Pennsylvania Joins a Growing Number of States to Allow Cross-Unit Drilling

An Analysis of Act 85 of 2019

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The unconventional oil and gas well community is innovating at a lightning fast pace resulting in more efficient and effective wellbores that extend past the traditional 640-acre unit size. Innovation has not only lowered costs but could decrease surface disturbance and environmental factors. If a lateral can extend through multiple units, only one well pad would be necessary, not to mention a decrease in materials, access roads, and temporary construction areas. However, doing so is often prevented by two issues: (i) existing spacing regulations; and (ii) restrictive leasehold provisions, including restrictions on unit size and foreign gas. This article will address these hurdles showcasing how recently enacted legislation known as Cross Unit Drilling for Unconventional Wells (Act 85 of 2019, amending The Act of July 20, 1979, P.L. 183 No. 60 known as The Oil and Gas Lease Act) (effective January 6, 2020) has eased the burden on operators; while noting potential risks, pitfalls and best practices.

<u>Current Unconventional Well Spacing Restrictions</u>

Through statute, Pennsylvania mandates that any unconventional gas well must be at minimum 500 feet measured horizontally from the vertical wellbore to a building or water well.[2] Further, an unconventional "well may not be drilled within 1,000 feet measured horizontally from the vertical wellbore to any existing water well, surface water intake, reservoir or other water supply extraction point used by a water purveyor without the written consent of the water purveyor."[3]

Additionally, an operator would be prevented from drilling between two appropriately sized (i.e. 640 contiguous acres) units due to a setback limitation requiring that a conservation well - defined by the Commonwealth as any well which penetrates the Onondaga horizon, or in those areas in which the Onondaga horizon is nearer to the surface than 3,800 feet - be placed at least 330 feet from the limit of the leased property (meaning the closest unit boundary).[4] For example, Unit A is restricted to 640 contiguous acres and Unit B is restricted in the same manner. Operator owns all of the working interest under all of the leases for both Unit A and Unit B. Operator wishes to drill a conservation well bore which extends beyond the unit limits of either unit and could, in theory and without additional lease-imposed restriction, drill between the two units. Operator would be explicitly barred from doing so due to the 330-foot location requirement.

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[2] 58 Pa. Consol. Stat. §3215.

[3] *Id.*

[4] P.L. 825, No. 369 § The Act of July 25, 1961. Please note that non-conservation wells are not subject to this 330-foot spacing requirement.

These restrictions present operators with the cumbersome task of balancing the strategic placement of a well pad within the established unit in the most efficient and least wasteful geologic location, and the placement of said well in such surface location so as not to infringe on the setbacks surrounding physical structures, water supplies, etc.

Restrictive Leasehold Provisions

The other most common issue which has traditionally prevented a cross-unit lateral is a restrictive leasehold provision. Of course, each lease must be examined on a case-by-case basis and other restrictions other than what is discussed herein could impact cross-unit drilling. However, the two most common and problematic are (i) unit size restrictions; and (ii) a foreign gas clause.

Restrictions on unit size are extremely common in oil and gas leases taken in the last fifteen years – typically set at no more than 640 contiguous acres, or if lucky, 1,280 contiguous acres. The fact that the lease could not be included in a unit larger than allowable by the lease provision essentially handcuffed the operator into smaller units than current technology permits.

A foreign gas clause in a lease prohibits the transfer of "foreign" gas or other products which are attributable to another unit. Courts in Pennsylvania have not been presented with a cross-unit drilling scenario which includes a lease containing a "foreign gas" clause; however, it is possible that a court would recognize the entirety of the contiguous units as one individual unit as it has done in similar fashion when recognizing a leased tract as inseparable from its co-unitized tracts in an established unit for purposes of analyzing a foreign gas clause.

In the instances where the above-described provisions, or other equally restricting provisions, are included in an oil and gas lease, operators have been left with little option but to approach all lessors and attempt to acquire an amendment and modification to the lease. Expectedly, although most of the corpus of the lessor-impacting portions of the lease remain unchanged, lessors are not always apt to signing the necessary instrument without protest and demand of re-negotiation.

Remedies of Act 85

Act 85 of 2019, allows an operator holding the working interest or fee interest for all tracts in contiguous units to utilize a wellbore that traverses via horizontal drilling more than one unit if (i) the operator reasonably allocates production; and (ii) the traversing well is not expressly prohibited in the lease. By codifying this ability, an operator may now operate beyond the existing spacing restrictions and lease-imposed restrictions to traverse between units freely and extend the length of the lateral farther for more efficient drainage. For illustration purposes, the operator may "stack" contiguous units. Unit A is 640 contiguous acres, with a well drilled thereon. Unit B is contiguous to Unit A, and Unit C is contiguous to Unit B. The operator can now extend the lateral from the well pad placed on Unit A through Unit A, continuing through Unit B, ending in Unit C, all while creating surface disturbance on only one portion of Unit A and maintaining effective production for payments to lessors.

One important fact to note is that Act 85 does not permit operators to unilaterally modify lease terms or drill an oil and gas well across any property not subject to an oil and gas lease. However, so long as the leases included in the unit do not expressly prohibit cross-unit drilling, it is permitted. It remains to be seen how broadly courts will interpret lease provisions as prohibiting cross-unit drilling. Therefore, while Act 85 very clearly eliminates the first hurdle of well spacing requirements, it has fallen somewhat short of eliminating the second hurdle.

Concerns and Best Practices

Several concerns arise after the passage of Act 85: (i) how to allocate royalties from a cross-unit well, and (ii) how to hold a cross-unit lease by production. Act 85 does not provide much guidance regarding the allocation of royalties from a cross-unit. An operator may drill across more than one unit if:

> (1) The operator reasonably allocates production from the well to or among each unit the operator reasonably determines to be attributable to each unit. The operator may allocate production on an acreage basis for multiple units provided the allocation has a reasonable correlation to the portion of the horizontal wellbore in each unit.

It would not be the first time that a subjectively "reasonable" standard has opened the door for litigious trouble. The most conservative operator – living in an ideal world - would obtain an allocation of payment document agreed to and acknowledged by the lessors in all effected units. This approach would grant contractual protection for the operator, thus preventing the likelihood of a successful argument on the grounds of subsurface commingling or misallocation of payments. However, this is often not a practical solution, and would likely result in additional headaches. Therefore, best practice would be to create an internal policy which sets out a clearly defined allocation method which is utilized in all cross-unit drilling scenarios without exception.

Another potential litigious issue is one that is all too familiar in the oil and gas industry – what is sufficient to hold the leases by production. It is fairly well settled that (of course, certain exceptions in lease language aside) production resulting from any leased tract within a unit and resulting royalty payments to all lessors within the unit is sufficient to hold all unitized leased tracts by production. However, let's revisit our example above. Unit A contains the well pad, and the lateral extends through Unit A, Unit B and ends with Unit C. It is determined that it is most efficient to hydro-fracture only below Unit C for 5 years. At the end of year 5, the primary term of the majority (if not all) of the leases comprising Unit A and Unit B are beyond their primary term. Will production from Unit C only be sufficient to hold the leases entirely comprising Unit A and Unit B by production, or will they have expired by their terms and the operator has missed the opportunity to develop those tracts? This will be a determination for the courts. Although it seems elementary, the best way to avoid this potential issue is to be diligent in maintaining lease records to be aware of which leases are held by production, which leases are not, and when leases may be approaching the end of the primary term in order to extend or renew if possible.

In conclusion, the Commonwealth of Pennsylvania has acknowledged the industry's ability to innovate and prevent waste and has responded in kind. Unfortunately, due to the infancy of this new tool, little guidance exists. Therefore, diligence in lease review and consistently applying new internal policies applied without exception is the best practice as the industry navigates the waters of this exciting new development.