Institute for
ENERGY LAW

Oil & Gas E-Report

ARTICLES

ISSUE 4 DECEMBER 2019

The IEL Oil & Gas E-Report is a publication the Institute for Energy Law of The Center for American and International Law. Please forward any comments, submissions, or suggestions to any of the editors or IEL's Associate Director, Vickie Adams.

Fifth Circuit: Pipeline Trespass Exposes Pipeline Operator to Claim for Profit Disgorgement under Louisiana Civil Code Article 486

John T. Kalmbach and W. Drew Burnham
Cook, Yancey, King & Galloway, APLC

In *Mary v. QEP Energy Co.,* No. 18-31107 (5th Cir. 9/20/19), 2019 WL 4581475, landowners sued QEP Energy Company ("QEP") for trespass, alleging that QEP pipelines extended outside the servitude defined in the parties' written pipeline servitude agreement by 31 feet in one instance and by 15 feet in another. The landowners sought, among other things, profit disgorgement under Louisiana Civil Code article 486. Under Article 486, the proper remedy depended upon whether QEP was in "good faith" or "bad faith." That Article provides:

> A possessor in good faith acquires the ownership of fruits he has gathered. If he is evicted by the owner, he is entitled to reimbursement of expenses for fruits he was unable to gather.
>
> A possessor in bad faith is bound to restore to the owner the fruits he has gathered, or their value, subject to his claim for reimbursement of expenses.

Following its own precedent, *SGC Land, LLC v. Louisiana Midstream Gas Services*, 939 F. Supp. 2d 612 (W.D. La. 2013), the Western District of Louisiana held that the standard for determining bad faith could be analogized to Louisiana Civil Code article 670, which states as follows:

> When a landowner constructs in good faith a building that encroaches on an adjacent estate and the owner of that estate does not complain within a reasonable time after he knew or should have known of the encroachment, or in any event complains only after the construction is substantially completed the court may allow the building to remain. The owner of the building acquires a predial servitude on the land occupied by the building upon payment of compensation for the value of the servitude taken and for any other damage that the neighbor has suffered.

Under this standard, the district court reasoned that, in this instance, there was no financial incentive or profit to QEP from the trespass, no evidence of harm to the plaintiffs caused by the misplaced pipelines, and no other evidence of bad faith by QEP. Accordingly, the district court held that QEP was not in bad faith and was entitled to a predial servitude for a reasonable area around the trespassing pipelines.

On September 20, 2019, the United States Fifth Circuit Court of Appeals reversed the district court and rejected the standard set forth in *SGC Land, LLC*. The Fifth Circuit held that Article 670 only applies to the construction of a building by a landowner and does not define the standard for a finding of good or bad faith under Article 486. According to the court, the owner of a servitude (like QEP) is not a "landowner," and a pipeline is not a "building." Rather, "good faith" within the meaning of Article 486 is governed by Louisiana Civil Code Article 487, which provides:

> For purposes of accession, a possessor is in good faith when he possesses by virtue of an act translative of ownership and does not know of any defects in his ownership. He ceases to be in good faith when these defects are made known to him or an action is instituted against him by the owner for the recovery of the thing.

The court explained that land is a "thing" and that ownership of a "thing" confers on the owner the ownership of the "thing" and everything that the "thing" "produces or is united with it, either naturally or artificially."[1] Under Louisiana law, these are known as "accessories" to land.[2] The right of ownership over a thing by virtue of it being an accessory is known as "accession." An owner of land is entitled to profits derived from accessories to land because profits are a type of "fruit." Under Article 486, if a possessor is deemed to be in bad faith, then he is obligated to "restore to the owner the fruits [*i.e.* profits] he has gathered, or their value, subject to his claim for reimbursement of expenses." The case was remanded for further proceedings in accordance with the court's ruling.

---

[1] *See* La. Civ. Code art. 482.
[2] *Id.* at cmt.(b).

Unleased Owner Was Not Entitled to Penalties Under Louisiana's Well Costs Reporting Statute Because that Owner Did Not Comply with Notice Requirements in Statute

Colleen C. Jarrott
Baker Donelson

Keith B. Hall
LSU Law Center

B.A. Kelly Land Co., LLC v. Aethon Energy Operating LLC, 2019 WL 5021267 (W.D. La.)[1] demonstrates that the penalty provision in Louisiana's Well Cost Report Statute will not apply if the party seeking to invoke the penalty does not strictly follow the notice provision contained in that Statute.

B.A. Kelly Land Company, LLC ("Kelly") owns a tract of land in Bossier Parish that is included within two compulsory drilling and production units[2]—the Lower Cotton Valley Zone, Reservoir A and the Haynesville Zone, Reservoir A. The land was subject to a mineral servitude,[3] but the servitude terminated in 2013 when the servitude owner died.[4] A mineral lease that had been granted by the servitude owner terminated when the servitude terminated,[5] and Kelly then became an unleased owner.

Aethon Energy became operator of the units in 2016. By then, fifteen wells in the Lower Cotton Valley unit and one well in the Haynesville unit had reached payout. As an unleased owner, Kelly was entitled to its pro rata share of each well's monthly revenue after payout, subject to a deduction of Kelly's pro rata share of ongoing operating costs.[6] On December 15, 2017, Kelly sent a certified letter to Aethon. The letter identified the units in which Kelly owned land, stated that Kelly was an unleased owner, and requested certain information about well costs and revenue.

On April 17, 2018, Kelly sent a second certified letter. This letter asserted that Aethon had not complied with Louisiana law because it failed to send a sworn, detailed statement that provided

---

[1] The case was heard by Judge Terry A. Doughty, who issued the ruling discussed above in October 2019.
[2] In Louisiana, mineral owners occasionally create a voluntary unit, and lessees occasionally exercise the pooling authority in their leases to create a declared unit, but most drilling units are created by order of the Louisiana Commissioner of Conservation, pursuant to the State's conservation statutes. Louisiana Revised Statute 30:9(B) authorizes the Commissioner to create drilling units, and Louisiana Revised Statute 30:10(A) authorizes the Commissioner to pool separately-owned tracts within a drilling unit. In Louisiana, whenever the Commissioner issues an order creating a drilling unit, the same order typically pools the separately-owned interests within the unit.
[3] Louisiana law does not allow the creation of a severed mineral estate. Wemple v. Nabors Oil & Gas Co., 97 So. 666 (La. 1923); Frost-Johnson Lumber Co. v. Salling's Heirs, 91 So. 207 (La. 1922). However, Louisiana law allows the creation of a mineral servitude. *See* La. Rev. Stats. 16, 21, 22, 23 (La. Min. Code arts. 16, 21, 22, 23). A mineral servitude is similar to a severed mineral estate, except that the mineral servitude is not permanent—it will terminate if there ever is a period of ten consecutive years in which it is not used. *See* Keith B. Hall, *Hydraulic Fracturing: If Fractures Cross Property Lines, is there an Actional Trespass?*, 54 Nat. Res. L.J. 361, 365 n.20 (2014); *see also* La. Rev. Stat. 31:27 (La. Min. Code art. 27) (mineral servitude will terminate by "prescription resulting from nonuse for ten years" if it does not terminate earlier based on a condition or term specified in the instrument creating the servitude).
[4] The instrument creating a servitude can provide that the servitude will terminate upon the occurrence of a specified event (for example, upon the death of the servitude owner). La. Rev. Stat. 31:27 (Min. Code art. 27).
[5] Mineral Code article 117 (La. Rev. Stat. 31:117) states: "A mineral lease may be granted by the owner of an executive interest whose title is extinguished at a particular time or upon the occurrence of a certain condition, but it terminates at the specified time or on occurrence of the condition divesting the title."
[6] *See* La. Rev. Stat. 30:10(A)(2).

the operating costs and expenses requested by the first letter. Aethon then contacted a Kelly and ultimately provided certain summary reports, but these did not contain the level of detail that Kelly sought.

In September 2018, Kelly filed a lawsuit based on Louisiana Revised Statutes 30:103.1 and 103.2 ("Well Cost Reporting Statute"). Kelly alleged that Aethon's reports failed to include the information required under Louisiana Revised Statutes 30:103.1 and that, pursuant to Revised Statute 30:103.2, the penalty for this failure was that Aethon forfeited its right to collect Kelly's pro rata share of the wells' operating costs. Kelly filed a motion for partial summary judgment that Aethon had forfeited its right to charge costs to Kelly.

The district court denied Kelly's motion. Under Revised Statute 30:103.1, a unit operator must send sworn, detailed reports to an unleased owner who makes a request for such information by certified mail.[7] Under 30:103.2, if the operator fails to send these reports within 90 days after the completion of a well, and if the operator also allows 30 additional days to elapse after receiving a certified letter providing notice that the operator has failed to send the required reports in response to the first letter, the operator forfeits its right to collect the unleased owner's share of "the costs of the drilling operations of the well."

Here, the district court found that the unleased owner's December 2017 letter did not qualify as a request for information pursuant to 30:103.1, and that the April 2018 letter did not meet the requirements for a notice to an operator pursuant to 30:103.2 that the operator had failed to comply with a prior request for information under the Well Cost Reporting Statute. The court explained that one of the shortcomings of the letters was that they failed to reference 30:103.1 or 30:103.2. Further, when a proper request is made, 30:103.1 requires the operator to send *initial* reports and *quarterly* reports, but Kelly's letters did not specifically request initial and quarterly reports. The court concluded that the "formal notice" requirement of the Statute was paramount given the Statute's penal nature and that any ambiguity in the notice was to be construed against the party who sent the notice. Thus, because Kelly's request to Aethon failed to follow the statutory requirements of the Well Costs Reporting Statute, the court denied Kelly's motion for partial summary judgment. Indeed, the court stated that it planned to enter a *sua sponte* summary judgment in favor of Aethon.[8]

---

[7] Adams v. Chesapeake Operating, Inc., 561 Fed. App'x. 322, 325 (5th Cir. 2014).

[8] *See* Celotex Corp. v. Catrett, 477 U.S. 317, 326 (1986) ("district courts are widely acknowledged to possess the power to enter summary judgments sua sponte, so long as the losing party was on notice that she had to come forward with all of her evidence"). In *B.A. Kelly Land Co.*, the court's ruling stated: "Given the Court's findings that the letters do not meet the strict requirements of the Well Costs Reporting Statute, the Court hereby gives Notice that it intends to sua sponte enter summary judgment in favor of Aethon, denying B.A. Kelly's forfeiture claims under § 103.2, and dismissing this suit with prejudice. B.A. Kelly has twenty-one (21) days to reply to this Notice. If no reply is filed, the Court will enter judgment in favor of Aethon."

Louisiana Federal Court Rejects Expert Testimony Projecting Lost Revenue for Non-Producing Oil and Gas Well

Lauren Brink Adams
Baker, Donelson, Bearman, Caldwell & Berkowitz, PC

A recent federal court decision has more fully defined the damages recoverable and expert testimony admissible in the case of a completely destroyed oil and gas well. In *Oracle Oil, LLC v. EPI Consultants*, Case No. 18-3674, 2019 WL 2250252 (E.D. La. May 24, 2019), the plaintiff and operator of a well located in Vermilion Parish, Oracle Oil, LLC ("Oracle"), filed suit against EPI Consultants ("EPI"), its engineer, based on EPI's performance of an allegedly faulty workover, which forced Oracle to drill a replacement well on a new lease. As part of its damages, Oracle sought to recover the lost net revenue the well would have generated had the well commenced production, relying on the expert testimony of petroleum engineer, Robert McGowen, as well as the costs of drilling a replacement well. The United States District Court of the Eastern District of Louisiana, however, excluded the expert's testimony directed to lost revenue under Federal Rules of Evidence 401 and 702 as both irrelevant and unreliable.

The court found expert testimony projecting future lost revenue was irrelevant to the action because future lost revenue is not an element of recoverable damage for a well that never produced and would never produce. The court explained it "found no Louisiana case, and the Plaintiff has cited to none, in which there was a complete loss of the well and the court awarded the amount of revenue the well would have generated as damages." Instead, the court found the proper measure of damage for a well that cannot be repaired is either (1) the difference in value of the well before and after the incident at issue or (2) the cost of a replacement well minus depreciation if the former cannot be determined with any reasonable degree of certainty. While the difference in the value of the well before and after the incident normally turns on projected hydrocarbons and projected net production revenue, the court seemingly rejected this measure of damages as speculative given the lack of production data and cost records for the well, which was never placed in production. Indeed, the court specifically targeted the expert's *estimation* of the total oil in place and operating expenses, *assumption* of the location for oil-water contact, *estimation* of oil recovery assuming a partial water drive, and *estimation* of the ultimate recovery assuming a 70% recovery of the solution-gas-place. Thus, the court rejected the expert's testimony projecting net production revenue as both irrelevant and "too speculative to be reliable and admissible."

While *Oracle* may appear to depart from standard expert practice at first blush, the court's decision is consistent with at least one state court decision rejecting estimates of the value of a well before and after the accident when the well was completely destroyed and thus profits projected over the production lifespan of the well were speculative and lacked actual post-accident production data.[1] In stark contrast, however, both state and federal courts have consistently allowed recovery for (and expert testimony projecting) lost revenue for a temporarily damaged well that eventually resumes production by way of repairs and/or re-drilling. In this instance, the courts have explained lost revenue compensates the injured party for his or her inability to use the capital investment in the lease for a certain period of time.[2] Thus, although the court's ruling may seem

---

[1] *See, e.g., Petrol Indus., Inc. v. Gearhart-Owen Indus., Inc.*, 424 So.2d 1059 (La. Ct. App. 1982) (rejecting an award of the "value of the well—calculated on the basis of future profits anticipated over the production lifespan" in favor of an award for the cost of drilling a replacement well minus depreciation when the oil well was destroyed and ultimately plugged and abandoned after an explosion).

[2] *See, e.g., Continental Oil Co. v. SS Electra*, 431 F.2d 391 (5th Cir. 1970), *cert. denied,* 401 U.S. 937 (1971) (awarding lost profits based on 130-day delay in oil production); *JFD, Inc. v. Shell Oil Co.*, Case No. 79-898, 1988 WL 40260 (E.D. La. Apr. 27, 1988)

harsh and could admittedly be read broadly, it is limited by its facts—particularly a destroyed well that would never be placed in production—and it left undisturbed those cases providing for the recovery of lost revenue in the instance of a temporarily damaged well that is repaired and placed back in production.

(awarding damages for "deferred gross revenue" based on the delay in oil production); and *Mobil Expl. & Producing v. A-Z/Grant Int'l Co.*, Case No. 91-3124, 1996 WL 204431 (E.D. La. Apr. 24, 1996) (holding lost profits are a permissible measure of damages based on a two-year delay in offshore well production).

After Second Removal to Federal Court, Coastal Land Loss Suit is Remanded Again to a Louisiana State Court

Keith B. Hall
LSU Law Center

Several coastal parishes in Louisiana have each filed multiple lawsuits in local state courts against various oil and gas companies, alleging that the companies' activities, including the dredging of canals to provide access to well sites, have contributed to coastal land loss. The lawsuits total 42 in all[1] and collectively the lawsuits name about 200 companies as defendants. The parishes assert that the defendants' activities violated Louisiana's State and Local Coastal Resources Management Act of 1978 (SLCRMA), commonly known as the Coastal Zone Management Act, La. Rev. Stat. 49:214.21 *et seq.* The parishes expressly disclaim any reliance on federal law, and the State of Louisiana has joined the lawsuits on the side of the parishes.

The defendants removed each of the lawsuits to federal court, asserting multiple bases for jurisdiction, including the Outer Continental Shelf Lands Act (OCSLA),[2] general maritime law, and federal question jurisdiction.[3] In each of the removed actions, a federal district court remanded the case to state court. The federal courts rejected the defendants' arguments that these cases fit into that rare category of lawsuits in which federal issues are so central to a plaintiff's state law claims that the state law claims support federal question jurisdiction. In addition, the federal district courts concluded that OCSLA did not apply because the plaintiffs were complaining about activities that occurred onshore or in state waters, not on the Outer Continental Shelf. Finally, the federal courts concluded that the Savings to Suitors' Clause precluded removal based on admiralty jurisdiction. Accordingly, the courts remanded all the actions to state court.[4]

However, after the plaintiffs submitted a particular expert report, defendants removed several of the lawsuits again. One of the actions that was removed a second time is *Parish of Cameron v. Auster Oil & Gas, Inc.*[5] In support of the second removal, the defendants stated that the expert report revealed that the plaintiffs' claims were primarily based on events that occurred prior to Louisiana's enactment of the Coastal Zone Management Act.[6] The defendants asserted that, during that earlier period of time, federal law governed the sort of activities that form the basis of the plaintiff's claim. Thus, federal law issues are central to the plaintiff's purported state law claims, and this allows removal of the case based on federal question jurisdiction. Further, argued the defendants, the suit also could be removed based on "federal officer jurisdiction" under 28 U.S.C. § 1442 because the plaintiff's claims were based in part on the defendants' activities during World War II, when the defendants were acting under the direction of federal officers.

In short, the defendants argued that the expert report was an "other paper" that reveals two bases for federal jurisdiction that were not revealed in the plaintiff's state court petition, and that

---

[1] *Parish of Cameron v. Auster Oil & Gas, Inc.*, 2019 WL 473394 *1 (W.D. La.).
[2] OCSLA is found at 43 U.S.C. §§ 1331 *et seq.* OCSLA contains its own jurisdiction provision at 43 U.S.C. § 1349(b).
[3] Federal question jurisdiction is authorized by 28 U.S.C. § 1331. In at least one of the lawsuits, the defendants also contended that diversity jurisdiction also existed, but the court disagreed and remanded. Parish of Plaquemines v. Riverwood Production Co., 2019 WL 2271118 *1 (E.D. La.). Diversity jurisdiction is governed by 28 U.S.C. § 1332.
[4] *See, e.g.*, Parish of Cameron v. Auster Oil & Gas, Inc., 2018 WL 2144281 (W.D. La. 2018) (Doughty, J.); Parish v. Rozel Operating Co., 2015 WL 403791 (E.D. La. 2015) (Africk, J); Plaquemines Parish v. Hilcorp Energy Co., 2015 WL 1954640 (E.D. La.) (Feldman, J.); Jefferson Parish v. Anadarko E & P Onshore LLC, 2015 WL 13534014 (E.D. La. 2015) (Lemelle, J.); Parish of Plaquemines v. Total Petrochemical & Refining USA, Inc., 2014 WL 6750649 (E.D. La. 2014) (Zainey, J.).
[5] *Parish of Cameron v. Auster Oil & Gas, Inc.*, 2019 WL 4734394 *1 (E.D. La.).
[6] *Parish of Plaquemines v. Riverwood Production Co.*, 2019 WL 2271118 *2-3 (E.D. La.).

federal law authorizes removal in such instances, so long as defendants remove the case within 30 days of receiving the "other paper" that first reveals the basis for removal.[7] Here, the defendants removed the case within 30 days of receiving the expert report.

The plaintiff moved to remand and the magistrate judge recommended granting the motion, concluding that the removal was not timely. The magistrate judge asserted that the removal was not timely because the plaintiff's original petition revealed that the plaintiff would be relying in part on actions that the defendants took prior to enactment of SLCRMA, probably including actions during World War II. Thus, the expert report did not demonstrate any basis for jurisdiction that was not apparent before. Instead, the report merely put a greater emphasis on the defendants' pre-SLCRMA activities. The defendants timely objected to the magistrate judge's recommendation, thereby putting the matter before United States District Court Judge Robert R. Summerhays.

Judge Summerhays disagreed with the magistrate judge's conclusion that the removal was not timely, concluding that the report revealed factual contentions not previously made clear in the plaintiff's petition. Nevertheless, he granted the plaintiff's motion to remand. In explaining his ruling, Judge Summerhays acknowledged that federal officer jurisdiction can support federal jurisdiction over claims asserted against private defendants, if the claims are based on actions that the defendants took under direction of a federal officer. But Judge Summerhays distinguished actions taken under the *direction* of federal officials from actions merely *regulated* by federal officials. Here, Judge Summerhays concluded, the defendants' activities may have been subject to significant federal regulation, but the actions were not taken under the actual direction of the federal officers.

As examples of cases in which private defendants had acted under the *direction* of federal officials, he pointed to "government contractor" cases in which plaintiffs sued a manufacturer, complaining about some allegedly dangerous characteristic of a product, but the manufacturer had produced the product according to specific specifications provided by the federal government. For example, in *Winters v. Diamond Shamrock Chemical Co.*, 149 F.3d 387 (5th Cir. 1998), a plaintiff brought suit based on harm allegedly caused by exposure to Agent Orange manufactured by the defendant. The court in that case concluded that the defendant was working under the direction of federal officials because it manufactured and provided a blend of herbicides specifically requested by the federal government.

As an example of a prior case in which a court rejected a contention that the defendants were acting under the direction of a federal official, Judge Summerhays pointed to *In re Methyl Tert Butyl Ether ("MTBE") Products Liability Litigation*, 488 F.3d 112 (2nd Cir. 2007), in which plaintiffs brought claims alleging that MTBE had contaminated drinking water supplies. The defendants contended that they were acting under the direction of federal officers because they were manufacturing MTBE as a gasoline additive that would allow the gasoline to satisfy a requirement under the federal Clean Air Act that gasoline contain at least 2 percent by weight chemical oxygen. The court rejected the argument that the defendants were working under the direction of federal officers. The court reasoned that, although the defendants were manufacturing MTBE as a way to comply with the Clean Air Act's chemical oxygen requirement, neither the Clean Air Act nor the regulations promulgated under it had specifically required that the companies use MTBE in particular, as opposed to some other additive, to meet the oxygen requirement.

---

[7] The deadline for removal generally is governed by 28 U.S.C. § 1446(b).

Judge Summerhays concluded that, in *Parish of Cameron v. Auster Oil & Gas*, the plaintiff is basing its claims on actions of the defendants that might have been regulated by the federal government, but that those actions were not performed under the direction of the federal government.

With respect to federal question jurisdiction, the defendants in *Parish of Cameron v. Auster Oil & Gas* noted that Louisiana's Coastal Zone Management provides an exception to certain permitting requirements for activities initiated prior to enactment of the Act. Further, the plaintiff's claims are based in part on a contention that this exception does not apply to the defendants' actions. In particular, the plaintiff argues that the exception applies only to actions *lawfully* initiated prior to enactment of the Coastal Zone Management Act and that the defendants' actions were not lawfully initiated. The defendants, in turn, assert that prior to enactment of Louisiana's Coastal Zone Management Act, the defendants' coastal activities were governed by federal law. Thus, to show that those activities were not lawfully initiated, the plaintiff necessarily will need to show that the defendants' activities violated federal law. Thus, the defendants argue, federal question jurisdiction exists.

Judge Summerhays rejected this argument, concluding that, for a state law claim to support federal question jurisdiction, a substantial *legal question* relating to federal law must be in dispute and must be central to resolution of the state law claim. Here, he explained, the disputed issues relating to the defendants' activities prior to enactment of Louisiana's Coastal Zone Management Act are primarily factual issues, not legal issues. Therefore, federal question jurisdiction does not exist. For these reasons, he granted the motion to remand.

In general, remand orders are not subject to appeal. Judge Summerhays noted, however, that 28 U.S.C. § 1447 gives defendants the right to an immediate appeal of a remand order when a case has been removed based on federal officer jurisdiction. He also noted that the defendants in this case had already indicated their intent to appeal and they had requested that the district court certify for interlocutory appeal the issue of whether federal question jurisdiction exists. Judge Summerhays granted the defendants' request and certified the issue regarding the existence or non-existence of federal question jurisdiction for interlocutory appeal, based on 28 U.S.C. § 1292(b).

Court of Appeals Reaffirms Application of Statute of Limitations to Lease Expiration Claims (and a Good Deal More)

Gregory D. Russell
Vorys, Sater, Seymour and Pease LLP

The landowner-appellants in *Jacobs v. Dye Oil, LLC*[1] acquired 10 acres of land in Monroe County, Ohio, in 2010. That property was encumbered by a lease that appellants' predecessor signed over thirty years earlier. The property was also burdened by a royalty reservation that expired in early 2011. Several years after acquiring the property, the appellants sent a demand letter to the lessee claiming back royalties. The lessee agreed to pay, but before making the payment, asked the appellants for certain signed tax forms to ensure the appellants were entitled to the royalties. The appellants refused and instead sued, claiming that the lease had terminated for failure to commence drilling operations within two years of its execution, for failure to pay royalties, for lack of production in paying quantities, and for the breach of various implied covenants. The trial court granted summary judgment to the lessee on all claims and the Seventh District Court of Appeals affirmed.

On appeal, the Seventh District reaffirmed the applicability of a statute of limitations, not only to breach of lease claims generally, but to claims of lease expiration more particularly, stating, "Although the trial court did not address Appellees' statute of limitations arguments, we find that the statute of limitations applicable to oil and gas leases **completely forecloses Appellants' breach of contract claim based on the failure to drill a new well or to commence production in the primary term**. The applicable limitations statute **also restricts the time period upon which Appellants may rely for recovery with respect to their other claims**." In so holding, the Seventh District significantly narrowed its earlier ruling in *Neuhart v. TransAtlantic Energy Corp.*, 2018-Ohio-4099, where the court refused to apply a limitations period in the context of a dispute over acreage retained under a lease containing a Pugh clause.

The Seventh District also held that the *lessor* owed a duty of good faith to the *lessee*. This included a good faith obligation to comply with the lessee's administrative requirements, including requiring the lessor to provide a notice of a change in ownership:

> In the absence of a change of ownership provision, we find that Appellants had a good faith obligation to notify Appellees of the change in ownership in the mineral rights. We further find that reasonable notice, which includes documentary evidence establishing the lessor's right to royalties under the Lease, is required. To hold otherwise would require lessees to determine the proper names and addresses of every lessor, as well as their right to royalties under the Lease, annually, semi-annually, or even monthly, depending upon the royalty schedule, in order to avoid forfeiture of the entire Lease.

Absent that notice, the lessee was not required to pay royalties (and thus there was no breach for failure to pay past due royalties).

Last, the court reaffirmed that a temporary cessation of production does not terminate a lease under the typical lease habendum clause. Quoting from an earlier case, it stated: "[A] mere temporary cessation in the production of a gas or oil well will not terminate the lease under a

---

[1] 2019-Ohio-4085.

habendum clause of an oil and gas lease where the owner of the lease exercises reasonable diligence and good faith in attempting to resume production of the well." It then noted that the only cessation that could be established was for a period of one year, which the court found was insufficient to terminate the lease, observing that "no Ohio appellate court has recognized forfeiture by operation of law based on less than two years of nonproduction." Thus, the Seventh District upheld the trial court's grant of summary judgment to the lessee on the issue of production in paying quantities.

There is a lot going on in this case – including a significant discussion on what the duty of good faith and fair dealing entails – and we commend it to your attention.

Tenth Circuit Court of Appeals Affirms District Court's Dismissal of Homeowners' Lawsuit Against Operators of Wastewater Disposal Wells (with Associated Hydraulic Fracturing Operations) Seeking Recovery for the Increased Costs of Obtaining and Maintaining Earthquake Insurance as the Alleged Result of the Operators' Operations. Court Further Declines to Certify Question to the Oklahoma Supreme Court.

Mark D. Christiansen
Edinger Leonard & Blakley PLLC

In *Meier v. Chesapeake Operating L.L.C.*,[1] the plaintiffs were Oklahoma home and property owners (homeowners). The defendants were "oil and gas companies whose hydraulic fracturing operations in Oklahoma involve the injection of wastewater deep into the ground."[2] In the present lawsuit, the homeowners asserted that the defendant companies had directly caused an unprecedented increase in Oklahoma earthquake activity by injecting millions of barrels of wastewater below the Arbuckle geologic formation. They contended that there was "a causal link between the injection of production water into the Arbuckle via disposal wells"[3] and the increase in earthquakes. The homeowners further alleged that this increase caused certain of the companies that provide earthquake insurance to increase their premiums by as much as 260 percent in the prior several years, and that many insurance companies had ceased issuing new insurance policies to provide such coverage.

Rather than asserting in this lawsuit that the foregoing increase in seismic activity caused actual damage to their homes and properties, the homeowners simply sought recovery of "'[t]he value of premiums paid to obtain earthquake insurance coverage; and/or . . . [t]he excess amount required to maintain earthquake insurance coverage after 2009,' as well as punitive damages."[4]

The homeowners filed this action in Oklahoma state district court, "asserting class allegations and alleging public nuisance, private nuisance, ultrahazardous activities, and negligence."[5] The defendants removed this case to federal court pursuant to the Class Action Fairness Act.[6]

The defendants moved to dismiss the lawsuit on the grounds that the homeowners lacked standing to bring this suit, and that the homeowners failed to state a claim for relief. The federal district court ruled that the homeowners had standing to sue; however, the court dismissed the lawsuit on the grounds that the homeowners failed to state a claim.[7]

The homeowners appealed.

[1] 2019 WL 2564069 (10th Cir. 2019). The Tenth Circuit Court of Appeals noted at the outset that this lawsuit was stayed as to the defendant White Star Petroleum, LLC which was in bankruptcy proceedings.
[2] 2019 WL 2564069 at *1.
[3] *Id.*
[4] *Id.*
[5] *Id.*
[6] 28 U.S.C. § 1332(d).
[7] The federal district court predicted that "the Oklahoma Supreme Court, if confronted with the issue, would find the relief requested by plaintiffs not legally cognizable under the circumstances present in the case at bar." 2019 WL 2564069 at *1.

The Tenth Circuit first addressed the homeowners' request that it certify to the Oklahoma Supreme Court the primary question presented on appeal. After considering certain legal authorities relating to the certification of questions by the federal courts, the Tenth Circuit concluded as follows:

> Because the question is not "sufficiently novel that we feel uncomfortable attempting to decide it without further guidance," and because the homeowners did not seek certification until after they were unsuccessful in the district court, we decline to certify the question. Instead, we now proceed to the merits and consider whether, under Oklahoma law, a homeowner can sue for increased insurance premiums absent any actual damage to property.[8]

In turning to the key issue presented on appeal, the Tenth Circuit noted that the district court, in dismissing this lawsuit for failure to state a claim, "[reasoned] that Oklahoma law does not recognize a claim for increased insurance premiums based on a risk that 'has not *materialized*'—that is, where 'plaintiffs have suffered no damage to their homes or their persons.'"[9] The Tenth Circuit agreed with this conclusion of the district court. It found that, while "no Oklahoma authority specifically addresses the question at hand, 'other states have consistently failed to recognize a cause of action for increased insurance premiums based on a tortfeasor's negligence.' " [Citation omitted] The court found that "it is highly unlikely the Oklahoma Supreme Court would allow proportional recovery for unmaterialized risk here. . . . "[10]

The homeowners argued that the district court below found that they had standing to sue (specifically addressing the injury-in-fact component of the standing inquiry). However, the Tenth Circuit stated:

> The injury-in-fact analysis for standing purposes is distinct from the question whether a plaintiff has adequately pleaded a claim for damages under Oklahoma law. Indeed, if courts conflated the two analyses, then every plaintiff who satisfied the minimum Article III requirements for standing would necessarily survive a 12(b)(6) motion, and could proceed to discovery, on the sole basis of a nominal damages claim. But such is not the case. Injury-in-fact for standing purposes simply requires that the plaintiff have a "sufficient personal stake" in the outcome of the litigation; "it in no way depends on the merits of the claim."[11]

The court went on to cite Oklahoma authority finding that an essential element in every common-law negligence-based tort claim is the occurrence of damage proximately caused by the breach of an alleged duty. The Tenth Circuit found that the homeowners had not adequately alleged such an injury under Oklahoma law.

With regard to the homeowners' assertion that Article 2, § 6 of the Oklahoma Constitution and Title 23, § 3 of the Oklahoma Statutes support their entitlement to damages, the Tenth Circuit responded: "Because the creation of an unmaterialized risk is not an 'unlawful act or omission'

---

[8] 2019 WL 2564069 at *3. In footnote 1 of his concurring opinion, Judge Hartz voiced his view that "[a] strong presumption against granting a request for certification [of a question of state law to the state's highest court] from a party that did not seek certification at the trial level is particularly unwarranted." *Id.*at *5, footnote 1. The cited footnote includes additional comments in support of the stated proposition.
[9] *Meier v. Chesapeake Operating L.L.C.,* 324 F.Supp.3d 1207, 1219 (W.D. Okla. 2018).
[10] 2019 WL 2564069 at *4.
[11] 2019 WL 2564069 at *4.

under Oklahoma tort law [23 Okla. Stat. Ann. § 3], and increased insurance premiums based on such risk are not damages 'allowed by the common law,' *see* Okla. Const. Art. 2, § 6, neither of these provisions creates a cause of action where the homeowners have otherwise failed to demonstrate one."[12]

As their final contention, the homeowners asserted that "the district court improperly dismissed their suit because, where only damages are disputed, Oklahoma law reserves the question for a jury."[13] The Tenth Circuit first observed that uncertainty as to the exact amount of resulting damage is no reason for denying damages altogether.[14] However, in this case, the homeowners were found to have failed to plead any legally cognizable harm. The court found that "[t]he question presented is not simply what damages the homeowners are entitled to, but, rather, whether the sole 'relief' they request in their complaint 'is legally cognizable.' *Meier,* 324 F.Supp.3d at 1215." The court concluded that, with the homeowners having pleaded no legally cognizable claim for relief, the district court properly dismissed their complaint under Rule 12(b)(6).

In sum, the Tenth Circuit declined the homeowners' request that the court certify the question to the Oklahoma Supreme Court, and it affirmed the district court's dismissal of the homeowners' complaint under Rule 12(b)(6).[15]

---

[12] *Id.*
[13] 2019 WL 2564069 at *5.
[14] *Id.*
[15] *Id.*

Defendant Acquired Ownership of Oil-and-Gas Leasehold Interest by Adverse Possession

Keith B. Hall
LSU Law School

Scribner v. Wineinger, 2019 WL 5251134 (Tex. Ct. App.-Fort Worth) was a dispute regarding adverse possession of an oil and gas lease.

The plaintiff was Kevin Scribner. In 1999, his father acquired an oil and gas lease that was recorded in Archer County, Texas. In 2002, his father conveyed the lease to him and recorded the assignment, but Scribner contends that he did not know about the assignment.

Scribner's father later died, leaving a will that granted certain authority over his estate to Louise Daniel. In March 2010, based on that authority, she executed a document purporting to assign to Latigo Drilling the same oil and gas lease that already had been assigned to Kevin Scribner. Latigo began operating under the lease in April 2010. Later that year, Latigo assigned the lease to Hanaco LLC. Over the next several years, the lease was assigned to new assignees multiple times, with each of the successive assignees operating the lease and producing oil and gas until transferring the lease to the next assignee.

Eventually, a representative of Parra Oil and Gas, Inc., which then held the lease under the chain of title from Latigo, discovered the 2002 assignment to Kevin Scribner. A lawyer representing Parra wrote to Scribner on multiple occasions, asking him to execute an assignment of his interest to Parra. Scribner declined to do so.

Indeed, in 2018, Scribner filed suit against Parra and other defendants, asserting claims for trespass to try title, trespass to real property, and conversion. The defendants answered, asserting adverse possession as a defense. Parra also asserted a counterclaim for trespass to try title, declaratory judgment, and suit to quiet title, based on an assertion that it had superior title under the five-year limitations period contained in section 16.025 of the Texas Civil Practice and Remedies Code. The district court granted summary judgment dismissing Scribner's claim and declaring that Parra was the owner of the lease. Scribner appealed.

The appellate court noted that, under Texas law, a severed mineral interest can be adversely possessed under Texas statutes of limitations. Under section 16.025 of the Civil Practice and Remedies Code, for a person to recover real property that is peacefully and adversely held by another, the person must do so within five years. After that, an action to recover the property is barred by the limitations period, and the adverse possessor obtains full title. Tex. Civ. Prac. & Rem. Code § 16.030. Further, if there is privity of estate between successive adverse possessors, such as when one purports to assign the property to a successor, an adverse possessor may "tack" or aggregate the successive periods of adverse possession to satisfy a limitations period. *See id.* § 16.023.

The appellate court then reviewed Texas law relating to the adverse possession of a severed mineral estate. The court noted that, in order for adverse possession of a severed mineral estate to trigger the running of a limitations period, "actual possession of the minerals must occur." A possessor's production of oil and gas constitutes "actual possession," so long as the possessor intends to actually "appropriate" the mineral estate, rather than merely to hold it until the true owner appears. A period of adverse possession is broken if the possessor acknowledges the title of another person *before* the completion of the limitations period, but will not defeat the limitations period if the acknowledgement occurs after the limitations period has run and title by adverse possession has accrued. An offer to purchase or acquire another person's interest can constitute an acknowledgement of that person's title. On the other hand, depending on the intent of the person making the offer, an offer to acquire a person's interest can constitute merely an effort to buy peace and avoid litigation, rather than an acknowledgement of title.

Scribner argued that Parra's attempts to obtain an assignment from him created fact issues regarding whether Parra had the requisite intent to "appropriate" the lease and whether Parra had acknowledged his title. The appellate court disagreed. Given that Latigo had begun operations in April 2010, the five-year limitations period had run in April 2015, based on Parra's tacking of the successive periods of possession by its predecessors in interest. Thus, even putting aside the possibility that Parra's attempt to obtain an assignment in 2016 was merely an attempt to buy peace and avoid litigation, this alleged acknowledgment came *after* title by adverse possession had already accrued.

Further, whether Parra had the requisite intent to appropriate was not relevant because title by adverse possession had accrued in April 2015, before Parra received its assignment, at a time when the lease was still held by one of Parra's predecessors in interest. Thus, the only relevant intent that mattered was the intent of Latigo and the successive assignees that held the lease up through April 2015, when title by adverse possession accrued. Scribner presented no evidence that those predecessors of Parra had ever acknowledged Scribner's title or that any of the predecessors lacked the intent to appropriate the lease.

Accordingly, the appellate court affirmed the summary judgments against Scribner and in favor of Parra, holding that Parra owned the lease based on a predecessor's acquisition of title through adverse possession, followed by an assignment to Parra.

Researchers Conclude that Hydraulic Fracturing has Probably Induced Earthquakes in Permian Basin

Keith B. Hall
LSU Law School

Two researchers have concluded that hydraulic fracturing probably has induced some seismic events in the Delaware Basin portion of the Permian Basin. The researchers, Anthony Lomax and Alexandros Savvaidis, report their conclusions in "Improving Absolute Earthquake Location in West Texas Using Probabilistic, Proxy Ground-Truth Station Corrections," *Journal of Geophysical Research: Solid Earth*, 124 (2019).

Their article joins a large body of scientific literature on the subject of induced seismicity. Indeed, for decades, scientists have reported that human activities can sometimes cause induced seismicity—that is, earthquakes triggered by human activity. The subject has received increased attention in recent years, however, because of a substantial increase in the frequency of earthquakes in the central U.S., particularly in Oklahoma, that scientists believe have been triggered by human activities. Scientists have concluded that most of the earthquakes that have been triggered by human activity in the United State have been induced by injection disposal of wastewater from oil and gas production. But in some cases, scientists have concluded that hydraulic fracturing has triggered earthquakes.

Lomax and Savvaidis write: "In the Delaware Basin numerous hydrocarbon extraction and injection processes are applied in close space-time proximity; in such a case, it is difficult or impossible to unambiguously relate seismicity to specific wells and activities (Foulger et al., 2018)." However, they conclude that "some seismicity in the Delaware Basin is more likely due to hydraulic-fracturing than salt-water disposal." They examined records of hydraulic fracturing activities and the occurrence of earthquakes in the Delaware Basin for the period September 2011 through May 2019.

They stated that "[s]ome of the strongest evidence for causality between [hydraulic fracturing] and seismic events in the study area is found to the southwest of Pecos … where relatively isolated [locations where there has been hydraulic fracturing of] wells form clusters of associations to most of the nearby seismicity … and there are few [salt water disposal] wells." In concluding that some seismicity was likely caused by hydraulic fracturing, the authors considered the timing of seismic events relative to hydraulic fracturing and the depths at which seismic activity occurred compared to hydraulic fracturing and saltwater disposal operations.

Monarch v. Badlands: Colorado Bankruptcy Court Finds Midstream Agreements Run with the Land Under Utah Law

Amanda Dick and Melissa Munson[1]
Steptoe & Johnson PLLC

On September 30, 2019, the United States Bankruptcy Court in the District of Colorado issued an Order holding that under Utah law, certain midstream contracts can constitute covenants running with the land, rendering such contracts inextinguishable under a Section 363 bankruptcy sale.[2] The court distinguished this decision from the recent case *Sabine Oil & Gas Corp. v. Nordheim Eagle Ford Gathering, LLC,*[3] in which the Second Circuit affirmed a bankruptcy court's holding that the midstream gathering agreement at issue was not a covenant running with the land under Texas law, and could be rejected by the debtor.

Background

Badlands Energy, f/k/a Gasco Energy, Inc. and other related entities (collectively, "Badlands"), owned and operated oil and gas assets in Utah. In August of 2017, Badlands voluntarily filed for Chapter 11 bankruptcy and sought the bankruptcy court's authorization to sell a portion of its Utah oil and gas assets ("Riverbend Assets") under Section 363 of the bankruptcy code – free and clear of liens, claims, encumbrances and interests. Wapiti Utah, LLC ("Wapiti") was the successful bidder for the Riverbend Assets. The proposed purchase and sale agreement between Badlands and Wapiti expressly provided that Wapiti, as purchaser, would not assume any midstream contracts in connection with the purchase ("Bankruptcy Sale").

Seven years prior to filing for bankruptcy proceedings, Badlands' predecessor, Gasco Energy, Inc., and Riverbend Gas Gathering, LLC executed an Asset Purchase Agreement with Monarch Midstream, LLC and other related entities (collectively, "Monarch"). As a result of this transaction, Badlands and Monarch became parties to a Gas Gathering and Process Agreement ("GPA") and an Agreement for Disposal of Salt Water ("SWDA") (collectively, "Agreements").

Under the GPA, Badlands dedicated and committed "all Gas reserves in and under" and all Gas owned and produced from more than 400 leases and lands within a defined geographical area, including the Riverbend Assets (collectively, "AMI"). The GPA further required Badlands to deliver a minimum volume of gas to Monarch each quarter or pay damages. The term of the GPA ran until March of 2025, or so long thereafter as wells connected to the system were capable of producing in commercial quantities. Under the SWDA, Badlands dedicated and committed to deliver "all" produced water from its operations within the AMI to Monarch's salt water disposal

[1] These materials are public information and have been prepared solely for educational purposes. These materials reflect only the personal views of the authors and are not individualized legal advice. It is understood that each case is fact-specific, and that the appropriate solution in any case will vary. Therefore, these materials may or may not be relevant to any particular situation. Thus, the authors and Steptoe & Johnson PLLC cannot be bound either philosophically or as representatives of their various present and future clients to the comments expressed in these materials. The presentation of these materials does not establish any form of attorney-client relationship with the authors or Steptoe & Johnson PLLC. While every attempt was made to ensure that these materials are accurate, errors or omissions may be contained therein, for which any liability is disclaimed.

[2] *Monarch Midstream, LLC, f/k/a Monarch Natural Gas, LLC, v. Badlands Production Company f/k/a Gasco Production Company, Badlands Energy, Inc. f/k/a Gasco Energy, Inc., & Wapiti Utah, LLC f/k/a Wapiti Newco, LLC*, No. 17-17465 KHT, 2019 WL 5549463, at *1 (Bankr. D. Colo. Sept. 30, 2019).

[3] 734 F. App'x 64 (2d Cir. 2018).

facilities. The SWDA further required Badlands to pay disposal fees. Both Agreements expressly stated in multiple sections throughout that the dedication and commitments stated therein were "covenants running with the land" and binding on the parties' successors and assigns.

Before the court entered an order approving the sale of the Riverbend Assets to Wapiti, Monarch filed an adversary proceeding seeking a declaratory judgment that the Agreements were covenants running with the land, and therefore, Wapiti could not take the Riverbend Assets free and clear of the Agreements.[4] Wapiti responded to the adversary proceeding, relying on *Sabine*, arguing that the midstream agreements were not covenants running with the land, and the Bankruptcy Sale should render the Riverbend Assets free and clear of all encumbrances. The court approved the purchase and sale agreement between Badlands and Wapiti, holding that the Bankruptcy Sale was subject to the court's determination in the adversary proceeding filed by Monarch; if the GPA and SWDA were covenants running with the land, Wapiti would assume the obligations under such Agreements.

Analysis

The court began with a determination that, despite language in the Agreements requiring application of the laws of the State of Colorado, its analysis was only proper under Utah law, because property interests are created and defined by the law of the state in which the property is situated.

Under Utah law, for a covenant to run with the land, four elements must be present: (1) touch and concern; (2) intent; (3) privity of estate; and (4) in writing. The Agreements were in writing, satisfying element number four, and the intent of the original parties was clear by the express provisions stating the commitments and dedications were covenants running with the land, satisfying element number two. The court focused its analysis on the first and third elements.

Relying on a Utah Supreme Court decision, *Flying Diamond Oil Corp. v. Newton Sheep Co.*,[5] the court stated that "touch and concern" is a broad test requiring evaluation of whether the covenant "bear[s] upon the use and enjoyment of the land," "enhances the land's value" for those benefitted, and "diminishes the land's value" for those burdened.

The court was unpersuaded by the argument that the Agreements cannot touch-and-concern the land because they relate to produced gas and water, neither of which are real property interests under Utah law. The court found that Utah law does not require conveyance of a real property interest to satisfy the touch-and-concern element. In considering this factor, the court specifically rejected the holding in *Sabine*. The court pointed out the difference in the nature of the dedication: in *Sabine*, the dedication was of all gas produced and saved, which the *Sabine* court determined did not create a covenant, because it concerned extracted minerals only, which are personal property under Texas law. The court found that under the GPA, the dedicated interests are real property interests, being the interests in all Gas reserves *in and under*, and all Gas *owned* and produced from, the leases and lands in the AMI. The principle point of distinction was that under *Sabine*, the touch-and-concern element required a conveyance of real property, whereas

[4] Monarch also asserted a $1.2 million breach of contract claim against Wapiti for fees due under the Agreements accrued by Badlands prior to the bankruptcy proceedings. The Court denied Monarch's motion for this breach of contract claim because "generally, a subsequent owner of land burdened by a real covenant takes subject to the covenant but is not liable for his predecessor's breach."
[5] 776 F.2d at 623-24.

the Utah law elucidated by *Flying Diamond* does not. Ultimately, the court determined that the GPA and the SWDA touched and concerned the land, because the dedication and commitments in the Agreements directly affected the use, value and enjoyment of the lands and leases in the AMI.

Having determined that the parties intended the covenants to run with the land and that the covenants were in writing and touched-and-concerned the land, the court turned to consideration of the final element – privity. The court noted that *Flying Diamond* identified the three traditional types of privity: (1) vertical,[6] (2) mutual,[7] and (3) horizontal.[8] Because Wapiti was the successor to the burdened estate of the original burdened entity, the court determined that vertical privity existed.

Turning to mutual privity and horizonal privity, the Court considered multiple decisions, including *Sabine* and *Flying Diamond*, in support of either eliminating the requirement for mutual privity or combining horizontal and mutual privity into one requirement. The court noted that the Utah Supreme Court has never held that mutual privity must be shown for a covenant to run with the land. The court further noted that the *Sabine* court collapsed mutual privity and horizontal privity into one paradigm that requires "a conveyance of an interest in property that itself is being burdened with the relevant covenant." The court recognized that the subject Agreements and related property interests did not display the traditional fact scenario for mutual privity, but held that that the simultaneous property interests of Badlands and Monarch in the AMI, and in the dedicated interests, nonetheless satisfed mutual privity to the extent that it was required under Utah law.[9]

The *Sabine* court held that horizontal privity of estate requires a conveyance of an interest in property that itself is burdened with the real covenant. Applying that standard, the *Sabine* court concluded that the gatherer's property interest in the form of a pipeline easement and separate parcel conveyance (made after the covenants were made) did not establish horizontal privity under Texas law. The court distinguished the present case from *Sabine*, noting that: (1) the covenants in the Agreements were created in connection with the simultaneous conveyance of the gathering and saltwater disposal systems from Badlands' predecessor to Monarch and (2) the GPA granted Monarch a "floating" easement across the dedicated leases and lands within the AMI. In determining that horizontal privity existed, the court held that such easements and dedications are "conveyances that simultaneously burden the same real property interest."

Having determined that under Utah law the Agreements were covenants running with the land, the court held that the Agreements could not be extinguished under Section 363(f) or Section 365 of the Bankruptcy Code. As a result, Wapiti's purchase of the Riverview Assets was subject to the Badlands GPA and the SWDA with Monarch.

The *Monarch* decision represents a departure from *Sabine* and provides support for midstream companies asserting in bankruptcy proceedings that their agreements burden successors in interest as covenants running with the land.

---

[6] Vertical privity "arises when the person presently claiming the benefit, or being subject to the burden, is a successor to the estate of the original person so benefited or burdened."
[7] Mutual privity "exists when the parties have a continuing and simultaneous interest in the same property."
[8] Horizontal privity "exists when the original covenanting parties create a covenant in connection with a simultaneous conveyance of an estate."
[9] The court noted that "although Monarch does not have a fee estate to the Dedicated Reserves, the Dedication is based upon an interest Monarch has in the land."

California Announces New Initiatives to Regulate Oil & Gas Activities

Keith B. Hall
LSU Law School

On November 19, 2019, the California Department of Conservation's Division of Oil, Gas and Geothermal Resources (DOGGR) announced three new initiatives for the regulation of oil and gas activity.[1]

First, DOGGR has imposed a moratorium on new extraction wells that use high-pressure cyclic steaming to extract oil. The moratorium is prompted in part by recent incidents in which steam injection operations apparently have caused surface expressions of oil in the Cymric oil field in Kern County. In a surface expression, oil breaks through to the surface. During the moratorium, regulators will study whether high-pressure cyclic steaming can be performed safely and in compliance with regulations that became effective in April that prohibit surface expressions.

Second, DOGGR announced that it plans to initiate a series of pre-rulemaking workshops in 2020 to seek input regarding "[r]egulations to strengthen protections for public health and safety." DOGGR stated that its upcoming rulemaking on this subject "will consider a range of protective measures, including prohibiting oil and gas activities within close proximity of homes, schools, hospitals, and parks," and that new or modified rules are expected later in 2020.

Third, DOGGR has requested that the California Department of Finance's Office of State Audits and Evaluation perform an audit of DOGGR's process for evaluating applications for permits for hydraulic fracturing and underground injections. While that audit is ongoing, DOGGR will subject pending applications for hydraulic fracturing to third-party scientific review by "independent experts from the Lawrence Livermore National Laboratory."

Governor Gavin Newsom characterized these actions as "necessary steps to strengthen oversight of oil and gas extraction as we phase out our dependence on fossil fuels." DOGGR also noted that, effective January 1, 2020, its name will be changed from the "Division of Oil, Gas and Geothermal Resources" to the "Geologic Energy Management Division," or CalGEM. The name change is the result of AB 1057, legislation recently passed by California and signed by Governor Newsom in October 2019. The legislation also amends California's oil and gas laws, including provisions governing financial assurance relating to the plugging and abandonment of wells.

[1] DOGGR's statement can be found at: https://www.conservation.ca.gov/index/Pages/News/California-Establishes-Moratorium-on-High-Pressure-Extraction.aspx.

GAO Finds Opportunities to Improve BOEM's Offshore Leasing

Keith B. Hall
LSU Law School

On October 24, 2019, the U.S. Government Accountability Office (GAO) publicly released a report titled "Offshore Oil and Gas: Opportunities Exist to Better Ensure a Fair Return on Federal Resources," GAO-19-531 (available at https://www.gao.gov/assets/710/701683.pdf). About a month earlier, the GAO sent copies to the Chairman of the House of Representatives Committee on Natural Resources and the Chairman of the Subcommittee on Energy & Mineral Resources, who had requested that the GAO examine fiscal issues relating to federal offshore leasing.

The report reviews the procedures used by the Bureau of Ocean Energy Management (BOEM) in estimating the economic value of offshore lease tracts and in evaluating bids submitted at lease sales. Some of GAO's conclusions should surprise no one. For example, the GAO concluded that "when oil prices are higher, bonus bids tend to be higher and, conversely, when oil prices are lower, bonus bids tend to be lower."[1] The report explains that the BOEM officials and industry representatives gave two explanations for this. First, bids are based in part on expectations about future prices of oil. If oil prices are high at the time of bidding, this leads companies to project higher prices for the future. Second, when oil and gas prices are high, companies have more income from production and therefore more resources to spend on acquiring new leases. The GAO also concluded that higher royalty rates leads to lower bonus bids and vice versa.[2]

The GAO reached other conclusions that are less obvious. For example, GAO estimates that a reduction in royalty rates on federal offshore leases between 1996 and 2000 probably resulted in the government receiving an extra $2 billion in bonus income, but a reduction of approximately $18 billion in royalties income, compared to what would have been received if royalties had not been lowered.[3]

Also, the GAO concluded that BOEM's practices in evaluating bids needs improvement. The report notes that, if BOEM concludes that a particular tract cannot be explored, developed and produced profitably—a so-called "nonviable" tract—BOEM will accept the highest bid (if any) that it receives on the tract, so long as the bid is higher than a minimum acceptable bid amount.[4]

On the other hand, if BOEM concludes that a tract can be explored, developed, and produced profitably—a so-called "viable" tract—BOEM conducts further economic analysis called "tract valuation." In tract evaluation, BOEM considers various factors to estimate the then-current fair market value for the tract being analyzed. BOEM performs such an evaluation near the time of lease sale in which the tract will be offered. BOEM also estimates the value that the tract would have at some lease sale further in the future. Next, BOEM discounts that estimated future value to account for the delay that will occur in receiving the lease revenue if the leasing of the tract is deferred until that future time. BOEM then establishes an acceptable bid threshold at the higher of either the estimated current fair market value or the discounted estimate of future value. If BOEM

[1] Report at 14.
[2] Report at 14-15.
[3] Report at 17.
[4] Report at 11.

receives a high bid that exceeds that threshold, BOEM accepts that bid. Otherwise, BOEM rejects the high bid.[5]

GAO concluded that the estimates BOEM makes of tract valuations via this process are sometimes lower than a true fair market value "due to the cumulative effect of three aspects of its bid evaluation process." First, BOEM "forecasts conservatively to account for uncertainties." Second, BOEM applies too high of a discount rate when comparing its estimate of bids that a tract might attract at a future sale to BOEM's estimate of the then-current value.

Third, when high bids do not meet the threshold that BOEM established in its tract analysis, BOEM sometimes lowers its valuation to justify accepting the bid. BOEM explained to GAO that it does this because it prefers to accept bids, even if they are lower than ideal, rather "than reject them and potentially never recoup the foregone bid revenue."[6] GAO notes, however, that data show that when BOEM has rejected bids on tracts and later offered the same tracts at subsequent lease sales, BOEM often has received significantly higher bids at the future sales. This leads GAO to conclude that BOEM should be more willing to reject low bids.

GAO made four recommendations. First, BOEM should develop a plan by which it could craft a progressive royalty structure. Under a progressive structure, royalty rates on each lease could be adjusted over time. When oil prices are high, the lessee would pay higher royalties. When prices are low, the lessee would pay lower royalties.[7] Second, BOEM should enlist an independent third party to examine the agency's method of estimating and discounting the future value of tracts.[8] Third, BOEM should take steps to ensure that its process is not biased toward adjusting the agency's own valuations downward to justify accepting low bids.[9] Fourth, BOEM should implement a systematic lookback process for evaluating the accuracy of the agency's past tract valuations and for improving its processes in the event any shortcomings are found in those valuations.[10]

The Department of Interior agreed with GAO's recommendation that BOEM devise a plan for developing a lease with a progressive royalty structure.[11] Interior disagreed with GAO's recommendation that BOEM enlist an independent third party to examine the agency's method of discounting its estimate of future values of tracts, but BOEM agreed to conduct its own evaluation of its discounting methodology.[12] Interior partially agreed with GAO's recommendation that BOEM take steps to ensure that its bid evaluation process is not biased toward lowering the agency's valuations of tracts in order to justify accepting bids, but Interior disagreed with some of GAO's characterizations of BOEM's current practices.[13] Finally, Interior partially agreed with GAO's recommendation that BOEM implement a systematic lookback process for evaluating its tract valuations.[14]

---

[5] Report at 13.
[6] Report at 31.
[7] Report at 40.
[8] Report at 41.
[9] Report at 41.
[10] Report at 41.
[11] Report at 41.
[12] Report at 41.
[13] Report at 42-43.
[14] Report at 43-44.

Institute for
ENERGY LAW

Oil & Gas E-Report
Institute for Energy Law
The Center for American and International Law
5201 Democracy Drive
Plano, TX USA 75024

IEL is an Institute of
THE CENTER FOR AMERICAN AND INTERNATIONAL LAW

Oil & Gas E-Report

Issue 4 December 2019