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Illinois Oil and Gas Update

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ILLINOIS OIL AND GAS UPDATE



By: *Robin Levine Stoller, Esq., Jessica C. Tully, Esq.,
& Andrew Barber¹*

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I. INTRODUCTION

The New Albany Shale lies under much of the Illinois Basin and has been producing small amounts of gas since 1858. The advent of horizontal drilling allowed for a dramatic increase in the volume of gas that can be extracted.

The Illinois Oil and Gas Act² regulates oil and gas drilling in Illinois, including permitting, well-spacing, and well-plugging, and is enforced by the Oil and Gas Division of the Office of Mines and Minerals of the Illinois Department of Natural Resources, established in 1944. Recent amendments to the Act, effective July 27, 2011, marked significant and expansive changes to the oil and gas drilling regulatory scheme in Illinois.

Despite this overhaul, however, the Oil and Gas Act does not specifically address issues related to hydraulic-fracturing (“hydro-fracturing”)—the propagation of fractures in a rock layer, a necessary component of mineral extraction in horizontal drilling. Over the past year and as a result of the successes of hydro-fracturing in other regions, Southeastern Illinois has experienced a modest “lease boom,” which has prompted the Illinois legislature to propose several amendments to the Oil and Gas Act regulating hydro-fracturing, along with proposing two new acts—The Dormant Mineral Act and The Oil and Gas Leasing Act—enabling operators to more easily obtain valid leases.

In addition to legislative reform, Illinois oil and gas law has been further defined by two cases decided in the past year: *Tri-Power Resources, Inc. v. City of Carlyle*,³ which allows “non-home-rule unit” municipalities to prevent oil and gas drilling through zoning ordinances, and *Nye v. Leavell*,⁴ which confirms Illinois’ position on what constitutes “production” under a lease. The *Tri-Power Resources* decision leaves the industry in a rather precarious position moving forward.

2. ILL. ADMIN. CODE tit. 62, § 240 (2011).

3. *Tri-Power Res., Inc. v. City of Carlyle*, 967 N.E.2d 811 (Ill. App. Ct. 2012).

4. *Nye v. Leavell*, No. 5-10-0093, 2011 Ill. App. LEXIS 2044, at *14 (5th Cir. Aug. 25, 2011).

II. ILLINOIS OIL AND GAS ACT AMENDMENTS

The Illinois Oil and Gas Act received a substantial makeover in 2011.⁵ A few of the more significant changes are addressed below, presented by order of appearance in the Act:

A. *Well Permit Application*⁶

The well permit application must now include the GPS location of the well. The applicant must own 100% of the rights to drill and operate on the lease and must submit a copy of the recorded operative lease or assignment. It is unclear whether submission of a Memorandum of Lease would be permissible under the statute.

B. *Change in Injection Fluid*⁷

The well permittee must now seek an amendment of the permit if the injection fluid changes from that originally identified on the permit. The application shall include a statement identifying the proposed injection fluid, even if the proposed fluid is water, along with the depth and name of the geologic formation from which the injection fluid is to be obtained.

C. *Setback*⁸

All new well locations shall not be less than 200 feet from the nearest occupied dwelling existing at the time the permit application is filed with the Department, unless the permittee obtains a written agreement with the surface owner upon which the dwelling is located specifically allowing for a closer well location. This amendment does not address situations where the occupier of the surface structure is merely a tenant, and not the owner of the surface.

5. The following sections were amended: ILL. ADMIN. CODE tit. 62, §§ 240.10, 240.131(b)(1), 240.131(e)(2), 240.132(b)(1), 240.132(e)(2), 240.132(j)(7), 240.133(b)(1), 240.133(e)(2), 240.140(a)(2), 240.150, 240.155(b)(1), 240.160(c)(1), (c)(2)(A)–(C), (c)(3), 240.180(b), 240.180(e), 240.185(b), 240.186(d), 240.190, 240.220(b), 240.220(d), 240.250(b), 240.310(f), 240.320(b), 240.320(c)(4), 240.320(d), 240.340(d), 240.340(e)(2)(B), 240.370(d)(4), 240.380(b), 240.380(c), 240.390(c), 240.410(d), 240.410(f), 240.430(c), 240.455(d), 240.455(e), 240.455(f), 240.460(c), 240.460(d), 240.460(f)(2), 240.460(k)(3), 240.465(a)(2), 240.465(c), 240.610(a)(2), 240.630(d), 240.710(a)(2), 240.750(c), 240.750(g), 240.760(b), 240.760(c)(1), 240.760(e)(5), 240.780(a)(1)(D), 240.810(c)(1), 240.810(c)(2)(A), 240.870, 240.875, 240.920(c), 240.1040(a), 240.1040(d)(4), 240.1050(b), 240.1110, 240.1130(e), 240.1130(f), 240.1132(e)(4), 240.1132(e)(5), 240.1140(e), 240.1150(d)(1)(B)(3), 240.1240, 240.1305, 240.1360(b), 240.1460(a), 240.1460(c)(2)(A)–(B), 240.1500(a)(2), 240.1600, 240.1610(d), 240.1640, 240.1650, 240.1660, 240.1700(b), 240.1700(c), 240.1805, 240.1810, 240.1820(b)(1), 240.1835(b), 240.1835(d), 240.1850(b), 240.1852(b), 240.1910(b), 240.1910(d), 240.1930(b) (2011).

6. *Id.* § 240.220(b), (d) (2011).

7. *Id.* § 240.390(c).

8. *Id.* § 240.410(f).

D. Spacing Requirements

The general requirement for drilling unit spacing is found in section 240.410, but several new drilling unit exceptions found in 240.430(c), 240.455(d), and 240.455(e) establish exemptions from traditional spacing requirements for new drilling units in post-primary oil recovery areas, for horizontal drilling units in primary oil recovery areas, and for horizontal drilling units in post-primary oil recovery areas.

E. Surface Casing⁹

This amendment requires surface casing to be set in the presence of a DNR representative and clarifies when cement and casing records are required to be submitted to the Department.

F. Abandonment¹⁰

Any idle production well on an active lease or unit that has not had commercial production during the last twenty-four consecutive months shall be deemed abandoned. Any idle production well on an inactive lease or unit, if the lease or unit has not had commercial production during the last twenty-four consecutive months, shall be deemed abandoned and not eligible for Temporary Abandonment status, pending a hearing held in accordance with section 240.1610.

III. CURRENT LAW

Tri-Power Resources, Inc. v. City of Carlyle is an important development of Illinois oil and gas law with regards to zoning and is of special note to operators producing within non-home-rule unit municipalities.¹¹ *Nye v. Leavell* confirms the long-standing *Gillespie* analysis of what constitutes production under an oil and gas lease.

A. City Bars Drilling Within its Municipal Limits: *Tri-Power Resources, Inc. v. City of Carlyle*

The issue presented in this case was whether the city of Carlyle, a non-home rule unit municipality, had the authority to prohibit or bar the drilling or operation of an oil or gas well within its municipal limits. Citing *Dillon's Rule*, the court found that the city of Carlyle had authority to prohibit oil and gas drilling within its municipal limits.¹²

9. *Id.* § 240.610(a)(2).

10. *Id.* § 240.1130(a), (b).

11. *Tri-Power Res., Inc. v. City of Carlyle*, 967 N.E.2d 811, 813 (Ill. App. Ct. 2012). A home-rule unit is the form of government for a county that has a Chief Executive Officer elected by the electors of the county or a municipality that has a population of 25,000 or more. Counties or municipalities with a population of less than 25,000 may elect to become home-rule units by referendum. Otherwise, the unit is a non-home rule unit.

12. *Id.*

In April 2005, Tri-Power Resources¹³ entered into an oil and gas lease with the owners of mineral rights on sixty-seven acres of then-unincorporated Clinton County.¹⁴ In June 2005, Tri-Power obtained a drilling permit from the Illinois DNR to drill for oil on the property.¹⁵ In September 2005, the city of Carlyle, located in Clinton County, annexed the land and zoned it a residential district, which disallows drilling for oil within residential limits.¹⁶

Subsequently, Tri-Power filed a complaint against the city, arguing that the city did not have the authority to deny Tri-Power's right to drill and that the zoning effectuated a taking of its property. Tri-Power sought summary judgment on that issue, and the circuit court denied the motion. Tri-Power then appealed, seeking a declaratory judgment on the certified question of whether the city of Carlyle had the authority to prohibit oil and gas drilling within its municipal limits.

The court found that the city of Carlyle is classified as a "non-home-rule unit" government because it has fewer than 25,000 inhabitants and has not elected to become a home-rule unit. Because the city is a non-home rule unit, it "can prohibit the drilling or operation of an oil or gas well within its municipal limits."¹⁷

As a non-home rule unit, the city is governed by *Dillon's Rule*:

Dillon's Rule states that non-home-rule units possess only those powers specifically conveyed by the constitution or statute; thus, such a unit may regulate in a field occupied by state legislation only when the constitution or statute specifically conveys such authority. However, even when a non-home-rule unit is conveyed the authority to regulate in a particular field, it may not adopt an ordinance that infringes upon the spirit of the state law or is repugnant to the general policy of the state. An ordinance enacted under those powers that conflicts with the spirit and purpose of a state statute is preempted by statute.¹⁸

In analyzing a possible conflict of the municipality's zoning ordinance with the Illinois Oil and Gas Act, the court found that a provision of the Oil and Gas Act, which states "[t]he corporate authorities of each municipality may grant permits to mine oil or gas, under such restrictions as will protect public and private property and insure proper remunerations for such grants,"¹⁹ demonstrates the intent of the legislature to grant municipalities permissive power to grant or deny permits. The court found no direct conflict between the municipi-

13. Tri-Power Resources is a privately-held independent energy company.

14. *Tri-Power Res., Inc.*, 967 N.E.2d at 812.

15. *Id.*

16. *Id.*

17. *Id.*

18. *Id.* at 813.

19. *Id.* at 814.

pality's zoning ordinance and any applicable state statutes and, therefore, upheld the ordinance.

It is important to note that the court did not express an opinion as to whether Tri-Power can seek compensation from the city for the loss of its lease or whether the city can prohibit Tri-Power from drilling with the permit that the Illinois DNR issued before the city annexed the drilling site.²⁰ The determination of these issues will be of great importance to operators in determining whether to lease in non-home-rule unit municipalities.

B. *Reasonable Diligence is Needed in Order to Be Continued Production: Nye v. Leavell*

One of the issues presented in this case was whether the trial court erred in its determination that the oil and gas lease between Greg Nye, as the original lessor's heir, and Eva Lovene Leavell and Stanley Leavell, as lessees, was terminated due to lack of production.²¹ The court, in applying the long-standing rule in *Gillespie v. Wagoner*,²² found that the trial court did not err and that the lease was terminated due to lack of production.

On February 28, 2005, Nye filed a complaint to cancel an oil and gas lease held by the Leavells.²³ Nye claimed that the lease was terminated by its habendum clause because the well had not produced oil in paying quantities since June of 2000 and that any equipment used to extract oil or gas either had been removed or was inoperable.²⁴ Nye alleged that the failures of the Leavells to execute and record a record of release created a cloud on the title.²⁵

The Leavells alleged that production on the well did not cease until February of 2001, due to a directive from the Illinois DNR prohibiting the Leavells from operating their wells.²⁶ On appeal, the Leavells also alleged that the trial court erred in applying *Gillespie v. Wagoner* to the issue of non-production because the Leavells' lease substantially differed from the lease at issue in *Gillespie* in that the Leavells' lease had a habendum clause insulating them from forfeiture stemming from DNR directives.²⁷

Citing the lower court, the court found that defendants "failed to show reasonable diligence to produce oil under the lease for a sub-

20. *Id.* at 817.

21. *Nye v. Leavell*, No. 5-10-0093, 2011 Ill. App. LEXIS 2044, at *1 (5th Cir. Aug. 25, 2011).

22. *Gillespie v. Wagoner*, 190 N.E.2d 765, 767 (Ill. 1963).

23. *Nye*, 2011 Ill. App. LEXIS 2044, at *2.

24. *Id.*

25. *Id.*

26. *Id.*

27. *Id.* at *14-15.

stantial period of time prior to their receiving a notice” from the Department of Natural Resources.²⁸

Noting that *Gillespie* has long been the authority on production standards, the court quoted *Gillespie*:

We believe the proper rule to be that temporary cessation of production after the expiration of the primary term is not a cessation of production within the contemplation and meaning of the ‘thereafter’ clause if, in the light of all surrounding circumstances, reasonable diligence is being exercised by the lessee to continue production of oil and gas under the lease.²⁹

The court found that the lower court’s determination and consideration of all the surrounding circumstances was supported by the record, finding in favor of plaintiff:

The trial court pointed to several pieces of evidence in its order. The plaintiff and other eyewitnesses testified that they did not observe any production activity and saw rods and tubing out and lying on the ground for a substantial period of time. In contrast, the trial court found that Stanley Leavell’s description of production lacked credibility. Furthermore, the trial court pointed to the payment history for the electric bills showing that the power had been disconnected on several occasions and field inspection reports from the Department of Natural Resources dated February 7, 2001, indicating that the wells had not been producing for more than two years.³⁰

This case reaffirms Illinois’ reliance on *Gillespie* in determining whether a lease is held by production, providing a reliable frame of reference for instances where production under the lease is in question.

IV. PROPOSED LEGISLATION REGULATING THE DEVELOPMENT OF UNCONVENTIONAL GAS

Although Illinois has a long history of conventional oil and gas drilling, unconventional gas drilling in Illinois is in its infancy. Southeastern Illinois is home to the New Albany and Maquoketa Shales, which are rich in natural gas liquids, including ethane. Ethane is an essential component of petrochemical products, such as plastic, and is a highly valued commodity. Based upon the success of hydro-fracturing in other shale basins, the industry is eyeing the New Albany and Maquoketa Shales for future development.

As of the publication of this update, there are no laws regulating hydro-fracturing in Illinois. There are, however, several proposed amendments to the Illinois Oil and Gas Act and two newly proposed

28. *Id.* at *15.

29. *Id.* at *14 (quoting *Gillespie v. Wagoner*, 190 N.E.2d 765, 767 (Ill. 1963)).

30. *Id.* at *15–16.

acts—the Dormant Mineral Act and the Oil and Gas Leasing Act, covering two broad topics: (1) Senate Bill No. 3280, House Bill No. 5853, and House Bill No. 3939, regulating hydro-fracturing; and (2) Senate Bill No. 3356 and House Bill No. 5889, regulating leasing.

A. *Hydro-Fracturing*

Regulations proposed regarding hydro-fracturing center on disclosure of chemical additives to “frac” water. Operators will be required to complete a form posted on the hydraulic chemical registry website of the Ground Water Protection Council and the Interstate Oil and Gas Compact Commission listing the total volume of water used and each chemical ingredient used and to submit the above-described form with the well completion report for the well.³¹ The proposed legislation also proscribes a process whereby operators may withhold and declare certain additives trade secrets and outlines causes of action by surface owners who have been directly negatively affected by hydro-fracturing.³²

Additionally, the proposed regulations require the Department of Natural Resources (“DNR”) to adopt rules that prohibit hydraulic fracturing in designated state areas, including parks, forests, natural areas, conservation areas, recreational areas, memorials, and wetlands.³³ This amendment does not speak to severed mineral interests owned by private individuals on DNR lands.

B. *Leasing*

In keeping with Illinois’ public policy to enable and encourage marketability of real property,³⁴ the Illinois Legislature has proposed the Dormant Mineral Act³⁵ and the Oil and Gas Leasing Act,³⁶ both of which make it easier for an operator to obtain valid leases.

The Dormant Mineral Act would apply in situations where the oil and gas had been severed from the surface estate and there had been no production for a twenty-year period. The surface owner can maintain an action to terminate a dormant mineral interest. A court order terminating a mineral interest, when recorded, merges the terminated mineral interest, including express and implied appurtenant surface rights and obligations, with the surface estate in shares proportionate

31. S.B. 3280, 97th Gen. Assemb., Reg. Sess. (Ill. 2011); *see also* H.B. 5853, 97th Gen. Assemb., Reg. Sess. (Ill. 2011).

32. S.B. 3280, 97th Gen. Assemb., Reg. Sess. (Ill. 2011); *see also* H.B. 5853, 97th Gen. Assemb., Reg. Sess. (Ill. 2011).

33. H.B. 3939, 97th Gen. Assemb., Reg. Sess. (Ill. 2011).

34. S.B. 3356, 97th Gen. Assemb., Reg. Sess. (Ill. 2011) (“The public policy of this State is to enable and encourage marketability of real property and to mitigate the adverse effect of dormant mineral interests on the full use and development of both surface estate and mineral interests in real property.”).

35. *Id.*

36. H.B. 5889, 97th Gen. Assemb., Reg. Sess. (Ill. 2011).

to the ownership of the surface estate, subject to existing liens for taxes or assessments.

House Bill No. 5889 proposes the “Oil and Gas Leasing Act.”³⁷ The purpose of this Act is to clarify the rights of joint owners of oil and gas, to promote and preserve the value of oil and gas reserves, and to maximize the recovery of oil and gas through the orderly and efficient development of oil and gas reserves for the benefit of all joint owners in a fair and equitable manner.

With this Act, any oil and gas owner vested with at least a one-half interest in the oil and gas shall be authorized to produce and remove oil and gas from the land,³⁸ and a trustee will be appointed to administer the royalties owed to owners not joined in a lease.³⁹

V. CONCLUSION

Over the past year, oil and gas operators in Illinois have been increasing efforts to secure leases on promising gas shale lands, and the Illinois Legislature has been quick to respond to both the needs of the industry and the concerns for the environment. In general, the Illinois Legislature has taken a balanced approach to regulating the industry.

In updating the Illinois Oil and Gas Act, the legislature addressed both industry and environmental concerns, relaxing spacing requirements for drilling units while requiring greater oversight in surface casing. Additionally, the legislature has taken a balanced approach to the presence of hydro-fracturing in its state, addressing environmental concerns through proposed hydro-fracturing regulations requiring the disclosure of chemical additives to “frac” fluid and encouraging economic development through proposed legislation encouraging leasing.

The courts have confirmed long-standing principles of production but have muddied the waters with their recent decision that a municipality could pass an ordinance that effectively banned oil production within the municipal limits. Future decisions on zoning are needed to clarify what recourse, if any, an operator has when it is zoned out of

37. *Id.* (stating the functions of the bill as follows: “Creates the Oil and Gas Leasing Act. Provides that the purpose of the Act is to clarify the rights of joint owners of oil and gas in this State, to promote and preserve the value of oil and gas reserves in the State, and to maximize the recovery of oil and gas through the orderly and efficient development of oil and gas reserves for the benefit of all joint owners in a fair and equitable manner. Provides definitions. Includes provisions concerning venue of an action seeking to impress a trust upon an oil and gas interest for the purpose of leasing and developing it, joint ownership of a freehold interest in an oil and gas estate, declaration of a trust in oil or gas land and the powers and duties of a trustee, court procedures, oil and gas leases, payments under an oil and gas lease, and construction of the Act. Effective immediately.”).

38. *Id.*

39. *Id.*

producing on a lease. Courts are generally slow to clarify confusing decisions, but it is possible that the Illinois Legislature will respond sooner rather than later.