

**IN THE SUPREME COURT OF PENNSYLVANIA  
MIDDLE DISTRICT**

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No. 64 MAP 2019

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PENNSYLVANIA ENVIRONMENTAL DEFENSE FOUNDATION,  
Appellant,

v.

COMMONWEALTH OF PENNSYLVANIA, and GOVERNOR of Pennsylvania,  
Tom Wolf, in his official Capacity as Governor, Appellees.

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**COMMONWEALTH OF PENNSYLVANIA’S AND GOVERNOR WOLF’S  
JOINT BRIEF IN OPPOSITION TO THE PENNSYLVANIA  
ENVIRONMENTAL FOUNDATIONS’ APPEAL**

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Appeal from the July 29, 2019 Order of the  
Commonwealth Court at No. 228 MD 2012

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**TABLE OF CONTENTS**

	<b>Page(s)</b>
TABLE OF AUTHORITIES .....	iii
PRELIMINARY STATEMENT .....	1
COUNTER-STATEMENT OF JURISDICTION .....	3
SCOPE AND STANDARD OF REVIEW .....	4
COUNTER-STATEMENT OF QUESTIONS PRESENTED .....	5
COUNTER-STATEMENT OF THE CASE .....	6
1. Procedural Background.....	6
2. Statement of Facts.....	12
SUMMARY OF ARGUMENT .....	20
ARGUMENT .....	21
I. PAYMENTS, OTHER THAN ROYALTIES, ESTABLISHED WITHIN THE COMMONWEALTH’S OIL AND GAS LEASES ARE INCOME THAT MAY BE USED FOR GENERAL FUND PURPOSES, NOT COMPENSATION FOR THE SEVERANCE OF A TRUST ASSET .....	21
II. COMMONWEALTH COURT DID NOT ERR IN APPLYING THE PRINCIPAL AND INCOME ACT OF 1947 SUCH THAT ONE-THIRD OF BONUS AND RENTAL PAYMENTS RECEIVED UNDER COMMONWEALTH OIL AND GAS LEASES MAY BE APPROPRIATED FOR GENERAL FUND PURPOSES .....	27
III. SECTIONS 1604-E and 1605-E OF THE FISCAL CODE AND SECTION 1912 OF THE SUPPLEMENTAL GENERAL APPROPRIATIONS ACT OF 2009, WHICH DIRECTED THE TRANSFER OF MONEY FROM THE OIL AND GASE	

LEASE FUND TO THE GENERAL FUND, ARE NOT  
FACIALLY UNCONSTITUTIONAL .....31

CONCLUSION.....32

**TABLE OF AUTHORITIES**

**Page(s)**

**CASES**

*Bolton v. Stillwagon*, 190 A.2d 105 (Pa. 1963) .....25

*Burgan v. South Penn Oil Co.*, 89 A. 823 (Pa. 1914).....23

*Kvaerner Metals Div. of Kvaerner United States, Inc. v. Commercial Union Ins. Co.*, 589 Pa. 317 (2006) .....4

*Payne v. Kassab*, 312 A.2d 86 (Pa. Cmwlt. 1973) .....9

*Pennsylvania Environmental Defense Foundation v. Commonwealth of Pa., et al.*, 108 A.3d 140 (Pa. Cmwlt. 2015)(“PEDF”).....8, 9

*Pennsylvania Environmental Defense Foundation v. Commonwealth of Pa., et al.*, 161 A.3d 911 (Pa. 2017)(“PEDF II”) .....*passim*

*Pennsylvania Environmental Defense Foundation v. Commonwealth*, 214 A.3d 748 (Cmwlt. 2019)(“PEDF III”).....*passim*

*Sabella v. Appalachian Development Corp.*, 103 A.3d 83 (Pa. Super. 2014).....23

*Walker v. Ehlinger*, 544 Pa. 298 (1996) .....4

**CONSTITUTIONAL PROVISIONS**

Pa. Const. art. I, § 27 .....*passim*

**STATUTES**

Conservation and Natural Resources Act, Act of June 28, 1995, P.L. 89,  
71 § 1340.302 .....9, 12, 28  
71 § 1340.101 .....12

Fiscal Code, Act of April 9, 1929, P.L. 343, as amended,  
72 P.S. § 1602-E .....*passim*  
72 P.S. § 1603-E .....*passim*

**STATUTES (continued)**

	<b>Page(s)</b>
2009 Fiscal Code	
72 P.S. § 1604-E .....	2, 5, 31
72 P.S. § 1605-E .....	2, 5, 31
2009 Fiscal Code Amendments	
Article XVI-E .....	9
Supplemental General Appropriations Act of 2009	
Act of October 9, 2009 (P.L. 779, No. 10A), 2009 Pa. Laws 10A	
§ 1912 .....	2, 5, 31
Oil and Gas Lease Fund Act (“Lease Fund Act”)	
71 P.S. § 1331 .....	15
71 P.S. § 1332 .....	15
Principal and Income Act of 1947,	
Act of July 5, 1947, P.L. 1283, <i>as amended,</i>	
<i>formerly</i> 20 P.S. §§ 3470.1-3740.15.....	<i>passim</i>
20 Pa.C.S. § 8102.....	26
20 Pa.C.S. § 8145.....	25
42 Pa.C.S. § 723.....	3

**RULES**

Pa.R.A.P. 1101(a)(1).....	3
Pa.R.A.P. 1532(b) .....	4, 11

## **PRELIMINARY STATEMENT**

This matter concerns an appeal from a decision by the Commonwealth Court that examined legal challenges brought by the Pennsylvania Environmental Defense Foundation (the “Foundation”) under the provisions of Article I, Section 27 of the Pennsylvania Constitution.

This Court determined that royalties – monthly payments based on the gross production of oil and gas at each well – are proceeds from the sale of oil and gas resources and are part of the corpus of the Article I, Section 27 trust. The Commonwealth Court, on remand, was tasked by this Court with examining the other revenue streams received by the Commonwealth as a result of oil and gas leases and whether, pursuant to trust law, those payments are income that may be appropriated to other purposes, or is compensation for the severance of trust assets and must remain in the corpus of Article I, Section 27 trust.

In relation to that analysis, the Commonwealth Court examined legislative action in the nature of appropriations by the General Assembly, of the proceeds from the oil and gas leases, pursuant to claims by the Foundation regarding the nature of the proceeds under Article I, Section 27.

Ultimately, following the submission of cross-applications for summary relief and oral argument, *en banc*, before the Commonwealth Court, the court denied the Foundation’s application for summary relief and granted the joint application of the

Commonwealth and Governor. The court held that bonus and rental payments are not for the permanent severance of natural resources and are therefore income that need not remain in the corpus of the Section 27 trust but may be appropriated for General Fund purposes. *Pennsylvania Environmental Defense Foundation v. Commonwealth*, 214 A.3d 748, at 773 (Cmwlth. 2019) (“*PEDF III*”). Further, the court held that the Principal and Income Act of 1947 was the trust law in effect at the time that Section 27 was ratified in 1971; therefore, pursuant to former Section 9 of the Principal and Income Act of 1947, one-third of the rental and bonus payments going into the Oil and Gas Lease Fund (the “Lease Fund”) constitute income and the other two-thirds constitute trust corpus. *PEDF III*, 214 A.3d at 774. Accordingly, Sections 1604-E and 1605-E of the Fiscal Code and Section 1912 of the Supplemental General Appropriations Act of 2009 which appropriated funds from the Lease Fund to the General Fund are not facially unconstitutional. *Id.*

## **COUNTER-STATEMENT OF JURISDICTION**

The proceedings that concluded in the Commonwealth Court's final declaratory judgment order entered July 29, 2019, were originally commenced in that court. Thus, the Supreme Court has appellate jurisdiction pursuant to 42 Pa.C.S. § 723(a) and Pa. R.A.P. 1101(a)(1) to review Commonwealth Court's final order based on the timely appeal by the Foundation.



## **SCOPE AND STANDARD OF REVIEW**

In this appeal from a declaratory judgment entered in the form of an order granting the Foundation's application for summary relief and denying the application jointly filed by the Commonwealth and the Governor (the "Commonwealth") pursuant to Pa. R.A.P. 1532(b), the scope of review is plenary. *Kvaerner Metals Div. of Kvaerner United States, Inc. v. Commercial Union Ins. Co.*, 589 Pa. 317, 329, 908 A.2d 888, 895 (2006).

The appellate standard of review of a court's declaratory judgment is whether the trial court's findings are supported by substantial evidence, an error of law was committed, or the trial court abused its discretion. *Walker v. Ehlinger*, 544 Pa. 298, 300 n.2, 676 A.2d 213, 214 n.2 (1996).

**COUNTER-STATEMENT OF QUESTIONS PRESENTED**

A. Are payments other than royalties, such as bonuses and rental payments, set forth in the Commonwealth's oil and gas leases, income that may be used for General Fund purposes rather than compensation for the sale of natural resources and part of the trust corpus that must be used for conservation and maintenance purposes?

*(Answered in the affirmative by Commonwealth Court)*

Suggested answer: Yes.

B. Is the Principal and Income Act of 1947 applicable to Article I, Section 27 such that one-third of bonus and rental payments made under Commonwealth oil and gas leases is income that may be appropriated for General Fund purposes?

*(Answered in the affirmative by Commonwealth Court)*

Suggested answer: Yes.

C. Are Sections 1604-E and 1605-E of the Fiscal Code and Section 1912 of the Supplemental General Appropriations Act of 2009, which directed the transfer of money from the Lease Fund to the General Fund, facially unconstitutional under Article I, Section 27 of the Pennsylvania Constitution?

*(Answered in the negative by Commonwealth Court)*

Suggested answer: No.

## COUNTER-STATEMENT OF THE CASE

### **1. Procedural Background**

On March 6, 2012, the Foundation filed a petition for review invoking the Commonwealth Court's original jurisdiction. Through its original petition, the Foundation sought declaratory relief against the Commonwealth of Pennsylvania, the Governor, the Secretary of the Budget, and the State Treasurer. Shortly thereafter, on April 30, 2012, the Foundation filed an amended petition for review naming as Respondents only the Commonwealth and the Governor. The Foundation filed a second amended petition for review on December 30, 2013.

The second amended petition is lengthy and wide-ranging; it contains fifteen separate requests for relief. Though labeled as requests for "declaratory relief" in the petition, some of these requests are simply statements of law, while others are actually requesting some form of injunctive relief.

On February 20, 2014, the Foundation asked Commonwealth Court for leave to amend its second amended petition to include allegations in response to the fiscal year 2014-15 Executive Budget proposed by Governor Corbett. The request was granted, and a third amended petition for review was filed on March 18, 2014.

In April 2014, the Foundation filed an application for summary relief. Within its application, the Foundation raised over twenty issues which focused on the Environmental Rights Amendment's protection of the Commonwealth's natural

resources. Shortly thereafter, it filed an application for preliminary injunction. A hearing on that application was held commencing on May 28, 2014 and concluding on June 3, 2014. On June 5, the Commonwealth Court issued a Memorandum and Order. Noting that any decision on the application for preliminary injunction during the pending budget process could affect decision-making of legislators and the Governor's Office, and that such interference would run afoul of the principle of separation of powers, the Commonwealth Court deferred resolution of the application until after final enactment of the FY 2014-15 budget.

On July 17, 2014, the Commonwealth Court issued an order on the parties' Stipulation in Settlement of the Application. The Order had the following effect: (i) precluding the Commonwealth and the DCNR from executing any additional leases for gas interests in State forests or parks until this Court issues a final order in this action; (ii) noting the Foundation's withdrawal of its request for special relief pertaining to the use of gas-leasing revenue for General Fund purposes and DCNR's ongoing operations in the budget enacted by the General Assembly in the General Appropriations Act of 2014, as well as the Foundation's request that the Court enjoin the transfer of projected revenue from new gas leases in FY 2014-15 directed by the General Assembly in amendments to the Fiscal Code; and (iii) establishing a briefing schedule for the response to the Foundation's motion and any cross-motion filed by the Commonwealth and Governor.

In August 2014, the parties filed cross-applications for summary relief.

The Commonwealth Court found some of the issues raised by the Foundation to be inappropriate for decision under the Declaratory Judgment Act, dismissed others for failure to join the lessees of the leases whom this Court deemed indispensable parties, and narrowed the remaining issues to three questions:

- a. Whether Sections 1602-E and 1603-E of the Fiscal Code, Act of April 9, 1929, P.L. 343, as amended, 72 P.S. §§ 1602-E, 1603-E, which provide that the General Assembly shall appropriate all royalty monies of the Lease Fund with \$50 million of the Lease Fund royalties to be appropriated to the DCNR, violate Pa. Const. Article 1, § 27;
- b. Whether the General Assembly's transfers/appropriations from the Lease Fund violate Article 1, § 27; and
- c. Who within the Commonwealth has the duty and thus bears the responsibility to make determinations with respect to the leasing of State lands for oil and natural gas extraction?

*Pennsylvania Environmental Defense Foundation v. Commonwealth of Pa., et al.*, 108 A.3d 140, 155 (Pa. Cmwlth. 2015) (“*PEDF*”).

On January 7, 2015, the Commonwealth Court granted the Commonwealth and Governor's joint application for summary relief and denied the Foundation's

request for a declaratory judgment that sections 1602-E and 1603-E of the Fiscal Code were unconstitutional. The Commonwealth Court further denied the Foundation's request for judgment that the Oil and Gas Lease Fund is a "trust fund" and that the General Assembly may only appropriate the monies therein to advance the purposes of Article I, Section 27, and that the Governor may override decisions of the Department under Section 1340.302(a)(6) of the CRNA. *PEDF*, 108 A.3d at 173.

The Foundation appealed the January 7, 2015 order to this Honorable Court. Jurisdiction was exercised over two overarching issues: 1) the standard of judicial review of government actions and legislation challenged under the Environmental Rights Amendment ("Article I, Section 27"), Pa. Const. art I, § 27, and 2) the constitutionality of Article XVI-E to the Fiscal Code addressing Marcellus Shale leasing ("2009 Fiscal Code Amendments"), Sections 1602-E and 1603-E, and the General Assembly's 2009-2015 appropriations from the Commonwealth's Oil and Gas Lease Fund. *Pennsylvania Environmental Defense Foundation v. Commonwealth of Pa., et al.*, 161 A.3d 911, 929 (Pa. 2017) ("*PEDF II*").

With respect to the first issue, this Court rejected the legal standard for challenges to the Environmental Rights Amendment delineated in *Payne v. Kassab*, 312 A.2d 86 (Pa. Cmwlth. 1973). *Id.* This Court held, instead, that "the proper standard of judicial review lies in the text of Article I, Section 27 itself as well as the

underlying principles of Pennsylvania trust law in effect at the time of its enactment.” *PEDF II*, 161 A.3d at 930.

This Court noted the third clause of the Environmental Rights Amendment “establishes a public trust, pursuant to which the natural resources are the corpus of the trust, the Commonwealth is the trustee, and the people are the named beneficiaries.” (“Section 27 trust”) *Id.* at 931-32. As trustee, the Commonwealth is thus imposed with the “duty to prohibit the degradation, diminution, and depletion of our public natural resources.” *Id.* at 933.

With respect to the second issue, this Honorable Court held that Sections 1602-E and 1603-E of the 2009 Fiscal Code Amendments, which relate exclusively to royalties, were facially unconstitutional, reasoning that the allocations of royalty payments from the oil and gas lease fund for non-conservation purposes are contrary to the trust’s purposes. *Id.* at 935. However, this Court observed that it was less clear how to categorize other revenue streams, i.e., the up-front bid-bonus payments and other payments designated as rental payments. *Id.* Accordingly, this Court opined that it is up to the Commonwealth Court, in the first instance, to determine whether these funds belong in the corpus of the Section 27 trust. *Id.* at 935-36. The action was remanded to the Commonwealth Court for additional proceedings as “the parties should be given the opportunity to develop arguments concerning the proper

classification, pursuant to trust law, of any payments called ‘rental payments’ under the lease terms.” *Id.* at 936.

On remand, the parties developed the record and filed cross-applications for summary relief pursuant to Pa.R.A.P. 1532(b). On December 12, 2018, the Commonwealth Court, sitting *en banc*, heard oral argument on the applications. On July 29, 2019, the Commonwealth Court issued its Opinion and Order granting the Foundations’ application and denying the application filed jointly by the Commonwealth and the Governor. R. 1715b-1762b. The Opinion and Order of the Commonwealth Court, authored and signed by Judge Michael H. Wojcik on behalf of the court *en banc*, are reported at 214 A.3d 748; the reported opinion and order are appended to the Brief of the Foundation.

On August 12, 2019, the Foundation filed a notice of appeal of Commonwealth Court’s final order to this Court, along with a jurisdictional statement. This Court noted probable jurisdiction of the appeal on December 2, 2019. On November 21, 2019, the Foundation filed an Application for Expedited Briefing Schedule. The Commonwealth and Governor jointly filed an answer objecting to such a schedule on December 2, 2019. On December 19, 2019, this Court denied the Foundation’s Application for Expedited Briefing Schedule.



On January 28, 2020, the Foundation filed its Brief and Reproduced Record. On February 7, 2020, the Commonwealth and Governor filed their joint Supplemental Reproduced Record.

## **2. Statement of Facts**

This Honorable Court has fully laid out the factual background of this case prior to remand within its decision in *PEDF II*. Accordingly, the Commonwealth and Governor will focus upon only those facts which have been developed as part of the remand and were submitted in support of the parties' cross-applications for summary relief which are the subject of this appeal.

Pursuant to the Conservation and Natural Resources Act, 71 P.S. § 1340.101 *et seq.* ("CNRA"), the primary mission of the Department of Conservation and Natural Resources ("DCNR" or "Department") is:

. . . to maintain, improve and preserve State parks, to manage State forest lands to assure their long-term health, sustainability and economic use, to provide information on Pennsylvania's ecological and geological resources and to administer grant and technical assistance programs that will benefit rivers conservation, trails and greenways, local recreation, regional heritage conservation and environmental education programs across Pennsylvania.

71 P.S. § 1340.101(b)(1). The CNRA also delegates authority to the DCNR to enter into leases for natural gas interests under State forest lands, "whenever it shall appear to the satisfaction of [the DCNR] that it would be for the best interests of this Commonwealth to make such disposition . . . ." 71 P.S. § 1340.302(a)(6). The leases

for oil and natural gas interests are the responsibility of the Bureau of Forestry. R. 1671b.

The Department's leases for oil and natural gas interests require four (4) different categories of payments to the Department: (1) a bonus bid payment, (2) a rental payment, (3) a royalty payment, and (4) interest due on late payments. R. 1671b. Each payment is paid at differing times, and for differing reasons.

When companies desire to engage in oil and gas exploration on State forest lands, they nominate that land to ask the Department to put it up for bid. *See* Commonwealth's Brief in Support of Summary Relief, Exhibit B at pg. 9. The decision of whether to lease State forest lands for this purpose is made by the Secretary of the Department. *Id.* Once that decision is made, the Department utilizes a formal bidding process for most of its leases of land tracts for oil and natural gas interests. *Id.*; *see also* R. 1672 b. To assist the Department in selecting the company who will receive the lease in the nominated land, it often uses a highest bid, or "bonus bid" payment to distinguish the bidders. *Id.*

The leases utilized by the Department state that "the first year's rental shall consist of the bonus payment which was made by Lessee and shall be payable upon delivery of this lease to Lessee." R. 1672b. Therefore, in order to consummate the lease, the winning bidder must pay their bonus bid payment upon delivery of the lease for execution. *Id.* These up-front, bonus bid payments are not consideration for

oil and gas that is extracted from the land. Not all leases result in the extraction of oil or gas, but every lessee pays a bonus payment. *Id.* The bonus bid payments are paid up front and without consideration of whether the successful bidder ever develops the tract of land. *See Commonwealth’s Brief in Support of Summary Relief, Exhibit B at pg. 13.*

Like the bonus bid payment, rental payments are unrelated to the extraction of oil and gas. Rental payments are required to be paid to the Department on an annual basis until the extraction of oil or gas occurs. *Id.; see also R. 1672b.* Even where no oil or gas is extracted, the rental payment remains due. Similarly, interest charged on late payments is due even when no oil or gas is produced. *R. 1673b.*

Royalty payments – monthly payments based on the gross production of oil and gas at each well – are different from bonus bid payments and rental payments. Royalty payments are directly related to the extraction of oil and gas, and only become due and owing if oil or gas is extracted from the public natural resource. Royalty payments represent proceeds from the severance of oil and gas and are consideration to the Department for that extracted oil and gas. *R. 1672b; see also Commonwealth’s Brief in Support of Summary Relief, Exhibit B at pg. 32.* Royalties are trust corpus and must be “committed to furthering the purposes, rights and protections afforded under Section 27, *i.e.*, to conserve and maintain our natural resources.” *PEDF II, 161 A2.3d at 935.*

The Lease Fund Act states that “[a]ll rents and royalties from oil and gas leases of any land owned by the Commonwealth, except rents and royalties received from game and fish lands, shall be placed in a special fund to be known as the ‘Oil and Gas Lease Fund’ which fund shall be exclusively used for conservation, recreation, dams, or flood control or to match any Federal grants which may be made for any of the aforementioned purposes.” 71 P.S. § 1331. When enacted, the Lease Fund Act further provided the Secretary with the discretion “to determine the need for and the location of any project authorized.” 71 P.S. § 1332. Since 1955, both the bonus bid payments and the rental payments from leases of land tracts for oil and natural gas interests have been deposited into the Oil and Gas Lease Fund. *See* Commonwealth’s Brief in Support of Summary Relief, Exhibit B at pgs. 13-14; *see also* Exhibit C at pg. 5.

Bonus payments have not been kept separate from the other payments deposited into the Oil and Gas Lease Fund (the “Fund”). *See* Commonwealth’s Brief in Support of Summary Relief, Exhibit C at pg. 5. Bonus payments, rental payments, and royalties are all deposited into the Fund and become comingled. *Id.*

The Department’s leases state that they are “for the sole purpose of (1) exploring, drilling, operating, producing, and removing of oil, gas and liquid hydrocarbons; and (2) at locations approved by the Department, laying pipelines and constructing roads...to produce, save, take care of, and transport extracted

products.” R. 1543b. The lease does not convey any control over the surface of the leased land tract; the Department maintains complete control and retains ownership of the land. R. 1556b, 1569b. The leases remain in force for a term of ten years from the effective date so long as the first well is drilled within the first five years. R. 1544b, 1577b, 1611b. All of the Department’s leases for oil and gas extraction provide that the Department retains any bonus bid payments and rentals received even when no oil or gas is produced. R. 1673b.

Between 2003 and 2015, the Department has terminated sixteen (16) separate oil and gas leases with various operators because no oil or gas was extracted from the tracts under lease; there was no sale of public natural resources in those scenarios. R. 1673b. Between 2003 and 2015, the Department received and retained a total of \$120,479,684.00 in bonus payments from leases that were terminated for lack of production and \$3,528,630.05 in rental payments. R. 1676b-1677b. Specifically, the following oil and gas leases were terminated for lack of production:

- a. The Tract 985 Lease was executed on December 12, 2003 and was terminated on June 12, 2008. The Department received a total bonus payment of \$1,175.00 and a total of \$9,458.75 in rental payments.
- b. The Tract 1014 Lease was executed on July 6, 2006 and was terminated on July 6, 2015. The Department acquired land for the bonus payment and received a total of \$12,320.00 in rental payments.

- c. The Tract 259-W Lease was executed on January 7, 2010 and was terminated on January 7, 2015. The Department received a total bonus payment of \$2,312,160.00 and a total of \$219,655.20 in rental payments.
- d. The Tract 416 Lease was executed on January 20, 2010 and was terminated on January 20, 2015. The Department received a total bonus payment of \$13,766,325.00 and a total of \$348,746.10 in rental payments.
- e. The Tract 419 Lease was executed on January 20, 2010 and was terminated on January 20, 2015. The Department received a total bonus payment of \$7,194,024.00 and a total of \$280,440.00 in rental payments.
- f. The Tract 1015 Lease was executed on April 26, 2010 and was terminated on April 26, 2015. The Department received a total bonus payment of \$4,004,000.00 and a total of \$190,190.00 in rental payments.
- g. The Tract 002 Lease was executed on May 10, 2010 and was terminated on May 10, 2015. The Department received a total bonus payment of \$1,700,000.00 and a total of \$23,375.00 in rental payments.

- h. The Tract 003 Lease was executed on May 10, 2010 and was terminated on May 10, 2015. The Department received a total bonus payment of \$1,644,000.00 and a total of \$39,045.00 in rental payments.
- i. The Tract 009 Lease was executed on May 10, 2010 and was terminated on May 10, 2015. The Department received a total bonus payment of \$11,422,000.00 and a total of \$542,545.00 in rental payments.
- j. The Tract 010 Lease was executed on May 10, 2010 and was terminated on May 10, 2015. The Department received a total bonus payment of \$20,892,000.00 and a total of \$496,185.00 in rental payments.
- k. The Tract 271-S Lease was executed on May 10, 2010 and was terminated on May 10, 2015. The Department received a total bonus payment of \$16,784,000.00 and a total of \$398,620.00 in rental payments.
- l. The Tract 337R Lease was executed on May 10, 2010 and was terminated on May 10, 2015. The Department received a total bonus payment of \$6,200,000.00 and a total of \$147,250.00 in rental payments.

- m. The Tract 338R Lease was executed on May 10, 2010 and was terminated on May 10, 2015. The Department received a total bonus payment of \$4,124,000.00 and a total of \$97,945.00 in rental payments.
- n. The Tract 339R Lease was executed on May 10, 2010 and was terminated on May 10, 2015. The Department received a total bonus payment of \$7,772,000.00 and a total of \$184,585.00 in rental payments.
- o. The Tract 750 Lease was executed on May 10, 2010 and was terminated on May 10, 2015. The Department received a total bonus payment of \$8,200,000.00 and a total of \$194,750.00 in rental payments.
- p. The Tract 768R Lease was executed on May 10, 2015 and was terminated on May 10, 2015. The Department received a total bonus payment of \$14,464,000.00 and a total of \$343,520.00 in rental payments.

R. 1673b-1676b.



## SUMMARY OF ARGUMENT

The Commonwealth Court's holding in *PEDF III* is correct. Unlike royalty payments, which are tied directly to the extraction of oil and gas from State forests and are compensation for the severance of that asset from the Section 27 trust, bonus bid payments and rental payments are made purely to secure the lease and for the lessee's ability to explore and develop the property in anticipation of extraction. They are, therefore, not proceeds received as consideration for severance of a trust asset and are income that need not remain in the trust corpus.

In 1971, the year that Article I, Section 27 was ratified, Pennsylvania's governing trust law for the disposition of natural resource trust principal was the Principal and Income Act of 1947. *See former 20 P.S. § 3470.* Pursuant to the Act, monies received as consideration for the permanent severance of the natural resources from the trust "shall be deemed principal to be invested to produce income." *Id.* at § 3470.9. Monies received unrelated to the permanent severance of a trust asset are to be divided such that one-third "shall be deemed income, and the remaining two-thirds thereof shall be deemed principal to be invested to produce income ..." *Id.* Accordingly, one-third of bonus bid and rental payments are income that may be used for purposes other than conservation and maintenance of the Section 27 trust. Therefore, the General Assembly's appropriation of these funds in the Fiscal Code and the 2009 Supplemental Appropriations Act was constitutional.

## ARGUMENT

### **I. PAYMENTS, OTHER THAN ROYALTIES, ESTABLISHED WITHIN THE COMMONWEALTH'S OIL AND GAS LEASES ARE INCOME THAT MAY BE USED FOR GENERAL FUND PURPOSES, NOT COMPENSATION FOR THE SEVERANCE OF A TRUST ASSET.**

As held by this Honorable Court in *PEDF II*, the Environmental Rights Amendment “establishes a public trust, pursuant to which the natural resources are the corpus of the trust, the Commonwealth is the trustee, and the people are the named beneficiaries.” *PEDF II*, 161 A.3d at 931-32. As trustee, the Commonwealth is thus imposed with the “duty to prohibit the degradation, diminution, and depletion of our public natural resources.” *Id.* at 933. To the extent the Commonwealth accepts payments as consideration for the sale or removal of trust principal, those payments remain corpus of the trust. *Id.* at 935. Royalty payments fall squarely within these parameters as monthly payments based upon the lessee’s gross production of oil and gas at the well. As royalties are compensation for the removal of trust assets, “[t]hey are part of the corpus of the trust and the Commonwealth must manage them pursuant to its duties as trustee.” *Id.*

However, the Commonwealth’s oil and gas leases actually generate three additional revenue streams: (1) a bonus bid payment, (2) a rental payment, and (3) interest due on late payments. R. 1671b. This Honorable Court remanded the within action to the Commonwealth Court for further development of the record and analysis regarding whether these revenues are similar to royalties and must remain

as part of the corpus of the trust. *PEDF II* at 935. The Commonwealth Court correctly held that they are not.

The Foundation argues that the Commonwealth Court erred in holding that neither up-front bonus bid payments, nor rental payments are proceeds from the sale or removal of trust assets, and therefore do not remain in the corpus of the trust. Instead, the Foundation argues its same position taken in the court below: that all payments made to the Commonwealth pursuant to their oil and gas leases are for the extraction, transportation, and removal of natural gas from our state forests. This has properly been proven false by the Commonwealth Court's analysis.

The Commonwealth Court reviewed the text of the State forest oil and gas leases themselves as well as the history of the DCNR's leasing process in order to determine whether these payments are in exchange for the removal of a trust asset. They are not. DCNR's leases are for ten years, with a primary term of five years in which the lessee must drill a well or the lease automatically terminates. (*See, e.g.*, R. 1544b, 1577b, 1611b). Thereafter, the lease will continue from year to year provided oil or gas is produced in paying quantities. *Id.* A bonus bid payment is due upon execution of the lease. *Id.* Beginning in the second year, the lessee owes annual rental payments based upon the acreage. *Id.* Those rental payments are reduced or stopped once the extraction of oil or gas begins and royalty payments become due instead. *Id.*

For over 65 years, the Commonwealth through the DCNR (formerly the Department of Forests and Waters) has treated bonus bid and rental payments as unrelated to the removal of oil and natural gas from the State forest lands. Rather, those assessments have been purely for the inchoate transfer of a leasehold interest to explore State forest lands for oil and natural gas. The “title conveyed in an oil and gas lease is inchoate, and is initially for the purpose of exploration and development.” *Sabella v. Appalachian Development Corp.*, 103 A.3d 83, 101 (Pa. Super. 2014) (citing *Calhoon v. Neely*, 50 A. 967, 968 (Pa. 1902)); *Burgan v. South Penn Oil Co.*, 89 A. 823, 826 (Pa. 1914).

The bonus bid payment, also referred to as a “bonus rental payment,” is made in exchange for obtaining that inchoate title. It is done up-front, prior to – and regardless of - the extraction of any natural resources, and primarily for the Department’s use in determining the successful bidder on a tract of land. *See* Commonwealth’s Brief in Support of Summary Relief, Exhibit B at pgs. 10-11. The Department accepts and keeps the bonus bid payment regardless of whether the natural resources are later discovered and extracted. R. 1673b.

Likewise, rent payments are similar to bonus bid payments. In fact, the bonus bid payment is both the successful bid on a lease and is considered the first year of rent. *See* Commonwealth’s Brief in Support of Summary Relief, Exhibit B at pgs. 22-23. Rents, and any interest on them, are due annually whether or not the lessee is

successful in exploring for oil or natural gas. R. 1672b. They are paid in anticipation of oil and gas production.

Ultimately, if the exploration for oil and gas is unsuccessful, no estate vests in the lessee and the lease terminates at the end of the primary term. *See* Commonwealth's Brief in Support of Summary Relief, Exhibit B at pg. 20. The DCNR has terminated sixteen (16) separate oil and gas leases in this manner because no oil or gas was extracted from the tracts under lease, but the DCNR kept the bonus and rent payments. R. 1673b. There was no sale of public natural resources in those scenarios. *Id.* As such, the DCNR received and retained a total of \$120,479,684.00 in bonus payments and \$3,528,630.05 in rental payments from leases that were terminated for lack of production. R. 1676b. All of those funds were deposited into the Fund. *See* Commonwealth's Brief in Support of Summary Relief, Exhibit B at pgs. 13-14; *see also* Exhibit C at pg. 5.

Further, it is clear in those instances that no conversion of the trust asset (State forest land, minerals, etc.) took place, nor is there any permanent possession of the property transferred to the lessee. The DCNR's leases make clear that the lease does not convey any control over the surface of the leased land tract; the Department maintains complete control and retains ownership of the land. R. 1576b, 1603b. The leases place "Drilling Restrictions" on the lessee making clear that "[u]nder the Department's multiple use policy, the surface and other portions of the leased

premises are continuously used for recreation, conservation and other purposes, and many other Department-authorized activities may be in progress on the lands. R. 1589b. Hence, Lessee shall conduct its operations so as to minimize interference with the other Department-authorized activities....” See the Foundation’s Exhibits B, C, and D, § 23.01. Thus, it is clear that a lessee’s right is temporary and limited in nature.

It is only when oil or natural gas exploration is successful that the lease estate vests. At that time, because trust assets are extracted and marketed by the lessee, payment for the proceeds of the sale of trust assets – the oil or natural gas – occurs in the form of royalty payments. Royalty payments are revenue received in exchange for the actual removal of the trust asset. The mere change of trust property from oil or natural gas to money did not destroy its relation to the trust corpus. See *Bolton v. Stillwagon*, 190 A.2d 105, 109 (Pa. 1963). This is the clear difference of bonus bid and rent payments from royalty payments.

Pursuant to Pennsylvania trust law, rent from real or personal property is to be allocated as trust income, not trust principal. 20 Pa.C.S. § 8145(a). Further, only “refundable deposits” for rent “shall be applied to principal.” 20 Pa.C.S. § 8145(b)(1). As neither the up-front bonus payment, nor the rent payments are refundable at the termination of the Department’s leases, they are not “deposits” as defined by Pennsylvania trust law. These amounts are purely for access to the State

forest land to explore and attempt to discover locations of oil and gas. They are not for the removal of those natural resources; royalty payments are. They are therefore income rather than trust principal. Trust principal is defined as “[p]roperty held in trust for distribution to a remainder beneficiary when the trust terminates or property held in trust in perpetuity.” 20 Pa.C.S. § 8102. Neither of these revenue streams are trust principal or corpus.

Accordingly, the Commonwealth Court’s answer to the remaining question on remand was correct: that the true purpose of the bonus-bid and rental payments is an inchoate leasehold interest in the State forest land for access to and exploration for oil and gas in our State forests and not for the severance of a trust asset. Rather, they are income, as they do not dispose of or deprive the trust of any further benefit from the trust asset. *PEDF III*, 214 A.3d at 773. Therefore, the Commonwealth and Governor request that this Honorable Court affirm the Commonwealth Court’s holding.

**II. COMMONWEALTH COURT DID NOT ERR IN APPLYING THE PRINCIPAL AND INCOME ACT OF 1947 SUCH THAT ONE-THIRD OF BONUS AND RENTAL PAYMENTS RECEIVED UNDER COMMONWEALTH OIL AND GAS LEASES MAY BE APPROPRIATED FOR GENERAL FUND PURPOSES.**

At the direction of this Court, the Commonwealth Court also analyzed the appropriate use of income received from the Article I, Section 27 trust pursuant to Pennsylvania trust law in place at the time that Section 27 was ratified. The court did so and concluded that the common law open well doctrine was abandoned in Pennsylvania in favor of the enactment of the Principal and Income Act of 1947 (“PIA”), which still applied in 1971 when the Environmental Rights Amendment was enacted. *PEDF* III at 765. Accordingly, per Section 9 of the PIA, one-third of the income derived from oil and gas leases may be used as income and appropriated other than for conservation purposes, and two-thirds shall be deemed principal and must remain as corpus of the trust. *Id.* at 774.

The Foundation’s arguments in favor of rejecting the application of the PIA are circular and repetitive. Its arguments all ignore this Court’s direction that the Commonwealth Court: “**in strict accordance and fidelity to Pennsylvania trust principles . . .** determine whether these funds belong in the corpus of the Section 27 trust.” *PEDF II* at 936 (emphasis added).

First, it is clear from the CNRA that the DCNR is empowered “to make and execute contracts or leases in the name of the Commonwealth for the mining or



removal of any valuable minerals that may be found in State forests” if the DCNR determines that it “would be for the best interests of this Commonwealth.” 71 P.S. § 1340.302(a)(6). In doing so, DCNR must act “toward the corpus of the trust with loyalty, impartiality and prudence.” *PEDF II* at 932 (citing *Robinson Twp. v. Cmwlth.*, 623 Pa. 564, 83 A.3d 901 (Pa. 2013) (plurality)). However, merely leasing the State forests for access and exploration for minerals does not permanently sever the trust asset. Contrary to the Foundation’s position, Article I, Section 27 does not ban the use or sale of the public natural resource. Rather, Article I, Section 27 contemplates the “continued, but judicious, use of the resources.” *PEDF III* at 768 (quoting *PEDF II* at 947 (Baer, J., concurring and dissenting)). The use of the word “conserve” rather than “preserve” reflects this. *Id.*

Second, the Foundation’s argument that the Commonwealth Court’s conclusion was in error again hinges upon the incorrect assumption that all revenue from oil and gas leases is for the removal of trust assets from the corpus. As argued above, the Commonwealth Court correctly determined that neither bonus bid payments, nor rental payments are for the severance of a trust asset and are therefore income, not principal.

Further, Article I, Section 27 states that “Pennsylvania’s public natural resources are the common property of all the people, including generations yet to come.” Pa. Const. art. I, § 27. At common law, the beneficiary is the person for

whose benefit the trustee holds the property. *PEDF III* at 761. The beneficiaries of the Article I, Section 27 trust are the people of Pennsylvania: both current and future generations. *Id.* The Commonwealth Court examined that at common law, “where the testator creates a life estate, a life tenant is entitled to income derived from the corpus, but not to assets representing the corpus itself, which is reserved for the beneficiaries in remainder or ‘remaindermen.’” *Id.* Pursuant to Pennsylvania trust principals, current Pennsylvanians have a present interest in the trust and are therefore life tenants, and the generations of the future represent the remaindermen. *Id.* This analysis correctly follows this Court’s direction to the Commonwealth Court and analyzes the Article I, Section 27 trust pursuant to Pennsylvania trust principals at the time of its enactment. It further aligns with the intent of Section 27, which must guide the interpretation of a trust provision: “to conserve and maintain [the public natural resources] for the benefit of all the people.” Pa. Const. art. I, § 27.

Accordingly, using Pennsylvania trust principals in effect as of 1971 when Section 27 was ratified, *former* Section 9 of the PIA which governed the disposition of natural resources, is directly applicable. *PEDF III* at 774. *Former* Section 9 states:

Where any part of the principal consists of property in lands from which may be taken ... minerals ... oil, gas or other natural resources and the trustee or tenant is authorized by the terms of the transaction by which the principal was established ... to sell, lease or otherwise develop such natural resources ... and no provision is made for the disposition of the proceeds thereof after the payment of expenses and carrying charges on the property, one-third of the net proceeds, if received as rent or payment on a lease, or as royalties, shall be deemed income, and the

remaining two-thirds thereof shall be deemed principal to be invested to produce income .... Such proceeds if received as consideration for the permanent severance of such natural resources from the land...shall be deemed principal to be invested to produce income.

*Former* Section 9 of the PIA, formerly 20 P.S. § 3470.9.

The situation at issue meets all of the requirements of former Section 9: 1) the principal of the Section 27 trust consists of forest lands from which natural resources may be taken; 2) the DCNR has been statutorily authorized pursuant to the CNRA to lease those lands for oil and gas development; and 3) Section 27 does not contain any provision as to how the proceeds of those transactions are to be allocated. Therefore, the Commonwealth Court's holding that pursuant to former Section 9, two-thirds of the proceeds from bonus bid and rental payments are to be deemed principal and remain in the trust corpus for conservation and maintenance purposes was correct. Therefore, the Commonwealth and Governor ask this Court to affirm the Commonwealth Court's holding.

**III. SECTIONS 1604-E and 1605-E OF THE FISCAL CODE AND SECTION 1912 OF THE SUPPLEMENTAL GENERAL APPROPRIATIONS ACT OF 2009, WHICH DIRECTED THE TRANSFER OF MONEY FROM THE OIL AND GAS LEASE FUND TO THE GENERAL FUND, ARE NOT FACIALLY UNCONSTITUTIONAL.**

As a result of the Commonwealth Court's holding that bonus bid and rental payments are not consideration for the severance of a natural resource and that pursuant to the PIA, one-third of proceeds from the Commonwealth's oil and gas leases is income that may be used for non-trust purposes, the court concluded that Sections 1604-E and 1605-E of the Fiscal Code (72 P.S. §§1604-E and 1605-E), and Section 1912 of the Supplemental Appropriations Act of 2009 are not facially unconstitutional. The Foundation's argument that the court erred in its finding once again relies purely upon its position that all proceeds from the leasing of State forest lands are principal that must remain in the trust corpus. As argued fully above, this is incorrect.

To the extent that one-third of the proceeds from bonus bid and rental payments on oil and gas leases are income, they may be used for any non-trust purpose. That necessarily implies that there was no violation of the Pennsylvania Constitution when the General Assembly appropriated those funds pursuant to sections 1604-E and 1605-E of the Fiscal Code and the Supplemental Appropriations Act of 2009.

## CONCLUSION

For the foregoing reasons, the Commonwealth and Governor respectfully request that this Court affirm the holding of the Commonwealth Court and declare that 1) bonus bid and rental payments received pursuant to the Commonwealth's oil and gas leases are not consideration for the severance of a natural resource and are therefore income; 2) that the Principal and Income Act of 1947 was the applicable Pennsylvania trust law in place at the time of the enactment of Section 27, making one-third of the proceeds income that may be appropriated for uses other than conservation and maintenance; and 3) Sections 1604-E and 1605-E of the Fiscal Code and Section 1912 of the Supplemental General Appropriations Act of 2009 are constitutional.

Respectfully submitted,

Date: February 27, 2020

By:



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**CERTIFICATE OF COMPLIANCE – WORD COUNT**

I hereby certify that the **Respondents’ Brief in Opposition to the Pennsylvania Environmental Defense Foundation’s Appeal** complies with the word-count limit set forth in Rule 2135(a)(1). Based on the word-count function of the word processing system used to prepare the brief, the brief contains 6,901 words (excluding portions of the brief covered by Rule 2135(b)).

By: malta  
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**CERTIFICATE OF COMPLIANCE – PUBLIC ACCESS**

I certify that this filing complies with the provisions of the *Public Access Policy of the Unified Judicial System of Pennsylvania: Case Records of the Appellate and Trial Courts* that require filing confidential information and documents differently than non-confidential information and documents.

By:   
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