2022 Ohio NARO

Ohio – Legal Update

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I. Major Issues

A. Uptick in Leasing and Drilling After Pandemic
B. Expansion of Leasing Areas
C. Forced Pooling/Unitization
D. Increased Caselaw on Oil and Gas Law

II. Uptick in Leasing and Drilling After Pandemic

A. There has been an uptick in leasing over the last year, most likely due to the increase in commodities prices.

B. Pre-pandemic there was a lower of amount of leasing going on mostly because significant portions of the target counties were leased and because commodities prices had dropped. The United States increased its oil and gas production so much that there were net exports of oil. This was a double-edged sword because consumers saw lower commodities prices, but landowners saw decreased royalties due to those lower commodities prices.

C. A lot of royalty owners can remember the leasing boom of the earlier 2010s. Multiple producers competing against each other to lease up the best lands in the best counties. This caused lease financials to increase in the hottest counties. After a significant amount of leasing occurred, the market slowed down, mostly in line with the drop in commodities prices.

D. Recently, we have seen an uptick in leasing in those areas which had heavy leasing during the leasing boom. Several leasing opportunities have been tied to future applications for forced pooling-unitizations. That process requires the producer to seek to lease unleased minerals using good faith efforts.

III. Expansion of Leasing Areas

A. There has been leasing activities in areas which were not necessarily part of the original leasing boom, or which were leased, but not developed.

B. We have seen recent efforts by some producers to lease up larger blocks of acreage in Guernsey County, Ohio. The Eastern side of that county, along with portions of Tuscarawas County, were leased during the first leasing groups. However, the central portion of Guernsey County was left, generally, unleased and/or undeveloped.

C. With higher oil prices we are now seeing a push into the center portion of Guernsey County. We are also seeing some producers new to the area: Ironhead Resources, EOG Resources, Reserve Energy, and R & S Operating.

D. With increased leasing negotiations and competition, we are seeing better terms for landowners. We are not yet where we were at the height of the first leasing boom, but some leases are getting pretty close.

IV. Forced Pooling/Unitization

A. While most landowners participate in well units based on their having leased their mineral rights, there are a significant number of landowners who are being forced into units under Ohio's forced pooling/unitization process.

B. A basic outline of the process:

   i. An oil and gas operator can seek an order from the State of Ohio (through the Ohio Department of Natural Resources) forcing landowners into oil and gas well units, even if the landowners do not wish to be parties to the unit. The producer needs to have 65% of the acreage voluntarily committed to the unit.

ii. If an application is granted, landowners without a lease have their oil and gas rights forced into the unit.

iii. As compensation for those rights being forced into the unit, the unleased landowners receive primarily two things: (1) a twelve and a half (12.5%) gross landowner's royalty and (2) a working interest in the amount of eighty-seven and a half (87.5%) based on pro-rata % of their acreage to the total acreage in the unit.

iv. However, the landowner does not begin receiving payments on its working interest until the oil and gas operator receives back the costs of drilling and equipping the well unit times a certain number, oftentimes two times the costs (200% return on the costs).

v. Given today's economics, the landowner likely will not receive payments for the working interest. These laterals can cost $10 Million per lateral.

C. Significant open issues:

i. What happens when the landowner's lease has a restriction on consolidation, such as saying no consolidation or limiting the total size of the unit?

1. The producer will sometimes come to the landowner asking to amend the lease to permit consolidation or to increase the maximum unit size.
2. Unfortunately, the landowner does not have all that much leverage.
3. However, a landowner should be very careful about amending the original lease's pooling provision. Some lease forms from the 1960s through the 1980s had protective language for the lessor to help prevent royalty dilution – placing small amounts of leased acres into larger units and then holding all of the acreage.

4. A few landowners have challenged a producer's ability to put leased acreage into larger units when the lease has smaller acreage maximums. The theory is that the producer cannot get around the lease's terms by using the forced pooling/unitization statute:
    a. *Am. Energy-Utica, LLC v. Fuller*, 5th Dist. Guernsey No. 17 CA 000028, 2018-Ohio-3250 – using the forced pooling/unitization statute with a lease prohibiting consolidation or prohibiting consolidation without lessor's consent is a breach of contract.
    b. *Paczewski v. Antero Resources Corp.*, 7th Dist. Monroe No. 18 MO 0016, 2019-Ohio-2641 – using a lease which is silent on the right to consolidate, including striking through consolidation paragraph, is not a breach of contract.
5. If the landowner doesn't want to fight the proceed and decides to amend the lease, the landowner should have an oil and gas attorney review the amendment and the lease's original terms. There can be favorable language in the original consolidation provision that the landowner may want to keep, including how the royalties are calculated.

ii. What happens if the landowner never gets paid on the 87.5% net proceeds portion of the interest?
    1. No one really knows what will happen with this issue. I am not aware of any case which has moved forward on a claim that the process doesn't fairly compensate the landowner for the forever gone natural resources.

iii. The General Assembly has been considering amendments to the law.

iv. The General Assembly amended the law earlier this year to set specific timeframes for the process:

   1. Requires the hearing on the application for the unit to be held within 60 days of the application. The chief can reschedule the hearing if the application is materially incomplete.
   2. Requires the chief to issue the decision on the application within 60 days of the hearing.

v. On February 23, 2021, the Ohio House introduced House Bill No. 152 which would make several significant changes to Ohio's unitization process.

vi. House Bill No. 152 seeks to make significant changes to the unitization process, some of which may harm unleased landowners:

   1. Creates a minimum charge against nonconsenting landowners in the amount of 300%, meaning the unleased landowner will not get payments on its 87.5% working interest until the oil and gas operator recovers 300% of the drilling and equipping costs.
   2. Within 30 days of the Chief's unitization order, the unleased mineral owner must choose one of the following options:

      a. Enter into a lease with the operator for the unleased acreage in the unit, with a 12.5% net royalty and a lease bonus in the amount of 75% of market value of lease bonus rate for the acreage within the proposed unit times the amount of the landowner's acreage in the unit. This means a landowner who owns 100 acres could be paid on a single acre included within the unit and then run the risk of never being paid for the 99 acres remaining outside the unit but tied up as leased.

    b. Consent to including the acreage in the unit and follow all terms of the proposed operating agreement.
    c. Fail to consent and then be subject to the 300% charge on drilling and equipping costs.
    d. Failure to elect within the time frame results in a lease at a 1/8th net royalty.

3. Permits the Chief to keep trade secret, research, development, or commercial information of the operator secret, meaning not being disclosed to the public, including at the public hearing.
4. Says that operating under a unitization order will fulfill all of the lessee's express or implied obligations under its oil and gas leases, including terms or limitations on the size of the unit.
    a. This means an operator could willingly breach its lease terms with impunity under a unitization order. This would appear to reverse recent case law holding an operator responsible for breaches of a lease through operating under a unit order.
5. Permits hearings to be conducted remotely.
6. This bill seeks to make significant changes to the unitization process. These changes would lessen the landowners' rights and would significantly reduce the economic value landowners receive from this process. It would subject unleased landowners to net royalties and entitle them to significantly less than market payments for their leased minerals.

7. H.B. 152 is still in the Energy and Natural Resources committee and the last hearing was in June 2021.

V. **Increased Caselaw on Oil and Gas Law**

A. How to Calculate Royalties

i. The Zehentbauer/Bounty Cases—involved the same oil and gas lease, originally entered into with Chesapeake.

ii. The federal courts in Ohio determined that the leases permitted deductions for post-production, even when the royalty clause required payment of royalties based on the gross proceeds for the sales of production. The leases defined gross proceeds to be revenue without reduction for post-production costs.

iii. The landowners would receive royalty payments "based upon the gross proceeds paid to Lessee for the gas marketed and used off the leased premises, including casinghead gas or other gaseous substance... *computed at the wellhead* from the sale of such gas substances so sold by Lessee." "Gross proceeds" were defined as "the total consideration paid for oil, gas, associated hydrocarbons, and marketable by-products produced from the leased premises." And gross proceeds were derived from sales either to (1) an unaffiliated *bona fide* purchaser in an "arms-length transaction," or (2) an "affiliate of Lessee," for a comparable sales price "and without any deductions or expenses."

iv. The federal courts said that these leases permitted deduction post-production costs using the netback method:

1. First, defining "gross proceeds" as including "*marketable* by-products" does not require that the royalties be based on downstream sales of *finished* by-products.

2. Second, the phrase "at the wellhead" modifies "gross proceeds" when the terms "volume" or "amount" do not appear in the royalty clauses. The court's reading of "at the wellhead" filled in the valuation point. The court essentially gap-filled in a valuation point. Because gas is processed at various downstream sales points it would be difficult to set a valuation point for the gas royalty calculation unless you set it as the wellhead.
3. Third, even if "computed at the wellhead" modifies "gas marketed and used off the leased premises," it also necessarily modifies "gross proceeds" because "gas marketed and used" modifies "gross proceeds." The district court read the phrase as: "[T]he words 'computed at the wellhead' appear in the sentence 'computed at the wellhead *from the sale* of such gas substances so sold by Lessee[.]' What is 'computed... from the sale' must be the proceeds of those sales."

v. The term "wellhead" or phrase "at the wellhead" will now likely indicate net proceeds in Ohio. In a post-Zehentbaurer/Bounty market, landowners need to focus on several issues when negotiating a gross proceeds royalty:
   1. Location – set the point of valuing the royalties beyond the wellhead, at least at the point of the first real sale.
   2. Gross revenue – make sure the producer must account for the full consideration for the sales of all products.
   3. Direct and indirect costs – make sure to account for the producer's direct-paid costs, but also include language about indirect costs, such as when midstream providers deduct costs before sending revenue to the producer.

4. Affiliate sales – protect against sham sales to affiliates.

vi. There are still pending cases about various royalty provisions. Most notably, there are cases pending against Antero Resources in the federal courts in Ohio (including the Grissom class action case) about how courts should interpret and apply leases with Market Enhancement Clauses.

1. These clauses were introduced sometime between the leasing boom when the landowners began demanding and the producers began accepting gross royalties. It appears it may have been offered by some producers to entice landowners to give up something in terms of post-production costs.
2. The Market Enhancement Clause's basic idea is the landowner does not pay a proportionate share of costs to get the product into a marketable form but does pay a proportionate share of costs which actually enhance the value of the product. Oftentimes the enhancement refers to receiving a better price for the product.
3. So, a cost can be assessed against the landowner's royalty under two circumstances: (1) the post-production service is incurred while the product is already marketable and (2) the amount of royalties to be paid to the landowner when considering the costs is more than what would have been paid had the sale happened before the costs.

B. Lease Expiration – No Arbitration in Ohio (*French v. Ascent-Resources*, 2022-Ohio-869)

i. Many landowners have had to sue producers to get older oil and gas leases released due to termination. Such cases usually involve claims the oil and gas lease expired due to lack of production in paying quantities.

ii. Several leases may have arbitration clauses. These clauses say the parties must resolve disputes using a private arbitrator and cannot go to court.
iii. What if the landowner claims the lease expired and the producer wants that claim to be decided by arbitration?
iv. In Ohio, a landowner and producer cannot be forced to arbitrate a claim about an oil and gas lease's expiration or termination. That claim must be decided by a court.
v. The Ohio Supreme Court held that Ohio Revised Code § 2711.01(B)(1) excludes controversies involving title or possession of real estate from mandatory arbitration.
vi. A claim seeking confirmation of lease expiration necessarily involves answering the title or possessory rights of the real estate, including its oil and gas rights. Here is a quote from the Court:
    1. "The action in this case is therefore a controversy involving the title to or the possession of real property. If the action is successful, it will quiet title to the property, remove the leases as encumbrances to the property, and restore the possession of the land to the lessors. If the action is unsuccessful, however, title to the land will remain subject to the leases, affecting the transferability of the property. *** Also, Ascent would have the continued right to possess and occupy the land, as permitted by the leases, denying French the right to use the property without restriction. See id. Either way, the action closely involves the title to or the possession of real property and, under R.C. 2711.01(B)(1), the action is not subject to arbitration."

C. Surface Use Agreements – Significant Damages to Landowner
   i. Involved 4 interrelated contracts: (1) a 2014 oil and gas lease, (2) Supplemental agreement, (3) Surface and subsurface agreement, and (4) Damage release agreement
   ii. Protégé drilled a well pad on the plaintiff's acreage
   iii. There were multiple attempts to re-seed the hill and each time the seed washed away and gullies were created.
   iv. ODNR issued a notice that Protégé needed to properly reclaim the area.
   v. A fourth reclamation failed and the plaintiff began having issues with cattle being harmed on site.
   vi. Protégé left the site and there were multiple issues still on site, including exposed wires and landscaping issues.
   vii. The trial court ruled in favor of the landowner:
      1. $349,093 in breach of contract damages for failing to remediate the property.
      2. $450,000 for conversion of the topsoil
      3. $20,000 for trespass, due to lack of access by the plaintiff
   viii. The appellate court affirmed:
      1. The lease had a continuing duty to restore the property to a condition pre-development.
         a. "While the trial court did not make an explicit finding that the Oil and Gas Lease was ambiguous, the trial court's other findings support this conclusion.
         b. The lease addresses surface restoration at Paragraph 31 and generally provides that the Lessee "shall use commercially reasonable efforts to repair and restore such damaged portion of the surface of the Leased Premises as nearly as

practicable to the condition in which said land existed before commencement of operations."

c. Paragraph 31 further provides that "[a]ll restoration work shall be done at the sole expense of Lessee." The lease does not define "commercially reasonable efforts" nor state how many efforts are required to restore the property.

d. The trial court likely viewed this language, especially "commercially reasonable efforts," as open-ended and ambiguous.

e. Given the ambiguity surrounding Protégé's duty to restore the property using commercially reasonable efforts, the trial court properly allowed extrinsic evidence which explained the parties' intent, and which described the restoration efforts.

f. The trial court appears to have relied heavily on Protégé's own witness, Jason Pugh, in reaching its conclusions."

2. The supplement agreement provided the topsoil was to be retained by plaintiff and placed at mutually agreeable location.

   a. Protégé converted the topsoil by using it during reclamation efforts and not leaving it at the site for plaintiff's sole use. From the trial court:

      i. "There is specific language in Paragraph 3 regarding a specific location for the topsoil stockpile. * * * The language in Paragraph three regarding the specific location as well as evidence of negotiations regarding the location indicate the intent that the topsoil stockpile was to be left for Zimmerview after construction was completed. There would be no need for this location language if Protégé was simply going to utilize the topsoil stockpile for cleanup/reclamation shortly after excavation.

ii. Paragraph 2 of Exhibit J-2 indicates that the topsoil was to be a form of consideration.

iii. The topsoil has no value as a form of consideration unless Zimmerview is allowed to retain the topsoil stockpile for its use. Further, the topsoil has no value as consideration if Protégé is allowed to use it for their own purposes.

iv. There is no language in Paragraph 3 of the Supplemental Agreement which allows further use of the topsoil stockpile.

v. Protégé's arguments regarding compliance with Paragraph three by utilizing the topsoil in cleanup/reclamation efforts lack merit. Without Paragraph 3, Protégé was already required to use commercially reasonable efforts to repair and restore the surface of Zimmerview's property as nearly as practical to the condition in which the land existed before commencement of operations. Protégé was already operating under a contractual requirement to reclaim the land, thus Paragraph 3 would have no meaning pursuant to Protégé's interpretation.

vi. Lastly Paragraph 3 indicates that the topsoil stockpile was not to be removed from its location "unless otherwise agreed upon." This indicates at a minimum, that both parties would be required to have input before the stockpile could be moved from the agreed upon location. Protégé's actions indicate that they utilized the stockpiled topsoil without seeking approval or agreement from Zimmerview. They utilized the topsoil at their own direction for their own needs on the construction site. There would be no need for language regarding mutual agreement prior to removal of the stockpile unless it was intended that the stockpile remain intact for Zimmerview."

ix. This case provides a great framework for negotiating a surface use agreement or surface use terms in oil and gas leases.

1. Restoration obligations…
2. Use of topsoil…
3. Typing restoration efforts to commercially reasonable efforts…

D. Depth Restrictions – Drilling Deeper than Permitted Formations

i. One term which has been included in some leases is a depth restriction. An example would be restricting the leased minerals to be those located within the Utica Shale or some other language.

ii. What happens when the producer drills a lateral in a deep formation for purposes of producing the permitted zone?

iii. In July 2021, a Belmont County awarded a landowner about $40 Million Dollars in a judgment against Rice Drilling D LLC and Gulfport Energy.

iv. The leases did not permit the producer to drill below the Utica Shale. The leases limited the producer to the Marcellus and Utica formations. However, the producers drilled into the Point Pleasant formation and were taking the production at that depth. They were producing products from the two permitted shales, but also from a lower formation.

v. There were no allegations that the producers had committed environmental damage or other damage to the property.

vi. The jury awarded $23,171,454.37 for gas taken from the deposit and $18,958,462.25 for gas the producers would continue to take, totaling $42,129,916.62, with $2,000,559 deducted for royalties, bringing the total to $40,129,916.62.

E. Paying Quantities – How to Prosecute a Difficult Claim

i. Landowners have an uphill battle when trying to win a claim that an oil and gas lease has expired due to lack of production in paying quantities.

ii. If the landowner sues the producer, the landowner (in the vast majority of cases) has the burden of proof on paying quantities.

iii. To win, the landowner must show that the lease was not profitable to the producer for at least two consecutive years. This requires proving that the producer's wells holding the lease produced enough revenue to generate a profit over operating expenses.

iv. The key term of the equation is operating expenses. Only recurring expenses which are incurred for the purpose of obtaining oil or gas production count for operating expenses. Here are some expenses falling into operating expenses and non-operating expenses:

1. Indirect operating expenses (meaning they are not counted against the revenue):
    a. office payroll,
    b. office lease,
    c. oil and gas software,
    d. office expenses, office postage,
    e. office professional,
    f. building utilities,
    g. fire resistant clothing,
    h. insurance for building and vehicles,
    i. shop and warehouse lease,
    j. furniture, equipment, and machines,
    k. vehicles,
    l. SERC Emergency Response,
    m. county tax,
    n. tax accounting fee, and
    o. well insurance.
2. Direct operating expenses (meaning they are counted against the revenue):
    a. landowner royalties,
    b. oil severance tax,
    c. gas severance tax,
    d. maintenance expenses,
    e. utilities, and
    f. operating expenses, like well pumping charges.

v. *Ullman v. Whitacre Enterprises, Inc.*, 7th Dist. Monroe No. 19 MO 0025, 2021-Ohio-4656, ¶¶ 71-73, *reconsideration denied,* 7th Dist. Monroe No. 19 MO 00252022-Ohio-1447.

F. Lease Termination – How Much Work is Need to Keep a Lease Active

i. *Scenicview Estates, LLC v. Eclipse Resources I, LP*, S.D.Ohio No. 2:19-CV-39, 2022 WL 715751

1. Unless a lease requires physical operations on the leasehold, then operations on a consolidated unit will be enough to hold the lease.

a. At a basic level this makes sense with consolidations – only a small portion of a unit will have physical operations: that portion with the well site and those tracts under which the physical laterals are located.