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FEDERAL — MINING

DANIEL A. JENSEN
— REPORTER —

COLORADO GRAVEL IS NOT PART OF RESERVED MINERAL ESTATE UNDER FEDERAL LAND EXCHANGE PATENT

In a federal decision applying Colorado state law, the Tenth Circuit Court of Appeals has ruled that gravel is not within the scope of a land exchange patent reserving “all minerals.” *United States ex rel. Southern Ute Indian Tribe v. Hess*, 348 F.3d 1237 (10th Cir. 2003). The relevant facts are as follows. Arvil Brown homesteaded, under the Stock-Raising Homestead Act, 640 acres near the Southern Ute Indian reservation in 1935. Brown’s patent reserved to the United States all “coal and other minerals.” Thereafter, the United States began negotiations to acquire the land from Brown for the benefit of the Southern Ute Tribe, pursuant to the Indian Reorganization Act of 1934. In 1946, Brown deeded his 640 acres to the United States. In return, Brown was given an exchange patent for a 440-acre tract, “subject to the reservation of all minerals in and to the land . . . to the United States for the use and benefit of the Southern Ute Tribe.” *Id.* at 1240. In 1963, Brown conveyed the land to his daughter, Lulu Hess.

In 1968, the Hess family began extracting and selling gravel from the property. In 1995, the United States, on behalf of the Tribe, filed suit against the Hess family seeking a declaration that gravel was a mineral within the scope of the exchange patent reservation, an injunction against further mining, and monetary damages for prior mining. The district court ruled in favor of the government on the grounds that under *Watt v. Western Nuclear, Inc.*, 462 U.S. 36 (1983), federal mineral reservations include sand and gravel. The Tenth Circuit reversed and remanded holding that *Watt* did not control the outcome because the mineral reservations clause was not required by statute. The court held that federal common law applied to the construction of the deed and that the content of that law should come from state law. The court remanded for application of Colorado law to the deed. *United States v. Hess*, 194 F.3d 1164 (10th Cir. 1999). On remand, the district court again ruled in favor of the government.

On appeal for the second time, the Tenth Circuit reiterated that Colorado state law was to be followed in interpreting the scope of the mineral reservation. 348 F.3d at 1243. The court then explained that under Colorado law, a standard reservation of all minerals generally does not include gravel. *Id.* at 1244. Specifically, if a majority of the property is underlain with gravel

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FEDERAL — OIL & GAS

GREGORY R. DANIELSON
— REPORTER —

APPEALS OF MMS DECISIONS HELD TIMELY FILED

American Petroleum Energy Company (American Petroleum) appealed two decisions of the Minerals Management Service (MMS) dismissing its appeals as untimely. In *American Petroleum Energy Co.*, 160 IBLA 59, GFS(O&G) 11(2003), the Interior Board of Land Appeals (IBLA) reversed the MMS and held that American Petroleum’s appeals properly identified the underlying case and were timely filed with the MMS.

By Order dated January 20, 1995 (Order), MMS directed American Petroleum to report and pay additional royalties on Southern Ute tribal oil and gas leases for 1987 through 1991. By letter dated February 14, 1995, American Petroleum responded to the MMS Order requesting a waiver of the royalty payments as calculated by MMS because American Petroleum had received the gas price on a net basis from the purchaser and the purchaser could not provide a description of various costs netted from the purchase price. Thereafter, by two separate letters, MMS advised American Petroleum that its Order and bill were currently in a “hold” status and that the MMS had not yet reached a decision because it was in the process of determining a reasonable allocation of costs. By memorandum dated January 13, 1997, and hand-delivered by MMS to American Petroleum on February 27, 1997, MMS notified American Petroleum that the hold status on the original Order had been cancelled. American Petroleum filed a Notice of Appeal on March 14, 1997 (First Appeal).

By decision dated May 15, 1997, MMS dismissed American Petroleum’s First Appeal because it was not timely filed, holding that American Petroleum’s Notice of Appeal should have been filed on or before February 25, 1995. American Petroleum appealed from the May 15, 1997, decision (Second Appeal). The Second Appeal was timely filed but did not accurately state the MMS docket number. On November 24, 1997, the MMS dismissed the Second Appeal as not timely filed because American Petroleum’s Notice of Appeal inaccurately described the MMS docket number.

IBLA rejected the MMS assertion that the Second Appeal was not properly identified. The regulations state that a Notice of Appeal must “give the serial number or other identification of the case.” 43 C.F.R. § 4.411(b) (2003). The IBLA held that despite

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and the gravel cannot be mined without disturbing the property's surface, then the general rule applies that a mineral reservation of "all minerals" does not include gravel. *Id.* at 1246. However, that general rule can be overcome upon a finding that the parties nevertheless intended, at the time of the deed or patent, for the word "mineral" to include gravel. *Id.* at 1247.

The district court determined that (1) a majority of the property was *not* underlain with gravel, and (2) the gravel *could* be mined without disturbing the property's surface. The Tenth Circuit held those findings to be unsupported by the record. *Id.* Likewise, the district court found that the parties intended for the reservation to include gravel, but the Tenth Circuit concluded otherwise. *Id.* at 1247-50. The Tenth Circuit reversed and remanded with directions to enter judgment for the Hess family, putting an end to the longstanding dispute.

As an aside, readers may wish to note that the U.S. Supreme Court has granted certiorari in a case that appears to signal some interest in overturning the *Watt* decision noted above. *BedRoc Limited, L.L.C. v. United States*, 314 F.3d 1080 (9th Cir. 2002), *cert. granted*, 124 S. Ct. 45 (2003). See Vol. XX, No. 1 (2003) of this *Newsletter*. A decision in the *BedRoc* case is expected by the end of June.

TENTH CIRCUIT AFFIRMS DECISION VOIDING OIL SHALE CLAIMS

The district court decision in *Exxon Mobil Corp. v. Norton*, 206 F. Supp. 2d 1085 (D. Colo. 2002), reported in Vol. XIV, No. 3 (2002) of this *Newsletter*, has been affirmed by the Tenth Circuit Court of Appeals. 346 F.3d 1244 (10th Cir. 2003). The Tenth Circuit agreed that the assessment work resumption doctrine does not apply to preserve unpatented oil shale claims where there has been a substantial lapse in the performance of assessment work. *Id.* at 1252. The claims at issue had no assessment work done for more than 40 years before regular work was resumed in the 1970s. The court affirmed that such activity was less than substantial compliance. *Id.* at 1252-54. The court also rejected arguments that Exxon's due process and equal protection rights were violated. *Id.* at 1249-52.

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the reference to the wrong docket number, the Notice provided the name of the appellant, the nature of the decision, and the date of the decision. In addition, the docket number used referenced a case that had been dismissed. As a result, IBLA held that the identification of the case was sufficient because a mere cursory examination of the records would have revealed that American Petroleum's appeal applied to the Order dated May 15, 1997, despite the incorrect reference to the docket number.

IBLA also held that the First Appeal was timely filed because MMS's actions and written representations after the issuance of

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the January 20, 1995, Order clearly belied the finality of that Order and its ripeness for appeal prior to February 13, 1997. Consequently, the appeal period did not begin to run until February 13, 1997, and American Petroleum's appeal was timely received.

EDITOR'S NOTE ON UNPUBLISHED OPINIONS: This *Newsletter* sometimes contains reports on unpublished court opinions that we think may be of interest to our readers. Readers are cautioned that many jurisdictions prohibit the citation of unpublished opinions. Readers are advised to consult the rules of all pertinent jurisdictions regarding this matter.

CONGRESS / FEDERAL AGENCIES OIL & GAS

LAURA LINDLEY AND ROBERT C. MATHES
— REPORTERS —

MMS ISSUES NEW REGULATIONS GOVERNING OUTER CONTINENTAL SHELF EASEMENTS AND RIGHTS-OF-WAY

On December 12, 2003, the MMS issued a final rule modifying requirements governing rights-of-use and easements and pipeline rights-of-way on the Outer Continental Shelf. 68 Fed. Reg. 69,308 (Dec. 12, 2003). These changes will increase the rental rates for pipeline rights-of-way and establish rentals for rights-of-use and easements. The MMS decided the change was necessary because of requests made by lessees and pipeline right-of-way holders to use large areas outside of their leasehold and pipeline right-of-way for accessory structures. The rule requires holders of rights-of-use and easements, and holders granted use of large areas as part of a pipeline right-of-way, to pay rentals on a per acre basis. The rule was needed primarily because areas of the Gulf of Mexico once thought beyond reach in water depths greater than 5,000 feet are now being explored for development since new and developing technology allows development and drilling in waters as deep as 10,000 feet. Many of the drill ships and floating production vessels needed for such development require floating production and off loading systems that must be stabilized above the sea floor and require a mooring system that may have a "footprint" radius greater than 8,500 feet. The proposed changes to 30 C.F.R. part 250 are intended to allow lessees and pipeline right-of-way holders the freedom to optimize the placement of their facilities on unleased Outer Continental Shelf areas or areas under lease to other companies, while still allowing the government to recover equitable compensation for the right to use the additional acreage. The rule became effective January 12, 2004.

MMS ANNOUNCES TEMPORARY ROYALTY REDUCTIONS FOR CERTAIN OFFSHORE GAS

On January 26, 2004, the MMS issued a final rule providing temporary incentives to promote deep gas drilling in shallow waters of the Gulf of Mexico. The incentives are in the form of royalty suspensions for specified volumes of gas produced from new wells drilled to a depth of at least 15,000 feet below sea level. 69 Fed. Reg. 3492 (Jan. 26, 2004) (to be codified at 30 C.F.R. pt. 203). Fifteen billion cubic feet (BCF) of gas will be royalty free from any new wells drilled and perforated to a depth between 15,000 and 18,000 feet subsea. If the well is drilled and perforated below 18,000 feet, then the royalty-free volume is 25 BCF. Although the rule takes effect March 1, 2004, it can be applied to qualifying wells drilled after March 26, 2003, the date the proposed rule was published. The rule further provides for a "royalty suspension supplement" for drilling certain unsuccessful deep wells and provides price thresholds that may result in the discontinuation of the royalty relief. 69 Fed. Reg. at 3509 (to be codified at 30 C.F.R. § 203.0). The temporary incentives authorized under 30 C.F.R. part 203 and 43 U.S.C. § 1337(a)(3)(B) allow MMS to reduce, modify, or eliminate royalties on certain producing or nonproducing leases or categories of leases in order to promote development, increase production, or to encourage production of marginal resources in the Gulf of Mexico. The objective of the incentive provided in the rule is to increase the volume of natural gas production from the Outer Continental Shelf by encouraging lessees to explore for and develop deep-well gas reserves. The preamble to the rule notes that these deep gas wells will be drilled in a mature oil and gas field, so that infrastructure is readily available to get any new gas to market. The suspension of royalties will terminate when the average daily closing NYMEX natural gas price exceeds \$9.34 per MMBtu (adjusted from the year 2004 for inflation) for the full calendar year.

ALABAMA — OIL & GAS

EDWARD G. HAWKINS
— REPORTER —

RE-TRIAL OF *EXXON CORP. v. ALA. DEP'T OF CONSERVATION* YIELDS \$11.8 BILLION DOLLAR VERDICT

On December 20, 2002, the Alabama Supreme Court reversed and remanded a \$3.5 billion dollar jury verdict in favor of the State of Alabama entered by a Montgomery County Circuit Court jury against Exxon in a royalty dispute case involving royalty payments under a State of Alabama off-shore lease. *Exxon Corp. v. Alabama Department of Conservation & Natural Resources*, 859 So. 2d 1096 (Ala. 2002). See Vol. XX, No. 1 (2003) of this *Newsletter*. The reversal turned on the trial court's allowing a letter by an Exxon in-house corporate lawyer into evidence.

Following a November 2003 re-trial, a second Montgomery County Circuit Court jury returned a verdict against Exxon in excess of \$11.8 billion dollars. See Gary McElroy, "Mobile Lawyers Broke Record," *Mobile Register*, Dec. 12, 2003, at B1. The lawyers for the State of Alabama attributed the verdict, in part, to evidence that Exxon had deducted from its royalty payments to the State costs such as a \$6,527 bill from the Grand Casino in

Biloxi and a \$30,000 bill for shirts. *Id.* The lawyers for Exxon reported that Exxon's deductions were "ordinary, necessary costs of running a business" and that the examples of deductions that the State offered into evidence were "prejudicial and inflammatory." *Id.* Exxon indicated that it intends to appeal the verdict. *Id.*

ALASKA — OIL & GAS

JOHN K. NORMAN
— REPORTER —

BRITISH PETROLEUM EXPLORATION (ALASKA), INC.'S "NORTHSTAR" PROJECT FOUND CONSISTENT WITH ALASKA COASTAL MANAGEMENT PROGRAM

On October 16, 2003, the Alaska Supreme Court affirmed a decision of the Superior Court which upheld a determination by the State of Alaska that British Petroleum Exploration (Alaska), Inc.'s (BP's) Northstar Project (Northstar) is consistent with the Alaska Coastal Management Program (ACMP). In *Greenpeace, Inc. v. Alaska*, 79 P.3d 591 (Alaska 2003), *reh'g denied* Dec. 3, 2003, the Supreme Court rejected arguments by Greenpeace that the state's consistency ruling was deficient as a matter of law. The supreme court held that (1) Alaska law did not require a formal cumulative impacts analysis of the Northstar Project, and (2) the state's consistency review did not improperly treat Northstar as a "phased project."

The Northstar Project is a plan by BP to develop the first offshore oil facility and subsea oil pipeline in the Northstar Unit, an oilfield in the Beaufort Sea near Prudhoe Bay. Because of the Northstar Project's magnitude, BP needed permits from at least four state agencies and five federal agencies. Under the ACMP, any project having impacts in a coastal area of Alaska and requiring multiple permits must undergo a comprehensive review to determine its consistency with Alaska's coastal management standards.

At the time the *Greenpeace v. Alaska* litigation was commenced, Alaska statutes required the Division of Governmental Coordination (DGC)—a division of the Governor's Office of Management and Budget—to conduct a review and issue a consistency determination. *See* Alaska Admin. Code tit. 6, § 50.070(a) (1984) (repealed 2003). During the last legislature, these statutes were repealed and the development and implementation of the ACMP has now been transferred from the Alaska Coastal Policy Council to the Department of Natural Resources. *See* Vol. XX, No. 3 (2003) of this *Newsletter*. Nonetheless, this statutory change does not affect the holding of the Alaska Supreme Court in *Greenpeace v. Alaska*.

Greenpeace argued that a cumulative impact is an "impact on the environment which results from the incremental impact of the action when added to other past, present, and reasonably foreseeable future actions." *Greenpeace*, 79 P.3d at 593. The Alaska Supreme Court found that Alaska law does not require a formal cumulative impacts analysis, much less one that is analogous to that required in an environmental impact statement under the National Environmental Policy Act, as Greenpeace had argued. Instead, the court held that the agency is only required to take a "hard look" at a project when doing a "whole-project analysis."

Because Greenpeace chose not to claim a breach of the "hard look" standard, the court declined to consider whether DGC's ruling would have satisfied this standard. Therefore, the court rejected the cumulative impacts arguments put forth by Greenpeace and upheld the state's permitting decision.

Greenpeace also argued that DGC erred as a matter of law by improperly "phasing" its review of the Northstar Project. Specifically, Greenpeace complained that DGC had improperly issued certain permits prematurely, thereby allowing work on the project to begin before the consistency review was completed, because DGC also approved "major aspects" of Northstar's future development without sufficient information to make a reasoned ACMP consistency determination. *Id.* at 598. The court noted that phased ACMP review is now governed by the recently enacted changes to Alaska Stat. § 46.40.094. That aside, the court rejected Greenpeace's arguments outright, holding that "[a] short but complete answer to Greenpeace's claim of improper phasing is that the Northstar project simply was not phased." *Greenpeace*, 79 P.3d at 599. Indeed, the court noted that BP had requested phased consideration, but DGC ruled that Northstar did not qualify for phasing under Alaska law, and that DGC expressly undertook to review the complete Northstar Project.

This decision is important because it provides some degree of definitiveness and consistency to the state's implementation of the ACMP. Indeed, if Greenpeace were to have persuaded the court to adopt its definition of cumulative impacts, this would have injected much ambiguity and uncertainty into the permitting process, e.g., would state agencies be required to inquire of each facility owner in the vicinity of a permittee as to their "reasonably foreseeable future actions?" Combined with recent statutory changes to the implementation and development of ACMP by the Alaska legislature, the *Greenpeace v. Alaska* decision helps to clarify and streamline the permitting process when ACMP decisions are implicated, and should be a welcome ruling for those engaged in resource development in Alaska.

Greenpeace requested rehearing by the Alaska Supreme Court which request was denied on December 3, 2003.

EXXON VALDEZ PUNITIVE DAMAGES

On January 28, 2004, U.S. District Court Judge H. Russell Holland ordered Exxon Mobil Corporation to pay \$4.5 billion, plus interest, in punitive damages to 32,677 punitive damages class members, mostly commercial fisherman in the Prince William Sound. *In re Exxon Valdez*, 296 F. Supp. 2d 1071 (D. Alaska 2004) (only Westlaw pagination available: 2004 WL 170354). The decision comes after Judge Holland had already considered the punitive damage award twice before after remand by the Ninth Circuit Court of Appeals, and nearly 14 years after the plaintiffs initially filed suit. For a history of the *In re Exxon Valdez* litigation and settlements, see Vol. XVIII, No. 4 (2001) of this *Newsletter*.

In this most recent punitive damages order, Judge Holland considered the \$5 billion jury award in light of the U.S. Supreme Court ruling in *State Farm Mutual Auto Insurance Co. v. Campbell*, 538 U.S. 408 (2003), as directed by the Ninth Circuit upon remand. Judge Holland also noted that "punitive damages awards must be subjected to a due process analysis which flows from the

decision of the United States Supreme Court in *BMW of North America, Inc. v. Gore*, 517 U.S. 559 (1996).” *In re Exxon Valdez*, 2004 WL 170354, at *6.

After analyzing the *In re Exxon Valdez* case in light of the *BMW* guideposts and the *State Farm* decision, Judge Holland concluded that Exxon Mobil Corporation’s conduct was reprehensible because “Exxon’s decision to leave Captain Hazelwood [a “relapsed alcoholic”] in command of the *Exxon Valdez* demonstrated reckless disregard for a broad range of legitimate Alaska concerns: the livelihood, health, and safety of the residents of Prince William Sound, the crew of the *Exxon Valdez*, and others.” *Id.* at *20. The judge further found that the ratio of punitive damages to actual harm inflicted on the plaintiffs (9.74 to 1) was within the permissible range and that comparable criminal and civil penalties could have exceeded \$5 billion. The judge accepted, however, Exxon’s motion for reduction or remittitur of the punitive damage award and reduced the \$5 billion award to \$4.5 billion in order to comply with the remand order from the Ninth Circuit.

Exxon has stated that it again plans to appeal to the Ninth Circuit, and that it will this time ask the appeals court to set the damages itself rather than remanding again to Judge Holland.

Editor’s Note: John Norman has been appointed by Governor Murkowski as Chairman of the Alaska Oil & Gas Conservation Commission, and this will be his last report for the Newsletter. The Editor and Foundation would like to thank Mr. Norman for his services. He has been a conscientious reporter on Alaska oil and gas matters, and we wish him well in his new position.

CALIFORNIA — MINING

CHRISTOPHER A. JONES
— REPORTER —

COURT SUSTAINS PLACER CLAIMS STAKED OVER LODES

In an unpublished opinion from California’s Third Appellate District, *Sykora v. Magorian*, No. SCV 38474, 2003 WL 22183945 (Cal. Ct. App. Sept. 23, 2003) (unpublished), the court affirmed a district court quiet title decision that found that the plaintiffs were the rightful owners of three placer mining claims overlying certain lode claims owned by the defendants. The court additionally found that the plaintiffs were entitled to an implied easement to access the claims through an existing roadway that crossed a portion of defendants’ property.

The defendants owned several lode claims collectively known as the Three Queens lode mine. As thanks for favors given by the plaintiffs to the defendants’ family, the defendants offered to allow the plaintiffs to locate placer claims over certain of the defendants’ Three Queens lode claims. The defendants also hoped that by allowing “friendly people” to locate placer claims over the lodes, it would prevent more hostile parties from staking placer claims over the property, although this motive was not disclosed to the plaintiffs. The defendants performed assessment work and proofs of labor for the plaintiffs’ claims and filed and recorded the claims which listed plaintiffs as the owners. The relationship

between the plaintiffs and defendants eventually soured, giving rise to plaintiffs’ quiet title action.

In the quiet title action, the defendants sought to establish that there was not a valid discovery of valuable mineral deposits in the disputed placer claims and that the plaintiffs’ claimed title to the claims was therefore invalid. The court rejected the defendants’ position, ruling that the defendants, having facilitated, invited, and consented to the plaintiffs’ staking of the three placer claims, were estopped to deny that there had been a valid discovery of valuable mineral deposits. While the court also found that there was a valid discovery on the three claims, it pointed out that such finding was unnecessary as the defendants had already consented to location of the claims and were estopped from denying discovery on the claims. Finally, the court found that by effectively transferring ownership to the three placer claims to the plaintiffs, the defendants impliedly granted an easement over the private road that had historically been used to access all the claims in the Three Queens area.

NEW LAW INCREASES MINING FEES

On October 10, 2003, the Governor signed Senate Bill 649 (Kuehl). This bill doubles the annual reporting fee requirement on each active or idle mining operation from \$50 - \$2,000 to \$100 - \$4,000. It also increased the annual limit of total revenue that could be generated by such fees from \$1,000,000 to \$3,500,000. In addition, the bill raises certain mining fees to fund a new abandoned mine program account. Producers must now pay \$5.00 per ounce of gold and \$0.10 per ounce of silver produced to the State Mining and Geology Board (Board). Finally, the bill amends the California Public Contract Code to clarify the law with respect to operators of surface mines in California that are not listed by the Board as having submitted an annual report evidencing an approved reclamation plan and financial assurance. Such operators are prohibited from selling mined material to any local agency within the state.

STATE BOARD PLANS TO AMEND FINANCIAL ASSURANCE RULES UNDER SMARA

At its regular business meeting in March 2004, the State Mining and Geology Board intends to adopt certain changes to its regulations implementing the financial assurance requirements of the Surface Mining and Reclamation Act of 1975 (SMARA). Currently, the regulations authorize local lead agencies to review and approve financial assurance adjustments and releases for existing mining operations. The regulations also give the Department of Conservation authority to review and comment on lead agency determinations regarding these matters and the lead agencies are required to respond to such comments. Under the amended regulations, in addition to responding to comments from the Department of Conservation, the lead agency will also have to obtain concurrence from the Director of the Department of Conservation as to the financial assurance adjustments and releases, thus making the Director’s recommendations in such matters binding on lead agencies.

CALIFORNIA — OIL & GAS

KEVIN L. SHAW
— REPORTER —

REGULATION OF PRODUCER-OPERATED PIPELINES

The U.S. Department of Transportation, in its final rule, 68 Fed. Reg. 46,109 (Aug. 5, 2003), regulates producer-operated gas and hazardous liquids pipelines that cross into state waters without first connecting to a transporting operator's facility on the Outer Continental Shelf (OCS). Operators are permitted to petition to have either the Minerals Management Service (MMS) rules and regulations apply to the pipeline, or to have the rules and regulations of the Office of Pipeline Safety under the Research and Special Programs Administration apply to such assets and operations. The rule is said to apply to about 10 producers operating in California OCS waters.

LEGISLATIVE DEVELOPMENTS

In Governor Davis's last days in office, he signed a number of bills, including the following:

Oil, Gas, and Geothermal Administrative Fund. 2003 Assembly Bill 1747, amending section 3110 and numerous other sections of the California Public Resources Code, creates the Oil, Gas, and Geothermal Administrative Fund and provides that certain monies previously paid into the General Fund—including various fees, penalties, and fines relating to the oil, gas, and geothermal wells and operations—will now be paid into this new fund. The funds are to be used in accordance with, among other things, section 3401 of the California Public Resources Code which requires that such production-related revenues are to be “used exclusively for the support and maintenance of the division of the department charged with the supervision of oil and gas.”

Sale of Armory Properties. 2003 Senate Bill 856, amending section 14763 of the Government Code, provides that in the event of the sale of certain properties known as the San Jose, Ecalexico, and Quincy Armories, the state shall reserve all “mineral deposits” (as defined in section 6407 of the Public Resources Code), without surface rights of entry if the tract is 15 acres or less and with rights of surface entry if the tract is more than 15 acres.

Offshore and Onshore Pipelines. 2003 Assembly Bill 16, amending section 30262 of the Public Resources Code, generally requires oil produced offshore from new or expanded oil extraction operations to be transported to shore by pipelines only, and that all such pipelines shall utilize the best achievable technology. The statute also generally requires that the oil, once transported to shore, be transported to processing and refining facilities by pipeline.

Greenhouse Gases. 2003 Senate Bill 552, adding a new section 25722.5 to the Public Resources Code, generally requires, among other things, that state agencies discourage the unnecessary purchase or lease of sport utility vehicles and that state agency vehicle fleets use appropriate alternative fuel in bi-fuel natural gas and bi-fuel propane vehicles.

Reporting by Producers and Others. 2003 Assembly Bill 1340, amending sections 25354 and 25364 of the Public Resources

Code, amends the weekly and monthly reporting requirements of producers, pipelines, refiners, and others with respect to petroleum supplies. The information is submitted to the Energy Resources Conservation and Development Commission in the Resources Agency.

Perchlorate Reporting Requirements. 2003 Senate Bill 1004, amending certain sections of the Water Code, changes certain reporting requirements and establishes certain new provisions relating to perchlorate-containing compounds.

Lindo Channel in General Bidwell State Park. 2003 Assembly Bill 1634 revises the terms under which the state previously conveyed certain lands to Butte County (including a portion subsequently conveyed by the county to the City of Chico). Land underlying the natural floodway known as Lindo Channel is now permitted to be sold “free of conditions, restrictions and limitations” imposed by prior law. Query whether the minerals that were previously reserved to the state will now pass to the new owner of the channel lands.

LEASE TERMINATED FOR LATE ROYALTY PAYMENT

In *Palladino v. South Coast Oil Corp.*, No. G030939, 2003 WL 22476217 (Cal. Ct. App. Nov. 3, 2003) (unpublished), an oil and gas lease provided that the lease could be terminated by the lessor if, within 30 days after written notice from the lessor of a breach of the lease, the lessee did not begin to remedy the breach. The lessor claimed that the lease was breached because the lessee had failed to pay minimum royalties or production royalties from a well that had been in continuous production since 1954. There was apparently no dispute that royalties were due. Although there may have been an informal, historical practice of sending royalty checks at intervals longer than monthly, after the lessor sent the demand notice, the lessee inexplicably did not deliver a check for accrued royalties until about 35 days after the demand. The court was not persuaded by the lessee's argument that its internal, administrative work in calculating royalties, etc. within the 30-day cure period, amounted to “beginning” to remedy the breach. Finally, the court noted that the general rule that the law abhors a forfeiture is not applicable to oil and gas leases, and found that the lease had terminated. *Id.* at *5-*6.

SETTLEMENT OF CRIMINAL MATTER DOES NOT PRECLUDE CIVIL SUIT

In 1997, an oil pipeline spilled less than 350 barrels of oil into a marsh. The spill was cleaned up, and the Contra Costa County District Attorney filed a criminal misdemeanor charge against Texaco, the operator of the pipeline. The California Department of Fish and Game settled the criminal matter in consideration of a payment of \$138,292. When the City of Martinez later filed a civil complaint against Texaco with 17 causes of action based on its status as the owner of a conservation easement burdening the marsh lands, Texaco argued that the prior settlement precluded the city from asserting the second set of claims. In *City of Martinez v. Texaco Trading & Transportation, Inc.*, 353 F.3d 758, 761 (9th Cir. 2003) the appellate court held that the city was entitled to maintain its damages claims as the holder

of a private easement, even though it likely could not maintain an action for any "public" claims.

COLORADO — MINING

HOWARD R. HERTZBERG
— REPORTER —

COURT LIMITS SUCCESSIVE RENEWAL OF MINERAL LEASES

In *Carder, Inc. v. Cash*, No. 02CA0046, 2003 WL 22722935 (Colo. Ct. App. Nov. 20, 2003, petition for rehearing pending as of Jan. 29, 2004) (unpublished), the Colorado Court of Appeals resolved several disputes relating to a sand and gravel mineral lease.

The December 1993 lease provided that the lessee would have the "option to renew [the lease] 'for successive periods of 5 years each.'" *Id.* at *3. In November 1998, the lessors "gave notice to lessee of nonrenewal or, alternatively, renewal under additional requirements." *Id.* at *1. That notice from the lessors apparently was prompted by their belief that the lessee was in material violation of the lease. The following month, the lessee gave notice of its election to renew the lease for five years. Several months later, the lessors locked the gates to the property; that action, along with a subsequent confrontation, prompted the lessee to sue for declaratory and injunctive relief, which in turn prompted the lessors to counterclaim. The trial court ruled primarily in favor of the lessee, but parts of its decision were reversed by the court of appeals.

A noteworthy aspect of the court of appeals' decision is its holding that the lease provisions granting the lessee the option to renew the lease for successive five-year terms only granted the lessee the right to renew for a single five-year term. In that regard, the court of appeals cited several cases, none from Colorado, for the proposition that: "a lease providing for renewal in general terms will [generally] be construed as providing for only one renewal." *Id.* at *3. The court of appeals also stated that "[a] lease will not be construed as conferring a right to perpetual renewals unless its language is so clear and unequivocal that it leaves no doubt that such was the intention of the parties." *Id.* at *2. The opinion cited a case that appears to mean that if a lease provides for a specified number of successive renewals, it can be renewed up to such number of times, but it is not clear from the opinion that the cited case would indeed support that proposition. Note that the court of appeals distinguished the right to renew the term of an easement from the right to renew the term of a lease.

Citing Colorado cases, the court of appeals further held that "where a lease contains no provision requiring the lessee to give notice of its election to extend the lease, no notice is necessary; the lessee's continuing in possession and tendering the monthly rental sufficiently indicate its desire to extend the lease for the additional term." *Id.* at *2.

The opinion addressed several other lease issues. One concerned the trial court's reformation of the lease in a manner that established additional terms and conditions. The court of appeals reversed, noting that reformation is allowed only when the document does not reflect the parties' agreement.

Another issue concerned the lessors' argument that substantial violations of the lease terms justified either termination of the lease under Colo. Rev. Stat. § 13-40-107.5(2), or adding new terms to the lease to deal with the violations. In rejecting that argument, the court of appeals held that the alleged violations in this case, which included allegations of a lack of accounting, refusal to weigh the gravel, and encroachment of lands outside the lease boundaries, did not fall within the scope of Colo. Rev. Stat. § 13-40-107.5(2). That provision is part of the forcible entry and detainer statute and provides that "an implied term of every lease of real property in this state [is] that the tenant shall not commit a substantial violation while in possession of the premises." "Substantial violation" is defined at Colo. Rev. Stat. § 13-40-107.5(3). In any event, the court of appeals also noted whether a breach is so material as to justify non-performance by the other party is a question of fact, and in this instance the breach did not rise to that level.

Other matters, with which the court of appeals dealt only in passing, included claims regarding conversion of personal property (here, the lessee's equipment), the covenant of quiet enjoyment, warranty of title, wrongful possession, unlawful forcible detainer, and damages resulting from the lessors' actions.

MISSISSIPPI — OIL & GAS

W. ERIC WEST
— REPORTER —

CONTEST OF NORM LAND SPREADING RULE CONTINUES

In 2000 the Mississippi Oil and Gas Board amended State-wide Rule No. 68 to allow and regulate surface and subsurface land spreading of oil field naturally occurring radioactive materials (NORM). This action was reported in this *Newsletter* at Vol. XVII, No. 2 (2000). In *Adams v. Mississippi State Oil & Gas Board*, 854 So. 2d 7 (Miss. Ct. App. 2003), several landowners filed a contest at the Oil and Gas Board seeking to prevent the option of land spreading of oil field NORM. After the rule was amended, these parties failed to appeal in the manner provided under the conservation statutes, which required the filing of a notice and a petition of appeal with the State Oil and Gas Board, after which the Board would compile the record and forward it to the proper trial court for a hearing on the record. Instead of following the statute, the landowners, within the time for taking an appeal, filed their appeal directly with the trial court. The Board took the position that the appeal was not properly perfected. The trial court agreed and dismissed the appeal.

The Mississippi Court of Appeals reversed and remanded. The court analogized an appeal of an order of the Oil and Gas Board to the appeal of a trial court judgment, which by statute begins with the filing of a timely notice of appeal in the trial court. The appeals court said Rule 4(a) of the Mississippi Rules of Appellate Procedure provides that if a notice of an appeal is mistakenly filed directly with the state supreme court, the supreme court shall note on it the date on which it was received and transmit the notice to the trial court. The notice of appeal is deemed filed in the trial court on the date so noted. The appeals

court said that Rule 4(a) expressly contemplates the failure to properly perfect an appeal from a trial court to the supreme court and provides an alternative procedure. The appeals court held the same allowance should prevail with regard to an appeal from the Oil and Gas Board although there is no statute so providing. The Mississippi Supreme Court denied certiorari. The matter is now back to trial court where the court could conceivably decide the 2000 amendment to Rule 68 was improperly adopted.

This rule was assumed to be valid in *Chevron U.S.A., Inc. v. Smith*, 844 So. 2d 1145 (Miss. 2002), reported in Vol. XX, No. 2 (2003) of this *Newsletter*, in which the court held that, under Mississippi conservation statutes and Statewide Rules No. 68 and 69, a landowner claiming NORM surface contamination must first exhaust his administrative remedies with the Oil and Gas Board before the landowner is entitled to bring a civil suit for such damages. The court held it was following its prior holding in *Donald v. Amoco Production Co.*, 735 So. 2d 161 (Miss. 1999). In assuming the validity of Rule 68 as amended, these cases are obviously inconsistent with the supreme court's allowing a continuation of a contest of the validity of the Rule.

MISSISSIPPI RULES OF APPELLATE PROCEDURE SAVE ANOTHER APPEAL

In *Wheeler v. Mississippi Department of Environmental Quality Permit Board*, 856 So. 2d 700 (Miss. Ct. App. 2003), the Permit Board of the Mississippi Department of Environmental Quality (DEQ) issued five permits under one order and one permit under a separate order to another applicant, all over the objection of Wheeler, who was notified in writing of his right to appeal by giving notice to the Board and posting a \$100.00 bond. Wheeler gave timely notice, naming only the Board as a defendant, and submitted a \$100.00 cashier's check. The two applicant/permittees intervened contending that a \$100.00 bond was required for each permit. The trial court (sitting as an appellate court for appeals from Permit Board action) agreed and dismissed the appeal as to five of the permits. The court later issued a judgment affirming the issuance of the permit for which it considered the appeal perfected. On appeal, the Mississippi Court of Appeals held that only one \$100.00 bond was due for each order appealed, regardless of the number of permits issued; therefore, Wheeler should have posted two \$100.00 bonds. The court also held that Wheeler's failure resulted in a discretionary dismissal so that under the Mississippi Rules of Appellate Procedure, Rule 2(a)(1), Wheeler was entitled to be notified of his failure to perfect his appeal and given 14 days to cure the imperfection.

In the *Adams* and *Wheeler* decisions, the Mississippi courts applied the Mississippi Rules of Appellate Procedure (MRAP) to appeals from actions of state agencies, although there is no basis in the MRAP or the respective statutes providing for the appeal procedure to support such application. In contrast, in *State Oil & Gas Board v. McGowan*, 542 So. 2d 244 (Miss. 1989), the Mississippi Supreme Court refused to apply the Mississippi Rules of Civil Procedure to Oil and Gas Board proceedings, stating: "There appears to be no authority for transplanting the Mississippi Rules of Civil Procedure [MRCP] into administrative proceedings. The scope of the rules, found in Rule 1, M.R.C.P., govern procedures in the circuit courts, chancery courts, and

county courts in all suits of a civil nature. Administrative hearings are not included within their purview as the State Oil & Gas Board is not a circuit, chancery or county court." *Id.* at 247.

The "scope" of Rule 1 of both the MRAP and the MRCP are almost identical, with neither containing a reference to administrative proceedings.

NEBRASKA — MINING

ANNETTE M. KOVAR
— REPORTER —

REGULATION OF GROUNDWATER AT URANIUM MINES

The U.S. Environmental Protection Agency has delegated the underground injection control program, created under the Safe Drinking Water Act, to the State of Nebraska through its Department of Environmental Quality (DEQ). The DEQ issues permits for mineral extraction wells under this program, including in-situ leach uranium extraction mining. In-situ leach uranium extraction mining facilities are also licensed by the Nuclear Regulatory Commission (NRC) under the Atomic Energy Act of 1954, as amended.

The DEQ and NRC both require groundwater protection at these uranium mines specifying sampling and analysis of radiological and non-radiological constituents; numerical standards for those constituents; monitoring well placement, construction, and sampling frequency; corrective action measures for standard exceedances; and groundwater restoration to specific groundwater quality standards for economically depleted portions of the uranium ore zones.

In an effort to reduce or eliminate duplicative activities, the NRC, on November 19, 2003, approved a staff-recommended initiative that would defer active regulation of groundwater protection by the NRC at in-situ leach uranium extraction facilities to states with acceptable programs. If the NRC concludes that a state's program provides adequate protection of public health and safety and the environment and is equivalent to that of the NRC, the NRC will enter into a Memorandum of Understanding (MOU) with that state. Once the MOU is in effect, the NRC would amend licenses for in-situ leach uranium extraction facilities in the state, at the request of the licensee, to remove license conditions pertaining to groundwater protection. The NRC would periodically review the state permits and inspection reports to ensure the state continues to conduct an acceptable program. The NRC would continue to conduct its other licensing reviews and inspection for public and worker radiation safety.

The NRC and DEQ are currently negotiating a MOU. Nebraska has one in-situ leach uranium mine that would be impacted by this initiative.

NEBRASKA — OIL & GAS

ANNETTE M. KOVAR
— REPORTER —

PROPOSAL TO INCREASE NON-CONSENT PENALTIES IN POOLING ORDERS

Legislative Bill 967 has been introduced in the 2004 Session of the Nebraska legislature. The bill would increase statutory non-consent "penalties" in pooling orders entered by the Nebraska Oil and Gas Commission. Under current law, in the absence of voluntary pooling of interest by all owners in the development and operation of a spacing unit, the Commission is authorized to enter an order, after notice and hearing, pooling all their interests. The pooling order provides for the drilling and operation of the authorized well on the spacing unit and affords the owner of each tract or interest in the spacing unit the opportunity to recover or receive his or her just and equitable share. A non-consenting owner's share is currently reduced 100% for tangibles and 200% for intangibles. *See* Neb. Rev. Stat. § 57-909. Legislative Bill 967 would increase these percentages on a graduated basis depending on the depth of the well.

**SOUTH DAKOTA —
OIL & GAS**

MAX MAIN
— REPORTER —

PROPOSAL TO REDUCE PERCENTAGE OF OWNERS REQUIRED TO RATIFY OIL AND GAS UNIT

At the request of the South Dakota Department of Environment and Natural Resources, the House Committee on Agriculture and Natural Resources has introduced House Bill No. 1014. This bill would reduce the percentage of working interest owners necessary to ratify a proposed oil and gas unit from 75% to 60%. Likewise, the bill would reduce the percentage of royalty owners necessary to ratify a proposed oil and gas unit from 75% to 60%.

TEXAS — OIL & GAS

WILLIAM B. BURFORD
— REPORTER —

EXPERT TESTIMONY UNRELIABLE IF NOT BASED ON FACTS

In *Kerr-McGee Corp. v. Helton*, 47 Tex. Sup. Ct. J. 248, No. 02-0356, 2004 WL 224458 (Tex. Jan. 30, 2004) (unpublished), the Texas Supreme Court reversed a judgment for the plaintiff lessors against their lessee on the basis that their expert petroleum engineer's testimony on the amount of their damages for drainage was unreliable.

Kerr-McGee drilled a prolific gas well, its Holmes 17-1, in Section 17, immediately south of the plaintiffs' Section 10, just 660 feet from Section 10's southern boundary. It drilled several more wells in the field, including two unsuccessful wells in

Section 10. Neither of the Section 10 wells was very close to the Holmes 17-1, though, and the lessors alleged that Kerr-McGee had breached its implied covenant to protect against drainage in that a prudent operator would have drilled an offset well as close as permissible to the Holmes 17-1 under Texas Railroad Commission rules. The plaintiffs' expert geologist testified that the productive zone extended into Section 10 and estimated its thickness there. The plaintiffs then presented the testimony of Riley, a petroleum engineer, that the hypothetical protection well would have produced approximately 6.1 Bcf of gas. His opinion was based, he testified, on the assumption that the hypothetical well would have produced at the same rate as the Holmes 17-1 and another successful well to its west.

Kerr-McGee did not challenge on this appeal the trial court's findings that there was substantial drainage, that a prudent operator would have drilled an offset well, and that the well would have been profitable. It argued that the petroleum engineer's testimony was unreliable, however, so that there was no evidence to support the trial court's award of damages. The supreme court agreed with Kerr-McGee.

The proponent of expert testimony must demonstrate that it is reliable, the court pointed out; if the expert's testimony is not reliable, it is no evidence. The reliability requirement focuses on the principles, research, and methodology underlying the expert's conclusions. Expert testimony is unreliable if it is not grounded in the methods and procedures of science and is no more than subjective belief or unsupported speculation. Expert testimony is unreliable if the court concludes that there is simply too great an analytical gap between the data and the opinion proffered. In reviewing the reliability of expert testimony, the court is not to determine whether the expert's conclusions are correct but only whether the analysis used to reach those conclusions is reliable.

Kerr-McGee complained specifically that Riley's assumption that the hypothetical well would produce at the same rate as two existing wells, on which he had based his conclusions, was unsupported. The assumption was contrary to actual facts, it asserted, because the two existing wells did not produce at the same rate. Further, Kerr-McGee argued, reservoir thickness determines a well's productivity, all else being equal, and the well would likely not produce at the same rates as the existing wells, where the producing zone was somewhat thicker than in Section 10. On cross-examination Riley had admitted that his assumption of the hypothetical well's productivity was based on no empirical data, and that he had no factual basis for projecting the production from the hypothetical well.

Although Riley had examined facts and data that would be appropriate in reaching an opinion on damages, there was no explanation of how those factors affected his calculations, if at all. Data from existing wells may be considered in predicting a hypothetical well's production, the court observed, but without knowing how Riley used that and other data to reach his conclusions, it could not determine whether his analysis was reliable. Moreover, he had not explained why known differences among the wells, such as difference in the thickness of the productive zone, would not result in different production rates. Summing up, the court declared that even if the data Riley used was the type generally relied on by petroleum engineers to estimate production, and even if the underlying facts and data he used were

accurate, there was simply too great an analytical gap between the data and Riley's conclusions for the conclusions to be reliable and therefore constitute evidence.

This case demonstrates that in oil and gas cases, as in others, it is not enough to show an expert witness's qualifications and then simply have the expert give his or her conclusions. In the expert's testimony, there must be a carefully laid path from data to conclusions, and every assumption the expert uses must have a sound basis in scientific theory and in fact.

ANOTHER ROYALTY OWNER CLASS CERTIFICATION REJECTED

The court in *Enron Oil & Gas Co. v. Joffrion*, 116 S.W.3d 215 (Tex. App.—Tyler 2003, no pet.), considered the appeal of the trial court's certification of a class consisting of all royalty owners in the Carthage Gas Unit, of which Enron, which later became EOG Resources, Inc., was the operator responsible for remitting royalty payments. The trial court granted certification based on the questions of (1) whether EOG had charged the royalty owners for compression costs, and how much, predicated on breach of the express covenant in the leases that royalty was to be free of production expenses; and (2) whether EOG had charged the royalty owners with post-production expenses greater than those a reasonably prudent operator would have charged, and if so by what amount, predicated on breach of the implied covenant to reasonably manage the leases. The class proponents sought to maintain the appropriateness of class certification on the basis that questions of law or fact common to the members of the class predominated over any questions affecting only individual members, satisfying Tex. R. Civ. P. 42(b).

A common question exists, the court noted, when the answer as to one class member is the same as to all. Courts determine whether common issues predominate by identifying the substantive issues that will control the outcome of litigation, assessing which issues will predominate, and determining if the predominating issues are in fact common to the class. In this case EOG calculated and paid royalty identically for all royalty owners, but there were numerous different forms of leases calling for different methods of royalty calculation. Some provided for gas royalty to be based on the net proceeds from sale; others based royalty on the value of the gas. A determination of whether EOG had breached an express covenant not to deduct expenses would have to be made lease-by-lease. Consequently, individual, not common, issues would be the focus of the parties' efforts in a trial. Likewise, under *Union Pacific Resources Group, Inc. v. Hankins*, 111 S.W.3d 69 (Tex. 2003), each lease must be analyzed to determine whether there is an implied duty not to charge post-production expenses greater than would a reasonably prudent operator. The possible permutations of the leases were endless, observed the court. There being no evidence that every lease had an implied covenant to refrain from charging post-production expenses greater than would a reasonably prudent operator, the royalty owners could not establish that common questions of law or fact predominated.

EXECUTIVE MINERAL OWNERS DID NOT BREACH LEASING DUTY TO NONEXECUTIVES

The court in *Hlavinka v. Hancock*, 116 S.W.3d 412 (Tex. App.—Corpus Christi 2003, pet. filed), held that in the absence of evidence of self-dealing, the plaintiff nonexecutive mineral owners had not established that the owners of the executive rights had breached any duty to lease.

The Hlavinkas owned the surface, an undivided 1/9 mineral interest, and all the executive rights in the tract of land involved in the case. The plaintiffs owned approximately 60% of the minerals, nonparticipating in the right to lease. During a period of significant leasing activity in the area, the Hlavinkas refused or ignored offers to lease the tract on terms similar to those accepted by some nearby landowners, apparently believing they should hold out for higher bonus rates. The Hlavinkas ultimately did not lease the tract. Instead they only agreed to permit seismic exploration in return for \$40.00 per acre for surface damages and disruption to their farming operations, which they did not share with the nonexecutive mineral owners. The nonexecutive owners sued, alleging the Hlavinkas had breached their fiduciary duties by refusing to lease, withholding material information, and engaging in self-dealing. The Hlavinkas appealed the trial court's judgment based on the jury's finding of \$187,195.65 in damages.

The standard of utmost good faith applies to one who exercises executive rights to lease or develop minerals, the court pointed out. This duty requires the executive right holder to execute the same type of oil and gas lease on the same terms as he would have done in the absence of an outstanding nonparticipating interest. According to *Manges v. Guerra*, 673 S.W.2d 180, 183 (Tex. 1984), the duty is a fiduciary one that requires the holder of the executive right to acquire for the nonexecutive every benefit he exacts for himself. This duty, the plaintiffs argued, required the Hlavinkas to lease the land for development if a reasonable offer to lease was made. The Hlavinkas had breached their duty, they alleged, by failing to negotiate with prospective lessees. The court disagreed.

This was not a case, said the court, in which the Hlavinkas were arbitrarily refusing to lease under any circumstances. They were willing to lease at a higher bonus rate they believed was being paid to neighboring landowners. Nor had the Hlavinkas entered into a transaction to exact a benefit for themselves to the exclusion of the nonexecutives. The plaintiffs misconstrued *Manges*, the court declared, in seeking to impose a fiduciary duty to lease on the executive interest owner. In doing so they incorrectly sought to equate a duty to develop with the executive's duty to use utmost good faith in the exercise of his rights. The duty to develop arises not from a fiduciary relationship but from an implied covenant applicable to oil and gas leases, recently held inapplicable to the relationship between executive and nonexecutive mineral owners in *In re Bass*, 113 S.W.3d 735 (Tex. 2003). Because they had not acquired any benefits for themselves pursuant to any lease, the Hlavinkas did not breach their fiduciary duty.

The Hlavinkas also could not be held liable for failing to provide the nonexecutive owners information concerning their leasing negotiations. The Hlavinkas owned the exclusive right to make a lease and had no duty to disclose any information.

Finally, the plaintiffs contended the Hlavinkas breached their fiduciary duty by allowing seismic operations for compensation to themselves but not the nonexecutive mineral owners. The court acknowledged that an executive acts improperly in negotiating for surface damage payments that reduce the size of the bonus, royalty, or other benefits that would have to be shared with the nonexecutive. The money the Hlavinkas received for surface damages did not have to be shared with the plaintiffs, however, unless the compensation was a substitute for a larger bonus, royalty, or other benefit that would have to be shared. Because the Hlavinkas had not used their power to lease, they had not breached a fiduciary duty to the nonexecutives.

This case seems to come close to holding that an owner of executive rights cannot be liable to a nonexecutive mineral owner without executing a lease. Moreover, the court seems unwilling to consider that the executive's surface damage compensation might have been a substitute for bonus. Why is a payment for seismic exploration rights not compensation for the grant of one of the attributes of the mineral estate merely because it is characterized by self-interested parties as surface damages?

EXCULPATORY CLAUSE EXCUSED OPERATOR'S ALLEGED BREACHES

In *IP Petroleum Co. v. Wevanco Energy, L.L.C.*, 116 S.W.3d 888 (Tex. App.—Houston [1st Dist.] 2003, pet. filed), the court applied the exculpatory clause of a standard AAPL form of operating agreement: "Operator shall have no liability as Operator to the other parties for losses sustained or liabilities incurred, except such as may result from gross negligence or willful misconduct." A group led by Wevanco approached IP Petroleum with a geological idea involving the risky reentry of an old well. IP agreed to participate and be the operator of the proposed well. The parties executed an operating agreement containing the quoted provision, appointing IP as operator, and calling for IP to drill to a depth of 9,125 feet or a depth sufficient to test the Lower Ellenburger Formation, whichever was the lesser. Mechanical difficulties significantly increased the cost of the reentry, as had apparently been feared, and the results were disappointing. The well had not yet reached the 9,125-foot limit, but it was disputed whether its total depth of about 9,000 feet was sufficient to have tested the Ellenburger Formation. Geologists assisting both IP and the Wevanco group believed the well was already past the interval in which they had hoped to encounter producible oil. The Wevanco group insisted that IP had a duty to continue to drill deeper, but IP refused on the basis that the geological idea had been tested and that the well was a dry hole. When IP proposed plugging and abandonment, giving the Wevanco investors the option pursuant to the operating agreement either to agree to the abandonment or to take over the well, they refused to do either. The Wevanco group sued for damages resulting from IP's breach of its alleged obligation to drill deeper. A jury found that IP had been grossly negligent in breaching its contract and awarded the Wevanco group more than \$4 million in damages plus more than \$1.5 million in attorney fees.

On appeal IP argued that the exculpatory clause absolved it from liability as the evidence was legally and factually insufficient to support the jury's finding of gross negligence or willful misconduct. The plaintiffs contended that the exculpatory clause

did not apply to their claims against IP because they were for breach of contract, not negligence. The court agreed with IP.

The basis of the plaintiffs' claims was alleged misconduct arising from the manner in which IP, as operator, conducted drilling operations, the court explained. Their petition included allegations that IP had failed to perform as a reasonably prudent operator, in a good and workmanlike manner, and with due diligence. These allegations, the court said, were unlike those made in *Cone v. Fagadau Energy Corp.*, 68 S.W.3d 147 (Tex. App.—Eastland 2001, pet. filed), and *Abraxas Petroleum Corp. v. Hornburg*, 20 S.W.3d 741 (Tex. App.—El Paso 2000, no pet.), the only cases the court found discussing exculpatory clauses with respect to liability for breach of contract. In those cases the breach of contract claims did not include allegations that the operator failed to act as a reasonably prudent operator nor arise from the manner in which the operator conducted operations.

Since the exculpatory clause applied, IP would not be liable unless it had been grossly negligent or had acted with willful misconduct. To support a finding of gross negligence, the court observed, there must be evidence that IP had actual knowledge of an extreme risk of serious harm—not the type of harm ordinarily associated with breaches of contract or even with bad faith denial of contract rights, but harm such as death, grievous financial injury, or financial ruin. Reviewing the evidence adduced at trial, the court found that although it might be sufficient evidence of negligence, it did not rise to the level of gross negligence as a matter of law. Further, a finding of willful misconduct would require evidence of a specific intent on the part of IP to cause the plaintiffs substantial injury, and there was none.

Finally, the court agreed with IP that the jury had improperly determined that it had breached a "participation letter" that allegedly required drilling to a depth that IP had not reached. The letter agreement had preceded the operating agreement and contained no exculpatory clause. The participation letter agreement required drilling to a depth necessary to test the "Ellenburger Cave Floor Zone," whereas the subsequent operating agreement authorized the operator to stop drilling at a specified depth even if the target zone had not been reached. The two agreements thus contained mutually inconsistent terms, so that the operating agreement, the court held, superseded the participation agreement.

PROCEDURAL ODDITY SAVES LEASE FROM JUDGMENT OF TERMINATION ON CESSATION OF PRODUCTION

In *Cannon v. Sun-Key Oil Co.*, 117 S.W.3d 416 (Tex. App.—Eastland 2003, no pet. h.), the plaintiff's manner of presenting its cessation of production case to the jury appears to have turned a favorable verdict into an unexpected affirmance for the defendant.

The Parker No. 1 Well on Cannon's ranch produced gas for a number of years beyond the primary term of a lease whose term would extend, in familiar language, as long thereafter as oil or gas was produced. In October 1995, with the consent of Cannon's predecessor in interest, the well was shut in while a new pipeline was laid across the ranch. When the pipeline was completed in May 1996, the lessee attempted to resume production, but the well would no longer produce. After successive attempts at repair

extending more than a year, the lessee finally succeeded in restoring the well to production in June of 1997. After buying the ranch, Cannon sued for a declaratory judgment that the lease had expired because of the cessation of production. At trial the jury found in Cannon's favor on the question of whether there had been a cessation of production in paying quantities but concluded that Cannon had revived the lease. The trial court entered judgment for Sun-Key, the lessee, on the revivor finding, and Cannon appealed.

The court of appeals first discussed the issue of revivor, noting that a lifeless lease is revived by the subsequent execution of a formal document that expressly recognizes in clear language the lease's validity. Here, although Cannon's deed on acquiring the ranch was made generally subject to all valid and subsisting leases, and although Cannon and his attorney had sent letters to the lessee requesting that future royalty and other lease payments be made to him and demanding that the lessee take action under applicable leases, none of these referred to any particular lease and clearly did not, in the court's view, show an intent to grant a new estate and revive the lease. There was no evidence, therefore, to support the jury's finding of revivor. The court nevertheless upheld the trial court judgment for Sun-Key. There was no evidence, the court held, for the jury's finding of cessation of production in paying quantities.

A lessor seeking to establish that a lease has terminated because of a cessation of production in paying quantities must meet a two-prong test, the court pointed out: (1) that the lease failed to yield a profit over a reasonable period of time and (2) that a reasonably prudent operator would not have continued to operate the well in the manner in which it was being operated for the purpose of making a profit and not merely for speculation. Sun-Key presented testimony of the lessee's diligence in attempting to restore production as a prudent operator would do if expecting to make a profit. Cannon, to the contrary, presented no evidence that a reasonably prudent operator would have operated in a different manner, would have restored production sooner, or would not have continued under the circumstances in its attempts to obtain production. Thus, there was no evidence for the jury's findings.

Cannon raised the seemingly unassailable argument that the two-prong "cessation of production in paying quantities" analysis relied on by Sun-Key and the court of appeals did not apply in this case because there was in fact a *total* cessation of production. Where there has been a total cessation, case law holds, the question of whether a reasonably prudent operator would have continued to operate the lease becomes irrelevant. The court of appeals met the argument by observing that Cannon had alleged "total cessation of production," an independent theory of recovery, in his petition but did not request that a "total cessation" issue be presented to the jury nor that the trial court make a finding on the issue. Thus, the court of appeals held, he had waived it.

The holding in this case seems hypertechnical and at odds with common sense. The reason that the two-prong approach is not required in cases of total cessation, it would seem, is that there is no occasion to question whether the quantities being produced should be regarded as "paying." It is not, as the court's holding here implies, a means of saving the lease based on the

lessee's bona fides or diligence. If production has in fact ceased altogether, the whole inquiry is simply obviated. The court could have held, and should have in logic, that a showing of total cessation of production, without any evidence of the lessee's activities, *a fortiori* amounts to a showing of cessation of production "in paying quantities" so as to support the jury's finding.

OPINIONS ON GAS RESERVES HELD FRAUD WHEN BASED ON FALSIFIED DATA

In *Arkoma Basin Exploration Co. v. FMF Associates 1990-A, Ltd.*, 118 S.W.3d 445 (Tex. App.—Dallas 2003, no pet. h.), the court decided the appeal of the trial court's award of large fraud damages in favor of several groups of investors against Arkoma Basin Exploration (ABE). Between 1988 and 1991, in return for a commission, ABE provided the investors information from its "unique database" of gas production and reserves and mineral ownership in the Arkoma Basin of Arkansas and Oklahoma, which the investors used in acquiring mineral rights from ABE. When the investors' interests failed to produce the amount of gas ABE had predicted, they concluded that ABE had misrepresented the available reserves and sued.

ABE's principal defense was that the information it had provided consisted only of opinions, predictions, and projections concerning future production. Under Virginia law, which governed the case, it argued, a claim for fraud must be based on a misrepresentation of present or preexisting facts, not opinions or statements of future events. Although acknowledging that honest estimates, projections, and opinions are not actionable for fraud under Virginia law, the court held that when a party's opinions are based on information it knows is false, the opinions nevertheless become actionable as fraudulent misrepresentations when they are used to mislead the plaintiff. The investors presented testimony indicating ABE manipulated its data to overstate reserves by two to three times, and the life of wells by several times. ABE determined that certain new wells might produce for 200 to 250 years, for example, estimates the investors' expert witness deemed "preposterous."

ABE had told the investors it had determined gas reserves using a particular process, but the investors presented clear and convincing evidence that ABE had not used that process but falsified the results through manipulation of the data and calculations. When estimates and opinions are based on deliberate, intentional falsification of the data and calculations, they are the product of falsified facts and part of the fraudulent misrepresentation. When those estimates are made to a person without the maker's specialized knowledge of the subject matter, they are actionable.

UNDERGROUND GAS STORAGE CAVERN NOT SEPARATELY TAXABLE

Coastal Liquids Partners, L.P. v. Matagorda County Appraisal District, 118 S.W.3d 464 (Tex. App.—Corpus Christi 2003, no pet. h.), decided whether the appraisal district had properly made a separate appraisal of a natural gas liquids storage facility, leased by Coastal, consisting of underground salt dome caverns. The district had listed an appraisal for the facility separately from the surface of the land under the category of "other" for the years 1995 through 1998, and under the category of "im-

provement" for 1999. Coastal protested the appraisals on the basis that the district had no authority to appraise the caverns for taxation separately from the surface. The court agreed that listing the salt domes separately constituted unlawful multiple appraisal.

Tex. Tax Code Ann. § 25.02(a) specifies that appraisal records are to include real property, separately taxable estates or interests in real property, the appraised and market value of the land, the appraised value of improvements, and the appraised value of a separately taxable estate or interest in land. The court followed *Harris County Appraisal District v. Coastal Liquids Transportation, L.P.*, 7 S.W.3d 183, 189-90 (Tex. App.—Houston [1st Dist.] 1999), *rev'd on other grounds*, 46 S.W.3d 880 (Tex. 2001), in holding that the caverns did not fit the definition of an "improvement" found in Tex. Tax Code Ann. § 1.04(3), as a building, structure, fixture, or fence; a transportable structure designed to be occupied; the subdivision of land by plat, or water, sewer, or drainage lines; or paving of unimproved land. It also rejected the district's argument that the caverns were separately taxable as an estate or interest in land. The cases on which the district based its argument upheld the taxation of mineral interests separately from the surface estate, and the court declined to extend them to allow separate appraisal for subsurface properties in general.

UTAH — OIL & GAS

FRED MACDONALD
— REPORTER —

POINT OF VALUATION FOR SEVERANCE TAX CLARIFIED

In *ExxonMobil Corp. v. Utah State Tax Commission*, 2003 UT 53, No. 20021023, 2003 WL 22770074 (Utah Nov. 25, 2003) (unpublished), the Utah Supreme Court ruled that severance tax must be based on valuation occurring in the immediate vicinity of the well, with the oil and gas remaining in a relatively natural state, but that the point of valuation must be one at which sales of the oil and gas may actually occur. Except as to ExxonMobil, the ruling is to be applied prospectively only.

Utah imposes a severance tax (3% - 5% depending upon the price of oil and gas) "on the basis of the value, at the well, of the oil or gas produced, saved, and sold or transported from the field where the substance was produced," subject to several enumerated exceptions, percentage reductions and credits. Utah Code Ann. § 59-5-102(1)(a). "Value at the well" is defined as "the value of oil or gas at the point production is completed." Utah Code Ann. § 59-5-101(19). Valuation is primarily to be "established under an arm's-length contract for the purchase of production at the well" and, in the absence of such a contract, in accordance with other specified methods in descending order including, lastly and only if no other specified method is applicable, the net-back method. Utah Code Ann. § 59-5-103(1). The net-back method allows deduction of costs of transporting and processing from the eventual sales or market price, up to 50% of the value of oil or gas. Utah Code Ann. § 59-5-101(7). The net-back method generally is the most favorable to producers.

ExxonMobil operates several oil and gas wells in and around the Aneth area of southeastern Utah. During the time period in

question, ExxonMobil evidently sold most of its oil from an off-site battery facility rather than separator tanks in the vicinity of its wells. When purchases were made from the separator tanks, the purchase price was adjusted downward to account for impurities and transportation costs. The Auditing Department of the Tax Commission based severance tax assessed against ExxonMobil at the actual point of sale. Thus, oil sold from the separator tanks would be taxed at a percentage of a price lower than oil sold from the battery facility. *ExxonMobil*, 2003 WL 22770074, at *1-2.

ExxonMobil sought a refund from the Auditing Department which was denied. It then sought a review of the decision by the Tax Commission. After both a hearing and rehearing, the Tax Commission was deadlocked (two votes to two votes). Under Commission rules, a deadlock results in a favorable ruling to the Auditing Division and thus ExxonMobil's refund request was denied. ExxonMobil appealed. *Id.* at *2.

ExxonMobil argued that the point for calculating value is the point at which the mineral is removed from the earth, equating the terms "production" and "extraction." The Tax Commission justified its decision to impose the tax at the point of actual sale by arguing that "completed production" implies some post-extraction alterations and that the statutory preference for the arm's-length contract valuation method would be defeated by a statutory scheme set up at a point where such arm's-length sales rarely occur, i.e., at the time of extraction. *Id.* at *3.

The court believed neither party's position completely reconciles with the valuation methods provision of the statutes. Addressing the Tax Commission's position, the court stated:

[The] position could never result in utilization of the net-back method because any sale would necessarily be at the point of completed production. . . . Additionally, the statutory definition of "well" notes that a well is an "extractive means." Utah Code Ann. § 59-5-101 (20) (2000). This seems to indicate physical extraction from the earth, not the extraction of oil or gas from other impurities further down the line. . . .

Id. at *4. However, the court also stated that ExxonMobil's position ignored the clear legislative preference for valuation by reference to actual contract for sale "because, according to the Tax Commission's unchallenged factual findings, sales rarely occur without at least some separation in a separator tank or some further refinement." *Id.* at *4.

The court declared the statutes, and in particular the term "production," as ambiguous. Upon finding ambiguity, the court was required to " 'construe taxation statutes liberally in favor of the taxpayer, leaving it to the legislature to clarify an intent to be more restrictive if such intent exists.' " *Id.* at *3 (quoting *County Board of Equalization of Wasatch County v. Utah State Tax Commission*, 944 P.2d 370, 373-74 (Utah 1997) (internal citations omitted)).

As such, the court concluded:

"At the well," where "production is complete," read in light of the language favoring valuation by reference to an arm's-length contract price but allowing other methods, including the net-back method, contemplates valuation in the immediate vicinity of the point of removal from the

earth. . . . Accepting the Tax Commission's position would lead to a widely disparate tax, based not on the value of oil or gas actually removed from the ground and thus taken from the state's pool of natural resources, but based on the sales and marketing strategies of the various interest holders.

ExxonMobil, 2003 WL 22770074, at *5. The court concluded, however, that the language of the statute also "compels calculation at some point where sales are not a distinct rarity." *Id.* The court stated:

The nature of the industry is such that sales rarely, if ever, occur directly from the valve structure, which appears to be the point of valuation advocated by ExxonMobil. The statute, however, assumes a market for oil and gas at the point of valuation.

Id. at *5. The court focused in on the separator tanks as such a point:

Valuation of the oil and gas at the separator tank allows valuation to occur while the oil and gas are in a relatively raw state, at the earliest possible, yet practicable, point of sale. Where no separator tank is used, valuation may still occur by reference to the value of similar oil at separator tanks in the same field. This valuation system allows the use of the preferences outlined in section 59-5-103, unlike the methods proposed by either of the parties.

Id.

Recognizing the revenue hardships its holding would impose on the state, the court limited the ruling to apply to ExxonMobil retroactively only; the ruling applies to all other parties prospectively. *Id.* at *6.

OPERATOR HAS AFFIRMATIVE DUTY TO ESTABLISH DOWNHOLE WELL INTEGRITY TO AVOID PLUGGING AND ABANDONMENT ORDER

In *Road Runner Oil, Inc. v. Board of Oil, Gas and Mining*, 76 P.3d 692 (Utah Ct. App. 2003), *cert. denied*, 78 P.3d 987 (Utah 2003), the Utah Court of Appeals upheld an order of the Utah Board of Oil, Gas and Mining (the Board) requiring an operator to permanently plug and abandon four wells, notwithstanding the operator's claims that the wells "projected considerable economic viability."

Under applicable regulations, wells must be plugged and abandoned after five years of non-activity or non-productivity, unless approval for extended shut-in time is given by the Division of Oil, Gas and Mining (the Division) "upon a showing of good cause by the operator." Utah Admin. Code R649-3-36(3). If an operator desires to shut-in or temporarily abandon a well, it must submit to the Division a notice explaining and providing data evidencing downhole well integrity. Utah Admin. Code R649-3-36(1.3). The Division will then either approve the shut-in or temporarily abandoned status or require remedial action to be taken to establish and maintain the well's integrity. Utah Admin. Code R649-3-36(2).

Road Runner operated the four wells in question but none had produced or been active for between 8 and 18 years. As a consequence, the Division issued a letter notifying Road Runner of its non-compliance with the cited regulations. The parties attempted

to negotiate a consent decree but were unsuccessful. The Division therefore initiated a request for agency action for the Board to order permanent plugging and abandonment of the wells. *Road Runner*, 76 P.3d at 693.

The Board held its first hearing on the matter and issued an order concluding that Road Runner was not in compliance with the applicable regulations and ordering the permanent plugging and abandonment of the wells. Road Runner did not contest the accuracy of the Division's records concerning Road Runner's liability or put on evidence of the downhole integrity of the wells. It did, however, put on evidence that various third parties might have an interest in taking responsibility for the wells and, as a consequence, the Board held its order in abeyance for a six-month period. As a condition for the six-month abeyance, Road Runner was ordered by the Board to "take action to address all immediate threats to public safety, health and welfare within sixty (60) days of [the] order." *Id.*

At the end of the six-month abeyance period, the Board convened another hearing, the purpose of which was to allow Road Runner to report on any arrangements with third parties and thereby show cause why the wells should not be plugged and abandoned as previously ordered. Although Road Runner provided evidence concerning the potential economic viability of the wells, it did not identify any third party arrangements concerning the wells and the Board again ordered Road Runner to plug and abandon them. As part of its reasoning, the Board found that the evidence of the viability of the wells was speculative and not supported by the downhole evidence as required under the cited regulations. The Board did find that Road Runner had satisfactorily remedied all surface conditions that constituted immediate threats to health, safety, and welfare. *Id.* at 693-94.

Road Runner sought and was granted a rehearing in front of the Board to clarify perceived inconsistencies between the two orders. After the rehearing, the Board entered an order confirming that the six-month abeyance period was simply to ascertain the interest of third parties in taking over the wells, concluding that well integrity data are a specific factor to be weighed as part of the "good cause" test to allow shut-in longer than one year, and ruling that Road Runner failed to carry the burden of demonstrating "good cause" to keep the four wells shut-in. Of particular note, the Board adopted most of the "good cause" factors recommended by Road Runner to be considered. Road Runner then appealed the Board's order to the Utah Supreme Court, which, under statutory discretion, referred the case to the Utah Court of Appeals. On appeal, Road Runner argued that the Board's decision was not based upon substantial evidence, that the Board ignored evidence demonstrating "good cause," that the Board erroneously interpreted and applied the cited regulations (in that it did not need to show downhole integrity to obtain an extension), that the Board's decision was arbitrary and capricious and contrary to the Board's prior practice, and that the decision was an abuse of discretion and contrary to a rule of the Board.

The court of appeals first confirmed that it is an affirmative duty upon an operator to present evidence of downhole integrity if it intends to obtain shut-in or temporarily abandoned well status beyond a one-year period. The court found that Road Runner did not provide any evidence of downhole integrity and

that its temporary remedial measures did not entitle it to, nor show good cause for, continued shut-in status. *Id.* at 696.

The court also ruled that the Board's finding that the operator failed to show "good cause" for extension was supported by substantial evidence. The wells were inactive and non-productive for between 8 and 18 years. Despite the testimony of Road Runner's experts regarding the wells' economic potential, no testimony regarding plans to bring the wells into an active productive state was provided. In addition, the record was wholly devoid of any information regarding the downhole integrity of the wells. The court stated:

While economic waste may occur if the Duchesne County Wells are permanently plugged and abandoned, such waste is outweighed by the risk the wells pose to human health, safety, and the environment. . . . Petitioners failed to present well integrity data, which would aid in alleviating fears regarding threats to public safety from a well site that is not structurally sound.

Id. at 697.

Road Runner argued that the Board had not acted upon any other wells that had been shut-in in excess of five years and therefore its order was contrary to the Agency's prior practice and arbitrary and capricious. The court rejected that argument on the basis that Road Runner made no showing that the Board's action was inconsistent with actions involving a similar fact pattern. In addition, the court stated that the Board's inability to deal with every inactive well is not enough to prove that the Board acted contrary to prior practice. *Id.* at 698. Because the court had found that the Board's decision was based upon substantial evidence, all of the other arguments of Road Runner were rejected. *Id.* at 697-98.

SITLA BOARD OF TRUSTEES REJECTS SUWA CHALLENGE TO LEASE SALE

In an unpublished Order issued August 25, 2003, Case No. 2003-001, the Board of Trustees (the Board) of the Utah School and Institutional Trust Lands Administration (SITLA) upheld a decision of the agency rejecting the protest of the Southern Utah Wilderness Alliance (SUWA) of the offer of 24 parcels located near the Book Cliffs for oil, gas, and hydrocarbon leasing. The Board ruled there is no administrative mechanism to consider and respond to such a protest, that SUWA had no standing to protest, and that the agency adequately balanced short- and long-term interests as required by statute, in proceeding with leasing as opposed to seeking a land exchange for lands with less "sensitive" environmental characteristics. The Board found adequate environmental protections are afforded under standard lease terms and regulations if and when development should occur. As stated by the Board, "[t]his entire action is based on SUWA's desire to engraft federal-type statutory requirements on [SITLA] where the Utah legislature has chosen not to do so."

Although this Order resulted from an informal adjudicative proceeding, it is noteworthy because it represents the first challenge by (and rejection of) an environmental group concerning the leasing by SITLA of trust minerals. Significantly, SUWA chose not to appeal the Board's decision to the Utah Supreme Court.

CANADA — OIL & GAS

NIGEL BANKES
— REPORTER —

ROYALTY CHARACTERIZATION AND INTERPRETATION

It is now the law of Canada that a working interest owner may, as a matter of law, carve out a royalty interest which is entitled to be treated as an interest in land: *Bank of Montreal v. Dynex* [2002] 1 SCR 146, discussed in Vol. XIV, No. 1, at 16 (2002) of this *Newsletter*. However, successors in title to properties encumbered by royalty interests continue to argue that the language used in a particular agreement evinced nothing more than a promise to pay. That argument succeeded before Justice LoVecchio in *Meek v. Fender Estate* [2003] AJ 1599, [2003] ABQB 1053. There the agreement in relevant part provided that:

[The granting clause] Delhi hereby sells, assigns, conveys, transfers and sets over unto Meek a gross overriding royalty in the amount of three percent (3%) of all oil, gas and other hydrocarbons which may be produced saved and marketed from any and all lands described in [the Schedule]. [Cl. V(2)(a).] Such overriding royalty shall be satisfied by payment . . . of Meek's proportionate share of the proceeds of sale of production of oil, gas and related hydrocarbons saved, recovered and marketed from the lands . . . less only production and severance tax applicable thereto, if any.

On the trial of a series of issues, Meek sought to argue that: (1) the Meek gross overriding royalty (GORR) gave rise to an interest in land, (2) the interest in land attached to the entire working interest in the property held by the assignee of the grantor and not just the percentage interest that the grantor had held at the time of the agreement, and (3) the GORR was free of processing and trucking costs.

The court held that this agreement did not, for several reasons, create an interest in land. Parts of the agreement (e.g., cl. V(2)(a)) were couched as a payment obligation; Meek's rights were passive, Meek had no right to drill, produce, or operate the lands; Meek had no right to take in kind; the language of conveyance was not as all embracing as the language of some other royalty agreements; the agreement was to provide compensation for services; and no caveat was ever filed to protect the royalty.

The Meek royalty, however, was not confined to the grantor's original 50% interest in the subject lands. The preamble to the agreement made it clear that the lands subject to the GORR obligation were the lands in which the grantor either had an interest pursuant to a listed agreement or in which it was entitled to acquire an interest. The plain meaning of these words contemplated future growth. Consequently, the GORR obligation attached to an additional 50% interest acquired pursuant to the terms of an independent operation clause.

The only permissible deductions from the proceeds of production were production and severance taxes. The language of the clause was clear and allowed this case to be distinguished from a long line of cases in which the courts required that royalties be calculated net of costs downstream of production.

In this reporter's view, Justice LoVecchio sets the bar far too high on the royalty characterization issue and the reasons he gives for rejecting that characterization are not persuasive. For example, royalties by their very nature are passive and the main distinction between royalty interests and working interests is that royalty owners can never carry out operations on the lands. I continue to think (see further discussion at Vol. XX, No. 3, at 24 (2003) of this *Newsletter*) that one possible way forward in the post-*Dynex* era is to suggest that *Dynex*, given the universally acknowledged desirability of royalties being characterized as an interest in land, effectively created a presumption in favour of that characterization. Courts should therefore be looking for evidence of a contrary intention. Justice LoVecchio seems to have been engaged in the opposite exercise.

ISSUANCE OF A WELL AUTHORIZATION DOES NOT INFRINGE FIRST NATION TREATY RIGHTS

The prairie provinces and the Peace River block of northeast British Columbia (BC) are subject to treaties between the Crown and the First Nations. Each treaty contains virtually identical language reserving to the First Nations certain hunting rights throughout their traditional territories, subject to those lands being taken up for other authorized purposes including lumbering and mining operations. It is an open question whether, and to what extent, and under what circumstances, provincial governments may owe duties to First Nations when issuing oil and gas disposition and regulatory approvals within traditional territories. In *Saulteau First Nation v. British Columbia (Oil & Gas Commission)*, [2004] BCJ 128, 2004 BCSC 92, Saulteau First Nation (SFN) sought to quash a decision of British Columbia's Oil and Gas Commission (OGC) to issue a well authorization on the basis that the OGC had failed in its constitutional duty of consultation to SFN, or, in the alternative, that the OGC's Act (the OGCA) was constitutionally inapplicable to traditional territories encumbered by a treaty obligation insofar as it provided for an unstructured discretion in the issuance of licences. Justice Cohen of the BC Supreme Court held that the OGC did owe a duty of consul-

tion but that, in this instance, it had discharged that duty notwithstanding its refusal to accede to SFN's request to reject or defer the application for a well authorization until studies of the cumulative effects of oil and gas exploration in the area had been undertaken.

Justice Cohen distinguished the OGC from other regulatory boards like the National Energy Board (NEB), which do not owe a constitutional duty of consultation, on the grounds that such a fiduciary-based duty is inconsistent with their status as quasi-judicial bodies: *Quebec (Attorney General) v. Canada (National Energy Board)*, [1994] 1 SCR 159. In Cohen's view, the OGC was fulfilling an administrative function rather than a quasi-judicial function. Justice Cohen also held that the OGCA did not present problems of unstructured discretionary powers that might infringe aboriginal or treaty rights. Cohen suggested it was important to distinguish between those statutes that directly prohibit the exercise of aboriginal and treaty rights and those statutes, such as the OGCA, which is a law of general application that, under some circumstances, has the potential to impact the exercise of such rights.

This most recent SFN decision is a companion to the earlier decision in *Kelly Lake Cree First Nation v. British Columbia*, [1999] 3 CNLR 126 (BCSC). It is important to note that the OGC conceded that it had a duty to consult in this case and the argument was about the scope of the duty. There remain at least two unresolved issues: (1) the application of the duty to consult to the Crown's decision to dispose of public oil and gas rights, and (2) the application of the duty to consult in jurisdictions like Alberta where the decision to issue a well licence or equivalent is vested in a regulatory body (the Energy and Utilities Board (EUB)) which is acknowledged to be a quasi-judicial body. This issue is squarely before the Alberta Court of Appeal in two EUB decisions for which that court has given leave to appeal: *Dene Tha' First Nation v. Alberta (Energy and Utilities Board)*, [2003] ABCA 372 and *Frog Lake First Nation v. Alberta (Energy and Utilities Board)*, [2003] ABCA 373.