

Overview of Rocky Mountain Oil & Gas Law

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Overview of Rocky Mountain Oil & Gas Law

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HOT TOPICS IN THE ROCKIES

- **SPLIT ESTATES**
- **DEDUCTIBILITY OF POST-PRODUCTION COSTS**
- **PHASED DEVELOPMENT OF FEDERAL LEASES**

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*PART I:
SPLIT ESTATES*

Split Estates: Why a Hot Topic?

- Rising Surface Values
- Urban Development
- Reservoir Development/Characteristics = Increased Surface Disturbance
- Limited Source of Experienced Work Force
- Legislation/Regulation

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What is a Split Estate?

- Separate Surface and Mineral Estates

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Split Estates: Case Law

- Dominance of the Mineral Estate: Grant of minerals without the right to obtain them was worthless.
- Implied Easement entitles mineral owner to use the surface required to develop its minerals.

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Earliest Cases: Due Regard

- Narrowly interpreted easement to use surface and required due regard for the rights of surface owners

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Reasonably Necessary Test

- If mineral owner acts within scope of easement and in a non-negligent manner, he will not be liable for any damages to surface.

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Reasonable Accommodation Doctrine

- Balancing test
- Accommodate surface owners to fullest extent possible consistent with right to develop mineral estate
- UT, WY, CO, NM, ND, WV, TX

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Surface Damage Legislation

- Illinois
- Indiana
- Kentucky
- Montana
- North Dakota
- Oklahoma
- South Dakota
- Tennessee
- West Virginia
- Wyoming

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Proposed Surface Damage Legislation

- New Mexico
- Colorado
- Montana (amendment for negligent operations – treble damages)

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Determining Loss of Land Value

- Based on surface owner's actual use at time of operations?
- Limited to loss of value to land actually used in operations?
- How will damages be determined when the duration of loss is temporary or uncertain?

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Wyoming Statute

W.S. § 30-5-401 et. seq.

- Effective July 1, 2005

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Wyoming Act Surface Compensation Provision

Requires operator to pay the surface owner damages for “loss of production and income, loss of land value and loss of value of improvements caused by oil and gas operations.” W.S. § 30-5-405(a)(i)

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Wyoming Damage Provisions

- Consideration “shall be given to the period of time during which the loss occurs.”
- Covers land “directly affected” by operations.
- Double damages if fail to pay annual installment under agreement after 60 days written notice.
- 2 year limitation period if no agreement.

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Surface Disturbing Operations

- Notice must be given no more than 180 nor less than 30 days before commencement of operations.
- Must disclose plan of work and operations

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Regulation by State Agencies

- WY: Permit approval requires certified statement that good faith negotiations with surface owner were attempted
- UT: Requires operator to make reasonable effort to obtain surface use agreement
- CO: Onsite inspection prior to APD issuance if surface owner has not executed surface damage agreement; can issue conditions to APD

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Regulation by Federal Agencies

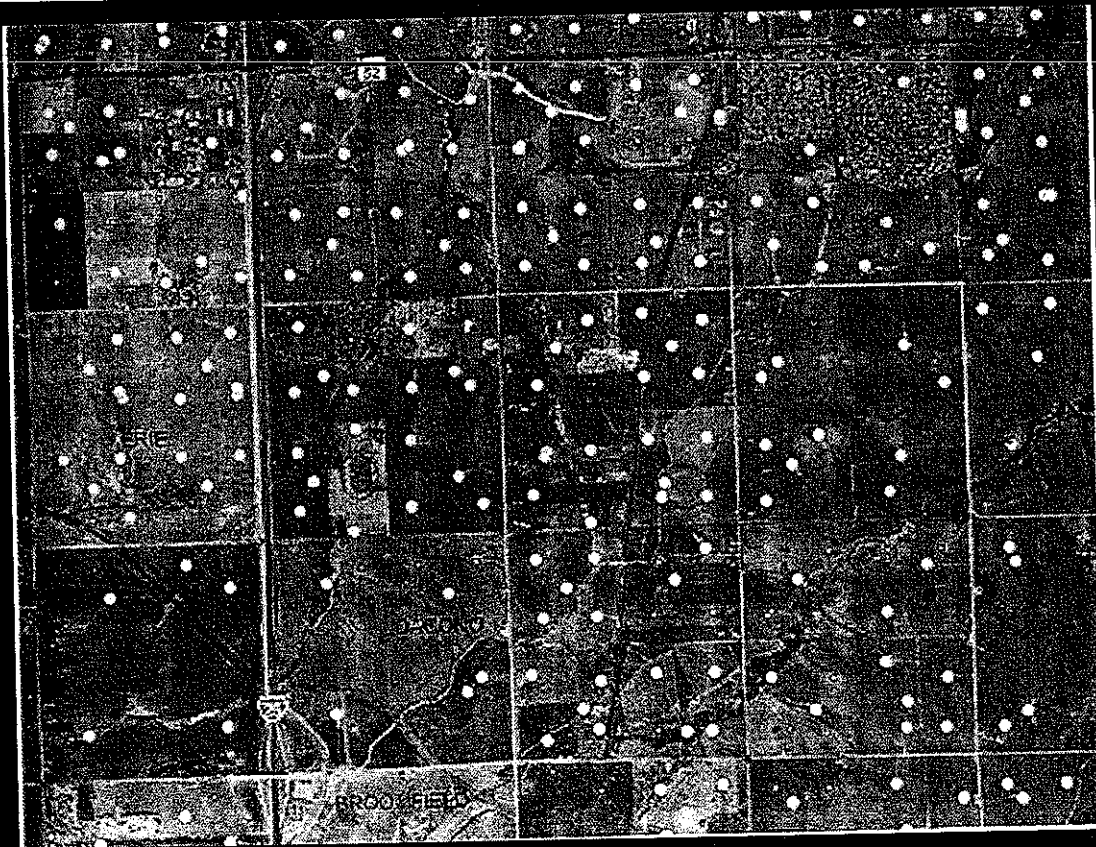
- IM Onshore Oil and Gas Order No. 1
 - Applies to private or state surface overlying federal minerals.
 - Requires good faith negotiations.
 - No permit absent agreement, waiver, or adequate bond to cover “damages for loss of crops and tangible improvements.”

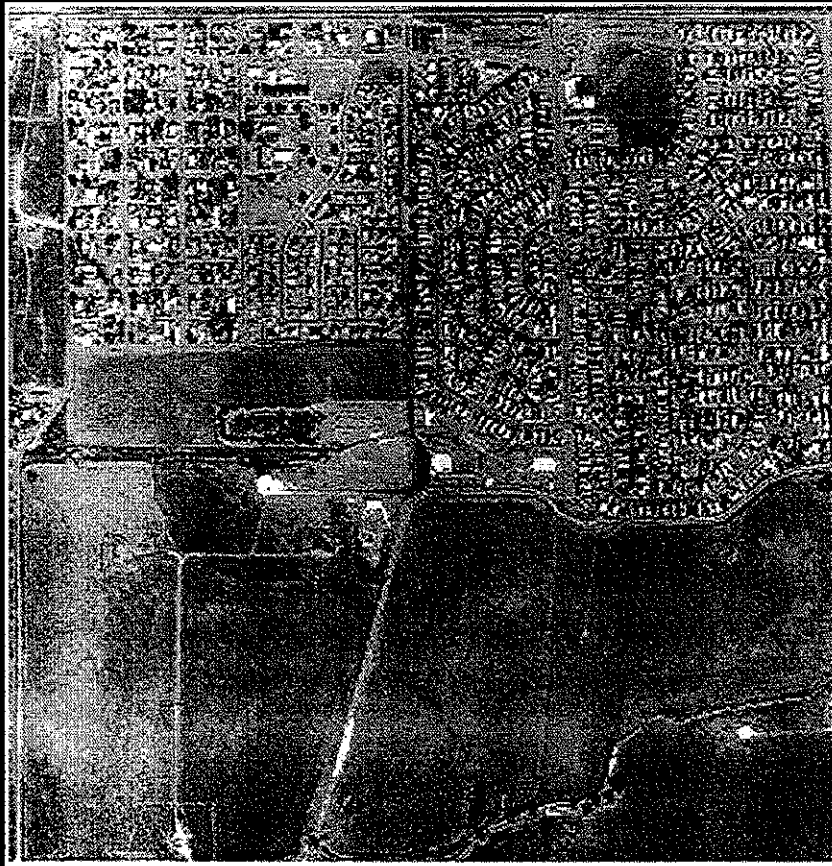
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Culprit #1: Urban Development

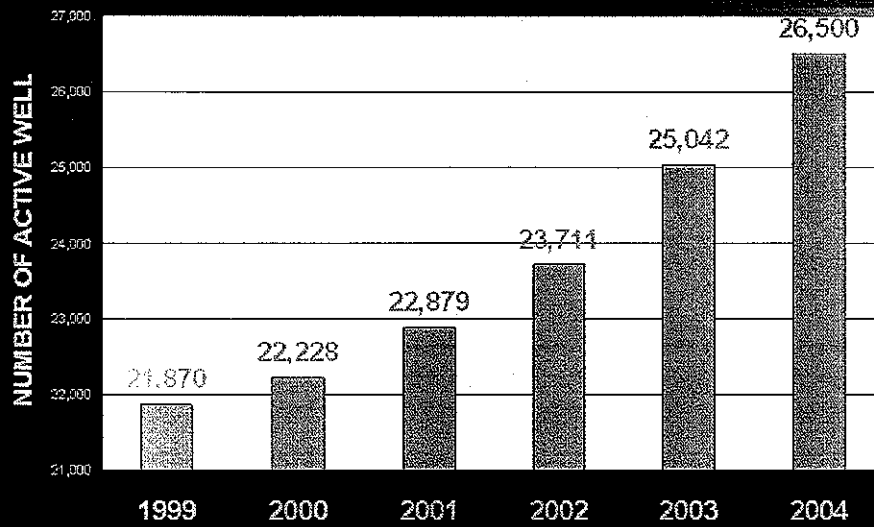
- Ranchers/Farmers VS Developers/Homeowners
- Increased Land Costs
- Multiple use effects

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TOTAL COLORADO ACTIVE WELL COUNT ^{6/2/04}

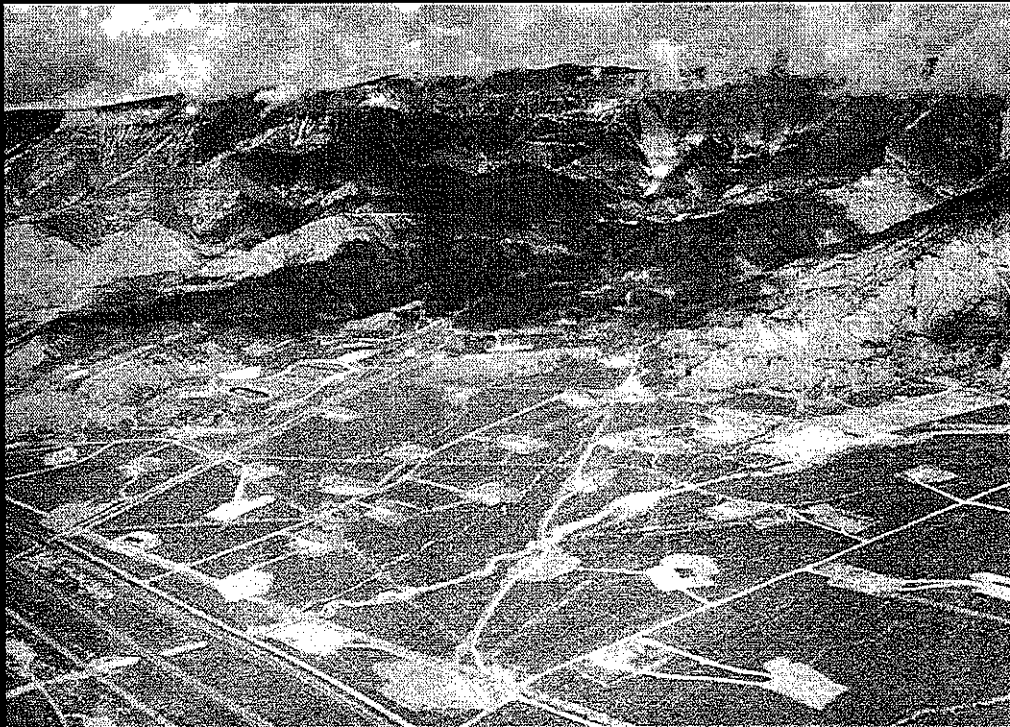


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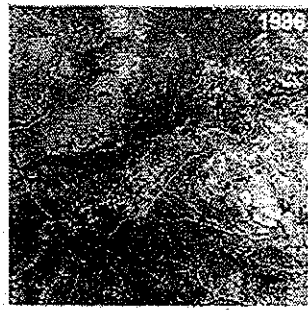
Culprit #2: Reservoir Development & Characteristics = Increased Surface Disturbance

- Larger extended fields
- Tight ubiquitous sands
- Increase surface activity
- Water disposal

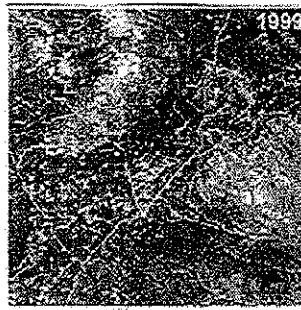
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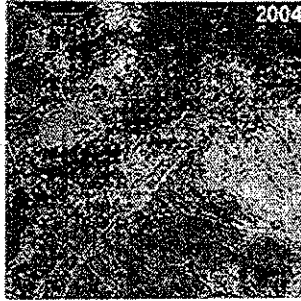
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changes to the Jordan Natural Gas Field



changes to the Jordan Natural Gas Field



changes to the Jordan Natural Gas Field

Culprit #3: Limited Source of Experienced Work Force

- Lack of experienced field hands
- Continual need for training
- Lack of understanding of surface owners and environmental needs

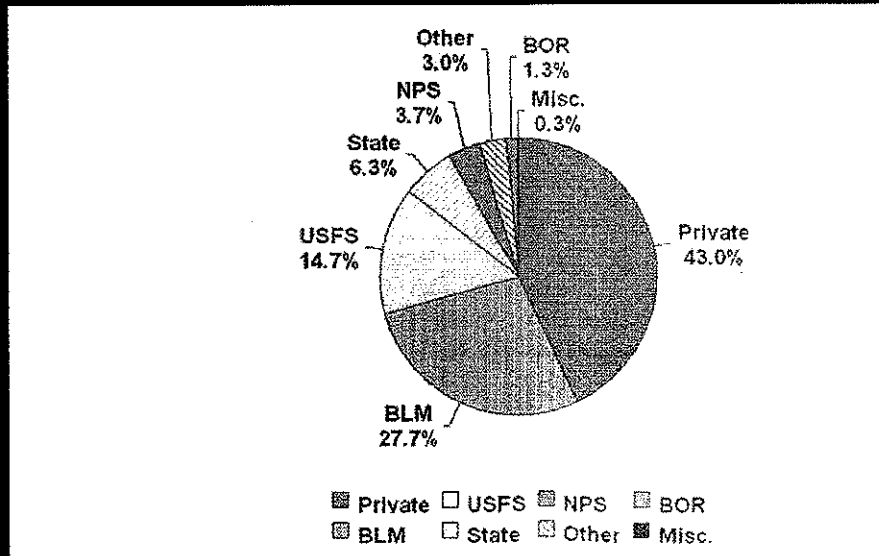
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Culprit #4: Legislation and Regulation

- Increased legislation/regulation by Federal, State, and local jurisdictions
- Continually changing environment

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State of Wyoming Surface Ownership - 2003



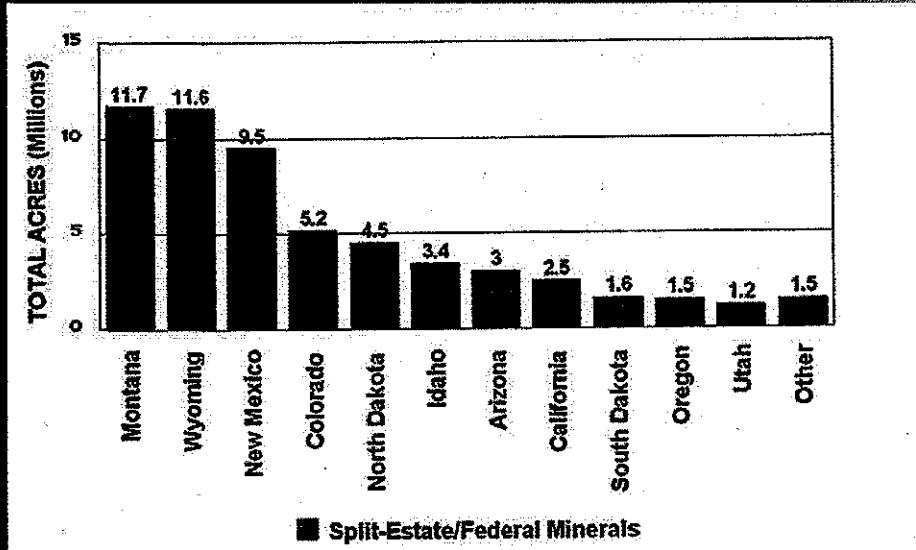
Source: Equality State Almanac, Wyoming 2003, pg. 3, Total WY Acres = 62,664,980

Misc. = Local Gov. (School District & Colleges, City, & County) F&WS

Total WY Acres = 57% Public, 43% Private

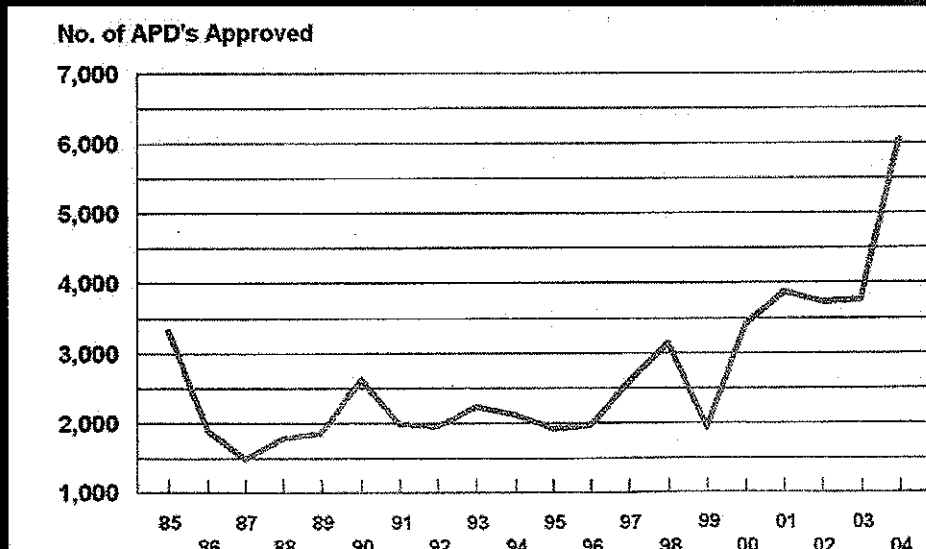
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Split-Estate Federal Minerals Land Ownership in the U.S.



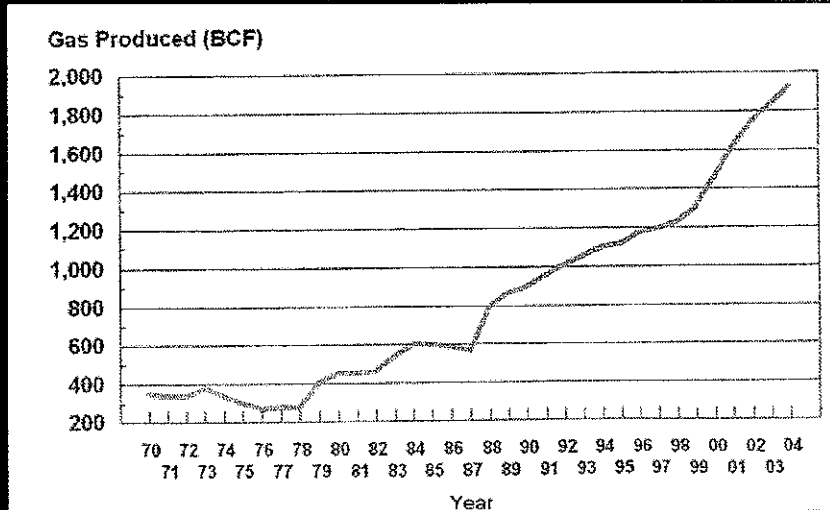
Source: Public Lands Statistics DOI - 2004, Table 1-3, pg. 9. Split Estate refers to private surface lands over Federal mineral rights.
 Total Split-estate Federal Minerals Land Acreage = 57.2 MM acres or about 8.2% of Total Federal Mineral Acreage of 699.7 MM acres.
 Surface lands include public domain and acquired lands of all Federal agencies. *Welborn Sullivan Meck & Tooley* 8% of total U.S. lands.

BLM – Oil and Gas Drilling Permits (APD's) Approved



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Yearly Gas Production in Wyoming



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PART II: DEDUCTIBILITY OF POST- PRODUCTION COSTS

Marketable Product Theory

- CO, KS, OK
- Implied covenant to market requires lessee to bear post-production costs incurred to obtain a marketable product, unless agreement to contrary

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The Colorado Approach: Rogers v. Westerman

- Royalties to be paid “at the well” or “at the mouth of the well”
- Gas sold at the well: royalties based on proceeds received
- Gas sold away from the well: royalties based on gas price less deductions for costs of gathering, compression & dehydration.

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The Colorado Approach: Rogers v. Westerman

- Lessees argued “at the well” was geographical point of valuation for royalties
- Court held that “at the well” language is silent re: allocation of costs
- When silent, look at implied covenant to market to determine if gas is marketable

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The Colorado Approach: Rogers v. Westerman

- Implied covenant to market requires lessee to incur costs necessary to place gas in condition acceptable for market
- If gas is marketable and costs enhance value of gas, sharing ok if:
 - (1) costs are reasonable
 - (2) royalty revenues ↑ proportionately to costs assessed against royalties

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The Colorado Approach: Rogers v. Westerman

- 2 factors to determine whether gas is marketable:
 - (1) Physical condition to be bought/sold
 - (2) Location – commercial marketplace
- Marketability is question of fact

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Criticism of Rogers Decision

- No explanation of “at the well”
- Implied covenant overrides lease terms
- No guidance re: “commercial marketplace”
- No guidance re: “reasonableness”
- Will courts allow marketing gas at the well?

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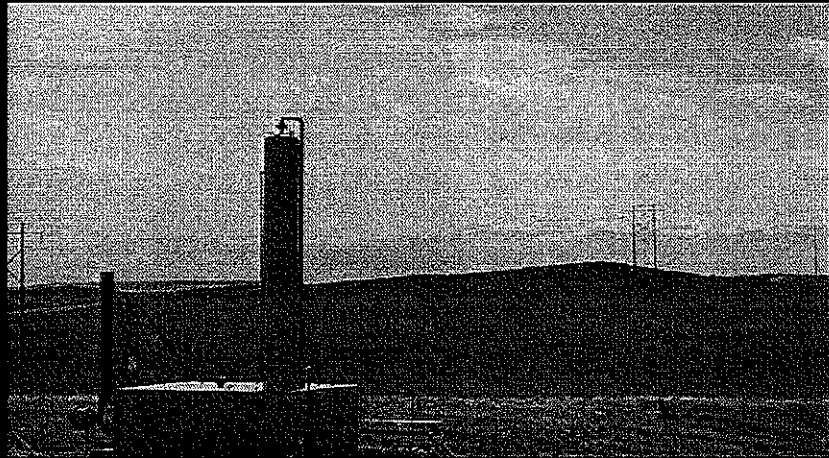
Drafting Considerations for Post-Production Costs

- Determine basis of royalty payments (proceeds received or market value)
- Specify where proceeds/value will be measured
- Consider whether parties intend to modify implied covenants
- Address prerequisites required by courts to support deductibility (e.g., define marketability)

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PART III: PHASED DEVELOPMENT OF FEDERAL LEASES

Phased Development for federal CBM leases in Montana: NPRC v. BLM



CBM Equipment on the CX Ranch

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Northern Plains Resource Council v. BLM

- Invalidated the FEIS authorizing full-field CBM development in Montana
- Requires the BLM to consider “phased development” alternative to full-field development
- Further CBM development in Montana under federal leases may be enjoined

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Background of Fidelity CBM Development

- **1997:** Fidelity began CBM operations in Montana, pumping groundwater into the Tongue River and several reservoirs
- **1998:** Fidelity received an exemption from the Montana Water Quality Act for the water
- **2000:** First claim against Fidelity under the Clean Water Act
- **2002:** Summary judgment entered for Fidelity by the Montana District Court
- **2003:** 9th Circuit reversed, finding the groundwater a pollutant within the meaning of the CWA

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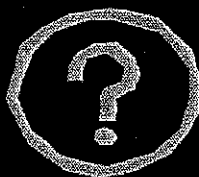
Background on the Current Case

- **1994:** The BLM issued a Resource Management Plan allowing for limited CBM development in Montana
- **2002:** The BLM completed a statewide Draft EIS recommending full-field development of CBM in Montana
- **2003:** The Northern Plains Resource Council (NPRC) and Native Action sued the BLM, claiming that the Final EIS violated NEPA and FLPMA

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The Result:

Phased Development



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The Montana District Court Holding

- The BLM failed to consider phased development as an alternative to full-field development
- The FEIS is therefore inadequate
- The BLM may take up to 2 years to produce a new FEIS

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Until then...

- All parties have appealed the decision
- The NPRC has filed for an injunction stopping all of Fidelity's federal well operations
- Fidelity claims the injunction may cost \$48 million or more
- The injunction is currently stayed while Fidelity considers a compromise offered by the NPRC

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What is Phased Development?

- No fixed definition, but...
- Limits to number of wells
- "Companies would be allowed to develop one area at a time and when complete, would move onto another"
- "Corridors would be left undeveloped to allow for wildlife movement"

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Phased development is new, at least for federal oil and gas leases

- Phased development has not been required by any other court for a federal mineral development EIS
- The Supreme Court has found that permits to drill will be approved absent unacceptable site-specific impacts (*Mobil Oil Exploration*, 530 U.S. 604 (2000))



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Is phased development allowed?

- The BLM is required to prevent drainage of federal minerals and to maximize production (Mineral Leasing Act and 43 CFR 3100)
- There is a checkerboard pattern of private and federal land in the Powder River Basin
- The private leases may drain CBM from the federal leases

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Is phased development allowed?

- The court found that the BLM must balance its responsibilities to maximize production with FLPMA, NEPA, and the CWA
- The federal leaseholders only had limited development rights under the 1994 RMP
- The court found that phased development is not a limitation on the leases, but an expansion of rights under the leases

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Impacts on other areas?

- Any FEIS not considering phased development in possible danger
- The Wyoming BLM did not consider phased development for its Powder River CBM FEIS – a new requirement?

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Conclusion

- An appeal is pending at the Ninth Circuit
- Until then, it is possible that development of the federal CBM leases will be enjoined

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