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Use of Vacuum Pump to Facilitate Production of Coal Mine Methane Did Not Negate Rule of Capture

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LSU Law School

Finite Resources, Ltd. and certain other companies (collectively, "Finite") own both the surface estate and the coal in most of the area occupied by an abandoned coal mine in Franklin County, Illinois. Royal Talon Company ("Royal") owned the remaining portion of the abandoned mine. In 2004, Royal granted a lease to DTE Methane Resources, LLC ("DTE") to extract coal mine methane[1] from Royal's portion of the mine.[2]

DTE drilled two wells to extract methane from the portion of the mine covered by its lease.[3] In 2007, DTE applied for and obtained a permit from the Illinois Department of Natural Resources ("DNR") to use a vacuum pump on the two wells.[4] Under Illinois regulations, use of a vacuum pump to produce oil or gas is prohibited, *unless* the operator obtains a permit.[5] DTE proceeded to use a vacuum pump to facilitate production of methane.[6] In 2012, DTE assigned its lease interest to Keyrock Energy LLC, which continued to operate the wells and use a vacuum pump on the wells.[7]

Finite asserts that it first learned about DTE's and Keyrock's use of a vacuum pump in 2018.[8] Finite petitioned DNR for a compulsory unitization order that would create a single unit that included its portion of the mine and that where Keyrock was operating, but DNR denied the petition.[9] Finite then sued DTE and Keyrock in state court, asserting claims for trespass, conversion of methane, an accounting, and common law unitization.[10] The defendants removed the case to federal court and moved for summary judgment, arguing that the rule of capture applied and precluded the claims asserted by Finite.[11] The district court granted the motion and Finite appealed.[12]

On appeal, Finite argued that the defendants' use of a vacuum pump violated Finite's correlative rights and negated application of the rule of capture.[13] The United States Court of Appeals for the Seventh Circuit rejected Finite's

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[1] Coal mine methane is methane released from coal in a mine. See "About Coal Mine Methane" at U.S. EPA website, https://www.epa.gov/cmop/about-coal-mine-methane. Coal mine methane is distinguished from coalbed methane, which is extracted from coal seams that have not been mined. *Id.*
[2] *Finite Resources, Ltd. v. DTE Methane Resources, LLC*, 2022 WL 3274105 *1 (7th Cir. 2022).
[3] *Id.*
[4] *Id.*
[5] 62 Ill. Admin. Code 240.1010.
[6] *Finite Resources*, 2022 WL 3274105 at *1.
[7] *Id.*
[8] *Id.*
[9] *Id.*
[10] *Id.*
[11] *Id.* at *2.
[12] *Id.*
[13] *Id.*

arguments. The appellate court noted that the Illinois DNR had specifically granted the defendants a permit to use a vacuum pump.[14] Further, oil and gas jurisprudence from other states has held that neither the use of crude oil pumps nor processes such as hydraulic fracturing will negate the rule of capture.[15] In addition, the Seventh Circuit quoted the WILLIAMS AND MEYERS oil and gas treatise for the proposition that use of a vacuum pump does not negate the rule of capture.[16] Finally, the court noted that Finite had not provided any authority—binding or persuasive—that use of a vacuum pump would negate the rule of capture.[17] For these reasons, the Seventh Circuit affirmed the district court's judgment dismissing Finite's claims.[18]

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[14] *Id.* at *3.
[15] *Id.*
[16] *Id.*
[17] *Id.* One Texas appellate court decision has held that, because Texas law prohibited the use of vacuum pumps on wells, the rule of capture did not apply in favor of a party that had used a vacuum pump. *See Peterson v. Grayce Oil Co.,* 37 S.W.2d 367 (Tex. App.—Forth Worth 1931). The Texas Supreme Court itself has commented on that case and stressed that the logic of the appellate court's holding was premised on the use of vacuum pumps being illegal. *Coastal Oil & Gas Corp. v. Garza Energy Trust*, 268 S.W.3d 1, 13 n.39 (Tex. 2008). Because Illinois regulations allow an operator to use a vacuum pump, provided the operator has a permit to do so, 62 Ill. Admin. Code 240.1010, and the defendants had such a permit, 2022 WL 3274105 at *1, the Texas jurisprudence does not favor Finite's position.
[18] 2022 WL 3274105 at *1. The Seventh Circuit also denied Finite's request that the court certify the legal issue to the Illinois Supreme Court. *Id.* The Seventh Circuit stated that it was reasonably certain that it had reached the right result under Illinois law and that it was not likely the issue would come up again. *Id.* at *3-4.

Louisiana Supreme Court Holds That Excess Remediation Damages Generally are not Available in Legacy Litigation Cases

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In June 2022, the Louisiana Supreme Court issued a decision in which the Court answers for the third time in the same case the question of whether so-called "excess remediation damages" are available in legacy litigation. The Court held that excess remediation damages are not available, meaning that, absent an express contractual provision calling for a greater level of remediation than necessary to satisfy regulatory conditions, a legacy litigation plaintiff cannot recover excess remediation damages.

In this article, that decision—*State of Louisiana v. Louisiana Land & Exploration Co.*, 2020-685 (La. 6/1/22), 339 So. 3d 1163—will be called "*LL&E III*." This decision affirmed on rehearing the result that the Court announced in *State of Louisiana v. Louisiana Land & Exploration, Co.*, 2020-685 (6/30/2021), 2021 WL 2678913, which this paper will call "*LL&E II*." On the other hand, *LL&E II* overruled a decision regarding excess remediation damages that the Court had issued about eight years before in *State of Louisiana v. Louisiana Land & Exploration, Co.*, 12-884 (1/30/2013), 110 So. 3d 1038 (which this paper will call "*LL&E I*"), in which the Court held that legacy litigation plaintiffs may be able to recover excess remediation damages even in the absence of an express contractual provision providing for a greater level of cleanup.

Background

The Vermilion Parish School Board (VPSB) sued several oil and gas companies in September 2004, alleging contamination of certain Section 16 Lands[1] that were or had been subject to oil and gas leases granted by VPSB.[2] In its petition, VPSB asserted claims for negligence, strict liability, unjust enrichment, trespass, breach of contract, and violation of Louisiana's environmental laws.[3] In this "legacy

[1] *State of Louisiana v. Louisiana Land & Exploration, Co.*, 2020-685 (La. 6/1/22), 339 So. 3d 1163.
In the early 1800s, the federal government took action to support the establishment of local public schools by donating to Louisiana the Section 16 lands then owned by the federal government within the State. See *id.* Louisiana has retained record title to the surface, but has given school boards substantial rights relating to Section 16 lands, including custody of the surface and ownership of mineral rights. For example, Louisiana has given school boards the right to grant mineral leases covering Section 16 lands and to keep all revenue from such leases. See La. Rev. Stat. 30:152 (giving to school boards the right to grant mineral leases for Section 16 lands); La. Rev. Stat. 30:154 (giving to school boards the right to retain all revenue from mineral leases on Section 16 lands).
[2] *Louisiana v. Louisiana Land and Exploration*, 2020-685 p. 2 (La. 6/30/2021), 2021 WL 2678913.
School boards, such as the Vermilion Parish School Board, effectively own the mineral interests associated with Section 16 lands within the respective parish. Although the State holds title to the land, Louisiana law grants the school board the right to grant mineral leases over such lands, the right to keep all revenue from those leases, and the right to bring suit in response to any alleged breach of a lease. See La. Rev. Stat. 30:152 (authority to lease); La. Rev. Stat. 30:154 (right to keep all lease revenue); La. Rev. Stat. 17:51 (authority to sue).
[3] *Louisiana v. Louisiana Land and Exploration*, 2020-685 (La. 6/01/2022), 2022 WL 1771757.

litigation,"[4] VPSB sought damages to cover the costs of remediating the property, as well as for diminution in value of the property, mental anguish, inconvenience, stigma damages, and punitive damages.[5] Although the State of Louisiana was not involved in bringing the lawsuit, VPSB's petition purported to bring claims on behalf of both VPSB and the State of Louisiana, which explains how the caption of the suit reads "State of Louisiana v. Louisiana Land & Exploration Co."

Act 312

In 2006, while this case was pending, the Louisiana Legislature enacted Act 312 of 2006. The Act, which is codified at Louisiana Revised Statute 30:29, establishes procedure for legacy litigation claims. One of the most important features of Act 312 is that it seeks to ensure that contaminated property will actually be remediated. To a significant extent, Act 312 was enacted in response to *Corbello v. Iowa Production*, 02-0826 (La. 2/25/03), 850 So.2d 686., in which the Louisiana Supreme Court affirmed a remediation award of more than $30 million, and held that the plaintiffs need not use the money to actually remediate the property. And indeed the plaintiffs never did remediate the property, even though the large size of the award was based in part on the plaintiffs' contention that an expensive remediation was necessary to prevent contamination on their land from migrating to neighboring lands.

The *Corbello* decision generated significant concern, and the Louisiana Legislature determined that public policy favors an actual remediation of contamination. In other words, a plaintiff whose land has been contaminated should get a complete remedy, but it should be in the form of a remediation of the property, not payment of a large sum of money that might be spent on other things, while the land remains contaminated. Accordingly, Act 312 requires a legacy litigation defendant who is liable for contamination to fund a remediation. Act 312 requires the Louisiana Department of Natural Resources to develop the most "feasible plan" for remediating the contaminated property to regulatory standards. Either party can present their own proposal for remediation, but ultimately the district court must approve one of the plans. The defendant or defendants who are liable must deposit funds into the registry of the court to fund the court-approved remediation, with the money that is initially deposited being equal to the estimated cost of the remediation plan. If the remediation ultimately costs more, the liable defendants must make up the difference. If the initial deposit is more than is required to complete the remediation, the excess is returned to the defendants.

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[4] The Louisiana Supreme Court explained the meaning of the term "legacy litigation" in *Marin v. Exxon Mobil Corp.*, 48 So. 3d 234, 238 n.1 (La. 2010), stating:

> "Legacy litigation" refers to hundreds of cases filed by landowners seeking damages from oil and gas exploration companies for alleged environmental damage in the wake of this Court's decision in *Corbello v. Iowa Production*, 02–0826 (La.2/25/03), 850 So.2d 686. These types of actions are known as "legacy litigation" because they often arise from operations conducted many decades ago, leaving an unwanted "legacy" in the form of actual or alleged contamination.

[5] *Louisiana v. Louisiana Land and Exploration*, 2020-685 p. 2 (La. 6/30/2021), 2021 WL 2678913.

Act 312 has been amended somewhat since 2006, but in this case none of the parties disputed the fact that the 2006 version of Act 312 applies to the case.[6]

LL&E I

The "UNOCAL" defendants (Union Oil Company of California and Union Exploration Partners) admitted responsibility for environmental damage and for funding a cleanup to regulatory standards, without admitting liability for VPSB's other claims.[7] Louisiana Code of Civil Procedure 1563 allows for such limited admissions in legacy litigation disputes.[8]

The UNOCAL defendants also filed a motion for a partial summary judgment that VPSB was not entitled to obtain a judgment for remediation damages in excess of what is needed to fund the most "feasible plan." This motion did not dispute that legacy litigation plaintiffs can recover for additional damages for the harms, if any, that they incurred other than damage to the land—*e.g.*, any personal injury caused by the contamination. Further, the motion did not dispute the notion that, if an express contractual provision between the parties requires a remediation of the land to conditions cleaner than regulatory standards, a plaintiff can obtain a judgment sufficient to cover that. However, the defendants asserted that, in the absence of such an express provision (and in this case there was no express provision providing for a remediation to standards cleaner than regulatory standards), the amount that plaintiffs can recover for remediation cannot exceed what is necessary to fund the most feasible plan to remediate the property to regulatory standards.

The defendants based their argument in part on Act 312. Act 312 requires that, when a party is found liable for environmental damages, the payments that the party makes for remediation of environmental damage must be deposited into the registry of the court for use in a funding a remediation to regulatory standards. If the funds deposited prove inadequate to complete a remediation to regulatory standards, the district court may require that the party cast in judgment be required to deposit additional funds. If money is left over after a remediation is complete, the excess is returned to the defendant. The version of Act 312 that applied in *La. Land & Expl. I* also addressed the possibility of additional damages being awarded for damage to the land. In particular, paragraph "H" stated Act 312 would not "preclude a judgment ordering damages for or implementation of additional remediation in

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[6] *Louisiana v. Louisiana Land and Exploration*, 2020-685 p. 2 (La. 6/30/2021), 2021 WL 2678913. "Act 312" refers to La. Acts 2006, Act No. 312, which was codified at Louisiana Revised Statute 30:29.

[7] *Louisiana v. Louisiana Land and Exploration*, 2020-685 (6/01/2022), 339 So. 3d 1163.

[8] Louisiana Code of Civil Procedure article 1573(A)(1) states:

> If any party admits liability for environmental damage pursuant to R.S. 30:29, that party may elect to limit this admission of liability for environmental damage to responsibility for implementing the most feasible plan to evaluate, and if necessary, remediate all or a portion of the contamination that is the subject of the litigation to applicable regulatory standards, hereinafter referred to as a "limited admission". A limited admission shall not be construed as an admission of liability for damages under R.S. 30:29(H), nor shall a limited admission result in a waiver of any rights or defenses of the admitting party.

excess of [regulatory standards] as may be required in accordance with the terms of an express contractual provision." The district court granted partial summary judgment in favor of the defendants on this issue, but the Louisiana Third Circuit reversed.

The Louisiana Supreme Court then granted writs to review the Third Circuit's decision. In *La. Land & Expl. I*, the Louisiana Supreme Court held that Act 312 does not preclude an award sufficient to remediate the land to a higher standard, even in the absence of an express contractual provision supporting such an award, if a factfinder concluded that a remediation to a higher standard was necessary to make a plaintiff whole. Further, the portion of any monetary judgment exceeding the amount needed to fund a remediation to regulatory standards need not be deposited into the registry of the court and need not be used for remediation. The Court remanded the case for further proceedings.

LL&E II

After *LL&E I*, the case went to a jury trial. The jury returned a verdict awarding $3,500,000 for remediation of the land to a regulatory standard and an additional $1,500,000 in damages for VPSB's strict liability claim. The jury rejected VPSB's other claims, including its claim for breach of contract. VPSB sought a new trial, based on a contention that the jury's verdict was inconsistent. In particular, VPSB argued that it was inconsistent to award monetary damages for remediation of contamination, but to reject VPSB's claim for breach of contract. The trial court denied the motion for a new trial.

VPSB and UNOCAL each appealed. The Louisiana Third Circuit held that the jury's verdict was inconsistent. For that reason, the appellate court reversed the trial court's judgment and remanded for a new trial. UNOCAL submitted a writ application to the Louisiana Supreme Court, which granted the application.[9]

The Court considered the issue of whether the jury's verdict was inconsistent, as VPSB contended.[10] VPSB asserted that the verdict was inconsistent because the jury had found that the land contained environmental damage for which UNOCAL was liable, but the jury verdict concluded that UNOCAL had not breached its lease by causing more than the normal wear and tear to the property. In contrast, UNOCAL contended that the verdict was not inconsistent. UNOCAL and at least one *amici* asserted that it is possible for contamination to exceed current regulatory standards, thus triggering liability under Act 312, without the contamination necessarily constituting more than the wear and tear on property that would be expected under the oil and gas lease standards that existed several years

[9] *State of Louisiana v. Louisiana Land & Exploration Co.*, 2020-685 (La. 10/6/2020), 302 So. 3d 523. The author of this article filed an amicus brief supporting the application. The amicus brief dealt with issues other than the ones discussed in this article.
[10] The Louisiana Supreme Court also considered certain liberative prescription (statute of limitations issues that are not discussed in this article).

ago, at the time the property allegedly became contaminated. The Third Circuit had agreed with VPSB, and thus had held that the jury's verdict was inconsistent.

The Louisiana Supreme Court concluded that the jury's verdict was not inconsistent, given the instructions issued to the jury, but that the jury instructions were flawed. The Court itself took the blame for this, stating that the erroneous instructions were made "in light of this Court's 2013 *LL&E I* decision, which we now see with clarity, was made in error." Specifically, in its June 2021 *LL&E II* decision, the Louisiana Supreme Court concluded that the Court had erred in *LL&E I* when it held that the 2006 version of Act 312 does not preclude "excess" remediation damages.

The Supreme Court stated that the 2013 holding constituted "palpable error." Further, because the trial court issued jury instructions that attempted to comply with the Supreme Court's 2013 holding led to reversible error. Accordingly, the Supreme Court remanded for a new trial.

LL&E III

Both VPSB and the defendants sought a rehearing. The defendants sought review of the Court's decision on prescription. VPSB sought review of the decision on excess remediation damages. The Court granted rehearing[11]—perhaps in part because the Court in *LL&E II* had raised the excess remediation damages *sua sponte* in its decision, without the parties having briefed that issue.

On rehearing, the Court in *LL&E III* stuck to its decision in *LL&E II*. A dissent disagreed with the Court's decision on prescription. The dissent argued that VPSB's hiring of a lawyer demonstrated sufficient knowledge to begin the running of prescription. The majority disagreed. Further, dissenting justices disagreed with the decision on "excess remediation" damages, but the majority still concluded that such damages are not allowed. The majority believed that a remediation to regulatory standards is a complete remedy. The dissent believed that a complete remedy might require remediation to greater than regulatory standards.

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[11] *State of Louisiana v. Louisiana Land & Exploration Co.*, 2020-685 (La. 10/19/2021), 326 So. 3d 257.

Terms and Conditions of Brine Injection Well Restart Order Upheld on Appeal

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On May 21, 2021, the Division of Oil and Gas Resources Management issued a "Restart Order" authorizing AWMS Water Solutions, LLC, to resume brine disposal injection operations at one of its wells located in Trumbull County, Ohio. Those operations had been suspended years earlier as a result of two seismic events of magnitudes 1.7 and 2.1 reported in the nearby vicinity and attributed to AWMS' operations. The Restart Order included two operating conditions objected to by AWMS, the first requiring the immediate suspension of future operations if a 2.1 seismic event occurs within three miles of the AWMS facility; and the second forbidding AWMS from restarting those operations unless and until it obtains the Division's approval.

On appeal, the Ohio Oil and Gas Commission (i.e., the entity having jurisdiction to hear these types of appeals) framed the issues as follows: "(1) whether it is reasonable to impose the seismic threshold of M 2.1, (2) whether the requirement to stop injection after exceeding Restart Order thresholds is unlawful or unreasonable, and (3) whether it is unlawful and unreasonable for the Order to require the Division's concurrence before restarting operations."[1] On each issue, the Commission upheld the Division's position and affirmed the order below.

The Commission began by noting the Division's general authority governing injection wells:

> The ability to engage in oil and gas production and disposal operations is a privilege, granted only when an operator obtains the appropriate permits to engage in such activities. It is not a right. ... The Chief's authority to grant or deny permits infers the ability to also suspend or revoke permits where continued operation under an issued permit could cause adverse impacts to health, safety, or the environment ... The authorities to permit operations and to suspend or revoke permitted operations infers an[] equal authority to restore operations in a safe manner.

As for the specific issues before it, the Commission recognized that an earthquake of magnitude M 2.1 is not itself a major threat and, as acknowledged by the Division, "is unlikely to cause significant damage to structures or infrastructure." Nonetheless, "it is a warning threshold that future, more risky earthquakes may ensue." As a consequence, "[d]ue to the fact that the surrounding community is made up of homes, schools, and businesses, many of which are in old buildings and vulnerable structures not designed to withstand earthquakes, the M 2.1 limit provides

[1] *AWMS Water Solutions, LLC v. Division of Oil & Gas Resources Management*, Appeal No. 997 (June 30, 2022).

a reasonable margin of safety to mitigate the risk of 'felt' earthquakes and the escalation of earthquakes to magnitudes and levels of ground shaking that may cause damage and threaten public health and safety."

This specific safety concern also supported the Division's requirement to suspend operations if the M 2.1 threshold is exceeded and its requirement that AWMS obtain the Division's assent before restarting its injection operations.

> If AWMS exceeds the 2.1 threshold, the Restart Order does not mandate a permanent shut down. Instead, the Order requires AWMS to pause its operations until it can conduct a full investigation, make any changes that may be necessary to ensure safe operation and get the Division's concurrence on restarting. This condition is a reasonable requirement to ensure the safety of the surrounding community.

And as for AWMS' objection that the Restart Order did not contain an express timeline for the Division to concur (or not) on restart operations, the Commission recognized the need for flexibility while at the same time acknowledging AWMS' concern as legitimate. "[T]he Division's review of AWMS's analysis is also dependent on the situation and on the quality of the analysis conducted by AWMS; these factors are not entirely in the Division's control." Nonetheless, "[a]bsent a specific timeframe, the Commission expects the Division to conduct any such review in a reasonable amount of time. While not applicable to this case, the Commission notes that deadlines do not appear to be at odds with the Division's newly enacted regulatory regime, which requires the Chief to take action on a written corrective action plan submitted by an operator of a well which has been suspended for causing induced seismicity within ten business days of receipt of the plan."

The Commission's decision here is part of a larger thread of AWMS decisions addressing brine injection well permitting issues under Ohio law and well worth your read if you are engaged in advising clients on the process in Ohio.

Carbon Capture Sequestration Forecast for Pennsylvania by a Look at West Virginia's Recent Carbon Capture Sequestration Statute HB 4491

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In May of 2022, West Virginia passed House Bill 4491 ("CCS Statute")[3] pertaining to carbon dioxide capture and sequestration ("CCS"), a pertinent element of blue hydrogen energy production.[4] The CCS Statute imposes requirements for the operation of injection wells used in an underground CCS storage process. Pennsylvania is following closely behind, as Senator Gene Yaw is planning to introduce similar legislation that would be known as the Pennsylvania Geologic Storage of Carbon Dioxide Act.[5] The Pennsylvania bill would establish a framework for CCS operations in Pennsylvania, like the West Virginia CCS Statute being discussed here has for West Virginia.[6] According to Senator Yaw's memorandum, the proposed legislation would establish a "legislative intent to facilitate carbon capture in Pennsylvania; designate property rights around storage sites in deep geologic formations; assign state regulatory authority of CCS facilities in Pennsylvania; specify the regulatory and permitting process within the existing federal structure; and create a cash fund sustaining regulatory operations, minimizing impact to taxpayers."[7] The inclusion of such provisions in the proposed Pennsylvania bill would make it very similar to the West Virginia CCS Statute.

Pennsylvania Governor Tom Wolf has been vocal about establishing a hydrogen and carbon storage hub for Pennsylvania.[8] The area's abundance of natural gas and existing expertise to produce the same has drawn interest from

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[1] The authors thank Morgan Null, a Summer Associate at Steptoe & Johnson PLLC, for her contributions to this article.
[2] *DISCLAIMER: 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.*
[3] *See* W. Va. Code § 22-11B-1, *et seq.*
[4] Blue hydrogen is typically produced from methane utilizing a carbon capture or carbon use component. Without such a carbon capture or carbon use component, hydrogen produced from methane is designated as grey hydrogen.
[5] Senator Gene Yaw, *Senate of Pennsylvania Session of 2021-2022 Regular Session Memorandum*, PENNSYLVANIA STATE SENATE (March 30, 2022), https://www.legis.state.pa.us/cfdocs/Legis/CSM/showMemoPublic.cfm?chamber=S&SPick=20210&cosponId=37118.
[6] *Id.*
[7] *Id.*
[8] Anya Litvak, *Pennsylvania Gov. Tom Wolf vows aggressive push to establish a hydrogen and carbon storage hub in the region*, PITTSBURGH POST-GAZETTE (May 16, 2022), https://www.post-gazette.com/business/powersource/2022/05/16/pennsylvania-gov-tom-wolf-hydrogen-carbon-sequestration-storage-hub-climate-energy-southwestern-natural-gas-shell-cracker-petrochemical-plant-beaver/stories/202205160087.

companies like Shell, Equinor, and EQT, who have stated that a hydrogen hub project could drive down carbon emissions.[9] Further, the Infrastructure Investment and Jobs Act of 2021 allocates $8 billion for at least four hydrogen hubs across the country.[10] Shell's cracker plant in Beaver County is expected to be among the first to use a carbon sequestration hub that could be operational by 2027.[11] CCS operations are pivotal to blue hydrogen production, which could be the next logical step in Pennsylvania for low-carbon energy production due to existing natural gas production and its related infrastructure.

In light of Senator Yaw's proposed legislation, a high-level review of the West Virginia CCS Statute may provide insight into the proposed bill in Pennsylvania. First, the West Virginia CCS Statute does not address or provide any eminent domain rights, which could be a significant challenge for any CCS project. Accordingly, CCS projects, in West Virginia, must generally be formed using voluntary contracts with owners of the underlying pore space. Examples of such contracts include deeds, leases, and easements. However, if a CCS operator is not able to obtain voluntary agreements with all pore space owners within the project area, the CCS Statute does provide an option to move forward without the vested rights from all of the pore space owners. Specifically, the CCS Statute provides that if after good faith negotiation and searching, the operator cannot locate or reach an agreement with all necessary pore space owners but has a written agreement with at least 75% of the parties with an interest in the pore space of the parcel, or in the case of collective storage, 75% of the acreage in the project area, all of the pore space for which voluntary agreements have not been reached will be statutorily included within the proposed storage facility, subject to certain other conditions set out in the CCS Statute.[12] CCS operations cannot be conducted on the surface of any tract of land belonging to a non-consenting owner, except for seismic studies and in cases of emergencies.[13] If an operator is unable to reasonably negotiate with a surface owner for the right to conduct a seismic study on lands owned by the surface owner, the West Virginia Oil and Gas Conservation Commission is permitted to authorize entry on such lands.[14] In that case, the "operator shall notify the owner or owners 15 days prior to entry, pay the surface owner just and reasonable compensation," and repair damages to the surface and any damage resulting from their entry.[15]

A primary issue in developing carbon storage facilities is determining ownership of the pore space. This issue is complicated when there is a severed mineral estate, as to whether the surface owner or the mineral owner holds the rights to the pore space. Importantly, the CCS Statute provides that title to pore space in all strata underlying the surface of lands and waters is vested in the owner of the overlying surface estate.[16] Presumptively, the Pennsylvania bill would also address the issue of pore space ownership, as indicated in Senator Yaw's

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[9] *Id.*
[10] *See* 42 U.S.C. § 16161a.
[11] Litvak, *supra* note 6.
[12] W. Va. Code § 22-11B-19(a)(2) and 22-11B-19(c)(2).
[13] W. Va. Code § 22-11B-19(a)(3) and 22-11B-19(c)(6).
[14] W. Va. Code § 22-11B-19(a)(3)(b).
[15] *Id.*
[16] W. Va. Code § 22-11B-18(a) (stating "[t]itle to pore space in all strata underlying the surface of lands and waters is vested in the owner of the overlying surface estate.")

aforementioned memorandum. Once the proper parties have been identified, the CCS operator could then move forward with acquiring the necessary rights.

There are at least three primary methods of obtaining the rights of storage in pore space, and each has its own advantages and disadvantages. The first option for acquiring pore space rights is through an outright purchase by deed from the surface owner. Generally, a purchase will have fewer restrictions than a lease. However, a CCS operator in West Virginia would need to also purchase the surface estate because the West Virginia CCS Statute prohibits any severance of the surface estate from the pore space.[17] Importantly, the CCS Statute does not affect transactions that took place before May 30, 2022, but the terms of such transactions must be "clear and unambiguous upon the face of the instruments which severed pore space from title to the surface estate."[18] Further, the CCS Statute goes on to provide "a rebuttable presumption that for all transactions prior to [May 30, 2022] . . . that the pore space remains vested with the surface owner, unless there was a clear and unambiguous reservation, conveyance, and/or severance of the pore space from the surface upon the face of the instruments."[19] Purchasing the entire surface estate may be more expensive compared to other acquisition methods making it economically less attractive to the CCS operator. The second acquisition avenue is through a CCS-specific lease of the pore space, like a traditional oil and gas lease, which remains permissible under the CCS Statute.[20] Leasing may be easier in Appalachia where property owners have more familiarity with these types of contracts. Pore space leases may also be less expensive for the operator than the outright purchase of the surface estate. However, leases are typically limited by a term of duration. The third acquisition method is a subsurface easement. This method may be advantageous because it may be less expensive than a deed or a lease, and the easement could be drafted to have either a temporary or perpetual term. However, the fact that easements are considered non-possessory gives the operator less rights than it would obtain by a deed.

Beyond property rights, a CCS operator must also consider the permanent nature of carbon dioxide sequestration projects and the allocation of liabilities throughout the lifecycle of the project. The most significant difference between the subsurface storage of natural gas and the storage of carbon dioxide is the permanency of carbon dioxide storage. To mitigate the liability risks and costs over the project's lifetime, the solution embodied in the West Virginia CCS Statute, and other similar legal models enacted in other parts of the country and world, is to allocate liability differently at various stages of the lifecycle: site selection, operation, closure, and post-closure.[21] Generally, the CCS operator bears all liabilities during site selection, operation, and closure periods. However, the CCS Statute permits the operator to seek a completion certificate ten years after the end of injections,

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[17] W. Va. Code § 22-11B-18(c) (stating "[t]itle to pore space may not be severed from title to the surface of the real property overlying the pore space" and that "[a]n instrument or arrangement that seeks to sever title to pore space from title to the surface is void and unenforceable.")
[18] W. Va. Code § 22-11B-18(d).
[19] *Id.*
[20] W. Va. Code § 22-11B-9.
[21] Ian Havercroft, *Lessons and Perceptions: Adopting a Commercial Approach to CCS Liability*, Global CCS Institute (2019), https://www.globalccsinstitute.com/wp-content/uploads/2019/08/Adopting-a-Commercial-Appraoch-to-CCS-Liability_Thought-Leadership_August-2019.pdf.

whereby responsibility for the CCS project would be transferred to the state.[22] The CCS Statute also requires that the operator pay certain fees allocated to the Carbon Dioxide Storage Facility Trust Fund, primarily “a fee on each ton of carbon dioxide injected for storage.”[23] This fund is designated for the “anticipated expenses associated with the long-term monitoring and management of closed storage facilities.”[24]

It is also important to understand the liabilities associated with CCS operations. First, an operator should be prepared to address general liabilities that may arise for damages caused by CCS operations. These liabilities can largely be managed by traditional insurance.[25] Second, administrative liability may arise when a CCS operator is subject to state or federal regulations, such as the Safe Drinking Water Act and Clean Air Act. Again, these administrative liabilities can largely be managed through insurance or self-insurance.[26] Third, there is potential for liability from greenhouse gas emissions in the event of a carbon dioxide leak from the CCS project, which could result in, among other things, a loss of emissions credits.[27] Unlike the liabilities associated with general or administrative matters discussed above, there appears to be a current lack of insurance options for addressing greenhouse related liabilities.[28]

As the importance of lower carbon sources of energy continues to grow, carbon capture and sequestration projects combined with blue hydrogen production projects may be an attractive option to promote clean energy in the Appalachian region. Accordingly, the West Virginia CCS Statute may provide a potential roadmap for Pennsylvania and other states to consider when it comes to advancing clean energy initiatives.

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[22] W. Va. Code § 22-11B-12.
[23] W. Va. Code § 22-11B-16.
[24] W. Va. Code § 22-11B-15.
[25] Havercroft, *supra* note 17.
[26] *Id.*
[27] *Id.*
[28] *Id.*

Texas Court Holds Exculpatory Clause Does Not Save Operator from Liability

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Non-operators under the 1989 Model Form JOA have been hoping to drive a stake through the dark heart of *Reeder v. Wood County Energy, LLC*, 395 S.W.3d 789 (Tex. 2012). A Texas appellate court's decision in *Bachtell Enterprises, LLC v. Ankor E&P Holdings Corp*., --- S.W.3d ---, 2022 WL 1670772 (Tex. App.—Houston 2022), might be a start. The question was whether the Article V.A. exculpatory clause exonerated the operator who intentionally passed expenses to non-operators without their consent.

The clause did not allow the operator to engage in such activities. The term "activities" is not so broad as to protect an operator such that it can have no liability for breach of any contract, absent willfulness.

Facts

Ankor, the operator, negotiated with CDM to construct a gas plant and told the non-operators that third-party ownership of the plant would, among other things, "eliminate[ ] the need for the [nonoperators] to provide capital for construction."

The non-operators approved AFE's for expenses totaling $385,000. Additional AFE's would cover certain other expenses. The JOA required non-operator consent for " … any single project reasonably estimated to require an expenditure in excess of $50,000."

Article V.A. required Ankor to "[c]onduct its <u>activities</u> … as a reasonably prudent Operator, … It shall have no liability as Operator … for losses sustained or liabilities incurred, except such as may result from willful misconduct" (emphasis added).

A year after the CDM agreement, Ankor told the non-operators that until the plant was paid off CDM would "retain[ ] all plant revenue as credit towards the full operating costs, transfer and fractionation fees, and amortized capital. Any balance due [CDM] is born by the Ownership. The balance … due [CDM] is approximately $1,590,000." Ankor then sent a JIB totaling $1.6MM. The non-operators refused to pay.

Trial Court

Ankor sued the non-operators claiming breach of the JOA for failure to pay the JIBs. Non-operators responded that Ankor breached first by:

- charging for gas plant construction without consent,

- withholding revenue without consent or authority,
- committing non-operators' gas to CDM without authority,
- agreeing not to disclose the CDM service agreement, and
- charging unauthorized attorney's fees.

The jury found that both Ankor and the non-operators breached the JOAs but Ankor breached first (and its breach was the result of willful misconduct). Both sides were awarded damages by the jury. The trial court awarded damages and attorneys' fees to Ankor and a take-nothing judgment against the nonoperators.

The Appeal

The exculpatory clause did not absolve Ankor of liability for failing to obtain consent for charges over $50,000. Other clauses were a factor in the holding, for example:

- imposing individual liability for performance of each party's obligations, and
- prohibiting Ankor from withholding oil revenues to reimburse costs in the absence of a non-operator delinquency.

In response to Ankor's argument that "activities" should be construed broadly to include even intentional breaches of contract that do not rise to the level of willful misconduct, non-operators countered that "Ankor's interpretation of the exculpatory provision turns [it] into a provision that allows the operator to impose liability on the Non-Operators when it is intended only to be a shield to the Operator's liability."

The clause was substantially similar to the one in *Reeder* in which the Supreme Court of Texas held that the term "activities" broadened the scope of the clause to include actions under the JOA beyond operations. (The 1982 form protects the operator's "operations"; the 1989 protects "activities".) In *Reeder* the operator was shielded from liability for its misconduct.

The appellate court refused to extend *Reeder* to excuse Ankor's willful misconduct. Ankor could not use the exculpatory clause offensively to impose liabilities on non-operators that Ankor knowingly incurred without consent. The non-operators were excused from their payment obligations. Judgment for Ankor was reversed.

West Virginia Supreme Court Reconciles MSA and Rate Sheet

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LSU Law Center

In *Antero Resources Corporation v. Directional One Services Inc. USA*, 873 S.E.2d 832 (W. Va. 2022), the West Virginia Supreme Court affirmed a judgment holding that a natural gas operator was liable for a supplier's equipment that was "lost-in-hole." In doing so, the Court harmonized a master service agreement and the supplier's rate sheet, holding that the two documents constituted a single contract. The defendant was Antero Resources Corporation ("Antero"), a large natural gas operator in the Appalachian Basin. The plaintiff was Directional One Services, Inc. USA ("Directional One"), a company that supplies equipment for directional drilling.

In 2014, Directional One submitted a written proposal to supply directional drilling equipment to Antero. The proposal, which the parties called a "rate sheet," stated that "all work quoted within will be performed under our … Terms and Conditions." The rate sheet specified daily fees for various types of directional drilling equipment. In addition, the rate sheet stated that if any of Directional One's equipment was "lost, damaged, [or] destroyed below ground," Antero would either reimburse Directional One for the value of the equipment or "fish" out and recover the equipment at no cost to Directional One. Finally, the rate sheet contained a provision whereby Antero could pay a higher daily rate for equipment in return for being liable to for only one-half the equipment's value if it was lost down hole. A representative of Antero signed and accepted the rate sheet. The rate sheet was occasionally amended to reflect new prices, though Antero did not sign the amended rate sheets.

The same day that Antero signed the rate sheet, the parties executed a "Master Service Agreement" or "MSA" drafted by Antero. A year later, the parties executed a virtually identical MSA. The two MSAs stated that Antero might, from time to time, request "Work," with "Work" being defined to include both services and equipment. The MSA provided that Antero would pay for any Work according to Directional One's published schedule of prices. The MSA also stated that Directional One would indemnify Antero for "the damage to or loss of property" belonging to Directional One.

Between 2014 and 2017, Directional One supplied equipment for drilling more than 250 of Antero's wells. During that time, Antero paid the prices stated on Directional One's most current rate sheet. Typically, Antero paid the higher price that entitled it to the "Lost in Hole Liability Reduction," meaning that Antero would be liable for only one-half the value of the equipment if was lost down hole. Sometimes equipment was lost down hole, and when that happened, Antero compensated Directional One for half the value of the lost equipment.

Eventually, Antero started paying the lower prices that did not provide for the "Lost in Hole Liability Reduction." After Antero started paying the lower prices,

equipment was lost down hole during the drilling of two wells, and Directional One billed Antero for the full value of the lost equipment, but Antero refused to compensate Directional One any amount for the lost equipment.

Directional One sued Antero in the Circuit Court for Tyler County, seeking compensation for the value of the lost equipment. Antero counterclaimed, asserting that Directional One had, in the past, improperly billed Antero (and received payment) for equipment lost down hole. Antero asserted that the provision in the MSA that required Directional One to indemnify Antero for lost or damaged property had the effect of absolving Antero from liability for equipment lost down hole. Antero also asserted a counterclaim that Directional One had double-billed for some services. The West Virginia Supreme Court entered an administrative order referring the case to the West Virginia Business Court.

After discovery, the parties each filed motions for summary judgment. The court granted Directional One's motion, concluding that the MSA and rate sheets constituted a single contract that required Antero to compensate Directional One for equipment lost down hole. Based on the same reasoning, the court denied Antero's motion for summary judgment on its claim to recover the payments that Antero previously had made for equipment lost down hole. The court denied Antero's motion for summary judgment on its claim for double billing. The court concluded that factual disputes precluded summary judgment on that claim. Later, a jury trial was held on the double billing claim, and the jury found that Antero had not proved any double billing, so the court entered a judgment for Directional One denying that claim. Antero appealed the summary judgment rulings, but not the judgment denying the double billing claim.

On appeal, the West Virginia Supreme Court affirmed, concluding that the MSA and rate sheet constituted a single contract. The Court noted that the MSA contained a provision requiring Directional One to indemnify Antero for lost or damaged property, while the rate sheet contained a provision requiring Antero to compensate Directional One for equipment lost down hole. The Court harmonized these provisions by concluding that Directional One had a duty to indemnify Antero for losses to equipment that occurred before the equipment went down hole, but that Antero was liable for equipment lost down hole.

Justices Walker and Armstead dissented. They reasoned that the MSA and rates sheet were in conflict with respect to liability for equipment lost down hole. They noted that the MSA contained a provision stating that it would govern in the event of any conflict with Directional One's published rate schedule. Based on that provision, they concluded that Antero would not be liable for Directional One's equipment that was lost down hole.

Interior Releases Proposed Five-Year Offshore Oil and Gas Leasing Program For 2023-2028

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On July 1, 2022, the U.S. Department of the Interior released its proposed Outer Continental Shelf (OCS) five-year program for offshore oil and gas leasing. The Outer Continental Shelf Lands Act (OCSLA) requires the Secretary of the Department of the Interior to "prepare and periodically revise and maintain an oil and gas leasing program" (i.e., a five-year plan). Despite this requirement, the Biden Administration previously halted lease sales and the development of a new five-year plan, including delaying the scheduled March 2021 lease sale until November 2021 (sale subsequently vacated by court order), then cancelling the remaining lease sales in the then-existing five-year plan, which expired at the end of June. The five-year program that was proposed continues the Biden Administration's commitment to energy transition with up to 11 potential lease sales in 2023-2028, but with none guaranteed.

Secretary of Interior Deb Haaland made the following statement as part of the Interior's release of the proposed plan:

> *The proposed plan puts forward several options from no lease sales up to 11 lease sales over the next five years. Like the current program finalized in 2016, it removes from consideration the federal waters off the Atlantic and Pacific coasts while inviting public comment on 10 potential sales in the Gulf of Mexico and one in the Cook Inlet off south-central Alaska . . . . From Day One, President Biden and I have made clear our commitment to transition to a clean energy economy. Today, we put forward an opportunity for the American people to consider and provide input on the future of offshore oil and gas leasing. The time for the public to weigh in on our future is now.*

The proposed plan, which generally tracks the 2017-2022 plan issued under the Obama Administration, contemplates 10 potential Gulf of Mexico lease sales, plus one potential Alaska Cook Inlet lease sale over the next five years. The proposed plan states that these areas "have the greatest resource potential and net benefits with the least potentially significant impacts and costs to society to meet national energy needs under existing laws and policies." No lease sales are proposed for other planning areas, including federal waters located offshore of the Atlantic and Pacific coasts. The proposed plan offers a maximum of two potential lease sales per year from 2023-2028 for Gulf of Mexico areas, noting that, due to the number of existing leases, two potential lease sales per year provides "adequate access to the region's oil and gas resources to meet national energy needs."

The plan also includes a "no action alternative" option for the Biden Administration to conduct no sales:

> *[T]his Proposed Program retains the Secretary's discretion at the PFP [Proposed Final Program] stage to determine that no OCS oil and gas lease sales in any planning area should be scheduled during the 2023–2028 period.*

The proposed plan reiterates that "BOEM continues to research potential net-zero emissions pathways and implications for the National OCS Program" and "the Secretary may re-evaluate national energy needs on an ongoing basis prior to holding any lease sales" in the future. The proposed plan seeks public comment on this range of options. Interior has never finalized a five-year plan calling for no lease sales to be held.

The proposed plan and additional information are available at https://www.boem.gov/oil-gas-energy/national-program/national-ocs-oil-and-gas-leasing-program-2023-2028. The Department of Interior will now hold a 90-day public comment period before it will begin considering its proposed final plan. Once a proposed final plan is issued, OCSLA mandates a 60-day waiting period to allow the President and Congress an opportunity for input. Secretary Haaland can then approve the final plan. As a result, even with issuance of the proposed plan, final approval of a new five-year leasing program is likely not feasible until sometime in 2023 creating a significant gap between the expiration of the current five-year plan and the issuance of a new plan. As part of the comment period, the Department will be holding virtual meetings in August to obtain additional public input. You can register for virtual meetings on BOEM's website.

Court Enforces Choice of Law Provision in Oilfield Indemnity Dispute

Keith B. Hall
LSU Law Center

Exco Resources, Inc. ("Exco") hired Select Energy Services, LLC ("Select") to drill a well in DeSoto Parish. *Federal Ins. Co. v. Select Energy Services, LLC*, 337 So. 3d 169 (La. App. 2nd Cir. 2022).

The parties' agreement required Select to indemnify Exco against liability arising from injuries to employees of Select (or its subcontractors) and required Exco to indemnify Select against liability arising from injuries to employees of Exco (or any of its invitees). The agreement also required each party to acquire liability insurance to support its indemnity obligation. The agreement stated that it would be governed by Texas law.

Three workers were injured in an accident. One of these was an employee of Select who filed suit against Exco in Texas. As required by the parties' agreement, Select (through its insurer) provided Exco with a defense and, after settling the lawsuit, paid the settlement.

Two of the injured workers were employees of an invitee of Exco. They sued Select in Louisiana. Under the parties' agreement, Exco owed Select a defense and indemnity. Exco (through its insurer) initially provided a defense, subject to a reservation of rights letter. But Exco later withdrew its defense, asserting that its obligation to defend and indemnify Select was unenforceable under the Louisiana Oilfield Anti-Indemnity Act ("LOAIA"), La. Rev. Stat. 9:2780.

Exco and its insurer then filed this suit, seeking a declaratory judgment that the indemnity provision in the parties' agreement was unenforceable under the LOAIA. The parties filed cross motions for summary judgment and the district court ruled in favor of Exco, holding that it did not owe an indemnity to Select. Select appealed to the Louisiana Second Circuit.

The appellate court noted that the opening section of the LOAIA states that it was enacted based on the legislature's conclusion that oilfield contracts sometimes contain inequitable clauses that require oilfield contractors to indemnify oil and gas companies, and that enforcing such contracts is bad public policy. The LOAIA goes on to prohibit enforcement of oilfield indemnity provisions, to the extent that a provision protects an indemnitee that has any level of fault, against liability for personal injury or death, whether that indemnitee is an oil and gas company or a contractor. Thus, if Louisiana law applies in *Select*, Exco's obligation to indemnify Select would be unenforceable.

However, the result would be different under Texas law. Texas has its own Oilfield Anti-Indemnity Act ("TOAIA") that generally prohibits enforcement of oilfield

indemnity agreements, but the Texas statute makes an exception, and allows enforcement, for mutual indemnity provisions that are supported by a contractual requirement that each party obtain insurance to support the indemnity. Thus, if Texas law applies in *Select*, Exco's obligation to indemnify Select would be enforceable.

The Second Circuit noted that Louisiana Civil Code article 3540 provides that contractual obligations generally "are governed by the law expressly chosen" by the parties in their contract, "except to the extent that law contravenes the public policy of the state whose law would otherwise apply under Article 3537." Civil Code article 3537 states in part that contractual obligations generally are to be "governed by the law of the state whose policies would be most seriously impaired if its law were not applied to that issue."

Here, Exco and Select were both Texas companies, their agreement was negotiated and executed in Texas, and it contained a Texas choice of law provision. On the other hand, Select sought indemnity for claims asserted in a Louisiana court for injuries that occurred in Louisiana. Further, the Louisiana Oilfield Anti-Indemnity Act declares that enforcement of oilfield indemnity statutes is against Louisiana public policy.

The Second Circuit discussed two prior Louisiana cases in which similar issues arose. In one, a Second Circuit case, an Arkansas contractor sought to enforce a contractual indemnity against a Texas oil company for personal injury claims asserted by a Louisiana plaintiff in a Louisiana court for an injury that incurred in Louisiana. The parties' agreement in that case provided that Arkansas law would apply, but the court in that case held that Louisiana law would apply and that the LOAIA rendered the indemnity obligation unenforceable.

The other case was a Louisiana Third Circuit case involving a dispute between a Louisiana subcontractor and a Texas contractor regarding an indemnity that would be enforceable under Texas law, in a contract stating that Texas law would apply. An accident occurred and some workers were injured. Assuming the contractual indemnities were enforceable, the subcontractor would owe the contractor indemnity for certain workers' personal injury claims and the contractor would owe the subcontractor indemnity for other workers' personal injury claims. The subcontractor provided an indemnity to the contractor, but the contractor later refused to provide an indemnity to the subcontractor, stating that the indemnity was unenforceable under the LOAIA. The Third Circuit held that Texas law applied and that the subcontractor could enforce the indemnity.

In *Select*, the Second Circuit concluded that the facts and circumstances of *Select* fitted more closely the circumstances of the prior Third Circuit case, rather than the circumstances of the prior Second Circuit case. *Select* held that Texas law would apply and that the indemnity provision in dispute was enforceable.

Fifth Circuit's Tax Doubleheader Allows $200 Million of $1.5 Billion Refund Claim

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Exxon Mobil Corporation v. U.S.A., 2022 W.L. 3052309, Case No. 21-10373 (5th Cir. August 3, 2022) says it is a "tax doubleheader" as Exxon's $1.5 billion tax refund case raised two issues: (1) application of the lease/sale distinction, and (2) the effect of a renewable fuels credit.[1] Exxon lost the "doubleheader" but beat a $200 million penalty.[2]

Facts

The $1 billion lease/sale refund claim arose from agreements with Qatar and with Malaysia's state-owned oil company.[3] Qatar's contracts gave Exxon exploration rights in a large offshore gas field for fixed periods, usually 20 years, in exchange for royalties on petroleum products.[4] The royalties included a percentage of proceeds from sales with a minimum payment based on the quantity of gas Exxon brought to its facilities.[5] Exxon also had to "build and operate facilities to transport, store, process, and market its products."[6] Exxon said it invested $20 billion in the facilities, including an offshore pipeline system, liquification facilities, and advanced ships to transport gas.[7] The facilities belong to Qatar when the agreements end.[8] The agreements sought creation of international markets for Qatari gas; and, the gas produced through Exxon's facilities could be worth twenty times more than the gas in place.[9]

The Malaysian agreements were similar, although they aimed to create a domestic market.[10] Exxon got the right to extract offshore minerals in exchange for "in-kind royalties" on oil and additional payments that depended on the quantity of oil produced.[11] Exxon also paid an "annual 'abandonment cess'" that did not depend on production.[12] The extensive facilities built by Exxon revert to Malaysia when the contracts expire.[13]

Exxon's tax returns for 2006 to 2009 treated the Qatari and Malaysian agreements as leases.[14] Later, it filed amended returns treating the agreements as

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[1] *Id.* at *1.
[2] *Id.*
[3] *Id.** 1 & n.1. Like the Court did, this article refers to Petronas as "Malaysia". *Id.*
[4] *Id.* at *1.
[5] *Id.*
[6] *Id.*
[7] *Id.*
[8] *Id.*
[9] *Id.*
[10] *Id.*
[11] *Id.*
[12] *Id.* That payment was to fund eventual plugging of wells. *Id.*
[13] *Id.*
[14] *Id.* at *2.

sales, which increased its taxable income.[15] Despite that increase, Exxon's "new math" resulted in a huge refund claim because it now claimed foreign-tax credits for the foreign taxes paid on amounts newly included in income.[16] The IRS disallowed the refund and imposed a $200 million penalty for seeking "an excessive refund without a reasonable basis."[17] Exxon paid the penalty and sued.[18] The district court rejected Exxon's $1 billion claim because the contracts' "predominate or primary purpose" demonstrated that they were leases; but, it ruled for Exxon on the penalty.[19]

The renewable fuel credit issue arose from legislation "incentivizing renewable fuels while also ensuring the viability of the Highway Trust Fund" which is funded by the excise tax on fuel.[20] The relevant statutes give renewable gasoline producers "a 'credit against' their excise tax" and an option to receive that credit as a direct payment of the amount by which the credit exceeds their excise tax.[21] The excise tax is deductible from gross income; and, for 2008 and 2009, Exxon's excise tax liability totaled about $6 billion.[22] As it produced renewable fuels, Exxon had a $960 million alternative fuels credit that its initial returns applied to reduce its excise tax payment to approximately $5 billion, which it then deducted from gross income.[23] Exxon's amended returns deducted the approximately $6 billion in excise tax from gross income.[24] That decreased its taxable income by the amount of the renewable fuels credit and lowered its tax bill by $300 million, the refund that it sought.[25] The IRS disallowed the refund saying "[s]ince you already used the Credit to reduce Excise Tax, you are not allowed to use the same Credit [ ] to … decrease taxable income"; the lower court agreed.[26]

Decision

A. Lease or Sale?

The Court began by observing that "[i]n a mineral lease, the transferor provides minerals in place and grants the transferee the right to explore those…in exchange for a share of the income from mineral production" while "[i]n a mineral sale, the transferor 'makes an outright transfer' of mineral interests for fixed consideration that does not depend on mineral production."[27] The lease/sale distinction depends on "the concept of 'economic interest'".[28] If a transferor (Qatar

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[15] *Id.*
[16] *Id.*
[17] *Id.*
[18] *Id.*
[19] *Id.* & n.2. The Court agreed with the parties that there was no basis for a "'predominate purpose' analysis"; the "correct test" for lease/sale distinction is the "economic interest test." *Id.* at *2, n.2.
[20] *Id.* at *8. The excise tax on fuels, hereafter "excise tax", is codified at 26 U.S.C. § 4801(a((1)(A). *Id.*
[21] *Id.*
[22] *Id.*
[23] *Id.* (Citing 26 U.S.C. §§ 6246(a) & 6247(e)).
[24] *Id.* at *8.
[25] *Id.*
[26] Id. at *9.
[27] *Id.*at *1.
[28] *Id.* at *2.

or Malaysia) retained an "economic interest" in the mineral deposits, then there was a lease; otherwise, there was a sale.[29] An "economic interest in minerals in place" is shown by having: "(1) an investment in the minerals and (2) income derived solely from extraction of the minerals."[30]

For the Court, the royalties paid to Qatar and Malaysia seemed dispositive of their having retained an economic interest.[31] Indeed, it observed that "[t]hese uncapped royalties, which last for the entire duration of the agreements, are similar to royalties that case after case deems an economic interest" and were "the quintessential and indeed textbook example of an economic interest."[32] Nor did economic interests disappear because the royalties reflected an increased value beyond the value of minerals at the wellhead.[33] "What matters is whether the payments depend on minerals," which "is why… minimum guaranteed payments, net-profit payments, and advance bonuses also result in an economic interest."[34]

Although neither Exxon nor the Court found any case "holding that a party with an unlimited royalty stream lacks an economic interest in minerals", Exxon "point[ed] to a subset of lease/sale cases in which the transferor receives … a fixed sum called a production payment."[35] The Court observed that production payments' "fixed sum nature…is the hallmark of a mineral *sale*" qualified by "the wrinkle…that production payments, like…royalties, can reflect income from minerals" requiring "closer scrutiny than the set prices suggest" of the question of whether recipients have an economic interest.[36] That "tricky question of whether production payments--which carry set prices but allow mineral extraction to help pay them—support an economic interest" is answered by a "bright-line rule": "[w]hen a payment can be satisfied by an alternative, nonmineral source of income, the recipient lacks an economic interest because minerals are not the sole source of recovery."[37] Stated otherwise, there is no economic interest created by a production payment unless it "can be satisfied solely by income from minerals."[38]

The Court observed that its "discussion of production payment cases was a detour" as the matter involved no production payments; however, it continued by noting that "Exxon … latches on to the 'solely' requirement … in the production-payment nook of oil-and-gas law" to contend "that landowners who lease property in exchange for oil royalties have no economic interest if they secure other contractual benefits in the same bargain."[39] In short, Exxon claimed that "Qatar and Malaysia lack an economic interest in minerals because they receive additional

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[29] *Id.*
[30] *Id.* at *3.
[31] *Id.* at 3-4 & 7.
[32] *Id.* at *3. Eventually, it also said that "Exxon's position is irreconcilable with decades of cases recognizing that royalties support an economic interest." *Id.* at *7.
[33] *Id.* at *4.
[34] *Id.*
[35] *Id.*
[36] *Id.*
[37] *Id.* at *5.
[38] *Id.*
[39] *Id.*

sources of income besides mineral royalties—infrastructure, access to markets, and in Malaysia's case, abandonment cess payments."[40]

The Court rejected Exxon's argument that economic interest depends on whether one "is entitled to oil payments and nothing else" because "[t]he correct question is whether a party has a right to any income that depends solely on the extraction and sale of minerals".[41] The Court found that demonstrated by "[t]he 'sales' cases' that Exxon reli[ed upon]" since all such cases "found no economic interest because the production payment could have been satisfied by minerals or nonmineral sources."[42] By contrast, "Qatar's and Malaysia's right to income through royalties depends solely on minerals"; and, their entitlement "to supplemental income is irrelevant."[43] Indeed, the Court concluded that allowing the lease/sale distinction to depend on other sources of income would allow manipulation by making "[t]ax treatment…depend on how many transactions are cobbled into one contract."[44]

The Court also rejected Exxon's view that the Court's rule about looking at how the royalties could be paid was "barred" by language in *Anderson v. Helverig,* 310 U.S. 404, 413 (1940) requiring courts to "treat payments 'as a whole' rather than 'distributively [ ] depending upon the source'".[45] But, the Court said that passage from *Anderson* merely meant that tax treatment did not depend on the actual payment source, that *Anderson's* rule was whether the payment could be satisfied from an alternative source, and that *Anderson* recognized the rule that a royalty owner had an economic interest, a rule that "resolves this case."[46] The Court used a footnote to dispatch Exxon's argument that damages for breach of contract could be an alternative source by deeming damages "too indefinite and unpredictable to constitute an alternative source" and saying that such a rule would eliminate all leases.[47] Finally, the Court concluded that Exxon "cannot explain cases in which we have recognized an economic interest despite the presence of both royalties dependent on oil and separate sources of income."[48]

B. The Penalty

The Court noted that 26 U.S.C. § 6676(a)(2017)[49] disallowed penalties for excessive claims "with a 'reasonable basis'" which the IRS defined as being " 'reasonably based on one or more of' a number of authorities."[50] Calling the issue

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[40] *Id.* The Court also stated in a footnote that "the 'solely' requirement applies in cases not involving production payments… ; [and], [t]his case would be different if the royalties …could be satisfied by another source besides petroleum." *Id.* at *6, n.6.
[41] *Id.* at *6.
[42] *Id.*
[43] *Id.*
[44] *Id.*
[45] *Id.* at *6.
[46] *Id.* at *6-7.
[47] *Id.* at *6, n.6.
[48] *Id.* at *7.
[49] The exemption standard has changed for claims filed after December 18, 2015. and now reads "due to a reasonable cause." See P.L. 114-113 (2018).
[50] *Id.* at *7 (Citing 26 C.F.R. § 1.6662-3(b)(3) & 1.6662-4(d)(3)).

a "close call", the Court noted that the lease/sale distinction was a "notoriously complex area of tax law" that a prior opinion "quips" involved "occult mysteries".[51] It cited a technical advice memorandum that also broadly read the "solely" requirement, noted that one of its prior decisions was particularly susceptible to such a reading, and affirmed the refund of the penalty.[52]

C. Alternative Fuel Credit

The Court said the issue was whether Exxon could deduct the excise tax it paid after the credit or the full excise tax without reduction by the credit.[53] This turned on the "meaning of 'credit'" in a statute providing "that there 'shall be allowed' a 'credit…against' the fuel excise tax."[54] "If the credit *reduces* excise tax, the taxpayer" would deduct the reduced amount that it actually paid.[55] "But, if, as Exxon contends, the credit *satisfies* or *pays* the excise tax, it does not alter the amount of tax imposed…[and] then the taxpayer could deduct the full amount of excise tax imposed without a reduction for the credit."[56]

The Court said Exxon's "gambit" was "the latest installment" of "nearly identical claims" made nationwide and unanimously rejected by two courts of appeals and three district courts.[57] The Court concluded that "the ordinary meaning of 'credit' " was decisive; and, that the term conveyed that it "*reduces* the amount that is otherwise owned."[58] Hence, "[i]t follows from this commonly understood meaning of 'credit' that when the …credit is applied against excise tax, it reduces that tax."[59] It rejected the contention that its interpretation was inconsistent with the statutory provision allowing "a tax-free direct payment" of the credit because that option did not permit payment "*in lieu of* the excise tax".[60] Instead, a taxpayer had to "first apply the credit to the excise-tax" and could then get a direct payment only of the amount by which the credit exceeded the excise tax.[61] It rejected all other arguments, without identifying them, by noting agreement with the reasoning of two other courts of appeals that had rejected them.[62]

Conclusion

The Fifth Circuit clearly explained, for tax purposes, how to distinguish between a sale and lease of minerals and joined other courts by holding that the

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[51] *Id.*
[52] *Id.* at *7-8.
[53] *Id.* at *8.
[54] *Id.* at * 9.
[55] *Id.*
[56] *Id.*
[57] *Id.*
[58] *Id.*
[59] *Id.*
[60] *Id.* at *10.
[61] *Id.*
[62] *Id.* (Citing *Delek US Holdings, Inc. v. U.S.,* 32 F.4th 495, 499-502 (6th Cir. 2022) and *Sunoco, Inc, v. U.S.,* 908 F.3d 710, 716-7 (Fed. Cir. 2018)).

deduction for excise tax is limited to the amount of excise tax paid after its reduction by the alternative fuel credit.

Ninth Circuit Confirms Power of Utilities Commission to Limit Liability

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The United States Court of Appeals for the Ninth Circuit analyzed whether a group of Plaintiffs' claims were preempted by the California Public Utilities Code. The Court held that they were.[1]

Underlying Facts

The Plaintiffs consisted of a group of U.S. Marines who were severely injured when a gas line exploded during a training exercise at Camp Pendleton, a Marine Corps base. The Plaintiffs asserted that San Diego Gas & Electric Company ("SDG&E") was liable for their injuries because it was aware of issues with gas lines at Camp Pendleton and continued to supply gas to the Marine Corps base. The district court granted summary judgment in favor of SDG&E. It held that California law preempted Plaintiffs' claims. This appeal followed.

Court of Appeals Decision

The Ninth Circuit concluded that California Public Utilities Code section 1759 preempted Plaintiffs' claims. Accordingly, the Court dismissed the claims for lack of subject matter jurisdiction.

To reach its conclusion, the Court recognized that the California Public Utilities Commission ("PUC") has broad power to regulate utilities, including the ability to "fix rates [and] establish rules."[2] Section 1759 of the California Public Utilities Code protects PUC's authority because it restricts a court's jurisdiction "to review, reverse, correct, or annul any order or decision of the commission…or to enjoin, restrain, or interfere with the commission in the performance of its official duties."[3]

Section 1759 bars private lawsuits against public utilities if awarding damages would "have the effect of undermining a general supervisory or regulatory policy of the commission."[4] Consequently, the "question of whether a utility regulation preempts a suit against a public utility company implicates a court's subject matter jurisdiction."[5]

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[1] *De la Rosa v. San Diego Gas & Electric Company*, No. 21-55269, No. 21-55315, 2022 WL 1714285 (9th Cir. May 27, 2022).
[2] *San Diego Gas & Elec. Co. v. Superior Ct. (Covalt)*, 920 P.2d 669, 681 (Cal. 1996).
[3] Cal. Pub. Util. Code § 1759(a).
[4] *Covalt*, 920 P.2d at 683 (discussing *Waters v. Pac. Tel. Co.*, 523 P.2d 1161 (Cal. 1974)).
[5] *De la Rosa*, 2022 WL 1714285, at *1; *see Kairy v. SuperShuttle Int'l*, 660 F.3d 1146, 1156 (9th Cir. 2011); *see also Wilson v. S. Cal. Edison Co.*, 184 Cal. Rptr. 3d 26, 41 (Ct. App. 2015) ("[S]ection 1759 is a statute involving subject matter jurisdiction, and divests trial courts of jurisdiction to entertain lawsuits that would interfere with the PUC's regulation of utilities.").

The Court examined the PUC regulation at issue—SDG&E Tariff Rule 26 ("Rule 26"), which states in relevant part:

> The consumer shall, at the Consumer's own risk and expense, furnish, install and keep in good and safe condition all Consumer Equipment as defined in Rule No. 1. Company shall not be responsible for the selection, installation, operation, maintenance, or condition of any Consumer Equipment or for any injuries or damages resulting therefrom . . . .

The Tariff defines Consumer Equipment as "[a]ll equipment for receiving and utilizing gas from the Company, including, but not limited to, any and all pipes . . . downstream of the Service Delivery Point." The Service Delivery Point is defined as the point "where the Utility's pipe connects to the customer's house line, usually the meter location."

To determine whether Section 1759 preempts a cause of action, courts apply the three-step *Covalt* test:

> (1) whether the PUC had the authority to adopt a regulatory policy on the subject matter of the litigation;
> (2) whether the PUC had exercised that authority; and
> (3) whether action in the case before the court would hinder or interfere with the PUC's exercise of regulatory authority.[6]

After applying those factors, the Court held that Rule 26 bars Plaintiffs' claims. It found that regarding the first step, PUC clearly had the authority to limit SDG&E's liability.[7] As to the second step, the Court held that PUC exercised its authority from the first step when it approved Rule 26.[8]

The Court recognized that permitting Plaintiffs to recover would interfere with the PUC policy expressed in Rule 26. The Court rejected Plaintiffs' argument that SDG&E had a duty to shut off Camp Pendleton's gas supply because it had known for many years of the issues at the base. Rejecting this argument, the Court held that Plaintiff's "theory of recovery would make SDG&E broadly responsible for injuries resulting from the 'operation, maintenance, or condition' of Consumer Equipment."[9]

Conclusion

The Court declined to read an exception into Rule 26's limitation on liability. The Ninth Circuit upheld the traditional rule that utilities commissions have the authority to rule-make, limit a court's jurisdiction, and limit liability.

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[6] *Kairy*, 660 F.3d at 1150 (citing *Covalt*, 920 P.2d at 687-95).
[7] *See Waters*, 523 P.2d at 1164 ("[L]imitations upon liability . . . ha[ve] long been considered to be a proper subject for commission regulation . . . .").
[8] *See Davis v. S. Cal. Edison Co.*, 186 Cal. Rptr. 3d 587, 604 (Ct. App. 2015) (stating that the PUC exercises its authority when it approves a tariff rule).
[9] *De la Rosa*, 2022 WL 1714258, at *2.

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