

Compulsory Integration in a Changing Energy World

To understand Compulsory Integration one must first understand a few fundamentals of Oil and Gas Law in New York State.

Although New York State was an early developer of oil and gas, it was quickly surpassed by Pennsylvania and then the Western States. Consequentially, Texas and Pennsylvania have a rich supply of judicial decisions (case law) from which to draw for answers to legal questions concerning who, when, how and where oil and gas development can proceed. A Texas law review has opined that New York State has virtually a clean slate regarding oil and gas case law. To that fact add that in Texas nearly every bar examination contains at least one question on oil and gas law. Not so in New York. The result is that every attorney who practices law in Texas and every judge who sits on their benches, has at least 'law school' knowledge of their state's oil and gas laws. In New York there are very few attorneys who know anything about oil and gas law, and even fewer who can speak cogently about it.

Additionally there is little or no statutory law on oil and gas law in New York. What does exist, exists in such unrelated statutes as the General Obligations Law, the General Construction Law, the Environmental Conservation Law, and the Real Property Law. Furthermore, New York State is part of an unusual interstate compact called the Interstate Compact to Conserve Oil and Gas, which also affects New York State residents and businesses operating in New York.

New York is surprising in what it does not address in statutes or cases: there is no state law governing or regulating oil and gas meters at the well site; there is no regulation of oil and gas leasing except a recent law offering a three day cooling off period after signing; there are no statutes or regulations governing the accounting and auditing obligations of oil and gas companies to landowners; there is no bonding related to the actual costs of restoration or clean-up of environmental degradation; and the gas gathering lines are all but unregulated in New York.

The topper is that when it comes to who owns the oil and gas underneath one's land, New York and America move into the surreal, a regular twilight zone of real property law. Who owns the oil and gas has been established by the courts, not the legislature or the State Constitution. The courts, with little or no knowledge of geology at the time, alighted on the legal principle called The Rule of Capture.

Ordinarily, a landowner who owns all the rights in his or her land (a fee simple) owns to the center of the earth and to the edge of the atmosphere (subject of course to FAA rules and over-flight rights regulated by the US of A). And this is true of 'hard rock' minerals, e.g. coal, talc, iron ore, etc, (but not gold and silver, as they were reserved to the state of New York).

Oil and Gas are different. In the earliest days of drilling it became clear that oil and gas moved underground in some way, for if one landowner had a producing well and the neighbor drilled

his own later, the first well's production invariably declined immediately. How this interconnection functioned was not known until the twentieth century. Meanwhile, oil and gas was labeled "fugitive" and subject to capture by the first person to extract it from the ground and take possession of it at the surface. Hence the phrase "rule of capture".

The rule of capture in its purest form, unaltered by statute, states that so long as your well bore remains within the boundaries of your land, then all the oil and gas you can extract and possess at the surface belongs to you. It matters not that any portion of that gas and oil originated under someone else's land. A ten acre parcel with ten wells on it could drain 600 acres if the geology allowed it. It did not matter whether the neighbor could not afford to drill a well. It did not matter that a small acreage could drain a larger acreage. The land with the well on it could drain the ground dry with nothing owed to the other landowners.

This circumstance left the remaining landowners with only one recourse - to drill their own wells, which, naturally, most often happened. This drilling led to severe environmental consequences, a vast waste of capital (too many wells just to protect against drainage), over supply, market collapses, and loss of well head pressure, leaving much oil in the ground, unrecoverable. Most Americans are unaware that the natural gas was long regarded as a useless resource of little or no value, and was usually vented into the air or burned off as waste. The rule fostered many unintended consequences, to the severe detriment of the nation, the industry, the land, and the landowners.

The solution offered to address these problems was not to abandon or abolish the rule, but instead was to form an Interstate Compact to Conserve Oil and Gas in which the states would pledge to adopt legislation which would accomplish the purpose of conserving oil and gas by the prevention of physical waste thereof from any cause. New York in honoring that purpose embraced the further purposes: to regulate the development, production and utilization of natural resources of oil and gas in this state in such a manner as will prevent waste; to authorize and to provide for the operation and development of oil and gas properties in such a manner that a greater ultimate recovery of oil and gas may be had, and that the correlative rights of all owners and the rights of all persons including landowners and the general public may be fully protected. New York is a member and these purposes are reflected in Title 3 of Article 23 of the Environmental Conservation Law, section 301. Implicit in all of this is that oil and gas is an energy resource which ought to be developed for the good of the nation as a whole, energy being one of the primary ways that a civilized society becomes and remains civilized. One must remember that these policies were forged in 1935, during the Great Depression.

As part of the mandate to protect the correlative rights (rights of owners to an equitable share of the oil and gas in a common pool or field) of the adjoining landowners, New York State passed Title 9 of Article 23 of the Environmental Conservation Law. The most recent rendition of that law was enacted in August of 2005 and was drafted by the industry, with an eleventh hour addition of the three day cooling off period at the request of the New York Farm

Bureau. Title 9 has many problems including the failure to recognize the true value of the landowner's resource.

In a nutshell, the statutory plan is as follows: No one can drill an oil or gas well in New York State without a permit from the Department of Environmental Conservation (DEC). With the permit application, the applicant, now called the operator, must file a unit map showing the area to be drained by the well and must integrate all the owners into the unit. Only one permit can be issued per unit. The operator must show that it has the right to drill or drain (this is called controlled interests, who have already agreed voluntarily to be integrated) between one hundred per cent and sixty percent of the area covered by the map. If the controlled area is less than one hundred but more than sixty percent, then a separate application must be made requesting a Final Order of Compulsory Integration before DEC and a hearing officer. Included in the application for Compulsory Integration is a list of the costs and expenses of drilling and completing the well. This list is called an Authorization For Expenditure (AFE). This process is necessary because when the permit is issued all other landowners in the unit will be prohibited, by law, from drilling a well to the depth and formation authorized in the permit. The sole method of recovering the oil and gas is the one permit.

Title 9 offers three choices, called elections, to the landowner who did not lease to anyone and who is being compulsorily integrated:

1. Do nothing and receive a royalty interest in the gas and or oil attributable to the landowner's percentage of acreage in the unit. The royalty awarded is equal to the lowest royalty in all leased parcels but not lower than 12.5 %. No expenses are allowed to be deducted in determining the royalty. This is called the Integrated Royalty Owner. The landowner has no liability for anything related to the well costs.
2. Give a certified check to the Operator for the landowner's percentage of the AFE, which is determined by his percentage in the unit. He have thirty days from the day he receive the hearing notice to raise all that cash. AFE's can be between \$1,000,000.00 and \$6,000,000.00 or more, depending on the well and the formation to which it will be drilled. His rate of return is determined by his percentage ownership of the unit acreage after all expenses are deducted. Depending on the well he could lose all his money and have no revenue whatsoever. The Landowner becomes liable for all future costs and liabilities on a pro-rata basis. Any failure to pay causes him to lose all his money and become, by default, a Royalty owner above. This is called the Integrated Participating Owner Election.
3. Not pay anything but affirmatively elect to be an Integrated Non-Participating Owner, but be subject to a penalty (called a 'risk penalty') of three hundred percent of what an Integrated Participating Owner above would have paid. This penalty is taken from the landowner's share of the oil and gas proceeds. Depending on the well he could get nothing or a return based on his percentage of the unit, less his pro-rata costs.

There are no other alternatives in New York States' compulsory integration process.

Disagreeing with Compulsory Integration as a concept is insufficient legal reason to abolish it. New York State, being bound by the Interstate Compact to Conserve Oil and Gas, must conserve oil and gas by the prevention of physical waste thereof from any cause. The repeal and abolition of compulsory integration would violate the compact by failing to have legislation in place protecting and promoting those purposes. Worse yet, the abolition of Compulsory Integration would return New York State to the wild, wild west of pure Rule of Capture, which as described earlier, is, when left unchecked by compulsory integration, extraordinarily wasteful of the oil and gas, financial capital, and the environment and allows a neighbor to take all the oil and gas of a landowner without paying a cent for it.

What can be done? Remembering that Title 9 of Article 23 of the ECL was written by the oil and gas industry with no hearings in the legislature and was submitted in June of 2005 as the legislative session was winding down, the answer is to amend the statute to allow the landowner a fair return. For instance, in North Dakota, (a state in the middle of an oil and gas boom) the royalty paid to the Integrated Royalty Owner is a cost-free weighted average royalty interest of all the other leases in the unit. For New York State, based on our experience, I would add that the weighted average royalty be conditioned that the royalty be no lower than 18.75%, and cost free.

Regarding the risk penalty of an Integrated Non-Participating Owner, in North Dakota, the Operator can only recover from the production attributable to the landowner a risk penalty of 50 % of the landowner's pro-rata share of the AFE. A figure of less than 100% recognizes and acknowledges that the landowner should be given a substantial discount against the costs because his or her land is being used without their permission and is essential to the Operator being able to acquire a permit to drill. The recovery of the risk penalty under North Dakota law is conditioned on the Operator having made an unsuccessful, good faith attempt to have the unleased landowner execute a lease. The landowner has the right to challenge the risk penalty before the Agency if the Operator has not made the good faith attempt required above.

North Dakota also requires a cash bond deposit in a special fund for plugging and abandoning wells and for reclamation of well sites.

If New York State were to adopt these North Dakota provisions as modified above, along with additional accounting, auditing, and operator non-discrimination requirements, then the Compulsory Integration process would come closer to fairly protecting the correlative rights of the landowners.

Compulsory Integration is necessary to protect the correlative rights of the landowners and to advance the policies set forth in the Interstate Oil and Gas Compact. However, the New York Statute needs immediate amendments to Title 9 of the Environmental Conservation Law to incorporate the changes suggested above.