (West 2013) (containing no reference specifying individual deductions).

<sup>205</sup> *Id.* § 34.1.

<sup>206</sup> *Id.*; Krancer & Hill, *supra* note 2, at 100.

<sup>207</sup> 58 PA. CONS. STAT. ANN. § 34.1 (West 2013).

<sup>208</sup> *SEREC Hearing, supra* note 4 (statement of D. McLinko).

<sup>209</sup> *Id.* (statements of M. Evanish and D. McLinko).

In addition, because most of the existing gas leases were signed before Act 66 came into effect,<sup>210</sup> it is unrealistic and unreasonable to presume that royalty owners had the foresight or knowledge to anticipate the pooling of leases.<sup>211</sup> In the absence of such foresight and knowledge, most, if not all, Pennsylvania gas leases signed prior to the passage of Act 66 likely do not contain apportionment provisions.<sup>212</sup> Unfortunately, unless or until natural gas companies agree to voluntarily alter existing leases, royalty owners will be bound by the apportionment that the company assigns.<sup>213</sup> Even if the parties decide to negotiate, gas companies will be operating from the default position that they do not need consent from the royalty owner to move forward with lease pooling.<sup>214</sup> By creating a statutory position of unilateral authority among lessee gas companies, Act 66 has greatly undermined royalty owners' negotiating power.<sup>215</sup>

#### *E. Mixed Legislative Efforts to Protect Against Royalty Payment Deductions*

Following Act 66 becoming law, at least three proposed bills emerged that would to limit the ability of lessees to take deductions that negatively affect royalty payments.<sup>216</sup> Although each bill would still allow deductions, each bill would also limit how, when, and to what extent lessees may take deductions and would guarantee that lessors receive either the one-eighth minimum royalty payment or the royalty payment specified in the lease.<sup>217</sup> Unfortunately, despite ongoing

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<sup>210</sup> Krancer & Hill, *supra* note 2, at 99; *SEREC Hearing*, *supra* note 4 (statements of D. McLinko and D. Miller).

<sup>211</sup> See Marie Cusick, *Corbett Signs Controversial Bill Giving Drillers Power to Pool Leases*, STATEIMPACT: PA. (July 9, 2013), <http://stateimpact.npr.org/pennsylvania/2013/07/09/corbett-signs-controversial-bill-giving-drillers-power-to-pool-leases> (citing NARO-PA).

<sup>212</sup> *See id.*

<sup>213</sup> *See* 58 PA. CONS. STAT. ANN. § 34.1 (West 2013).

<sup>214</sup> *See id.*

<sup>215</sup> *Pennsylvania's New Pooling Law*, *supra* note 1 (quoting NARO-PA).

<sup>216</sup> *See* H.B. 1650, 197th Gen. Assemb., Reg. Sess. (Pa. 2013), *available at* <http://www.legis.state.pa.us/cfdocs/legis/PN/Public/btCheck.cfm?txtType=PDF&sessYr=2013&sessInd=0&billBody=H&billTyp=B&billNbr=1650&pn=2323>; H.B. 1684, 197th Gen. Assemb., Reg. Sess. (Pa. 2013), *available at* <http://www.legis.state.pa.us/cfdocs/legis/PN/Public/btCheck.cfm?txtType=PDF&sessYr=2013&sessInd=0&billBody=H&billTyp=B&billNbr=1684&pn=3177>; H.B. 1732, 197th Gen. Assemb., Reg. Sess. (Pa. 2013), *available at* <http://www.legis.state.pa.us/cfdocs/legis/PN/Public/btCheck.cfm?txtType=PDF&sessYr=2013&sessInd=0&billBody=H&billTyp=B&billNbr=1732&pn=2414>.

<sup>217</sup> *See* H.B. 1650; H.B. 1684; H.B. 1732.

concerns with royalty payment deductions and support for reform by individual members of Pennsylvania's General Assembly, the legislature as a whole appears to be moving slowly in prioritizing and passing new legislation to protect royalty owners.<sup>218</sup>

Pennsylvania House Bill No. 1650 ("H.B. 1650") would require lessees to calculate royalty payments based on the gross proceeds of a sale at fair market value.<sup>219</sup> H.B. 1650 presumes that the gross proceeds equal the fair market value if the sale occurred under a "good faith contract entered into by nonaffiliated parties of adverse economic interests."<sup>220</sup> If the contract of sale did not occur at arm's length or between nonaffiliated parties, then the lessee would have "the burden to establish that" it paid the royalties based on fair market value.<sup>221</sup> From the royalties, a lessee could not deduct severance tax, impact fees, Commonwealth agency fees, or post-production costs.<sup>222</sup> Under H.B. 1650, post-production costs include the "loss of produced volume, whether by use as fuel, line loss, flaring, venting or otherwise," as well as costs that the lessee incurs between the wellhead and point of sale, including "gathering, dehydration, compression, treatment, processing, marketing and transportation costs incurred in connection with the sale of such production."<sup>223</sup> If passed, H.B. 1650 would only apply proactively to new or modified leases.<sup>224</sup> Although not clear from H.B. 1650's language, it appears that, so long as another statute or source of law does not completely prohibit

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<sup>218</sup> See, e.g., Marie Cusick, *Royalties Bill on the Back Burner Until Fall*, STATEIMPACT: PA. (June 19, 2014), <http://npr.org/pennsylvania/2014/06/19/royaltiesbillonthebackburneruntilfall>.

<sup>219</sup> H.B. 1650.

<sup>220</sup> *Id.*

<sup>221</sup> *Id.*

<sup>222</sup> *Id.*

<sup>223</sup> *Id.*

<sup>224</sup> *Id.*

deductions,<sup>225</sup> lessees would be able to deduct post-production costs, provided they do so before calculating the royalty payments, not after.<sup>226</sup>

Pennsylvania House Bill No. 1732 (“H.B. 1732”) contains provisions similar to those of H.B. 1650.<sup>227</sup> H.B. 1732 would add the following restrictions on royalty payments:

Unless otherwise provided for in the terms of a lease, royalties shall be calculated on the gross value of the oil, natural gas or gas of other designation at the wellhead. The lessee may not deduct any severance taxes, impact fees or postproduction costs, including any loss of volume or costs associated with gathering, dehydration, compression, treatment, processing, transporting and marketing the product. Deductions shall only be enforceable if the value of the royalty after the deductions results in at least one-eighth, or that percentage or royalty determined by the lease, of the gross value of the oil, natural gas or gas of other designation at the wellhead.<sup>228</sup>

Although H.B. 1732 appears to not allow lessors to receive potentially higher royalty payments based on increased value at a point of sale beyond the wellhead,<sup>229</sup> it at least prohibits some of the deductions that have caused great concern among royalty owners.<sup>230</sup> Unfortunately, at the time of this writing, neither H.B. 1650 nor H.B. 1732 have moved beyond the House Resources and Energy

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<sup>225</sup> See, e.g., 58 PA. CONS. STAT. ANN. § 3502 (2012) (prohibiting producers from shifting the responsibility of paying impact fees to a “landowner, leaseholder or other person in possession of real property, upon which the removal or extraction occurs”). Despite this prohibition, leases by both Chesapeake and Chevron include provisions for deducting a percentage of the Act 13 impact fees. Laura Legere, *Marcellus Leases Allow for Impact Fee Deductions, Despite Law Forbidding It*, STATEIMPACT: PA. (Oct. 16, 2013), <http://stateimpact.npr.org/pennsylvania/2013/10/16/marcellusleasesallowforimpactfeedeductionsdespitelawforbiddingit>.

<sup>226</sup> See H.B. 1650.

<sup>227</sup> Compare H.B. 1650, with H.B. 1732, 197th Gen. Assemb., Reg. Sess. (Pa. 2013), available at <http://www.legis.state.pa.us/cfdocs/legis/PN/Public/btCheck.cfm?txtType=PDF&sessYr=2013&sessInd=0&billBody=H&billTyp=B&billNbr=1732&pn=2414>.

<sup>228</sup> H.B. 1732.

<sup>229</sup> See *id.*

<sup>230</sup> Compare *id.*, with SEREC Hearing, *supra* note 4.

Committee (“HEREC”) since being introduced and referred to it in September of 2013.<sup>231</sup>

Another progressive bill that would have protected royalty owners, Pennsylvania House Bill 1684 (“H.B. 1684”), was unfortunately removed from the table on October 6, 2014.<sup>232</sup> Despite receiving one House committee’s approval, the natural gas industry strongly opposed H.B. 1684 as an unconstitutional violation of existing contracts.<sup>233</sup> H.B. 1684 recognized in its findings and declarations that lessees have been reducing royalty payments below the minimum one-eighth guarantee and that the General Assembly has the authority to prevent lessees from taking deductions that lower payments below the minimum one-eighth guarantee.<sup>234</sup> H.B. 1684 adopted an extensive, but not exclusive, definition of “post-production costs.”<sup>235</sup> It would have invalidated leases that did not provide the minimum one-eighth guaranteed royalty and would have prohibited the deduction of taxes, fees, and other production costs.<sup>236</sup> Additionally, H.B. 1684 would have prohibited the deduction of post-production costs or any other costs that reduced royalty payments below the one-eighth guarantee.<sup>237</sup> H.B. 1684 would have required lessees to calculate royalty payments based on the point of sale at the fair market value to a non-related business entity.<sup>238</sup> If a sale did not occur at arm’s length between non-related business entities, the lessee would have had the burden of showing that it based its royalty payment on the fair market value.<sup>239</sup> Finally,

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<sup>231</sup> *Bill Information > Regular Session 2013–2014 > House Bill 1732*, PA. GEN. ASSEMBLY, <http://www.legis.state.pa.us/cfdocs/billinfo/billinfo.cfm?year=2013&ind=0&body=H&type=B&BN=1732> (last visited Jan. 10, 2014); *Bill Information > Regular Session 2013-2014 > House Bill 1650*, PA. GEN. ASSEMBLY, <http://www.legis.state.pa.us/cfdocs/billInfo/billInfo.cfm?sYear=2013&sInd=0&body=H&type=B&bn=1650> (last visited Jan. 10, 2014).

<sup>232</sup> *Bill Information > Regular Session 2013–2014 > House Bill 1684*, PA. GEN. ASSEMBLY, <http://www.legis.state.pa.us/cfdocs/billinfo/billinfo.cfm?year=2013&ind=0&body=H&type=B&bn=1684> (last visited Dec. 29, 2014).

<sup>233</sup> Marie Cusick, *Royalties Bill Stalled in State Legislature*, STATEIMPACT: PA. (Apr. 23, 2014), <http://stateimpact.npr.org/pennsylvania/2014/04/23/royaltiesbillstalledinstatellegislature>.

<sup>234</sup> H.B. 1684, 197th Gen. Assemb., Reg. Sess. (Pa. 2013), available at <http://www.legis.state.pa.us/cfdocs/legis/PN/Public/btCheck.cfm?txtType=PDF&sessYr=2013&sessInd=0&billBody=H&billTyp=B&billNbr=1684&pn=3177>.

<sup>235</sup> *Id.*

<sup>236</sup> *Id.*

<sup>237</sup> *Id.*

<sup>238</sup> *Id.*

<sup>239</sup> *Id.*

H.B. 1684 would have applied to existing and future leases, but it would not have required recalculation of past payments or invalidated leases if past royalty payments did not meet the one-eighth minimum.<sup>240</sup>

On October 23, 2014, Marie Cusick, reporter for StateImpact: Pennsylvania, reported that former Governor Corbett “signed two bills providing more transparency for people who have leased their property for natural gas drilling.”<sup>241</sup> One of those bills, the “Unconventional Well Report Act,” amended a provision of title 58 of the Pennsylvania Consolidated Statutes to require unconventional well operators to file “monthly report[s] specifying the amount of production on the most well-specific basis available.”<sup>242</sup> The Act set a deadline of March 31, 2015 for filing initial reports showing a well’s status.<sup>243</sup> Subsequent monthly reports must show changes in well status, if any, and “production data for the preceding reporting period.”<sup>244</sup> The Act allows the Commonwealth to use the reported information “in enforcement proceedings, in making designations or determinations under section 1927-A of . . . [t]he Administrative Code of 1929, or in aggregate form for statistical purposes.”<sup>245</sup> In addition, the Act requires the DEP to make the reports publicly available on its website.<sup>246</sup> While the Act promotes transparency by allowing royalty owners to compare monthly statements with data reported to the state,<sup>247</sup> some royalty owners still desire greater legislative protection against royalty deductions.<sup>248</sup>

On January 28, 2015, the Pennsylvania State Senate passed two bills, Senate Bill 147 (“S.B. 147”) and Senate Bill 148 (“S.B. 148”), designed to better protect

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<sup>240</sup> *Id.*

<sup>241</sup> Marie Cusick, *Corbett Signs Bills Addressing Gas Transparency Issues*, STATEIMPACT: PA. (Oct. 23, 2014, 12:42 PM), <http://stateimpact.npr.org/pennsylvania/2014/10/23/corbett-signs-bills-addressing-gas-transparency-issues>. For the purpose of relevance, this Note only discusses one of the bills.

<sup>242</sup> Unconventional Well Report Act, 2014, Pub. L. 2853, No. 173 (Pa. 2014), *available at* <http://www.legis.state.pa.us/cfdocs/legis/li/uconsCheck.cfm?yr=2014&sessInd=0&act=173>.

<sup>243</sup> *Id.*

<sup>244</sup> *Id.*

<sup>245</sup> *Id.*

<sup>246</sup> *Id.*

<sup>247</sup> *Id.*

<sup>248</sup> Cusick, *supra* note 211.

royalty owners' interests.<sup>249</sup> Although the State Senate had passed both bills in its previous session, the bills have not yet made it past the State House of Representatives.<sup>250</sup> However, at least one House member has affirmatively indicated a lack of opposition to both bills.<sup>251</sup> As of this writing, both bills have been referred to HEREC.<sup>252</sup>

S.B. 147 would amend title 58 in the following ways: (1) adding definitions for the terms “joint venture,” “lessee,” and “lessor”; (2) requiring interest owners in a joint venture to provide the venture’s basic identifying information and the proportionate shares/interests of the marketed oil or natural gas; (3) allowing a lessor, upon written request, to review documents relating to the determination of royalty payments once every twelve months; and (4) prohibiting the lessor from disclosing reviewed information except to an attorney or an accountant or in a judicial proceeding.<sup>253</sup> While requiring additional disclosure of and access to information regarding royalty determinations addresses some concerns, S.B. 147 does not list any consequences for non-compliance,<sup>254</sup> potentially undermining enforceability and accountability.

S.B. 148 would provide protection for a lessor who “reports a violation or suspected violation of a contractual agreement.”<sup>255</sup> S.B. 148 allows lessors to bring a “[g]ood faith action” (one based on a reasonable belief and “without malice or ulterior motive”) to secure lease rights or to determine compliance with a lease.<sup>256</sup>

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<sup>249</sup> Marie Cusick, *State Senate Unanimously Approves Gas Royalty Bills*, STATEIMPACT: PA. (Jan. 28, 2015, 3:57 PM), <http://stateimpact.npr.org/pennsylvania/2015/01/28/state-senate-unanimously-approves-gas-royalty-bills>.

<sup>250</sup> *Id.*

<sup>251</sup> *Id.*

<sup>252</sup> *Bill Information > Regular Session 2015–2016 > Senate Bill 147*, PA. GEN. ASSEMBLY, <http://www.legis.state.pa.us/cfdocs/billinfo/billinfo.cfm?year=2015&sInd=0&body=S&type=B&bn=147> (last visited Mar. 26, 2015); *Bill Information > Regular Session 2015–2016 > Senate Bill 148*, PA. GEN. ASSEMBLY, <http://www.legis.state.pa.us/cfdocs/billinfo/billinfo.cfm?Year=2015&sInd=0&body=S&type=B&bn=148> (last visited Mar. 26, 2015).

<sup>253</sup> S.B. 147, 198th Gen. Assemb., Reg. Sess. (Pa. 2015), available at <http://www.legis.state.pa.us/cfdocs/billinfo/billinfo.cfm?year=2015&sInd=0&body=S&type=B&bn=147>.

<sup>254</sup> *See id.*

<sup>255</sup> S.B. 148, 198th Gen. Assemb., Reg. Sess. (Pa. 2015), available at <http://www.legis.state.pa.us/cfdocs/billinfo/billinfo.cfm?sYear=2015&sInd=0&body=S&type=B&bn=148>.

<sup>256</sup> *Id.*



A determination of compliance includes, but is not limited to, an accounting.<sup>257</sup> S.B. 148 prohibits a lessee from retaliating against a lessor who pursues a good faith action.<sup>258</sup> If the lessee does retaliate, the lessor may seek an injunction, damages, or both.<sup>259</sup> In addition to paying damages, a lessor found to have violated the anti-retaliation provision may have to pay a fine of up to \$1,000 for each day that the violation has occurred.<sup>260</sup> If the court finds that the lessor did not act in good faith, then the court “may order the lessor to pay reasonable damages to the lessee.”<sup>261</sup> In addition to providing clear protection to lessors who have legitimate concerns about their rights under a lease, S.B. 148 strikes a reasonable balance between lessor and lessee interests by protecting those lessees who comply with the law and the agreed upon lease terms from bad faith claims.<sup>262</sup>

*F. Reactions to Act 66’s Lease Pooling Provision*<sup>263</sup>

Although NARO-PA supported the original S.B. 259,<sup>264</sup> it has reacted negatively to the addition of section 34.1 of the amended GMRA.<sup>265</sup> Again, section 34.1 states that “[w]here an operator has the right to develop multiple contiguous leases separately, the operator may develop those leases jointly by horizontal drilling unless expressly prohibited by a lease.”<sup>266</sup> Essentially, section 34.1 allows companies to pool leases without royalty owner consent.<sup>267</sup>

NARO-PA has “support[ed] ‘fair’ pooling,” but it contends that section 34.1 allows pooling without rules and compromises landowner bargaining power with

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<sup>257</sup> *Id.*

<sup>258</sup> *Id.*

<sup>259</sup> *Id.*

<sup>260</sup> *Id.*

<sup>261</sup> *Id.*

<sup>262</sup> *See id.*

<sup>263</sup> For more detailed legal analyses of Senate Bill 259’s pooling provision, see Russell Bopp, *A Wolf in Sheep’s Clothing: Pennsylvania’s Oil and Gas Lease Act and the Constitutionality of Forced Pooling*, 52 DUQ. L. REV. 439 (2014). *See also* Denis P. Zuzik, *Shale Gas Leasing—Recent Legislation—an Alternative Perspective*, 84 PA. B. ASS’N Q. 171 (2013).

<sup>264</sup> *SEREC Hearing, supra* note 4 (statement of J. Root).

<sup>265</sup> *Pennsylvania’s New Pooling Law, supra* note 1.

<sup>266</sup> 58 PA. CONS. STAT. ANN. § 34.1 (West 2013).

<sup>267</sup> *Pennsylvania’s New Pooling Law, supra* note 1.

natural gas companies.<sup>268</sup> According to NARO-PA, royalty owners “who signed contracts years ago” did not anticipate the changes and developments resulting from “modern shale gas drilling.”<sup>269</sup> NARO-PA has also criticized section 34.1 as being vague and overly broad.<sup>270</sup> It asserts that the General Assembly and then-Governor Corbett should have addressed pooling in a stand-alone bill, accusing both parties of “hiding” and “fast-tracking” section 34.1.<sup>271</sup> Former Pennsylvania DEP Secretary Michael Krancer and Margaret Anne Hill claim that NARO has openly supported “forced pooling” and have found no explanation for NARO-PA’s negative reaction.<sup>272</sup>

According to Krancer and Hill, new section 34.1 does not: allow forced pooling; change existing lease terms; create an imbalance of bargaining power between natural gas developers and landowners; “compel any landowner to agree to the development of natural gas on their property”; expand oil or gas operators’ ability to define drilling unit size; and/or increase “the ability of an operator to hold by production any parcels of leased land.”<sup>273</sup> Krancer and Hill also wrote that when existing leases lie on a “horizontal path,” section 34.1 allows the transportation of natural gas “across a particular parcel back to the top hole.”<sup>274</sup> They also assert that section 34.1 “provides for minimizing the surface impacts and disturbance” (e.g., building fewer well pads, crossing fewer streams, fragmenting less forest, and disturbing less earth).<sup>275</sup>

Krancer and Hill think that everyone should support section 34.1’s alleged benefits.<sup>276</sup> They claim that section 34.1 achieves former Governor Corbett’s Marcellus Advisory Committee’s goals “of benefiting surface owners” by: providing more detailed information about royalty payment deductions; “account[ing] for opportunities (in this case, a reduction in the use of surface land) provided by the technological advances of horizontal drilling”; minimizing surface

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<sup>268</sup> *Id.* (quoting NARO-PA).

<sup>269</sup> Cusick, *supra* note 211.

<sup>270</sup> *Id.*

<sup>271</sup> *Id.* (quoting Trevor Walczak, Vice President of NARO-PA).

<sup>272</sup> Krancer & Hill, *supra* note 2, at 97.

<sup>273</sup> *Id.*

<sup>274</sup> *Id.*

<sup>275</sup> *Id.*

<sup>276</sup> *Id.*

impacts, and preventing “waste or stranding of natural gas.”<sup>277</sup> Along those lines, the West Virginia Surface Owners’ Rights Organization (“WVSORO”) has stated that “horizontal drilling develops 500 acres per well pad with a resulting two percent surface disturbance, while vertical drilling using 1,000-foot spacing between each well would only develop a mere [twenty-three] acres and would disturb [nineteen] percent of the surface.”<sup>278</sup>

On the day former Governor Corbett signed S.B. 259, he released a one-page letter explaining his positions on the new law.<sup>279</sup> Corbett described the newly required royalty payment disclosures as “important steps to better inform landowners and leaseholders regarding the production occurring from their property.”<sup>280</sup> In his letter, he said nothing about the concerns of unfairness that arose at the SEREC Hearing regarding royalty deductions.<sup>281</sup>

Regarding section 34.1, former Governor Corbett stated that he intended it to “enhance efficient development of oil and natural gas while safeguarding the rights and protections of landowners and leaseholders.”<sup>282</sup> He claimed that he did not intend to “alter or affect the common-law Rule of Apportionment” or any existing lease’s agreed-upon terms.<sup>283</sup> Corbett asserted his belief that “the Pennsylvania constitutional protections which guard against legislative impairment of contracts serve as an added backstop to these concerns.”<sup>284</sup> He then stated that he did not believe Act 66 “expands the ability of an oil or gas operator to define the size of a drilling unit, or to expand the ability of any operator to hold by production any

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<sup>277</sup> *Id.* (citing OFFICE OF THE LIEUTENANT GOVERNOR, GOVERNOR’S MARCELLUS SHALE ADVISORY COMM’N REPORT (2011), available at [http://files.dep.state.pa.us/PublicParticipation/MarcellusShaleAdvisoryCommission/MarcellusShaleAdvisoryPortalFiles/MSAC\\_Final\\_Report.pdf](http://files.dep.state.pa.us/PublicParticipation/MarcellusShaleAdvisoryCommission/MarcellusShaleAdvisoryPortalFiles/MSAC_Final_Report.pdf)).

<sup>278</sup> Krancer & Hill, *supra* note 2, at 101–02 (citing *Why Multiple Horizontal Wells from Centralized Well Pads Should Be Used for the Marcellus Shale*, W. VA. SURFACE OWNERS’ RIGHTS ORG. (July 12, 2013), [http://www.wvsoro.org/resources/marcellus/horiz\\_drilling.html](http://www.wvsoro.org/resources/marcellus/horiz_drilling.html)).

<sup>279</sup> See Letter from Pennsylvania Governor Tom Corbett to the Honorable General Assembly of Pennsylvania (July 9, 2013) [hereinafter Letter from Pennsylvania Governor Tom Corbett], available at <http://stateimpact.npr.org/pennsylvania/2013/07/09/corbett-signs-controversial-bill-giving-drillers-power-to-pool-leases>.

<sup>280</sup> *Id.*

<sup>281</sup> See *id.*

<sup>282</sup> *Id.*

<sup>283</sup> *Id.*

<sup>284</sup> *Id.*

parcels of leased land.”<sup>285</sup> Corbett claimed that Act 66 would “further minimize environmental impacts and surface disturbance,” maximize royalties’ economic benefits to royalty owners, increase the total number of Pennsylvania royalty owners through increased efficient oil and gas development, and ensure fair compensation of royalty owners.<sup>286</sup>

State Senator Gene Yaw of Bradford County, who introduced S.B. 259, once contended that section 34.1 is not “unfair to landowners.”<sup>287</sup> According to Senator Yaw, if someone can go on land to drill a horizontal well, then logically they can drill under it.<sup>288</sup> State Representative Garth Everett of Lycoming County, who introduced section 34.1, also stated that he could not remember who thought of or proposed the amendment.<sup>289</sup> Although Everett recalled an EQT Corp. (“EQT”) lobbyist had encouraged passing S.B. 259, he noted that such efforts were “so common in Harrisburg that he could not remember other specific people from interest groups who talked to him.”<sup>290</sup>

Despite assertions that section 34.1 would not undermine or compromise leaseholder’s rights or expectations,<sup>291</sup> “[l]ess than two weeks after” former Governor Corbett signed S.B. 259 into law, “EQT [] filed a lawsuit against seventy Western Pennsylvania landowners over drilling rights.”<sup>292</sup> EQT claimed that under the new section 34.1, “landowners did not have the right to prohibit the company from doing seismic testing in search of gas on their properties.”<sup>293</sup>

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<sup>285</sup> *Id.*

<sup>286</sup> *Id.*

<sup>287</sup> Cusick, *supra* note 211.

<sup>288</sup> *Id.*

<sup>289</sup> Timothy Puko, *Gas Well Pooling Provision Mystifies State Lawmakers*, TRIBLIVE: BUSINESS (July 4, 2013), <http://triblive.com/business/headlines/4303895-74/bill-pooling-provision#ixzz2YAmp5eBn>.

<sup>290</sup> *Id.*

<sup>291</sup> See Letter from Pennsylvania Governor Tom Corbett, *supra* note 279; Krancer & Hill, *supra* note 2, at 97; Cusick, *supra* note 211 (citing Pennsylvania State Sen. G. Yaw).

<sup>292</sup> *Pennsylvania’s New Pooling Law*, *supra* note 1.

<sup>293</sup> *Id.*

## V. CONCLUSION AND RECOMMENDATIONS TO BETTER PROTECT ROYALTY OWNERS

Contrary to certain arguments, there appears to be no valid reason to conclude that the original GMRA codified the natural gas industry's practice of selling at the wellhead.<sup>294</sup> On its face, the original GMRA codified a guaranteed minimum royalty payment of one-eighth of the gas's value at the point of sale.<sup>295</sup> Simply because the point of sale has shifted over time, thus incurring additional production expenses, gas companies should not be free to defy a statutory mandate and reduce the royalty payments.<sup>296</sup>

Admittedly, some companies that have leased mineral rights may very well sell their gas at the wellhead. In those cases, calculating royalty payments based on the price at the wellhead seems reasonable. However, companies that continue the process of refining and/or moving the product beyond the wellhead until they have processed the product into the proper form in which they intend to sell it have *not* yet finished production. For those companies, because production costs continue until they sell the product, that sale should be statutorily subject to a minimum one-eighth royalty payment to the gas rights' owners.<sup>297</sup>

In line with the proper and generally accepted statutory minimum one-eighth requirement as many Pennsylvania royalty owners understand it, the General Assembly needs to adopt a common sense definition of "royalty" based on the proceeds from sale without deductions. As was argued in *Kilmer* and has since been supported by royalty owners, the commonly accepted definition of the term "royalty" is "a compensation or portion of the proceeds paid to the owner of a right, as a patent or oil or mineral right."<sup>298</sup> By adopting the common definition the term,

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<sup>294</sup> *Cf.* *Kilmer v. Elexco Land Servs., Inc.*, 990 A.2d 1147, 1157–58 (citations and quotations omitted); Bibikos & King, *supra* note 62.

<sup>295</sup> See 58 PA. CONS. STAT. ANN. § 33 (West 2013), *repealed by* Act 66 of 2013, P.L. 473, No. 66, § 1, 58 PA. STAT. ANN. §§ 33.1–35.4 (West 2013); *see also SEREC Hearing*, *supra* note 4 (statement of D. Sikes).

<sup>296</sup> See *SEREC Hearing*, *supra* note 4 (statement of D. Sikes).

<sup>297</sup> See *id.* (statements of J. Rotz and D. Sikes); *but see Kilmer*, 990 A.2d 1147; H.B. 1650, 197th Gen. Assemb., Reg. Sess. (Pa. 2013), *available at* <http://www.legis.state.pa.us/cfdocs/legis/PN/Public/btCheck.cfm?txtType=PDF&sessYr=2013&sessInd=0&billBody=H&billTyp=B&billNbr=1650&pn=232>; H.B. 1684, 197th Gen. Assemb., Reg. Sess. (Pa. 2013), *available at* <http://www.legis.state.pa.us/cfdocs/legis/PN/Public/btCheck.cfm?txtType=PDF&sessYr=2013&sessInd=0&billBody=H&billTyp=B&billNbr=1684&pn=3177>.

<sup>298</sup> *Kilmer*, 990 A.2d at 1151 (quoting Landowner's Br. at 19). *See also SEREC Hearing*, *supra* note 4.

the General Assembly would be keeping in line with royalty owners' reasonable expectations.<sup>299</sup>

Accordingly, the GMRA should be protecting royalty owners' interests. However, because the Commonwealth has failed to act in a manner that properly addresses current natural gas development issues, the GMRA does not adequately do its job. Some natural gas companies arguably continue to take improper deductions from royalty payments, and, rather than limiting those companies' ability to take deductions, the General Assembly has allowed this practice to continue. Moreover, via Act 66's forced pooling provision, the General Assembly has further tipped the balance of power in favor of lessee natural gas companies by allowing these companies to unilaterally change lease terms.<sup>300</sup> In light of ongoing developments surrounding Pennsylvania's natural gas development, the General Assembly needs to take stronger action to protect royalty owners' interests. That action includes statutorily defining "royalty" and not placing industrial interests before royalty owners' interests.

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<sup>299</sup> See *SEREC Hearing*, *supra* note 4 (statement of D. Sikes).

<sup>300</sup> See *Pennsylvania's New Pooling Law*, *supra* note 1 (quoting NARO-PA).