May 17, 2013 Fracking, Compulsory Pooling Study Group

What is a "drilling unit" and when is it established; leased vs. unleased owners in a "pooling" order; who pays for the "risk" when drilling; immunity or indemnification for surface owners forced into a pool...who pays legal costs when things go wrong; notice to owners when land is about to be fracked; trusting/verifying "fair" royalty payments; forcing federal, state, local parks/lands into a compulsory pool

Note: All Study Groups report to full Mining & Energy Commission. Study Groups have numerous "invited" members and will complete their recommendations for submission to the Legislature by October.

Compulsory Pooling Study Group, chaired by Ray Covington. Held in Sanford. (MEC members Charles Holbrook, Jim Womack)

1. Unitization vs Compulsory Pooling, who defines?
The term Compulsory Pooling is used in NC General Statutes. NC has no legal definition of "unitization" (or drilling unit), and MEC must define what that is. Attorney Ted Feitshans recommended a "process approach" rather than defining a "unit" based on certain acreage, like other states. Holbrook said the operator will acquire leases that adhere to oil field parameters (geologic and engineering) and then request the creation of a "unit" from the MEC. MEC would also hear from land owners during that process. Womack said could define "pooling" as a type of activity, and "unitization" as the specific process to arrive at the drilling unit. Holbrook says there could be multiple operators in same area, and their responsibility would be to come to MEC to establish the boundary of the "unit," which reflects the extent of the fracking line. Each well must have a defined unit at a specific vertical depth. Note: Could have multiple wells on same well pad and different "units" would be established based on fracking depth and horizontal direction. Womack said study group should define terms: Compulsory Pooling and Unitization. Lynn, Attorney General's office said the Interstate Oil and Gas Compact Commission (on web) has a model oil and gas conservation act with a "unitization" section.

2. Leased vs. unleased owners in a pooling order.
Some states establish a percentage of "leased" owners before a pooling order is issued, and some establish a surface acreage "unit." DENR staff, Layla, said many states have NO minimums. PA recommends against compulsory pooling of "unleased" owners. Leased owners are "assumed" to want to move forward, but some may want to hold-out for better prices (and therefore must be "compelled" into a pool). Lynn, AG's office, suggested Study Group propose a specific number (percentage) of voluntary acreage the MEC would use as its criteria for pooling, and establish the principle that NC strongly discourages compulsory pooling. DENR staff, Trina, said having "no minimum" requirements puts more responsibility on the MEC administration. Consensus on requiring a minimum of 50% of leased owners to agree before operator seeks a pooling order. Womack said put some percentage requirement on operator, but allow for waivers. In addition to leased and unleased owners, those owners who have a "working interest" need to be considered.

Attorney John Humphrey gave four unitization scenarios that could involved leased/unleased owners:

(a) Dueling operators in same area; MEC must settle the dispute
(b) Unleased landowners who must be protected
(c) Leased landowners with an operator who does not control enough land for a viable unit
(d) Leased landowners who want "in" the unit, but are outside the boundary

3. Risk Penalty for all hold-outs?

Attorney Ted Feitshans discussed subdivisions located in the fracking area and how these small landowners would be assessed a risk penalty [a pro-rated share of the production costs after well is productive and before royalties are paid]. Holbrook said most land owners bear no up-front costs for drilling; the operator pays all costs. However, since NC shale beds will be exploratory, there should be a higher risk penalty assigned (200% or more?) because operators won't know richness of the hydrocarbon, or the amount of water and combustibles in the gas until post-drilling laboratory analysis. Covington wants to give MEC leeway in setting the risk penalty, but get best deal possible for landowners.

4. Subgroup assigned task.

To tackle procedural issues and identify "best practices," Covington assigned a subgroup as follows: DENR staff Layla Cummings, Trina Ozer, Walt Haven; attorneys Lynn Weaver, John Humphrey and Ted Feitshans; Grady McCallie (NC Conservation Network) and James Robinson (RAFI). Covington said he needs a list of main recommendations for Compulsory Pooling by the MEC's June 7 meeting; however the entire Study Group would come together late summer to finalize a report.

5. Indemnification and Immunity.

Attorney Feitshans said the "land owner" in a unified estate is the "lessor" in these pooling agreements, but in severed (split) estates the "mineral rights owner" is the lessor. S820 (Session Law 2012-143) only indemnifies the "surface owner," but not subsurface mineral owners on severed estates. Nor does the law contain the words "duty to defend" in the indemnification wording; this will be in the first law suit when damages occur. Even with indemnification protection, the unleased (pooled) surface owner would have to PAY their own legal costs in a suit for damages. Another possibility is to grant immunity to the pooled surface owner, so that a suit for damages can proceed and lawyers are NOT paid until after the court case; but he cautioned that courts take a skeptical view of immunity. It is preferable to stick with indemnification protections. Recommendations:

(a) Unleased owners should have NO liability and have the "right" to indemnification for their own injuries and damaged economic interests.
(b) Leased owners should be indemnified through the terms of their joint operating agreement OR original lease, whichever indemnification is greater. Mindful of US Constitution's 5th Amendment (takings clause, due process) and 14th Amendments (due process) if change core provisions of the contract.
(c) If unleased owner chooses a "working interest," then offer indemnification (same as "leased owner") in the options approach.

(d) Any pooling order from MEC should include language to "require" the operator to pay to defend the unleased land owner if sued for damages by a third party.

Lynn Weaver said to not overlook compensation for surface owners themselves, and need to specify that landowners should be compensated for harm, not just action by a third party.

6. Notice.
Attorney John Humphrey had recommendations on providing "notice" to surface estate owners above "compelled" mineral rights. S820 requires the operator to provide a written notice 14-days prior to coming onto a property; however NO notice is required before that operator accesses the subsurface...that could affect timing of baseline water samples. (There are notification problems with inherited land that is non-probated and has no addresses for heirs.) However, recommends that Operators provide notice to "compelled" owners of surface estates and "compelled" owners of mineral rights 30 days to 6 months prior to initiating drilling in the production unit.

7. Reporting.
Attorney John Humphrey had recommendations regarding what production information might be provided so people know they are getting their fair share of royalties, and a way to verify the information. Components for the report could include ID of well, lease number, owner ID, total production volume sold, price per unit, month/year of sale, owner's % interest.

8. Compulsory pooling of special lands?
Trina Ozer said CANNOT force federal lands (Lake Jordan, Ft. Bragg) into a compulsory pool, but could pool state and local government-owned lands, since no law against it. Question about USDA conservation easements...those would be considered federal lands and therefore cannot be pooled. However, private conservation easements and soil and water conservation easements are different; each would have to be considered separately. Did the conservation easement have language covering mineral rights and/or subsurface activity, or deed restrictions imposed? Could the State condemn an easement for road access, which restricts the use of property owned by a Land Trust? Local government-owned lands should be considered as well as State-owned lands. Covington wondered if this Study Group should take a position (yes or no) about whether state or local government property can be compelled into a pool. Trina said she would seek advice from the Secretary of DENR. Question about whether a local government would need to get public input before they "pooled" any of their holdings. Trina will check with School of Government on disposal of property.

NOTE: NEXT MEETING of Compulsory Pooling Study Group is Friday, May 31,1:00-5:00 pm, Green Square, 217 W. Jones St., Raleigh.

Diana Hales, retired