IN THE COURT OF COMMON PLEAS OF CENTRE COUNTY, PENNSYLVANIA
CIVIL ACTION - LAW

FROST FAMILY, L.P., Plaintiff, v. NCL APPALACHIAN PARTNERS, L.P., a limited partnership, ANDARKO E & P COMPANY, LP, and ULTRA RESOURCES, INC., Defendants.	:	No. 2009-2923

Attorney for Plaintiff:	*James N. Bryant, Esq.*
Attorney for Defendant NCL Appalachian Partners, L.P.:	*David C. Pohland, Esq.*
Attorney for Defendants Andarko E & P Co., LP, and Ultra Resources, Inc.:	*Elizabeth A. Dupuis, Esq.* *Kevin J. Garber, Esq.*

OPINION AND VERDICT

Kistler, J.

On June 16, 2009, Frost Family, L.P. [hereinafter "Plaintiff"] filed a complaint against Defendant NCL Appalachian Partners, L.P. [hereinafter "Defendant NCL"] to quiet title to Plaintiff's property due to an alleged breach of an oil and gas lease attached to the property. On October 25, 2010, Anadarko E & P Co., L.P. and Ultra Resources, Inc. were joined as defendants in the lawsuit. Plaintiff subsequently filed a Motion for Summary Judgment, which was denied by this Court in an Opinion and Order dated April 6, 2011. A non-jury trial was held on May 23, 2011. After a review of the relevant law, the Court finds for the Defendants, for the following reasons.

FINDINGS OF FACT

On or about January 19, 1978, Edwin and Lois Frost entered into a lease agreement with C.E. Beck for the right to explore subsurface oil and gas on the Frosts' 501 acres of property located in Boggs and Snow Shoe Townships within Centre County, Pennsylvania. This lease was subsequently assigned to Eastern States Exploration Company, and in 1983 and 1984, Eastern States drilled two wells, Frost #1 and Frost #3, on the property in the Upper Devonian Reservoirs. In approximately 1984, John Frost took title of the property from his parents Edwin and Lois Frost, and the property is now held in a family limited partnership, Frost Family, L.P. In December 1998, Eastern States offered to purchase Plaintiff's 1/8 interest in the two Frost wells. Plaintiff declined this offer by the lessee, and countered with an offer to purchase back the lessee's 7/8th's interest in the two Frost wells. The lessee did not respond to Plaintiff's offer.

Thereafter, the lease was assigned to Equitable Production Company. In 2002, Plaintiff wrote Equitable Production Company a letter expressing concerns that production from the two Frost wells was very low. Also in this letter, Plaintiff asked the lessee to commence additional drilling.

In 2005, the lease was assigned to Defendant NCL. Defendant NCL subsequently sold half of its interest in deep natural gas in Plaintiff's property (which includes natural gas reserves in the Marcellus Formation)[1] to Defendant Anadarko E & P Co., L.P. [hereinafter "Defendant Anadarko"] in a land trade transaction, and half of the same interest to Defendant Ultra Resources, Inc. [hereinafter "Defendant Ultra"] in a straight

[1] The Marcellus Formation is a shale containing large amounts natural gas, located between 6,000 and 8,000 feet below the surface. Geologist Dan Billman, accepted as an expert witness in the field of geology in this case, testified that natural gas producers are only in the beginning stages of Marcellus Formation exploration, and he added that the Marcellus Formation is potentially the second largest natural gas field on earth.

sale. Defendant NCL made approximately $110,000,000 in profits on its sale of half of these deep gas rights to Defendant Ultra. Defendant NCL continues to hold its leasehold interest in Plaintiff's "shallow" natural gas (which includes the Upper Devonian Reservoirs), and it continues to operate Frost #1 and Frost #3 at a cost of approximately $70.00 per month, for a very small profit. All parties agree that although royalties have been paid every year since their creation, Frost #1 and Frost # 3 have always been "poor producers." Defendant NCL is producing only very minimal amounts of gas out of these two wells, and is accordingly paying Plaintiff annual royalties of $298.00, on average.[2] All parties agree it would be imprudent to drill additional "shallow" (Upper Devonian) wells on Plaintiff's property based on geologic maps and production figures.

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[2] Plaintiff received the following royalty figures, as reported on IRS income tax forms, over twenty four years:
1986: $533
1987: $555
1988: $599
1989: $529
1990: $605
1991: $337
1992: $387
1993: $379
1994: $337
1995: $301
1996: $231
1997: $147
1998: $101
1999: $174
2000: $0
2001: $389 est
2002: $86
2003: $82
2004: $84
2005: $188
2006: $313
2007: $323
2008: $237
2009: $240 est

The pertinent provisions of the oil and gas lease are summarized as follows. The lessee has a duty to "develop the acreage . . . as a reasonably prudent operator." In discharging this obligation, however, the lease specifies that the lessee need not drill more than one well for every 640 acres of leased property capable of producing gas. The lessee is also obligated to pay Plaintiff royalties from the production of gas from those wells in the amount of one eighth of the market value of the gas sold or used from the leased property. If wells are not drilled within one year of the signing of the lease, the lessee is obligated to pay delay rental of $501.00 per year. Likewise, if wells are drilled but are shut-in, the lessee is obligated to pay shut-in rental. Both lessor and lessee are permitted to freely assign their rights under the lease. The lease has a primary term of five years and a secondary term which lasts "as long thereafter as the above described land, or any portion thereof . . . is operated by the lessee in the search for or production of oil and gas." The lessor has no right to repurchase under the lease. Finally, it should be noted that the lease was a negotiated document, as the lessors modified the offered terms by blackening and initialing several provisions in the lease.

DISCUSSION

In the Complaint, Plaintiff alleges Defendant NCL breached the terms of the oil and gas lease in five ways. These alleged contractual breaches will be discussed in turn below.

I. The royalty payments are less than the shut-in payments required by the lease.

Under the terms of the lease, the lessee must pay Plaintiff shut-in rental if the wells drilled on Plaintiff's property become shut-in (closed). Although Plaintiff does not allege the wells are shut-in or that shut-in rental is due, Plaintiff argues that the fact that his royalty payments are less than the shut-in rental amount evidences the inadequacy of the royalty payments he is receiving. While the Court can only agree that the royalties received have been paltry, there is no lease provision mandating that royalties exceed the shut-in rental amount, nor is there case law to support this conclusion. Therefore, Plaintiff is not entitled to relief on this claim.

II. Wells on adjacent lands are extracting gas under Plaintiff's property.

Plaintiff contends there are wells within six hundred yards of the leasehold boundary that Plaintiff believes are draining gas from the leasehold property. It is unclear whether Plaintiff contends he should be entitled to a share of royalties from this drained gas, or whether he alleges these facts because he believes Defendant NCL has a duty to drill additional wells on his property to prevent any natural gas drainage into adjacent wells. In either case, Plaintiff is not entitled to relief on this claim.

First, Plaintiff is not entitled to a share of adjacent well royalties under his lease. In Pennsylvania, property owners are only entitled to their share of royalties from adjacent wells when their land is subject to the Oil and Gas Conservation Law and is protected by a unitization or pooling order. 58 P.S. § 401.1 et seq. The Oil and Gas Conservation Law, however, only applies to wells that penetrate the Onondaga Horizon or are more than 3,800 feet deep. 58 P.S. § 403. In the case *sub judice*, Plaintiff produced no evidence that adjacent wells penetrate the Onondaga Horizon or are more than 3,800 feet deep, so as to be subject to the Oil and Gas Conservation Law. Plaintiff also failed to produce evidence of a unitization or pooling order or agreement governing any of these adjacent wells. Finally, Plaintiff presented no evidence, beyond his strong suspicion, that his gas is being drained into adjacent wells. For all these reasons, Plaintiff is not entitled to royalties from adjacent wells.

Secondly, Defendant NCL did not breach the lease regarding adjacent well drainage. There is no lease provision that requires that the lessee drill heavily in order to prevent potential gas drainage into adjacent wells. Consequently, Defendants have breached no duty owed to Plaintiff regarding gas drainage into adjacent wells, and Plaintiff is therefore entitled to no relief on this claim.

III. The lessee has taken no steps to develop new gas on the property.

The lessee has a duty to "develop the acreage . . . as a reasonably prudent operator." In discharging this duty, however, the lease specifies that the lessee need not drill more than one well for every 640 acres of leased property capable of producing gas. This duty was fulfilled when Defendant NCL's predecessor drilled the two Frost wells, and the duty remains fulfilled because there is no lease provision that requires each future assigned lessee to drill additional wells. Moreover, all parties agree the Frost wells are poor producers and that it would be imprudent to develop additional Upper Devonian wells. Therefore, Defendant NCL has not breached the terms of the lease by failing to develop new wells on the property.

Plaintiff contends Defendant NCL should have developed deep natural gas wells instead of selling its deep natural gas rights to Defendant Ultra and Defendant Anadarko. Plaintiff does not contend he should have received a portion of the profits of these deep gas transactions; rather, Plaintiff cites the sales as evidence that Defendant NCL should have developed deep gas wells. The lease, however, does not require the lessee to develop deep natural gas reserves, nor does the lease prohibit the lessee from selling its interest in the deep gas rights. Dwayne Goodsell, a geologist and expert witness for Plaintiff, testified that a prudent operator would develop the deep gas in Plaintiff's property. Goodsell conceded, however, that various business considerations also factor into the prudence of gas development. In this case, Defendant NCL decided to sell its interest in deep natural gas because it determined it was too expensive to commence a Marcellus Formation drilling operation. The evidence adduced at trial revealed that this was a reasonably prudent business decision, and one permitted by the terms of the lease.

In sum, Defendant NCL did not breach the lease by failing to develop new gas on the property because the lease expressly provides that in discharging its obligation to develop the land as would "a reasonably prudent operator," the lessee need only drill one well per 640 acres, and this obligation was fulfilled in this case. Plaintiff is therefore entitled to no relief on this claim.

IV. The Lessee has taken no steps to protect the Lessor's interest in the lease.

The Court is unaware of any rule of law requiring an oil and gas lessee to protect the lessor's interest in a lease. Plaintiff provided no authority to support this allegation, and the Court can find no requirement in the lease or in case law that would require a lessee to protect a lessor's interest. "Royalty-based leases are to be construed in a manner designed to promote the full and diligent development of the leasehold for the mutual benefit of both parties." *Hite v. Falcon Partners*, 13 A.3d 942, 944, 945 (Pa. Super. Ct. 2011). In the case *sub judice*, the wells are producing a very small profit for Defendant NCL, and very small royalties for Plaintiff. Therefore, the lease is being operated for the mutual, albeit small, benefit of both parties. Plaintiff is not entitled to relief on this claim.

V. The Lessee has done nothing to improve or develop the property since 1979 and therefore is in violation of the renewal provisions of the lease.

The lease has a primary term of five years and a secondary term which lasts "as long thereafter as the above described land, or any portion thereof . . . is operated by the lessee in the search for or production of oil and gas." Defendant NCL continues to produce gas from the Frost wells; therefore, the lease is being held open by production. Importantly, there is no lease provision requiring the lessee to make improvements or develop the land beyond the initial wells in order to comply with the renewal provision of the lease. Consequently, Defendant NCL has properly extended the lease by production and is not in violation of the renewal provision.

Plaintiff argues the current royalty payments, which are less than the amount of delay rental provided for in the lease, cannot extend the secondary term of the lease under the reasoning of the Superior Court's recent opinion in *Hite v. Falcon Partners*. In *Hite*, the Superior Court held that when wells have not been drilled, the mere payment of delay rental is insufficient to extend the secondary term of an oil and gas lease. *Hite*, 13 A.3d at 944. *Hite* cannot control in this case, however, because there was no production in *Hite*, whereas in the case at bar, there has been consistent production since the drilling of the wells. Still, Plaintiff argues that because delay rental payments are insufficient to extend a lease indefinitely, royalties that are less than the amount of delay rental should likewise fail to extend a lease. In other words, Plaintiff suggests that under the reasoning of *Hite*, the Court should establish a new rule of law that royalty payments less than the amount of delay rental are insufficient to extend oil and gas leases held by production.

The Court declines to extend *Hite* in this way. There is no lease provision or case law that requires a specific minimum production amount in order to extend the secondary term of an oil and gas lease. Without any such authority, the Court will not establish a minimal threshold of gas production necessary to hold a lease under production. Because Defendant NCL continues to produce gas from Plaintiff's property, it is not in violation of the renewal provision of the lease, and Plaintiff is not entitled to relief on this claim.

ORDER

AND NOW, this 20th day of July, 2011, following a non-jury trial held in the above captioned case, and upon consideration of the evidence submitted at that trial, the Court finds for the Defendants, and grants no relief to Plaintiff.

BY THE COURT:

Thomas King Kistler, Judge