

ADMINISTRATIVE WATCH

ADDRESSING ENVIRONMENTAL, ENERGY AND NATURAL RESOURCE ISSUES



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2011: An Unconventional Year for Unconventional Gas Development in PA

Last year was a year of accelerated activity in Pennsylvania's natural gas development, especially as the development of the Marcellus and Utica Shale gas formations continued to grow. As in previous years, environmental issues presented significant challenges to natural gas developers. However, in 2011, many more issues associated with non-environmental topics were drawn to the forefront. With this article, the environmental and energy attorneys of Babst Calland provide a brief overview of some of the challenges and issues from the past year in the following areas relating to natural gas development: environmental, litigation, land use, labor and employment, mergers and acquisitions, and title. We also outline the coming development of the Utica Shale as we look forward to 2012.

Environmental Challenges and Issues

During each season of 2011, producers wrestled with significant changes to the regulatory picture regarding environmental issues. Some of the most significant changes occurred last winter when former Environmental Hearing Board judge Michael Krancer replaced John Hanger as the Secretary of the Pennsylvania Department of Environmental Protection (PADEP). In February, extensive changes to Chapter 78 of the oil and gas regulations were promulgated. These regulatory changes included new casing and cementing provisions, procedures for responding to stray gas complaints and requirements to defend against and respond to water pollution/diminution claims. Although these changes resulted in increased requirements for producers, the natural gas industry generally accepted the majority of these changes without opposition.

In the spring, Secretary Krancer issued a press release requesting that producers stop taking shale gas wastewaters to certain wastewater treatment plants, even though those plants had been grandfathered to accept such shale gas wastewater following the promulgation of the total dissolved solids regulations in Chapter 95 of the Pennsylvania Code. Discontinuing this outlet for the disposal of flowback water forced many producers to search for alternative methods to manage the liquids, including more expensive treatment options or underground injection. Later in the spring, the United States Environmental Protection Agency's (EPA) Region 3 Office issued information request letters to Pennsylvania's six largest natural gas operators, specifically asking those operators to disclose their disposal and recycling methods for shale gas wastewater.

During the summer, Governor Corbett's newly-formed Marcellus Shale Advisory Commission issued its recommendations to revise the laws regulating the natural gas industry. The Governor responded to the Commission's report by announcing a plan to guide the General Assembly and state agencies to develop and modify laws and regulations affecting the natural gas industry, including imposing an impact fee, increasing setback distances for well sites, and expanding the distance for which an operator is presumed to be liable for impacts to water wells. At the date of this printing, no such legislative changes have been enacted.

In the fall, PADEP issued a draft policy to address spills and releases from oil and gas wells and related operations. The policy contains stringent spill reporting requirements for a broad array of materials commonly used or produced at well sites. The policy also imposes new cleanup criteria and procedural requirements developed under Pennsylvania's Land Recycling and Environmental Remediation Standards Act, commonly known as Act 2. In the context of air permitting, PADEP also announced the availability of interim final guidance for performing single stationary source determinations for the oil and gas industry. The permitting issues raised by this "aggregation" guidance and prior guidance documents have been an area of increased interest by producers and midstream companies. In addition, in September, Secretary Krancer announced plans to reorganize PADEP, such that the Bureau of Oil and Gas Management was elevated to the Office of Oil and Gas Management, placing PADEP's central staff and field staff under the same management structure. The reorganization is intended to ensure that PADEP regulates the oil and gas industry across its regional offices in a more uniform manner.

In 2011, other administrative agencies having jurisdiction over the environmental aspects of natural gas development increased their oversight of the industry. In particular, the United States Army Corps of Engineers and EPA increased inspections of stream and wetland disturbances at natural gas sites and subsequently undertook aggressive enforcement actions. EPA published its plan to study the potential impacts of hydraulic fracturing on drinking water resources and began its sampling efforts in Pennsylvania. EPA also submitted comments criticizing PADEP's new technical guidance on air aggregation determinations for oil and gas operations, which was issued in October 2011. In its comments, EPA questioned PADEP's interpretation of the phrase "continuous and adjacent" and the state agency's proposed use of a quarter-mile distance test, which PADEP has proposed to be applied on a case-by-case basis when making air aggregation determinations.

Litigation Challenges and Issues

The past year saw continuing litigation in the Pennsylvania state and federal courts relating to issues raised by shale gas development. In addition to the high-profile cases like *Butler v. Charles Powers Estate* and the legal challenge to a drilling ordinance in South Fayette, both discussed in more detail below, a variety of other issues were either brought before or resolved by courts. Litigation relating to property damage and water contamination allegedly caused by drilling operations and hydraulic fracturing continued in 2011. Two well-published cases, *Fiorentino v. Cabot Oil & Gas Corp., et al.*, No. 3:09-cv-02284 (M.D. Pa.) and *Berish v. Southwestern Energy Prod. Co., et al.*, No. 3:10-cv-01981 (M.D. Pa.), progressed to the discovery phase during 2011, while several new cases were filed against other operators. The plaintiffs in these cases have generally asserted claims for loss of property value, water contamination, medical monitoring and/or personal injury. In addition, at least one court has ordered such claims to be arbitrated pursuant to a provision contained in an oil and gas lease between the parties. *Phillips v. Chesapeake Appalachia, LLC*, No. 3:11-mc-00126 (M.D. Pa.).

Lease-related litigation also continued in 2011, with cases being filed relating to disputes over lease formation, bonus payments and the continued validity of leases held by production from shallow wells. The past year saw several courts issue decisions bearing on the primary terms of oil and gas leases. In *Hite v. Falcon Partners*, 13 A.3d 942 (Pa. Super. Ct. 2011), the Pennsylvania Superior Court held that, under the terms of the lease at issue, delay rental payments in lieu of production served only to extend the lease during the one-year primary term, but not thereafter. In *Lauchle v. Keeton Group LLC*, 768 F. Supp. 2d 757 (M.D. Pa. 2011), a federal court in Pennsylvania refused to equitably extend the primary term of oil and gas leases that had expired for the period of time that the lessors had maintained an unsuccessful lawsuit relating to royalties under the lease. Following the 2010 decision in *Kilmer v. Elexco Land Services, Inc.*, 990 A.2d 1147 (Pa. 2010), royalty litigation continued in 2011, but many cases were narrowed or otherwise dismissed as a result. In one case that was impacted by the Kilmer ruling, a federal court in Erie approved a settlement of a class action relating to royalties. *Frederick, et al. v. Range Resources-Appalachia, LLC*, No. 08-cv-288 (W.D. Pa.).

Land Use Challenges and Issues

During 2011, the natural gas industry continued to face a fragmented local regulatory structure in Pennsylvania. The Commonwealth's regulatory landscape was subject to constant change in the form of new and revised municipal and county land use ordinances specifically targeting the operations of the industry. Although there is no centralized database tracking municipal ordinance activity in the Commonwealth, Babst Calland, working with the Marcellus Shale Coalition, has been able to identify and analyze more than 140 municipal ordinances that have been adopted since late 2009 or are currently pending. The ordinances enacted to date vary widely, ranging from those that permit gas development in all zoning districts to those that ban gas development outright, and including just about every permutation in between.

The increasing diversity of local regulations may be attributed to the fact that Pennsylvania's appellate-level courts have not issued any decisions further clarifying the Pennsylvania Supreme Court's 2009 landmark decisions in *Range Resources – Appalachia, LLC v. Salem Township*, 964 A.2d 869 (Pa. 2009), and *Huntley & Huntley v. Borough Council of the Borough of Oakmont*, 964 A.2d 855 (Pa. 2009). Both decisions addressed the extent to which the Pennsylvania Oil and Gas Act preempts, or supersedes, local municipal regulation of gas well drilling activity, but left many questions unanswered. Several members of the natural gas industry challenged land use ordinances at the local level in 2011, raising arguments that may provide additional guidance once decided. For example, Range Resources filed a validity challenge to South Fayette Township's Zoning Ordinance late in 2011 arguing, among other claims, that the ordinance is preempted by the Oil and Gas Act and illegally excludes oil and gas development from the Township. This challenge is currently pending in the Allegheny County Court of Common Pleas.

The Pennsylvania General Assembly considered several options for addressing the thicket of local land use regulations imposed on the industry in 2011. Both the Senate (SB 1100) and the House (HB 1950) passed bills in November setting forth certain restrictions on local authority to regulate oil and gas development. For example, the bills authorize oil and gas operations as a permitted use in all zoning districts, while imposing specific setback distances between existing buildings and lot lines. In addition, the bills allow for parties to request ordinance reviews by the Pennsylvania Attorney General or Commonwealth Court, rather than the current ordinance challenge procedure that begins at the local level before the governing municipality. As of the date of this article, inconsistencies between these two bills on other matters are being negotiated, and no final action has been taken by the legislature.

Labor and Employment Challenges and Issues

This past year, the Equal Employment Opportunity Commission received nearly 100,000 job discrimination charges, the highest number of complaints filed by employees in the Commission's 46-year history. With the heavy physical demands of many Marcellus and Utica Shale jobs, the majority of suits in the natural gas industry in 2011 involved claims of unlawful discrimination on the basis of age or disability. It is expected that this trend will continue into 2012.

Throughout 2011, the most common employment claims remained focused on employee misclassification issues and breaches of non-compete and non-solicitation agreements. The use of independent contractors is growing in the gas industry, and the uptake in misclassification related claims means that employers in the industry must remain especially careful when classifying an individual as an independent contractor. The use of independent contractors may save companies as much as 30 percent on labor costs, provide desirable flexibility in trades and skills that are required only on a short-term basis, and relieve companies of certain taxes and insurance costs. Consequently, it is no surprise that the use of independent contractors has increased throughout the energy industry, especially in the fields of well site development and construction. However, in 2011, misclassification of workers as independent contractors resulted in severe penalties against employers, so employers in the gas industry should proceed with caution when classifying a worker as an independent contractor. In 2011 Pennsylvania enacted the Construction Workplace Misclassification Act (which defines its scope of coverage broadly enough to include some construction in the oil and gas fields). This Act provides that an individual who performs services in the construction industry may be classified as an independent contractor only if the individual has a written contract to perform such services, is free from direction over performance of such services, and is customarily engaged in an independently established trade,

occupation, profession or business of providing such services. The Department of Labor and the Internal Revenue Service are expected to continue the increased scrutiny of workers' classification.

In addition to litigation regarding shale gas employment-related issues, labor issues began to rise. In fact, union leaders in West Virginia began to set the stage for a multi-front battle against major natural gas-related projects that do not employ local union workers. The West Virginia Affiliated Construction Trades Foundation began airing television advertisements targeting a \$500 million gas processing plant being built in the northern West Virginia Panhandle. Moreover, more than 200 members of the Teamsters Union began striking in the pipeline construction industry in Pennsylvania and West Virginia over a dispute involving changes to the employee pension plan. In the Tri-State area, it is likely that union activity for field workers will continue to rise in 2012.

Mergers and Acquisitions - Challenges and Issues

Continuing the trend from 2010, there was significant activity in the upstream transaction market in 2011. During the past year, several major Marcellus Shale acquisitions occurred – most notably, Chevron's acquisition of Atlas Energy, Inc. for \$4.3 billion in February, Exxon Mobil's \$1.7 billion acquisition of Phillips Resources Inc. and TWP Inc. in June, and Chevron's acquisition of 228,000 net leasehold acres from Chief Oil & Gas and Tug Hill Inc. There has also been a high volume of joint development activity as holders of Marcellus Shale gas reserves have sought outside money and expertise to develop their property holdings and gathering and processing capacity. For example, Consol Energy agreed to partner with Noble Energy for the joint development of Consol's 663,350 Marcellus Shale acres in Pennsylvania and West Virginia in exchange for aggregate payments to Consol of approximately \$3.4 billion. One driving force behind the upstream activity is the continued stagnancy of natural gas prices. Lower prices can cause difficulties for small and mid-sized producers that, in turn, can create enticing opportunities for larger companies with the capital to focus on the long-term value of the shale gas assets.

Midstream activity has also continued in 2011. New, larger volume midstream infrastructure is necessary to serve the industry as gas production increases. For example, Chesapeake Midstream Partners LP has announced that it will acquire Appalachian Midstream Services LLC for \$865 million, and Williams Partners announced that it is buying 43 miles of pipeline and other assets in the Marcellus Shale from Delphi Midstream Partners for approximately \$750 million.

Because shale gas may contain natural gas liquids, such as methane, propane and ethane, transactions related to the production and use of natural gas liquids were another area of considerable activity in 2011. For instance, NOVA Chemicals was party to multiple deals with shale gas producers by which NOVA secured ethane feedstock for its Corunna cracker in Ontario, Canada. Such deals are likely to continue in 2012 as chemical companies are turning to natural gas liquids from shale formations as an alternative to crude oil based feedstock. Only days into 2012, Enterprise Products Partners announced that it will create the ATEX Express pipeline, a pipeline that will originate in Washington County, Pennsylvania and have the capacity to transport as much as 190,000 barrels of ethane daily to Texas. It is also expected that Shell Oil Co. will announce the location of its multibillion-dollar ethane cracker in the first quarter of 2012. It has been estimated the new Shell petrochemical complex could attract up to \$16 billion in private investment and create more than 17,000 jobs.

Title: The Butler case and the Future of the Dunham Rule

The future of Pennsylvania's Dunham Rule as it applies to shale gas has been called into question by the case of *John E. and Mary Josephine Butler v. Charles Powers Estate et al., William H. Pritchard and Craig L. Pritchard*. Under the Dunham Rule, a long-standing judicially-recognized rule of property in Pennsylvania, there is a rebuttable presumption that the exception and reservation or conveyance of "minerals" in a deed does not include oil and gas. In *Butler*, William and Craig Pritchard, heirs of Charles Powers, asserted that the mineral owner, and not the owner of oil and gas, owns the gas within the Marcellus Shale formation. *Butler* could have significant implications. If the longstanding Dunham Rule is changed, claims by mineral owners would likely ensue. *Butler* is currently being considered by the Pennsylvania Supreme Court.

The Butler decision may require producers to assess the risks associated with proceeding with planned operations. Going forward, producers should consider including language in leases that ensures (regardless of the outcome of Butler) by specific descriptive language, a leasehold of shale gas.

Utica Shale Challenges and Issues

The Utica Shale, which lies under the more familiar Marcellus Shale and covers a wider geographic area, may prove more valuable than the Marcellus Shale because of the oil and natural gas liquids it contains. Industry interest in the Utica is already apparent by recent major acreage acquisitions and the billions of dollars natural gas producers spent in 2011 to acquire Utica Shale acreage. For example, Chesapeake Energy and Total E&P USA, Inc. entered into a joint venture whereby Total acquired a 25% interest in approximately 619,000 net acres in the Utica Shale for approximately \$2.3 billion and Hess Corporation and Consol Energy entered into a joint venture whereby Hess acquired a 50% interest in approximately 220,000 acres in the Utica Shale for approximately \$594 million.

Although Utica Shale is present in eight states, including Pennsylvania, and parts of Canada, most of the Utica activity thus far has been focused in Ohio. Production volumes are still relatively small, but the number of Utica-targeted horizontal drilling permits issued to Ohio operators from January through September 2011 rose more than twenty-fold over 2010, according to the U.S. Energy Information Administration. The Ohio Department of Natural Resources projects estimates for the Utica Shale region to include recoverable reserves between 1.3 billion and 5.5 billion barrels of oil and up to 15.7 trillion cubic feet of natural gas.

In 2012, the Utica Shale should increase in prominence, especially in the areas where the Marcellus Shale is not present. It is likely that in areas where the Marcellus is present and capable of being produced, the Marcellus may be the initial target for production, because it is shallower, less expensive to drill and has proven productive. However, in the areas where the Marcellus has been developed, the Utica will have an infrastructure advantage, such as drilling pads, access roads, pipelines, and title and environmental due diligence that should permit developing the Utica at a faster pace than in places where the Marcellus has not been developed.

Conclusion

In 2011, shale gas development continued to face increased regulation by federal, state and local governmental entities and active private party litigation. In 2012, we expect to see much of the same as Marcellus and Utica Shale development moves forward in the Tri-State area. As noted throughout this article, several pieces of legislation, PADEP policies, and lawsuits were introduced in 2011, but not resolved. Babst Calland will continue to monitor these developments and their impact on the natural gas industry, in the mean time please contact Lisa Bruderly with any questions or concerns at 412-394-6495 or lbruderly@babstcalland.com.

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