Compulsory Integration and Eminent Domain

By Attorney Christopher Denton

Eminent Domain and Compulsory Integration are inextricably linked and invariably misunderstood as a consequence. We first need to examine the legal background before discussing their problems.

In New York State a landowner who owns the oil and rights to his land only owns the right to access the common pool of supply of the oil and gas. This theory resulted from the problem of drainage when neighbors drilled wells on adjoining properties and discovered that the second well often caused the first well to drop in production at the moment that the first well came on line.

New York State courts adopted the Rule of Capture to explain who is entitled to retain oil and gas once it has come out of the well. The Rule of Capture states that so long as your well bore drilled on your own land does not go into the land of your neighbor, you are entitled to keep as your own, without compensation to the neighbor, all the oil and gas which exits your well, even if it drains your neighbor.

The consequences of the Rule of Capture is that every landowner felt compelled to put a great number of wells on her property, that owners overproduced in order to protect their source of oil and gas, that gas was often simply burned off or vented directly into the air, that oil was left in the ground because of lack of well pressure caused by over drilling, that the price of oil and gas would go through boom and bust cycles, and that both capital and oil and gas were wasted in great amounts. There were no restrictions on the number of wells per property nor their distance from each other.

To address these problems, the oil and gas producing states took different approaches. These approaches included minimum distances between wells (well spacing), forced pooling (Compulsory Integration in New York), drainage protections, and correlative rights. All of them, however, included some form of permitting and unitization.

In New York, Permitting and Unitization mean that the state requires that a permit be issued by the State before a well can be drilled and that a boundary must be formed around the well (the size being dependent on the formation to which the

well is drilled) and that only one permit shall be issued in that unit. The purpose of the unit is twofold: first to separate the drilled well in the unit from any other well drilled outside the unit at a distance far enough way that neither well will drain the other; and secondly to reduce the number of wells drilled in the unit, thereby reducing the costs of producing the gas.

By limiting drilling in each unit to only one permittee, the State has effectively eliminated the oil and gas rights of the neighboring landowner whose property is included in the unit. This is true because in New York State the landowner only owns the right to drill, not the oil and gas in place. By removing these rights from the permitless landowner, the state must either compensate the owner for their loss or require the permitted landowner to pay for that loss. Instead, the State, in an act of bizarre incongruity, has imposed a penalty on the landowner for having her rights taken away from her. (This is the notorious "risk penalty" in compulsory integration, which is discussed later.)

On top of this fact is the fact that Compulsory Integration grants the permittee the right to drill under the land of the neighbor who is forced into the well. The Compulsory Integration Order effectively grants an easement to drill under the neighbor's land, no less intrusive than an easement for a pipeline just beneath the surface of unleased land. Therefore it can be argued that the right to drill under another person's land without a consensual easement is a taking and requires compensation in eminent domain. This is separate and apart from any notion of drilling expenses, and who should pay for them.

In review,

In the Past:

1. Originally a landowner had the right to drill and take and keep whatever came out of the well.
2. But the landowner could not drill under her neighbor without a lease from the neighbor.
3. The landowner could not be charged for oil and gas that came out of his own well, even if it drained from the neighbor's land and vice versa.
4. No permits were required to drill on one's own property.
5. A landowner could drill as many wells on her land as the surface would hold.
6. The landowner could burn or vent as much gas as she wanted to, even to the point of wasting it and causing the reservoir underneath to be depleted.
7. Each landowner and driller felt compelled to drill as many wells as possible to maximize their return and to protect the neighbor from draining the oil and gas from his land to the driller's well.
8. There were no environmental rules.

Today:
1. A landowner has the right to drill and take and keep whatever comes out of the well.
2. A landowner cannot drill without a permit.
3. A landowner cannot obtain a permit without forming a unit for the purposes the assuring that wells are not 'communicating' (draining) one another.
4. Only one party can be issued a permit for each unit.
5. All other landowners in the unit are prohibited from being issued a permit in the unit for the same formation.
6. By law each landowner in the unit is entitled to his Correlative Rights. (meaning the right to a proportionate share of the oil and gas in the unit based upon one's acreage in the unit)
7. Every parcel of land in the unit must be made part of the unit by being leased to the driller or by being placed in the unit by an Order of Compulsory Integration.

Here are the questions in eminent domain:

1. Who should pay the landowner for the underground drilling easement that the driller has taken to drill the well under the landowner's property?

Answer: The driller should pay, because he gets the benefit of taking gas that the driller could not drain without the well bore passing into the property of the neighboring landowner.

2. How do we value the underground drilling easement?

Answer: It should be Offset against the cost of acquiring the gathering pipeline, building it, maintaining it, and compressing and transporting the gas. The right to drill under one's property in exchange for the right to transport gas through another's pipeline, both to run with the land and the easement.

3. Who pays the landowner for his loss of his right to drill? How do we determine what the value is?

Answer: The driller should pay for the oil and gas, as it is the driller who takes it. We should value it at the price that the oil and gas sells for on the open market and not to an affiliate.

4. Should there be any deductions for the cost of drilling the well, preparing the gas, putting in the pipeline, building roads on someone else's property and for marketing the gas when the driller does not go under the neighbor's land?

Answer: No, because the driller no longer has to drill defensive wells along the border of the driller's leased land and therefore no one else can drill or drain the reservoir.

5. What about the claim of a free ride and the risk taken by the driller?

Answer: The free ride is a myth and an industry construct to weaken the bargaining position of landowner's who do not want to sign bad leases.

It has been claimed that the so called "risk penalty" in compulsory integration is designed to prevent the integrated landowner from obtaining a "free ride" in the development of oil and gas.

To understand the false claim of a free ride, we need to remember a crucial piece of law. In New York State, the oil and gas industry cannot drill under any land unless they have first obtained a lease from the owner of the oil and gas rights or have obtained an Order of Integration from The Department of Environmental Conservation. This is axiomatic.

The entire risk penalty concept turns reality on its head. It is the landowner who has the rights to the oil and gas, it is the landowner who pays the taxes all those years, it is the landowner who has the strict liability under law for pollution on her property regardless of who causes the spill. The risk of which the oil and gas company speaks is the risk of a 'dry hole'. In other words, the loss of its well drilling costs. With today's 3D seismic for on shore drilling, that risk is minimal. Yet that risk has never accounted for the risk to the land owner of a spill caused by the driller nor the risk that the driller will be totally incompetent and foul the entire site (such as bad casing, bad site preparation, spills, runoff, or rig accidents). The landowner never gets credit for bearing these risks, although he should. And these risks are substantial and permanent for the landowner, and can be greater than a risk of a dry hole.

Secondly, the 'free ride' isn't 'free', it is a right which the landowner **has earned** under the Law of Capture. It is the quid quo pro in exchange for one's right to drain another's gas from a well on one's own property. If your neighbor wants to drill and take your gas and there is no compulsory integration, then both of you share the risk of success and failure, but each in a different way. If your neighbor is successful, you will lose gas and oil to the neighbor until you drill your own well. If it is a dry hole, then the neighbor will lose his drilling costs. You risk losing the oil and gas if you wait, and the neighbor risks losing his drilling costs if he drills. Each owner has the right to decide WHEN to drill, and therefore bears his own risks of proceeding or waiting.

Thirdly, the real 'free ride' is by the driller. In Compulsory Integration the driller does not have to pay fair market rates for your gas or provide you with negotiated environmental protections. And there is no risk at all for a gathering line once the well is drilled and proven as a producer. The 'risk penalty' should be eliminated altogether in all phases of Compulsory Integration.

Fourthly, in North Dakota, for instance, the law provides that the risk penalty in Compulsory Integration is only 50% for an individual land owner, but 200% for a

corporation, etc.

Fifthly, no owner who is forced into integration in New York State should bear any liability whatsoever. If the landowner is forced into this, why should he bear any liability for the acts of a driller who was not chosen by the landowner and for whom no insurance is required by law?

Sixthly, current New York Law requires that a unit be formed for a well. In that unit only one permit holder has the right to drill a well. All other owners are prohibited from drilling a well. Hence landowners cannot protect themselves from being drained by the driller. The landowner does not receive market value compensation for this loss of the right to drill for gas and oil. And he loses the right to protect against drainage by the neighbor. The landowner does not receive compensation for this loss.

Seventhly, as a consequence, the driller, because it is the only one allowed to drill a well in the unit, no longer has to drill as many wells as possible to compete for drainage rights against the neighbor (a circumstance otherwise required by the Law of Capture). The driller therefore saves the cost of tens or hundreds of wells. Thus, Compulsory Integration, without justification, commandeers that right to decide when to drill, without paying for it, thereby taking away your right to wait and see, and at the same time takes away your right to drill at all. The landowner has not receive any compensation for the loss of these rights.

Eighthly, in business, exclusivity and monopoly franchises are valued at a premium. Yet when DEC awards a permit which results in a compulsory integration order, the single permit drilling monopoly granted to the driller is not valued and paid to the landowner who no longer has the right to drill, no longer has the right to develop, and no longer has the right to produce his gas. Instead the landowner is given back 12.5% of his gas while the company with the drilling monopoly receives 87.5% of the gas. This makes no sense at any level.

6. What would be the result of requiring the drillers to compensate the landowners for the loss of rights taken by the drillers in Compulsory Integration?

Answer: The drillers would have to bargain for and pay better leases in order to obtain the necessary rights to drill. No longer could Title 9 of Article 23 of the Environmental Conservation law be used to intimidate and bully landowners into leases which do not reflect current economic and environmental values.

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