FOREWORD:

This paper will focus on recent legal developments in the courthouse, legislation and regulatory bodies in the upstream sector of the oil and gas industry. It will also address the author’s sense of what the future portends for legal purposes in this sector of the oil and gas industry.

IT’S BOOM TIMES IN THE OIL PATCH

The latest boom in the oil and gas industry is being experienced on a national scale. Many of the geographical areas now in the throes of the exploration and production of oil and gas reserves have a limited historical frame of reference, if any. The legal and regulatory infrastructure is patchwork thin in many of the numerous shale developments across the country. If I were a cynic, the “litigator’s prayer” (for strife amongst the people) has been answered: boom times have produced a bumper crop of courthouse and regulatory tussles, which seem only to gain momentum and numerosity with every passing month. Texas is no stranger to private litigation between and among the various interested parties, and yes even with the federal regulators, EPA being the most frequent antagonist.

Numerous states are now hosting shale plays (oil and/or gas) including at last count 20 states: Texas, Louisiana, Arkansas, Oklahoma, New Mexico, Colorado, Wyoming, Nebraska, North Dakota, Michigan, South Dakota, Montana, New York, Pennsylvania, Maryland, West Virginia, North Carolina, Ohio, California. Each of these states is involved in regulatory overhauls at varying levels, as well as re-examining statutory and case law jurisprudence covering a wide variety of topics. Adding to this mix the plethora of federal agencies promises a drawn-out regulatory scum between the state and federal agencies and environmentalists which will play itself out in multiple forums, including local governments, state and national legislatures, as well as state and federal courthouses.
Joint Operating Agreement Issues

The 2012 Reeder case from the Texas Supreme Court illustrates a potentially very significant distinction between the commonly-used 1982 and 1989 AAPL form JOAs. Reeder v. Wood County Energy, LLC, No. 10-0887, 2012 WL 3800231 (Tex. Aug. 31, 2012). After Reeder, depending on the specific form JOA that is used, the exculpatory clause that otherwise limits operator liability for negligence to acts of “gross negligence” may reach beyond “operations under the contract” and apply to any breach of the JOA. At trial, a jury found that the operator breached his duty as operator under the JOA “by failing to maintain production in paying quantities or other operations in the [subject field].” On appeal, Reeder challenged, among other things, the jury’s findings that he breached the JOA. The appellate court determined that the exculpatory clause in the JOA did not apply to Fry’s claims for breach of the JOA. Relying on a breach of contract standard, the appellate court upheld the jury’s conclusion that Reeder breached the JOA. The ultimate issue before the Supreme Court was whether or not the exculpatory clause of the JOA governs the breach of contract claims against the operator. The subject JOA, based on the 1989 AAPL form JOA, read in relevant part:

Operator shall conduct its activities under this agreement as a reasonable prudent operator, in a good and workmanlike manner, with due diligence and in accordance with good oilfield practice, but in no event shall it have any liability as Operator to the other parties for losses sustained or liabilities incurred except such as may result from gross negligence or willful misconduct.


The Court contrasted this with the 1982 form JOA, which read in relevant part:

[Operator] . . . shall conduct and direct and have full control of all operations on the Contract Area as permitted and required by, and within the limits of, this agreement. It shall conduct all such operations in a good and workmanlike manner, but it shall have no liability as Operator to the other parties for losses sustained or liabilities incurred, except such as may result from gross negligence or willful misconduct.

Id.

The Supreme Court noted the distinction in the subject matter covered by the two clauses—the operator’s “activities under this agreement” versus “all such operations.” Id. The Court then cited a series of Texas appellate court cases interpreting similar exculpatory clause language and limiting the exculpatory clauses to “claims that the operator failed to act as a reasonably prudent operator . . . and not for other breaches of the JOA.” The Court ultimately concluded that the modified language in the 1989 form “broadens the [exculpatory] clause’s protection of operators” to include all actions under the JOA. Id., *5. On the facts of the case, the Court
concluded that there was no evidence that the operator “did not care about the consequences” of his actions so as to meet the gross negligence standard. *Id.*, *7.*

As will be noted later, the vintage of the latest AAPL Form JOA (1989) and disputes such as the subject of the *Reeder* case underscore the need for a contemporary model form JOA.

Another decision in 2011 by the Texas Supreme Court focused on the perils from the use of form contracts in the oil and gas industry, which some say is addicted to the use of forms. In the case of *Houston Exploration Co. v. Wellington Underwriting Agencies, Inc.*, 352 S.W.3d 462 (Tex. 2011), the Court held that deleted provisions of a form contract can be used to determine the proper scope of the final contract. The Court noted that the parol evidence rule “does not prohibit consideration of surrounding circumstances that inform, rather than vary from or contradict, the contract text.” Notwithstanding the dissenting justices’ complaint that “[t]hough the deleted text is legible, we must not summon dead words for live contracts”, a majority of the justices held that the deleted language was significant in determining the scope of the remaining language. To the extent that many oil and gas-related contracts are the result of lining-through provisions of form agreements, *Houston Exploration* provides a particularly important reminder of the limitations of the parol evidence rule and a peril in the use of “one-size-fits-all” form contracts.

**Conveyances and Restrictions**

In Texas, “minerals” are defined to include, *inter alia*, oil and natural gas which has not been produced. However, such is not the case in Pennsylvania as recently confirmed by its Supreme Court. *Butler v. Charles Powers Estate*, ___ A.3d ___, 2013 WL 1749828 (Pa. April 24, 2013). The Court’s ruling is sure to have a considerable impact on the exploration and production of all shale formations throughout the state. The Court’s address of the issue was raised when a lower court suggested that an 1882 case could not be used to separate mineral rights from gas rights in instances involving the Marcellus Shale. In rejecting the lower court’s view, the Court cited approvingly the 1882 “Dunham Rule” saying that natural gas is not a mineral, regardless of what it is trapped in or what method is used to extract it from the ground. 2013 WL 1749828, *11-12.

**Releasing Minerals and ORRI Issues**

In *SM Energy Co. v. Sutton*, 376 S.W.3d 787 (Tex. App.—San Antonio 2012, pet. filed), the San Antonio Court of Appeals considered whether certain overriding royalty interests were extinguished as to part of a lease that had been released back to the landowner. On appeal, the only issue was whether the ORRIs had been extinguished after the partial release. The court ultimately reversed and rendered judgment that Sutton take nothing on his claims. It held that, because the original lease contemplated a partial termination, it was the ORRIs’ owners’ burden “to include an express provision to save their ORRIs from being extinguished” by a partial release. Without such a provision, the court had no trouble finding that the ORRIs were extinguished and that they were not saved because the new leases were signed more than one
year after the termination of the “present lease” to which the ORRIs pertained. The court was also generous enough to enunciate a fairly straightforward rule for other parties to follow: “When a lease has a valid contractual provision that allows the lessee to release all or part of the leasehold . . . an overriding royalty interest that initially burdened the entire lease is extinguished as to the released acreage or interest unless another contractual provision, such as a savings clause, expressly provides otherwise.”

Common Carriers / Eminent Domain (Condemnation)

Just as oil and water don’t mix, residents (sometimes even royalty owners) complain that drilling activity is disruptive of their domestic tranquility and health. The populist fervor opposing urban drilling activity has produced a welter of local ordinances regulating such activities, not uncommonly in the form of outright drilling bans or moratoria. It should then come as no surprise that the affected operators have sued, complaining of inverse condemnation by a regulatory taking.

Last August, the Houston 14th Court of Appeals rendered an opinion on the multi-million dollar verdict rendered by a trial court against the City of Houston for inverse condemnation of the plaintiff’s mineral interests in and around the Lake Houston watershed. *City of Houston v. Train Enterprises, Inc.*, 377 S.W.3d 873 (Tex. App.—Houston [14th Dist.] 2012, pet. filed). The suit was grounded on the plaintiff’s claim that Houston’s restrictive ordinance on oil and gas drilling constituted a compensable taking of plaintiff’s property rights as an inverse condemnation. In deciding the reverse the trial court’s judgment, the court of appeals considered 3 factors described in Texas Supreme Court and United States Supreme Court cases. Those factors are as follows: (1) the nature of the government’s action and whether it was rationally related to a legitimate government end; (2) the investment-backed expectations of the property owners; and (3) the economic impact of the regulation or law upon the property owner. In consideration of the 3 factors, the court found that, notwithstanding the adverse economic impact of the regulations on the value of plaintiff’s mineral estate, the other factors weighed heavily in favor of Houston and therefore the plaintiff should take nothing on its claim.

On the eminent domain front, in 2011, the Texas legislature passed a bill requiring all entities, whether private or public, to file a letter with the Texas Comptroller of Public Accounts no later than Dec. 31, 2012 “stating that the entity is authorized by the state to exercise the power of eminent domain and identifying each provision of law that grants the entity that authority.” The penalty for non-compliance is the Sept. 2, 2013 expiry of the entity’s authority to exercise the power of eminent domain. The report to the Comptroller is to be used by the Texas Legislative Council to prepare “non-substantive” revisions of the statutes granting eminent domain authority “to reflect the state of law after the expiration of an entity’s domain authority effective under subsection (c).”

The Supreme Court of Texas has recently made clear that merely filing with the Railroad Commission as a common carrier under Chapter 111 of the Texas Natural Resources Code does
not, by itself, carry a conclusive effect in court as to the carrier’s ability to assert public use for eminent domain. In *Texas Rice Land Partners, Ltd. v. Denbury Green Pipeline-Texas LLC*, 363 S.W.3d 192 (Tex. 2012), the Court rejected the premise that “merely making [a] pipeline available for public use is sufficient to confer common-carrier status,” and emphasized that, “a private enterprise cannot acquire condemnation power merely by checking boxes on a one-page form.” If a landowner challenges a pipeline operator’s common-carrier designation, the operator must prove that it will transport CO₂ “to or for the public for hire” by selling to one or more third-party customers. The strongly-worded opinion in *Denbury* should serve as a wake-up call to those pipelines seeking common-carrier status in Texas, suggesting careful attention to the specific facts of *Denbury* that the Court found important in denying Denbury’s attempt to establish common-carrier status as a matter of law.

Eminent domain cases concerning pipelines will continue to be a potential hotbed of litigation. Although *Denbury* established that a purported common-carrier must prove, beyond filling in the appropriate regulatory application, that it will sell to third-party customer(s), it left open the question of whether a purported common-carrier is entitled to immediate access to private property regardless of whether a challenge to the carrier’s eminent domain power is outstanding.

While the TransCanada Keystone Pipeline has succeeded in overcoming Texas landowners’ complaints as to the condemnation of their lands for the Pipeline’s use, the federal government has yet to put its imprimatur on this venture in the face of strident opposition from environmentalists.

**Condemnation Issue – Ownership and Use of Groundwater**

In its decision in *Edwards Aquifer Auth. v. Day*, 369 S.W.3d 814 (Tex. 2012), the Texas Supreme Court made important statements regarding the ownership and use of groundwater pumped to the surface and stored in an impoundment. The underlying dispute centered on the State’s claim (the Edwards Aquifer Authority) that water produced and stored but not used for “beneficial” purposes, had become state water and thus beyond the control of the Authority and the surface owner for permitting purposes. The Court held that produced and stored water must be used for some beneficial purpose (irrigation, not recreation) or it would become state water. In its address of the larger issue, whether land ownership in fee included a real property interest in the groundwater subject to the Constitution’s requirement of compensation for a “taking”, the Court reviewed a variety of factors associated with determining whether a “taking” requiring compensation had occurred. The Court ultimately determined that land ownership included an interest in the groundwater in place, comparable to oil and gas in Texas. The case was then remanded to the lower courts for a determination whether a “taking” requiring compensation had occurred, and if so what was the appropriate compensation. Commentators see the decision as having significant impact on oil and gas operations that require permitting to drill water wells. Thus, should a groundwater conservation district determine to withhold a permit, that decision must confront the issue whether a “taking” has occurred and therefore what compensation is required. The denial of permits may well be grist for the litigation mill in the future.
Surface Owner vs. Royalty Owner

The legal competition between the owners of the dominant estate (minerals) and the servient estate (surface) certainly has a lengthy lineage. Complaints of a mineral owner’s excessive use of the surface commonly give right to causes of action in trespass or nuisance. Texas courts have been historically unsympathetic to surface owners’ complaints, absent proof of negligence, breach of contract or breach of a statutory duty. However, jurisprudence abounds in many states embracing the accommodation doctrine which requires the mineral owner to accommodate an existing use of the surface estate. Mere inconvenience to the surface owner will not suffice, as there must be a substantial impairment of the existing use. The “superiority” or “dominance” of the mineral estate owner ends when the interests of neighboring landowners, government entities or other third parties are adversely affected by the operator’s actions.

The case of Merriman v. XTO Energy, Inc., No. 10-09-00276-CV, 2011 WL 1901987 (Tex. App.-Waco May 11, 2011, pet. granted) provides a recent example of the accommodation doctrine at work. In this case, the surface owner sued the lessee, XTO, to require XTO to move a well on his property because it allegedly interfered with his cattle operations. The Court held that the accommodation doctrine did not require XTO to move the well, because the surface owner had reasonable means of developing the land through alternate uses that were not impracticable or unreasonable. Although the surface owner's current method of cattle operation was convenient to him, the court of appeals emphasized that convenience of the surface owner is not the sole issue. The court of appeals affirmed summary judgment for XTO. The case is now pending before the Supreme Court. Oral argument to the Texas Supreme Court was held in February and an opinion is awaited, the impact of which could be significant to Texas oil and gas operations.

Royalty Owner vs. Executive Rights Holder

The mineral estate in Texas consists of five interests: (1) the right to develop (the right of ingress and egress), (2) the right to lease (the executive right), (3) the right to receive bonus payments, (4) the right to receive delay rentals, (5) the right to receive royalty payments. These interests are often colloquially referred to as a “bundle of sticks.” Texas law recognizes that individual “sticks” can be sold while others are retained. In addition to being defined as one of the five rights of a mineral owner, the executive rights to lease have been defined by courts and treatises as the exclusive right to execute oil and gas leases. The legal measure of the duty owed by the executive rights holder to the royalty holder has been recently defined by the Texas Supreme Court as a fiduciary duty of “utmost fair dealing”. Lesley v. Veterans Land Bd. Of State, 352 S.W.3d 479 (Tex. 2011).

In a case of more recent vintage from the Texarkana Court of Appeals, the court addressed the obligations of the executive mineral interest owner (when acting as a lessee) to a nonparticipating royalty interest owner. Friddle v. Fisher, 378 S.W.3d 475 (Tex. App.—Texarkana 2012, pet. denied). In that case the royalty owner complained of neither being informed about nor paid
royalties pursuant to an oil and gas lease entered into by the executive as “lessor”, neither “lessor” nor lessee notifying the royalty owner. The court held, inter alia, that the executive owed a fiduciary duty to the royalty owner that required the executive to get for the non-executive royalty owner every benefit that the executive gets for itself. This fiduciary duty imposed on the executive also required that the executive be accountable to the royalty owner as a constructive trustee for the portion of funds attributable to the royalty owner.

Royalty Owner v. Lessee

Recent case law underscores the need for the royalty owner to be vigilant in the protection of its rights vis à vis the lessee, including e.g. the timely payment of royalties. In Shell Oil Co. v. Ross, 356 S.W.3d 924 (Tex. 2011), the Supreme Court analyzed both the discovery rule and the doctrine of fraudulent concealment in holding that limitations barred a royalty owner’s claim based on underpayment of royalties. The Rosses, the royalty owners, were paid royalties by Shell Oil based on wells located both on the lease of the Rosses’ property (the “Lease Wells”) and on other property that had been pooled with the Rosses’ lease (the “Unit Wells”). Shell admitted at trial that it had “made a mistake” for a period of several years in calculating the royalties due for the Lease Wells, which resulted in underpayments to the Rosses from 1994 through 1997. The Rosses sued Shell for the underpaid royalties in 2002, alleging breach of contract, fraud, and unjust enrichment. Shell defended on limitations grounds, but the Rosses asserted that both fraudulent concealment and the discovery rule tolled limitations. Both the trial court and the court of appeals found for the Rosses, holding that fraudulent concealment applied so as to toll limitations. The Supreme Court reversed. The court first examined fraudulent concealment. Although the court noted that, “[a] defendant’s concealment of wrongdoing may toll the running of limitations,” the doctrine required the Rosses to prove that Shell knew it had made a mistake and acted with the intent to conceal it. The court also noted the crucial caveat that, “fraudulent concealment only tolls the statute of limitations until ‘the fraud is discovered or could have been discovered with reasonable diligence.’” The Rosses argued that it was reasonable for them to rely on statements on Shell’s royalty check stubs because misrepresenting the price on the stubs would be a violation of the Natural Resources Code. The court disagreed stating that, “[r]easonable diligence requires that owners of property interests make themselves aware of relevant information available in the public record.” The court noted that the large difference in price paid under the Lease Wells and the Unit Wells (a difference of 50-60%) should have put the Rosses on notice, since the payments were based on wells in a common reservoir. The court also cited the El Paso Permian Basin Index as a readily available public source of price information that would have put the Rosses on notice of the underpayments. Finally, the court also noted that the Texas General Land Office records would have revealed the prices that Shell paid the State, which would have put the Rosses on notice of the underpayments because under the pooling agreement for the Rosses’ lease, Shell was required to pay the State and the Rosses each a one-sixteenth royalty. The court concluded that, “[a]s a matter of law, the Rosses did not use reasonable diligence since readily accessible and publicly available information could have led to the discovery of Shell’s underpayments.” The court dismissed the Rosses’ discovery rule argument on the same grounds. The court noted that
the discovery rule only tolls limitations if the injury is “inherently undiscoverable.” Because the Rosses “could have timely discovered the underpayments through the exercise of due diligence,” their claim was not inherently undiscoverable, and the discovery rule did not toll limitations. Shell Oil demonstrates the potential significance of the multitude of information potentially available to royalty owners to determine if they are being underpaid royalties. Although Shell Oil did have the unique fact that the Rosses were being paid different prices for their leased and pooled wells, the public Permian Basin Index record was also specifically noted by the court. Given that failure to exercise due diligence in discovering a claim can be fatal to the application of both the fraudulent concealment doctrine and the discovery rule, Shell Oil demonstrates the large limitations hurdle many royalty underpayment claims may face.

Samson Lone Star, Ltd. Partnership v. Hooks, 389 S.W.3d 409 (Tex. App.—Houston [1st Dist.] 2012, no pet.) is another recent case demonstrating the potential difficulties encountered by royalty owners in overcoming statute of limitations defenses. In Samson, the royalty owners, the Hooks, leased property in Jefferson County to Samson. The lease contained a “buffer zone” provision where, if a well was completed within a certain distance from the leased property, Samson was required to either drill an offset well, pay compensatory royalties, or release offset acreage. In April 2000, Samson began drilling a well, the BSM well, on a tract adjacent to the Hooks’ lease. Although the drillsite was outside the buffer zone of the Hooks lease, the BSM well was a directional well that actually bottomed inside the buffer zone. The BSM well was completed in August 2000, and on February 15, 2001, Samson sent the Hooks a letter offering to pool the Hooks’ lease with the BSM well. The letter included a plat created before the well was completed that noted a proposed bottom location inside the Hooks’ buffer zone. Samson then sent the Hooks a plat created by Samson’s landman that, although not entirely clear, could have been interpreted as showing a bottom location inside the Hooks’ buffer zone. The Hooks agreed to the proposed pooling, and Samson sent the corresponding royalty checks. However, the Hooks subsequently found out that the BSM well had actually bottomed inside their lease’s buffer zone, and they filed suit against Samson in May 2007 for fraud, arguing that Samson made false representations concerning the location of the bottom of the BSM well in order to avoid paying compensatory royalties based on the BSM well’s completed location being inside their lease’s buffer zone. The jury found for the Hooks, finding that the Hooks could not have discovered their fraud claims until April 2007. The court of appeals disagreed. The court of appeals cited a directional survey on the BSM well that had been filed with the Railroad Commission in July 2000, before the BSM well was even fully completed, as a document that should have put the Hooks on notice of the location of the bottom of the well. The court noted that, “[a]ny inquiry into the records available from the lessee, Samson, or from the Railroad Commission would have shown the Hooks the actual location of the BSM No. 1 well’s bottom hole in February 2001, when pooling was first proposed to them.” Because the documents filed with the Railroad Commission were public record, the court held that the Hooks should have known that the BSM well bottomed within their lease’s buffer zone at the moment Samson first proposed the pooling.
The general rule in Texas is that royalties are defined as the landowner’s share of production, free of the expenses of production. Nonetheless, litigation continues over exactly what expenses qualify as “expenses of production.” In *Occidental Permian Ltd. v. French*, 391 S.W.3d 215 (Tex. App.—Eastland Oct. 31, 2012, no pet.), Occidental Permian began injecting carbon dioxide into two properties in order to boost oil production. This resulted in a stream of produced natural gas that was treated off-site to remove the carbon dioxide in order to make it a sellable product. Occidental maintained that the cost of treating the gas was shareable with the royalty owners. The Eastland Court of Appeals stated that the royalty owners had not presented sufficient evidence to support their proposed royalty calculation, implicitly holding that removing carbon dioxide from a gas stream was part of the cost of treating the gas so it could be sold. The landowners plan to appeal, inviting the Supreme Court to determine once and for all whether the cost of removing injected carbon dioxide from a gas stream is shareable with royalty owners.

In a case pending in the federal district court in Dallas, royalty owners in the Barnett Shale, including billionaire investor Ed Bass, have challenged the “industry practices” of Chesapeake Energy Corp. which has deducted “post-production costs” from the natural gas sales prices used as a baseline for royalties. The difference between gas prices paid Chesapeake and the amount paid to the plaintiff royalty owners is substantial. Conventional wisdom is that royalty owners should explicitly prohibit such charges in their leases so as to prevent being assessed costs associated with the gathering, compressing and treating of the produced gas.

**Statute of Frauds**

The writing requirements of Texas law for transactions involving or affecting real estate, in the person of the Statute of Frauds, continue to be a common source of problems in the oil patch. Areas of Mutual Interest (“AMI”) are common features in oil and gas development cooperation agreements, joint operating agreements, and exploration agreements. AMIs require the parties to the agreement to share their interests in any mineral rights they acquire within a defined geographic area. AMIs are designed to limit competition for leases and align the interests of the participants such that there is no incentive for one party to use jointly acquired information to obtain leases for its own benefit. Historically, these provisions have been of particular interest to litigators because of the fact that they fall under the requirements of the Statute of Frauds. In the seminal case of *Westland Oil Development Corp. v. Gulf Oil*, 637 S.W.2d 903 (Tex. 1982), the Texas Supreme Court held that, as an agreement to assign an interest in an oil and gas leasehold estate, an area of mutual interest agreement is subject to the Statute of Frauds. The Supreme Court went on to hold that a description of “lands in the area of the farmout acreage” was insufficient to meet the statute of frauds and therefore unenforceable. AMI agreements have traditionally been very informally-drafted, and many may well fail to meet the legal description requirement of the Statute of Frauds and thus may in fact be unenforceable in court.
Court and Administrative Agency Activity – Water and Air

Although “clean air” issues are often drowned out by the environmental hubbub over “clean water”, the fact is that both play an active regulatory role in the production of hydrocarbons.

In 2012, the United States Supreme Court focused on a suit brought by several states and New York City against a host of power companies and others. *American Electric Power Co. v. Connecticut*, 549 U.S. 497, 131 S. Ct. 2527 (2011). The plaintiffs’ claims alleged that by contributing to global warming, the companies substantially and unreasonably interfered with public rights in violation of the federal common law of interstate nuisance or state tort law. The District Court had determined that the issue presented constituted a “political question.” However, the Court of Appeals for the Second Circuit reversed the trial court’s determination and held that the political question doctrine did not bar the claims. Reaching the merits of the cases, the Court of Appeals held that plaintiffs had stated a claim under the “federal common law of nuisance” doctrine and that the Clean Air Act did not displace the federal common law. The US Supreme Court reversed and held that the Clean Air Act displaces any federal common law relief on the issue of curtailment of carbon-dioxide emissions from fossil-fuel fired power plants, determining that there is “no room for a parallel track [of federal common law].” In making this determination, the Supreme Court noted that the applicable test for whether congressional legislation precludes the creation of federal common law is “whether the statute ‘speak[s] directly to [the] question’ at issue.” The Court referred to the Clean Air Act as “an all-encompassing regulatory program” and noted that the EPA was actively engaged in a rulemaking to set greenhouse gas emissions standards for fossil-fuel fired power plants. The Court was further swayed by the facts that Congress had designated an “expert agency” to oversee these complex determinations and that the plaintiffs have the ability to seek judicial review in the event that they have concerns about the EPA’s rulemaking.

Hydraulic Fracturing

In the writer’s estimation, there are two groups constituting the opposition to hydraulic fracturing, who also coincidently oppose the development of oil and gas reserves generally. They are the “NIMBYS” (Not In My Back Yard) and the “NIABYS” (Not In Anybody’s Back Yard). The first group are the likely antagonists to the industry in the form of lawsuits, local support of ordinances and other legislation banning oil and gas activity and promoting the election of representatives who share their mindset. The second group is a lengthy list including the Sierra Club and other organizations claiming that the environment cannot coexist with oil and gas development generally, and hydraulic fracturing specifically. With the stage set for the debates between these groups and the oil and gas industry, the exchanges have been sharp and continual, in the past 4 years particularly. Political activity has increased significantly in the courthouses, the Congress, state legislatures, state regulatory agencies and county/local governments. Often times the debate is framed by competing “authoritative” studies regarding, e.g., the impact of oil and gas development activity on the air and water. The EPA study of the impact of hydraulic fracturing on water supplies, commissioned in 2010 by a Democratically-
controlled Congress, continues with the promise of a definitive report next year. However, the Chairman of the Texas Railroad Commission has essentially declared that “the fix is in” against the industry since the membership of the Advisory Panel for the EPA study has been pulled from Eastern universities, including from states experiencing little or no hydraulic fracturing activity. By contrast, only a few Texas academics and industry experts have been selected for the Panel. In the meantime, the latest target for an academic paper is the Harvard study critical of the FracFocus website for disclosure of chemicals used in oil field operations, which website was developed and is managed by numerous states’ oil and gas regulatory programs. No surprise that state regulators and the industry have greeted this report as factually baseless and no more than a political expression of the environmental faction opposing drilling and development.

ON THE HORIZON – LEGISLATION, REGULATION AND LITIGATION

The referenced activity in multiple juridical and legislative forums across the country is a function of the domestic shale revolution in the oil and gas industry which has produced truly staggering metrics by any measure. In last year’s final months, U.S. oil production was noted to have risen to a 20-year high of 7 million barrels a day. Earlier this year, a report estimated 2.384 trillion cubic feet of recoverable natural gas reserves, a 25 percent increase from its prior biennial assessment, and double the results of a study from several years ago. The report only covered areas in the Atlantic, Rocky Mountain and the Gulf Coast. The engine that drives these outsize numbers is the combination of horizontal drilling and hydraulic fracturing. President Obama’s Energy Secretary nominee has himself recognized a “stunning increase in production of domestic natural gas in recent years has been nothing less than a revolution that has led to reduced emissions of carbon dioxide and other gases that cause global warming.”

Proposed Legislation before the Texas Legislature

- RIP “RRC”?

If certain constituents in the Texas legislature have their way, the agency in Texas charged with regulating oil and natural gas development may lose its moniker – “the Texas Railroad Commission.” While there is disagreement about the new moniker, there is no dispute that “railroad” should be dropped from the moniker since the energy agency has had nothing to do with railroads for quite a spell. The pace of change in the name is hostage to more substantive disputes about reforms to the agency’s operations and the use of campaign contributions by those seeking election to the statewide Commissioners’ offices, of which there are currently three.

- Water Use in Drilling

Recently, the Texas Railroad Commission rewrote regulations designed to facilitate the recycling and reuse of produced (flowback) water from oilfield operations. These actions are seen as recognition that Texas is “resource rich and water poor.” Recycling of water is regarded as necessary to both encourage water reuse and to protect the state’s water supplies without

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handicapping the oil and gas industry. Groundwater districts in Texas have asked legislators to clarify when they can require a permit for energy companies to tap groundwater for use in operators. The rub for the groundwater districts is confusion over exemption requirements for fracking, defined as either oil and gas “drilling or exploration” (exempt from permit) or “oil and gas production” (permit required).

Two bills before the Texas legislature would mandate recycling and prohibit the use of injection wells. Industry opponents prefer instead the offer of incentives to companies that filter and reuse the flowback water. Proponents of the bills insist that the bills are necessary to encourage recycling.

Hydraulic Fracturing – Federal v. State

The advocates of federal regulation of oil and gas drilling and operations, especially the area of hydraulic fracturing, argue that a confusing patchwork of rules is the product of the current system of multiple state and federal regulators. The states and the oil and gas industry maintain that the states have shown themselves well-equipped to regulate fracking and to address the benefit and cost impacts of fracking which are mostly local. Where national interests are implicated, such as land administered by the federal Bureau of Land Management, the Department of Interior has yet to devise and implement regulations concerning the regulation of hydraulic fracturing.

The AAPL JOA Forms

As mentioned previously, the AAPL JOA Form (1989) is plainly outdated and in need of revisions occasioned by, most notably, the combination of horizontal drilling and hydraulic fracturing in drilling and completion operations. The writer is told that the AAPL is studying the situation, but no work product has been produced to date. Thus, a cautionary note is made with respect to the use of forms in this industry, especially forms which are obviously antiquated. The disregard of this advice, compounded by the need to avoid informality in leasing and other arrangements, will dramatically increase the prospects for the participants to find themselves in the courthouse to fix what should not have been broken in the first place.

Imports / Exports

After the Arab oil embargo in the 1970s, crude oil exports were banned in order to protect domestic oil supplies. What a dramatic difference the passage of 4 decades and new drilling technology has wrought! At the current rate of domestic crude production from tight oil formations, domestic crude production will exceed 8 million barrels per day late next year and the Energy Information Agency projects that monthly domestic crude oil production could surpass imports this year. With the combination of dramatically increased domestic production, fuel switching, automobile mileage efficiency improvements and new battery production, the goal of “energy independence” may soon be in reach for the United States. In these halcyon
times, the industry has undertaken efforts to promote the export of crude oil and natural gas. In the case of natural gas, whose current and projected metrics are even more stunning than those of crude oil, the United States Department of Energy has several export applications pending for decision in the next several weeks. The proposition of LNG exports is not without some controversy to industrial users of natural gas who have become increasingly dependent on natural gas as a fuel at an attractive price to those users. Producers maintain that exports will create incentives for American companies to drill for more natural gas, create more economic growth, reduce our trade deficit and enhance our country’s geopolitical interests. This supply/demand equation and its impact on prices and product availability is a subject of some tension between producers and consumers. It will likely play itself out in the form of export permits with increased regulation at the DOE level and potential legal disputes over, e.g., fulfillment of supply contracts at prices which are currently favorable to the buyer/consumer.

Oil and Gas Tax Preferences

President Obama’s budget proposal calls for dramatic reductions, and elimination in some instances, of existing tax benefits for oil and gas producers. The producers have responded vigorously to defend the current energy tax program while educating the public about these taxes and their favorable effect on current and future U.S. production. To sum up the producers’ disposition on the subject, “it’s wrong to penalize the oil and gas industry.” Predicting the outcome of this scrum is beyond the meager prophetic resources of this writer, lest someone mistake me for an oracle or soothsayer.

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