

## Recent developments in Pennsylvania concerning leases held by gas storage

It is common for oil and gas leases in Pennsylvania to allow for the storage of natural gas. Pennsylvania case law regarding dual-purpose oil and gas leases, which grant both production rights and storage rights, is complex and provides very fact-specific holdings which may not be applicable to every dual-purpose lease. However, in this past year, two favorable decisions have been issued providing a better understanding of the status of such a lease that is held by storage operations alone.

Conflict can arise when the primary term of a lease ends and no production has taken place, but the oil and gas lease is maintained as part of a gas storage field. Based on the terms of the oil and gas lease, a landowner may receive less compensation for gas storage rentals than for oil and gas production royalties, which has led to disputes between the landowner and the operator. Depending on the terms of the lease, it may be possible to hold such a lease indefinitely through the storage of gas and the payment of rentals. Since 2004, there has been some uncertainty regarding the lease terms necessary for a producer to maintain all of its rights under a lease through storage operations once the primary term for production terminates. At least one federal court applying Pennsylvania law has held that storage rentals will not always preserve production rights into the secondary term of a lease.

Much of the controversy concerning gas storage leases is the result of a 2004 federal court case that held that storage operations do not automatically extend the production rights of an oil and gas lease. The case of *Jacobs v. CNG Transmission Corporation*, 332 F. Supp. 759 (2004), before the U. S. District Court for the Western District of Pennsylvania, examined a dual-purpose lease that for many decades was used only for gas storage. The lease at issue was amended in 1956 and permitted the producer to use the lease for both oil and gas production and the storage of gas. The defendant began storing non-native gas on the property during the primary term of the lease and continued to do so for decades until the time of the lawsuit. However, no oil and gas wells were drilled on the property during or after the primary term of the lease. The plaintiffs in the case asserted that by failing to use the oil and gas lease for production, the defendant lost these rights and the lease

converted to a storage-only lease.

The plaintiffs' first argument in *Jacobs* was that the obligations and rights under the oil and gas lease were severable, or essentially contained two transactions that should be treated independently. The *Jacobs* court rejected this argument and held that the consideration to the lessor was not distinct between the two purposes of the lease, and the lease as whole revealed an intent for one complete contract. However, the court ultimately found in favor of the plaintiffs on other grounds. The court held that the producer was under an implied duty to develop

the lease following the primary term, and its long-term failure to comply with such a duty to produce resulted in the surrender of its production rights. The court also evaluated the lease terms and found that while the lease protected storage rights by payments during a gap in production, there was no similar preservation of production rights in the storage provisions. Additionally, the court examined the storage rental clause and found that it expressly applied to hold "the sands, strata and horizons where gas may be stored." This was not indicative of a preservation of all strata under the lease. Based on these terms, the court held that the production rights were not compensated for in the gas storage rental fees, and therefore the lease was abandoned as to oil and gas production.

Subsequent cases involving gas storage have taken a different approach than the *Jacobs* court. A similar issue was addressed in the case of *Penneco Pipeline Corporation v. Dominion Transmission, Inc.*, 2007 U. S. Dist. LEXIS 46621 (2007), also before the U. S. District Court for the Western District of Pennsylvania. This suit was brought by plaintiffs holding top leases over land in storage fields in Indiana, Armstrong and Westmoreland counties. In the *Penneco* case, the court looked first to severability of the production and the storage rights under the leases owned by the defendant and held that the rights were not divisible based on the terms of the leases, similar to the decision in *Jacobs*. However, the *Penneco* court held that the language of the defendant's leases precluded any breach of an implied covenant to produce oil and gas. Under the leases at issue, the parties "agreed that delay rentals would be paid until a well yielding royalties was drilled on the leased premises or until storage rentals became due and payable, and the consideration and rentals paid and to be paid constituted adequate consideration for the right to drill or not drill." Further,

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the leases stated, “storage rental fees or well storage fees are to be made in lieu of and not in addition to royalties, delay rentals or other sums otherwise due.” The court held that these provisions allowed the defendant to make storage rental payments to maintain not only storage rights, but the entire leasehold. Therefore, as long as the lessee paid the appropriate rentals under the lease for gas storage, the production rights could be preserved. Finally, the plaintiffs argued that an abandonment of the production rights occurred due to the absence of any oil and gas production over the course of decades. Nonetheless, the *Penneco* court held that mere non-use was not sufficient to show an intentional abandonment of the production rights.

More recently, the Superior Court of Pennsylvania issued a non-precedential decision involving gas storage in the case of *Warren v. Equitable Gas Company*, Case No. 697 WDA 2014 (2015). This case involved a dual-purpose lease in Greene County, and the trial court found in favor of a defendant that was holding a lease for gas storage only. The court affirmed the holding of the trial court, finding that the lease in question was not severable between oil and gas production and storage rights, and the terms of the lease provided for full compensation for storage and production operations. In *Warren*, the plaintiffs also brought a claim that the oil and gas lease was unconscionable and asserted that the landowner was not sophisticated in oil and gas leases and did not intend for a lease to be held by storage only. However, the court concluded that there was insufficient evidence to support such claim and there was no proof that the compensation was inadequate or less than what the parties intended.

The issue of gas storage was addressed most recently in the federal case of *Mason v. Range Resources – Appalachia, LLC*, 2015 U.S. Dist. LEXIS 97471 (2015), which evaluated a tract in Washington County covered by a 1961 oil and gas lease that was utilized as part of a protective zone for a storage field, which is an area that acts as a buffer zone around a storage field. The owners of the property entered into a top lease that expired, and then sought to re-lease the production rights to several potential lessees, but were declined due to the existence of 1961 lease. The plaintiffs presented several arguments, including the adequacy of the consideration for the storage rentals and an ambiguity of the lease terms as to whether rentals were delay rentals or storage rentals. However, the court held that the lease terms were clear in that the lessee could hold the leasehold, including production rights, as part of a storage zone if rentals were paid to the lessors. The lease expressly allowed the lessee to use the property for production, gas storage or as a protective zone around a storage field.

While the holding of the *Jacobs* case has not been completely reversed, the recent cases on gas storage show a trend that Pennsylvania courts will likely uphold a dual-purpose lease as long as the lease terms indicate an intent that the two rights are alternative options for the lessee. This approach recognizes that the two rights are interconnected and a necessary part of oil and gas development, and are usually contemplated as part of an oil and gas lease. The *Jacobs* decision should be viewed as applicable only to a narrow set of facts, such as where a lease

provides that oil and gas royalties or rentals are the *only* compensation for oil and gas production and entirely separate from storage rentals. However, this is an issue that Pennsylvania courts may revisit in the future, as the *Penneco* and *Warren* cases are non-precedential. These cases also highlight the importance of drafting clear provisions in an oil and gas lease that preserve all of an operator’s rights to extend the lease.

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