

## FEDERAL — MINING

PATRICIA J. WINMILL  
— REPORTER —

### NOTICE MINING IN RIPARIAN AREAS DOES NOT VIOLATE NORTHWEST FOREST PLAN

A recent decision issued by a California federal district court concludes that the Northwest Forest Plan does not require plans of operation (POOs) for mining in riparian areas, unless the mining is likely to result in a significant disturbance of surface resources. *Karuk Tribe v. U.S. Forest Service*, No. C 04-4275 SBA, 2005 WL 1562945 (N.D. Cal. July 1, 2005). In 1994, the Secretaries of Agriculture and Interior approved the Northwest Forest Plan (the Plan). The Plan amends numerous Bureau of Land Management and Forest Service plans for areas within the range of the northern spotted owl in the Northwestern United States. The Plan imposes ecosystem wide standards and land use allocations designed to balance extractive uses of federal land with protection of wildlife species. Slip op. at 3-4. One of the land use allocations adopted in the Plan is Riparian Reserves, where conservation of aquatic and riparian resources is to be given emphasis. *Id.* at 4. Along with other standards governing

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## FEDERAL — OIL & GAS

GREGORY R. DANIELSON  
— REPORTER —

### MONTANA FEDERAL DISTRICT COURT FINDS EIS INADEQUATE AND NINTH CIRCUIT ENJOINS COALBED METHANE DEVELOPMENT PENDING APPEAL

The U.S. District Court for the District of Montana granted in part and denied in part cross-motions for summary judgment in a challenge to the Bureau of Land Management's (BLM) approval of the 2003 Final Statewide Oil and Gas Environmental Impact Statement (Statewide EIS) and proposed amendments to the Resource Management Plan (RMP). In the consolidated cases known as *Northern Plains Resource Council v. Bureau of Land Management*, Civ. Nos. 03-69, 03-78 (D. Mont. Feb. 25, 2005), Judge Anderson of the Montana district court ruled that the Statewide EIS failed to analyze an appropriate range of alternatives for development of coalbed methane (CBM) as required by the National Environmental Policy Act (NEPA). That inadequacy, the district court found, resulted from the BLM's failure to consider a "phased development" alternative that would contemplate a lesser degree of development than full-field develop-

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## MINING — OIL & GAS ENVIRONMENTAL ISSUES

ROGER L. FREEMAN  
— REPORTER —

### TENTH CIRCUIT ISSUES IMPORTANT RULING ON APPLICATION OF CLEAN WATER ACT TO INACTIVE MINE SITES

On August 24, 2005, the Tenth Circuit issued an important decision in *Sierra Club v. El Paso Gold Mines, Inc.*, No. 03-1105 (10th Cir. Aug. 24, 2005), on appeal from the U.S. District Court for the District of Colorado. The case explores and expands upon prior precedent surrounding the application of the Clean Water Act to inactive mining sites. The issue has generated much debate among environmental groups, industry, and various administrative agencies and had been addressed by some courts, but not by the Tenth Circuit. The decision may broaden the reach of the National Pollutant Discharge Elimination System (NPDES) per-

mitting system to inactive mine sites across the Rocky Mountain West. However, the decision reiterates the need to firmly establish a hydrologic connection between the pollutant discharge from an inactive mine site and the ultimate receiving waters in order to sustain a Clean Water Act claim.

The case originated in the historic Cripple Creek Mining District in Teller County, Colorado—an area that has been the subject of environmental focus for some decades. The specific site at issue, consisting of approximately 100 acres of land, is owned by El Paso Gold Mines, Inc. (El Paso). El Paso never conducted mining operations on the property, upon which an inactive gold mine, the El Paso Mine, is located. A key feature of the mine is

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minerals management, the Plan requires that a POO be approved for all mining operations located within a Riparian Reserve. *Id.*

The Karuk Tribe's suit alleged that the Forest Service violated the Plan, and the Klamath National Forest Plan, by allowing mining operations located in Riparian Reserves to proceed under a notice of intent (NOI), rather than a POO. *Id.* at 10. The Tribe argued that the Klamath Forest Plan, which incorporated the POO requirement, is binding on the Forest Service and that, accordingly, the Forest Service is compelled to require a POO for every operation conducted within a Riparian Reserve. The court disagreed, first observing that such a requirement would violate the General Mining Law and 36 C.F.R. § 228, under which the Forest Service may not require a POO for mining operations that are not likely to result in a significant disturbance of surface resources. *Id.* at 18. However, rather than concluding that the POO requirement violated the statute and regulations, the court concluded that under the Plan itself, and the Forest Service's longstanding interpretation of it, no POO can be required for mining operations in a Riparian Reserve unless it is likely to result in a significant disturbance of surface resources. *Id.* at 18-22. The Plan states that its standards do not apply where they would be contrary to existing law and regulation. *Id.* at 18-19. The court reasoned that because a blanket requirement mandating a POO for all mining operations in Riparian Reserves would violate the Part 228 mining regulations, the Plan by its terms provides that the regulations supersede the POO requirement and no POO can be required unless an operation poses a likelihood of significant disturbance. *Id.* at 19. In addition, the court reviewed numerous Forest Service interpretations of the POO requirement in which the agency had similarly concluded that, in order to reconcile the requirement with the Part 228 regulations, the requirement must be interpreted as applying only where an operation is likely to result in significant disturbance to surface resources. *Id.* at 19-22. Accordingly, the court concluded that allowing notice mining within Riparian Reserves did not violate either the Plan or the Klamath Forest Plan.

The Karuk court also rejected the plaintiff's arguments that the Forest Service's review of NOIs for mining operations within Riparian Reserves triggered the obligation to conduct environmental reviews under the National Environmental Policy Act (NEPA) and the consultation requirements imposed under the Endangered Species Act (ESA). As to the NEPA claim, the court followed the holding in *Sierra Club v. Penfold*, 857 F.2d 1307 (9th Cir. 1988), and concluded that the non-discretionary act of processing an NOI is not a "major federal action" that triggers NEPA review. *Id.* at 23-24. Similarly, the court concluded that the processing of an NOI, in which the agency determines whether or not the operation is likely to cause significant surface disturbance, is not an authorization of that activity within the meaning of the ESA. *Id.* at 24-27.

## MINERAL LAW NEWSLETTER

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### **SURFACE USE RULES REQUIRE MINERS TO RECLAIM AND REMOVE PRE-EXISTING STRUCTURES**

In two recent decisions, the Interior Board of Land Appeals (IBLA) has concluded that a claimant who acquires a millsite and exercises “dominion” over the millsite is liable for the removal of structures placed on the ground by previous owners. *Betty Dungey*, 165 IBLA 1, GFS(MIN) 12(2005), and *Marietta Corp.*, 164 IBLA 360, GFS(MIN) 9(2005). The primary surprise in these cases is that they follow closely on the heels of a series of cases that suggested a completely different result.

The contrary series of cases begins with *James R. McColl*, 159 IBLA 167, GFS(MIN) 20(2003), reported in Vol. XX, No. 3 (2003) of the *Newsletter*. In *McColl*, the claimant had purchased millsites that had been staked over ground encompassing a prior milling operation. Remnants from the prior operation included several mill buildings, a trailer, various equipment, and trash. *Id.* at 171-72. IBLA ruled that under the terms of 43 C.F.R. §§ 3715.5-1 and .5-2, which require removal of structures and equipment after mining ceases, an unpatented millsite claimant is not liable to reclaim structures left on the millsite by prior operators. In reaching this decision, IBLA focused on the regulations’ use of personal pronouns to describe a claimant’s obligation to reclaim and remove structures located on the claim, concluding that the regulations could not reasonably be interpreted to extend liability to structures constructed by prior operators. *Id.* at 180-82.

IBLA adhered to the *McColl* rule in two subsequent decisions decided in 2004: *Karen V. Clausen*, 161 IBLA 168, GFS(MIN) 15(2004), and *Dan Solecki*, 162 IBLA 178, GFS(MIN) 26(2004). In *Clausen*, even though the claimant occupied and used the historic milling structures located on the millsites, IBLA set aside the Bureau of Land Management’s (BLM) order to remove the buildings, noting that under *McColl*, a claimant is “not responsible to reclaim a building which was abandoned and pre-existed his occupancy.” 161 IBLA at 179. IBLA went on, however, to observe that the record did not indicate whether the claimant owned the historic buildings and remanded the matter to the BLM for an ownership determination, perhaps suggesting that if the claimant did own the buildings, she might be held responsible for their reclamation. *Id.* at 179-80.

In *Solecki*, the IBLA appeared to resolve the lingering ownership question, ruling that even when a claimant purchased, occupied, and used structures left on the millsite by prior operators, the claimant was not responsible for the removal of those structures. 162 IBLA at 196. As it did in *McColl* and *Clausen*, IBLA again emphasized that its conclusion was based on the use of personal pronouns in the regulations governing removal of mining structures. Because the regulations refer only to removal of structures “you” leave on the claim, the Board reasoned that BLM has no authority to require a claimant to remove structures left by prior operators. *Id.* at 195-96. Significantly, IBLA also

noted that other provisions of the reclamation regulations, which are cast in a “plain English” rulemaking style that uses personal pronouns to describe a claimant’s reclamation obligation, are subject to the same interpretation. IBLA observed that: “The pronouns make it impossible to apply [the regulations] directly to a situation where a miner obtains property placed on the site in years past.” *Id.* at 196, n.6.

The first departure from these rulings occurred in *Marietta Corp.*, which also involved a historic milling operation. One of the appellants, *Marietta*, purchased the buildings and personal property from the prior operator. 164 IBLA 360, 363, GFS(MIN) 9(2005). Another appellant, *Comstock Ore Buyers*, later staked a new millsite over the site of the prior operations and entered into an agreement with *Marietta*, allowing *Marietta* to maintain ownership of some of the structures. *Id.* at 365. IBLA concluded that in this case 43 C.F.R. §§ 3715.5-1 & .5-2 could be construed to require removal of the pre-existing structures. IBLA acknowledged that the rulings in *McColl*, *Clausen*, and *Solecki* did reflect a concern that the regulations did not “adequately cover the situation where a claimant occupies buildings left by a predecessor,” but concluded that each of those cases was distinguishable and did not resolve the issue. *Id.* at 375. IBLA ruled that because *Marietta* had purchased the buildings located on the claim and *Marietta* and *Comstock* exercised dominion and control over those structures, the Subpart 3715 regulations are properly read as requiring the claimants to remove them. *Id.* at 376.

*Betty Dungey* involved three sisters who inherited a millsite from their father who, along with a co-owner, had constructed structures and placed equipment on the claims. 165 IBLA 1, 3-4, GFS(MIN) 12(2005). Although the sisters never occupied or used the millsite, they did not disclaim the millsite under the state’s probate law and filed maintenance fees in order to maintain the claim. *Id.* at 5 & 12-13. Acknowledging that the *McColl*, *Clausen*, and *Solecki* line of cases had raised issues about the proper interpretation of 43 C.F.R. §§ 3715.5-1 and .5-2, IBLA cited to the recent ruling in *Marietta* and concluded that because the sisters had acquired the millsite and exercised dominion and control over it by paying the maintenance fees, they were liable for the cost of removing the pre-existing structures. IBLA characterized the holding in *Marietta* as extending the terms “you” and “yours” used in 43 C.F.R. § 3715.7-1 to include persons who acquire structures and personal property located on a claim and exercise dominion over *that property*. *Id.* at 15. IBLA acknowledged that the sisters never conducted operations on the site, but concluded that by paying maintenance fees, they had exercised dominion over the millsite, and could be held responsible for removing the pre-existing structures. *Id.* at 15-16. In essence, the *Dungey* ruling extends the holding in *Marietta*, and the reach of the liability imposed under 43 C.F.R. §§ 3715.5-1 & .5-2. *Marietta* imposed the liability of the regulations on claimants who acquire a millsite containing pre-existing structures and exercise dominion over those structures. *Dungey* extends that

**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.

liability to include claimants who acquire and maintain a millsite containing pre-existing structures, even though they never use or occupy the structures or even enter the millsite.

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ment. The court held that such an alternative would be consistent with the purpose of the Statewide EIS, which was “to analyze options for developing CBM in a manner that would minimize societal and environmental impacts resulting from such development.”

Judge Anderson’s decision, however, rejected other challenges to the Statewide EIS and RMP based on NEPA, the Federal Land Policy and Management Act (FLPMA), and the National Historic Preservation Act (NHPA). The district court held that the BLM’s refusal to consider in detail an alternative requiring reinjection of produced water was not unreasonable, and that the BLM did not act arbitrarily in preparing separate EISs for the Montana and Wyoming portions of the Powder River Basin. The court expressed an “advisory opinion” that the BLM generally took the requisite “hard look” at impacts under NEPA, although it did identify “areas of concern.” The court further found the FLPMA challenges not ripe for review and the NHPA claims inadequately supported.

On April 5, 2005, the district court entered an injunction limiting the BLM’s issuance of CBM drilling permits to 500 per year while the BLM supplemented the Statewide EIS. The Northern Cheyenne Tribe, Native Action, and the Northern Plains Resource Council, plaintiffs in the two consolidated cases, appealed the injunction ruling to the Ninth Circuit and sought emergency injunctive relief. The plaintiffs asserted that irreparable harm would result from the level of development permitted under Judge Anderson’s injunction.

In an order issued by Circuit Judges Pregerson and McKeown in *Northern Cheyenne Tribe v. Norton*, Civ. Nos. 05-35408, 05-35413 (9th Cir. May 31, 2005), the Ninth Circuit granted emergency motions for injunction pending appeal. The order enjoined the BLM from “approving any coal bed methane production projects in the Powder River Basin of Montana” pending resolution of the appeal or further order of the court. The order also enjoined defendant-intervenor Fidelity Exploration and Production Co. from drilling any further wells or constructing any production and transportation infrastructure associated with those elements of its Coal Creek Project that are subject to BLM approval.

The consolidated appeals from the district court’s decision are proceeding before the Ninth Circuit under an expedited briefing schedule. Oral argument is scheduled for September 15, 2005.

### D.C. CIRCUIT AFFIRMS DENIAL OF DEDUCTION OF COSTS OF REMOVING CO<sub>2</sub> IN VALUING ROYALTY

Amoco Production Company (Amoco) appealed the decision of the U.S. District Court for the District of Columbia, denying its request for declaratory relief and injunction against the Department of the Interior (DOI), and holding that Amoco owed

additional royalties on its production of coalbed methane gas from certain federal leases. This decision was previously reported in this *Newsletter*, at Vol. XXI, No. 2 (2004). In *Amoco Production Co. v. Watson*, 410 F.3d 722 (D.C. Cir. 2005), the Court of Appeals of the District of Columbia affirmed the district court’s decision and upheld the DOI’s determination that Amoco owed additional royalties.

Amoco produces coalbed methane gas in the San Juan Basin under federal oil and gas leases. Producers of this gas must remove excess carbon dioxide, considered to constitute 2% - 3% or more of the volume, from the coalbed methane to meet the specifications of the mainline natural gas pipelines. The Minerals Management Service (MMS) issued a letter on April 22, 1996, to lease operators and royalty payors explaining guidelines for calculating royalties on coalbed methane. These guidelines provided that (1) removing excess carbon dioxide was considered a cost of placing the gas in marketable condition and (2) the producers could deduct the costs of transporting the methane and the allowable 2% - 3% portion of carbon dioxide to the treatment center, but not the cost of transporting the excess carbon dioxide to be removed. The MMS subsequently issued an order finding Amoco deficient in its royalty payments for the period between 1989 and 1996.

The D.C. Circuit held that the Assistant Secretary’s interpretation of the Mineral Leasing Act (MLA), which required Amoco to pay royalties on the cost of treating the gas to reduce the carbon dioxide to the level required to place the gas in marketable condition, was not unreasonable. The court explained that the Assistant Secretary’s decision followed the language of the Mineral Leasing Act (MLA), 30 U.S.C. § 226(b)(1)(A), which requires producers to pay royalties based on the “amount or value of the production removed or sold from the lease.” The court held that this phrase is sufficiently broad to cover gas produced from the lease that is marketed at a remote location.

The appellate court also held that the Assistant Secretary’s approach to the MLA’s marketable condition rule was consistent with the regulatory scheme. The Assistant Secretary concluded that because the “dominant market for gas from the area is for gas that is utilized in distant markets with a much lower carbon dioxide content,” sales contracts for treated gas were typical for the area, while those for untreated gas were not. The court explained that the Assistant Secretary’s conclusion conformed to the purpose and wording of the regulation, 30 C.F.R. § 206.151, which defines gas in “marketable condition” as gas acceptable to “a purchaser under a sales contract typical for the field or area.”

The appellate court additionally held that excess carbon dioxide must be removed for the gas to be considered marketable under 30 C.F.R. § 206.152(i), which states that the lessees must “place gas in marketable condition . . . at no cost to the Federal Government.” Because the removal of the excess carbon dioxide is necessary to place the gas in marketable condition, these costs could not be considered transportation costs.

The appellate court also addressed the application of the six-year statute of limitations under 28 U.S.C. § 2415(a). The court held that the statute of limitations does not apply to bar an administrative order demanding payment owed pursuant to the MLA and its regulations. The D.C. Circuit declined to follow the

Tenth Circuit and joined the rationale of the Fifth Circuit in declining to apply the statute of limitations to the administrative order.

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a partially collapsed mine shaft known as the El Paso Shaft. The El Paso Shaft connects to the Roosevelt Tunnel, a six-mile drainage tunnel constructed around 1910 to drain groundwater from the various mines in the Cripple Creek Mining District. The Roosevelt Tunnel ultimately discharges into Cripple Creek, which eventually empties into the Arkansas River.

The case originated in November 2001, when the Sierra Club and the Mineral Policy Center filed suit against El Paso, alleging a violation of section 402 of the Clean Water Act, 33 U.S.C. § 1342, by discharging zinc and manganese from a point source into Cripple Creek without a valid permit. A federal magistrate judge granted summary judgment for the plaintiffs, ultimately ordering El Paso to pay \$94,900 in civil penalties and attorneys' fees and costs, as well as ordering El Paso to apply for an NPDES permit.

In the meantime, interestingly enough, the Colorado Water Quality Control Division (CWQCD) was pursuing an administrative action against El Paso based on these very same facts. This case was ultimately referred to a Colorado administrative law judge (ALJ), who concluded that El Paso *could* be liable for pollutants running out of its mine workings even though it was not currently mining the property. However, contrary to the magistrate judge's conclusion, the ALJ saw no evidence of a hydrological connection between the El Paso Shaft and Cripple Creek, but then found that El Paso *was* discharging pollutants into state waters simply because the discharge from the El Paso Shaft entered the Roosevelt Tunnel. In short, the ALJ found that the water in the Roosevelt Tunnel constituted "state waters," and therefore there was no need to make the hydrological connection to the creek itself. This proceeding was then stayed pending the Tenth Circuit decision.

The Tenth Circuit addressed three oft-debated issues surrounding the application of the Clean Water Act to inactive mine sites in the Rocky Mountain West. First, El Paso argued, pursuant to the Supreme Court decision in *Gwaltney of Smithfield, Ltd. v. Chesapeake Bay Foundation, Inc.*, 484 U.S. 49 (1987), that the Sierra Club's lawsuit was based on "wholly past" violations of the Clean Water Act that were not actionable at this time. The Tenth Circuit disagreed, emphasizing that the discharge of pollutants through the El Paso Shaft was alleged by plaintiffs to be "an *ongoing discharge* of pollutants from a point source into navigable waters." Slip op. at 14 (quoting Order at 13). The court then distinguished precedent cited by El Paso, noting that the ongoing migration cases relied on by El Paso all involved an identifiable discharge from a point source that "occurred in the past"—whether it be a spill, leak from a chemical plant, or dumping of waste rock at a mine. In these cases, the Tenth Circuit reasoned, the "discharging activity" from a point source had ceased, all that remained was the migration of pol-

lutants from the source into the waterway. *Id.* In contrast, the court held that the instant case did not involve mere migration but an allegation that the El Paso mine shaft itself remained the point source discharge under the "unique facts of this case." The court found that the El Paso Shaft constituted the ongoing man-made source delivering pollutants to the Tunnel, therefore creating the ongoing/continuous violation necessary to sustain a citizen suit under the Clean Water Act.

The court then tackled the related issue of whether the fact that the mine site was completely inactive, or even abandoned, removed El Paso from the reach of the act. Reviewing administrative, statutory, and prior judicial precedent, the court concluded that the key phrase "addition of any pollutant" did not require that a point source "owner," such as El Paso, take some affirmative conduct before liability attaches. In other words, an owner of a source can be liable for a discharge of pollutants occurring on its land, whether or not the owner acted in some way to cause the discharge. Using an analogy that will doubtless be echoed in other forums in the future, the court concluded, "This is a case where if you own the leaky 'faucet,' you are responsible for its 'drips.'" Slip op. at 27.

Finally, the court tackled the oft-debated issue of the extent to which a hydrologic connection between the original source and the receiving waters is required in order to substantiate a Clean Water Act claim. Noting that the language of the Clean Water Act certainly requires a connection or link between the discharge of pollutants and their addition to navigable waters, the court overruled this aspect of the magistrate judge's opinion, which had held that no factual dispute existed that a hydrological connection had been established. The court closely compared the expert reports filed by plaintiffs and defendants, each of whom had studied the hydrological and geological conditions in the area and had entered the Roosevelt Tunnel at some point to observe the underground workings. Emphasizing the need to view the facts in favor of the non-moving party, the court held that plaintiffs failed to establish the absence of a genuine factual dispute surrounding the hydrologic condition. Importantly, the court noted that the experts may well have agreed that some water from the El Paso Shaft reached the portal, but had not agreed whether "pollutants" coming from the shaft actually are discharged. Citing the dramatic declines in zinc levels as water flows from the El Paso Shaft toward the portal, and the apparently complex process of infiltration and exfiltration that occurs along the length of the Roosevelt Tunnel, the court concluded that just because El Paso Shaft water flowed through the Tunnel, the same pollutants did not necessarily travel along with it. Perhaps not by coincidence, the court returned to the ALJ decision in the state CWQCD proceedings and noted that the ALJ had concluded that the state did not have an objective explanation as to why zinc levels had dropped so dramatically by the time they discharged from the portal. Impliedly, the court rejected the ALJ's supposition that the mere discharge into the Roosevelt Tunnel itself was sufficient to establish a Clean Water Act violation at the federal level, and remanded the case for further factual proceedings on this issue.

The Tenth Circuit decision may help build momentum for final implementation of a Good Samaritan Act, both at the feder-

al and state levels, to support the conduct of voluntary clean-up/remediation activities at inactive mine sites where point source discharges continue to flow from historic mine activities. At last word, efforts were continuing in the U.S. Senate, led by Senator Ken Salazar, to advance legislation on this point. Moreover, the decision promises to cause further pause for mine operators in making decisions whether to expand their operations or otherwise take on an ownership position at inactive mine sites with historic pollution problems. Perhaps the one bright side for mine operators is that the case underscores the proposition, discussed in prior columns, that the mere allegation of a hydrologic connection between a pollutant source and receiving waters is not sufficient to sustain a Clean Water Act claim. Either way, the case promises to be only an interim stop along the long path towards resolving this complex and interesting issue.

## CONGRESS / FEDERAL AGENCIES GENERAL

ROBERT C. MATHES  
— REPORTER —

### CONGRESS ENACTS ENERGY POLICY ACT OF 2005

Shortly before the August recess, Congress passed the Energy Policy Act of 2005 (the Energy Policy Act), Pub. L. No. 109-58, 119 Stat. 594 (2005). The vote in the House of Representatives was 275 to 156 and the Senate passed the final measure by a vote of 74 to 26. The Act is a far reaching piece of legislation impacting a wide variety of energy-related issues ranging from the efficiency of refrigerators to the location of liquefied natural gas terminals. Below is a brief summary of a few of the most significant highlights from the Energy Policy Act.

*Geothermal Energy.* Title II, Subtitle B, of the Energy Policy Act, the subtitle also known as the John Rishel Geothermal Steam Act Amendments of 2005, significantly revises and overhauls the geothermal leasing program. The Geothermal Steam Act Amendments include provisions for new lease terms, new lower royalty rates, and revisions to the current leased acreage limitations.

*Oil and Gas.* Additionally, the Energy Policy Act contains numerous provisions that relate to the onshore and offshore production of natural gas, as well as provisions relating to the exportation and importation of natural gas. Section 311 of the Act gives the federal government the exclusive authority to approve or deny an application for the siting, construction, expansion, or operation of liquefied natural gas terminals, as well as setting forth the procedures for filing the applications.

Section 322 of the Energy Policy Act exempts hydraulic fracturing from the definition of "underground injection" under the Safe Drinking Water Act, and thus limits the Environmental Protection Agency's (EPA) authority over hydraulic fracturing operations. Similarly, section 323 exempts oil and gas exploration and production activities from the Federal Water Pollution Control Act, limiting EPA's authority over the construction of oil and gas well pads and locations.

Title 3, Subtitle E, of the Energy Policy Act establishes a permanent royalty-in-kind (RIK) program, replacing the temporary RIK pilot project that was operating in Wyoming and the Gulf of Mexico. The program allows the Secretary of the Interior to demand that royalties be paid in kind, in a marketable condition, rather than as a percentage of gross proceeds received.

The Act additionally creates marginal property production incentives for those leases that produce less than 15 barrels of oil per day or 90 million BTUs of gas per well per day averaged over a period of three months. The relief for marginal properties is conditioned upon the base price of \$15.00 per barrel for oil and \$2.00 per million BTUs for gas production for a period of 90 consecutive trading days. The royalty reduction shall be the lesser of 5% or the applicable rate under any other statutory or regulatory royalty relief provision that applies to the affected production. *See* § 343.

Section 350 of the Energy Policy Act amends the Combined Hydrocarbon Leasing Act allowing the Bureau of Land Management (BLM) to issue leases for oil and gas separate from those for tar sands. This provision effectively opens approximately one million acres of BLM land in Utah to conventional oil and gas leasing.

The Act additionally modifies section 27(d)(1) of the Mineral Leasing Act, which prohibits an entity from owning or controlling more than 246,080 acres of federal oil and gas leases in any one state at any one time. The limitation was modified by excluding leases for which royalty, including compensatory royalty or royalty in kind, was paid in the preceding calendar year.

*Access to Federal Lands.* The Energy Policy Act contains several provisions intended to facilitate onshore oil and gas leasing and permitting practices including a requirement that the Secretary of the Interior and the Secretary of Agriculture perform an internal review of current onshore oil and gas leasing and permitting practices. *See* § 361. The Act additionally contains several provisions intended to facilitate leasing and new statutory deadlines for the BLM to consider applications for permits to drill. Section 366 provides that the BLM must notify the applicant within 10 days of the receipt of an APD whether the application is complete or what information is missing and must, within 30 days, issue a permit or defer the decision after notifying the applicant of the list of actions the agency must take to comply with other laws such as NEPA and a deadline for completion of such actions.

Additionally, the Energy Policy Act requires the Secretary of the Interior and the Secretary of Agriculture to develop and implement best management practices (BMPs) designed to improve the administration of oil and gas leasing and development operations within 18 months of enactment. New regulations implementing the BMPs must be promulgated for comment not later than 180 days after the BMPs have been developed. *See* § 362.

Section 365 of the Energy Policy Act creates and funds a pilot program in the Rocky Mountains that would establish seven teams to provide "one-stop shopping" for APDs. The teams would include representatives from the Forest Service, the BLM, the Fish and Wildlife Service, the Corps of Engineers, and the applicable governors. The pilot projects will be located in Grand Junction/Glenwood Springs, Colorado; Miles City, Montana;

Carlsbad, New Mexico; Farmington, New Mexico; Vernal, Utah; Buffalo, Wyoming; and Rawlins, Wyoming, and will be funded for the next nine fiscal years from lease bonus payments.

The Act also prevents the BLM from implementing a rule-making, at least until 2015, that would authorize an increase in fees to recover additional costs related to processing drilling-related permit applications. The BLM had issued proposed cost recovery regulations, including an escalating fee of up to \$4,000 per drilling permit, in July 2005. 70 Fed. Reg. 41,532 (July 19, 2005).

*Oil Shale Leasing and Development.* Section 369 of the Energy Policy Act creates a research and development program to study and implement oil shale leasing and development in Colorado, Utah, and Wyoming. It also directs the BLM to prepare a programmatic EIS on commercial leasing of oil shale, including the socio-economic impacts of leasing and development. Finally, the Act directs the BLM to begin commercial lease sales within 2-1/2 years.

*National Environmental Policy Act Review.* Section 390 of the Energy Policy Act creates a rebuttable presumption that the use of categorical exclusions would apply to certain activities conducted pursuant to the Mineral Leasing Act for the purpose of development of oil and gas. These items include

- (1) Individual surface disturbances of less than 5 acres so long as the total surface disturbance on the lease is not greater than 150 acres and site-specific analysis . . . has previously been completed.
- (2) Drilling an oil or gas well at a location or well pad site at which drilling has occurred previously within 5 years prior to the date of spudding the well.
- (3) Drilling an oil and gas well within the developed field for which an approved land use plan or any environmental document prepared pursuant to NEPA analyzed drilling . . . within 5 years prior to the date of spudding the well.
- (4) Placement of the pipeline in an approved right-of-way corridor, so long as the corridor was approved within 5 years prior to the date of placement of the pipeline.
- (5) Maintenance of a minor activity, other than any construction or major renovation of a building or facility.

*Coal.* In addition to several studies for clean coal power initiatives and clean power projects such as coal gasification and electron scrubbing demonstration projects, the Energy Policy Act contains several provisions relating to federal coal leases including the repeal of the 160-acre limitation for coal leases. *See* § 432. The Act also authorizes the Secretary of the Interior to approve a mining plan for a period of more than 40 years if the Secretary determines that the longer period will ensure the maximum economic recovery of the coal deposit or that the longer period is in the interest of orderly, efficient, or economic development of the coal resource. *See* § 433. Additionally, the Act eases the requirement for the payment of advance royalties, *see* § 434, eliminates the deadline for submission for coal lease operation and reclamation plans, *see* § 435, and eases the requirements for a coal lessee to provide surety bonds or financial assurances to guarantee the payment of deferred bonus bids, *see* § 436.

*Indian Energy and Environmental Reviews.* Section 502 of the Energy Policy Act creates an Office of Indian Energy Policy and Programs within the Department of Energy to promote Indian self-determination and Indian tribal energy development, efficiency, and use. Additionally, the Act authorizes Indian tribes and nations to proceed with the approval of a lease or right-of-way without prior approval of the Secretary of the Interior, but only after the tribe and the Department of the Interior develop an operating agreement regarding the environmental review and approval process. *See* § 503 (to be codified at 25 U.S.C. §§ 3501 *et seq.*).

#### COURT STRIKES DOWN PORTIONS OF FOREST SERVICE'S APPEAL REGULATIONS

On July 2, 2005, the U.S. District Court for the Eastern District of California struck down five separate provisions of the Forest Service's regulations regarding appeals for project level decisions. *Earth Island Institute v. Pengilly*, 376 F. Supp. 2d 994 (E.D. Cal. 2005), was originally filed as an appeal of the Forest Service's approval of a timber sale, and became a facial challenge to the Forest Service's appeal regulations after a settlement was reached regarding project approval. The plaintiffs originally challenged the validity of eight Forest Service regulations and argued that: (1) the regulations categorically excluding certain decisions from National Environmental Policy Act analysis are unlawfully exempted from appeal; (2) the regulations exempting decisions signed by the Secretary and Under Secretary of Agriculture from comment and appeal violate the Administrative Procedure Act; (3) the Appeals Reform Act (ARA) does not allow the Forest Service to limit appeal standing to those who had filed "substantive comments"; (4) the "most effective timing" provision for public comment violates the ARA; (5) the ARA does not permit the Forest Service to intentionally refuse to decide an appeal; (6) "emergency situations" may not be defined to include pure economic losses to the government; (7) the ARA does not permit regional foresters to make emergency stay exemption determinations; and (8) the regulations improperly shorten the stay period by five days.

After reviewing each of the challenged provisions, the court determined that five specific portions of the Forest Service's regulations

are invalid . . . and will be severed from the Forest Service Regulations: 36 C.F.R. § 215.4(a) (excluding from notice and comment procedures projects and activities that are categorically excluded from documentation in an EIS or EA); 36 C.F.R. § 215.12(f) (excluding from appeal procedures decisions that have been excluded from documentation in an EIS or EA); 36 C.F.R. § 215.20(b) (exempting from notice, comment, and appeal procedures decisions signed directly by the Secretary); 36 C.F.R. § 215.10(a) (permitting delegation of the determination that an emergency situation exists); and 36 C.F.R. § 215.18(b)(1) (providing that an appeal decision will be sent to the appellants five days after the decision is rendered).

376 F. Supp. 2d at 1011. With the exception of 36 C.F.R. § 215.18(b)(1), which the court determined was issued in violation of the notice and comment procedures of the Administrative

Procedure Act, the court determined that the above regulations were issued in violation of the Appeals Reform Act, Pub. L. No. 102-381, Title III § 332(a), 106 Stat. 1419 (1992), codified at 16 U.S.C. § 1612.

It is worth noting that the Appeals Reform Act was specifically adopted by Congress in 1992 in response to rules proposed by the Forest Service that would have excluded from notice, comment, and appeal processes “any proposed action not subject to environmental analysis and documentation in an Environmental Assessment.” 57 Fed. Reg. 10,444, 10,446 (Mar. 26, 1992). The court in *Earth Island* specifically determined that the above-referenced regulations improperly exempted certain Forest Service decisions from appeal, improperly exempted certain Forest Service decisions from the automatic stay provision of the Appeals Reform Act, and improperly limited the public comment and appeals process required by the Appeals Reform Act. At this time it is not clear whether the Forest Service will appeal the district court decision or whether the Forest Service considers the decision binding outside the Eastern District of California or the administrative boundaries of the Ninth Circuit.

## CONGRESS / FEDERAL AGENCIES OIL & GAS

ROBERT C. MATHES  
— REPORTER —

### BLM SOLICITS NOMINATIONS FOR OIL SHALE RECOVERY PROGRAMS

On June 9, 2005, the Bureau of Land Management (BLM) issued a notice initiating a demonstration project under which small tracts may be leased for oil shale research, development, and demonstration, pursuant to the BLM’s authority under section 21 of the Mineral Leasing Act, 30 U.S.C. § 241, to lease federal lands for oil shale development. 70 Fed. Reg. 33,753 (June 9, 2005). In the notice, the BLM describes the initiation of a phased or staged development approach to oil shale development in Colorado, Utah, and Wyoming. The first step, announced by the notice on June 9, 2005, is to develop a research development and demonstration leasing program. The BLM’s oil shale program design allows tracts of up to 160 acres to be used to demonstrate the economic and technical feasibility of developing oil shale reserves over a 10-year period. Additional five-year extensions will be granted where “obvious significant progress has been made towards perfecting the technology during the primary period of ten years.” 70 Fed. Reg. at 33,754.

Applicants may also identify up to an additional contiguous 4960 acres which the applicant requests BLM to reserve for a preference right lease to be awarded following: (1) the demonstration that the applicant’s technology . . . has the ability to produce shale oil in commercial quantities; (2) evaluation pursuant to the National Environmental Policy Act that concludes that commercial scale operations of the applicant’s technology . . . does not pose environmental or social risks unacceptable to BLM;

(3) provision of adequate bond to cover all costs associated with reclamation and abandonment of the expanded lease area; and (4) consultation with state and local governments on a strategy to mitigate socio-economic impacts, including but not limited to, the infrastructure to accommodate the required workforce.

70 Fed. Reg. at 33,754. The lessee shall pay the United States, in advance, the statutorily established rent of 50 cents for each acre or fraction thereof during the continuance of the lease. However, the BLM will not require the lessee to pay royalties so long as the lessee is not producing commercial quantities from the leasehold, as determined by the BLM. Nominations for oil shale research, development, and demonstration leases had to be filed between June 9, 2005, and September 7, 2005.

### MMS AMENDS FEDERAL RULE ON OFFSHORE PLATFORMS AND STRUCTURES

The Minerals Management Service (MMS) issued final regulations on July 19, 2005, streamlining the permitting process for floating platforms and incorporating by reference into MMS regulations industry standards pertaining to floating production systems. Until this rulemaking, MMS regulations did not specifically address floating facilities separately from fixed platforms. The final rule amends the current subpart I of 30 C.F.R. pt. 250 to include coverage of floating offshore oil and gas production platforms. 70 Fed. Reg. 41,556 (July 19, 2005) (to be codified at 30 C.F.R. pt. 250). The amendments are designed to address the rapid increase in deep water exploration and development, and the industry’s increasing reliance on floating facilities for those activities. The new regulations became effective August 18, 2005.

### BLM TERMINATES STRIPPER WELL ROYALTY RATE REDUCTIONS

The BLM announced on July 21, 2005, that it will stop offering reduced royalty rates for certain low-producing oil wells known as “stripper wells.” The BLM will end its Stripper Well Royalty Rate Reductions Program effective for sales on or after February 1, 2006. 70 Fed. Reg. 42,093 (July 21, 2005). The program was intended to ensure that stripper wells—defined as wells producing fewer than 15 barrels of oil per day—would remain in operation, thus maintaining a royalty revenue stream and preventing the premature abandonment of low-producing oil wells. Under existing BLM regulations the BLM has the authority to terminate royalty rate reductions for stripper well properties upon six months’ notice. 43 C.F.R. § 3103.4-2(b)(4).

## ALABAMA — OIL & GAS

EDWARD G. HAWKINS  
— REPORTER —

### UPDATE ON *ALABAMA V. EXXON*: BACK TO THE ALABAMA SUPREME COURT

For at least the past 12 years the State of Alabama has been in continuing royalty disputes with oil companies that are producing gas from Mobile Bay under state offshore leases. The disputes involve issues such as: whether the lessee has free use

of gas for fuel, what value of the product should be used to calculate the royalty, whether the lessee can cost net, whether the lessee can allocate drilling costs to state leases where no wells exist for purposes of calculating payout, and whether the lessees owe royalties on condensate and sulfur. *See Alabama v. Exxon Corp.*, No. 99-2368 (Cir. Ct. Montgomery County, Ala. Mar. 29, 2004) (post-judgment order).

Two of the disputes resulted in significant verdicts for the State, but the oil companies appealed those verdicts to the Alabama Supreme Court. *Exxon Corp. v. Department of Conservation & Natural Resources*, 859 So. 2d 1096 (Ala. 2002), and *Hunt Petroleum Corp. v. State*, 901 So. 2d 1 (Ala. 2004). Both cases involved the payment of production royalties under the State of Alabama offshore lease forms. In both cases, juries awarded the State of Alabama substantial compensatory and punitive damages on breach of contract and fraud claims. The *Exxon* case has gone before two separate Montgomery, Alabama, juries. The first trial resulted in a verdict against Exxon on December 20, 2000, in the total amount \$3.507 billion (\$87.7 million compensatory and \$3.4 billion punitive damages). The Alabama Supreme Court overturned that verdict on appeal and remanded the case back to the Montgomery County Circuit Court. *Exxon Corp. v. Department of Conservation and Natural Resources*, 859 So. 2d 1096 (Ala. 2002). *See* Vol. XX, No. 1 (2003) of this *Newsletter*. On remand, a second Montgomery County jury returned a verdict in the total amount of \$11.902 billion (\$102.8 million compensatory and \$11.8 billion punitive). (*Department of Conservation and Natural Resources v. Exxon Corp.*, No. CV-99-2368 (Cir. Ct. Montgomery County, Ala. Nov. 14, 2003). *See* Vol. XX1, No. 1 (2004) of this *Newsletter*. The trial court remitted the second verdict to \$3.5 billion in punitive damages by post-judgment order entered on March 29, 2004. The order is *available at* [www.cunninghambounds.com/pdf/04-03-29POSTJUDGMENTORDER.pdf](http://www.cunninghambounds.com/pdf/04-03-29POSTJUDGMENTORDER.pdf) (website of law firm representing the State). The second *Exxon* verdict is now returning to the Alabama Supreme Court on appeal (Supreme Court Case No. 1031167). The parties have gone through mediation, but were unable to reach settlement.

The defendant oil companies characterize the cases as “contract disputes,” while the State of Alabama emphasizes the fraud aspects of the cases. None of the reported materials, whether in the media or in the reported decisions of the Alabama Supreme Court, reveal a clear picture about the actual issues in the *Exxon* dispute or the evidence that was before the juries. The trial court’s post-judgment order following the second jury verdict in the *Exxon* case, however, gives an in-depth look at the issues and the evidence for and against each party.

The State of Alabama filed its Appellee’s brief in the second appeal of the *Exxon* case on June 30, 2005. *Amicus curiae* briefs have been filed on the State’s behalf by The Retirement Systems of Alabama; the Alabama Securities Commission; the Alabama State Employees Association; the Attorneys General of Alaska, Oklahoma, West Virginia, and Delaware; the Taxpayers Against Fraud Education Fund; and the National Association of Royalty Owners, Inc. The case should now be under submission for consideration by the Alabama Supreme Court.

#### REDUCED FILING REQUIREMENTS WITH THE STATE OIL AND GAS BOARD OF ALABAMA

The State Oil and Gas Board of Alabama, in Order No. 2005-44, on April 22, 2005, approved amendments to the Oil and Gas Board Administrative Code that reduce the filing requirements for logs, directional surveys, drill stem tests, and core analyses.

## CALIFORNIA — MINING

PENNY ALEXANDER-KELLEY  
M. WILLIAM TILDEN  
— REPORTERS —

#### GOLD MINING DOES NOT REQUIRE “SPECIAL USE AUTHORIZATION”

In *United States v. McClure*, 364 F. Supp. 2d 1183, 1186 (E.D. Cal. 2005), Terry Lee McClure was charged with operating a gold mining suction dredge in a river without an approved plan of operations. The government claimed he was violating 36 C.F.R. § 261.10(k), which prohibits the “[u]se or occupancy of National Forest System land or facilities without special-use authorization when such authorization is required.” McClure defended on the grounds that his mining operations may have required an approved plan of operations but they did not require a “special-use authorization,” and thus there was no violation of 36 C.F.R. § 261.10(k). The district court agreed, noting that 36 C.F.R. § 251.50(a) designates as “special uses” “[a]ll uses of National Forest System lands, improvements, and resources, *except* those authorized by the regulations governing . . . [among other things] *minerals*. . . .” Thus, uses authorized by the mining rules were not “special uses” and 36 C.F.R. § 261.10(k) could not be the basis for McClure’s alleged violation of law.

The result in *McClure* suggests that there may be a gap in the federal rules. On the other hand, the government might have had more success if it had charged McClure with violating 36 C.F.R. § 261.10(a), which prohibits “[c]onstructing, placing, or maintaining any kind of road, trail, structure, fence, enclosure, communications equipment, or other improvement on National Forest System lands or facilities without a special use authorization, contract, or approved operating plan.” Using this authority, the government might have argued that McClure was “constructing, placing, or maintaining . . . [an] improvement on National Forest Lands without . . . [an] approved operating plan.”

Interestingly, if McClure had an approved operating plan but was operating outside its scope, he could have easily been charged under 36 C.F.R. § 261.10(l), which prohibits “[v]iolating any term or condition of a special-use authorization, contract or approved operating plan.” As the court noted, however, “[a] miner may be charged under 36 C.F.R. 261 for violating an approved plan of operations, but may not be charged for failing to submit a ‘notice of intent’ or to file a ‘plan of operations,’ when required to do so.” 364 F. Supp. 2d at 1186 (citations omitted).

**Note:** The report on the *McClure* case was prepared by Mark S. Squillace, Mining Editor of this *Newsletter*.

## GOVERNOR ANNOUNCES APPOINTMENTS TO THE STATE MINING AND GEOLOGY BOARD

On March 31, 2005, Governor Arnold Schwarzenegger announced the appointment of five new members of the State Mining and Geology Board (SMGB). These appointments were made despite the fact that the SMGB has been slated for proposed elimination or reform in accordance with the Governor's California Performance Review, his government reorganization plan. The appointees require Senate confirmation which has not yet occurred.

## S.B. 668 WOULD AMEND THE SURFACE MINING AND RECLAMATION ACT (SMARA) TO ALLOW MORE STATE AGENCY INTERVENTION IN LOCAL MINING/LAND USE DECISION-MAKING

In February 2005, State Senator Kuehl again introduced Senate Bill (S.B.) 668 to amend the Surface Mining and Reclamation Act of 1975, Cal. Pub. Res. Code §§ 2770 *et seq.* (SMARA). The proposed amendment would expand the authority of the State Department of Conservation (DOC) to intervene in local lead agency land use decisions concerning mining in three key ways.

First, under current law, SMARA requires a local lead agency to submit to the DOC proposed reclamation plans for review and comment by the DOC. The proposed amendment to Cal. Pub. Res. Code § 2774(d)(2) would require the local lead agency to provide written responses to the DOC at least 30 days prior to approval and provide 30 days' notice to the DOC and the affected surface mining operator regarding the time, place, and date of a hearing for the approval of such reclamation plans or, if no hearing is required, to provide 30 days' notice of the intent to approve.

Second, S.B. 668 proposes to amend Cal. Pub. Res. Code § 2774.1(f), which currently requires the DOC to provide 15 days' notice of a violation of the act to the local lead agency prior to taking any action to enforce SMARA or determining that the violation amounts to an imminent and substantial endangerment of the public health or safety or the environment. The proposed amendment would authorize the Director of the DOC, after providing the lead agency with written comments, to file a court proceeding against the lead agency seeking to set aside the lead agency's approval of a reclamation plan or amendment thereof or approval of a financial assurance. Such court action would have to be brought within 45 days of the lead agency's approval, provided that the lead agency has given notice as required by Cal. Pub. Res. Code § 2774(d). If the lead agency fails to provide notice to the DOC, the DOC may file a court action against the lead agency up to 180 days after the lead agency approval.

Finally, S.B. 668 would amend Cal. Pub. Res. Code § 2774.1(g) to authorize the DOC Director to seek an injunction in state court against a surface mining operation that is allegedly operating pursuant to a reclamation plan or financial assurance that does not conform to the law, or is operating "outside the boundaries of its approved reclamation plan." The Director need not demonstrate absence of irreparable harm or the insufficiency of other legal remedies to obtain such injunctive relief.

## CALIFORNIA — OIL & GAS

KEVIN L. SHAW  
— REPORTER —

### CITY OF LONG BEACH MAY CREATE AN OIL ABANDONMENT RESERVE FUND FROM ITS OIL REVENUES

In *State ex rel. California State Lands Commission v. City of Long Beach*, 23 Cal. Rptr. 3d 126, 133 (Cal. Ct. App. 2005), the court held that California law "authorizes the City [of Long Beach] to create and maintain an oil abandonment reserve to cover costs that are certain to occur and can be reasonably estimated." *Id.* at 133.

In 1911, the State granted the City of Long Beach all of its right, title, and interest in tidelands situated within the boundaries of the city, to be held in trust for use in establishing a harbor and in constructing anything necessary or convenient for the promotion of commerce and navigation. The conveyance was subject to other conditions and reservations as well.

The City of Long Beach derives revenue from its tidelands. Oil and gas beneath the tidelands are produced under contracts between the City and oil company contractors, rather than conventional oil and gas leases. With one exception, the contractors have no obligation to plug and abandon wells and remove remaining production facilities after the contracts end. The City and the State of California expect a substantial number of wells and production facilities to remain after the contracts terminate. The cost of plugging and abandoning the wells and removing facilities is estimated to be between \$200 million and \$500 million. The City created an abandonment reserve fund, funded through a continuing monthly per barrel charge, in order to meet this future cost.

According to California law, the city may only retain oil revenue for amounts expended for subsidence costs, amounts expended for oil and gas operations, and a specified amount for trust purposes. 1964 Cal. Stat. ch. 138, § 4(d) & (e). Pursuant to the statute, oil revenue that is not retained for such purposes nor paid to the State Lands Commission to cover the cost of administering the act, is to be paid to the State, free from the public trust. (In the 1950s, the California Supreme Court held that the legislature has the power to partially revoke the public trust.) The State filed a petition for writ of mandate, to compel the City to cease withholding funds from oil revenues for the plugging and abandonment (P&A) reserve fund and to pay all such funds previously withheld to the State. The State argued that the legislature by using the word "expended" forbade the City from reserving funds for future use. The court disagreed. It stated that the well plugging and abandonment are required by law and the "costs thereof are unquestionably attributable to the extraction or sale or disposition of oil and gas from the tidelands—a category of expense expressly made deductible by the Legislature in calculating oil revenue." *City of Long Beach*, 23 Cal. Rptr. 3d at 137 (internal quotations and brackets omitted).

**AGREEMENTS RELEASING COMPANY FROM LIABILITY FOR TRANSPORTATION OF RECYCLED OIL FIELD MATERIALS ARE ENFORCEABLE**

A California appellate court concluded that signed releases holding a defendant harmless for transporting its soil from its oil field to plaintiff's commercial property are enforceable. *Santa Maria Enterprises, Inc. v. Texaco Exploration & Production, Inc.*, B161737, 2005 Cal. App. Unpub. LEXIS 2658, at \*1 (Cal. Ct. App. Mar. 24, 2005) (unpublished).

The officers of Santa Maria, a real estate company, wanted to obtain soil—oil field sump material—from Texaco's oil field to build parking lots on its property. Texaco relied on Santa Maria's representation that it would cover the material with asphalt. An official from the Regional Water Quality Control Board (Board) inspected the material and found that it contained no toxic substances. The Board approved the use of the material on Santa Maria's property.

Santa Maria signed three agreements that released Texaco from liability. The first stated: "The undersigned landowner acknowledges that they have agreed to purchase permitted, recycled oil field road material. . . . The undersigned landowner accepts ownership of this material to be used according to the conditions in the attached permit and with the receipt of this material agrees to completely absolve Texaco E & P, Inc. of any future liability." *Id.* at \*3. The other two releases each stated that

Landowner has agreed to purchase the Earthen materials for the sole purpose of beneficial reuse as a compacted base fill under an asphalt parking area. . . . Texaco will . . . arrange for the transportation of the Earthen Materials from their current location to the Property. . . . Landowner releases and discharges Texaco . . . from any claims arising out of or related to the activities contemplated by this Agreement, including removal or remedial actions, related investigations and . . . damage actions. . . .

*Id.* at \*4.

Two years later, Santa Maria said it found oil debris in the area where the soil was delivered. The Board ordered Texaco to remove the material. It would not have ordered Texaco to do so if Santa Maria had paved over the sump material with asphalt. Santa Maria sued Texaco and RMR, a licensed contractor that had transported the sump material from Texaco's oil field to Santa Maria's property. The trial court found for the defendants.

Among other conclusions, the appellate court held that the releases were valid. The releases were not contracts of adhesion nor were they facially unlawful. The officers of Santa Maria were familiar with the oil business and the contracts did not authorize the delivery of contaminated oil field sump waste. Texaco's lack of a contractor's license did not invalidate the releases. Also, Texaco's compliance with the Board's order was not an admission of liability. The release also immunized RMR even though it was not expressly mentioned in the releases. Lastly, hauling dirt to be used as landfill under asphalt is not an ultrahazardous activity subject to strict liability.

**UNDER CALIFORNIA CONSTITUTION, MINERAL RIGHTS ARE NOT TAXED WHEN THEY ARE DISCOVERED OR ATTAIN VALUE**

*Central California Power Agency No. 1 v. County of Sonoma*, 19 Cal. Rptr. 3d 713 (Cal. Ct. App. 2004), discussed the formula used in Cal. Const. art. XIII, § 11, to calculate the value of land for purposes of taxation. That section sets forth the rules for the taxation of lands owned by a local government that are located outside its boundaries.

The Central California Power Agency (CCPA), comprised of the City of Santa Clara, the Modesto Irrigation District, and the Sacramento Municipal Utility District, built the Coldwater Creek Geothermal Power Plant in Sonoma County. The plant began operating in 1988 and four years later CCPA acquired leasehold interests in the Coldwater Creek Geothermal Steam Field. The steam field provided fuel for the plant. These interests in geothermal rights, along with related personal property and improvements, are the property at issue in this case.

CCPA paid the property taxes that Sonoma County imposed, but it requested that the State Board of Equalization (SBE) review and adjust the amounts for certain years. The central question was how to value the subsequently established mineral reserves under § 11. SBE determined that § 11 required property to be valued at the lowest of (1) its current market value, (2) its value under Cal. Const. art. XIII A, also known as Proposition 13, and (3) its value as determined by the formula prescribed in Cal. Const. art. XIII, § 11. Sonoma County claimed that the Proposition 13 value, at \$48 million, was the lowest. Using the formula in § 11, Sonoma County included additional values for subsequently discovered mineral reserves, so valued the property at \$215 million. SBE disagreed with Sonoma County's calculation. It concluded that a § 11 valuation already included all interests in the land, and thus that Sonoma County could not include additional value for the mineral rights. Under the § 11 formula, the property should be valued at \$4.5 million, which would be the lowest value. CCPA filed a claim for a refund of taxes based on the SBE decision.

The superior court and the majority of the appellate court agreed with the State Board of Equalization, which found that Sonoma County had improperly included additional value for the mineral rights in its § 11 calculation. Section 11(a) provides that lands and improvements owned by a local government outside its boundaries are taxable in certain instances. Section 11(b) provides that "Taxable land belonging to a local government and located outside of Inyo and Mono counties shall be assessed at the place where located and in an amount that does not exceed the lower of (1) its fair market value times the prevailing percentage of fair market value at which other lands are assessed and (2) a figure derived [by multiplying the 1967 assessed value by the ratio of the statewide per capita assessed value of land as of the last lien date prior to the current lien date to \$ 856]." *CCPA*, 19 Cal. Rptr. 3d at 723-24 (brackets in original). The ratio used in the statute is known as "the Phillips factor." The appellate court affirmed the judgment of the lower court which concluded that SBE had correctly determined the value of the property under § 11 by multiplying the 1967 assessment by the Phillips factor and adding the value of improvements. Section 11,

instead of making an exception for subsequently emerging value based on oil, gas, or geothermal discovery or production, values all interests in land as of 1967 and adjusts their assessed value by the Phillips factor for each subsequent year.

#### **REFORMATION OF GRANT DEED TO RESERVE OIL, GAS, AND MINERAL RIGHTS UPHELD**

The court in *Weyandt v. Dillett*, A104548, 2004 Cal. App. Unpub. LEXIS 8936, at \*1 (Cal. Ct. App. Sept. 30, 2004) (unpublished) affirmed the judicial reformation of a grant deed. The reformation had the effect of deleting a limited reservation in favor of the grantor/plaintiff, Shirley Weyandt, of the right to drill and remove any oil or gas below a depth of 500 feet below the surface of the property. The grant deed, as reformed, provided that the plaintiff reserved all oil, gas, and mineral rights to the property.

The land purchase agreement (pursuant to which the grant deed was given) executed by the grantee/defendant (Fred Dillett), stated that "Buyer is aware that mineral rights do not transfer with the sale." *Id.* at \*4. The appellate court stated that the intent of the parties to the purchase agreement, which was signed before the grant deed, was to exclude mineral rights from the sale of the property. Fred Dillett knew from the promotional brochure for the property, his discussions with the real estate broker, and plaintiff's response to an inquiry on the subject, that the grantor did not intend to include mineral rights in the sale. Substantial evidence was presented to support the reformation of the grant deed based on mutual mistake. The plaintiff was not bound by her allegation of "unilateral mistake" in her first amended complaint. Furthermore, her failure to discover the description of the mineral rights in the grant deed did not preclude her from obtaining a reformation of the contract. She was entitled to rely on the terms of the prior land purchase agreement which preserved her mineral rights to the property, particularly because she had consistently reasserted those rights after the agreement had been executed.

Reformation was found to be the proper remedy instead of rescission. The remedy of rescission required Dillett to show that his consent to the sale agreement was not real or free, which he was unable to do. Also, even though another grantee/defendant, Robert Smallman, did not sign the land purchase agreement, the appellate court found that he and Therese Smallman were assignees of Dillett's contract rights as purchasers of an interest in the property from Dillett. Robert Smallman testified that he had agreed with Dillett to purchase a one-third interest in the property that had arisen from the prior agreement with Weyandt. Therefore, he took subject to Dillett's rights under the land purchase agreement and grant deed, as reformed.

#### **FAILURE TO CLEAN UP CONTAMINATION FROM LEAKING PIPELINES NOT DEEMED A BENEFIT UNDER CALIFORNIA STATUTE**

In *Watson Land Co. v. Shell Oil Co.*, 29 Cal. Rptr. 3d 343, 346 (Cal. Ct. App. 2005) (partial publication) the court held that Shell Oil Company's failure to clean up contamination from its leaking pipelines was not deemed a benefit under Cal. Civ. Code § 3334. That section provides that a detriment caused by a

wrongful occupation of real property includes the value of the use of the property for the time of that wrongful occupation, the reasonable cost of repair or restoration of the property to its original condition, and the costs, if any, of recovering the possession. The value of the use of the property is the greater of the reasonable rental value of that property or the "benefits obtained by the person wrongfully occupying the property by reason of that wrongful occupation." Cal. Civ. Code § 3334(b)(1).

Watson Land Company claimed that Shell Oil Company was responsible for groundwater and soil contamination under its land, the Watson Center. Shell operated pipelines in the two major pipeline corridors that ran under the Watson Center. The jury awarded Watson the cost of clean up and, pursuant to Cal. Civ. Code § 3334, an amount equal to the benefit Shell derived when it failed to clean up the contamination. The appellate court reversed the amount of "benefits" damages awarded by the jury. The court stated that "[b]enefits" are not "obtained" by reason of a wrongful occupation unless the trespass itself provided the trespasser with a financial or business advantage." *Watson Land Co.*, 29 Cal. Rptr. 3d at 350. "No such financial advantage accrues to the owner of a leaking pipeline, at least insofar as the owner was not using the leak to effectuate disposal or to obtain some other financial gain separate from the failure to remediate the trespass." *Id.*

#### **DESPITE CHOICE-OF-LAW PROVISION, CALIFORNIA'S ATTORNEYS' FEES PROVISION APPLIES**

In *ABF Capital Corp. v. Grove Properties Co.*, 23 Cal. Rptr. 3d 803 (Cal. Ct. App. 2005), the transaction at issue was a New York partnership agreement to be performed in New York, concerning oil and gas operations in Oklahoma and Texas. The agreement stated that it was to be construed under the laws of the State of New York and stated that in the event it is decided that the defendants have breached the agreement, the defendants, a California general partnership and a California citizen, were obligated to pay attorneys' fees. The plaintiff sued defendants in California alleging that the defendants had breached the "Assumption of Liabilities" contract, in violation of a duty to the plaintiff as third party beneficiary of that contract. The defendants prevailed in that dispute. The defendants moved for an award of attorneys' fees under Cal. Civ. Code § 1717(a), which provides for mutuality of unilateral attorneys' fees provisions. The appellate court agreed with the defendants and reversed the order denying attorneys' fees.

The court stated that California has a substantially greater interest in the determination of this procedural issue than New York does and New York law conflicts with the fundamental policy of California law on this issue. Also, the fundamental policy underlying Cal. Civ. Code § 1717, the prevention of unfair litigation tactics through one-sided attorneys' fees provisions, applies to business entities as well as to individuals.

#### **REGULATION OF PORTABLE DIESEL-FUELED ENGINES**

The California Air Resources Board has adopted an airborne toxic control measure to reduce diesel particulate matter emissions from portable diesel-fueled engines having a rated brake horsepower of 50 and greater. Cal. Code Regs. tit. 17, §§ 93116,

93116.1, 93116.2, 93116.3, 93116.4 & 93116.5. Equipment using such engines include pumps, cranes, oil-well drilling rigs, rock crushing and screening equipment, and power generators. Among other requirements, diesel-fueled portable engines must use certain types of fuel and must be certified to meet emission standards. All diesel-fueled portable engines must use one of the following: a CARB diesel fuel (also known as a diesel fuel Nos. 1-D or 2-D), an alternative diesel fuel that has been verified to control emissions, or a CARB diesel fuel utilizing fuel additives that have been verified to control emissions. With certain exceptions, all portable diesel-fueled engines must be certified to meet emission standards for newly manufactured nonroad engines by 2010.

## OKLAHOMA — OIL & GAS

JAMES C. T. HARDWICK  
— REPORTER —

### MARKET VALUE, FIDUCIARY DUTY, AND OTHER ROYALTY ISSUES

*Howell v. Texaco Inc.*, 2004 OK 92, 112 P.3d 1154 (Okla. 2004), involved the determination of market value of gas at the well when the first arm's-length sale occurs after the gas has been processed, whether a lessee has a fiduciary duty to a royalty owner based upon a lease and communitization agreement, and other issues of importance to producers and royalty owners. Texaco was the owner and operator of the Velma Gas Plant and also the owner of wells and leases for some of the gas processed at that plant. Although the plant and the wells were within different operating divisions of Texaco, they were owned by the same legal entity. As plant operator, Texaco purchased gas at the well from unaffiliated producers in the same field as its own produced gas on a percentage of proceeds (POPs) contract basis under which the producer was paid for its gas based upon residue gas sales and a percentage of the sales of the recovered plant products.

At issue were Texaco's leases stipulating royalty based on market value and others stipulating royalty based on proceeds at the prevailing market rate at the well (both being treated by the court as market value leases). Texaco asserted that it discharged its royalty obligations by paying its royalty owners under those leases on the same or a higher basis as it paid unaffiliated producers for gas purchased under its POPs contracts. The royalty owners asserted that market value at the well should be based upon the first arm's-length transaction, which occurred here after the gas was processed. Further, in calculating its royalty payments, Texaco had not measured and did not separately pay royalty on scrubber oil and drip condensate recovered downstream of the wellhead. Texaco asserted that the scrubber oil and condensate were considered in the percentage paid under its POPs contract. Royalty owners, however, asserted that royalties should also include amounts received for these products.

The court first stated that market value is the price negotiated by a willing buyer not obligated to buy and a willing seller not

obligated to sell in a free and open market. It stated that market value at the well is determined by an arm's-length sale at the well when there is such a sale, relying on its holding in *Tara Petroleum Corp. v. Hughey*, 1981 OK 65, 630 P.2d 1269 (Okla. 1981). *Tara* held that if a producer enters into an arm's-length, good-faith gas purchase contract with the best price and terms available at the time, that price is the "market price" and, according to *Howell*, establishes market value. However, because here there was no arm's-length sale at the well, market value could be constructed by evidence of the prevailing market price based on arm's-length wellhead sales or offers of purchase close in time to the sale at issue, either from the same well or from other wells in the vicinity. Further, in addition to the prevailing market price method, the *Howell* court held that market value could also be established by the work-back method, subtracting "allowable costs and expenses" from the first downstream, arm's-length sale price. *Howell*, 112 P.3d at 1159.

By the court's discussion of *Mittelstaedt v. Santa Fe Minerals, Inc.*, 1998 OK 7, 954 P.2d 1203 (Okla. 1998), it appears that "allowable costs" are those that the lessee is permitted to charge against the royalty owner under *Mittelstaedt*. The court stated that royalty owners are entitled only to the value of gas that is marketable at the wellhead, that under *Mittelstaedt*, when the gas is marketable at the wellhead, reasonable post-production costs may be charged against royalty payments but that the burden is on the producer to justify costs and expenses. As if to emphasize the point, the court repeated its *Mittelstaedt* holding that a producer may not deduct the costs of obtaining a marketable product, but costs incurred after the gas becomes marketable may be apportioned between royalty owner and producer.

The court next stated that the royalty owner has the right to be paid at the best price available, and that when a producer is paying royalty based on one price but selling gas for a higher price, the royalty owner is entitled to be paid on the higher price. From this, in the most controversial part of its ruling, the court concluded that the royalty owners were entitled to have their royalty payments based upon the prevailing market price or the work-back method, whichever method results in the higher market value.

As for Texaco's argument that it was not required to pay separately royalties on scrubber oil and condensate because their values were reflected in the percentages paid under third-party POPs contracts and thus in the royalty payments, the court reasoned this was a factual matter for the trial court on remand. However, the court admonished that, when using the work-back method, the court must consider the value of those products in calculating market value at the well.

This reporter has some observations on the court's market value ruling. The opinion mentions an intra-company contract between Texaco's production division and its gas plant division for the sale of gas from Texaco's leases under which the prices in this contract were at least as high as the non-affiliate POPs prices. The court even states that an intra-company sale cannot be the basis for calculating royalty payments. This has led at least one commentator to treat *Howell* as a case involving an affiliate sale. However, there was no sale of the gas prior to processing since the same Texaco entity was involved and Texaco never

argued that there was. The intra-company contract likely was used merely as an accounting device for implementing royalty payments.

It seems deducible from the court's holding that the court would apply its earlier *Tara* holding, equating an arm's-length contract price with market price, only when the first arm's-length sale is at the well and not when it is at a distant location. This follows because the court permits the prevailing market price method to establish a market value at the well higher than would result from application of the work-back method to the first arm's-length sale.

The court's application of the work-back method is novel in a couple of respects. First is the court's apparent willingness to permit deduction of only those costs that meet the requirements of *Mittelstaedt*. *Mittelstaedt*, which deals with deductibility of post-production costs in calculating royalty, requires that the gas be in marketable condition when those costs are incurred. However, the traditional work-back method utilizes the producer's actual costs between the point of valuation and the point of sale since the goal of that methodology is to determine what a willing buyer would pay a willing seller for the gas at the well. That price is dictated by the producer's actual costs incurred. See Kramer, "Royalty Interests in the United States: Not Cut From the Same Cloth," 29 *Tulsa L.J.* 449, 461 (Spring/Summer 1994).

Second, the conclusion that royalty is to be calculated based on the higher value resulting from the prevailing market price methodology or the work-back method does not accord with the recognized hierarchy for determining market value. The work-back method is described as the "least desirable," and the existence of comparable sales from which a market value can be determined forecloses use of the work-back method. See Kramer, *supra*.

Royalty owners in *Howell* also asserted that Texaco owed them a fiduciary duty as lessee under the leases that were subject to certain communitization agreements. The communitization agreements considered by the court were voluntary agreements entered into before the advent of Corporation Commission imposed drilling and spacing units under Okla Stat. tit. 52, § 87.1. Plaintiffs relied upon *Young v. West Edmond Hunton Lime Unit*, 1954 OK 195, 275 P.2d 304 (Okla. 1954), and other decisions following *Young*. *Young* involved a statutory field-wide unit created by Corporation Commission order. Texaco argued that, since no such unit or order was involved here, no fiduciary duty existed. The court sided with Texaco on this issue, noting that the communitization agreements provided for royalties to be paid in proportion to the acreage owned by each royalty owner, but otherwise the leases remained in force by reason of production anywhere in the communitized area. The court stated that, unlike unitization orders, the communitization agreements were contracts just like the leases and did not impose any greater obligations on Texaco than did the leases themselves. In contrast, reasoned the court, the interests in *Young* had been coercively unitized pursuant to statute with the result that the "leases no longer controlled." However, because here the communitization agreements expressly provided for the leases to remain in force, no fiduciary duty arose.

With the *Howell* decision, a dispute has arisen between lessees and royalty owners as to the breadth of the fiduciary duty holding. Producer/lessees assert that the *Howell* rationale applies equally to ordinary drilling and spacing units formed under Okla Stat. tit. 52, § 87.1, arguing that the only material impact on the underlying leases of such a unit is to require proportional payment of the royalty just like the communitization agreements in *Howell*. On the other hand, royalty owners argue that *Young*, not *Howell*, controls § 87.1 units because those units involve a coercive unitization order. So far, some courts have been reluctant to apply *Howell*'s fiduciary duty holding beyond voluntary communitization agreements.

As for royalty owners' claims that Texaco was liable for both constructive and actual fraud, the court noted that constructive fraud could be based on a statutory legal duty. The Production Revenue Standards Act, Okla Stat. tit. 52, § 70.12, requires certain information to be furnished with each royalty payment. The court stated that the act placed a duty upon Texaco to accurately inform the royalty owners of the facts upon which their royalty payments were based. It reversed the trial court's partial summary judgment for Texaco for constructive fraud on the basis that Texaco had not submitted summary judgment material showing compliance with the act. Further, the trial court's partial summary judgment for Texaco for actual fraud was reversed because Texaco failed to show no detrimental reliance for all royalty owners.

#### GROSS PRODUCTION TAX ON PROCESSED GAS

*State ex rel. Oklahoma Tax Commission v. Texaco Exploration & Production, Inc.*, 2005 OK 52 (Okla. June 28, 2005) (unpublished), is the gross production tax counterpart of *Howell*. The issue addressed in this case was the proper method to determine gross value of the gas when there is no arm's-length sale at the wellhead. The Tax Commission sued Texaco in state district court alleging that Texaco, for the purpose of evading payment of taxes, intentionally had implemented a scheme to calculate gross production tax on a price less than fair market value. The underlying facts, as to the gas to be valued and the point of first arm's-length sale, were identical to *Howell*, as the same gas was involved. Texaco claimed that it correctly paid taxes based upon the prevailing price established by comparable sales paid under POPs contracts to non-affiliate producers in the field for gas of like kind, quality, and character. The Tax Commission argued that Texaco was required to pay taxes based upon the gross proceeds realized from the first arm's-length sale. The trial court ruled for Texaco, concluding that the gross value of the gas was best reflected by the prevailing price in the field for gas of similar kind, quality, and character at the time of production.

The state supreme court first addressed whether the Tax Commission could forego the administrative assessment process and sue in district court for a determination of the taxes. The court held that generally the tax laws were to be enforced through the administrative process prior to bringing suit in court. However, both the Tax Commission and Texaco urged that the Tax Commission's allegations of intentional under-reporting invoked the district court's jurisdiction under a statute permitting a proceeding to go to court without assessment "in the case of either a false or fraudulent report or return." The supreme court concluded that

the Tax Commission's allegation of intentional schemes to evade taxes invoked the subject matter jurisdiction of the district court.

As for the value issue, the applicable statutes impose a tax on the severance of the gas at the rate of 7% of the gross value of the production of gas and require reporting of the total value of the gas "at the time and place of production, including any and all premiums paid for the sale thereof, at the price paid." Okla. Stat. tit. 68, § 1010(B)(5). The statute also permits the Tax Commission to require the tax to be paid on the basis of the prevailing price if the gas is sold under circumstances where the sale price does not represent the cash price prevailing for gas of like kind, character, or quality in the field.

The court purported to find some guidance in *Apache Gas Products Corp. v. Oklahoma Tax Commission*, 1973 OK 34, 509 P.2d 109 (Okla. 1973), in which the court had held that each producer should calculate the tax based on its individual sales contract except when that contract does not reflect arm's-length bargaining. In that instance, the Tax Commission should calculate the tax based on the prevailing price in the field at the time of production.

The court then turned to *Howell* (discussed above), noting that *Howell* recognized three methods for establishing market value at the well: the actual sale price paid in an arm's-length wellhead sale and, in the absence thereof, the prevailing market value method or the work-back method. The court concluded that the methods for establishing wellhead value in *Howell* fell within the "comprehensive language" used in the gross production tax statutes—"gross value" under one provision, total value including all premiums under another provision, and prevailing price under a third provision. From this, the court held that in the absence of an actual arm's-length sale at the wellhead, gross value of the gas for calculation of gross production taxes is to be determined using the prevailing price method or the work-back method adopted in *Howell*, whichever results in the higher value.

As of this report, Texaco's petition for rehearing is pending, supported by several *amicus curiae*.

## TEXAS — OIL & GAS

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### NONCONSENT PENALTY UNDER OPERATING AGREEMENT IS ENFORCEABLE WHEN OPERATIONS BEGAN BEFORE END OF NONCONSENT NOTICE PERIOD

The court in *Valence Operating Co. v. Dorsett*, 164 S.W.3d 656 (Tex. 2005), reversed and remanded a court of appeals decision that had shocked most lawyers familiar with the practical application of oil and gas operating agreements. See *Dorsett v. Valence Operating Co.*, 111 S.W.3d 224 (Tex. App.—Texarkana 2003), reported on in Vol. XX, No. 4 (2003) of this *Newsletter*.

Dorsett was a 4.05391% working interest owner and Valence the operator of the 677-acre Mobley Gas Unit under a 1977 AAPL Form 610 model form operating agreement. Article VI.B. of the form governs drilling operations after the first well. It provides that a party desiring to drill is to give the other parties notice of

the proposed operation, whereupon those receiving the notice have 30 days within which to elect to participate in the cost. Failure to respond is deemed an election not to participate. If a working interest owner does not participate, it is deemed to have relinquished its interest in the well until those who drilled the well have received specified sums out of production proceeds, in this case 100% of the cost of newly acquired surface equipment beyond the wellhead connection and 300% of the cost of drilling and completing the well. In order to be entitled to the benefits of the latter so-called "nonconsent penalty," the form of agreement provides, the party or parties electing to participate "shall, within sixty (60) days after the expiration of the notice period of thirty (30) days . . . actually commence work on the proposed operation and complete it with due diligence. . . ." 164 S.W.3d at 659.

Between 1996 and 2001 Valence drilled eight gas wells in the unit, each time notifying Dorsett and offering her the opportunity to participate in the cost. In each case Valence began at least preparatory work on the drilling location before the end of Dorsett's 30-day response period, sometimes even before Valence had sent the well proposal. Dorsett received the proposals but did not elect to participate. When Valence imposed the operating agreement's nonconsent penalty, Dorsett disputed its right to do so. Valence was required by the agreement, she contended, to allow the 30-day notice period following each well proposal to elapse before commencing work on the proposed operations. Valence's failure to have done so, the court of appeals agreed, breached the agreement and precluded its enforcement of the nonconsent penalty.

Valence countered that the purpose of the form's phrase requiring the operator to commence work "within sixty (60) days after the expiration of the notice period" is to ensure that work is not unreasonably delayed after the consent deadline, not to prohibit early commencement of work. Noting that the court's primary concern in construing a written contract is to ascertain the parties' true intention and that in doing so it must consider the entire writing, the supreme court agreed. Nothing in the agreement form's language forbids the operator from commencing work before the end of the notice period. The purpose of the provision for two distinct periods, according to the court, is to retain the working interest owner's right to 30 days' notice before being required to make a decision while also requiring the operator to commence work no later than 90 days after formally proposing the operation.

The court also recognized what the court of appeals evidently did not: that the operator's early commencement of operations could only benefit nonoperators that have not yet made a decision and harms them in no way Dorsett could identify. An early start might avoid drainage or lease expiration, and the operator bears the entire risk so long as others still have the right to elect to consent or not.

Dorsett also argued that the operating agreement's nonconsent penalty was an unenforceable liquidated damages provision. The supreme court disagreed, pointing out that liquidated damages fix in advance compensation accruing from a party's failure to perform its obligations, whereas the nonconsent penalty rewards the participating parties for undertaking a defined risk. As a nonconsenting party, Dorsett was not being punished for breaching the

agreement; she simply agreed not to participate in a return on an investment she did not make. The nonconsent penalty is designed to allow reasonable compensation for working interest owners who undertake the risk of developing new wells. Other terms sometimes used to describe this provision of the typical operating agreement, such as “sole risk clause” and “risk charges,” the court observed, convey this rationale more accurately than “penalty,” a word not found in the agreement form itself but ingrained in industry vernacular.

The decision wisely confirms the practical construction that the industry had always placed on operating agreements’ well proposal and commencement requirements. To have done otherwise would have served no identifiable purpose of the operating agreement, to the benefit of no one other than nonoperators hoping for a free ride.

#### STORAGE CAVERNS MAY BE TAXED

The Texas Supreme Court decided in *Matagorda County Appraisal District v. Coastal Liquids Partners, L.P.*, 165 S.W.3d 329 (Tex. 2005), that underground salt dome caverns used to store liquid hydrocarbons are subject to ad valorem taxation. Coastal, the lessee and user of the caverns, maintained that the caverns were inseparable from the surface and thus not separately taxable. The use of the caverns was in fact separate and apart from whatever uses were taking place on the surface, the court held, and assessing the caverns separately imposed no likelihood of double taxation. Moreover, the appraisal district’s listing of the caverns as “improvements” for 1999 after having listed them as “other” in previous years was no indication that they were being improperly taxed. So long as the appraisal district’s records were sufficiently descriptive to give Coastal notice of what property was included in each tax account, and thus some assurance that it was not included twice, assessment of the caverns under an incorrect category was immaterial and would not exempt them from taxation. Besides, the caverns were man-made and at least for taxation purposes were, in the court’s view, an “improvement,” one of the specifically taxable categories of real property.

#### COST TO CURE IMPROPER MEASURE OF SURFACE DAMAGE

The court in *Primrose Operating Co. v. Senn*, 161 S.W.3d 258 (Tex. App.—Eastland 2005, pet. filed), reversed the trial court’s award, based on a jury verdict, of more than \$3 million in favor of the plaintiff ranch owners against the operator of oil and gas wells on the ranch for surface contamination damage, interest, and punitive damages.

The Senns bought only the surface of the 23,013-acre Covered “S” Ranch in 1997 for \$3,164,000. There had been oil and gas production on the ranch since 1939, and there were some 500-600 producing wells at the time of the purchase, of which Primrose operated approximately 200. The Senns promptly began systematically searching for leaks and spills and, not surprisingly in a mature oil field, found some. Their expert testified that the soil affected by the spills at Primrose’s well sites covered a total of only about 10 acres but were spread out across the area. They needed to be remediated, he went on, by removing the contaminated dirt and replacing it with clean soil, the cost of which

would be \$2,110,000. A real estate appraiser testified for the Senns that the ranch’s value was diminished by the “cost to cure” of \$2,110,000, plus another 20% of the cost to cure for the negative stigma attached to the contamination on the basis that the cost might be more than expected. The jury assessed both the cost to clean up the contamination and the diminution in the ranch’s value at \$2,110,000, and the trial court awarded actual damages in that amount.

The court began its analysis by acknowledging that where injury to land is temporary and able to be remedied at reasonable expense, damages are measured by the cost of restoring the land to its condition prior to the injury. In the case of permanent injury, and where the cost to restore the land is excessive or not economically feasible, however, the appropriate measure of damages is the diminution in the land’s fair market value. The court here held as a matter of law that the cost to restore the land to its condition prior to the leaks was not reasonable, so that the proper measure of damages was diminution in value. Because the only evidence in support of the jury’s finding of diminution in value was the cost to cure, the trial court judgment was supported by no competent evidence and had to be reversed.

The court’s explanation is not entirely satisfying. In particular, other than that it seems obvious, it is unclear how the court arrived at its determination that remediation was not economically feasible. From remarks about the plaintiffs’ experts’ failure to take into account that the ranch was not in pristine condition when the Senns bought it and that some leaks and spills are inevitable, it is clear that the court simply did not believe that 10 acres of contaminated soil on a 23,000-acre ranch in the middle of oil country could possibly reduce by more than half the amount a willing buyer would pay. A little more attention to why this was so and how it leads to the conclusion that the cost of soil replacement would be unreasonable, together with a succinct holding that cost to cure is irrelevant under these circumstances and that value may only be proven by comparable sales, would have been helpful.

#### DISCLAIMER DID NOT WAIVE DEVISE OF LIFETIME MINERAL BENEFITS IN ADDITION TO CONVENTIONAL LIFE ESTATE

The court in *Phillips v. Ivy*, 160 S.W.3d 91 (Tex. App.—Waco 2004, pet. denied), interpreted the devise by James Bradford Ivy of a life estate in minerals to his wife Betty and a disclaimer signed by Betty Ivy. Article III of James Bradford Ivy’s will read as follows:

I hereby give, devise and bequeath all of my real property, whether separate or community to my daughter NADINE IVY PHILLIPS, subject however to a life estate in said real property, including all the oil, gas, coal and other minerals which I hereby give, devise and bequeath to my wife, BETTY JEAN IVY, to use and enjoy during her lifetime, including all rents and profits therefrom as well as bonuses and royalty income.

*Id.* at 93. Betty Ivy filed a timely disclaimer in which she refused to accept “any interest under Article III of the will other than a life estate, it being my intent hereby that I have no interest in the remainder of such property.” *Id.*

Nadine filed a declaratory judgment action for construction of the will and Betty's disclaimer. The principal issue on appeal of the trial court's summary judgment for Betty was whether Betty, after her disclaimer, was entitled to more than a conventional life estate in James Bradford Ivy's minerals.

A life tenant with a conventional life estate, the court observed, may not dispose of the corpus of the estate, and oil and gas royalties and bonus are generally considered corpus. An exception arises, however, when a testator expresses a different intent. By using the phrase "as well as bonuses and royalty income," James made a specific bequest to Betty of the royalties and bonuses from his real property in addition to the conventional life estate. This much seems not to have been controversial; the dispute concerned the effect of the disclaimer. Nadine's position was that it limited Betty to a conventional life estate, so that Nadine would be entitled to the remainder in bonuses and royalty. Betty maintained that her life estate still entitled her to retain all bonuses and royalties absolutely, without remainder in Nadine.

Without offering its rationale, the court affirmed the trial court's conclusion that the disclaimer did not operate as a waiver of any part of the life estate to which Betty was entitled under James's will. A dissenting justice believed the disclaimer clearly had the effect of limiting Betty to a traditional life estate, and it indeed is difficult to see what effect the disclaimer was intended to have if not that. It is a defensible proposition, on which the majority seems to have relied, that the additional right to retain bonuses and royalties was an attribute of Betty's life estate and not some other estate altogether. Under this rationale Betty's disclaimer of all but a life estate did not affect those rights. For the court to give no explanation of what effect Betty must have instead intended, and to fail even to express any rationale whatever, seems something of a dereliction.

#### **ROYALTY RESERVATIONS UPHELD AGAINST GRANTEE'S DENIAL OF GRANTOR'S TITLE**

The long and confusing hodgepodge that is the court's opinion in *Sauceda v. Kerlin*, 164 S.W.3d 892 (Tex. App.—Corpus Christi 2005, no pet. h.), makes it difficult to distill the salient principles the case may stand for. Perhaps it stands for little more than that it is never too late for plaintiffs with an appealing case to assert a lost South Texas land title.

Kerlin, a young New York lawyer, came to Texas in 1938 to pursue the purchase of title claims from members of the Balli family. The claims, dating from as long ago as the 1830s, involved Padre Island, which runs many miles along the South Texas coast. The Ballis were descendants of Juan Jose Balli, one of two men to whom Mexico had granted the land in 1829. Kerlin persuaded the Balli heirs to cooperate and acquired 11 deeds from family members, each conveying the grantor's interest in Padre Island as an heir of Juan Jose Balli, and reserving a 1/64 of 1/8 nonparticipating royalty in the grantor's pro rata interest. Kerlin then went about acquiring other doubtful title claims to the island with the idea of reopening and attacking earlier title litigation in order to assert the titles he had acquired. In 1939 Kerlin and his attorney, who represented Kerlin and purportedly the Balli heirs, although they were never told, succeeded in a

motion for new trial in litigation that had lain dormant since a 1928 judgment adverse to the Balli heirs.

Kerlin engaged in settlement discussions over the next several years, during which he asserted his Balli titles with particular emphasis on a tract of approximately 7,500 acres. In Brownsville on a three-day pass from duty in the army in 1942, Kerlin finalized a stipulation under which the title litigation was settled. The Balli heirs went unmentioned in the agreed judgment, but Kerlin received title to some 20,000 acres of Padre Island in the settlement, including a 7,500-acre tract alluded to in correspondence from a business associate as being "for the Juan Jose interest." While in Brownsville he executed reconveyances to the Balli heirs on his attorney's advice to abandon the Balli claims. The reconveyance deeds were never delivered or recorded, however, nor were the Balli heirs ever told the outcome of the litigation. Kerlin did tell Balli family members, on inquiries in 1954 and 1985, that their claims were no good. Meanwhile, Kerlin profited handsomely from land sales and oil and gas royalties. The Balli heirs finally sued Kerlin in 1993, and in 2000 they were awarded a judgment based on jury findings that, among other things, Kerlin was estopped to deny the royalty reservations in the Balli deeds and that he had acquired 7,500 acres in the settlement for the benefit of the Ballis that he had not shared with them.

Kerlin was bound by the nonparticipating royalty interests reserved in his deeds from the Balli family, the court of appeals held. Kerlin was mistaken in arguing that estoppel by deed does not conceptually apply to reservations, although he may be forgiven for his logic that a grantor possessing no title has nothing out of which to reserve an interest. According to Texas cases cited by the court, a grantee is concluded by recitals in the deed he has accepted, including reservations in favor of the grantor.

The court of appeals also held that the trial court had not erred in holding as a matter of law that Kerlin, as holder of the executive rights, owed a fiduciary duty to the Balli heirs, as holders of nonparticipating royalty interests. The court acknowledged that this fiduciary duty is only imposed on an executive in conjunction with the execution of oil and gas leases. When Kerlin executed leases on the property and withheld the money to which the Ballis were entitled under the reservations in their deeds, claiming his interests were not based on the Balli deeds, he breached his fiduciary duty. Although the jury had found that Kerlin had breached his fiduciary duty during the 1942 settlement, the court of appeals' holding properly seems limited to Kerlin's failure to see that the Balli royalty interests were given effect.

Why were the Balli heirs' claims not barred by limitations or laches after some 50 years? Tex. Civ. Prac. & Rem. Code § 16.063 provides that the absence from the state of a person against whom a cause of action may be maintained suspends the running of the applicable statute of limitations. Kerlin had been absent from the state, residing in New York, since the 1942 settlement. Although § 16.063 generally does not apply to nonresidents, it does apply to a nonresident who was present in the state when his obligation arose. Since Kerlin was physically in Texas to finalize the settlement but absent since, the statute was tolled. The court also upheld the trial court's application of fraudulent concealment as a defense to the bar of limitations. Kerlin contended that

fraudulent concealment was inapplicable because the disposition of the lawsuit in 1942 was a matter of public record. Kerlin failed to provide any argument in support of his proposition, however, evidently only citing cases defining the Texas discovery rule, a different doctrine. If Kerlin was arguing in effect that the Ballis should have known of the circumstances in the exercise of reasonable diligence notwithstanding Kerlin's deception, which could have overcome the fraudulent concealment argument if borne out, the court failed to notice. As for laches, the court simply stated its conclusion, with no discussion at all, that Kerlin failed to meet the requirement of showing detriment or harm resulting from the Ballis' delay in bringing the case.

#### ARBITRATION AWARD FOR WELL DAMAGE ENFORCED

The court in *Baker Hughes Oilfield Operations, Inc. v. Hennig Production Co.*, 164 S.W.3d 438 (Tex. App.—Houston [14th Dist.] 2005, no pet.), decided the appeal of a summary judgment enforcing an arbitration award against well service contractor Baker Hughes in favor of Hennig, the operator of a well on which Baker Hughes was engaged to perform a perforating job.

Baker Hughes's perforating tool collapsed in Hennig's well and was left in the hole. Hennig began fishing operations and was ultimately able to retrieve part of the tool. Hennig refused to pay Baker Hughes for the lost tool, claiming the recovered part showed the tool had collapsed because it did not meet Hennig's pressure specifications. Baker Hughes filed an arbitration demand pursuant to its contract with Hennig, seeking payment for the lost tool. Hennig counterclaimed for damages to the well resulting from the tool's collapse and, after a four-day arbitration, was awarded \$351,090.43, the cost of fishing.

Texas law favors arbitration, the court began, and a reviewing court may not substitute its judgment for the arbitrators' merely because it would have reached a different result, nor may it set aside an arbitration award for a mere mistake of fact or law. Here the parties' agreement stated they would arbitrate any controversy or claim arising out of or relating to Baker Hughes's services. Such a broad arbitration provision empowered the arbitrators to decide Hennig's breach of contract claim against Baker Hughes, regardless of whether specifically presented as such. Moreover, the arbitration panel had not committed a gross mistake implying bad faith and failure to exercise honest judgment, as Baker Hughes alleged. A party may recover repair costs, the arbitrators' measure of damages, if the costs were reasonable and the repairs necessary. Hennig pled that its fishing operations were reasonable, prudent, and in accordance with generally accepted standards, and the record did not demonstrate a gross mistake in the panel's finding Hennig's costs reasonable and necessary. Finally, the trial court had not erred in correcting the arbitration award to include the date prejudgment interest began to accrue. The Texas Arbitration Act allows a court to modify an arbitration award if the form of an award is imperfect in a manner not affecting the merits of the controversy. The arbitration panel had awarded prejudgment interest at a specified rate, although it had neglected to include the date of accrual in its award. The trial court's judgment in supplying the date merely corrected the award to effectuate the arbitrators' intent.

#### EASEMENT INCLUDES RIGHT TO TRANSPORT HYDROGEN

Affirming a summary judgment for the defendant holder of a pipeline easement, the court in *C&E Land Co. v. Air Products LP*, 401 F.3d 602 (5th Cir. 2005, per curiam), held that the grant of a pipeline right-of-way "for the transportation of oil, petroleum, gas, the products of each of the same, water, other liquids and gases, and mixtures of any of the foregoing" unambiguously allowed the transportation of hydrogen. *Id.* at 603. In the absence of any ambiguity, the court refused to consider the plaintiff's arguments based on extrinsic evidence and the doctrine of *ejusdem generis*.

## UTAH — MINING

CHRISTOPHER A. JONES  
— REPORTER —

#### GRAVEL PIT EXPANSION HELD NOT A PERMISSIBLE CONDITIONAL USE UNDER ZONING ORDINANCE PERMITTING "MINERAL EXTRACTION AND PROCESSING"

*Carrier v. Salt Lake County*, 104 P.3d 1208 (Utah 2004), involved a dispute over the expansion of an existing gravel pit from 11.5 acres to approximately 62.2 acres. In October 2000, Harper Contracting Inc. (Harper), the owner of the gravel pit, submitted an application to Salt Lake County Planning Commission (Planning Commission) seeking approval of this expansion, and styling its application as an "amendment" to its existing conditional use permit. The Planning Commission approved the application on February 13, 2001.

In response, plaintiffs David Carrier and Save Our Canyons (collectively, SOC) appealed the approval to the Salt Lake County Board of Adjustments (Board), arguing that allowing gravel pit operations in the expanded area would violate the zoning requirements applicable to that area. The expansion area was zoned FR-20, a forestry and recreation zone that allowed "mineral extraction and processing" as a conditional use, but did not expressly authorize gravel pits or quarries. The expansion area was also within the Foothill and Canyon Overlay Zone (FCOZ), which allows mineral extraction and processing uses only if a waiver of certain stringent development standards is obtained and the applicant complies with 10 enumerated development criteria.

The Board voted to uphold the Planning Commission's approval of Harper's amendment application to expand its gravel pit operations, reasoning that the property had a long history of mining operations, the gravel pit use at issue was classified as a "mine" by the Utah Division of Oil, Gas, and Mining (DOG M) when the original conditional use permit was issued in 1992, and the original conditional use permit was issued in reliance on DOGM's classification. The Board went on to note that the approval of Harper's original conditional use permit in 1992 was never appealed. However, the Board did remand the application back to the Planning Commission to further consider the definition of a "gravel pit" as compared to a "mine," whether FCOZ development waivers were required, and conditions that would mitigate the expansion of the gravel pit operation.

On remand, the Planning Commission again approved Harper's amendment application without defining the terms "gravel pit" and "mine," and with a determination that waiver of the relevant FCOZ standards was allowed based on evidence supporting only three of the ten enumerated development criteria. SOC again appealed the Planning Commission's determination to the Board. The Board voted to uphold the Planning Commission's determination in its entirety and, in response, SOC filed a complaint in district court against the Planning Commission, the Board, and Salt Lake County. In its complaint, SOC asked the court to declare that the proposed expansion of Harper's gravel pit was not allowed in the FR-20 Zone as a matter of law and that the Planning Commission's approval of the application was void for failure to follow necessary FCOZ requirements.

Following discovery, both parties filed cross motions for summary judgment. The district court denied the County's motion and granted SOC's motion, ruling that the Planning Commission lacked the authority to amend Harper's original conditional use permit and that the County was therefore required to determine whether the proposed expansion was a permitted or conditional use under existing zoning ordinances. Given this, the court reasoned that by designating the use as mineral extraction and/or gravel pit interchangeably, without defining either one, and by failing to determine whether this use met the requirements of the FR-20 Zone ordinances, the Planning Commission failed to follow relevant county zoning ordinances. It further reasoned that the terms "mineral extraction" and "gravel pit" are not interchangeable, and that the explicit inclusion of gravel pits as authorized uses in other zones, but exclusion in the FR-20 Zone, indicated that gravel pits are not included in the definition of mineral extraction. Consequently, the court concluded that, by approving the application for a gravel pit as if it were an application for mineral extraction, the Planning Commission approved the application in violation of law. Finally, the district court concluded that even if the conditional use permit had been appropriately issued, the Planning Commission nevertheless failed to adhere to the requirements mandated under FCOZ, which allows for the waiver or modification of development standards only upon evidence that all 10 of the requisite criteria have been met with specific reasons provided for each waiver granted. Because the Planning Commission only addressed three of the 10 criteria and failed to set forth reasons justifying the waivers, the court concluded that the Planning Commission violated FCOZ. The district court thus held that the Planning Commission's approval of the application for expansion of the gravel pit into the FR-20 Zone, as well as the Planning Commission's approval of the waivers to the FCOZ development standards, was null and void.

On appeal, the Utah Supreme Court upheld the district court ruling, focusing on the reasoning that, in this particular case, "mineral extraction and processing" does not encompass gravel pit operations. The court noted that the term "gravel pit" is specifically listed as a conditional use in other zones within Salt Lake County and that the omission of "gravel pits" as an enumerated permitted conditional use in the FR-20 Zone suggests that a gravel pit is not an authorized conditional use in that zone. The court also found it instructive that under Utah's Mined Land Reclamation Act, sand, gravel, and rock aggregate are explicitly excluded from the definition of the term "mineral deposit." Utah

Code Ann. § 40-8-4(14)(a). Given this, the court reasoned that it is reasonable to interpret the conditional use "mineral extraction and processing" to exclude gravel pit operations. 104 P.3d at 1218.

## WYOMING — MINING

WILLIAM N. HEISS  
— REPORTER —

### FEDERAL DISTRICT COURT FINDS AREA OF MUTUAL INTEREST CLAUSE NOT A COVENANT RUNNING WITH THE LAND

In *Mountain West Mines, Inc. v. Cleveland-Cliffs Iron Co.*, 376 F. Supp. 2d 1298 (D. Wyo. 2005) the U.S. District Court for Wyoming found that an area of mutual interest (AMI) clause did not bind successors to the agreement containing the clause. In the 1960s Mountain West acquired various uranium properties in the Powder River Basin. In 1967, Mountain West and defendant, Cleveland-Cliffs Iron Company (Cliffs), entered into an option agreement with respect to certain properties, granting Cliffs the option to acquire from Mountain West various interests in exchange for payments to Mountain West, including percentage royalty payments on uranium production. The option agreement contained an AMI clause that obligated Cliffs to pay production royalty on uranium from any properties acquired by Cliffs within the AMI. The AMI clause provided:

With respect to "other lands" and any and all lands acquired by "Mountain West" in the "Powder River Basin" . . . by lease or otherwise after the date of this Option and Agreement, said lands will be assigned or deeded at "Cliffs' " request . . . subject only to a two and one-half percent (2-1/2%) overriding royalty or reserved royalty to "Mountain West" . . . It is further understood and agreed that "Mountain West" will be entitled to and "Cliffs" agree [sic] to convey a two and one-half percent (2-1/2%) royalty interest to "Mountain West" in any lands it may hereafter acquire in the "Powder River Basin."

*Id.* at 1300.

In 1969 Cliffs exercised its option and obtained an interest in four properties. Through various assignments these properties were eventually owned by Power Resources, Inc. (Power) and Pathfinder Mines Corporation (Pathfinder).

Mountain West claimed that the AMI clause bound all of Cliffs' successors in interest and that accordingly, Power and Pathfinder were required to pay royalties on the original four properties and on any other property obtained in the Powder River Basin, regardless of when the purchase took place or from whom the property was obtained. The defendants filed a joint motion for summary judgment on all claims; the plaintiff filed a motion for partial summary judgment on breach of contract and for declaratory relief.

The issues were referred to U.S. Magistrate Judge Beaman who heard oral argument and issued a report and recommendation in favor of the defendants. In conducting a *de novo* review of Magistrate Beaman's report, the court found that the report

and recommendation should be adopted in its entirety. In addition, the court found that the Mountain West agreement did bind Cliffs' successors with respect to royalty payments owed on the original four properties. The court recognized that those royalty payments ran with the land, but found that the AMI clause contained in the original option agreement did not bind Cliffs' successors since that would allow Mountain West to obtain a royalty interest in land neither it nor Cliffs ever owned. The court stated that common sense dictates it could not have been the intent of the parties for Mountain West to receive a royalty interest on any property acquired in the Powder River Basin by Power and Pathfinder, other than the original four properties.

In determining that the AMI clause contained in the 1967 option agreement did not bind Cliffs' successors, the court reviewed Wyoming law regarding covenants that run with the land. Under Wyoming law, the intention of the original parties alone cannot create a covenant running with the land. Four elements must be met in order for a covenant to run with the land. The original covenant must be enforceable, the parties must intend that the covenant run with the land, the covenant must touch and concern the land, and there must be privity of estate between the parties. *Id.* at 1304 (citing *Jackson Hole Racquet Club Resort v. Teton Pines Ltd. Partnership*, 839 P.2d 951, 956 (Wyo. 1992)). Echoing the Magistrate's recommendation, the court found elements two and four were lacking and accordingly ruled that the AMI clause did not run with the land.

The plaintiff argued that the privity of the defendants arose through their successor relationship to the covenantor, citing, *inter alia*, *North Finn v. Cook*, 825 F. Supp. 278 (D. Wyo. 1993), and *Westland Oil Development Corp. v. Gulf Oil Corp.*, 637 S.W.2d 903 (Tex. 1982). The court distinguished these cases from the present case since, in those cases, "the original parties to the agreement had an interest in the land when the covenant was made, and the subsequent party obtained an interest in *that land* subject to the covenant from one of the original parties." *Mountain West*, 376 F. Supp. 2d at 1307.

While the court found that the option agreement bound successors as to covenants concerning the original four properties, there was nothing in the agreement to indicate that the AMI provision was intended to run with the land. In fact, the court noted that the deed between Cliffs and its immediate successor specifically stated that Cliffs warranted to its successor that the successor "does not share or take any responsibility of [Cliffs] to pay mineral production royalty to [Mountain West] from property *other than the Subject Property*." *Id.* Thus, the magistrate properly found that the AMI clause did not run with the land.

## WYOMING — OIL & GAS

WILLIAM N. HEISS  
— REPORTER —

### WYOMING SUPREME COURT FINDS EXCEPTION TO *DUHIG* WHERE GRANTEE IS COTENANT WITH GRANTOR

In *Gilstrap v. June Eisele Warren Trust*, 2005 WY 21, 106 P.3d 858 (Wyo. 2005), the Wyoming Supreme Court was faced with a *Duhig* situation in which the grantee was the owner of the

outstanding interest. Mrs. Gilstrap died with a will devising her 680-acre surface estate and a 320-acre mineral estate to her three children: Ray, William, and Daisy. Pursuant to an agreement among the siblings providing for a different division, the court in Mrs. Gilstrap's probate entered a decree of distribution in which Ray received all of the surface estate and one-half of the 320-acre mineral estate, while William received the other one-half of the mineral estate. Daisy received other assets, but no real property. In 1940, William, Daisy, and their spouses executed a warranty deed purporting to convey the entire property, both surface and minerals, to Ray, for consideration, with the following reservation: "Excepting and reserving however to Daisy Pearl Williams, . . . an undivided one-third interest, and to William Preston Gilstrap, . . . an undivided one-third interest, in and to all oil, gas and other mineral rights in said lands not heretofore reserved by the United States." *Id.* at 861.

In 2003, William's and Daisy's heirs brought a quiet title action claiming an interest in the mineral estate. They alleged that the parties to the deed intended to vest a one-third mineral interest in each sibling. However, they conceded that because Ray did not join as a grantor, his one-half interest remained unaffected. Ray's successors counterclaimed and asked that title to all of the minerals be quieted in their favor. Relying on *Duhig v. Peavy-Moore Lumber Co.*, 144 S.W. 2d 878 (Tex. 1940), they claimed that the warranty deed conveyed the entire mineral estate to Ray because Daisy's attempt to reserve an interest she did not own should be attributed to William, causing his reservation to exceed the one-half interest he owned. Neither party claimed the deed's language was ambiguous. Both parties moved for summary judgment.

The district court granted the defendants' motions and denied the plaintiffs', ruling that pursuant to *Duhig*, Ray's successors owned the entire mineral estate. William's and Daisy's heirs appealed to the Wyoming Supreme Court.

Before applying rules of construction to the deed the court noted that the facts of this case differed from other similar cases in three important ways. First, the deed contained two grantors, raising the question of whether each grantor warranted ownership of the full amount of the grant. Second, one of the grantors who reserved a one-third interest owned no interest. Finally, the grantee seeking to enforce the warranty was a cotenant of one of the grantors and, thus, was the owner of the outstanding interest.

At the outset, the court noted the general assumption in deeds with multiple grantors is that the warranty obligation is joint, not several, unless specific language in the deed indicates that each grantor is warranting only his or her individual interest. Since the deed under consideration contains no such language of severance, William and Daisy are jointly liable for the warranty.

The supreme court reviewed the *Duhig* doctrine as adopted by Wyoming in *Body v. McDonald*, 334 P.2d 513 (Wyo. 1959), in which it was found that actual notice by the grantee of the outstanding mineral interest is irrelevant since the grantor may warrant title even when he does not own what he is warranting. In reviewing *Duhig* and *Body*, the court, quoting Williams and Meyers, stated: "the key question is, not what the grantor purported to retain for himself, but what he purported to give to

the grantee.” Williams and Meyers, *Oil and Gas Law*, § 311, at 580.34 (rev. 2003).

In this case, the deed plainly purported to convey to Ray 100% of the full 680 acres. As to the reservation, each grantor clearly reserved a one-third mineral interest. Since the grantors clearly intended to reserve two-thirds of the minerals, the deed granted one-third of the mineral estate. The district court, by considering facts outside the four corners of the deed, determined that Daisy’s reservation was a nullity since she had no interest in the minerals at the time the deed was executed. The supreme court found flawed the district court’s conclusion that the interest unsuccessfully reserved by Daisy should be attributed to William, resulting in a reservation of two-thirds to William, thus exceeding his one-half interest and resulting in a breach of warranty.

The Scott appellees argued that Daisy’s reservation “has no meaning.” They contended that the deed conveyed two-thirds to Ray since William granted 100% and only reserved one-third. Applying *Duhig* would result in William conveying all of his one-half and the reservation would fail. The supreme court also found this interpretation flawed.

Both the argument of the Scott appellees, which added the failed reservation to the interest conveyed to the grantee, and the district court’s analysis, which added it to William’s reservation, would require the court to ignore the face of the deed, which purports to convey only a one-third interest to Ray. Only if William warranted to Ray that he owned 100% of the minerals could the deed be construed to grant more. The court found no precedent to support giving the grantee more than the deed itself granted.

The court summed up its holding by concluding that “where the grantee is a co-tenant and thus the owner of the outstanding interest, that interest must be subtracted from the interest purportedly warranted by the grantor.” 106 P.3d at 866. This holding did not result from the grantee’s actual or constructive knowledge of the outstanding interest, nor upon the parties’ subjective intent, recognizing that such an approach injects an unacceptable level of uncertainty to record title. Instead, the court held “that a grantee may not bring an action for breach of warranty where he owns the outstanding interest that the grantor is alleged to have warranted.” *Id.* at 866.

#### **WYOMING SUPREME COURT REQUIRES VOLUMETRIC DATA IN CONTEST OF FAIR MARKET VALUATION OF GAS FOR PRODUCTION TAX**

In *Wyoming Department of Revenue v. Guthrie*, 2005 WY 79, 115 P.3d 1086 (Wyo. 2005), the Wyoming Supreme Court reviewed a finding by the State Board of Equalization which had been overturned on appeal to the district court concerning a deduction for fuel use in determining the taxable value of gas produced. Michael T. Guthrie d/b/a MTG Operating Co. (MTG) produced coalbed methane and sold the production to Western Gas Resources under a bona fide arm’s-length transaction. Western paid MTG for the volume of gas delivered, minus certain deductions, as allowed under the three gas purchase contracts. The Wyoming Department of Audit questioned the “fuel use adjustment” under the gas purchase contracts and requested informa-

tion on how that adjustment was calculated. MTG did not document the exact volume of gas used for fuel. All of the gas purchase contracts provided that the sales price of MTG’s gas was to be determined pursuant to a formula based on volumetric information. Since MTG was unable to verify the volumes used for the fuel use adjustment, the Department of Revenue disallowed the deduction.

On appeal to the Board of Equalization, MTG offered testimony that the volume of fuel used for compression could be determined by applying a back calculation, using the difference between the contract price and the monthly gas purchase statement prices. MTG also provided evidence that the actual fuel use allowance taken was within local industry standards. The Board refused to accept the back calculation offered by MTG as verification of the fuel use adjustment. Because MTG failed to produce evidence of the actual amount of gas used for compression, the Board affirmed the Department of Revenue’s decision to disallow the fuel use deduction claimed by MTG. MTG appealed the Board’s decision to the district court, which found the evidence presented by MTG sufficient to adequately verify the fuel use adjustment. The district court reversed the Board’s decision and ordered that the deduction for fuel use be allowed. The Department of Revenue appealed this decision to the Wyoming Supreme Court.

The supreme court stated that the scope of review was of the agency action as though the appeal were directly to the court from the agency. The supreme court stated that the primary issue was what, exactly, MTG was required to prove. MTG argued that the Department has no statutory authority to look beyond the actual payment received and accepted by MTG as full payment. The court stated that an administrative agency, as a creature of statute, must limit its activities to those authorized by the legislature. Wyo. Stat. § 39-14-208(b)(i) charges the Department with arranging for audits of these taxpayer reported values if

- (A) Taxable volumes or values were not accurately reported;
- (B) Clerical errors were made in determining taxable volumes or values;
- (C) Taxable volumes or values for the year that production occurred were not calculated in compliance with Wyoming statutes or rules governing the determinations; or
- (D) Additional payment for production was received and not reported whether such payment was received in the year of production or in subsequent years.

This statute was cited to refute MTG’s argument as to the scope of the audit.

As for the actual determination of taxable value, both parties agreed that pursuant to Wyo. Stat. § 39-14-203, the fair market value in this case is established by a bona fide arm’s-length transaction. However, the parties disagreed as to the role the gas purchase contracts should play in determining the taxable value of MTG’s production. MTG argued that the Department has authority to determine only if a contract exists that is a product of a bona fide arm’s-length transaction. MTG also argued that if such a contract exists, the Department must accept what the parties agree is an acceptable price and that individual adjustments need not be verified as long as the adjustment itself is allowed by the contract.

The Department, on the other hand, argued that the value established by the bona fide arm's-length transaction is embodied in the terms of the gas purchase contracts, and that MTG's self-reported value of its production could only be verified upon audit. Looking at past case law, the supreme court found it settled that the Department can and should refer to any applicable contracts when independently verifying taxable values. The gas purchase contracts all provided that the sales price of MTG's gas was to be determined pursuant to a formula based on volumetric calculation. MTG did not document the exact volume of gas used for fuel. Because the exact volume of fuel gas was not documented, the contract price for that gas, its legislatively defined fair market value, could not be precisely established.

The supreme court found that the district court's decision reflected the wrong standard of review. Whether or not MTG presented sufficient evidence supporting its position is not relevant to review agency action upon a full hearing. The standard of review requires the reviewing court to determine whether, upon reviewing the entire record, substantial evidence exists to support the agency action. Since the Board specifically found that MTG failed to present the volumetric information verifying the exact amount of fuel used for compression activities, the supreme court determined that this finding is supported by substantial evidence. In a footnote, the supreme court stated that MTG may be willing to accept valuations without verification, but the Department is statutorily prohibited from doing the same. 115 P.3d at 1097 n.2.



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