

FEDERAL -- MINING

Daniel A. Jensen, Reporter

Surface Use Rules Do Not Require Miners to Reclaim Pre-Existing Disturbances

In 1996, the Bureau of Land Management (BLM) adopted "plain English" surface use and occupancy regulations. Those regulations at 43 C.F.R. subpart. 3715 generally prohibit occupancy and use of unpatented mining and millsite claims unless the use is reasonably incident to exploration, development, mining, or processing of locatable mineral deposits. James McColl owned 12 unpatented millsite claims in Maricopa County, Arizona. The land within the claims had been disturbed by previous lead and silver mining operations. The BLM ordered McColl to remove a mill building, an ore bin, and a tailings pond placed there by a previous owner, and to recontour and reseed those areas. McColl readily agreed to reclaim the disturbances that he caused during his ownership and occupancy, but argued he had no obligation to reclaim prior existing disturbances caused by others.

In *James R. McColl*, 159 IBLA 167, GFS(MIN) 20(2003), the Interior Board of Land Appeals (IBLA) agreed with McColl insofar as the BLM had required McColl to reclaim disturbances caused by prior operators. The IBLA ruled that the regulations clearly require reclamation only of disturbances made by the occupant during his or her operations. *Id.* at 181. Citing the use of personal pronouns and the "inherent elasticity of 'plain English,' especially when used as legal jargon," the IBLA concluded that the surface use and occupancy regulations simply were not drafted with such downstream liability in mind. *Id.* That part of the BLM's order requiring McColl to reclaim his own disturbances was affirmed.

Surety of Canceled Bond Is Liable for New Disturbances to Previously-Disturbed Areas

In an unpublished decision involving a Nevada hardrock mine, the Ninth Circuit Court of Appeals affirmed the district court's decision that a surety's cancellation of a mine reclamation bond does not terminate the surety's liability for subsequent disturbances to previously-disturbed areas. *United States v. Safeco Insurance Co.*, No. 02-15737, 2003 WL 21259777 (9th Cir. May 29, 2003). The subject bond stated that when a surety (in this case, Safeco) cancels a reclamation bond, the bond "shall remain in full force and effect as to all areas within the plan of operations disturbed prior to the effective date of such cancellation." *Id.* at *2. Safeco cancelled the bond and claimed that the cancelled bond did not cover further disturbances to previously-disturbed areas of the mine. The appeals court disagreed, holding that the bond continues to cover new disturbances to areas disturbed prior to cancellation. *Id.* The court held that the plain language of the bond unambiguously provides continued coverage for the *areas* disturbed prior to cancellation and does not exclude disturbances caused by mining in those areas after cancellation. *Id.*

The court rejected Safeco's argument that such an interpretation rendered Safeco's right of cancellation illusory. By cancelling the bond, Safeco limited its liability to those areas disturbed prior to cancellation. While Safeco's reclamation liability could increase after cancellation based on further mining of previously-disturbed areas, it could not be extended to areas that had not been disturbed at the time the bond was canceled. *Id.*

Court Sustains Interior Rules Allowing Mine Subsidence in Protected Areas

Volume XVIV, No. 2 (2002) of this *Newsletter* reported a federal district court decision that the Surface Mining Control and Reclamation Act of 1977 (SMCRA) prohibits underground mining activities that will cause surface subsidence within certain statutorily protected areas, including national parks, wilderness areas, and historic sites. The district court struck down an Interior Department interpretive rule providing that subsidence from underground coal mining is *not* included within the statutory definition of "surface coal mining operations" and therefore is not prohibited within the protected areas, violates the statutory language of SMCRA, and is thus invalid. *Citizens Coal Council v. Norton*, 193 F. Supp. 2d 159 (D.D.C. 2002). The practical result of the court's ruling was to preclude underground mining activities that would cause surface subsidence within the statutorily protected areas.

The court of appeals has reversed that ruling. In *Citizens Coal Council v. Norton*, 330 F.3d 478 (D.C. Cir. 2003), the court of appeals observed that "SMCRA is a complex and often puzzling statute." *Id.* at 480. The court assumed, however, that the agency's interpretive rule could be analyzed under the two-part test of *Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984). *Id.* at 481. Under this familiar test, the court

first determines whether the statute is ambiguous. If not, the court enforces the statute. But if the statute is ambiguous, then the court defers to any reasonable agency interpretation. In this case, the court found that the statute was ambiguous and that the Secretary of the Interior's interpretation was reasonable. Accordingly, the rule was sustained.

Interestingly, the court apparently failed to consider the impact of the Supreme Court's decision in *United States v. Mead Corp.*, 533 U.S. 218 (2001). In *Mead*, the Court held that certain tariff classification rulings by the U.S. Customs Service were not entitled to *Chevron* deference. In reaching this holding, the Court noted that "the overwhelming number of our cases applying *Chevron* deference have reviewed the fruits of notice-and-comment rulemaking or formal adjudication." *Id.* at 230. The Court also cited with approval a law review article noting that "interpretive rules may sometimes function as precedents ... and they enjoy no *Chevron* status as a class." *Id.* at 232. Given the closeness of the question, it is unclear whether the court of appeals would have reached a different result if it had applied a lesser form of deference to the agency interpretive rule. Indeed, in finding the Secretary's interpretation reasonable, the court conceded that it was "not necessarily the most rational one." *Citizens Coal Council* at 483.

Strict Liability Applies to Violation of Forest Service Mine Permitting Rules

In *United States v. Good*, 257 F. Supp. 2d 1306 (D. Colo. 2003), the court held that violations of the Forest Service's mine permitting regulations are strict liability offenses. Quentin Good was charged and convicted of damaging property of the United States by using a mechanized backhoe, without authorization or approval, to remove overburden and to perform reclamation work on his unpatented mining claim. He was also charged and convicted of constructing an A-frame structure on his claim for use as his principal residence. Mr. Good's primary defense was his good faith belief, based on a notice of intent submitted to and approved by the State of Colorado, that he was authorized to conduct the operations for which he was charged. Good argued he lacked the requisite intent to violate the Forest Service regulations.

Finding the violations to be "public welfare" offenses, the court held the violations to be strict liability offenses, such that the government does not need to establish any element of intent on the part of the defendant. *Id.* at 1318. Good was found not guilty on two of the counts against him because of misconduct by a Forest Service employee, but was found guilty of the other four charges without regard to his intent.

The court also affirmed that the Forest Service could proceed by criminal misdemeanor prosecution rather than administratively through notices of noncompliance and proceedings to cancel his claim. *Id.* at 1319.

Dependent Millsite Must Be Patented with Associated Mining Claims

In *Ulf T. Teigen (on Reconsideration)*, 159 IBLA 142, GFS(MIN) 17(2003), the Interior Board of Land Appeals (IBLA) held that a dependent millsite may be patented only if the mining claim to which it is appurtenant is either already patented or a patent is granted simultaneously with the millsite patent.

Teigen filed a patent application for his millsite claim, covering five acres of non-mineral land, in 1991. The millsite was "dependent" because it was to be used in connection with a specific lode mining claim. Teigen filed a patent application for the associated lode mining claim in 1994, but that application was not accepted by the Bureau of Land Management (BLM) because of a Congressional moratorium preventing the processing of new patent applications. This series of events left the millsite patent application grandfathered under the moratorium, but the mining claim patent application prohibited under the moratorium. In 1996 Congress required the BLM to create and follow a plan to complete the processing of 90% of the grandfathered applications within the following five years.

Compelled to act on the grandfathered millsite patent application, the BLM rejected that application because it was not associated with any existing patented mining claim and its associated mining claim could not be patented because of the moratorium. The IBLA upheld that action. *Id.* at 149. The BLM and the IBLA did acknowledge that rejection of the millsite patent application does not preclude Teigen from refileing it in association with a mining claim patent application if and when the moratorium is lifted. *Id.* at 149 n.4.

FEDERAL -- OIL & GAS

Gregory R. Danielson, Reporter

Wyoming Federal District Court Reverses IBLA Decision Invalidating Federal Leases

Pennaco Energy, Inc. and other intervening third parties filed an appeal of a decision of the Interior Board of Land Appeals (IBLA) which reversed the Bureau of Land Management's (BLM) issuance of oil and gas leases. *See*

Vols. XVII, No. 4 (2000), XVIV, Nos. 2 & 4 (2002) of this *Newsletter*. In *Pennaco Energy, Inc. v. Department of the Interior*, 266 F. Supp. 2d 1323 (D. Wyo. 2003), the U.S. District Court for the District of Wyoming reversed the decision of the IBLA and affirmed BLM's decision to issue the leases.

This case involved BLM's decision to issue three federal oil and gas leases located in the Powder River Basin. The IBLA reversed the BLM decision to issue the federal oil and gas leases holding that the BLM did not conduct sufficient environmental analysis pursuant to the National Environmental Policy Act (NEPA) prior to selling the leases in question. In reversing the IBLA decision, the district court held that the Buffalo Resource Management Plan and the Wyodak Environmental Impact Statement (EIS) together provided BLM with all the information it needed to take the requisite hard look before making the leasing decision.

The court relied upon the Tenth Circuit decision in *Park County Resource Council, Inc. v. U.S. Department of Agriculture*, 817 F.2d 609 (10th Cir. 1987), and held that NEPA's hard-look requirement exists at the pre-leasing stage but it is a more general requirement than at the project-level stage. The extensive analysis of the environmental effects of coalbed methane development in the Wyodak EIS reasonably supplemented the pre-leasing analysis set forth in the Buffalo Resource Management Plan so as to provide sufficient information to enable BLM to take a hard look at the potential impacts of oil and gas development on the three leases. The court held that IBLA's opinion arbitrarily and capriciously elevated form over substance by separating the two documents and refusing to consider them together.

DC Circuit Rejects Gas Valuations Based on Resale Price of Marketing Affiliate

Fina Oil and Chemical Co. (Fina) appealed a decision of the U.S. District Court for the District of Columbia holding that the Minerals Management Service (MMS) could order a lessee to pay royalty based on the value of an affiliate's resale price to a non-affiliated third-party purchaser. The U.S. Court of Appeals for the District of Columbia in *Fina Oil & Chemical Co. v. Norton*, 332 F.3d 672 (D.C. Cir. 2003), reversed the district court and held that the applicable regulations require valuation of gas proceeds based on the initial sale by Fina and not the resale price of its affiliate.

In 1993 the MMS issued an order rejecting Fina's valuation of gas based upon use of the benchmarks set forth in the regulations and required Fina to base its royalty valuation on the higher prices that its affiliate, Fina Natural Gas Company, received from subsequent downstream arms-length sales. Fina appealed the decision to the Interior Board of Land Appeals (IBLA) and that appeal was summarily denied based upon the Assistant Secretary's decision in *Texaco Exploration & Production, Inc.*, MMS-92-0306-O&G (May 18, 1999). In *Texaco*, the Secretary held that the gross proceeds provision required all valuations to equal at a minimum the gross proceeds "accruing to the lessee," a term the Secretary interpreted as the total consideration received by the corporate family to which the producer and non-marketing affiliate belong. See Vol. XVI, No. 3 (1999) of this *Newsletter*.

In rejecting the district court's decision, the court of appeals held that the statute's definition of "lessee," the regulation's language and structure, and the agency's own pronouncements at the time of the regulation's promulgation all demonstrate that "gross proceeds accruing to the lessee" refers only to the proceeds accruing to Fina and not to the entire corporate family of which Fina is a member. The court stated that the definition of "lessee" contained in section 3(7) of the Federal Oil and Gas Royalty Management Act clearly defines "lessee" as the person issued a lease. The court noted that there is no reference to "affiliates" of such persons.

IBLA Confirms That Federal Lessee must Ordinarily Bear the Costs of Placing Producer's Gas in Marketable Condition at No Cost to the Government

J-W Operating Company Inc. (J-W) was audited by the Colorado Department of Revenue and found to have underpaid royalties on unprocessed gas produced from several federal leases in the amount of \$62,017.76. J-W Operating challenged the Department's finding before the Royalty Valuation Division (RVD) of the Minerals Management Service (MMS). The RVD issued a letter decision and bill for collection to J-W Operating on August 19, 1997. J-W appealed the RVD decision to the Associate Director of the MMS who affirmed the RVD decision, but reduced the assessment to approximately \$53,000.00. In *J-W Operating Co.*, 159 IBLA 1, GFS(O&G) 6(2003), the Interior Board of Land Appeals (IBLA) affirmed the MMS' decision and held that MMS correctly required the inclusion of the costs of dehydration and compression as part of gross proceeds.

Under the terms of J-W's contract with K-N Energy, if the gas delivered at a gathering line did not meet a particular pressure requirement, J-W was required to reimburse the purchaser 2 to 7 cents per MCF. Pursuant to the terms of a separate contract, J-W transferred lease production at the wellhead to YGS, a related company which gathered, dehydrated, and compressed that production and delivered the gas to a marketing company at a contract rate of 0.69 per MMBTU. The marketing company paid J-W the index spot price less one cent.

J-W appealed the Associate Director's decision arguing that because title to the gas passed at the well, royalty must be based on the value at the well. The appellant further argued that compression expenses were not related to placing the gas in a marketable condition but to transporting the gas, and that the marketable condition rule does not require the lessee to condition the gas so that it is suitable for secondary markets. The IBLA disagreed and noted that gross proceeds has been defined to include "payments to the lessee for certain services such as compression, dehydration, measurement, and/or field gathering to the extent that the lessee is obligated to perform them at no cost to the Federal Government." *J-W Operating*, 159 IBLA at 11-12. The IBLA thus determined that the appellant had inappropriately deducted costs and other expenses which should not have been charged against the government's royalty. The basis for the IBLA holding is the "underlying principle ... that a Federal lessee must ordinarily bear the costs of placing produced gas in marketable condition at no cost to the Government and may not deduct those costs from the royalty value." *J-W Operating*, 159 IBLA at 12.

Inclusion of FWS Guidelines in EIS Does Not Violate Rulemaking Provision of APA

Fred E. Payne (Payne) appealed from a July 6, 1999, Record of Decision of the State Director of the Utah State Office of the Bureau of Land Management (BLM) approving the Ferron Natural Gas Project. Payne, an overriding royalty interest owner, objected to the size of the buffer zone created around active raptor nests. In *Fred E. Payne*, 159 IBLA 69, GFS(O&G) 7(2003), the Interior Board of Land Appeals (IBLA) affirmed the Record of Decision approving the Ferron Natural Gas Project.

BLM initially moved to dismiss Payne arguing that an overriding royalty interest owner lacks standing because he is not adversely affected by the Record of Decision. IBLA denied BLM's motion to dismiss holding that Payne made a threshold showing that he would be adversely affected by BLM's decision to preclude well development and production activities in a 1/2-mile radius around active raptor nests, which may potentially prevent the drilling of a number of wells on the leasehold in which Payne owned an overriding royalty interest.

Payne contested BLM's reliance on Fish and Wildlife Service (FWS) guidelines for establishing the buffer zone because the guidelines were not included in the draft EIS and, therefore, interested parties were deprived of the opportunity to comment on the applicability of the guidelines. IBLA rejected this argument holding that although the guidelines were not referenced in the DEIS the no-surface-occupancy buffer zones were part of the proposal and therefore provided sufficient opportunity for comment.

Payne also argued that the reliance on the guidelines is improper in the absence of their promulgation as a regulation pursuant to the notice and comment rulemaking provisions of the Administrative Procedure Act (APA). IBLA held that the FWS guidelines were not binding in this context and noted that BLM left itself discretion to grant variances from the buffer zone. Accordingly, the guidelines, unlike regulations, do not constitute rules of law binding on the BLM and therefore there is no violation of the rulemaking provisions of the APA.

CONGRESS / FEDERAL AGENCIES -- GENERAL

Laura Lindley, Reporter

Status of Forest Service Roadless Policy

Judge Brimmer's decision (described elsewhere in this *Newsletter*) enjoining the Forest Service's roadless rule leaves the Forest Service's policy with respect to use of inventoried roadless areas up in the air. The roadless rule establishes nationwide standards for the management of 58.5 million acres of National Forest non-wilderness lands which were identified as roadless in the Forest Service's November 2000 environmental impact statement (EIS). The rule was published on January 12, 2001, days before the end of the Clinton Administration, with an effective date of March 13, 2001. 66 Fed. Reg. 3244 (2001). The Bush Administration suspended the effectiveness of the rule until May 12, 2001, but on May 10, 2001, the U.S. District Court for the District of Idaho issued an order enjoining implementation of the rule. That decision was immediately appealed to the Ninth Circuit Court of Appeals. Given the legal uncertainty, the Forest Service then adopted an interim policy by which the roadless rule would generally be observed except that the Chief of the Forest Service reserved the authority to approve timber harvests or road construction in inventoried roadless areas. This interim policy would expire June 14, 2003.

On December 12, 2002, the Ninth Circuit reversed the district court decision, and directed the district court to dissolve its injunction and remanded the case. *Kootenai Tribe of Idaho v. Veneman*, 313 F. 3d 1094 (9th Cir. 2002). On June 9, 2003, shortly before the expiration of the interim policy, the Forest Service announced that it would retain the roadless rule published in 2001. At the same time, the Forest Service also announced that it would propose an amendment to the rule which would allow a state's governor to seek relief from the road construction prohibition for exceptional circumstances "such as to protect public health and safety or reduce wildfire risks." Forest Service

Press Release No. 0200.03 (June 9, 2003). The press release also states that relief from the rule would be allowed to maintain existing facilities such as dams, or to provide reasonable access to private property or privately owned facilities. The rule currently allows road construction or reconstruction in inventoried roadless areas if a road is needed pursuant to "reserved or outstanding rights," which presumably would permit access to mining claims. It also allows road construction or reconstruction if a road is needed in conjunction with the "continuation, extension, or renewal of a mineral lease on lands that are under lease by the Secretary of the Interior as of January 12, 2001 or for a new lease issued immediately upon expiration of an existing lease." 36 C.F.R. § 294.12(b)(7) (2002). In connection with its settlement of a lawsuit with the State of Alaska over the roadless rule, the Forest Service has also proposed a rule that would exempt the Tongass National Forest from the rule and has issued an advance notice of proposed rulemaking seeking comment on the applicability of the roadless rule to both the Tongass and the Chugach National Forests in Alaska. 68 Fed. Reg. 41,865, 41,863 (July 15, 2003).

A month after the Forest Service announced that it would implement the roadless rule, Judge Brimmer of the U.S. District Court in Wyoming enjoined the rule. As detailed elsewhere in this *Newsletter*, that decision has been appealed to the Tenth Circuit by a coalition of environmental groups but, as of the deadline for this *Newsletter*, not by the United States. Local Forest Service offices are telling the public that they are awaiting instructions from Washington before allowing any road construction in inventoried roadless areas. To further complicate matters, the Community Rights Counsel has filed a letter of complaint with the Tenth Circuit alleging that Judge Brimmer should have recused himself from the roadless rule case because of his significant stock holdings in oil and gas companies. A copy of the letter is available at www.communityrights.org/Brimmer/complaint.asp. However, no oil and gas company or industry trade association was involved in the roadless rule case before Judge Brimmer.

BLM Revamps Appraisal Functions

In the wake of continuing criticism of the Bureau of Land Management's (BLM) real estate appraisal process, most recently by the Appraisal Foundation and internal reviews, Secretary of the Interior Gale Norton announced that a single departmental office would be formed to provide a uniform appraisal process for all Department of the Interior agencies. Appraisals are prepared in connection with land exchanges or acquisitions by BLM and other agencies. The Department expects that a centralized appraisal office, independent of the land management goals of a local office, will be less susceptible to criticisms of bias and lack of adherence to professional appraisal standards.

Robert Mathes, Guest Reporter

Roadless Rule Enjoined

On July 14, 2003, the U.S. District Court for the District of Wyoming issued an injunction permanently enjoining the roadless rule, 36 C.F.R. §§ 294.10 to 294.14 (2002). In a suit brought by the State of Wyoming against the U.S. Department of Agriculture and various federal officials, Judge Brimmer found that the roadless rule was promulgated in violation of the National Environmental Policy Act (NEPA) and the Wilderness Act. *Wyoming v. U.S. Dep't of Agric.*, No. 01-CV-860B, 2003 WL 21995163 (D. Wyo. July 14, 2003).

On October 13, 1999, President Clinton directed the Forest Service to initiate administrative proceedings to protect inventoried roadless areas and to determine whether roadless protection was warranted for any uninventoried roadless areas. In response to this directive, the Forest Service published a notice of intent (NOI) to prepare an environmental impact statement (EIS) to analyze the effects of eliminating road construction activities in the remaining unroaded portions of the inventoried roadless areas within the National Forest System. The comment period for the NOI closed after only 60 days despite numerous requests for extensions. The draft EIS and proposed roadless rule were issued in May of 2000 and the final EIS was issued on November 13, 2000. The final EIS adopted a more restrictive roadless rule alternative than that disclosed in the draft EIS and added an additional 4.2 million acres of inventoried roadless area. The final Roadless Area Conservation Rule was published in the Federal Register on January 12, 2001, with an effective date of March 13, 2001. 66 Fed. Reg. 3244 (2001). The Bush Administration suspended the effectiveness of the rule until May 12, 2001. Six days later, on May 18, 2001, the State of Wyoming filed suit against the Department of Agriculture alleging violations of the National Environmental Policy Act, the National Forest Management Act, the Wilderness Act, the Multiple Use and Sustained Yield Act, and other statutes.

The Wyoming U.S. District Court determined that the promulgation of the roadless rule violated NEPA in several respects. First, the court found that the Forest Service's scoping process was inadequate and that the Forest Service's decision not to extend the scoping comment period was arbitrary and capricious. The court decided that Wyoming and other affected states could not meaningfully participate in determining the scope and significant issues to be analyzed in the EIS in the short time provided for filing scoping comments. In particular, the court was concerned with the fact that the Forest Service did not specify what roadless areas the rule would be applied to and

what alternatives would be discussed. Second, the court held that the Forest Service's decision to deny Wyoming and other affected western states cooperating agency status without explanation was arbitrary and capricious. Third, the court found that the Forest Service failed to rigorously explore and objectively evaluate all reasonable alternatives because the Forest Service refused to consider alternatives that did not meet its purpose of immediately stopping activities that resulted in a degradation of roadless areas. Fourth, the court found the Forest Service's cumulative impacts analysis to be inadequate. Finally, the court held that the Forest Service's decision not to issue a supplemental EIS in light of the substantial changes between the draft rule and the final EIS was arbitrary, capricious, and contrary to law.

The district court additionally found that the roadless rule was promulgated in violation of the Wilderness Act of 1964 because the rule was an impermissible attempt to establish de facto wilderness through administrative rulemaking rather than through Congressional designation. The court found that the Forest Service's definition of a roadless area is synonymous with the Wilderness Act's definition of "wilderness" and further found that the uses permitted in a wilderness area and those permitted in an inventoried roadless area to be essentially the same. As such, the court found that the rulemaking improperly infringed upon the authority of Congress and was thus a violation of the Wilderness Act.

On July 16, 2003, the Biodiversity Associates, Defenders of Wildlife, National Audubon Society, Natural Resources Defense Council, Pacific Rivers Council, Sierra Club, Wilderness Society, and Wyoming Outdoor Council filed a notice of appeal from the court's decision.

CONGRESS / FEDERAL AGENCIES -- OIL & GAS

Laura Lindley, Reporter

Offshore Operating Rules

The Minerals Management Service (MMS) adopted new rules, which took effect March 24, 2003, governing drilling operations in the Outer Continental Shelf (OCS). 68 Fed. Reg. 8402 (Feb. 20, 2003). The new rules replace existing Subpart D of Part 250, 30 C.F.R., covering oil and gas drilling operations, and cover the procedure for obtaining a drilling permit as well as technical matters such as casing and cementing requirements, blowout preventer systems, and diverter systems. In addition, effective August 21, 2003, the MMS rules will be amended to incorporate by reference the American Petroleum Institute (API) Recommended Practice 14 F which addresses the design and installation of electrical systems for certain offshore facilities. 68 Fed. Reg. 43,295 (July 22, 2003) (to be codified at 30 C.F.R. §§ 250.114, 250.803 & 250.1629).

The MMS has also recently issued two Notices to Lessees (NTL) that are of interest to OCS lessees. NTL No. 2003-NO 4, issued effective May 9, 2003, is an interpretive rule that defines what quantity of production qualifies as paying quantities so as to extend an OCS lease beyond its primary term. The NTL states that "paying quantities" requires the production of a sufficient volume of oil or gas to yield a positive income stream after subtracting "normal" expenses, which include royalties and direct lease operating costs. Direct lease operating costs include processing fees, labor costs, fixed and variable operating costs incurred on the lease, and fixed and variable operating costs allocated to the lease when production is processed off the lease.

NTL No. 2003-NO 6, effective June 17, 2003, updates the criteria that MMS will use to determine when a supplemental bond is required to cover potential lease abandonment liability. Generally, the NTL makes it slightly easier for a company to demonstrate financial reliability. This NTL supersedes NTL No. 98-18N and its addendum.

FEDERAL -- FERC

Jeffery S. Dennis, Reporter

FERC Declines to Abrogate California Energy Contracts

In a 2-1 decision on June 26, 2003, the Federal Energy Regulatory Commission (FERC or Commission) ruled against the Public Utilities Commission of the State of California (CPUC) and the California Electricity Oversight Board (CEOB) on their claim that the contracts they entered into with a group of sellers of energy during the 2000-01 energy crisis were unjust and unreasonable and not in the public interest. *Public Utilities Comm'n v. Sellers of Long Term Contracts*, Nos. EL02-60-000, EL02-62-003, 103 FERC ¶ 61,354, 2003 WL 21485863 (2003). The complainants were seeking to have the long-term contracts de-clared voidable at the State of California's discretion, or to have the contracts abrogated entirely.

In reaching its decision, FERC affirmed an administrative law judge's (ALJ) initial decision that the applicable standard of review for the contracts at issue was the "public interest" standard. The Commission's adoption of the

"public interest" standard under the circumstances surrounding the California energy crisis is the fundamental, precedent-setting aspect of the case.

The public interest standard, arising out of the Supreme Court's *Mobile-Sierra* line of decisions (*United Gas Pipe Line Co. v. Mobile Gas Serv. Corp.*, 350 U.S. 332 (1956); *Federal Power Comm'n v. Sierra Pacific Power Co.*, 350 U.S. 348 (1956)), requires that to justify modification or abrogation of an existing contract, the complainant must show that the rates contained in the agreement are so low as to make the agreement contrary to the public interest. The original *Mobile-Sierra* cases held that, where a public utility seller and its customer entered into a contract at a particular rate, and the seller did not reserve the right to later unilaterally file a new rate with the Commission under section 205 of the Federal Power Act (FPA), the seller could not unilaterally seek to have a new rate substituted for the agreed-upon rate. Importantly, those cases also held that the Commission, under section 206 of the FPA, had only very limited power to alter an existing contract rate once it had accepted that contract.

The *Sierra* case listed several factors meeting the public interest standard it outlined, including articulating a requirement that a selling utility show that the rates in the contract were so low as to harm the public interest by impairing the financial ability of the selling utility to continue service, to put an excessive burden on other customers, or to be unduly discriminatory. While originally applied only to claims by sellers that the contract rate was exceedingly low, the *Mobile-Sierra* public interest standard has been applied to claims by purchasers that contract rates are exceedingly high. By contrast, the "just and reasonable" standard of review, which the complainants in the case sought to have applied, would have required that the complainants simply show that the contracts at issue provide for rates which are "unjust and unreasonable" under more traditional principles of utility rate regulation.

In its order, the Commission adopted the initial decision of the ALJ that the public interest standard must be applied to contracts that do not reserve a right in either party to unilaterally file for changes to the contract rates, and do not specifically identify an appropriate standard of review. In adopting this approach, the FERC refused the arguments of several complainants that the just and reasonable standard should be applied to these contracts because they were entered into under each seller's authority to sell energy at market-based rates, and thus were not previously reviewed by the Commission, unlike previous contracts entered into in a more tightly regulated regime, where the *Mobile-Sierra* doctrine was initially developed.

In order to justify contract modification under the public interest standard in this particular case, the Commission required the complainants to demonstrate not just that "forward prices became unjust and unreasonable due to the impact of spot market dysfunctions," but also "that the rates, terms, and conditions [of the contracts] are contrary to the public interest." 2003 WL 21485863 at *9. The Commission determined that the complainants failed to meet this difficult burden. In making this determination, the Commission considered the facts surrounding the execution of the contracts at issue in light of the factors identified in the *Sierra* case, noted above.

First, FERC determined that the contracts were not causing financial distress to the complainants to the point of threatening their ability to continue operating. The Commission decided there was no credible record evidence showing that the contracts at issue in the case had placed the complainants in dire financial distress or had placed an undue burden on other customers. The Commission noted that the California Department of Water Resources (CDWR), one of the complainants, was achieving an energy portfolio with a weighted average price of \$70/MWh, which was a price squarely within the range stated in CDWR's central objectives.

Second, the Commission examined whether there was discriminatory conduct on the part of the sellers of energy, which FERC deemed relevant because discriminatory conduct has been used as a trigger for applying the *Mobile-Sierra* doctrine in past cases. In this case, no evidence of discriminatory conduct was found on the part of the sellers.

Finally, the Commission ruled that the complainants had other options and at least *some* bargaining power when they entered into the energy contracts. According to the Commission's review of the record evidence, CDWR had obtained over 200 energy bids and was free to negotiate with the bidders of their choice. Based on this, FERC determined that the contracts were not the product of unequal bargaining power because the complainants had sufficient options when they negotiated the agreements and were initially pleased with the bargain that they had obtained.

FERC concluded, based on the above, that the complainants "failed to demonstrate the financial impairment, excessive burden or undue discrimination described in *Sierra* or any other factor sufficient to meet the 'public interest' standard of review." *Id.* at *13. The Commission declared that the complainants' only apparent ground for modifying the contracts was their later dissatisfaction with the bargain they had negotiated. However, because the transactions were not the result of unfairness, bad faith, or duress and were instead the result of CDWR's voluntary choices, FERC deemed contract modification to be unwarranted in the case.

Commissioner William Massey dissented from the Commission's ruling. His dissent focused on both the proper standard of review and whether the burden of each possible standard of review was met. Commissioner Massey argued that the just and reasonable standard of review was the appropriate standard for this case, reasoning that for a customer to waive its right to file a section 206 complaint seeking Commission alteration of existing rules, the waiver must be explicitly stated in the contract, and when the contract does not specifically state the standard of review to be used, the just and reasonable standard applies. Commissioner Massey went on to argue that the just and reasonable burden was met by the complainants. Additionally, Commissioner Massey wrote in his dissent that the complainants had also met the more rigorous public interest standard. According to Commissioner Massey, the facts presented in the case were so unique that the Commission should not limit itself to the traditional factors analyzed under the public interest standard, as identified in the *Sierra* case. The Commissioner argued that the public interest standard should be examined in light of the circumstances which surrounded the making of the particular contracts at issue, and that under those extreme circumstances the contracts were themselves tainted, and no public interest would be served in upholding contracts negotiated under such extraordinary and unprecedented conditions.

The majority's choice to use the public interest standard of review in the circumstances presented by the California energy crisis, and its adoption of the ALJ's determination that "case law is clear that where a contract fails to specifically provide that the contract may be unilaterally altered, *Mobile-Sierra* requires that proposed changes meet the 'public interest' standard," *id.*, are crucial aspects of the order. In adopting the ALJ's characterization of the *Mobile-Sierra* case law, FERC may be setting a strong precedent favoring the public interest standard of review in contract modification cases, in the absence of specific contract language to the contrary.

FERC Issues New Guidelines on Cultural Resources Investigations for Pipeline Projects

FERC's Office of Energy Projects has issued new and revised "Guidelines for Reporting on Cultural Resources Investigations for Pipeline Projects." The guidelines are available at www.ferc.gov/industries/gas/enviro/culresor.pdf. The guidelines are issued by Commission staff to help pipeline project sponsors assist the Commission in meeting its obligations under the National Historic Preservation Act (NHPA). Congress enacted the NHPA with the intent of preserving and managing the cultural resources located on federal lands, and to take into account the effect of federal actions on private lands. Section 106 of the NHPA requires all federal agencies, prior to authorizing an activity under their jurisdiction, to take into account the effect the activity or undertaking will have on cultural resources listed or eligible for listing on the National Register of historic properties. The guidelines prepared by FERC staff provide step-by-step measures to streamline the preparation of report filings under section 106.

ALABAMA -- OIL & GAS

Edward G. Hawkins, Reporter

Alabama Supreme Court Rebuffs NORM Case on Procedural Grounds

In the case of *Morgan v. Exxon Corp.*, No. 1012345, 2003 WL 21362958 (Ala. June 13, 2003) the Alabama Supreme Court used the Alabama 20-year rule of repose to deny relief to landowners seeking NORM contamination damages from two former well operators. In 1996, the landowners discovered the presence of arsenic, lead, zinc, benzene, toluene, xylene, petroleum hydrocarbons, chlorides, crude oil, and normally occurring radioactive material (NORM) on their land. The landowners then filed an action in 1996 against a number of oil industry defendants, including Mobil Oil Corporation (Mobil), which last operated on the land in the 1960s, and Marshall Oglesby (Oglesby), which last operated on the land in the early 1970s.

Asserting the Alabama 20-year rule of repose, Mobil and Oglesby obtained a partial summary judgment from the trial court, since neither had conducted operations on the plaintiffs' land during the 20 years preceding the filing of the suit. The plaintiffs' failure to discover the contaminants until 1996 did not prevent the running of the rule of repose, since it commences at the moment of the event causing the injury, not upon discovery of the injury, the court held.

In an attempt to avoid the bar of the rule of repose, the plaintiffs argued that the application of the rule of repose in their case was preempted by the Comprehensive Environmental Response, Compensation, and Liability Act, codified as amended by the Superfund Amendments and Reauthorization Act of 1986, at 42 U.S.C. §§ 9601-9675 (CERCLA). Specifically, the plaintiffs argued that 42 U.S.C. § 9658(a)(1) provides that any applicable state statute of limitation commences to run on the "federally required commencement date" (FRCD), if there is a conflict between the state law commencement date and the FRCD. The plaintiffs pointed out that the FRCD occurred when the plaintiffs knew or reasonably should have known that contamination was present. 42 U.S.C. § 9658(b)(4)(A).

Thus the plaintiffs contended that, under CERCLA, the 20-year rule of repose would have commenced to run in 1996 upon the plaintiffs' discovery of the problem.

The Alabama Supreme Court rejected the plaintiffs' preemption argument because the plaintiffs failed to prove that CERCLA applied. In this regard, the court focused on the "petroleum exclusion" appearing in 42 U.S.C. § 9601(14) & (33). The court noted that CERCLA's petroleum exclusion applies to any indigenous constituents of petroleum not in concentrations exceeding what is normally found in petroleum. The court found that the plaintiffs were relying on CERCLA to change the commencement date for the Alabama 20-year rule of repose. By relying on an exception to the general rule, the plaintiffs bore the burden of proving that their case *did not fall* within the CERCLA petroleum exclusion. The plaintiffs did not make a record in their summary judgment response that the arsenic, lead, zinc, benzene, toluene, xylene, and NORM found on their land were in concentrations exceeding those normally found in petroleum. Since the plaintiffs failed to prove that CERCLA applied to their case, the FRCD did not apply, and the plaintiffs had nothing to save them from the 20-year rule of repose.

The *Morgan* case shows both sides to a NORM case filed long after operations cease how and when CERCLA may save a plaintiff's case when a state law statute of limitation or rule of repose bars the claim. *Morgan* also goes into CERCLA's petroleum exclusion with respect to contaminants that may also be indigenous in petroleum.

ALASKA -- OIL & GAS

John K. Norman, Reporter

2003 Legislation Affecting the Oil & Gas Industry

The Alaska legislature produced a number of bills this year that reduce regulatory burdens, provide tax incentives, and remove litigation risks associated with oil and gas development in Alaska. Many of these changes came at the behest of Governor Frank Murkowski, and include changes to the law regarding stranded and natural gas development, modifications to Alaska's Coastal Management Program and Oil Discharge Prevention and Contingency Plans, adjustments to the state's oil and gas royalty scheme, statutory changes that alter litigation rules regarding awards of attorneys' fees to so-called "public interest" litigants, and new rules regarding lawsuits seeking injunctive relief against permitted facilities. These broad legislative changes create incentives and enhanced opportunities for oil and gas development in Alaska.

Stranded and Shallow Gas Legislation

The legislature passed several bills meant to provide an incentive for "stranded" and shallow natural gas exploration and development in Alaska. House Bills 16 and 69 and Senate Bill 151 all modify or alter the current regulatory environment for stranded and natural gas exploration and development.

House Bill 16, titled "Stranded Gas Development Act Amendments," amends the Alaska Stranded Gas Development Act standards applicable to determining whether a proposed new investment constitutes a qualified project and establishes new standards to determine whether a person or group qualifies as a sponsor under the Act.

The Stranded Gas Development Act, Alaska Stat. § 43.82.010-43.82.990, was originally enacted in 1998. Prior to H.B. 16, the Act only allowed for natural gas projects if the gas was to be exported in liquefied form. H.B. 16 did away with this limitation and authorizes gas development and transportation to take place in any form. This legislation also lowers the bar in terms of a developer's required net assets and creates opportunities for more companies to participate in the proposed North Slope natural gas pipeline project.

The legislature has also attempted to spur development of the state's shallow natural gas reservoirs by the passage of House Bill 69. The new law recognizes that regulatory requirements may impede development of the state's shallow natural gas resources, and that "shallow natural gas is abundant and widespread in Alaska and bears the promise of providing Alaskans, particularly Alaskans living in rural areas, with an inexpensive and clean source of energy if those resources can be economically developed." H.B. 69 amends the law to include a new subsection, Alaska Stat. § 31.05.030(j), requiring the Alaska Oil and Gas Conservation Commission (AOGCC) to determine if the volume of oil expected to be encountered "will be of such quantities that an oil discharge prevention and contingency plan" is required for a well drilled to develop shallow natural gas. Alaska Stat. § 31.05.060(c) was added to allow the AOGCC to issue a variance, in the case of shallow gas development, from the regulations that normally require public notice and opportunity to be heard for actions taken by the AOGCC. The new law allows a lessee or operator to request a variance from the public notice requirement if shallow gas development operations may be unduly delayed by compliance therewith, provided certain other statutory requirements are met. H. B. 69 also authorizes the Commissioner of the Alaska Department of Natural Resources (DNR) to waive local planning authority approval and compliance with local ordinances and regulations, if there is an overriding state interest. The

new law defines "shallow natural gas" as coalbed methane, natural gas drilled for under a shallow gas lease, or natural gas drilled for in a well, the true vertical depth of which is 4,000 feet or less. Alaska Stat. § 31.05.170.

Finally, the new law amends Alaska Stat. § 46.04.030(b) to exempt shallow natural gas production from the requirement to obtain an approved oil discharge prevention and contingency plan from DNR, unless AOGCC determines that the well to be drilled for shallow natural gas may penetrate a formation capable of flowing oil and the volume of oil expected to be encountered will be of such quantity that a contingency plan should be required. The new law also provides that projects for the exploration and development of shallow natural gas are presumed to be consistent with the Alaska Coastal Management Program.

In Senate Bill 151, the legislature changed the regulation of natural gas pipelines under the "Pipeline Act." The new law amends Alaska Stat. § 42.06.350(c) by eliminating the words "North Slope" from the law. This means that a natural gas pipeline need not be a North Slope natural gas pipeline to benefit from the provisions of Alaska Stat. § 42.06, the "Pipeline Act," which allows a natural gas pipeline carrier to charge separate rates for firm transportation and for interruptible transportation service, and to charge a reservation fee or similar charge for reservation of capacity in a natural gas pipeline. The Pipeline Act has been further amended to expand the definition of "natural gas pipeline" and "natural gas pipeline carrier" to include all of the facilities of a total pipeline system.

Environmental Legislation

In House Bill 191 and Senate Bill 74 the legislature changed the regulatory apparatus that governs the Alaska Coastal Management Program (ACMP) and oil discharge prevention and contingency plans (Contingency Plans). A "Contingency Plan" is officially called an "Oil Discharge Prevention and Contingency Plan" because it embraces actions to prevent an oil spill and, in the event of a spill, describes the resources to be employed to clean it up. House Bill 191 significantly changes the ACMP by eliminating the Alaska Coastal Policy Council, and transferring implementation of the ACMP to DNR. H.B. 191 also requires a consistency determination to be made within 45 days after an initial request is submitted. The new law excludes from the consistency review process projects that are subject to authorization by the Alaska Department of Environmental Conservation (ADEC) or to issuance of an authorization or permit by AOGCC.

Senate Bill 74 extends the renewal period for Contingency Plans. Under existing law, an operator must prepare a Contingency Plan for terminals and distributors of crude and refined oil products, marine tankers and barges that transport crude and refined oil products, and oil pipelines and onshore and offshore oil exploration and production facilities. S.B. 74 is based on a legislative finding that "focusing on the actual testing of oil spill prevention and response preparedness, through in-the-field inspections, drills, and exercises, is our most effective means of ensuring spill prevention and response readiness and protection of the environment." The bill amends Alaska Stat. § 46.04.030, which governs Contingency Plans, to change the renewal period for such plans from three to five years. The bill also extends the expiration date of a Contingency Plan approved by ADEC before the effective date of the bill (April 30, 2003) for two years, or for a shorter period if a shorter period has been requested by the holder of an approved plan. The amendments are significant because they place emphasis on "actual testing" and "in-field inspections," not merely on evaluation of "paperwork."

Senate Bill 142 designates DNR as the lead agency for resource development projects in Alaska. Previously, the lead agency was ADEC. The new law amends Alaska Stat. § 38.05.020(b) and states that DNR will "lead and coordinate all matters relating to the State's review and authorization of resource development projects." This bill, along with House Bill 191, which transferred implementation of the Alaska Coastal Management Program from the Alaska Coastal Policy Council to DNR, significantly expands DNR's role in Alaska resource development projects.

Litigation Risk

Litigation is always a serious consideration for any operator involved in oil and gas development. House Bills 86 and 145 address litigation risks and attempt to level the playing field between so-called "public interest litigants" and resource development companies.

House Bill 86 relates to state permitted projects and is intended to "avoid costly litigation about projects overseen by [state] agencies." This bill makes liable anyone who "initiates or maintains a malicious claim for injunctive relief against a state permitted project . . ." The liability encompasses incidental or consequential damages as well as actual damages suffered by the permittee or owner of the project as a result of a malicious claim, including losses of wages and salaries paid to employees or contractors idled or put to nonproductive labor, and increased material costs caused by the malicious claim. A "malicious claim for injunctive relief" is a "baseless legal or administrative claim" if, among other things, it is made in bad faith or with malice and the permittee is damaged

by the claim. The bill also amends the Alaska Coastal Management Program by statutorily providing that a consistency determination made under the ACMP is "not subject to review, stay, or injunction by any court."

House Bill 145 eliminates a judicially-created exception to awards of attorneys' fees, otherwise governed by Rule 82 of the Alaska Rules of Civil Procedure. Up to now, this exception exempted "public interest litigants" from awards of attorneys fees and costs against them, but allowed them to recover fees and costs from parties against whom they brought suit. H.B. 145 eliminates the ability of state courts to discriminate in the award of attorneys' fees and costs against a party in a civil action or appeal based on the nature of the policy or interest advocated by the party, the number of persons affected by the outcome of the case, whether a governmental entity could be expected to participate in the case, the extent of the party's economic incentive to bring the case, or any combination of those factors. The new law requires public interest litigants, like all other litigants, to post a bond or other security to protect persons who will be affected by the litigant's request for entry of a stay or other interlocutory relief. The new law applies to all civil actions and appeals filed on or after September 11, 2003.

Both H.B. 86 and H.B. 145 are likely to have an impact on the decisionmaking process a "public interest" litigant undertakes before filing suit against a permitted project. The risk of having attorneys' fees and costs associated with injunctive relief assessed against public interest litigants is expected to deter the filing of time-consuming and costly lawsuits that have little merit or are filed with malicious intent. The resulting reduction in litigation risk should make resource development companies more comfortable in proceeding with exploration and development projects in Alaska.

Oil and Gas Royalty Changes

In addition to the foregoing regulatory and litigation-related changes, the legislature modified the state's oil and gas royalty scheme to offer incentives in the form of natural gas exploration and development tax credits. *See* House Bills 28, 57, 61, and 246, and Senate Bill 185.

House Bill 61 establishes an exploration and development incentive tax credit for operators and working interest owners directly engaged in the exploration for and development of natural gas for sale and delivery from a lease or property in Alaska, without reference to volume. The gas exploration and development tax credit was created by amending the Alaska Net Income Tax Act, codified at Alaska Stat. § 43.20. Specifically, Alaska Stat. § 43.20.043 was added to allow a taxpayer that is an operator or working interest owner directly engaging in the exploration for and development of gas to apply as a credit against its state tax liability 10% of the taxpayer's qualified capital investment and 10% of the annual cost incurred by the taxpayer for qualified services in the state during each tax year for which the credit is allowable.

The new law requires the Alaska Department of Revenue to produce a report no later than November 30, 2008, detailing the effect of the tax credit by showing the number of successful new gas discoveries for which the tax credit was provided, the volume or amount of new gas reserves brought into production, the total credits that were applied to the tax liability, the amount of royalties and oil and gas property production taxes paid from new gas production, anticipated gas production for which credits were allowed under Alaska Stat. § 43.20.043, and any other information that may help evaluate the effectiveness of the exploration tax credit program as an incentive to explore for and produce new gas reserves.

House Bills 28, 57, and 246 and Senate Bill 185 overhaul the current oil and gas royalty system. These bills allow for: (1) adjustments to royalties reserved to the state to encourage otherwise uneconomic production of oil and gas, (2) audits of oil and gas royalties, (3) a reduction of royalties on certain oil produced from Cook Inlet submerged lands, and (4) a credit for certain exploration expenses against oil and gas property production taxes on oil and gas produced from a lease or property in the state.

Support for Oil and Gas Development in the Coastal Plain of ANWR

The Legislature adopted a Resolution urging the U.S. Congress to pass legislation opening the Coastal Plain of the Arctic National Wildlife Refuge (ANWR) to oil and gas exploration, development, and production. S. J. Res. 4. The Resolution notes that the 1.5 million-acre Coastal Plain makes up only 8% of the 19 million-acre refuge, and that development of the oil and gas reserves within the refuge's Coastal Plain would affect an area of only 2,000 to 7,000 acres (less than 1/2 of 1% of the total area of the Coastal Plain).

The Resolution stresses that the Alaska State Legislature "opposes any unilateral reduction in royalty revenue from exploration and development of the coastal plain of the Arctic National Wildlife Refuge, Alaska, and any attempt to coerce the State of Alaska into accepting less than the 90 percent of the oil, gas, and mineral royalties from the federal land in Alaska that was promised to the state at statehood." *Id.* at 3. Although this Resolution was

passed by the Alaska Legislature and has been signed by Governor Frank Murkowski, efforts to persuade the U.S. Congress to open the Coastal Plain of ANWR to oil and gas development have thus far been unsuccessful.

The authorization of new oil and gas royalty and gas exploration and development tax credits and the new regulatory changes should make Alaska a more attractive place for companies to explore for and develop oil and gas. In combination with the changes that affect the litigation climate in Alaska, these statutory revisions signal a fundamental shift by the State of Alaska, toward supporting, and indeed encouraging development of the state's abundant natural resources.

ARKANSAS -- OIL & GAS

Thomas A. Daily, Reporter

Recent Arkansas Legislation Mandates Standardized Forms

The 2003 Arkansas General Assembly enacted Act No. 757 which requires all documents affecting title to real property except surveys and plats to be in a standardized format. In order to be recordable, such documents, including oil and gas leases and assignments must:

be on 8½" by 11" paper; have a 2½" margin at the right top of the first page, a ½" margin on the sides and bottom of all pages, and a 2½" margin at the bottom of the last page; have an area reserved on the top right of the first page for the file mark of the recorder; contain the following information: title of document; and name of grantor and grantee, where applicable; be acknowledged ...; and be legible.

The Act applies to all such documents executed on or after January 1, 2004.

CALIFORNIA -- OIL & GAS

Kevin L. Shaw, Reporter

Proposed Joint Regulations for Offshore Oil and Gas Drilling and Production Facilities

New joint regulations have been proposed (the Proposal) for the State Lands Commission (SLC) and Division of Oil, Gas and Geothermal Resources (DOG) governing offshore oil and gas drilling and production facilities. The proposed regulations are online at http://www.slc.ca.gov/regulations/regulations_default.htm. The Proposal would create new regulations under Cal. Code Regs. tit. 14., div. 2.4.6 and Cal. Pub. Res. Code §§ 3000-4000, 6000-7000, both of which concern offshore oil and gas drilling and production.

The Proposal has been in the works for about 10 years. The purpose of the Proposal is to combine and clarify overlapping codes from the DOG and the SLC for oil and gas development on certain state lands. To promote efficiency and consistency, the SLC is working to incorporate the two sets of regulations. In effect, the Proposal allocates the legislative and review obligations in the following general manner: the DOG will address the formulation of and compliance with regulations concerning wells, and the SLC will address the formulation of and compliance with regulations concerning production facilities.

Prior to final adoption the Proposal must pass through many state agency reviews. Then, if the Proposal is adopted, DOG and SLC will participate to implement it so that operators need only refer to and comply with one set of regulations on a particular topic. If adopted, the Proposal will probably replace Cal. Code Regs. tit. 14., div. 2.4.1.1 and create new regulations under Cal. Code Regs. tit. 14., div. 2.4.6.

Certification Program for Distributed Generation

The Air Resources Board has promulgated regulations implementing a separate certification program for distributed generation facilities. Cal. Code Regs. tit. 17, §§ 94200-94214. "Distributed Generation" is electrical generation near the place of use. New electrical generation units, which may be used in the operation of various oil and gas facilities, as well as more generally in industrial and commercial settings, are subject to these new emissions standards.

New Resources Available to Practitioners

"Urban Development of Oil Fields in the Los Angeles Basin Area." This report, on the website for the Division of Oil, Gas and Geothermal Resources (DOG), explains DOG's construction site review program and describes the building and safety procedures needed for urban development of oilfield properties. The report can be downloaded from <ftp://ftp.consrv.ca.gov/pub/oil/publications/tr52.pdf>.

"Drilling and Operating Oil and Gas Wells in California." This publication, which summarizes DOG requirements and procedures (written for a new operator), is posted on the DOG website at <ftp://ftp.consrv.ca.gov/pub/oil/publications/pr6s.pdf>.

Access to Well Records. Current information on how and where to obtain access to, and types of DOG well records open to the public is on the DOG website at ftp://ftp.consrv.ca.gov/pub/oil/Access_to_Records.pdf.

Status of Offshore Oil and Gas Leases. A report to the State Lands Commission on the status of offshore oil and gas leases, including information on individual leases, is available at www.slc.ca.gov/Reports/Offshore_Oil_and_Gas.htm.

Application Forms. Application forms and related documents for state leases are online at www.slc.ca.gov/Division_Pages/MRM/Applications.htm.

Legislative Developments

Streamlined Process for Acquiring Gas Pipeline Easements from Utilities. 2001 Assembly Bill 1234, codified in a new chapter of the Cal. Pub. Util. Code §§ 3250, *et seq.*, permits a gas producer to acquire gas pipeline easements from public utilities for the purpose of accommodating the producer's gas plant. The new statute is an indirect consequence of the effects of deregulation of public utilities.

Community Property with Right of Survivorship. 2000 Assembly Bill 2913, which added Cal. Civ. Code § 682.1, modifies California community property law to provide that the community property, when expressly declared in the conveyance or other transfer document to be the "community property with right of survivorship" of the husband and wife, may transfer to the surviving spouse automatically on the death of the other spouse without probate. The statute was said to have been enacted to reverse the unfavorable federal tax treatment of certain California property interests held by husbands and wives in joint tenancy.

Reconveyances of Deeds of Trust; Trustee's Sales under Deeds of Trust. 2001 Assembly Bill 1090, which amended Cal. Civ. Code §§ 2941, 2943, changes certain features of the timing and permissible fees that may be charged by lenders with respect to deeds of trust on California lands, including deeds of trust encumbering oil and gas properties. In addition, 2002 Senate Bill 1504, which amended Cal. Civ. Code §§ 2924b, 2941, and Cal. Prob. Code § 5501, deals with the failure of the trustee under a deed of trust to give notice to the IRS when a notice of federal tax lien has been recorded, and makes other technical revisions with respect to the address to which a deed of trust reconveyance is to be mailed by the county recorder following recordation.

Drilling Contractor Entitled to Payment Under Daywork Provisions

In *Gary Drilling Co. v. Onesta Corp.*, No. F038807, 2003 WL 178867 (Cal. Ct. App. 5th Dist., Jan. 27, 2003), the California Court of Appeal held that the drilling contractor was entitled to payment under the "daywork" provisions of an International Association of Drilling Contractors (IADC) form of turnkey drilling contract. The contract provided that the contractor was to be paid the turnkey price if the well reached 6,000 feet, and also contained provisions to the effect that work not covered by the turnkey provisions was to be performed on a daywork basis. The operator decided to log the well prior to reaching total depth and running casing, and thereafter the hole was lost. The operator argued that since the contractor failed to drill a well to the contract depth, it owed the contractor nothing.

After a 10-day trial in Los Angeles County, an appeal on certain issues and a second trial in Kern County, the drilling contractor prevailed and that outcome was upheld in the second appeal. The case featured claims that the IADC form, as modified by the parties, was unconscionable (rejected by the court), and that a standard contract provision limiting the recovery of consequential damages was unenforceable under Cal. Civ. Code § 1668 to the extent it attempted to immunize a party from its own fraud or willful injury to the property of another or violation of the law (seemingly accepted by the court).

Structure of Coastal Commission Held to be Unlawful

In *Marine Forests Society v. California Coastal Commission*, 104 Cal. App. 4th 1232, 128 Cal. Rptr. 2d 869 (2002), *as modified on denial of reh'g*, 2003 Cal. App. LEXIS 93 (Jan. 23, 2003), *cert. granted*, 132 Cal. Rptr. 2d 527, 65 P.3d 1285 (Cal. 2003), the California Court of Appeal held that since a majority of the Coastal Commission's members are effectively appointed by and answerable to the legislature, the commission is a legislative agency and not subject to the control of the executive branch. The statutory scheme was found to violate the separation of powers doctrine. The court then enjoined the commission from exercising executive powers, but stayed enforcement of that order pending further review of the constitutional issues. Subsequent to the decision, bills were introduced in the legislature to address the structural issue. Since the initial decision, the court of appeals has denied a rehearing

and modified its original opinion); however, the California Supreme Court has granted review of the case and ordered that the original decision be depublished.

Tax Valuation -- Elk Hills

The valuation of oil producing properties for property tax purposes was addressed in *Maples v. Kern County Assessment Appeals Board*, 103 Cal. App. 4th 172, 126 Cal. Rptr. 2d 585 (2002), *cert. denied*, 2003 Cal. LEXIS 248 (Jan. 15, 2003). Occidental acquired the giant Elk Hills Oil Field in 1998 for an adjusted price of \$3.53 billion. When the Kern County Assessor valued the property at the full sales price, Occidental successfully appealed the assessment to the County Assessment Appeals Board on the ground that its purchase of the field was through a sealed bid process, and Occidental's bid included the value of *unproved* reserves. Since producing properties are typically valued for property tax purposes on an estimate of the *proved*, not *unproved*, reserves (see Cal. Code Regs. tit. 18, § 468), the price did not reflect fair market value for assessment purposes.

Although the superior court agreed with that decision, the court of appeals reversed, holding that the sales price, including the *unproved* reserves component, was presumed to be the fair market value under Cal. Rev. & Tax. Code § 110(b), and that Occidental's evidence of the value of the proved reserves was insufficient to overcome that presumption. Accordingly, the court held that the assessor was correct in assessing taxes on the full \$3.53 billion purchase price. The California Supreme Court subsequently denied Occidental's petition for review of the decision.

Pipeline Safety

People ex rel. Sneddon v. Torch Energy Services, Inc., 102 Cal. App. 4th 181, 125 Cal. Rptr. 2d 365 (2002), arose from the failure of Torch to comply with pipeline safety conditions imposed by Santa Barbara County on a use permit granted to Torch's predecessor-in-interest for pipelines and other onshore facilities to support the operation of Platform Irene in the Outer Continental Shelf (OCS) offshore Santa Barbara. The county sued Torch for fines and penalties for its breach of the pipeline safety conditions contained in its permit and to compel compliance with such conditions. Torch, however, claimed that the area of oil pipeline safety regulations had been preempted by the Federal Pipeline Safety Act of 1979, 49 U.S.C. §§ 60101-60125 (PSA).

The court of appeals agreed with Torch and held that Congress, with the enactment of the PSA, had expressly preempted the field of oil pipeline safety regulation. The court, however, also held that because Torch accepted the benefit of the county's permit, it was judicially estopped from asserting the defense of preemption. Accordingly, Torch was precluded from both accepting the benefit of the permit and challenging the conditions contained in it.

Insurance Coverage

In *Bechtel Petroleum Operations, Inc. v. Continental Insurance Co.*, 96 Cal. App. 4th 571, 117 Cal. Rptr. 2d 399, *cert. granted*, 120 Cal. Rptr. 2d 431, 47 P.3d 224 (2002), the court of appeals held that an operator was not covered under its general liability policies for toxic tort claims made by oilfield workers due to the absolute pollution exclusion in those policies. However, the California Supreme Court has granted review of the case.

Offshore Leasing

Although new offshore California leasing has been effectively stopped, the state and federal moratorium has not been applied to pre-existing leases. *California ex rel. California Coastal Commission v. Norton*, 311 F.3d 1162 (9th Cir. 2002), concerned the Minerals Management Service's (MMS) grant of suspensions of the primary term of existing but undeveloped outercontinental shelf (OCS) oil and gas leases off the coast of California. The Ninth Circuit held that the MMS's approval of the lease suspensions was subject to consistency review by the State of California under the Federal Coastal Zone Management Act, 16 U.S.C. §§ 1451-1465, for a determination of whether the leases are consistent with policies enacted in counties regarding oil transportation. Further, the court held that the MMS was required to explain why the lease suspensions did not fall within one of the exceptions to the categorical exemption under the National Environmental Policy Act, 42 U.S.C. §§ 4321-4370f, where there is substantial evidence that an exception may apply.

Reporter's Note: The reports on the final four cases are taken from the California State Bar's *Oil & Gas Law Newsletter*. Thanks to Julie Carter, John Harris, and Jack Quirk for their work on these summaries.

MISSISSIPPI -- OIL & GAS

W. Eric West, Reporter

Waiver of Right to Arbitrate

The decision here reported should be of interest, if not concern, to anyone taking comfort in an arbitration provision in a contract even though the case does not involve mineral law. In *Sanderson Farms, Inc. v. Gatlin*, 848 So.2d 828 (Miss. 2003), the Mississippi Supreme Court, in a 6-3 decision, held that Sanderson breached an arbitration provision and, therefore, waived its right to arbitration because Sanderson failed to pay a part of the initial administrative fee in an arbitration demand initiated by Gatlin under American Arbitration Association (AAA) rules.

When Gatlin tendered one-half of the initial filing fee, he was advised by AAA that he was responsible for the entire fee, which he then paid. More than a year went by as Sanderson and Gatlin submitted documents in preparation for the hearing. As the time for the hearing approached, AAA billed Gatlin \$8,250 as an estimate of his share of the cost of the hearing. Gatlin claimed he did not have the money to pay the charges, abandoned the arbitration, and for a filing fee of \$94 filed suit in a Mississippi trial court seeking, among other relief, nullification of the arbitration provision and other provisions relating to the limitation of damages. The event that triggered this suit was Sanderson's cancellation of Gatlin's (chicken) Broiler Production Contract upon discovery that Gatlin had dumped nearly 200 chickens in a thicket on his property in violation of Mississippi Board of Animal Health regulations. The majority opinion stated that under the Broiler Production Agreement, contrary to the interpretation by Sanderson and the AAA, Sanderson was obligated to pay one-half of the initial filing fee so that Sanderson breached the arbitration provision by failing to pay its share of the fee and, thereby, waived the right to arbitration.

The minority's position was that, under the Federal Arbitration Act, 9 U.S.C. §§ 1-14, decisions under that Act, and Mississippi decisions, when the enforceability of an arbitration agreement is at issue, a court should first determine (1) whether an arbitration agreement exists and (2) whether the specific dispute falls within the scope of what the parties agreed to arbitrate. If the court finds affirmatively on these questions, the dispute *must* be referred to arbitration, which in this case would have included the issue of whether the initial filing fee should be shared or borne by the party demanding arbitration. The implication of this case is that any breach (or failure to agree with an opposite party's interpretation of an arbitration provision) may result in the waiver of the right to have the dispute decided by an arbitrator and the consequent resolution of the dispute by a jury of the opposite party's peers.

NORM Case Report Update

The decision in *Chevron U.S.A., Inc. v. Smith*, reported on in Vol. XX, No. 2 (2003) of this *Newsletter*, has now been released for publication and is reported at 844 So.2d 1145 (2003).

Copies of the cases summarized above are also available at www.mssc.state.ms.us.

NEW MEXICO -- OIL & GAS

John S. Nelson, Reporter

Oil and Gas Proceeds Withholding Tax Act

The 46th Legislature of the State of New Mexico enacted the Oil and Gas Proceeds Withholding Tax Act, 2003 N.M. Laws ch. 86, §§ 4-12 (the Act). The Act takes effect on October 1, 2003, and is to be codified at N.M. Stat. Ann. §§ 7-3A-1 to 7-3A-9.

Under the Act, a person or entity that pays proceeds derived from crude oil, natural gas, liquid hydrocarbons, or carbon dioxide produced from any well located in New Mexico to the person or entity entitled to such proceeds (payee) must first deduct and withhold a percentage of the amount of such proceeds that otherwise would have been payable to the payee. For the period of time from October 1, 2003, to December 31, 2004, the percentage is 6.75% of such proceeds. Thereafter, the percentage is to be determined by regulation of the New Mexico Taxation and Revenue Department. The withheld amount is to be remitted to the Department periodically, and is credited against the amount of any state income tax owed by the payee. The withholding requirement applies to royalty interests, overriding royalty interests, production payments, working interests, and any other interest expressed as a right to a specified interest in the cash proceeds received from the sale of, or the cash value of, oil and gas production. The withholding requirement does not apply to net profits interests and other types of interests that cannot be quantified by reference to a specified share of oil and gas production.

Interestingly, the Act provides an exemption from the withholding requirement for payments made to a payee with a New Mexico address as shown on a U.S. Internal Revenue Service Form 1099-Misc. While this writer has not explored the constitutional implications of this exemption (if any) such as possible challenges based upon the

commerce clause or lack of equal protection, on the surface it would seem to be a potentially fertile ground for litigation.

The Act also exempts from the withholding requirement payments to (1) the United States or the State of New Mexico or any agency, instrumentality or political subdivision of either; (2) any federally-recognized Indian nation, tribe, or pueblo, or any agency, instrumentality, or political subdivision thereof; and (3) organizations that have been granted an exemption from federal income tax under 26 U.S.C. § 501(c)(3).

OKLAHOMA -- OIL & GAS

James C.T. Hardwick, Reporter

Tort Claim Allowed as Answer to Petition Under Surface Damages Act

In *Ward Petroleum Corp. v. Stewart*, 64 P.3d 1113 (Okla. 2003), Ward, the oil and gas operator, sought to drill a well on the Stewarts' property. When negotiations for surface damages failed, Ward initiated proceedings under the Surface Damages Act, Okla. Stat. tit. 52, §§ 318.2-318.9, seeking the appointment of appraisers to determine the amount of surface damages as the result of Ward's operations. Under the Act, once appraisers are appointed the operator has the right to enter. Appraisers were appointed and returned a report of \$8,600 as diminution in value of the surface estate. The landowners filed a demand for jury trial and thereafter sought to amend their answer to add a separate tort claim for pollution, apparently on a nuisance theory. Ward objected on the ground that the Act requires a separate civil action for such a claim. However, the trial court permitted the filing as a related tort claim. The Oklahoma Supreme Court affirmed.

The court noted that the Surface Damages Act limits damages recoverable to those a surface owner sustains or will sustain by reason of drilling and maintenance of oil and gas production on the land, and the damage standard is the resulting diminution in the fair market value of the surface. Because the Act requires application of railroad condemnation procedures, the court looked to condemnation law for guidance. The court noted that condemnations are special statutory proceedings that are distinguished from other civil actions in pleading, practice, and procedure. The statutory procedural requirements are mandatory. The court noted that the Act contains no provision authorizing an answer or counterclaim. After noting its prior conflicting decisions, the court concluded that for judicial convenience and efficiency, a related tort claim could be filed in the same case as a case under the Surface Damages Act. However, the court warned that the trial court must assure that the proceeding under the Act and the related tort claim are maintained on two distinct procedural tracks, one governed by the Surface Damages Act, and the other governed by the Oklahoma Pleading Code, and that these two tracks must remain distinct throughout the entire case, including the trial. Further, the case under the Act should be tried separately from the related tort claim so that the resolution of the tort claim never impedes the primary goal of the Act of providing prompt compensation to the surface owner.

Three justices dissented urging that a proceeding under the Surface Damages Act and a claim for nuisance were incompatible and required separate trials, and that the majority failed to appreciate that a nuisance claim raises additional issues such as causation, liability, and the applicable statute of limitations.

Overproduced Party's Sale of Interest Does Not Trigger Immediate Gas Balancing

In *Unit Petroleum Co. v. Mobil Exploration & Production North America, Inc.* (Okla. Civ. App. Mar. 11, 2003), Mobil and Unit were working interest owners in the USA Spaid Well with Unit owing a 6.3% interest and with Mobil owning a 52.9% interest. The well was governed by a 1956 Model Form Operating Agreement with no gas balancing provisions. In February 1997, Mobil sold its interest to Amoco which, in November 1997, sold its interest to Gothic. At the time of its sale to Amoco, Mobil was overproduced by at least 158,101 mcf, and Unit was underproduced by at least 50,425 mcf. In November 1997, Unit made demand upon both Mobil and Amoco for immediate cash balancing. This was refused. However, in March 1998, Gothic permitted Unit to begin balancing in-kind. The well had sufficient reserves for Unit to eventually balance in-kind. In February 1999, Unit sued Mobil, alleging that it had the right to immediate cash balancing. Amoco intervened, and Gothic was brought in as a third-party defendant.

Mobil and Amoco asserted that Gothic had assumed all liability for gas imbalances. Unit argued that the operating agreement created a cotenancy in production and that under *Harrell v. Samson Resources Co.*, 980 P.2d 99 (Okla. 1998), cash balancing became mandatory upon Mobil's sale as a consequence of the termination of Mobil's cotenant relationship with Unit. The trial court refused to order cash balancing, finding that neither Mobil's sale nor the equities required immediate cash balancing.

The court of civil appeals said that although balancing in-kind is customary and preferred, the balancing of equities determines the appropriate method to balance. The court found distinctions between *Harrell* and the current case, and concluded that the mere fact of a sale of an overproduced party's interest is not the sole determinant of the right to balance. Instead, Unit's right to immediate cash balancing depends upon whether Mobil's sale of its interest resulted in the derogation of Unit's rights as a cotenant in production and the beneficiary of the trust relationship between cotenants. This could not be determined without first deciding whether Mobil repudiated its trust relationship with Unit, triggering the running of the statute of limitations. Even though the well may have sufficient reserves to balance in-kind, custom and usage in the industry would not be permitted to defeat a cotenant's right to an accounting from a former cotenant by precluding suit for a period that may extend beyond the limitations period. Although Mobil's sale of its interest did not automatically mandate cash balancing, the court said if, as a part of its sale, Mobil had denied further liability for the overproduction or otherwise repudiated its trust, Unit may obtain pre-depletion cash balancing. In such case, it would be entitled to cash balancing, regardless of whether the well had sufficient reserves to balance in-kind since Mobil will have relinquished any control over Unit's ability to balance in-kind. In balancing the equities, the trial court concluded that the statute of limitations had not yet started to run on Unit's claim, and thus, a derogation of Unit's rights had not occurred. However, because the record did not reveal whether Mobil had denied the continuation of a trust relationship with Unit by denying future liability to Unit for Mobil's overproduction, summary judgment was improper. The court of civil appeals reversed and remanded for further proceedings accordingly.

No Rescission for Moving Well Locations

In *Palace Exploration Co. v. Petroleum Development Co.*, 316 F.3d 1110 (10th Cir. 2003), Palace entered into a letter agreement with Petroleum Development Co. (PDC) for the drilling of the Rairdon Well. PDC had furnished Palace information on nearby wells, including maps showing the location of the Rairdon Well site and an authorization for expenditure (AFE) estimating well costs at \$280,000. The drilling plan called for the well to be drilled "on air," which would be considerably less expensive than drilling with mud. Subsequently, the parties signed an exploration agreement and an operating agreement. The operating agreement provided that PDC, as operator, would have no liability to other parties for losses sustained or liabilities incurred except those resulting from gross negligence or willful misconduct. After execution of the documents, PDC determined its initial geological information depicted on one of the maps furnished Palace was inaccurate and, as a result, PDC shifted the well location 1,600 feet to maximize chances of hitting the target sand. However, PDC did not notify Palace of the relocation. The exploration agreement provided the well would be drilled in the NW/4 of Section 8, and the operating agreement provided the well would be drilled at "a legal location in the W/2 of Section 8." *Id.* at 1114. Neither agreement stipulated a more precise location.

During drilling, PDC encountered a water zone requiring the abandonment of air drilling and, instead, PDC was required to "mud up." Palace declined to participate in completion of the well. Palace's total costs in the well were \$378,057.93. Palace sued PDC alleging fraud and failure of consideration, claiming PDC knowingly made false representations in relation to its \$280,000 AFE, and sought rescission of the exploration agreement and operating agreement and restitution of the monies paid under the agreements. Shortly before trial, Palace sought to amend the pretrial order to add a claim for breach of contract and damages based on gross negligence, a law action rather than one in equity. The trial court refused the amendment and required the case to be tried to an advisory jury. The jury returned a verdict for PDC, which the court adopted.

Much of the appellate court's opinion deals with whether the amendment should have been permitted and the case submitted to the jury for legal damages based upon Palace's breach of contract claim. The court of appeals found that the amendment should have been allowed and that Palace was deprived of its right to jury trial and due process rights. It remanded the case accordingly. However, of greater interest at this point was Palace's assertion that the trial court erred by denying Palace's motion for summary judgment as a matter of law. This focused upon Palace's assertion that the letter agreement between Palace and PDC established a fiduciary relationship, that PDC therefore had the duty to inform Palace of a change in well location, that PDC committed constructive fraud by failing to disclose the change in the well location, and thus Palace should be allowed to rescind its agreements with PDC. The court of appeals sidestepped the nature of PDC's duty to Palace and focused on whether there was any misrepresentation. The court noted the advisory jury found in favor of PDC on both the well location issue and the AFE calculation issue in connection with the issues submitted to it, and that the jury had heard the testimony of an oil and gas consultant who testified that an indicated well location on maps such as submitted to Palace were "usually sort of very tentative," and that "in the final phase of fine-tuning a location, locations are almost always changed at the last minute and usually the non-operator is not notified." *Id.* at 1121. Further, the consultant testified

the move was prompted by the desire to get the drilling closer to the target sand. Based thereon, the court of appeals found the jury's conclusion was reasonable.

TEXAS -- OIL & GAS

William B. Burford, Reporter

Seismic Data Held Trade Secrets Protectable from Discovery; Mineral Owner Owes No Development Duty to Nonparticipating Royalty Owner

In *In re Bass*, 46 Tex. Sup. Ct. J. 988, No. 02-0071, 2002 WL 32126139 (July 3, 2003), the Texas Supreme Court held that the trial court had abused its discretion in allowing the plaintiff non-participating royalty owners discovery of geological seismic data possessed by the defendant mineral owner, in a suit asserting the mineral owner's breach of an implied duty to develop the land. The mineral owner, Bass, resisted on the ground that the seismic data constituted a trade secret.

The Texas Rules of Evidence protect trade secrets from discovery, noted the court, if allowance of the privilege will not tend to conceal fraud or otherwise work injustice. Tex. R. Civ. Ev. 507. Under *In re Continental General Tire, Inc.* 979 S.W.2d 609 (Tex. 1998), a party asserting the trade secret privilege has the burden of proving that the discovery information qualifies as a trade secret. The burden then shifts to the party seeking trade secret discovery to establish that the information is necessary for a fair adjudication of its claim. The questions before the court were, therefore: (1) whether the mineral estate owner proved that its seismic data were trade secrets, and (2) if so, whether the non-participating royalty owners established that discovery of the trade secret information was necessary to a fair adjudication of their claim for breach of an implied duty.

Not surprisingly, the court held Bass had met his burden of establishing the seismic information was a trade secret. A trade secret, the court noted, is any formula, pattern, device, or compilation of information which is used in one's business and presents an opportunity to obtain an advantage over competitors who do not know or use it. In determining whether a trade secret exists, Texas courts apply the *Restatement (First) of Torts'* six-factor test: (1) the extent to which the information is known outside of the holder's business; (2) the extent to which it is known by employees and others involved in his business; (3) the extent of the measures taken by him to guard the secrecy of the information; (4) the value of the information to him and his competitors; (5) the amount of effort or money expended by him in developing the information; and (6) the ease or difficulty with which the information could be properly acquired or duplicated by others. *Restatement (First) of Torts* § 757 cmt. B (1939). In keeping with the position taken in the more recent *Restatement (Third) of Unfair Competition* § 39 cmt. d, that it is not possible to state precise criteria for determining the existence of a trade secret, and with treatment of the issue by a majority of other jurisdictions, however, a party claiming a trade secret should not be required to satisfy all six factors, because trade secrets do not fit neatly into each factor every time. Other circumstances could also be relevant to the trade secret analysis.

It is undisputed, the court observed, that the oil and gas industry typically treats seismic data and other methods for obtaining subsurface geological information as trade secrets, and other jurisdictions have held seismic data entitled to trade secret protection. Applying the *Restatement's* six-factor test to determine whether Bass's data constituted trade secrets under the circumstances, the court found that Bass had presented substantial evidence that nearly all the factors weighed in Bass's favor. Given that geological seismic data is given industry-wide trade secret protection in the oil and gas trade, that other jurisdictions have adopted the industry's position and deemed this data trade secrets, and that under the six factors the record demonstrated that the evidence weighed in favor of trade secret protection, the court held that seismic data and its interpretations are trade secrets protected by the Rules of Evidence.

Turning to the question of whether trade secret discovery was necessary here for a fair adjudication, the court noted that necessity depends on whether the trade secret's production is material and necessary to the litigation. For trade secret production to be material to a litigated claim or defense, a claim or defense must first exist. The court therefore addressed whether Bass in fact had a duty to develop as the plaintiffs alleged.

According to the plaintiffs, Bass breached a fiduciary duty to them to develop Bass's land, arising from the relationship between the mineral estate owner, Bass, and the royalty owners. A duty to develop, however, arises not from a fiduciary relationship, said the court, but from the implied covenant doctrine of contract law in which courts read a duty to develop into an oil and gas lease when necessary to effect the parties' intent. Conversely, a fiduciary duty arises out of agency law based on a special relationship between two parties. The plaintiffs' argument confused a fiduciary duty with a duty to develop -- two distinct duties developed under different legal theories. The court therefore addressed separately whether Bass owed the royalty owners either a duty to develop or a fiduciary duty.

Implied covenants are not favored by law and will not be read into contracts except as legally necessary to effectuate the plain, clear, unmistakable intent of the parties. It is not enough that an implied covenant is necessary in order to make a contract fair; it must arise from the presumed intention of the parties as gathered from the instrument as a whole. From these propositions oil and gas jurisprudence recognizes an implied covenant to develop in oil and gas leases after discovery of oil or gas in paying quantities. No oil and gas lease existed here, though. Bass instead held under a general warranty deed, with nothing in the record to indicate it was anything other than a typical real estate transaction involving conveyance of a fee simple title. An implied covenant to develop has never been read into general warranty deeds in Texas, and the court saw no reason to do so, as it would potentially place many Texas landowners in a position of owing a duty to remote royalty owners that would burden fee simple estates in a manner contrary to traditional property law.

The plaintiffs relied on *Manges v. Guerra*, 673 S.W.2d 180, 183 (Tex. 1984), and *Schlittler v. Smith*, 129 Tex. 628, 101 S.W.2d 543, 545 (1937), for the proposition that a mineral estate owner owes a nonparticipating royalty owner a fiduciary duty or duty of good faith and fair dealing to develop the mineral estate. *Schlittler v. Smith*, the court pointed out, involved a very narrow duty in which the executive mineral owner, when executing a lease, owes a duty of utmost fair dealing to protect the amount of the royalty. Here Bass had not executed a lease and, in any event, the amount of the plaintiffs' royalty was fixed by the terms of their deed so that the *Schlittler v. Smith* duty would have no application.

The *Manges* court did indeed hold that a fiduciary duty arose between the holder of executive rights and the owner of a 50% mineral interest, nonparticipating in leasing rights. This duty, the court held, required the holder of the executive rights to secure for the non-executive every benefit he exacts for himself. *Manges* had therefore breached his fiduciary duty by leasing to himself under numerous unfair terms. The nonparticipating royalty owners here correctly stated that Bass owed them a duty to acquire for them every benefit he would acquire for himself. There was no evidence of self-dealing by Bass, however. Because Bass had not acquired any benefit for himself by executing a lease, no duty had been breached.

Because the record both failed to demonstrate the existence of an oil and gas lease that would create an implied duty to develop and failed to show Bass breached his duty as the executive, the court held, the trial court abused its discretion in compelling trade secret production.

Texas Supreme Court Reverses Certification of Royalty-owner Class Including Both Proceeds and Market-Value Lessors

In a widely expected decision, the Texas Supreme Court, in *Union Pacific Resources Group, Inc. v. Hankins*, 46 Tex. Sup. Ct. J. 973, 111 S.W.3d 69 (Tex. 2003), unanimously reversed a trial court's class certification, upheld by the El Paso court of appeals, for a class consisting of gas royalty owners in Crockett County who claimed that Union Pacific breached an implied duty to obtain the best price reasonably obtainable on sale of its gas. As thus defined, the class included royalty owners under both leases providing for royalty payment based on the proceeds received by the lessee and leases providing for royalty to be calculated on the market value of gas sold.

The royalty owners alleged that Union Pacific sold the gas to affiliated companies at below-market index prices and calculated royalty based on those prices, and that the affiliated purchasers then sold to third parties at prices that Union Pacific should have obtained in the first instance. Payment of royalty based on the index prices was, according to the plaintiffs, a breach of Union Pacific's implied covenant to reasonably market the gas and to obtain the best current price reasonably obtainable. Union Pacific objected to class certification on the basis that it had no such duty to lessors whose leases based payment on the current market price for gas, as royalty under those leases is based on fair market value regardless of the price the lessee actually obtains for the gas.

The supreme court agreed with Union Pacific. Even though the price on which royalty is calculated under a market-value lease may be similar to an appropriate sale price under a proceeds lease, they are independent of each other and subject to different methods of evaluation. Market value is generally determined by comparing the sale price to other sales comparable in time, quality, quantity, and availability of marketing outlets. The implied covenant to market applicable to lessees under leases providing for royalty payment based on proceeds, by contrast, focuses on the lessee's behavior rather than on evidence of other sales and asks whether the lessee acted as a reasonably prudent operator under the same or similar facts and circumstances. As the court held in *Yzaguirre v. KCS Resources, Inc.*, 53 S.W.3d 368, 372 (Tex. 2001), market value may be wholly unrelated to the price the lessee receives as proceeds under a sale contract. *Yzaguirre* further held that while a lessee under a proceeds lease has an obligation to obtain the best current price reasonably available, that obligation does not extend to market-value leases, thus confirming Union Pacific's argument that those royalty owners within the class with market-value leases had no cause of action for breach of an implied covenant to reasonably market oil and gas.

Yzaguirre must be taken into account, declared the court, in determining whether a purported royalty-owner class meets such certification questions as commonality; i.e., that there are questions of law or fact common to the class. Although the threshold for commonality is not high, it does require at least one issue of law or fact that inheres in the complaints of all class members and that is subject to generalized proof. Here, however, no issue identified by the trial court met that standard. All of the issues instead asked whether Union Pacific had breached the implied covenant to market by failing to obtain arms' length prices or whether it had engaged in a sham transaction by charging its affiliates a preferential price. Union Pacific's inter-affiliate transactions did not determine the amounts it owed under a market-value lease. Sales to an affiliate at artificially low prices or subject to inordinate marketing fees might reduce the proceeds Union Pacific purported to receive but would not reduce the price it was obligated to pay lessors under market-value royalty leases. Because the royalty owners' complaints all depended on Union Pacific's failure to obtain the best available price, there could be no questions common to a class whose members included lessors under both proceeds and market-value leases.

The royalty owners argued, and the court of appeals had agreed, that the distinction between market-value and proceeds leases was immaterial in this instance, because market value was here equivalent to the best price reasonably obtainable and both were equal to the prices Union Pacific affiliates received on resale of the gas to third parties. Whether these prices are in fact equal is a matter to be proven, the court said. The question before it was merely whether such unity of value can be established through common proof, and the court held that it could not.

Temporary Injunction Enforcing Removal of Operator Upheld

In *Tri-Star Petroleum Co. v. Tipperary Corp.*, 101 S.W.3d 583 (Tex. App. 2003, pet. denied), the court of appeals affirmed the trial court's temporary injunction prohibiting Tri-Star, the designated operator of a gas project in Australia, from interfering with Tipperary's assumption of operatorship pursuant to a majority vote of the non-operators under the applicable joint operating agreement.

After protracted disputes over the conduct of operations and billings, Tipperary had filed suit against Tri-Star seeking damages for its alleged mismanagement of the project and a declaration that Tri-Star had breached the operating agreement and that good cause existed for its removal as operator. During the pendency of the suit the nonoperators affirmatively voted to remove Tri-Star as operator and replace it with Tipperary. The vote was taken pursuant to the provision, typical to most operating agreements, that the operator may be removed by the affirmative vote of two or more nonoperators owning a majority in interest if it fails or refuses to carry out its duties. When Tri-Star refused to relinquish operations, Tipperary applied for a temporary injunction to enforce the removal. The trial court granted the temporary injunction, finding that Tipperary was the current lawful operator and that it had established a probable right of recovery, probable injury in the interim, and no adequate remedy at law.

The only issue before the trial court at a temporary injunction hearing, the court of appeals noted, is whether the applicant is entitled to the status quo pending a trial on the merits. The status quo is defined as the last actual, peaceable noncontested status that preceded the controversy. The last peaceable noncontested status was that of Tri-Star as operator, Tri-Star urged, prior to commencement of the suit. The subsequent vote for its removal could therefore not have established the status quo. The court of appeals held, to the contrary, that the trial court could have rationally determined that the last peaceable, noncontested status between the parties was after the filing of the underlying suit but prior to Tipperary's application for the injunction and consisted in the nonoperators' ability to follow the operator removal provision of the operating agreement. There was evidence, the court further held, to support the trial court's finding of Tipperary's probable right to recovery. The nonoperators had determined that they had cause to remove Tri-Star, and the trial court was only required in a temporary injunction hearing to find that Tipperary had a probable right of recovery, not that it would ultimately prevail. Finally, in view of evidence that Tipperary and other nonoperating working interest owners were suffering ongoing and continuing harm from Tri-Star's alleged mismanagement and underperformance, the trial court did not abuse its discretion in finding a threat of irreparable injury to real or personal property for which there was no adequate remedy at law.

Arbitration Agreement Held Revocable for Material Breach

The same litigation that resulted in the court of appeals' upholding a temporary injunction enforcing Tri-Star's removal as operator also involved a 1996 mediation agreement by which the parties had sought to settle disputed charges made to the joint account by Tri-Star, as operator of the Australian gas project. In *Tri-Star Petroleum Co. v. Tipperary Corp.*, 107 S.W.3d 607 (Tex. App. 2003, no pet. h.), the court of appeals upheld the trial court's refusal to enforce the arbitration provisions of the agreement.

The mediation agreement called for Tri-Star to hire a "Big Six" accounting firm to review the project, to review available international accounting procedure forms and select a procedure best suited to the project, and then to

determine which expenses were properly chargeable to the joint account. Such determination, according to the agreement, "shall be final and binding on the parties hereto and may be enforced as [a] final judgment under the Arbitration Statute of the State of Texas." *Id.* at 611. Any further unresolved audit disputes would likewise be resolved by the accounting firm "in the same manner." After an unexplained delay of several months, Tri-Star hired the Brisbane office of Ernst & Young to perform the tasks contemplated by the agreement. Ernst & Young issued its report about 20 months later, whereupon Tri-Star filed a motion in the lawsuit, which had by that time been initiated by Tipperary over Tri-Star's alleged mismanagement of the project, to confirm the Ernst & Young report as an arbitration award for preexisting billing disputes and to compel arbitration of further disputes that had developed in the meantime. The trial court, after an evidentiary hearing, held the arbitration agreement unenforceable due to its material breach by Tri-Star, with the participation of Ernst & Young.

The first question for the court of appeals, it said, was whether material breach is a valid ground for revoking an arbitration agreement. A fundamental principle of contract law, it observed, is that when one party to a contract commits a material breach, the other party is excused from any obligation to perform. Because material breach is a ground for revoking a contract, according to the court, it should be a ground for revoking an arbitration agreement. Pointing to evidence that Ernst & Young had acted on behalf of Tri-Star and not impartially for all parties to the project and that Tri-Star had actively influenced the Ernst & Young report to its benefit while attempting to limit Tipperary's access to the accountants, the court further held the trial court could have inferred that Tri-Star engaged in a conscious effort to exclude Tipperary from knowledge of and access to the process and had exercised undue influence over Ernst & Young. Tipperary was not afforded a hearing, an opportunity to present evidence, or other rights guaranteed under the Texas Arbitration Act. The evidence, the court held, supported the finding that the efficacy of the arbitration process was irretrievably compromised so that Tipperary was deprived of its bargained-for resolution of disputes. Thus, Tri-Star's breach could be found material, giving Tipperary the right to revoke it both with respect to the past billing disputes and future ones.

Drilling Contract Did Not Establish Operator's Right to Control Drilling

The court in *Primrose Operating Co. v. Jones*, 102 S.W.3d 188 (Tex. App. 2003 pet. filed), construed a standard form drilling contract between Primrose, the operator, and Palmer Oilfield Construction Co., the drilling contractor. The contract provided for Palmer to drill the well to 3600 feet on a footage basis, during which Palmer would direct, supervise, and control drilling operations. All drilling below that depth, to a maximum depth of 3650 feet, would be on a day work basis under Primrose's direction, supervision, and control. After the well had been drilled deeper than 3600 feet and casing was being run in the well, Jones, an employee of Palmer, was struck by a joint of casing and injured. Based on a jury verdict, the trial court rendered judgment for Jones for \$2,690,000 in damages plus \$741,624 in prejudgment interest, the responsibility for which was apportioned by the jury 90% to Primrose and 10% to a subcontractor who provided inappropriate tools. Primrose appealed, complaining of Jones's failure to secure a finding on Primrose's control over Palmer.

As a general rule, the court observed, a general contractor does not have a duty to see that an independent contractor performs the work in a safe manner. An exception exists, however, when the general contractor retains or exercises control over the subcontractor's activities, in which case the general contractor owes a duty to exercise reasonable care in the supervision of the subcontractor's activity. A plaintiff must obtain a finding on each essential element of his cause of action or face reversal, Primrose pointed out, unless the opponent did not object to the failure to submit a question on the issue or the element is established as a matter of law. Jones had not obtained a finding on Primrose's control of Palmer's activities but argued (1) that Primrose's right of control was established by its contract with Palmer, and (2) that Primrose had waived any complaint by failing to properly object.

Jones argued that under the drilling contract, all operations after the drill bit passed 3600 feet were to be conducted on a day work basis, subject to Primrose's control. Primrose countered that the contract's provisions for work to be conducted on a day work basis only applied to work performed below 3600 feet, and the court of appeals agreed. Acknowledging Jones's argument that the court's construction might result in some difficulty in knowing which provisions govern at any particular point in the operation, the court pointed to provisions specifying that the setting of casing below the contract depth would be on a day work basis, which would be unnecessary if all operations after the contract depth is reached were on that basis. It held that the contract did not reveal an intent that all operations conducted in the well once it exceeded the footage contract were to be conducted on a day work basis. Because it was clear that the accident had occurred after just a few joints of casing had been run, indicating that the injury did not occur during work at the bottom of the well, the mere evidence that the well had been drilled below 3600 feet was insufficient to establish Primrose's right of control. Further, Primrose had requested a jury question and charge on whether Primrose controlled Palmer's work during the casing operation, which the trial court had

denied. Thus, Primrose had sufficiently called the trial court's attention to the control issue and had not waived its objection to Jones's failure to obtain a finding. Because Jones had failed to establish Primrose's duty to him, the court of appeals reversed the trial court's judgment and rendered judgment that Jones take nothing.

UCC Requires Honesty in Fact in Merchant's Determination of Posted Price

In *HRN, Inc. v. Shell Oil Co.*, 102 S.W.3d 205 (Tex. App. 2003, no pet. h.), the court of appeals reversed the trial court's summary judgment in favor of Shell, a wholesale seller of gasoline to the plaintiff independent retailers. The retailers leased their stations from Shell and were, as part of the arrangement, obligated to buy their gasoline from Shell at Shell's "dealer tank wagon" or "DTW" price. The retailers alleged that Shell set its DTW price unreasonably high, so that the retailers were unable to price their gasoline competitively, intentionally to drive the retailers out of business so that Shell could concentrate on more profitable distribution channels.

Following *Mathis v. Exxon Corp.*, 302 F.3d 448 (5th Cir. 2002), a case decided under Texas law on practically identical facts, the court decided that where an agreement calls for the price to be fixed by the seller or buyer, Uniform Commercial Code (UCC) § 2.305(b), enacted in Texas as Tex. Bus. & Com. Code Ann. § 2.305(b) (Vernon 1994), requires that the price be set in good faith based on two standards -- one objective, requiring the merchant setting the price to observe reasonable commercial standards of fair dealing; and one subjective, requiring that the merchant act with an honest intent or with "honesty in fact." Shell contended that unless it were shown that it engaged in price discrimination, it was entitled to a presumption that its price was set in good faith, in keeping with official comment 3 to UCC § 2.305, that "in the normal case" a "posted price" or the like satisfies the good faith requirement. The court of appeals agreed with the *Mathis* court that the good faith requirement imposes on merchants not only the objective duty to observe reasonable commercial standards in setting the price but also a subjective duty of honesty in fact. Any lack of subjective honesty-in-fact good faith would be abnormal, removing the case from comment 3's presumption applicable in the "normal case." The court emphasized that a case must involve more than mere allegations of improper motives to take a claim outside the normal case. Here the dealers had produced evidence of Shell's intent to drive them out of business sufficient to avoid summary judgment.

Although not an oil and gas case, this decision may present an avenue to royalty owners and other sellers of oil and gas production to challenge operators' and purchasers' setting of prices where contracts call for settlement based on a posted price. Any significant evidence of an improper motive may be sufficient to avoid summary judgment based on the setting of the price in a commercially reasonable manner.

Trial Court Abused its Discretion by Refusing to Allow Well Tests

In *re SWEPI L.P.*, 103 S.W.3d 578 (Tex. App. 2003, no pet.), decided the appeal by SWEPI, dba Shell Western E&P, of the trial court's denial of Shell's motion for entry onto land for testing. The Casas family had sued Shell for failure to drill a well on their land, on which Shell had formerly held a lease, to protect it from drainage from wells on adjacent land. After Shell's lease expired, a new lessee, Camden Resources, Inc. had drilled a producing gas well on the Casas land. The plaintiffs claimed that production from the Camden well substantiated their claim that Shell should have drilled and that they had been drained. Shell came to believe the Camden well may have been bottomed under Shell's adjacent lease rather than on the Casas land, and it questioned the results of the plaintiffs' pressure tests from the well, which, according to the plaintiffs, showed drainage had occurred. Shell filed a motion under Texas Rule of Civil Procedure 196.7, which governs discovery by entering onto land to inspect, measure, survey, photograph, test, or sample the property or any designated object or operation thereon, to permit it to perform a directional survey and a bottom pressure survey. The trial court denied the motion on the plaintiffs' and Camden's objections.

Under Rule 196.7 an order for entry onto the property of a nonparty may only issue upon good cause shown. After determining that Shell's motion had been timely, the court of appeals turned to the issues of relevance and good cause. The plaintiffs contended that the Camden well was producing from a continuous reservoir underlying both the Shell lease and the plaintiffs' land and that the well was not as productive as if it had been drilled before adjacent wells took most of the gas reserves. Shell, to the contrary, suggested that the well was only economically productive because it was producing from a reservoir underlying Shell's adjacent leases, not connected to a smaller, less viable reservoir under the Casas property. Because part of Shell's defense was premised on the location of the well and the only way to know where the bottom of the well was located was by a directional survey, the survey was relevant to Shell's defense. Similarly, the bottom pressure survey was relevant to Shell's defense: The plaintiffs claimed a comparison between the bottom-hole pressure in the Camden well to the initial pressure in an offsetting Shell well showed drainage, but Shell's expert did not believe the plaintiffs' tests had been accurately performed or interpreted.

"Good cause" for a discovery order is shown, the court noted, where the movant establishes that (1) the discovery sought is relevant and material, and (2) the substantial equivalent of the material cannot be obtained by other means. Reiterating that the discovery Shell sought was relevant, the court pointed out that all parties agreed the directional survey was the only way to determine the bottom location of the well and, against the plaintiffs' argument that Shell could rely on their own tests, that Shell was not present when those tests were done to supervise the methods and procedures used and, to effectively refute the plaintiffs' tests, was entitled to conduct its own. Thus, held the court, Shell had shown good cause for the tests. A showing of "good cause" is a showing that the movant's defense will be compromised by the denial of discovery, and the trial court's denial was an abuse of discretion.

Camden argued that Shell's requested tests were too intrusive and could cause irreparable damage to its well. Both tests are commonly performed, however. Given that the requested tests were the only method available for obtaining the information, their importance to the claims and defenses in the lawsuit, and that the cost and risk of testing could be allocated to Shell, they were neither too intrusive nor unduly burdensome. Camden further argued that the court should defer to the Railroad Commission, which has primary jurisdiction over regulation of oil and gas drilling and had denied Shell's request for a directional survey. The Railroad Commission, said the court of appeals, can only determine that it will not pursue a claim of statutory violation, not that a well is not trespassing. Additionally, the Railroad Commission requires a finding of probable cause to order a directional survey, whereas a party seeking entry to land for discovery need only show "good cause."

Evidence Insufficient to Raise Question of Failure to Reasonably Develop

Grayson v. Crescendo Resources, L.P., 104 S.W.3d 736 (Tex. App. 2003, pet. filed), decided the appeal of the take-nothing judgment against several oil and gas lessors on their claims for drainage and breach of the implied covenant to reasonably develop the lease.

After completing the Hall-McCoy 1-24 as a marginally productive gas well to the A chert zone of the Upper Morrow Formation in the lessors' Section 24, the lessees drilled a very successful A chert well, the Fowlston 1-23, just across its south boundary, in the adjoining Section 23. Another well in the northwest quarter of Section 24, the 2-24 well, was not productive from the A chert zone. The lessors sued, alleging the lessees' failure to drill another well in the southwest quarter of Section 24, at a "mirror image location" to the Fowlston 1-23, breached the lessees' covenants to protect against drainage and to reasonably develop Section 24. The trial court submitted jury questions on the alleged failure to protect against drainage, which were answered adversely to the plaintiff lessors. The court refused, however, to submit a jury instruction that a reasonably prudent operator is obligated to develop the lease and a question on whether a reasonably prudent operator would have drilled the mirror-image offset well. A court must submit all properly requested questions, instructions, and definitions raised by the pleadings and supported by some evidence, and the lessors complained that since there was evidence to support their claim for failure to develop, the trial court's refusal to submit the instructions and question was reversible error.

The jury's finding that there was no substantial drainage from the offset well, argued the lessors, did not preclude recovery on their claim for failure to develop. They relied largely on expert testimony that the desired offset well would be a "development" well, i.e., one drilled to a proven producing reservoir, as opposed to an exploratory well, and that development wells have a greater chance of success than exploratory wells. The experts' statements merely established that a well drilled to protect from drainage is, by definition, a development well because it is drilled into a known producing reservoir. They were not probative, said the court, on the question of the implied duty to develop the lease. Because the lessors' evidence was all focused on whether an offset well should be drilled rather than whether an additional well or wells were necessary to develop Section 24, they had not presented legally sufficient evidence to support a finding on the question of failure to develop. The trial court's refusal to submit the requested instruction and question was therefore proper.

Indemnity and Release Provisions of Drilling Contract Enforced

Tesoro Petroleum Corp. v. Nabors Drilling USA, Inc., 106 S.W.3d 118 (Tex. App. 2002, no pet. h.), involved a contract between Tesoro, the operator of the Longoria No. 2 Well, and Nabors, a drilling contractor, for the drilling of the well. The contract was a standard form of day work drilling contract, in which Nabors assumed liability for damage to or loss of its surface equipment and released Tesoro from liability for such damage or loss, and Tesoro assumed responsibility for damage to or loss of the hole and released and indemnified Nabors from and against liability for that damage or loss. Each indemnified the other against liability to its own employees, subcontractors, or invitees. The assumptions of liability and indemnities were made without regard to the cause or the negligence of any party, except the gross negligence or willful misconduct of either party (the latter exception having been added to the standard contract language at Tesoro's request). Each party agreed to maintain insurance for the liabilities it

assumed, in the same kind and amount as the other party, and to cause its insurer to waive subrogation of its rights against the other party. After the blowout preventers failed during drilling, the Longoria No. 2 blew out and caught fire, resulting in the destruction of Nabors's drilling rig and loss of the hole.

After settlement with a nonoperating working interest owner on its claims for, among other things, gross negligence and willful misconduct, Nabors sought indemnification by Tesoro under the contract. Additionally Zurich American Insurance Company, Nabors's insurer, brought a subrogation claim against Tesoro for the insurance proceeds paid Nabors for the loss of its rig. Tesoro appealed from a summary judgment requiring it to indemnify Nabors, and Zurich appealed a summary judgment that it breached the drilling contract by filing its subrogation action.

Tesoro argued that it was not required to indemnify Nabors against the nonoperating working interest owner's claims because the claims were for Nabors's gross negligence and willful misconduct, for which Tesoro had not agreed to indemnify Nabors. Tesoro, however, had agreed to indemnify Nabors for any acts resulting in loss of the hole except those stemming from gross negligence and willful misconduct. The nonoperator claimant's allegation that the loss was due to Nabors's gross negligence and willful misconduct was insufficient to eliminate Tesoro's contractual duty to indemnify Nabors. Tesoro had to demonstrate the existence of a genuine issue of material fact as to whether gross negligence or willful misconduct on the part of Nabors had caused the blowout, and it had presented no summary judgment evidence beyond assertions of improper conduct. There was no showing of the presence of the elements elevating Nabors's alleged negligent act or omission to gross negligence: that the act or omission involved an extreme degree of risk and that Nabors knew of the risk but nevertheless proceeded in conscious indifference to the rights, safety, or welfare of others.

Turning to Zurich's appeal, the court first addressed its argument that the indemnity agreement in the drilling contract was void under the Texas Oilfield Anti-Indemnity Act, Tex. Civ. Prac. & Rem. Code Ann. §§ 127.001-127.007 (Vernon 1997), so that the waiver of subrogation requirement of the contract, applicable only to liabilities assumed by the parties, was unenforceable. The Anti-Indemnity Act generally prohibits indemnification provisions in drilling contracts that indemnify against the indemnitee's own negligence. However, it allows such provisions in the case of "mutual indemnity obligations" if limited to the extent of agreed insurance coverage. Zurich asserted that the indemnity agreement did not qualify as a "mutual indemnity obligation" under Tex. Civ. Prac. & Rem. Code Ann. § 127.005, defining such obligations as those in which the parties agree to indemnify each other against loss, liability, or damages arising in connection with bodily injury, death, and damage to the respective employees, contractors, or their employees, and invitees of each party. The provision of the drilling contract relating to damage or loss to Nabors's rig required Nabors to release Tesoro from liability but was not an *indemnity*, Zurich pointed out, in contrast to the other portions of the indemnification agreement specifically requiring the parties to indemnify each other against various liabilities. Zurich argued that this destroyed the agreement's mutuality. The court rejected Zurich's argument. Mutuality extended to every other portion of the indemnification agreement, it observed. The contract did not require indemnification of Tesoro against liability for loss of the rig for the very good reason that no one but Nabors could suffer from loss of the rig. Any indemnity Nabors could give Tesoro for claims against it for loss of the rig would be superfluous. The contract therefore fell within the exclusion carved out for mutual indemnity obligations.

The court further rejected Zurich's claims that Nabors's release of Tesoro from liability for loss of the rig was unenforceable because it failed to meet the requirements that (1) an agreement that an indemnitee be indemnified against the consequences of its own negligence must express that intent in specific terms, and that (2) the release must be conspicuous. The contract provided that all indemnity obligations and/or liabilities assumed would be "without regard to the cause or causes thereof, including . . . the negligence of any party or parties . . ." 106 S.W.3d at 122. This language is sufficient under applicable precedent, held the court, to indemnify a party clearly and unequivocally against its own negligence. The heading of the indemnification portion of the agreement, entirely in capital letters, "RESPONSIBILITY FOR LOSS OR DAMAGE, INDEMNITY, RELEASE OF LIABILITY AND ALLOCATION OF RISK," would attract the attention of a reasonable person. *Id.* at 132.

The court, however, reversed the trial court's summary judgment against Zurich on its claims based on Tesoro's alleged gross negligence. The drilling contract excluded liability arising from a party's own gross negligence and willful misconduct from the indemnification agreement, and the agreement plainly limited each party's waiver of subrogation to the liabilities each assumed. Nabors did not assume liability for loss of the rig caused by Tesoro's gross negligence. Zurich had presented the affidavit of an expert petroleum engineer that Tesoro should have taken certain steps as operator to prevent the blowout and that Tesoro had acted in full knowledge of the danger and with conscious indifference to the rights, safety, and welfare of others. The affidavit was sufficient to raise a fact issue as to whether the blowout was caused by Tesoro's gross negligence.

Actions That Could Have Been Brought in Prior Litigation Barred by Res Judicata

Madera Production Co. v. Atlantic Richfield Co., 107 S.W.3d 652 (Tex. App. 2003, no pet. h.), decided on procedural grounds claims by Madera under an exploration agreement between it and ARCO. Under the agreement ARCO, in response to a well proposal by Madera, had the option either to farm out to Madera or to participate. ARCO was also required to allow Madera to participate in any wells it might propose and to offer Madera a preferential right to purchase interests it desired to sell or farm out. Madera sued over ARCO's failure to assign its interest in one well which Madera alleged ARCO had farmed out and to enforce an extension of the agreement to which it alleged ARCO had agreed. The suit was removed to federal court. Late in the federal court suit Madera discovered that ARCO had farmed out to Wagner & Brown and C.W. Royalties some of the leases covered by the Madera-ARCO agreement and sought to amend its complaint to join Wagner & Brown and C.W. and to add a breach of contract count against ARCO. The federal court denied Madera's motion to amend its complaint as untimely. After an adverse judgment in federal court, Madera sued ARCO, Wagner & Brown, and C.W. and affiliates in state court in Dallas County on the claims it had not been allowed to bring in the federal court suit. Venue was transferred to Gregg County on the motions of Wagner & Brown and C.W. and its affiliates, and the trial court there granted all of the defendants' motions for summary judgment on the basis of res judicata. The court of appeals affirmed.

Ruling first on the transfer of venue, the court noted that in actions for recovery of real property or to quiet title to real property, venue is mandatory in the county in which all or a part of the property is located under Tex. Civ. Prac. & Rem. Code Ann. § 15.002(a) (Vernon 2002). No matter how pled, Madera's action was based on the ownership of a real property interest, its rights to the ARCO interests under its agreement. Transfer of venue to Gregg County, where the mineral interests involved in the litigation were located, was therefore proper.

Turning on the basis for the trial court's summary judgment, the court of appeals observed that in Texas, proof of three elements is required for an action to be barred by res judicata: (1) a prior final judgment on the merits by a court of competent jurisdiction, (2) identity of parties or those in privity with them, and (3) a second action based on the same claims as were raised or could have been raised in the first action. Texas applies a transactional approach in determining what claims are barred by res judicata. A final judgment on an action extinguishes the right to bring suit on the transaction, or series of connected transactions, out of which the action arose. Madera's state court claims arose out of the same operative facts it sought to advance in its amended complaint in federal court, which could have been brought there if timely made. Its failure to bring the claims was the result of its failure to exercise due diligence to discover them in time to do so. The defendants other than ARCO were in privity with ARCO as successors in interest to the ARCO mineral rights. The elements of res judicata were met by the final judgment in the federal court action, and Madera's state court suit was barred.

Certification of Royalty Owner Classes Reversed

In *Phillips Petroleum Co. v. Bowden*, 108 S.W.3d 385 (Tex. App. 2003, no pet. h.), the court considered Phillips's appeal of the trial court's certification of three classes of royalty owners under leases located in Texas, where Phillips was the lessee, alleging underpayment of royalty by Phillips. The classes consisted of Subclass 1, royalty owners under leases for which payment of gas royalty is based on proceeds or the amount realized, from which Phillips sold gas to its affiliate Phillips Gas Marketing for resale; Subclass 2, royalty owners under leases on which royalty is paid pursuant to a Gas Royalty Agreement containing certain terms, including payment on the basis of residue gas sold but not on liquids; and Subclass 3, royalty owners in the Texas Panhandle under leases providing for payment on an amount realized/proceeds basis or on a market value/market price basis, from which Phillips sold gas to its affiliate GPM pursuant to a gas purchase contract.

The court of appeals noted the statutory threshold requirements -- numerosity, commonality, typicality of the representatives' claims, and adequacy of the representation -- for certification of the class action. It further stressed that the class action must satisfy at least one of the four categories found in Tex. R. Civ. P. 42 (b), observing that the class proponents here proceeded under Rule 42(b), which requires that the questions of law or fact common to the members of the class predominate over any questions affecting only individual members, and that a class action is superior to other available methods for the fair and efficient adjudication of the controversy. The court focused on the latter predominance requirement in addressing each subclass, pointing out that it is far more demanding than the related but more general commonality requirement. The test for predominance is not whether common issues outnumber individual ones, but whether common or individual issues will be the object of most of the litigants' efforts. A judgment in favor of the class should settle the entire controversy, and all that should remain is for class members to file their proofs of claim.

With respect to Subclass 1, the court noted, the jury will have to determine which royalty owners are included in the class, requiring a lease-by-lease and well-by-well analysis. Even after identifying the class members, it would

then be required to determine the duty Phillips owed to each, requiring further analysis of each lease for the presence of an express marketing covenant and for the terms of each such marketing clause. Beyond those individual analyses, the jury would have to ascertain whether, in each case, Phillips had breached its covenant based on whether it had acted as a reasonably prudent operator. Because individual issues regarding duty and breach would necessarily predominate over common issues, the trial court abused its discretion in certifying Subclass 1.

Similarly with respect to Subclass 2, the court concluded that the jury would have to examine the circumstances surrounding each of numerous Gas Royalty Agreements. The trial court proposed simply to present the jury a single question of whether Phillips had breached the particular form of agreement by failing to pay royalty on extracted liquids and then require the jury to state the formula Phillips should have used to compute royalty payments. The perceived need for the jury to find the formula Phillips should have used showed that the trial court had implicitly found the Gas Royalty Agreements ambiguous. Inquiry into the intentions and understandings of each individual royalty owner in entering into an agreement thus becomes necessary, so that individual questions would predominate over those common to the class. Moreover, with respect to Subclass 2, one of its class representatives was found to be inadequate since her royalty might actually decrease if the class's efforts were successful; and the other representative's qualifications had not been demonstrated at the time of certification.

Subclass 3, whose putative members were paid on the basis of a percentage of proceeds received by Phillips's marketing affiliate, after deduction of marketing charges, was likewise held defeated by failure to show the predominance of common issues over individual ones. The percentage was negotiated for each contract based on the particular circumstances of the gas being sold. To determine whether Phillips breached its duty to manage and administer the leases, the jury would have to conduct an inquiry into the circumstances surrounding each contract, including distance between the wells and gathering facilities, availability of gas for sale, and marketing alternatives. Inquiry into these factors would require individualized proof, so that individual issues would predominate over common issues. The court also held that the plaintiffs' claim for breach of Phillips's implied covenant to manage and administer the leases, upon which the certification of Subclass 3 was based, was unsupported with respect to class members whose royalty was required to be based on market value, inasmuch as the amount received by Phillips under its percentage-of-proceeds contracts would not affect the amount payable to market-value royalty owners.

CANADA -- OIL & GAS

Nigel D. Bankes, Reporter

The Potentially Broad Scope of Indemnity Clauses

From time to time the argument is made that indemnity clauses are confined to covering the indemnified from damages suffered as a result of actions commenced by third parties (*Erehwon Exploration Ltd. v. Northstar Energy Corp.* (1993), 15 Alta. L.R. (3d) 200, 222-24 (Q.B.)). The argument draws strength from the Supreme Court of Canada's decision in a drilling case: *Mobil Oil Canada Ltd. v. Beta Well Service Ltd.*, (1974), 43 D.L.R. (3d) 745 (Alta. S.C., App. Div., *aff'd* 50 D.L.R. (3d) 158 (SCC)). Some forms of the argument almost seem to suggest that the proposition is a proposition of law and not just a rule of interpretation or a presumption. The Ontario Court of Appeal has firmly and, in my respectful view, correctly, scotched that notion in its decision in *TransCanada Pipelines Ltd v. Potter Station Power Limited Partnership*, [2003] O.J. 1879, *aff'g* [2002] O.J. 429, and restored the proposition that the scope of an indemnity clause will always be a matter of construction.

The facts were that TCPL, the owner of an interprovincial pipeline system and a natural gas compressor station, entered into a contract in 1990 with Potter, pursuant to which Potter purchased lands adjacent to the compressor for the purposes of constructing a cogeneration facility and agreed to purchase waste heat from the station. Potter agreed to indemnify TCPL "from and against all liability, actions, claims, losses, costs and damages which may be brought against or suffered by TransCanada and which TransCanada may incur, sustain or pay arising out of or in connection with: (a) construction, operation and maintenance of the Facility"

In 1995 the land on which the compressor was situated subsided causing damage to the compressor. TCPL sued Potter relying on the indemnity and alleging that the subsidence was caused by Potter removing groundwater from an underlying aquifer in order to operate its facility. Potter brought a summary judgement motion to dismiss the action on the basis that the indemnity clause only provided TCPL with an indemnity against claims by third parties and not an indemnity against damages suffered by TCPL directly. The court of appeal, affirming the judgement of Justice Lane at trial, dismissed the motion. The court held that even admitting that the starting point for interpreting the words "indemnify and save harmless" was to assume that they applied only to third party claims, the clause in question contemplated that TCPL could claim the indemnity both: (1) when an action was brought against TCPL, and (2) when TCPL itself suffered damages. The latter clause was more apt to describe first party damage.

The court distinguished *Mobil Oil* both because of the precise words of the indemnity clauses at issue but also because the drilling contract at issue in *Mobil Oil* contemplated that the contractor would perform its work in a good and workmanlike manner, a standard of performance that was inconsistent with absolute liability on the part of the contractor.

Another 1981 CAPL AFE Cost Overrun Case

Canadian courts continue to struggle with the idiosyncratic language of the 1981 iteration of the standard form CAPL operating procedure which seems to suggest that a supplementary authorization for expenditure (AFE) is required in the case of a cost overrun in order to bind joint operators to those additional expenses. Although one court has striven to avoid the inevitability of that conclusion through a very innovative interpretation of the plain language of the agreement (*Novalta Resources Ltd. v. Ortynsky Exploration Ltd.*, (1994), 18 Alta. L. R. (3d) 4 (Q.B.)), the most recent case, *Powermax Energy Inc. v. Argonauts Group Ltd.*, [2003] A.J. 433, [2003] A.B.Q.B. 71, follows another decision (*Morrison Petroleum Ltd. v. Phoenix Canada Oil Co.*, [1997] A.J. 275, 198 A.R. 81 (Q.B.)), in confirming the plain meaning of the text. Operators using the 1981 version of CAPL would be well advised to amend the agreement to avoid this unfortunate (albeit technically correct) result.

Argonauts, the designated operator, sent out an AFE in April 2000 to authorize installation of facilities at a jointly owned battery to provide for better separation of oil and water and the conservation of solution gas. The AFE estimated costs at \$820,585.00 premised on purchasing parts, including a water knockout facility, and then an amount for installation. After the AFE was executed discussions ensued as to purchasing a used battery facility from FC instead. Powermax did not object and took the position that while the purchase cost of this facility was higher than it had approved in the AFE, it assumed that labour costs would be lower, i.e., by failing to object it was not consenting to a cost overrun.

For a variety of reasons, in particular the unanticipated need to spend significant sums on restoring the purchased facility, Argonauts expended at least \$2.4 million on the work which was completed by no later than December 2000. No supplementary AFE was issued until January 9, 2001. Powermax met the original cash call for the AFE but refused to make further payments except under protest and reserving all rights. On several occasions Argonauts purported to exercise its clause 505 operator's lien and sell Powermax's production to satisfy perceived indebtedness. Powermax sought a declaration that it was not liable for its share of the cost overruns. Justice Chrumka granted the declaration.

The court held that Argonauts was in breach of its clause 301 duties to consult with joint operators and to obtain *forthwith* a supplementary AFE for cost overruns exceeding 10%; there was also a change in the nature of the authorized operation. Powermax had not expressly, impliedly, or by its conduct ratified or acquiesced in the expenditures. The fiduciary analysis, discussed below, also supported the conclusion that Powermax was not liable for cost overruns.

Argonauts exceeded its authority in purporting to claim and exercise lien rights and in selling Powermax's production. Argonauts could only exercise lien rights under clause 505(b) of the CAPL form operating procedure, which established the following conditions: (1) the joint operator fails to pay agreed costs, (2) the operator serves notice specifying the default and requiring it to be remedied, (3) the default continues unremedied, (4) the operator elects to treat the default as an immediate and automatic assignment to the operator of the proceeds of the sale of the joint operator's production, and (5) the operator requires the purchaser of the joint operator's production to make future payments to the operator. Argonauts failed at the first hurdle since it seized production in order to satisfy cost overruns for which Powermax was not liable. It was also in breach of the explicit notice requirement.

Argonauts was acting in a fiduciary capacity in relation to Powermax in constructing the battery, in spending money for the joint account, and in dealing with revenues belonging to Powermax; it was also the trustee of monies received both for AFE purposes and from the sale of production. Argonauts breached its fiduciary and trust duties by failing to make full disclosure to joint operators, by seizing and selling for its own account Powermax's share of production, and by resorting to self-help remedies without first commencing an action for recovery of the monies.

Powermax was not unjustly enriched by being able to take advantage of the operation, despite not being liable for its share of the cost overruns. If there was an enrichment, the CAPL agreement provided a juristic reason for the enrichment. Similarly, Argonauts could not avail itself of claimed set-off rights because to do so was inconsistent with its status as a trustee.

Powermax was entitled to judgement for the amount of production revenues seized by Argonauts to meet the alleged cost overruns and additional damages since Argonaut's seizures rendered Powermax unable to meet its commitments under firm service contracts and thus incurred penalties. The court declined to award the punitive damages sought (\$100,000) but did award solicitor client costs on a full indemnity basis. The court declined to grant

punitive damages notwithstanding the facts that Argonauts incurred costs three times those authorized by the AFE, that it failed to obtain prior authorization for these overruns, and that it resorted to a self-help remedy to reimburse itself for these overruns over the protests of Powermax and notwithstanding the court's characterization of this behaviour as both an intentional tort and an intentional breach of trust.

A Registered But Expired Oil and Gas Lease Is Not a Cloud on Title

In *Terry v. Nalliger*, [2002] B.C.J 2213, [2002] B.C.S.C 1383, the purchaser sought return of its deposit paid under a June 2001 contract of sale and purchase. The sale was never completed because of the actions of the purchaser but the purchaser nevertheless claimed to be entitled to the deposit on the grounds that the vendor was not able to fulfil the terms of the contract to deliver clear title since registered against the title was a 10-year oil and gas lease dated January 30, 1988. The report does not disclose whether the lease was in the conventional form of a primary term with continuation thereafter for production or deemed production; instead, the court simply opined that this lease "even though registered against title, has expired by effluxion of time but had not yet been discharged or cleared from the title." The court held that the continued registration of the lease was a mere technicality and that the vendor could discharge the registration without the consent of any third party and accordingly the vendor was not in default and was entitled to retain the deposit.

GORs as Interests in Land: The Continuing Saga

Every so often the appellate courts take a bold step in systematizing the law and offering guidance to the lower courts. One such decision was the Alberta Court of Appeal's decision followed by the Supreme Court of Canada in *Bank of Montreal v. Dynex Petroleum Ltd.*, [2002] S.C.R. aff'g [2001] 2 W.W.R 693. I commented on that decision at Vol. XIV, No. 1, at 16 (2002) of this *Newsletter*. The court there held that a gross overriding royalty (GOR) and a net profits interest (NPI) were capable as a matter of law of subsisting as interests in land provided that the parties creating the interests manifested their intention to do so. But there was a snag. All that was before the court was the pure point of law and while the decision is relatively easy to apply on a go-forward basis, what did it mean for existing agreements?

The matter was sent back to trial for a consideration of the particular agreements in question to determine if the royalties thereby created were interests in land and therefore binding upon the purchaser from the trustee in bankruptcy or whether, in the alternative, the GOR holders might have some claim against the Bank. There was surely reason to hope that the breath of fresh air that animated the court of appeal's judgement would also animate the judgement at trial on the merits. There was also reason to hope that the trial judgement would build upon the guidance offered by the senior courts and provide some clear indication of how to deal with existing agreements. The result is disappointing.

In a judgement handed down on March 14, 2003, *Bank of Montreal v. Dynex Petroleum Ltd.*, [2003] A.B.Q.B 243, Justice Hawco ruled that while the interests out of which the GORs and NPIs were carved did amount to interests in land, the GOR and NPIs do not constitute interests in land and that therefore the royalty owners will have to find some alternative basis for claiming against the Bank of Montreal. In reaching his conclusion, Justice Hawco chose to emphasise that the agreements provided that the grantor was to pay or cause to be paid a royalty; the agreements did not provide a right to take in kind, and only one of the agreements was protected by a caveat.

I believe that the decision is flawed for a number of reasons. First, by fastening on the obligation to pay and the absence of a right to take in kind Justice Hawco, despite his protestations to the contrary, really is taking us back to the bad old days when the courts haggled over prepositions: see, for example, *Emerald Resources Ltd. v. Sterling Oil Properties Management* (1969), 3 D.L.R. (3d) 630 (Alta. App. Div.). I think that the court of appeal set its head against this approach not only in the earlier proceedings in this case but also in the Gross Royalty Trust Agreement (GRTA) litigation and most notably in Justice O'Leary's decision for the court of appeal in *Scurry Rainbow Oil Ltd. v. Kasha*, (1996), 135 D.L.R. (4th) 1. In my view, and admittedly in the context of a lessor's royalty, the court in the GRTA cases has really said that the lessor's royalty is presumed to be an interest in land and that it will take some powerful expression of contrary intention to rebut that presumption.

Second, if a judgement is to provide real guidance for the future it needs to offer some more details in the form of supportive reasoning. For example, Justice Hawco seems to make much of the fact that only one of the GORs was protected by caveat. But what we do not know from this judgement is whether or not the caveat was available as a means to protect the interest. A caveat cannot be filed to protect a royalty carved out of a Crown lease and we know that at least one of these interests involved a Crown lease. Similarly, Justice Hawco makes a great show of quoting extensively from the royalty agreements but his quotations are necessarily selective and in any case we also need to know what the agreements did not provide for. For example, in the case of one GOR, Justice Hawco provides the

calculation clause of the royalty but not the granting clause. In no case does he tell us what the agreements provided for by way of an enurement clause and neither does he tell us whether the agreement contemplated the filing of caveats (something which is surely more persuasive than the actual filing of a caveat).

What might be a way ahead here? I think that we might begin by recognizing the implications of the commercial realities that Justice Hawco apparently acknowledges. Thus Justice Hawco goes out of his way to agree with Professor Ellis' much quoted observation to the effect that no one in the oil and gas business who thought about what they were doing would intentionally create a royalty that was a mere contract. Surely the implication of this is that this should be the presumed intention of the parties and that we should be looking for evidence of a contrary intention. It is true that we sometimes leave matters of presumed intention to the legislature but liens that arise by operation of law such as the vendor's lien for unpaid purchase monies are surely nothing more than a presumed intention to charge the land as security based upon the commercial realities of the situation.

While the *Dynex* agreements might present some difficult problems of characterization, others are more straightforward. A case in point is *Lorne H. Reed & Associates Ltd. v. ProMax Energy Inc.*, [2003] A.J. 774, [2003] A.B.Q.B. 774, in which Justice McIntyre gave summary judgement on a royalty claim. Although the judgement does not reproduce the exact terms of what Justice McIntyre described as a "full-blown GOR Agreement," Justice McIntyre's summary refers to the following elements of the agreement: royalty secured by a lien on the payor's working interest; royalty and lien "shall be interest in land and shall run with the land;" and the agreement was to bind heirs, successors, and assigns, all as pointing to the conclusion that the royalty was clearly an interest in land.