

RECENT DEVELOPMENTS IN TEXAS, UNITED STATES, AND INTERNATIONAL ENERGY LAW

I. INTRODUCTION	212
II. RECENT DEVELOPMENTS IN TEXAS ENERGY LAW	213
A. The Mineral Owner's Right to Use the Surface: The Basics and Recent Texas Cases by <i>Peter Vermillion</i> and <i>Gaye White</i>	213
B. Texas Oil and Gas Case Summaries by <i>Thompson & Knight LLP</i>	225
III. RECENT DEVELOPMENTS IN UNITED STATES ENERGY LAW	239
A. What Next for FERC Compliance? FERC's Enforcement Policy Statement, One Year Later by <i>Noel Symons</i>	239
B. United States Oil and Gas Case Summaries	263
IV. RECENT DEVELOPMENTS IN INTERNATIONAL LAW	271
A. Venezuela: Migrating Away from the Apertura Petrolera by <i>John Keffer</i> and <i>Maria Vargas</i>	271
B. Libya: Recent Developments Impacting Foreign Investment by <i>Matin Hunt</i> and <i>Feras Gadams</i> and <i>Tarek Eltumi</i>	281

I. INTRODUCTION

The *Recent Developments in Texas, United States, and International Energy Law* section consists of selected cases and discussions of legislation and regulation related to energy law. Part II focuses on developments in Texas energy law. This part includes an article on conflicts between surface owners and mineral owners and summaries of recent Texas cases. Part III focuses on developments in energy law throughout the United States. This Part includes an article on the evolution of FERC's approach toward enforcement and summaries of cases from around the United States. Part IV concludes with international developments in energy law and presents changes in Libya and Venezuela.

II. RECENT DEVELOPMENTS IN TEXAS ENERGY LAW

A. The Mineral Owner's Right to Use the Surface: The Basics and Recent Texas Cases

PETER VERMILLION* AND GAYE WHITE**

As the development of the Barnett Shale spreads into urban and residential areas of North Texas, the tension between the rights of mineral interests owners and their lessees (collectively “lessees”), on the one hand, and surface owners, on the other, increases steadily along with it. For those properties where mineral rights have been severed from the surface, often in deed instruments from decades past, surface owners are often surprised to learn that a mineral lessee has the “dominant” estate or right to use the surface as may be reasonably necessary to explore, develop, and transport minerals (e.g., oil and gas).¹ On the other hand, mineral owners or their lessees often mistakenly believe their right to use the surface is “absolute” or “unlimited.” Although there are limited instances where a deed or oil and gas lease will provide carte blanche access and use of the surface by the lessee, in most cases the lessee is limited to “reasonably necessary” use of the surface giving “due regard” for the rights of the surface owner.²

Lessee's Right to Use the Surface

The lessee's right to use the surface is rooted in the common law doctrine of implied easement. Obviously, if a lessee was unable to use the surface, the lessee's right to explore and develop the minerals would be meaningless. Thus, a right to use the surface, if not expressly granted by the deed or lease, is recognized in order to prevent a taking of the rights of the lessee.³ As long as the use of the surface is reasonably necessary

* Pete Vermillion is a partner in the Energy Practice Group of Kelly, Hart & Hallman LLP and maintains offices in both Austin and Fort Worth. Prior to practicing law, Mr. Vermillion was a petroleum geologist for both major and independent oil and gas companies. He specializes in oil and gas litigation but also handles oil and gas transactional matters and business litigation. He has extensive trial experience, has authored articles concerning oil and gas issues, and has worked on a number of international oil and gas projects.

** Gaye White is an associate in the Oil & Gas Section of Thompson & Knight LLP in Austin. Prior to practicing law, Ms. White was a petroleum engineer. She specializes in energy regulatory and transactional matters. Ms. White received her BS in Petroleum Engineering from Texas A&M University in 1995 and her J.D. from the University of Texas in 2000.

1. *Getty Oil Co. v. Jones*, 470 S.W.2d 618, 621 (Tex. 1971); *Tarrant County Water Control & Improvement Dist. v. Haupt, Inc.*, 854 S.W.2d 909, 911 (Tex. 1993), (*Haupt I*), *opinion on remand*, 870 S.W.2d 350, 353 (Tex. App.—Waco 1994, no writ) (*Haupt II*).

2. *Getty Oil*, 470 S.W.2d at 621. This concept is known in Texas as the “accommodation doctrine.”

3. *Id.*; *Haupt I*, 854 S.W.2d at 911.

and gives due regard for the existing use of the surface owner, the lessee's right and preference to use the surface is dominant—meaning that if a conflict of use arises and there is no reasonable alternative, the lessee's right to use the surface trumps that of the surface owner.⁴ Indeed, a lessee may be entitled to injunctive relief and damages for improper interference by the surface owner (e.g., “Uh, mister, just which part of my shotgun do you not understand?”).⁵ Of course, what is “reasonably necessary” for the lessee and what constitutes “existing use” by the surface owner are often where the legal battles are fought.⁶

The right to use the surface by the lessee includes the right of ingress and egress and the right to select the locations of wells and facilities upon the property, as long as the exercise of these rights is reasonable.⁷ The lessee also has the right to construct roads, tanks, pits, and flow lines, as well as to conduct seismic testing, etc., as may be reasonably necessary to explore, develop, and transport minerals.⁸ In determining whether the mineral estate's use of the surface is reasonably necessary, the fact that such use creates mere inconvenience or nuisance is not controlling.⁹ Nor does the fact that the surface may have diminished value as a result of the lessee's operations mean that the lessee's surface use is unreasonable.¹⁰

4. *Haupt I*, 854 S.W.2d at 911.

5. See, e.g., *Ball v. Dillard*, 602 S.W.2d 521, 523 (Tex. 1980) (mineral lessee awarded damages based on increase in drilling costs resulting from delay caused by wrongful denial of access by surface lessee); *Montfort v. Trek Resources, Inc.*, 198 S.W.3d 344, 352-53 (Tex. App.—Eastland 2006, no pet. hist.) (surface owner enjoined from locking out lessee, altering equipment, and filing frivolous pleadings with the Texas RRC); *Davis v. Devon Energy Prod. Co.*, 136 S.W.3d 419, 421, 425 (Tex. Civ. App.—Amarillo 2004, no pet.) (surface owner enjoined after demanding lessee leave premises while clutching a hammer); *Parker v. Texas Co.*, 326 S.W.2d 579, 581-83 (Tex. Civ. App.—El Paso 1959, writ ref'd n.r.e.) (surface owner enjoined after meeting operator at entrance to property armed with a pistol).

6. Whether the use of the surface is reasonably necessary is a fact question. *Haupt II*, 870 S.W.2d at 353; *Getty Oil*, 470 S.W.2d at 621, 627 (reasonableness may be measured by usual, customary, and reasonable practices in the industry under similar circumstances; what might be reasonable use of the surface on a prairie may be unreasonable within an existing residential area).

7. See, e.g., *Ball*, 602 S.W.2d at 523 (surface owner could not deny lessee entry to property); *Phillips Petroleum Co. v. Cargill*, 340 S.W.2d 877 (Tex. Civ. App.—Amarillo 1960, no writ) (surface tenant had no legal right to deny lessee access to land in order that lessee might develop oil and gas lease); *Gulf Oil Corp. v. Walton*, 317 S.W.2d 260, 262-63 (Tex. Civ. App.—El Paso 1958, no writ) (evidence insufficient to show that mineral owner's plan for waterflood contemplated unreasonable use of surface or that additional roads and drill sites would use more of the surface than reasonably necessary). Note, however, that Texas courts have held that requiring mineral lessees to enter the property through locked or unlocked gates is not unreasonable interference with the development of the mineral estate. *Getty Oil Co. v. Royal*, 422 S.W.2d 591 (Tex. Civ. App.—Beaumont 1968, writ ref'd n.r.e.); *Texaco Inc. v. Parker*, 373 S.W.2d 870 (Tex. Civ. App.—El Paso 1963, writ ref'd n.r.e.).

8. See, e.g., *Delhi Gas Pipeline Corp. v. Dixon*, 737 S.W.2d 96, 97-98 (Tex. App.—Eastland 1987, writ denied) (right to lay pipeline); *Ottis v. Haas*, 569 S.W.2d 508, 513-14 (Tex. Civ. App.—Corpus Christi 1978, writ ref'd n.r.e.) (right to construct tanks and other surface equipment); *Yates v. Gulf Oil Corp.*, 182 F.2d 286, 291 (5th Cir. 1950) applying Texas law (right to conduct seismic testing).

9. *Getty Oil*, 470 S.W.2d at 621, 627-28; *Ottis*, 569 S.W.2d at 514.

10. See, e.g., *Sun Oil Co. v. Whitaker*, 483 S.W.2d 808, 812 (Tex. 1972).

Although in most cases the surface owner owns both surface and subsurface water rights—unless, for example, expressly reserved or granted to the mineral owner under the severance deed—the lessee is also entitled to use water, whether surface or subsurface, as “reasonably necessary” for operations.¹¹ This has become an increasing concern for surface owners, especially considering that completion techniques in the Barnett Shale can often require large quantities of water.¹² Nevertheless, the lessee will not be required to purchase or import water from other sources provided use of the water on lease is reasonably necessary (i.e. not excessive or wasteful) to develop the minerals underlying the lease and there are no reasonable alternatives.¹³

The lessee also has the general right to dispose of salt water in subsurface formations.¹⁴ In areas such as the Fort Worth Basin, production from the Barnett Shale has led to production of salt water and other produced wastes in unprecedented amounts. Many of the area’s residents are concerned about the potential pollution to groundwater and surface lands that may be caused by salt water disposal wells. In response, staff at the Railroad Commission of Texas (the Commission) have proposed that the Commission increase the area of review requirement for applications for disposal wells under Statewide Rule 9 from a quarter mile to a half mile for disposal wells in Wise, Denton, and Tarrant Counties.¹⁵

11. See, e.g., *Whitaker*, 483 S.W.2d at 811 (right to use water). In some instances, the language of the lease may expressly provide the lessee rights to use surface water or to drill water wells. *Id.* See also *Carroll v. Roger Lacy, Inc.*, 402 S.W.2d 307, 315-16 (Tex. Civ. App.—Tyler 1966, writ ref’d n.r.e.) (lessee shall have the right to use gas, oil, and water free of cost for operations).

12. The Railroad Commission of Texas reports, for example, that hydraulic fracture completions in the Barnett Shale use anywhere from 60,000 to 100,000 barrels of water per completion. See RAILROAD COMMISSION OF TEXAS, WATER USE IN THE BARNETT SHALE, http://www.rrc.state.tx.us/divisions/og/wateruse_barnettshale.html (last visited Oct. 11, 2006). Note, the *Texas Drilling Observer Weekly* recently reported the Texas Senate Committee on Natural Resources held a hearing in June 2006 to discuss whether the oil and gas industry should continue to be exempt from obtaining permits from ground water districts to use fresh water for rig use and completion operations. See *Committee Questions Need for Fresh Water Permit Exemption*, TEX. DRILLING OBSERVER WKLY, Oct. 9-13, 2006, at 1.

13. *Whitaker*, 483 S.W.2d at 811. See also *Robinson v. Robbins Petroleum Corp.*, 501 S.W.2d 865, 867 (Tex. 1973) (ownership of the minerals carries with it the right to use the surface, including water, to the extent reasonably necessary to develop and produce the minerals). The Texas Water Code does limit use of fresh water in some secondary recovery operations, such as waterfloods, where there are alternative substances that can be economically utilized, such as gas or other liquids. TEX. WATER CODE ANN. § 27.0511 (Vernon 2006).

14. See *Brown v. Lundell*, 344 S.W.2d 863 (Tex. 1961); *TDC Engineering, Inc. v. Dunlap*, 686 S.W.2d 346 (Tex. Civ. App.—El Paso 1959, writ ref’d n.r.e.).

15. Memorandum from Steven J. Seni, Assistant Director, The Railroad Commission of Texas, to The Railroad Commission of Texas (Feb. 10, 2004) (on file with author); see also *Commission Institutes New Policy for Certain Disposal Wells in Wise County*, TEX. DRILLING OBSERVER WKLY., Feb. 2-6, 2004 at 1. The Fort Worth City Council has also passed an ordinance establishing a moratorium until January 16, 2007, on applications for salt water disposal wells in order to consider a variance request for injecting into the Caddo Sands formation instead of the Ellenberger formation. See Fort Worth, Tex., Ordinance 17224-10-2006 (Oct. 3, 2006).

The lessee must still comply with applicable statutes, rules, and regulations, such as drilling permits, and in certain municipalities or counties, spacing requirements related to existing structures.¹⁶ In addition, surface use by the lessee is limited to exploration, development, and transport of minerals underlying the lease or mineral estate. The lessee, for example, must secure an easement or right-of-way to transport off-lease or off-premise production or to access the acreage to explore adjacent acreage (unless the acreage is pooled together).¹⁷ The deed in which the minerals and surface are severed or the lease granted to a lessee may also provide express parameters for the lessee's rights to use the surface and obligations to pay damages, which may trump any implied or common law rights.¹⁸

The Accommodation Doctrine and "Existing Use"

To be afforded protection under the accommodation doctrine, the surface owner has the burden of showing (i) an existing use that is substantially impaired, (ii) that reasonable alternatives for the lessee exist, and (iii) that the alternatives available to the surface owner are impractical and unreasonable.¹⁹ Along the growing fringes of urban areas, many landowners have purchased acreage for the sole purpose of residential development or building a "dream home." Does a lessee have the right to locate a well or build a road upon a site where a home or perhaps a pool is planned on land the surface owner purchased for that very purpose? In some instances, where the acreage is close to existing residential areas, the surface owner may have paid a significant sum for the property. How "existing" must "existing use" be? For example, must a structure exist or does existing use include planned use provided the planning is in advanced stages with the only thing lacking being actual commencement of

16. For example, the City of Fort Worth prohibits drilling a well within 600 feet of any residence, religious institution, public building, hospital, school, or public park without obtaining a permit from the City. In addition, to drill within 300 feet requires a variance and the unanimous consent of all property owners within a 300 foot radius of the proposed well and the affirmative vote of not less than three-quarters of the members of the city council. *See* FORT WORTH, TEX. REV. ORDINANCES ch. 15, art. II, § 15.36.1(d) (2001). The City of Cleburne, Texas, has a similar drilling ordinance restricting the drilling of a well within 200 feet of a residence, commercial structure, or public building. *See* CLEBURNE, TEX., CODE OF ORDINANCES, Title XI, § 118.04 (2002).

17. *See, e.g., Robinson*, 501 S.W.2d at 867-868; *Delhi Gas Pipeline Corp. v. Dixon*, 737 S.W.2d 96, 98 (Tex. App.—Eastland 1987, writ denied) (gas purchaser does not have right to transport off-lease gas without easement or condemnation); *Chevron Oil Co. v. Howell*, 407 S.W.2d 525 (Tex. Civ. App.—Dallas 1966, writ ref'd n.r.e.) (mineral owner enjoined from accessing surface to directionally drill adjoining lease).

18. *See, e.g., Landreth v. Melendez*, 948 S.W.2d 76 (Tex. App.—Amarillo 1997, no pet.) (accommodation doctrine inapplicable where terms of mineral reservation expressly provide standard for mineral owner's surface use).

19. *Haupt I*, 854 S.W.2d 909, 911 (Tex. 1993); *Getty Oil v. Jones*, 470 S.W.2d 18, 621 (Tex. 1971).

construction (e.g., completed architect plans, land surveyed, loan and appraisal obtained, materials secured, construction contracts signed)? Does existing use include recreational use of the property (e.g., hunting or four-wheeling)?

In most cases, “existing use” means what it says—a use *currently* being made by the surface owner or its lessee.²⁰ Possible future use, tentative plans, or sporadic use generally does not constitute existing use or can otherwise be altered to minimize any conflict. However, that is not an absolute and may depend on the circumstances. Indeed, accommodation doctrine cases tend to be fact specific.²¹ If a surface owner can show that it has substantially prepared for an intended use, a court may find such planned use sufficient.²²

For example, in *Texas Genco, L.P. v. Valence Operating Co.*, the plaintiff operated a power plant on its property and disposed of ash from expended coal in earthen pits.²³ The surface owner moved for injunctive relief to stop the lessee from drilling a well on one of the pits where it planned to dispose of ash. The lessee argued that since the pit was not being used, it was not an existing use. The court found, however, that although the pit was not yet being used, it still constituted existing use because operations had been done in preparation to use the pit.²⁴ The court also found that the minerals could be reached by the lessee moving its surface location and directionally drilling.²⁵

To help eliminate the uncertainty or tension between planned mineral development and residential or commercial development of the surface, the Texas Legislature passed legislation in 1983 allowing for surface developers to create “qualified subdivisions” for planned residential, commercial, or industry use.²⁶ Chapter 92 of the Texas Natural Resources Code allows a surface developer to obtain approval from the Railroad Commission of a subdivision plat that specifies where drill sites and easements will be located. Generally the statute provides for one drill site for every 80 acres within a 640-acre subdivision in counties with populations in excess of 400,000 or counties with populations of 140,000 that

20. See *Haupt II*, 870 S.W.2d 350, 353 (Tex. App.—Waco 1994, no writ).

21. *Getty Oil*, 470 S.W.2d at 627-28.

22. *E.g.*, *Texas Genco, L.P. v. Valence Operating Co.*, 187 S.W.3d 118 (Tex.App.—Waco 2006, pet. filed).

23. *Id.*

24. *Id.* at 124.

25. *Id.* at 125. See also *Haupt II*, 870 S.W.2d at 355. In addition, when determining whether a use may be “grandfathered in” or excepted from newly passed zoning ordinances that would otherwise prohibit the use, courts have found instances where planned use may be sufficient to be protected. See *Board of Adjustment of the City of San Antonio v. Wende*, 92 S.W.3d 424, 431-33 (Tex. 2002) (land leased for quarry operation established existing use although quarry operations had not commenced).

26. See TEX. NAT. RES. CODE ANN. §§ 92.001-007 (Vernon 2001)

border a county with population in excess of 400,000.²⁷ Many surface owners view the qualified subdivision rule as a way to minimize future potential conflicts with lessees over use of the surface. Pursuant to the authority granted by the Texas Legislature in Chapter 92, the Commission adopted Statewide Rule 76 to implement the qualified subdivision process.²⁸ About forty-five applications have been filed at the Commission. However, several of those have been withdrawn or dismissed prior to the Commission's entering a final order. Perhaps the reason this rule has not been more widely used at the Commission is that it actually operates as a means of bringing the surface and mineral owners together to negotiate an agreement without the need of further pursuing the matter before the agency.

Damages

Damages, as one might expect, are another area of contention between lessees and surface owners. Many surface owners are surprised to learn that they are not entitled to surface damages in Texas even when the surface is altered or are livestock injured. Because many oil and gas operators enter into surface damage agreements with surface owners in part to avoid the headache and expense of litigation, many surface owners believe such agreements or payments are required by law. They are not (at least not in Texas).²⁹ As long as the lessee is using the surface as "reasonably necessary" and giving "due regard" to existing surface use, damages are generally not recoverable.³⁰ Moreover, the lessee is not under any implied duty to restore the surface following the termination of operations to its prior condition unless expressly obligated by contract or unless failure to perform such restoration is negligent.³¹ Of course, as

27. *Id.* at § 92.002

28. 16 TEX. ADMIN. CODE § 3.76 (West 2006).

29. Several states have enacted surface damage acts requiring operators to compensate surface owners for value of crops destroyed and diminution in value of the surface, including Oklahoma, North and South Dakota, West Virginia, Illinois, and Kentucky, but not Texas. The Oklahoma Surface Damages Act requires that an operator (i) must give a surface owner written notice of intent to drill and enter into good faith negotiations to determine surface damages before entering upon site for oil or gas drilling, and (ii) must make a surface damage offer up front and if no agreement reached, must petition court for appointment of appraisers. Violation of the Act exposes the operator to treble damages. OKLA. STAT. tit. 52, §§ 318.2-318.9 (1982). In 2003, the Texas Legislature declined to enact a surface use bill modeled after the Oklahoma statute. *See* H.B. 1803, 78th Leg., Reg. Sess. (Tex. 2003). In 2005, legislation requiring the mineral estate owner to notify the surface owner of pending oil and gas operations also failed to pass. S.B. 575, 79th Leg. Reg. Sess. (Tex. 2005).

30. *See, e.g., Vest v. Exxon Corp.*, 752 F.2d 959, 961-63 (5th Cir. 1985) (no evidence that the drilling locations were unnecessary or not justified to develop minerals). *See also, e.g., Santana Oil Co. v. Henderson*, 855 S.W.2d 888, 890 (Tex. App.—El Paso 1993, no writ) (must show lessee used more land than was reasonably necessary to carry out purpose of lease to recover for injury to cattle absent intentional or reckless act).

31. *Warren Petroleum Corp. v. Monzingo*, 304 S.W.2d 362, 363 (Tex. 1957).

mentioned above, what constitutes “reasonably necessary” is often at issue. Pollution is not reasonably necessary, for example, nor can a lessee negligently damage the surface.³² A lessee will also face exposure for damages for operations that are not reasonably necessary or outside the reasonably necessary area required for exploration and development (e.g., excessive use of the surface).³³ The lease itself may contain express provisions concerning surface damages, for example, to agricultural crops or structures, regardless if the operator is acting reasonably or within a justified area necessary for exploration and production.³⁴ A surface owner may seek breach of contract damages (e.g., breach of lease provisions), decreased market value, interference with peace and enjoyment of surface (“nuisance” damages), physical damage to land, loss of crops or livestock, etc., predicated on excessive or unreasonable use of surface.³⁵

As development of the Barnett Shale continues, it is a certainty that more and more surface use conflicts will arise. Many surface owners will be shocked to learn that the lessee has the dominant estate and can use what they perceive as “their land.” Lessees have to wield their power carefully, balancing being cooperative while at the same time not appearing to waive their rights or creating unreasonably expectations or demands for damages by surface owners. Nevertheless, more accommodation up front, whether legally required or not, will probably result in less expensive litigation down the road.

Notable Recent Cases

Texas Genco, LP v. Valence Operating Co., 187 S.W.3d 118 (Tex. App.—Waco 2006, pet. filed). The surface owner operated a limestone plant and generated its own electricity by burning coal. The residual coal ash was disposed of in predetermined cells or pits. When the lessee planned to drill a well utilizing one of the pit areas planned for ash disposal, the surface owner obtained a temporary injunction preventing the drilling of the well. However, the surface owner was denied a permanent injunction at trial and appealed. The Waco Court of Appeals reversed and remanded for entry of a permanent injunction holding that the surface owner had an existing use that would be substantially impaired, even

32. See, e.g., *Gen. Crude Oil Co. v. Aiken*, 344 S.W.2d 668, 671 (Tex. 1961) (negligent disposal of produced water) (holder of the dominant estate must exercise rights with due respect for the rights of the owner of the servient estate and without negligence); *Mieth v. Ranchquest, Inc.*, 177 S.W.3d 296, 305 (Tex. App.—Houston [1st Dist.] 2005, no pet.) (discharge of salt water on surface in violation of Commission regulations could constitute negligence per se).

33. *Gen. Crude Oil*, 344 S.W.2d at 671.

34. See, e.g., *Vest*, 752 F.2d at 961-63 (lease required lessee to compensate for damage to growing crops without respect to reasonableness of mineral development).

35. See, e.g., *Oryx Energy Co. v. Shelton*, 942 S.W.2d 637 (Tex. App.—Tyler 1996, no writ) (damages awarded for excessive use).

though ash was not currently being disposed of in the cell or pit. The court of appeals also held that in this instance directional drilling was a reasonable alternative to reach the minerals.

Montfort v. Trek Resources, Inc., 198 S.W.3d 344 (Tex. App.—Eastland 2006, no pet. h.). This case involved a situation where the subsurface water rights and a freshwater gathering system were reserved by the mineral interest owner at the time the surface and minerals were severed (as opposed to otherwise going with the surface). The mineral owner agreed to furnish fresh water to the surface owner. The lessee later purchased the rights to the subsurface water and gathering system from the mineral interest owner. After the surface owner locked out the lessee from the property and interfered with its operations, the lessee obtained both a temporary and permanent injunction restraining the surface owner from interfering with the lessee's operations and equipment, as well as from making frivolous and false complaints to the Commission. On appeal the Eastland Court of Appeals noted that the surface owner's interference created potential dangers including preventing the lessee from accessing problem wells and possibly causing spills by tampering with equipment. The court of appeals held the lessee's damages could not be measured with any certainty and affirmed the injunction. The court also addressed other issues including that the obligation to provide fresh water to the surface owner was a covenant running with the land and that the surface owner did not have standing to make any claims or demands under the unit agreement.

Duke Energy Field Services, L.P. v. Meyer, 190 S.W.3d 149 (Tex. App.—Amarillo 2005, pet. denied). In this case, the surface owner and its surface lessee brought suit against a pipeline company related to an oil leak in pastureland. Plaintiffs recovered nominal damages at trial for damages to the land but more than \$75,000 in damages to livestock, plus attorneys' fees. Plaintiffs alleged they observed cows in the leak area "licking and rubbing their noses" in the oil. One of the cows aborted a calf the following day and over a period of time some thirty cows aborted or had dead calves and problems continued the following year. Although there was some expert testimony that drinking oil can cause cows to abort their calves, the Amarillo Court of Appeals reversed the judgment as to the damages to livestock, holding that there was no evidence the cows actually ingested the oil and/or that expert testimony established there were possible other causes that were not ruled out.

Mieth v. Ranchquest, Inc., 177 S.W.3d 296 (Tex. App.—Houston [1st Dist.] 2005, no pet.). This is a case where the surface owners won the bat-

tle but lost the war. The surface owners sued the lessee for negligence after a number of operations resulted in spills and pollution on the surface. The lessee failed to construct adequate levees around pits allowing drilling fluids, diesel fuel, oil, salt water, and sewage from a trailer house on location to spill onto plaintiffs' pasture. The lessee even pumped fluids out of a pit into a ditch that drained into a nearby creek. The Commission had repeatedly cited the operations for violating Statewide Rule 8, designed to protect fresh water from pollution by salt water. The jury awarded \$200,000 as reasonable costs to repair or remediate the property but plaintiffs failed to establish any diminution in value of the property at trial. The Houston Court of Appeals noted that the proper measure of damages for permanent injury to the land is the diminution in value of the land, whereas the measure of damages for a temporary injury is the cost of restoration and agreed with the trial court that the injury to the land was permanent in nature, holding that when the surface is so injured as to make the land less productive in the future, the injury is permanent, even though it may not be perpetual. Although it was held that the violations could serve as negligence per se, the judgment for the lessee was affirmed because plaintiffs failed to establish any diminished land value.

Primrose Operating Co. v. Senn, 161 S.W.3d 258 (Tex. App.—Eastland 2005, pet. denied). This case is similar to *Mieth v. Ranchquest, Inc.*, 177 S.W.3d 296 (Tex. App.—Houston [1st Dist.] 2005, no pet.), summarized above. The issue in this case again concerned the proper measure of damages for injury to land caused by the negligence of the mineral lessee. The surface owners sued the mineral lessee for alleged contamination of soil on their ranch related to numerous oil and saltwater spills from pipelines. Following a first trial resulting in a take-nothing judgment in favor of the mineral lessee, the trial court granted the surface owners' motion for a partial new trial that was limited to the issue of the mineral lessee's liability for surface damages. The surface owners' experts offered testimony that the market value of the land would be reduced by the cost of the clean up and associated stigma. On retrial, the jury found that the mineral lessee had negligently caused the contamination and awarded the surface owners \$2.11 million for the cleanup costs and \$86,000 as punitive damages. The mineral lessee argued that this award was based on unscientific evidence, which was not supported by legally or factually sufficient evidence. The Eastland Court of Appeals held that, as a matter of law, the restoration of the land was not "economically feasible" and thus the injury was permanent in nature. The court noted that the proper measure of damages for permanent injury to land is the diminution in fair market value. The court reversed and rendered a take nothing judgment in favor of the mineral lessee holding that simply reducing the market value of the

land by the cost of the cleanup was not competent evidence of diminution of value.

Trenolone v. Cook Exploration Co., 166 S.W.3d 495 (Tex. App.—Texarkana 2005, no pet.). In this case, the surface owners appealed a summary judgment entered in favor of a mineral lessee concerning a dispute as to whether the mineral lessee had the right to use an abandoned easement and pipeline located on the lease. The surface owners argued that the ownership of the easement vested in the owners of the surface when the owner of the pipeline easement executed a written release of the easement and that the mineral lessee was prohibited from using the pipeline. The mineral lessee contended that the oil and gas lease gave it the right to use the pipeline and that the pipeline itself became owned by the lessee because it was the first to possess the pipeline following its abandonment. However, there was some evidence in the record that suggested that it was possible that the mineral lessee took possession of the pipeline before it was abandoned, in which case, such possession would be unlawful. The Texarkana Court of Appeals determined the pipeline was personal property and not real property since the easement agreement provided that the owner of the easement had the right to remove the pipeline. However, it reversed and remanded the case after finding fact questions existed as to the right of the lessee to use the easement and as to ownership of the pipeline.

Denman v. SND Operating, L.L.C., 2005 WL 2316177 (Tex. App.—Texarkana, 2005) (no pet.). The primary issue in this case was whether the surface owners had standing to bring various causes of action against the mineral lessee for damages to their property. The surface owners appealed the trial court's grant of the mineral lessee's plea to the jurisdiction on several causes of action. The surface owners identified several injuries that had occurred since they purchased the property, such as damage to their tractor and farm equipment coming into contact with oil and gas production equipment, but many of their alleged injuries occurred before the surface owners purchased the property. The Texarkana Court of Appeals held that the surface owners had standing to sue for the damages incurred from the mineral lessee's activities after they purchased the property but that the surface owners lacked standing for the majority of their claims because they were for pre-existing injuries. Texas law is clear that the cause of action for injury to property belongs to the owner of the property at the time of the alleged injury and that subsequent owners lack standing to sue, absent an express provision in the deed granting them that power. The Texarkana Court of Appeals also affirmed the trial court's grant of the mineral lessee's summary judgment concerning the

claims brought under the Texas Litter Abatement Act. The court held that this statute was inapplicable to the surface owners' claims because it expressly excludes solid waste resulting from oil and gas exploration and production.

Grinnell v. Munson, 137 S.W.3d 706 (Tex. App.—San Antonio 2004, no pet.). In this case, the mineral lessee was the party suing for damages, claiming that the surface owner damaged an aircraft runway that it was allowed to maintain on the property pursuant to its mineral leases. The surface owner filed a counterclaim alleging various causes of action against the mineral lessee as well as the mineral lessors and sought a declaratory judgment that the oil and gas leases had terminated due to a lack of production in paying quantities. The surface owner then filed a summary judgment motion that the leases had terminated. The trial court denied that motion and the surface owner filed this appeal. The San Antonio Court of Appeals held that the surface owner “clearly” did not have standing because the surface owner was not a party to the leases and, unquestionably, the oil and gas leases were not intended to benefit him in his capacity as surface owner.

Davis v. Devon Energy Prod. Co. L.P., 136 S.W.3d 419 (Tex. App.—Amarillo 2004). The principal issue in this case was whether the construction and use of caliche roads by the mineral lessee, for access to its oil and gas wells and facilities, was reasonably necessary for its operations on the surface and whether it substantially interfered with the surface owner's use of the surface. After analyzing the accommodation doctrine, the Amarillo Court of Appeals concluded that usual and customary industry standards dictated the need for all-weather roads, such as caliche roads, to access well sites and that the construction and use of the roads was reasonable and necessary and did not substantially interfere with the surface owner's farming operations.

B. Texas Oil and Gas Case Summaries

THOMPSON AND KNIGHT, LLP*

Seagull Energy E&P, Inc. v. Eland Energy, Inc., 49 Tex. Sup. Ct. J. 744 (2006)

This case dealt with the issue as to whether the sale of a working interest that was subject to an operating agreement released the seller from any further obligations to the operator.

Seagull Energy E&P, Inc. (“Seagull”) was the operator of two offshore oil and gas leases and had entered into operating agreements (“Operating Agreements”) with the original working interest owners. Eland Energy, Inc. (“Eland”) acquired a working interest in both leases. Pursuant to the assignment under which it acquired its interests, Eland agreed to be liable for, and expressly assumed, a proportionate part of the obligations created by the existing Operating Agreements.

Two years later, Eland sold its interests at auction to Nor-Tex Gas Corp. (“Nor-Tex”) for \$500 each. Nor-Tex agreed to assume and be liable for a proportionate part of the obligations under the Operating Agreements. Nor-Tex defaulted on its obligations and filed bankruptcy.

Seagull sued Eland for the amounts due under the Operating Agreements. Seagull moved for summary judgment that Eland’s assignment of its working interests to Nor-Tex did not affect Eland’s liability. The district court granted summary judgment in favor of Seagull in the amount of \$268,000, plus interest and attorneys’ fees. Eland appealed.

The Operating Agreements are silent on the liability of assigned interests. Thus, the court of appeals focused on language in the Operating Agreements stating that the working interest owner is liable in proportion to its participating interest. The court noted that a party’s participating interest is based on ownership. As a result, the appellate court determined that, if there is no ownership, there is no participating interest, and, thus, no liability. Accordingly, the court of appeals reversed the trial court and held that Eland was not liable.

* The following case summaries were originally prepared by Thompson & Knight LLP attorneys for the *Oil, Gas and Energy Resources Law Section Report*, a quarterly publication of the State Bar of Texas. These summaries are provided to the *Texas Journal of Oil, Gas, and Energy Law* and do not constitute legal advice. Not all of the attorneys who prepared the case summaries are board certified in oil, gas, and mineral law.

Established in 1887, Thompson & Knight today is a dynamic firm of approximately 420 attorneys. Thompson & Knight has four offices in Texas (Austin, Dallas, Fort Worth and Houston) and one office in New York City. The firm’s international offices are located in Brazil, Europe, Mexico, and North Africa.

The Texas Supreme Court accepted the petition for review. In its opinion, the Supreme Court discussed the principles involved in determining the liability of an assignor on a contract. Generally speaking, the court observed that a party cannot escape liability under a contract merely by assigning the contract to a third party. Therefore, parties remain liable unless expressly or impliedly released from a contract.

The Supreme Court acknowledged that certain subjects or circumstances might result in the termination of liability upon an assignment. As an example, the court noted that a promise to maintain a dam on one's property to a certain water level for a neighbor would cease upon the conveyance of the land. Here, Eland did not argue that the subject or circumstances implied that Eland should be released of its obligations. Even if Eland did so argue, however, such circumstances would not apply.

Since the Operating Agreements did not expressly provide that Eland's obligations thereunder would terminate upon assignment, and because Seagull did not expressly release Eland, the Texas Supreme Court reversed the court of appeals and held Eland liable under the Operating Agreements.

Bridgeport Tank Trucks v. Lien Agent, 2006 U.S. App. LEXIS 18671 (5th Cir. July 25, 2006)

In this case, the Fifth Circuit reviewed, *de novo*, the issue of whether an oversecured lienholder may receive attorneys' fees and costs under the Bankruptcy Code pursuant to 11 U.S.C. § 506(b). The bankruptcy court held that Bridgeport Tank Trucks, West Fork Tank Trucks Inc., Baker Hughes Oilfield Operations Inc. and Wilson Supply (the "Appellants"), all creditors of the debtor oil company ("EnRe"), were entitled to receive principal and interest but were not entitled to receive attorneys' fees and costs under 11 U.S.C. § 506(b). The district court affirmed, as did the Fifth Circuit Court of Appeals. Specifically, the Fifth Circuit ruled that attorneys' fees are not permitted when the basis of the security interest is a statutory materialmen's lien. Since such statutory liens are non-consensual and constitute the only basis for the Appellants' secured claims, collection fees—including attorneys' fees and costs—are not recoverable.

The Appellants performed work on oil and gas wells in Texas and Wyoming. Some of Appellants' contracts provided that EnRe would pay costs and attorneys' fees in the event of litigation to collect what EnRe owed; however, none of the Appellants had express security agreements. All Appellants timely filed for and obtained statutory materialmen's liens ("M&M Liens") on EnRe's property pursuant to Texas or Wyoming law. Upon EnRe's bankruptcy filing, all Appellants duly filed proofs of claim.

Although Congress recently amended 11 U.S.C. § 506(b) as part of the Bankruptcy Abuse Prevention and Consumer Protection Act, the parties to this case agreed that the prior version of the statute controlled.

The controlling version provides:

To the extent that an allowed secured claim is secured by property the value of which, after any recovery under subsection (c) of this section, is greater than the amount of such claim, there shall be allowed to the holder of such claim, interest on such claim, and any reasonable fees, costs, or charges provided for under the agreement under which such claim arose.

In its holding, the Fifth Circuit reasoned that the plain language of the statute assumes that creditors who seek fees possess a security agreement that authorizes the charging of collection of fees. A general agreement for fees, such as a clause in a labor/supply contract, does not qualify if it is not the agreement under which the “allowed secured claim” arose. In this case, it was undisputed that state involuntary lien laws constituted the only basis for Appellants’ allowed secured claims. Absent security agreements, these claims fail to satisfy the statute’s requirement for over-secured creditors’ recovery of collection fees.

Previously, the Fifth Circuit held that “the plain language of section 506(b) distinguishes between voluntary secured claims (i.e., security agreements) and involuntary secured claims (i.e., statutory liens).” *City of Farmers Branch v. Pointer (In re Pointer)*, 952 F.2d 82, 89 (5th Cir. 1992). As in the *In re Pointer* case, it was this court’s opinion that all creditors can recover interest on an oversecured claim, but only creditors who have voluntary secured claims can recover penalties, fees, and costs.

The Appellants asserted several arguments. First, they argued that the consensual/non-consensual distinction is not supported by statute. The Fifth Circuit responded, however, that it is bound to follow the *In re Pointer* court, which makes such a distinction. Next, the Appellants argued that the M&M Liens were consensual since state law provides for both mineral liens and attorneys’ fees for the collection thereof (albeit in separate statutory provisions) and that state law is a backdrop to all contracts performed in the state. In other words, the M&M Liens embody a consensual agreement, unlike, for example, purely non-consensual tax liens. The Fifth Circuit held that this argument also failed since, while statutory liens may be inevitable, they are not consensual. A secured claim based on a statutory lien arises out of state law, not out of the parties’ agreement to a lien, even though the parties have agreed to do business. If state law did not authorize the M&M Liens, Appellants would have purely unsecured claims. Finally, Appellants contended that their claims represented consensual liens since EnRe expressly agreed to grant

them substitute liens through a post-bankruptcy cash collateral order. This argument failed because the bankruptcy court carried forward the statutory liens, specifically stating that they “shall have the same priority as the prepetition liens of such M&M lienholders.” Thus, substitute liens merely retained the statutory character of the liens they replaced.

In conclusion, according to the Fifth Circuit, absent a security agreement between parties, oversecured statutory materialmen lienholders will not be allowed to recover attorneys’ fees, costs, and other collection fees under 11 U.S.C. § 506(b).

ConocoPhillips Co. v. Incline Energy, Inc., 189 S.W.3d 377 (Tex. App.—Eastland 2006, pet. filed)

In this case, the Eastland Court of Appeals construed a Gas Purchase Agreement (the “Agreement”) to determine whether the purchase price to be paid by ConocoPhillips Company (“Conoco”), as buyer, for natural gas delivered by Incline Energy, Inc. (“Incline”), as seller, was to be based on (a) the prices Conoco received for the sale of residue gas and processed natural gas liquids (“NGLs”) or (b) the price Conoco received for the sale of residue gas sales alone. The appellate court, in reversing the judgment of the trial court, held that the Agreement was unambiguous, and, by its terms, the purchase price to be paid to Incline for gas delivered under the Agreement was to be predicated solely on the price received by Conoco for residue gas sales.

Conoco and Incline entered into the Agreement in 1986 to provide the terms for the purchase and sale of gas produced from the Olivia Spencer No. 1 Well. A 1988 amendment to the Agreement stated, in relevant part, as follows:

[F]or the period beginning on the effective day hereunder and extending for the Term hereof, the price per MMBTU to be paid by Buyer to Seller shall be eighty percent (80 percent) of the price(s) which Buyer receives under its Resale Agreement(s) for all *gas* purchased and sold hereunder at the Point(s) of delivery, such gas produced from the subject lands and leases (emphasis added).

Conoco, following its interpretation of the express terms of the Agreement (including the amendment), paid Incline based on the following formula: (i) 80 percent of the weighted average residue gas price received by Conoco for residue gas sales, multiplied by (ii) the number of MMBTUs Incline delivered to the delivery point (which in this case was Conoco’s pipeline). The number of MMBTUs delivered by Incline was determined by taking into account both the volume of the entire gas stream and the heating content of same at the delivery point. At the point

of delivery, the gas included NGLs, and the NGLs were included in the measurement of MMBTUs.

Incline claimed that Conoco's interpretation of the Agreement was incorrect and that it should be paid based on the prices received by Conoco for both processed NGLs and residue gas, not solely residue gas.

The trial court held that a latent ambiguity existed "as to whether or not the parties to the [Agreement] contemplated payment when the gas purchased was processed on the basis of both residue gas and natural gas liquids or on residue gas alone." The trial court then held that Incline's interpretation of the Agreement was in line with the true intentions of the parties to the Agreement and awarded Incline roughly \$800,000 in damages, based upon prices for vaporous gas as well as prices for NGLs.

In reversing the trial court, the court of appeals distinguished between a patent ambiguity and latent ambiguity. The court stated that a contract is patently ambiguous when the ambiguity is apparent on its face, while a latent ambiguity is "one that exists when a contract is unambiguous on its face 'but fails by reason of some other collateral matter when it is applied to the subject matter with which it deals.'" The court of appeals then rejected the trial court's finding of a latent ambiguity based on the court's view that the case at hand did not involve collateral matters, but, rather, the "very heart and essence of the agreement: the pricing mechanism." Accordingly, the court of appeals held that the Agreement should be enforced as written and that the Agreement required Conoco to pay to Incline a purchase price of 80 percent of the price Conoco received for residue gas sales for each MMBTU delivered to the delivery point.

Ramirez v. Flores, No. 04-05-00075-CV, 2006 Tex. App. LEXIS 2911, (Tex. App.—San Antonio, April 12, 2006, no pet.)

This was a suit for reformation of a warranty deed. The deed at issue conveyed a fee estate in the subject land to the defendant. The plaintiffs contended that they agreed to sell the surface estate and 1/16 of the mineral estate to the defendant, as evidenced by the earnest money contract, and that a scrivener's error caused the warranty deed not to reflect the true agreement of the parties. The trial court granted a directed verdict in favor of the defendant. On rehearing, the appellate court withdrew its previous opinion and judgment, and reversed the judgment of the trial court and rendered judgment reforming the warranty deed to reflect that it conveyed the surface estate and a 1/16 interest in the mineral estate, as was contended by the plaintiffs. At the outset of the opinion, the court of appeals discusses directed verdicts and the standard of review to determine whether a party is entitled to a directed verdict. That portion of the

opinion is not discussed herein, and the reader is referred to the opinion for the discussion of directed verdicts in general.

As to the reformation of a deed, the court stated that a party is entitled to reformation when it proves that it reached an agreement with the other party but the deed does not reflect the true agreement due to a mutual mistake. A mutual mistake is one common to both or all parties, wherein each labors under the same misconception with respect to a material fact, the terms of the agreement, or the provision of a written instrument designed to embody such an agreement. A mutual mistake is generally established from all the facts and circumstances surrounding the parties and the execution of the instrument. It is well settled that a scrivener's failure to embody the true agreement of the parties in the written instrument is such a mistake as to afford grounds for reformation for a mutual mistake. The court cited cases supporting each of the foregoing statements.

In this case, evidence was presented on behalf of the plaintiffs as to the typical real estate closing procedures followed by the title company involved in the subject transaction. This evidence reflected that the subject earnest money contract set forth the agreement that the plaintiffs would convey the surface estate and 1/16 of the mineral estate to the defendant. The escrow officer for the title company testified that the warranty deed should have embodied this agreement, and that the title company failed to furnish the earnest money contract to the attorney who prepared the deed. Additional evidence was offered by the plaintiffs, which indicated that no other agreements were made between the parties, and nothing else happened to change the terms of the earnest money contract.

The defendant testified, among other things, that the parties reached an oral agreement that the plaintiffs would convey the fee estate in the subject land to the defendant. However, the record revealed that the earnest money contract contained a clause prohibiting oral modification of the agreement. The court stated that this clause precluded the defendant from asserting that the terms of the original agreement were changed by an alleged oral modification to the agreement, and, therefore, such testimony had no probative value and must be disregarded. In this connection, a footnote in the opinion states:

Texas law permits a written contract, not required by law to be in writing, to be modified by a subsequent oral agreement even though the written contract includes a clause prohibiting oral modification of the agreement. *Hyatt Cheek Builders-Engineers Co. v. Bd. Of Regents*, 607 S.W.2d 258, 265 (Tex. Civ. App.-Texarkana 1980, writ dismissed). The [subject earnest money contract], however, could not be modified by a subsequent oral agreement because it was required by law to be in writing. See TEX. BUS. & COM. CODE ANN. §

26.01(b)(4) (Vernon 2002) (stating a contract for the sale of real estate must be in writing to be enforceable).

After reviewing all of the relevant evidence, the appellate court found that (a) the warranty deed did not embody the true agreement of the parties due to a mutual mistake, (b) the defendant did not offer any evidence of probative value to rebut the evidence offered by the plaintiffs, and (c) a scrivener's error caused the warranty deed not to reflect the true agreement of the parties. On the basis of those findings, the San Antonio Court of Appeals held that the plaintiffs were entitled to reformation of the warranty deed as a matter of law.

First Permian, L.L.C. v. Graham, No. 07-05-0135-CV, 2006 Tex. App. LEXIS 4346 (Tex. App.—Amarillo, May 18, 2006, pet. filed)

In 1963, the Grahams assigned their interest in oil and gas leases to Pan-American Petroleum Corporation, reserving a production payment and a preferential right to match any offer to purchase the leases accepted by Pan-American. The assignment of the leases contained a provision binding the heirs, successors, and assignees of both the Grahams and Pan-American.

The reserved production payment was paid in full in 1975. Subsequently, the leases were acquired by First Permian. In 2002, First Permian offered the leases for sale, along with other assets, to prospective bidders.

The question presented in this case was whether the preferential right terminated upon payout of the production payment.

Finding that the preferential right expired upon complete payment of the production payment, the Amarillo Court of Appeals stated that “the preferential right was intended to exist only so long as necessary to protect the interest of the Grahams, their heirs, successors or assigns in the full payment for the leases. This is the only construction that gives full meaning to all of the provisions of the assignment.”

The court also stated that, as a covenant running with the land, the preferential right “endures only so long as the interest in land to which it is appended” and that such right “terminated with the payment of the final production payment in 1975.”

Bargsley v. Pryor Petroleum Corp., NO. 11-04-00126-CV, 2006 Tex. App. LEXIS 4474 (Tex. App.—Eastland, May 25, 2006, pet. filed)

This was an appeal from a jury verdict holding that an oil and gas lease issued to Coy Bargsley (“Bargsley”) had terminated and that a later oil and gas lease to Pryor Petroleum Corporation (“Pryor”) covering the

same property was in effect. The jury verdict was affirmed in part and reversed and remanded in part.

In 1976, Bargsley obtained an oil and gas lease on 320 acres in Stephens County, Texas. He drilled three gas wells and one oil well on said lands. In the late 1980s or early 1990s, Bargsley ceased to produce the wells and the lease terminated. However, Bargsley left equipment on the lease and maintained electrical service to the lease. On December 9, 1996, Bargsley acquired a new lease with a one (1) year primary term.

The new lease provided that if, at the expiration of the primary term, there was no production on the leased premises, but lessee was engaged in drilling operations, said lease would not terminate as long as such operations were continuously prosecuted as defined therein. Apparently, there was a question as to whether production was sufficient to maintain the lease. Even if there was no commercial production, however, Bargsley argued that he was engaged in operations during the primary term of the lease and that the continuous operations provision kept his lease alive beyond the primary term. In its opinion, the court noted that the operations in question consisted of "long-stroking" the existing oil well, laying a pipeline to the gas wells, doing electrical work on the lease, allowing the electricity to remain on, replacing a tank, and allowing all of the equipment to remain at the wells. The court held that such activities, under certain circumstances, might be considered "operations" but were not "drilling operations" as a matter of law. As such, the appellate court held that Bargsley was not engaged in drilling operations at the end of the primary term; thus, the trial court did not err in so holding in its partial summary judgment.

The lease also provided that, in the event of cancellation or termination, lessee had the right to retain 20 acres around each oil or gas well producing or "being worked on." The appellate court determined that, although the operations being conducted did not qualify as "drilling operations," there was a genuine issue of material fact concerning whether the oil well was "being worked on" upon termination of the lease, such as would entitle the lessee to retain 20 acres. Accordingly, if the jury found there was no production sufficient to extend the primary term of the lease, then the issue of whether the well was "worked on" likewise should have been submitted to the jury for its consideration. Thus, the trial court erred to the extent it granted summary judgment based upon the determination that, as a matter of law, the oil well was not being worked on at the end of the primary term.

Bargsley also argued that the trial court improperly placed the burden of proof upon him as to whether production was in paying quantities. The court agreed that such burden of proof should have been on Pryor. Having found that the burden of proof was misplaced in connection with pro-

duction, the court determined that such error may have caused the rendition of an improper judgment.

In summary, the trial court's declaration that the Bargsley lease terminated for lack of production in paying quantities was reversed and the issue remanded. To the extent that the trial court declared that the Pryor lease was superior to the Bargsley lease, such judgment was also reversed and remanded. To the extent that the partial summary judgment addressed the fact issue of whether the oil well was "being worked on," such judgment was reversed and the issue was to be presented to the fact finder in accordance with the appellate court's opinion. The award of attorneys' fees was reversed and remanded for further consideration. In all other respects, the judgment of the trial court was affirmed.

Garcia v. Garcia, No. 04-05-00538-CV, 2006 Tex. App. LEXIS 5265 (Tex. App.—San Antonio, June 21, 2006, no pet.)

In 1957, appellants' predecessors in title executed a warranty deed in favor of the appellees' predecessors in title, which conveyed:

Eighteen (18) acres of land, more or less, undivided, being all our right, title and interest in and to 891.30 acres of land, more or less, in Porciones Nos. 34 and 35, Zapata County, Texas, and being all of a tract described as 899 acres in Quit Claim Deed from Dionicio Garcia to Santiago Garcia Benavides dated March 31, 1944, and recorded in Volume 52, Pages 601-602 of the Zapata County Deed Records.

The grantors under such conveyance owned 18 surface acres and an undivided 60.2395 mineral acres in the 891.30-acre tract. In 2004, appellees filed suit seeking a declaration that the deed conveyed all right, title, and interest of the grantors on the date of the deed. The trial court granted summary judgment for appellees, concluding that the deed was unambiguous and conveyed all of the interest the grantors owned in both the surface and mineral estates. The San Antonio Court of Appeals affirmed.

Appellant contended that the general description ("all our right, title and interest") should not be used to enlarge the specific description ("eighteen acres . . . undivided"). The rule of construction advanced by the appellants, however, is not given broad application. Such rule applies only when there is a repugnance between the specific and the general descriptions. Here, no conflict or repugnance existed. The deed was unambiguous and the general description enlarged on the particular description. In concluding its opinion, the court noted that it is rare that a general grant cannot be given its literal effect.

Vela v. Wagner & Brown, LTD., No. 04-04-00745-CV, 2006 Tex. App. LEXIS 5277 (Tex. App.—San Antonio, June 21, 2006, no pet. h.)

This oil and gas drainage case addresses the calculation of damages. Wagner & Brown, Ltd. (“Wagner”) was a working interest owner and operator of three adjacent leases in Zapata County, Texas. A common gas reservoir lies under all three leases. Wagner drilled a total of nine wells in the field: three on the Lopez lease, five on the Cavazos lease, and one on the Vela lease. The royalty owners in the Cavazos lease sued Wagner for breach of its implied duty to protect the Cavazos lease from substantial drainage by the Lopez wells.

The trial court granted the royalty owners’ motion *in limine* and ruled that damages would be calculated using a hypothetical well model to calculate “lost royalties,” and Wagner could not take any credit for future production of the real wells. The court instructed the jury to calculate the damages for drainage by measuring the difference between (a) the royalties that would have been paid on hypothetical wells drilled at the proper time and in the proper locations and (b) the actual royalties paid.

The jury found \$3 million in damages from drainage. The royalty owners had settled with all other defendants prior to trial, and Wagner had made a pre-trial election of a dollar-for-dollar settlement credit. Since the damages award of \$3 million was less than the \$8.9 million total settlement paid by the other defendants, the trial court entered a take-nothing judgment against the royalty owners. The royalty owners appealed.

The appellate court affirmed the trial court’s judgment and upheld the \$3 million damages award because it fell within the range of evidence concerning damages that was presented at trial.

Also within the context of this appellate case, Wagner challenged a pre-trial order that assessed \$75,000 in sanctions against it for spoliation and discovery abuse. Wagner had failed to produce the work product of one of its experts, whose petrophysical calculations were relied upon by a drainage and damages expert. The trial court ordered Wagner to re-create the expert’s underlying computer data and calculations. Of the \$75,000 in sanctions, \$25,000 was intended to reimburse the royalty owners for past expenses related to their costs and attorneys’ fees in pursuing motions to compel discovery of the data. The additional \$50,000 was for anticipated future expenses for additional expert analysis of the data and for five to eight depositions based on the analysis of the re-created data. The data was never fully re-created and the expert’s testimony was excluded. Based upon the trial court’s detailed findings of a general and continuing pattern of discovery abuse, as well as the delay and expenses suffered by the royalty owners, the appellate court held that the trial

court did not abuse its discretion in assessing the sanctions and affirmed the trial court's order.

ConocoPhillips Co. v. Ramirez, 2006 Tex. App. LEXIS 5710 (Tex. App.—San Antonio, June 28, 2006, no pet. h.)

The central issue in this case is whether statewide rules are “adopted” “for” a field. The San Antonio Court of Appeals held that statewide rules are not “adopted” “for” a field.

On February 10, 1975, Ramirez's predecessor-in-interest executed an oil and gas lease in favor of ConocoPhillips's predecessor-in-interest, covering 1,053 acres in Zapata County, Texas, for a five-year primary term. After the expiration of the primary term, paragraph 18 of the lease governs the amount of acreage the lessee is entitled to hold. Paragraph 18 provides, in short, that at the end of five years after the expiration of the primary term, the lessee is entitled to hold 640 acres for each gas well drilled below 5,000 feet unless the Texas Railroad Commission (“TRRC”) had “adopted” a rule “for” the field in which the gas well is drilled; if the TRRC has “adopted” a rule “for” a field, the lessee is entitled to the acreage specified in that rule.

Subsequently, on February 10, 1985, five years after the expiration of the lease's primary term, the Serafin No. 1 gas well was producing gas from a depth greater than 5,000 feet. Ramirez argued that the TRRC “adopted” statewide Rules 37 and 38 “for” the field in which the Serafin No. 1 gas well was drilled and, accordingly, ConocoPhillips was entitled to only 40 acres around the well. ConocoPhillips disagreed, arguing that statewide rules are not “adopted” “for” a field and, therefore, it was entitled to 640 acres around the well. At trial, the court rendered judgment for Ramirez. The appellate court reversed.

The court of appeals noted that, to regulate oil and gas production, the TRRC has adopted general rules applicable throughout the State of Texas. However, since these general rules cannot adequately address the widely varying conditions found in the thousands of oil and gas reservoirs in Texas, the TRRC may issue orders with detailed regulations for a specific field, which the TRRC calls “field rules.” Since the general field rules apply statewide, the court noted that they must be promulgated in accordance with the rulemaking provisions of the Texas Administrative Procedure Act (“TAPA”); field rules, however, apply to a specific field and a specific group of operators and must therefore be adopted under the adjudication provisions of the TAPA. Reasoning that these procedural differences make clear that a statewide rule is not a field rule, the appellate court held that, although statewide Rules 37 and 38 apply to the field in which the Serafin No. 1 gas well was drilled, such rules were not

“adopted” “for” the field. Accordingly, the court ruled that statewide Rules 37 and 38 are not field rules and, therefore, under paragraph 18 of the lease, ConocoPhillips was entitled to hold 640 acres around the Serafin No. 1 gas well.

Ramirez made three arguments to the contrary, which the appellate court briefly discussed. First, Ramirez argued that paragraph 18 is ambiguous, and stated that her expert testified that it was the TRRC’s policy for a proration analyst to “adopt” statewide rules for a particular field when the field is discovered and application is made to the TRRC by the operator. The court disagreed, reasoning that Ramirez’s ambiguity argument, as well as her interpretation of paragraph 18 and her expert’s testimony, erroneously equates “adoption” with “application.” Noting that to “adopt” means “to accept formally and put into place,” while to “apply” means to “put into operation or effect,” the court stated that, under Texas law, an operator’s application for a permit does not cause the TRRC to “adopt” statewide rules, but, rather, the TRRC promulgates statewide rules through a formal rule-making procedure. Thus, because a formal adjudicative proceeding, in which specific field rules are “adopted,” did not occur before statewide Rules 37 and 38 were applied to the field in which the Serafin No. 1 gas well was drilled, the court ruled that, although such rules apply to the field in which the Serafin No. 1 gas well was completed, they were not “adopted” “for” the field. Accordingly, the court of appeals found that parol evidence from Ramirez’s expert was irrelevant.

Ramirez also argued that paragraph 18 is inconsistent with and overridden by the statewide rules. The court disagreed, noting that the statewide rules merely establish minimum spacing and density requirements. Furthermore, the court reasoned that, if statewide Rules 37 and 38 were construed as determining the amount of acreage the lessee is entitled to hold five years after the expiration of the primary term, it would render part of paragraph 18 meaningless since the statewide rules would always control.

Finally, Ramirez argued that the drafters intended paragraph 18 to protect against the remote possibility that spacing or proration rules by a governing body may not exist at the time paragraph 18 is triggered, thereby allowing a lessee to hold the entire leased acreage with just one well. The court of appeals disagreed, stating that such an interpretation (a) ignores the paragraph’s plain language and structure, (b) would be nonsensical, and (c) is contrary to the general rules of construction.

Wagner & Brown, LTD. v. Sheppard, 2006 Tex. App. LEXIS 6112 (Tex. App.—Texarkana, July 14, 2006, no pet. h.)

The main issue in this case is whether a mineral interest in a pooled unit remains subject to the unit if the oil and gas lease covering that interest terminates but the unit continues to produce. Here, the Texarkana Court of Appeals held that the mineral interest was no longer subject to pooling under these circumstances.

Sheppard owned an undivided one-eighth mineral interest in a 63-acre tract, subject to a 1994 oil and gas lease in favor of a predecessor of Wagner & Brown (“W&B”). Pursuant to its pooling authority under the lease, W&B pooled the Sheppard tract into a 122-acre unit and drilled two producing unit wells, both of which were located on the Sheppard tract.

Sheppard’s lease contained a provision causing the lease to terminate if the first royalty payment was not made within 120 days of the first sale of oil or gas. W&B failed to make the first royalty payment within such time period. W&B did not dispute that the lease terminated and that it, therefore, would have to treat Sheppard as an unleased co-tenant. Accordingly, after the lease terminated, W&B paid Sheppard co-tenant revenue (1/8), rather than a mere royalty. In accounting to Sheppard for her revenue, however, W&B attempted to dilute Sheppard’s revenue by the tract factor for the Sheppard tract in the pooled unit, prompting Sheppard to file suit.

The court of appeals noted that all parties subject to a pooling agreement own an undivided interest in the pooled mineral interests in proportion to their contribution to the unit. Accordingly, a pooling or unitization of mineral leasehold interests constitutes a transfer of an interest in real estate. The more difficult question was whether the transfer of that interest by a lessee exists only for so long as the lease that transferred the interest to the lessee remains in effect.

The court cited authority holding that, when a determinable fee estate expires, the reverted interest is conveyed back to the owner free and clear of liens, claims, and encumbrances. In this case, the lease terminated, and the mineral estate reverted to the fee owner. Even though the lessee had the right to pool the property, it could pool no more than it owned, and the lessee only had an ownership in the Sheppard mineral estate until that right was terminated. Accordingly, the court of appeals concluded that W&B must account to Sheppard for her unleased mineral interest on a tract basis and not a pooled unit basis.

A second issue in the case was whether W&B could recoup Sheppard’s share of the costs of drilling, testing, completing, and equipping the wells that W&B had incurred before the lease terminated. The court held that W&B could recoup only those drilling, testing, completing, and equipping costs that were incurred after the termination of the lease. Prior to that

time, the court reasoned, Sheppard had no liability for what the lessee chose to do.

The parties also disagreed over whether W&B could deduct Sheppard's share of certain types of costs in its accounting to Sheppard. W&B attempted to recoup certain expenses incurred on other tracts in the unit, including landman's fees, lease bonuses, recording fees, and title opinion expenses. The court of appeals cited the general rule that the extracting co-tenant must account for the value of the minerals taken, less the necessary and reasonable costs of production and marketing. Since there was no evidence that these expenses were involved in production or marketing from the drill site tract, the court held that they could not be recouped. With respect to certain overhead charges under W&B's joint operating agreement, the court acknowledged that overhead for operation of the unit was "something that is typically connected with the production of the well" but denied W&B's attempt to deduct such charges on evidentiary grounds.

A final issue in the case was whether W&B could offset revenues from one well to pay for expenses incurred on the other well. The court of appeals upheld the trial court's finding and held that W&B must account to Sheppard on a well-by-well basis, rather than on an aggregate basis.

III. RECENT DEVELOPMENTS IN UNITED STATES ENERGY LAW

A. What Next for FERC Compliance? FERC's Enforcement Policy Statement, One Year Later

NOEL SYMONS*

Over the past decade the enforcement practices of the Federal Energy Regulatory Commission ("FERC") have evolved in response to changes in FERC's responsibilities and energy market conditions. At times enforcement has not seemed to be a priority, and at other times FERC has seemed intent on zealous enforcement backed by large monetary penalties. Today, FERC appears to be less focused on imposing headline-grabbing penalties than on finding other ways to encourage regulated entities to strengthen their compliance efforts. These changes have been confusing to many in the regulated community.³⁶

Late last year FERC modified its enforcement/compliance paradigm with the issuance of a policy statement called *Enforcement of Statutes, Orders, Rules, and Regulations* ("Enforcement Policy Statement").³⁷ As this article describes, the *Enforcement Policy Statement* establishes a "carrot and stick" approach to enforcement. The "carrot" is that companies with strong compliance programs are to be rewarded for their *effort* at compliance, by receiving lighter penalties when compliance problems occur. The "stick" is that companies that do not have strong compliance programs are to be punished more severely.

The "stick" threatened in the *Enforcement Policy Statement* has substantial heft given the enactment of the Energy Policy Act of 2005 ("EPAAct 2005").³⁸ In particular, EPAAct 2005 gave FERC new authority to impose civil penalties of up to \$1 million per day, per violation, for many

* Noel Symons is counsel at Skadden, Arps, Slate, Meagher & Flom LLP. Mr. Symons represents electric utilities and natural gas pipelines on compliance matters. He was the lead editor and a contributing author for *Energy Regulatory Compliance: The Skadden Handbook*, and was the principal author of the Edison Electric Institute's computer-based training on Standards of Conduct now in use by more than 40 companies and 75,000 trainees. Mr. Symons would like to thank his colleagues Gerald L. Richman and John L. Shepherd, Jr., for their input.

36. This article contains many references to the viewpoint of the "regulated community" or "regulated companies." These references reflect views that, while generally widespread, were not universal to every company regulated by FERC. Many of these statements are not substantiated through citation to any document in the public domain. Such references reflect the observations of the author based upon frequent discussions of the topics in question with a wide variety of individuals at industry trade conferences and the like, and should not be viewed as representing the views of any particular organization, including Skadden, Arps and its clients.

37. *Enforcement of Statutes, Orders, Rules, and Regulations*, Policy Statement on Enforcement, 113 F.E.R.C. ¶ 61,068 (2005) [hereinafter *Enforcement Policy Statement*].

38. Pub. L. No. 109-58, 119 Stat. 594 (2005).

violations of the Federal Power Act (“FPA”)³⁹ and the Natural Gas Act (“NGA”).⁴⁰

FERC’s use of the “stick” has ample precedent, but its offer of the “carrot” is new and therefore more tenuous and uncertain to regulated companies. Indeed, in the years leading up to the *Enforcement Policy Statement*, the enforcement/compliance relationship between FERC and the regulated community had become polarized and highly adversarial. Some companies were concerned that internal compliance efforts would create an audit trail of compliance failures that would be held against them if self-reported, or if discovered through a FERC audit. So when FERC suggested, through the *Enforcement Policy Statement*, that it wanted to build a more cooperative relationship, one founded at least in part on trust of the agency, the initial reaction of many regulated companies was “show me” skepticism. This article describes how FERC, under the guidance of Chairman Joe Kelliher, appears to be embarked on a course that is designed to build the trust necessary for the type of truly cooperative enforcement/compliance paradigm envisioned by the *Enforcement Policy Statement*.

1. Transition to the New Behavioral Style of Regulation

Given the variability over time of FERC’s approach to enforcement, and the confusion this has engendered within the regulated community, understanding the current FERC enforcement/compliance paradigm requires more than a simple reading of the *Enforcement Policy Statement*. While that policy is important as the outward embodiment of what FERC is trying to accomplish, FERC’s evolving application of the policy can be fully understood only in its historical context.

The key to understanding FERC’s growing emphasis on enforcement and compliance is to understand that FERC is changing the way it regulates. The old rate-case model of regulation of power sales is fading away and being replaced with a more behavioral style of regulation.⁴¹ FERC increasingly is focused on providing companies in competitive markets

39. *See id.* sec. 1284(e), 119 Stat. at 980 (amending 16 U.S.C. § 825o-1). The potential penalties for violations referred to the Department of Justice for criminal prosecution were likewise greatly increased. *See id.* sec. 1284(d), 119 Stat. at 980 (amending 16 U.S.C. § 825o(a)).

40. *See id.* sec. 314(b)(1)(B) (amending 15 U.S.C. 717t-1) (establishing civil penalties); *id.* sec. 314(a) (amending 15 U.S.C. 717t) (increasing criminal penalties).

41. FERC continues cost-of-service, rate-case style regulation for services that it deems to be monopoly services, in particular transmission services, though even for transmission services the rate-case process has been streamlined somewhat through the adoption of a pro forma transmission tariff. *See e.g., Preventing Undue Discrimination and Preference in Transmission Services*, Notice of Proposed Rulemaking, Docket Nos. RM05-25-000 and RM05-17-000, 115 F.E.R.C. ¶ 61,211 (2006).

with wide discretion to set their own rates, terms, and conditions for sales of power, within broad parameters designed to protect the market and the ultimate consumer. Those parameters tend to prohibit *behavior* that FERC views as having an anti-competitive effect or an adverse impact on ratepayers, but still allow wide discretion for companies (and individuals within companies) to set rates.⁴²

Most of the major pro-competitive changes in regulation during the last fifteen years have been followed by one or more corresponding changes in regulation that prohibit behavior that might be anti-competitive or harmful to ratepayers. For example, FERC began in 1989 to grant parties *prior* authorization to sell power at negotiated, market-based rates.⁴³ Parties with this authorization could operate outside the old rate-case model of regulation, because they did not need a rate case to validate their rates. But over time FERC placed limits both on who could receive market-based rate authorization⁴⁴ and on the behavior of companies that have it.⁴⁵ Similarly, when FERC mandated open access to the

42. In many senses FERC has always been an agency that regulated behavior, but the type of behavior that FERC regulates is very different now than it used to be. FERC's original model was to narrowly circumscribe the behavior of regulated entities by establishing specific rates, terms, and conditions for regulated services. Rate cases could occupy years and involve dozens of parties. But at the end of the process, companies (and individuals within companies) typically had little or no discretion to change rates, terms, and conditions of service.

43. See *Citizens Power & Light Corp.*, 48 F.E.R.C. ¶ 61,210 (1989). Subsequently, FERC authorized blanket market-based sales authority for natural gas pipelines and their marketing affiliates. See Order No. 636, *Pipeline Service Obligations and Revisions to Regulations Governing Self-Implementing Transportation Under Part 284 of the Commission's Regulations, and Regulation of Natural Gas Pipelines After Partial Wellhead Decontrol*, F.E.R.C. Stats. & Regs. ¶ 30,939 (1992), *order on reh'g*, Order No. 636-A, F.E.R.C. Stats. & Regs. ¶ 30,950 (1992), *order on reh'g*, Order No. 636-B, 61 F.E.R.C. ¶ 61,272 (1992), *aff'd in part, rev'd in part*, United Distribution Cos. v. FERC, 88 F.3d 1105 (D.C. Cir. 1996), *cert. den.*, 520 U.S. 1224 (1997), *on remand*, Order No. 636-C, 78 FERC ¶ 61,186 (1997), *order on reh'g*, Order No. 636-D, 83 FERC ¶ 61,210 (1998); Order No. 547, *Regulations Governing Blanket Marketer Sales Certificates*, [Regs. Preambles 1991-96] F.E.R.C. Stats. & Regs. ¶ 30,957 (1992), *order denying rehearing and granting clarification*, 62 F.E.R.C. ¶ 61,239 (1993). While the NGA, standing alone, grants FERC jurisdiction over natural gas sales in interstate commerce, see 15 U.S.C. §§ 717(b), 717o (2005), as a result of subsequently enacted provisions of the Natural Gas Policy Act, 15 U.S.C. §§ 3301-3432 (2005) and the Natural Gas Wellhead Decontrol Act, P.L. 107-60, 103 Stat. 187 (1989), the only gas sales FERC has jurisdiction to regulate are sales for resale of domestic gas by natural gas pipelines, LDCs, or their affiliates. See *Reporting of Natural Gas Sales to the California Market*, 95 F.E.R.C. ¶ 61,262 (2001).

44. See, e.g., *AEP Power Mktg., Inc.*, 107 F.E.R.C. ¶ 61018, *order on reh'g*, 108 F.E.R.C. ¶ 61,026 (2004) (establishing FERC's latest test for whether an applicant and its affiliates qualify for market-based rates because, inter alia, they lack market power in generation).

45. See *Prohibition of Energy Market Manipulation*, 114 F.E.R.C. ¶ 61,047, *order on reh'g*, 114 F.E.R.C. ¶ 61,300 (2006) (promulgating latest rules against manipulation of energy markets). See also, e.g., *Consolidated Edison Energy Mass., Inc.*, 90 F.E.R.C. ¶ 61,225 (2000) ("Where . . . a power marketer affiliated with a traditional public utility seeks market-based rate authority, the Commission [FERC] requires the filing of an affiliate code of conduct to safeguard against affiliate abuse and protect against the possible diversion of benefits or profits from traditional public utilities with captive ratepayers to an affiliate entity for the benefit of shareholders") (citing *PPL Martins Creek, LLC*, 90 F.E.R.C. ¶ 61,063 (2000)).

electric transmission⁴⁶ and gas transportation⁴⁷ systems of entities subject to its jurisdiction, it created behavioral rules to ensure that such access was provided on a nondiscriminatory basis.⁴⁸

Over time, these and other pro-competitive regulatory changes have expanded power markets and vastly increased both the number and type of companies,⁴⁹ and the number of people within companies,⁵⁰ who are

46. See *Promoting Wholesale Competition Through Open Access Non-Discriminatory Transmission Services by Public Utilities; Recovery of Stranded Costs by Public Utilities and Transmitting Utilities*, Order No. 888, 61 Fed. Reg. 21,540 (May 10, 1996), [Regs. Preambles 1991-96] F.E.R.C. Stats. & Regs. ¶ 31,036 (1996), *order on reh'g*, Order No. 888-A, 62 Fed. Reg. 12,274 (Mar. 14, 1997), [Regs. Preambles 1996-2000] F.E.R.C. Stats. & Regs. ¶ 31,048 (1997), *order on reh'g*, Order No. 888-B, 81 F.E.R.C. ¶ 61,248 (1997), *order on reh'g*, Order No. 888-C, 82 F.E.R.C. ¶ 61,046 (1998), *aff'd in relevant part sub nom.*, *Transmission Access Policy Study Group v. FERC*, 225 F.3d 667 (D.C. Cir. 2000), *aff'd sub nom.*, *New York v. FERC*, 535 U.S. 1 (2002).

47. Order No. 636, *Pipeline Service Obligations and Revisions to Regulations Governing Self-Implementing Transportation Under Part 284 of the Commission's Regulations, and Regulation of Natural Gas Pipelines After Partial Wellhead Decontrol*, F.E.R.C. Stats. & Regs. ¶ 30,939 (1992), *order on reh'g*, Order No. 636-A, F.E.R.C. Stats. & Regs. ¶ 30,950 (1992), *order on reh'g*, Order No. 636-B, 61 F.E.R.C. ¶ 61,272 (1992), *aff'd in part, rev'd in part*, *United Distribution Cos. v. FERC*, 88 F.3d 1105 (D.C. Cir. 1996), *cert. den.*, 520 U.S. 1224 (1997), *on remand*, Order No. 636-C, 78 F.E.R.C. ¶ 61,186 (1997), *order on reh'g*, Order No. 636-D, 83 F.E.R.C. ¶ 61,210 (1998).

48. See *Open Access Same-Time Information System (formerly Real-Time Information Networks) and Standards of Conduct*, Order No. 889, 61 Fed. Reg. 21,737 (May 10, 1996), [Regs. Preambles 1991-1996] F.E.R.C. Stats. & Regs. ¶ 31,035 (1996), *order on reh'g*, Order No. 889-A, 62 Fed. Reg. 12,484 (Mar. 14, 1997), [Regs. Preambles 1996-2000] F.E.R.C. Stats. & Regs. ¶ 31,049, *reh'g denied*, Order No. 889-B, 62 Fed. Reg. 64,715 (Dec. 9, 1997), [Regs. Preambles 1996-2000] F.E.R.C. Stats. & Regs. ¶ 31,253 (1997); *Inquiry Into Alleged Anticompetitive Practices Related to Marketing Affiliates of Interstate Pipelines*, Order No. 497, 53 Fed. Reg. 22,139 (June 14, 1988), [Regs. Preambles 1986-1990] F.E.R.C. Stats. & Regs. ¶ 30,820 (1988), *order on reh'g*, Order No. 497-A, 54 Fed. Reg. 52,781 (Dec. 22, 1989), [Regs. Preambles 1986-1990] F.E.R.C. Stats. & Regs. ¶ 30,868 (1989), *order extending sunset date*, Order No. 497-B, 55 Fed. Reg. 53,291 (Dec. 28, 1990), [Regs. Preambles 1986-1990] F.E.R.C. Stats. & Regs. ¶ 30,908 (1990), *order extending sunset date*, Order No. 497-C, 57 Fed. Reg. 9 (Jan. 2, 1992), [Regs. Preambles 1991-1996] F.E.R.C. Stats. & Regs. ¶ 30,934 (1991), *reh'g denied*, 57 Fed. Reg. 5815 (Feb. 18, 1992), 58 F.E.R.C. ¶ 61,139 (1992); *Tenneco Gas v. FERC*, 969 F.2d 1187 (D.C. Cir. 1992) (affirmed in part and remanded in part), *order on remand and extending sunset date*, Order No. 497-D, 57 Fed. Reg. 58,978 (Dec. 14, 1992), [Regs. Preambles 1991-1996] F.E.R.C. Stats. & Regs. ¶ 30,958 (1992), *order on reh'g and extending sunset date*, Order No. 497-E, 59 Fed. Reg. 243 (Jan. 4, 1994), [Regs. Preambles 1991-1996] F.E.R.C. Stats. & Regs. ¶ 30,987 (1993), *order denying reh'g and granting clarification*, Order No. 497-F, 59 Fed. Reg. 15,336 (Apr. 1, 1994), 66 F.E.R.C. ¶ 61,347, *order extending sunset date*, Order No. 497-G, 59 Fed. Reg. 32,884 (June 27, 1994), [Regs. Preambles 1991-1996] F.E.R.C. Stats. & Regs., ¶ 30,996 (1994). Both the electric (Order No. 889) and gas (Order No. 497) Standards of Conduct subsequently were superseded by the Order No. 2004 Standards of Conduct. See *Standards of Conduct for Transmission Providers*, Order No. 2004, 68 Fed. Reg. 69,134 (Dec. 11, 2003), [Regs. Preambles] III F.E.R.C. Stats. & Regs. ¶ 31,155 (2003) *order on reh'g*, Order No. 2004-A, 69 Fed. Reg. 23,562 (Apr. 29, 2004), [Regs. Preambles] III F.E.R.C. Stats. & Regs., ¶ 31,161, *order on reh'g*, Order No. 2004-B, 69 Fed. Reg. 48,371 (Aug. 10, 2004), [Regs. Preambles] III F.E.R.C. Stats. & Regs., ¶ 31,166, *order on reh'g*, Order No. 2004-C, 70 Fed. Reg. 284 (Jan. 4, 2005), [Regs. Preambles] III F.E.R.C. Stats. & Regs., ¶ 31,172 (2004), *order on reh'g*, Order No. 2004-D, 110 F.E.R.C. ¶ 61,320 (2005) [hereinafter Standards of Conduct].

49. An industry once dominated by vertically integrated utilities has evolved to include a wide variety of entities to take advantage of the new regulatory flexibility. Early entrants were power marketers, see, e.g., *Enron Power Mktg., Inc.*, 65 F.E.R.C. ¶ 61,305 (1993), *order on clarification and reh'g*, 66 F.E.R.C. ¶ 61,244 (1994), and merchant generators, see, e.g., *Cataula Generating Co., L.P.*, 79 F.E.R.C. ¶ 61,261 (1997). Brokers followed, see, e.g., *LG&E Energy Mktg., Inc.*, 83 F.E.R.C. ¶ 61,130 (1998), and exchanges such as the Intercontinental Exchange, or

subject to the new style of behavioral regulation.⁵¹ These changes significantly increase the risk of non-compliance, because they increase the chances of human error. Compliance risks also are expanded by the growth of the trading function as a profit center, which increases incentives for traders to push for favorable interpretation of ambiguous FERC rules where such interpretations may increase trading profits.

Under the old rate-case model, FERC viewed itself both as a regulator that set rates and as an administrative court that resolved disputes over tariff violations, but not as a cop on the beat. Typically, FERC relied upon third parties—generally customers—to bring complaints and draw alleged violations to the agency’s attention. FERC’s enforcement staff was small and comprised of lawyers, not investigators. But the regulatory and marketplace changes described above created a need for FERC to have the ability to confirm compliance proactively without waiting for a rate case or a complaint filed by a customer. In other words, the new behavioral style of regulation required corresponding changes to FERC’s enforcement practices.

For much of the 1990s it seemed that FERC was slow to act on this need to modify its enforcement paradigm to match its new behavioral style of regulation. This may have been due to the gradual pace of pro-competitive regulatory change, and the correspondingly gradual pace of changes to the market, in particular the growth in importance of the trad-

“ICE,” were created, *see* ICE: The Energy Marketplace, <https://www.theice.com/homepage.jhtml> (last visited Nov. 1, 2006). Opening of retail markets through access initiatives at the state level led to creation of aggregators and others who buy at wholesale to serve retail load that was previously captive to the traditional local utility. *See, e.g.*, James Barkley and Paul Pfeffer, *Texas Electric Markets and Electricity Regulation*, 1 TEX. J. OF OIL, GAS, AND ENERGY L. 106, 106-108 (2006) (discussing retail competition in Texas). The evolution continues today as the maturing markets draw the interest of new types of players who are not affiliated with traditional utilities or other power sector interests. For example, investment banks and hedge funds, as well as international financial institutions, increasingly are creating power marketing units or affiliates, *see, e.g.*, *JP Morgan Chase Bank, NA*, 110 F.E.R.C. ¶ 61,292 (2005), *330 Fund I, L.P.*, Docket Nos. ER06-125-000 (Aug. 7, 2006) (Letter Order), or buying them, *see, e.g.*, *Cinergy Mktg. & Trading, L.P.*, 116 F.E.R.C. ¶ 62,197 (2006) (authorizing acquisition of a power marketer by Fortis Bank S.A./N.A., a Belgian bank).

50. The increase in the importance and frequency of trading operations, as well as the increase in discretion involved with setting rates, terms, and conditions for such transactions, meant that companies were significantly increasing their internal trading staffs. For example, in the old days, trading typically consisted of occasional economy power sales between neighbors. Now, entities often have national trading operations with separately staffed “desks” for trading in various regions, and the volume of sales is much higher. In the old days, with the rates set in advance (or established by formulas set in advance), there was no need for significant human resources support for trading. Now, the variety of traded “products” seems to grow daily, and the difference between profit and loss is often driven by the quality of a trader’s market projections. As a result, modern trading organizations typically are supported by a sophisticated infrastructure of market researchers, analysts, lawyers, and others.

51. There likewise has been a significant increase in the number of people who *may be* subject to behavioral regulation. With the increasing variety of both job functions and behavioral rules, and the frequent changes to both, determining which employee is subject to what behavioral rules is a significant and essentially never-ending challenge.

ing function. Whatever the reason, there was a long period as these new rules were being developed when it was unclear what the likelihood and consequences of FERC enforcement actions would be, except for a few sporadic examples.⁵² That changed shortly after Pat Wood became FERC chairman, when FERC's approach to enforcement came under scrutiny in the wake of the Enron collapse and the California energy crisis.

2. Expanded Enforcement Efforts—The Chairman Wood Era

Spurred by the California energy crisis of 2000–2001 and resulting pressure from Congress to demonstrate a strong hand on enforcement matters, Chairman Wood famously laid down a marker for the electric industry, declaring that companies that violate the rules should “have their heads chopped off.”⁵³ He went on: “Stick ‘em up on stakes and everybody else will behave a lot better.”⁵⁴

Under Chairman Wood, FERC greatly expanded the resources devoted to enforcement, from 15 or so lawyers to about 110 staff members, including economists, engineers, attorneys, auditors, data management specialists, financial analysts, regulatory policy analysts, and energy analysts. With these expanded resources came more audits, and more negotiated penalties, frequently for millions of dollars.⁵⁵

Audits and investigations became much more comprehensive, involving not only the early behavioral rules such as FERC's Standards of Conduct and Codes of Conduct, but also detailed examinations of individual transmission and sales transactions, possible market manipulation, financial instruments, and internal corporate decision-making by both electric utilities and interstate pipelines and their affiliates.

52. See *Amoco v. Natural Gas Pipeline Co. of America*, 82 F.E.R.C. ¶ 61,038, *order on reh'g and clarification*, 82 F.E.R.C. ¶ 61,300, *order on reh'g, reconsideration and clarification*, 83 F.E.R.C. ¶ 61,197 (1998) (imposing penalties for violations of Standards of Conduct); *Washington Water Power Co.*, 83 F.E.R.C. ¶ 61,282 (1998) (requiring disgorgement of profits and imposing penalties for, inter alia, granting an affiliate preferential transmission rates).

53. Jim Landers, *Federal Regulator Begins Nationwide Inquiry of Deregulated Energy Prices*, DALLAS MORNING NEWS, Feb. 12, 2002.

54. *Id.*

55. See, e.g., *Transcontinental Gas Pipeline Corp.*, 102 F.E.R.C. ¶ 61,302 (2003) (\$20,000,000); *Portland Gen. Elec. Co.*, 105 F.E.R.C. ¶ 61,302 (2003) (\$8,500,000 in refunds); *Idaho Power Co.*, 103 F.E.R.C. ¶ 61,182 (2003) (\$203,000 in refunds, \$5.8 million transfer from affiliate to Idaho Power for benefit of ratepayers and \$118,000 in further payments); *Dominion Res., Inc.*, 108 F.E.R.C. ¶ 61,110 (2004) (\$4.5 million in refunds to storage customers, \$500,000 NGPA civil penalty); *Williams Cos.*, 111 F.E.R.C. ¶ 61,392 (2005) (\$4 million refund to storage customers and \$3.6 million civil penalty); *Florida Power Corp.*, 111 F.E.R.C. ¶ 61,243 (2005) (\$6.4 million refund/credit to ratepayers). Sometimes resolutions that did not involve direct monetary payments nonetheless still had significant cost elements. See, e.g., *MidAmerican Energy Co.*, 112 F.E.R.C. ¶ 61,346 (2005) (agreement to spend \$9.2 million constructing previously unplanned transmission upgrades and forgo recovery of all costs associated with the projects for a six-year period from the in-service date).

During this period FERC Enforcement Staff appeared to become more skeptical of the energy industry and less likely to show deference to industry practices and explanations. FERC Enforcement Staff took harder lines with targets of investigations, for example, challenging the ability of transmission providers and affiliated merchants to mount a “joint defense” and to consult with each during an audit or investigation. They became increasingly interested in “audit trails”—contemporaneous memoranda, e-mails, or meeting notes—and sometimes drew negative inferences where such audit trails did not exist. They increasingly sought access to attorney-client communications and attorney work product.

While the efforts of FERC’s Enforcement Staff were uncovering a growing number of problems at individual companies, resulting in more negotiated penalties and other corrective actions, there was debate in the industry as to the overall effectiveness and fairness of FERC’s approach. There was concern that the increase in the amount of enforcement activity and the nature of FERC’s enforcement tactics were direct results of congressional pressure following the Enron collapse and the California energy crisis.⁵⁶ Public perception that changes in FERC enforcement practices were politically motivated gave rise to a fear that, in order to ease political pressure, FERC’s quest for “heads” to “put on a stake” was result-driven.

This fear was fed by a very active “grapevine” of compliance personnel who frequently met, called one another, or traded e-mails, not only about best practices but also about the activities of the agency. Each new settlement resulting from a FERC enforcement action was carefully scrutinized, and seemingly harsh penalties and tough new compliance controls agreed to in such settlements contributed to a growing negative perception of FERC enforcement practices. But perhaps an even bigger factor in shaping this negative perception was hearsay anecdotal information that increasingly suggested that FERC’s get-tough attitude included virtual indifference to the compliance efforts of a company being investigated. For example, stories circulated that companies that identified, corrected, and self-reported violations to FERC were being harshly dealt with, without any sense that the agency took into account or gave credit for either the act of self-reporting or the good faith inherent in the com-

56. While there is little doubt that these factors were the proximate cause of FERC’s escalation of its enforcement practices, the growth in the amount of resources devoted to FERC enforcement was separately justified by the historical context described above, and in particular FERC’s growing need to track, on an ongoing basis, compliance with a wider variety of rules that applied to more and more activities by more and more people associated with growing trading functions. As described above, the regulatory and marketplace changes that resulted in a need for new FERC enforcement practices were gradual. But the changes in enforcement practices came fairly precipitously. So there was a temporal disassociation between cause and effect that made the sudden ramp-up of enforcement, and the get-tough rhetoric of Chairman Wood, seem more arbitrary than it actually was.

pany's intent to fix the problem. Companies therefore increasingly took the viewpoint that it was not safe to self-report a violation or to turn to FERC Staff for advice when a problem arose, for fear of an excessive enforcement action. This distrust meant that problems that might have been resolvable through informal FERC Staff guidance were not always being fixed.

Of course, even if FERC would not give credit for compliance efforts, all else being equal, a company should still have an incentive to have a strong compliance program, because strong compliance ordinarily means fewer problems, which should translate to less likelihood of penalties. But the grapevine was spreading word that FERC Enforcement Staff conducting audits and investigations were actively seeking the subject company's own audit reports and compliance records. There was widespread speculation that these records were being sought to help FERC Staff locate past compliance violations that could then be punished. Taking this one step further, regulated companies began to debate a seeming paradox: was it possible that having a strong compliance program would actually increase, rather than decrease, FERC-related risks, by increasing the likelihood that past violations that had long since been corrected would be discovered and penalized?

For most regulated companies, their answer to this critical question came to influence their approach to FERC compliance. It seemed certain that, with FERC requesting internal audit records, there was increased risk that FERC would learn of past compliance violations it might not otherwise have detected. And clearly FERC would at least consider punishing companies for such violations. The question therefore boiled down to this: would FERC take compliance efforts into account in deciding whether to seek penalties? Anecdotal information suggested that FERC was not, in fact, giving credit for compliance efforts.

As a result, some companies became reluctant to conduct internal audits or other routine compliance checks, or to have strong compliance controls that would result in discoverable records of compliance problems, for fear that they would be creating an audit trail for FERC Enforcement Staff to follow in a subsequent audit or investigation.⁵⁷ In other words, the negative perception created by FERC's seemingly extreme "get-tough" attitude led to FERC compliance practices at some compa-

57. As noted *supra* at note 37, this article should not be read to attribute such concerns to any particular company. Anecdotal evidence of such concerns abounded and was freely shared among industry members at any number of industry conferences at the time. Such concerns were publicly expressed by panelists, including the author, at a May 6, 2005, FERC-sponsored technical conference in Chicago, Illinois, on the Standards of Conduct and Market Behavior Rules, at which two commissioners and many members of FERC's Enforcement Staff were present. The *Enforcement Policy Statement* was issued a bit less than five months later.

nies that resembled nothing so much as an ostrich sticking its head in the sand.

3. The New Face of Enforcement Under Chairman Kelliher

By the time that Joe Kelliher became FERC Chairman, it was clear that FERC's aggressive "stick only" approach was producing the counterproductive "head in the sand" behavior described above in many companies. This caused a conundrum for FERC. The ultimate purpose of enforcement is to encourage compliance, not discourage it. Enforcement alone could not ensure the compliance of all regulated companies, because no matter how much FERC might increase its enforcement resources, it could not hope to police the behavior of all regulated entities all the time. So the essential question facing FERC was whether and how it should change its enforcement program to entice the regulated community to become partners, rather than adversaries, in building a more effective compliance paradigm.

This is not to suggest that it should have been obvious, at the time that FERC was first ramping up its enforcement efforts, that reliance on the threat of punishment alone would not work—after all, the deterrence principle underlies much of our criminal justice system. But even the criminal justice system has been changing when it comes to criminal sentencing of organizations. In particular, the 2004 amendments to the Federal Sentencing Guidelines for Organizations ("Sentencing Guidelines")⁵⁸ crystallized the notion, soon thereafter replicated in FERC's *Enforcement Policy Statement*,⁵⁹ that the promise of withholding punishment should be used as a tool to encourage companies to develop strong, centralized compliance programs.⁶⁰ These amendments to the Sentencing Guidelines followed closely upon the heels of the corporate scandals of the early part of the decade and the enactment of the Sarbanes-Oxley Act of 2002,⁶¹ and helped usher in a new era of strong corporate-level compliance programs.

Oddly enough, though, some of the same companies that otherwise had excellent corporate-level compliance programs and strong corporate

58. U.S. SENTENCING GUIDELINES MANUAL § 8 (2005), available at <http://www.USSC.gov/2004guid/gl2004.pdf>.

59. The *Enforcement Policy Statement* explicitly recognizes the influence of the Sentencing Guidelines on FERC's own enforcement policy. *Enforcement Policy Statement*, *supra* note 37, at P 8. Additionally, the FPA provides for criminal penalties in some circumstances, e.g., 16 U.S.C. § 825o(a) (2005), and a company facing criminal prosecution by the Department of Justice for an alleged FPA violation could face direct application of the Sentencing Guidelines.

60. U.S. SENTENCING GUIDELINES MANUAL § 8C2.5(f); see also U.S. SENTENCING GUIDELINES MANUAL ch. 8, introductory cmt. ("The two factors that mitigate the ultimate punishment of an organization are: (i) the existence of an effective compliance and ethics program; and (ii) self-reporting, cooperation, or acceptance of responsibility").

61. 18 U.S.C. § 1541A (2005).

compliance cultures had felt themselves driven to the “head-in-the-sand” approach when it came to FERC-specific compliance. Thus, in hindsight, it was evident that the approach of such companies to FERC compliance was not due to some sort of intransigence. Rather, the different approach by such companies to general corporate compliance versus FERC-specific compliance seemed to be attributable to an outside factor—specifically, the fear that FERC would punish companies for discovering compliance problems, even if the problems were then corrected. The fix seemed obvious: FERC needed something like the Sentencing Guidelines that would take strong compliance efforts into account in determining whether to assess penalties for compliance problems.

a. The Enforcement Policy Statement

According to Chairman Kelliher, the goal of the October 20, 2005, *Enforcement Policy Statement* was to “encourage regulated entities to establish and maintain effective compliance programs.”⁶² He said that FERC wants to encourage regulated entities to “develop a compliance culture.”⁶³ The *Enforcement Policy Statement* outlined a policy under which an effective compliance program ordinarily will serve as a mitigating factor in assessing penalties. Chairman Kelliher gave this example:

[I]f two different entities commit the same violation, and one entity has an effective compliance program, self-reported the violation, took remedial action, cooperated with the Commission’s investigation, and the violation was an isolated instance, and the second entity had no compliance program, its senior management learned of the violation but took no action, the entity had a history of violations, and failed to cooperate with the investigation, the civil penalties levied would be substantially different.⁶⁴

Thus, as discussed at the outset of this article, the *Enforcement Policy Statement* predicts the use of both the carrot and the stick. But the most significant aspect of the *Enforcement Policy Statement* is that it delineates the circumstances under which the carrot and stick are likely to be used. Chairman Kelliher seemed to indicate that this was a conscious effort to allay the negative perceptions of FERC’s enforcement practices that, as discussed above, were widespread at the time. He said: “We have a duty to be clear on what the rules are. Compliance should not be elusive, it should not be subjective, and it should be objective to the greatest extent

62. Joseph Kelliher, Chairman, Fed. Energy Reg. Comm’n, Statement on Agenda Items M-1, M-2, and M-4 (Oct. 20, 2005), available at <http://www.ferc.gov/press-room/statements-speeches/kelliher/2005/10-20-05-kelliher-M-1.asp>.

63. *Id.*

64. *Id.*

possible. Our goal is to encourage compliance—and to quickly identify and sanction non-compliance.”⁶⁵

Of course, FERC’s ability to “sanction non-compliance” had, as of the date of issuance of the *Enforcement Policy Statement*, recently increased dramatically. EAct 2005 gave FERC greatly enhanced penalty authority, including authority to impose civil penalties of up to \$1,000,000 per day per violation for violations of the NGA⁶⁶ and Part II of the FPA,⁶⁷ and FERC can seek criminal penalties as well, including, potentially, jail sentences for individuals.⁶⁸ This is important because it heightened the threat of FERC’s stick. The *Enforcement Policy Statement* takes advantage of that heightened threat by telling regulated entities how they can avoid it. Key aspects of FERC’s enforcement policy can be summarized as follows:

i. Punishment vs. Disgorgement of Ill-Gotten Gains

The *Enforcement Policy Statement* is intended to provide a means by which a company can minimize punishment for a wrongful activity, but not a means by which it can keep the ill-gotten fruit of such activity. Thus, in all cases, “companies will be expected to disgorge unjust profits whenever they can be determined or reasonably estimated,”⁶⁹ but FERC will exercise its discretion in evaluating appropriate remedies “above disgorgement of profit.”⁷⁰

ii. Two-Part Analysis for Discretionary Penalties

FERC has established a series of factors⁷¹ that it will consider in “exercis[ing its] discretion to apply remedies in a fair, reasonable, and appropriate manner.”⁷² However, FERC was careful to state that it was not creating a schedule of penalties but rather would address penalties on a case-by-case basis.⁷³ Some conduct may be “so egregious that the full use of the Commission’s penalty authority is necessary regardless of the presence of other factors.”⁷⁴ Conversely, since “no list can cover every possi-

65. *Id.*

66. *See* Energy Policy Act of 2005, Pub. L. No. 109-58, sec. 314(b)(1)(B), 119 Stat. 594, 690-91 (2005) (amending 15 U.S.C. § 717t-1).

67. *See id.* sec. 1284(e), 119 Stat. at 980 (amending 16 U.S.C. § 825o-1).

68. *See id.* sec. 1284(d), 119 Stat. at 980 (amending 16 U.S.C. § 825o(a)) (allowing criminal penalties for violations of the FPA); *id.* sec. 314(a), 119 Stat. at 690 (amending 15 U.S.C. 717t) (allowing criminal penalties for violations of the NGA).

69. *Enforcement Policy Statement*, *supra* note 37, at P 19.

70. *Id.*

71. *Id.* at P 17-27.

72. *Id.* at P 12.

73. *Id.* at P 13.

74. *Id.* at P 18.

ble significant factor, [FERC] will consider other pertinent factors as appropriate.”⁷⁵ FERC’s proposed analysis has two parts, looking first at factors related to the seriousness of the offense and second at mitigating factors. There is some overlap between the two parts of the analysis.

Part 1: Seriousness of the Offense

The first part of FERC’s penalty analysis considers the seriousness of the offense, including the harm caused, whether the offense was intentional, and whether it had the sanction of management.⁷⁶

Part 2: Mitigating Factors

The second part of FERC’s penalty analysis will examine whether a company should get “credit,” in the form of a reduced penalty, for internal compliance, self-correction, self-reporting, and cooperation.⁷⁷ This credit is the core of the major evolution in FERC’s enforcement policy represented by the *Enforcement Policy Statement*. Although companies that seek to prevent, detect, correct, and report violations still will face some risk of punishment, FERC’s point is that companies face a much higher risk should they fail to do so. FERC has identified three specific types of mitigating factors it will consider in this analysis.

Internal Compliance

FERC “encourage[s] companies engaged in jurisdictional activities to take steps to create a strong atmosphere of compliance in their organizations” and so has announced a list of “factors” to be used “in determining credit given for a company’s commitment to compliance.”⁷⁸ Chief among these are whether the company has an established, formal, independent compliance program, the level of support the compliance effort gets from senior management, whether the company audits its own compliance with FERC regulations, and whether the company takes disciplinary action against wrongdoers and otherwise takes effective steps to prevent repeat violations.⁷⁹

75. *Id.* at P 17.

76. *Id.* at P 20. In evaluating the seriousness of the offense FERC will consider, inter alia, the following: Did the violation cause harm or provide a benefit to the wrongdoer? Was the action willful, manipulative, or deceitful? Was it part of a broader scheme, or conducted in concert with others? Does the company have a history of violations? How long did the wrongdoing last, and was senior management aware of it? Was there a cover-up? What effect would penalties have on the financial viability of the wrongdoer? *Id.*

77. *Id.* at P 22-27.

78. *Id.* at 22-23.

79. *Id.* Other factors include, inter alia, whether the compliance program is comprehensive and supported with adequate resources, how often it is reviewed and modified, whether com-

Self-Correction and Self-Reporting

FERC “place[s] great importance on self-reporting” of both intentional and inadvertent violations.⁸⁰ Although FERC will not determine in advance how much credit a company will get for self-reporting, “[i]t is possible . . . that prompt and full self-reporting of violations, coupled with steps to correct the adverse impacts on customers or third parties from the misconduct, may result in significant reduction in the amount of civil penalty or no civil penalty being assessed,”⁸¹ though “[c]ompanies should still expect to disgorge any unjust profits.”⁸²

Cooperation

FERC “expects” cooperation, but may give credit for “exemplary cooperation, that is, cooperation which quickly ends wrongful conduct, determines the facts, and corrects a problem.”⁸³ Cooperation “must come very early in the process, and must be in good faith, and continuing.”⁸⁴ Although the factors for cooperation are similar to those for self-reporting, they are independently relevant because FERC “will consider these factors even for entities that did not self-report violations, provided that cooperation was provided once the violation was uncovered.”⁸⁵ Presumably this is intended to refer to violations brought to the attention of FERC before compliance personnel of the company—e.g., through an audit, a whistle-blower or a third-party complaint.⁸⁶

FERC made a point of stating that its application of the factors will not be mechanistic. Thus, meeting some factors while being uncooperative on others will not result in credit.⁸⁷ FERC provides a list of actions that it

pany policies regarding compensation, promotion, and disciplinary action factor into compliance, and whether the company has training programs sufficient to instill an understanding of relevant rules and of the importance of compliance. *Id.*

80. *Id.* at P 24.

81. *Id.* at P 25.

82. *Id.* Factors FERC will consider in determining whether to give “credit” for self-reporting include, inter alia, the manner in which the company uncovered the conduct in question, whether FERC was promptly notified, whether management encouraged cooperation, whether knowledgeable individuals met promptly with FERC Enforcement Staff, whether FERC was provided with comprehensive information, and whether the company took immediate corrective action. *Id.* at P 24.

83. *Id.* at P 26.

84. *Id.*

85. *Id.*

86. In determining whether to give credit for cooperation, FERC will consider, inter alia, whether the company volunteered to provide internal investigation or audit reports, whether the company hired an independent outside entity to assist in its investigation, whether senior management encouraged cooperation, whether the company facilitated FERC access to knowledgeable personnel and to records, and whether the company fairly and accurately determined the effects of the misconduct, including benefits to the company and harm to others. *Id.*

87. *Id.* at P 27.

deems uncooperative, generally consisting of conduct that would have the effect of delaying or obstructing a FERC investigation.⁸⁸

iii. Application of the *Enforcement Policy Statement*

Although FERC's evaluation of whether there are sufficient mitigating factors to warrant lower penalties will be conducted on a case-by-case basis, FERC appears to indicate that it is looking for a sort of critical mass of positive factors, stating that credit will be most likely where "many of the positive factors of internal compliance, self-reporting, and cooperation are present."⁸⁹

The enforcement policy "will be applied, as appropriate, to individuals as well as to corporate entities."⁹⁰ FERC stated that "there is no doubt that entities and individuals" are subject to prosecution under the criminal provisions of the FPA in addition to civil remedies.⁹¹ It added that "perjury, obstruction, and making false statements to Commission Staff are criminal offenses," citing 18 U.S.C. § 1001.⁹² FERC warned that "[i]f the misconduct is serious enough, we may refer the matter for criminal prosecution to provide adequate punishment and deterrence."⁹³

In some contexts "violations of more than one statute, order, rule, or regulation may result in separate penalties."⁹⁴ This is particularly significant because in some cases a single action (or inaction) can result in violation of multiple rules. For example, it is possible that an illicit trading activity involving affiliates would be deemed to violate Anti-Market Manipulation Rules, Standards of Conduct, and Codes of Conduct. Such an example could result not only in separate penalties for the various affiliates involved but also potentially multiple penalties for each due to the violation of multiple rules, notwithstanding that the violations all involve a single incident.

b. *Proof in the Pudding*

The *Enforcement Policy Statement* sets out a framework to use both the carrot and the stick to develop a more cooperative enforcement/compliance relationship between FERC and regulated entities. But

88. *Id.* One important issue is whether FERC will consider a company to be uncooperative if the company asserts the attorney-client privilege or other protections as a basis for declining to produce reports and records of internal investigations. If a company were to produce such materials to FERC, it would risk waiving the privilege. Some law enforcement agencies, including the Department of Justice, have been insisting on such steps if a company wants to be viewed as cooperative. This approach can, however, chill the self-investigative process.

89. *Id.* at P 29.

90. *Id.* at n.2.

91. *Id.* at P 15.

92. *Id.*

93. *Id.*

94. *Id.* at P 14.

such a relationship must be founded on trust that the agency will hold to its part of the bargain and not punish companies (or at least not punish them as severely) for self-reporting compliance problems or for keeping records of the problems discovered and corrected through a strong compliance program. As related above, the *Enforcement Policy Statement* was issued at a time when the regulated community was still reeling from the seemingly abrupt escalation of FERC enforcement efforts and its get-tough attitude and tactics.

Under Chairman Kelliher, the Office of Enforcement (which contains both FERC's audit and investigatory functions) remains a key player in FERC's efforts to monitor the energy industry. The Office of Enforcement has initiated audits in new areas, such as compliance with market-based sales tariffs, FERC document retention requirements, interlocking directorates, and price reporting. But the approach of FERC's Enforcement Staff seems to have changed. It appears that FERC, in the year since the issuance of the *Enforcement Policy Statement*, has embarked upon a campaign with two closely related objectives: first, to show that it is more interested in compliance than punishment, and second, to show that it intends to abide by the *Enforcement Policy Statement*.

This apparent intent has manifested itself through a number of factors, such as a period of restraint in which FERC has not aggressively employed its new penal authority, and through evenhanded, measured application of the *Enforcement Policy Statement*. For example, industry members are coming to learn, through experience, that FERC now appears to have a different approach to self-reporting of violations and will often refrain from imposing penalties if the self-reporting entity takes quick and effective steps to prevent the problem from occurring again, just as the *Enforcement Policy Statement* suggests.⁹⁵ FERC also has adopted a new policy for issuances of FERC Staff "no-action" letters, under which Staff examines a proposed activity and works with the party requesting the letter to find a solution under which FERC Staff would not recommend that the Commission commence an enforcement action.⁹⁶ This policy already has resulted in issuance of several no-action letters.⁹⁷

Even in cases where audits or investigations turn up problems, FERC has been more restrained than it was a year or two ago, focusing more on

95. See *id.* at P 25 ("It is possible . . . that prompt and full self-reporting of violations, coupled with steps to correct the adverse impacts on customers or third parties from the misconduct, may result in significant reduction in the amount of civil penalty or no civil penalty being assessed.").

96. See *Interpretive Order Regarding No-Action Letter Process*, 113 F.E.R.C. ¶ 61,174 (2005). FERC recently expanded the no-action letter process to apply to more types of regulated activities. See *Interpretive Order Modifying No-Action Letter Process*, 117 F.E.R.C. ¶ 61,069 (2006).

97. See *Cinergy Services, Inc.*, Docket No. NL06-1-000 (Jan. 31, 2006) (No-Action Letter); *American Transmission Co. LLC*, Docket No. NL06-2-000 (Apr. 28, 2006) (No-Action Letter); *Texas Eastern Transmission, L.P.*, Docket No. NL06-4-000 (Aug. 25, 2006) (No-Action Letter).

prospective compliance and less on penalties.⁹⁸ Perhaps the most telling example lies in the contrast between the outcomes of two audits, one that occurred prior to the *Enforcement Policy Statement* and one that came after. The audits involved Progress Energy (“Progress”)⁹⁹ and LG&E Energy (“LG&E”).¹⁰⁰ Both cases uncovered several similar alleged rules violations, and in each case the alleged rules violations derived from similar facts. In particular, it was alleged in both cases that the companies had violated Code of Conduct requirements by sharing facilities and market information between regulated and unregulated merchant functions.¹⁰¹ The utility subsidiaries of Progress Energy agreed, less than a year before the *Enforcement Policy Statement*, to \$6.4 million in refunds and credits to regulated retail and wholesale customers.¹⁰² LG&E agreed, less than a year after the *Enforcement Policy Statement*, to purely forward-looking corrective actions, with no penalties.¹⁰³ The *LG&E Audit Report* indicated that “LG&E has been very cooperative throughout the audit”¹⁰⁴ and described efforts that LG&E had made to correct each of the compliance problems detected by FERC Enforcement Staff.¹⁰⁵ As noted above, “cooperation” is one of the three primary mitigating factors that FERC will consider in assessing, under the *Enforcement Policy Statement*, whether and to what degree a company should be punished,¹⁰⁶ while correction of compliance violations is something that ordinarily will be considered under the self-reporting factor.¹⁰⁷ Thus, the difference between the results of the LG&E and Progress audits may be attributable to a conscious effort by FERC to view the LG&E audit through the lens of its new *Enforcement Policy Statement*.

4. Where Does FERC Enforcement Go Next?

FERC’s actions over the year since the issuance of the *Enforcement Policy Statement*, while not conclusive, indicate that FERC is attempting

98. See, e.g., *Southern Co. Servs., Inc.*, 117 F.E.R.C. ¶ 61,021 (2006) (imposing forward-looking corrective measures but no penalties).

99. See *Florida Power Corp.*, 111 F.E.R.C. ¶ 61,243 (2005).

100. *Audit of Code of Conduct, Standards of Conduct, Market-Based Rate Tariff, and MISO’s Open Access Transmission Tariff at LG&E Energy LLC*, Docket No. PA05-9-000 (July 17, 2006) [hereinafter *LG&E Audit Report*]. The *LG&E Audit Report* is attached to a letter order from the Director of FERC’s Office of Enforcement approving and directing the corrective actions recommended in the audit. *LG&E Energy Servs., Inc.*, Docket No. PA05-9-000 (July 17, 2006) (Letter Order) [hereinafter *LG&E Letter Order*].

101. *Florida Power Corp.*, 111 F.E.R.C. ¶ 61,243 at P 5.A-G (2005) (describing Progress Energy’s Code of Conduct violations); *LG&E Audit Report*, *supra* note 100, at 2 (describing LG&E’s Code of Conduct violations).

102. *Florida Power Corp.*, 111 F.E.R.C. ¶ 61,243 at P 7.a (2005).

103. E.g., *LG&E Audit Report*, *supra* note 100, at 4.

104. *Id.* at 2.

105. *Id.*, *passim*.

106. See *Enforcement Policy Statement*, *supra* note 37, at P 21, 26.

107. *Id.* at P 24.

to reshape its enforcement practices. But FERC still faces an obstacle to building the trust necessary to make the cooperative relationship envisioned by the *Enforcement Policy Statement* fully successful, namely the negative perception of its enforcement efforts created before the release of the *Enforcement Policy Statement*. That perception, while slowly changing, nonetheless lingers. Part of the problem is that FERC, in essence, needs to prove the negative—that is, FERC needs to show, over time, that companies will not be punished for building strong compliance programs that uncover and correct compliance failures.

In this regard the issue that is naturally of greatest interest to the regulated community is whether, and in what context, FERC's stick will reappear. As described above, FERC has not imposed many significant penalties since it issued the *Enforcement Policy Statement*. Part of the reason for this no doubt has been that, while violations may be as serious as those that previously drew penalties, FERC has found other factors, such as the strong cooperation and efforts at correcting problems noted in the *LG&E Audit Report*, that warrant mitigation under the *Enforcement Policy Statement*.

But interestingly, the *LG&E Audit Report* provides little direct insight into the state of LG&E's compliance program.¹⁰⁸ This raises the question whether, for example, a company can always avoid punishment simply by cooperating fully with an audit or investigation and correcting compliance violations when they are pointed out by FERC Enforcement Staff. That seems unlikely, to say the least. For one thing, before becoming Chairman, then-Commissioner Kelliher was a major proponent of expanded FERC civil penalty authority.¹⁰⁹ Also, the *Enforcement Policy Statement* indicates that some types of egregious conduct could override all forms of mitigation.¹¹⁰

More fundamentally, though, the *Enforcement Policy Statement* has three factors, of which cooperation is only one, and correction of compliance violations is part of another.¹¹¹ And while these factors are no doubt important, it seems unlikely that FERC, in the long run, will view cooperation and correction of violations after such violations have been identified by FERC Enforcement Staff to be sufficient grounds, standing alone, to avoid penalties in all instances, particularly where the violations are serious or where they were allowed to occur because the company

108. This is not to suggest that LG&E Energy does not have a strong compliance program—the author does not know. Rather, cooperation was the factor that FERC emphasized.

109. See Joseph Kelliher, *Market Manipulation, Market Power, and the Authority of the Federal Energy Regulatory Commission*, 26 ENERGY L. J. 1, 23 (2005).

110. *Enforcement Policy Statement*, *supra* note 37, at P 18.

111. Under the *Enforcement Policy Statement* correction of compliance violations is part of the same mitigating factor that considers whether a company has self-reported the violation. See *id.* at P 24.

had an inadequate compliance program.¹¹² After all, the purpose of the *Enforcement Policy Statement* is to provide an incentive for the creation of such programs, and FERC would not want to rob that incentive by allowing companies to avoid penalties even without a strong compliance program. So why the seemingly sole reliance on LG&E's cooperation and post-detection compliance fixes as a mitigating factor?

The most logical explanation is that FERC is giving companies time to adopt the practices recommended in the *Enforcement Policy Statement*. At heart, the *Enforcement Policy Statement* is built on notions of fundamental fair play in the relationship between the regulator and the regulated,¹¹³ and it would be consistent with such notions to give regulated entities a reasonable amount of time in which to build, in some cases from scratch, the comprehensive compliance programs necessary to get credit under the *Enforcement Policy Statement*. But if, in fact, FERC currently is in the midst of such a "honeymoon" period, it cannot be expected to last forever. At some point, FERC no doubt will expect to see signs of the development and impact of such programs, and at some point FERC no doubt will expect all companies that plan to follow the guidance of the *Enforcement Policy Statement* to have implemented sophisticated programs for FERC compliance. At that point, logically, the honeymoon will end, and companies that commit serious rules violations in the absence of strong compliance programs will be punished.

How this honeymoon period ends will be critical to shaping the perception of the regulated community toward FERC's revamped enforcement program, and hence toward the long-term success of the cooperative relationship envisioned by the *Enforcement Policy Statement*. That is because the end of the honeymoon period will, by definition, mark the reemergence of significant penalties. As related above, the negative perceptions of the pre-*Enforcement Policy Statement* era were shaped not so much by the existence of penalties as by fear that penalties would be imposed despite (or even because of) strong compliance programs. FERC's task at the end of the honeymoon period thus will be, at least in concept, simple: except in cases of egregious violations, FERC must impose penalties only where companies have not implemented strong compliance programs. In other words, FERC must follow the *Enforcement Policy Statement*.

112. As noted above, FERC seems to indicate, in the concluding sentence to the *Enforcement Policy Statement*, that it is looking for a critical mass of "many" of the factors it identifies in order to give credit. *See id.* at P 29 ("where many of the positive factors of internal compliance are present, we will take those factors into account in determining the appropriate penalties for violations").

113. *See, e.g., id.* at P 29 ("Entities subject to the Commission's jurisdiction should expect firm but fair enforcement in the future").

While the concept may be simple, implementation will be less so. In order to have a chance to successfully manage perception and build cooperation, FERC must attempt to strike a *balance* that reinforces, rather than disrupts, the message it is sending during its current trust-building honeymoon phase. There are three factors that likely will be critical to the long-term success of the *Enforcement Policy Statement*: reasonableness of penalties, consistency of application of penalties, and clarity of explanation of penalties.

a. Reasonableness of Penalties

FERC will need to wield its stick in measured fashion by saving significant penalties for companies that have committed major violations in the *absence* of the sort of concerted compliance program called for by the *Enforcement Policy Statement*. FERC must be careful to make its punishments proportionate not only to the wrongdoing but also to the extent of the compliance failure. If companies are punished severely for minor violations or for violations that occurred in spite of well-designed compliance controls, we likely will see a recurrence of head-in-the-sand syndrome. The approach outlined in the *Enforcement Policy Statement* balances the severity of the transgression against the various mitigating factors, principally the existence of a strong compliance program. If this approach is followed, it should result in reasonable penalties.

b. Consistency of Application of Penalties

Just as importantly, FERC needs to persuade the regulated community that the new compliance relationship envisioned in the *Enforcement Policy Statement* is built to last and that it will survive the three member, Keliher-led FERC that originated it. Because part of the negative perception that some companies developed regarding FERC enforcement practices is rooted in concern that FERC's enforcement practices seemed at times inconsistent or even arbitrary, FERC must counter that by demonstrating consistency in application of the *Enforcement Policy Statement*, and in particular in imposing penalties. With several new Commissioners on board this year, the industry is watching carefully for any signs of deviation and will continue to do so with each changing of the guard.¹¹⁴

114. Interestingly, one of the new commissioners, Commissioner Moeller, recently issued a concurrence warning the industry of his intent to "pay particular attention" to "even the most minor tariff violation" because such violations "have the potential to trigger a series of events that could adversely affect the reliability of our nation's energy supply and infrastructure." *Chandeleur Pipe Line Co.*, 117 F.E.R.C. ¶ 61,051 (2006) (Moeller, Comm'r, concurring).

c. Clarity of Explanation of Penalties

As explained above, the difficulties that FERC faces now in building a cooperative compliance relationship with regulated entities largely derive from the negative perception that many regulated companies have developed about FERC's enforcement practices. A resurgence of penalties that are not clearly and expressly tied to the policies of the *Enforcement Policy Statement* runs the risk of reinforcing such negative perceptions. Conversely, good explanation, at every opportunity, of how FERC's enforcement process tracks the *Enforcement Policy Statement* will bolster the credibility of the agency and help to persuade regulated companies that following the *Enforcement Policy Statement* is in their interests.

Thus far, FERC has been doing a good job implementing the *Enforcement Policy Statement* but has been overly modest in taking credit for its actions. FERC could better explain how its actions are in accordance with the *Enforcement Policy Statement*. For example, while the *LG&E Audit Report* recognizes that LG&E was cooperative and discusses LG&E's prompt efforts to correct rules violations, there is no express statement as to whether LG&E's actions were considered, under the *Enforcement Policy Statement*, a mitigating factor in determining not to seek civil penalties. Similarly, without any detailed discussion of the significance of the status of LG&E's compliance program, it is difficult to know exactly what message to take from that case.

The lack of clarity on FERC's reasons for *not* seeking monetary penalties from LG&E has important potential implications. While this article speculates that there is a honeymoon period for companies to build their compliance programs, and that it will likely end sooner rather than later, there is no official indication from FERC to that effect. If in fact FERC does start to impose monetary penalties for similar violations in the future, without explanation of the distinction, there is a serious risk that FERC's enforcement actions will be perceived as arbitrary, which likely would reinforce the lingering negative perceptions about FERC enforcement. Ideally, if we are now in a honeymoon period, FERC will avoid the appearance of arbitrariness by warning companies *in advance* that the honeymoon is coming to an end.

Self-reporting is another good example. As noted above, there have been instances of self-reported violations since the issuance of the *Enforcement Policy Statement* that have gone unpunished. Such occurrences have not, however, been well publicized by FERC. While there are doubtlessly confidentiality considerations in play in some instances, it should be possible to accumulate and report generic data on the frequency of such occurrences without sacrificing confidentiality. By publicizing such data FERC would demonstrate that self-reporting is no longer an automatic ticket to an investigation or significant penalties. Perhaps

equally importantly, by taking the time to prepare public reports of this nature, FERC would be sending the message that this change is deliberate.

Interestingly, a recent Government Accountability Office (“GAO”) report on FERC’s enforcement practices with respect to natural gas markets found fault, not with FERC’s enforcement practices, but with FERC’s failure to publicize them.¹¹⁵ GAO reported that FERC has a number of investigations under way, but that because FERC does not publicize such investigations before they are final, stakeholders are not aware of the extent to which FERC is policing the markets and making sure that prices are free from market manipulation.¹¹⁶ GAO believes that, due to their lack of awareness of FERC’s enforcement efforts, some stakeholders “lack confidence in the fairness of natural gas commodity prices.”¹¹⁷ GAO recommended several measures that would give more transparency to FERC’s enforcement efforts, while preserving confidentiality, such as revealing the type and number of investigations under way, but not the parties being investigated.¹¹⁸

In short, GAO recommends more publicity for FERC enforcement efforts related to gas markets to increase confidence in gas prices by correcting the *perception* that FERC is not actively engaged in enforcement activities. While GAO’s recommendation is narrowly tailored to the issue it was examining, the same reasoning applies here: FERC can help correct existing negative perceptions of its enforcement practices by better explaining and publicizing its efforts to implement the *Enforcement Policy Statement*.

5. Conclusion: What Does All This Mean For The Regulated Community?

A recent case may mark the beginning of the end of the honeymoon period posited in this article.¹¹⁹ With the significant changes under way

115. See U.S. GOV’T ACCOUNTABILITY OFFICE, NATURAL GAS, ROLE OF FEDERAL AND STATE REGULATORS IN OVERSEEING PRICES 5 (Sept. 2006).

116. *Id.* at 21.

117. *Id.* at 20.

118. *Id.* at 22.

119. See *AmerenUE*, 117 F.E.R.C. ¶ 61,001 (2006) (approving stipulation and consent agreement between owner of hydro project and FERC enforcement Staff requiring owner to pay \$15,000,000, including \$10,000,000 civil penalty, and to implement a program improving “safety and compliance conditions,” arising from alleged violations of hydro license conditions and of the Commission’s regulations). While this penalty was assessed under provisions of the FPA that only apply to violations of FERC’s hydroelectric safety regulations, and which predate EPAct 2005, it is noteworthy that this penalty far exceeds any previous hydroelectric penalty. Moreover, in the *Enforcement Policy Statement* FERC draws a direct parallel to its hydroelectric enforcement rules, stating, “The guidance of this Policy Statement is consistent with the existing rule on factors we consider in the context of hydropower project violations and penalties.” *Enforcement Policy Statement*, *supra* note 37, at P 11.

right now in substantive rules governing the energy industry,¹²⁰ the potential for rules violations associated with an incomplete or out-of-date compliance program has never been greater, which may mean that if and when FERC starts making examples, there may be more than a few.

The rapidly changing and growing scope of behavioral rules, coupled with the increase in FERC's use of its penalty authority predicted here, points to the need for regulated companies to have FERC compliance programs at least as comprehensive as the programs they use to manage general corporate compliance. Risk levels have increased significantly—as discussed above, EPAct 2005 gave FERC authority to impose penalties of up to \$1 million per day per violation. Thus, it should be expected that violations will result in material, multimillion-dollar penalties. Moreover, the new requirements are far more pervasive than the old rules, applying in some cases to the behavior of most of the utility's employees, many of whom enjoy far more discretion than they enjoyed before. This scope of application makes it inevitable that rules violations will occur, through human error and new incentives to increase profits by “pushing the envelope” in interpreting ambiguous FERC rules, no matter how sophisticated the company's compliance program.

Without the *Enforcement Policy Statement*, this combination of high potential penalties with high risk of rules violations would be a recipe for disaster. Like the Sentencing Guidelines, the *Enforcement Policy Statement* provides companies a means to mitigate this risk by adopting strong, centralized compliance programs to prevent, or to detect and correct, compliance problems. Such programs will limit compliance errors, and while self-audits and other elements of effective compliance programs still will create FERC audit trails, FERC's *Enforcement Policy Statement* changes the paradigm by making it more to the company's benefit to find and correct compliance problems than to ignore them.

At the same time, the history described here shows that FERC's views on compliance matters are anything but static, and are influenced by a number of factors that change over time, including the nature of FERC's regulatory responsibilities and the changing composition of the Commission. It will be incumbent on the agency to show the regulated community that the policies of the *Enforcement Policy Statement* will survive such changes, particularly in the early years of implementing the new policy. The good news is that the *Enforcement Policy Statement* benefits both the

120. Examples include FERC's pending rulemakings on new enforceable reliability rules, see *Mandatory Reliability Standards for the Bulk-Power System*, 117 F.E.R.C. ¶ 61,084 (2006), and on the parameters for obtaining and maintaining prior authorization to sell power at market-based rates, *Market-Based Rates for Wholesale Sales of Electric Energy, Capacity and Ancillary Services by Public Utilities*, Notice of Proposed Rulemaking, 115 F.E.R.C. ¶ 61,210 (2006), as well as its recent rulemaking establishing anti-market manipulation rules. See *Prohibition of Energy Market Manipulation*, 114 F.E.R.C. ¶ 61,047, *order on reh'g*, 114 F.E.R.C. ¶ 61,300 (2006).

B. UNITED STATES OIL AND GAS CASE SUMMARIES*

Meisler v. Gull Oil, Inc., 848 N.E.2d 1112 (Ind. Ct. App. 2006)

This case held that an implied covenant of reasonable development does not apply to the diligent operation of existing oil and gas wells when the lease contains a *habendum* clause addressing production. Here the habendum clause provides that so long as oil or gas is produced from the leased property, the lease will remain in effect.

Ronald and Donald Meisler (“Meislers”) are owners of 221 acres of land, the entirety of which is covered by a seventy-year-old oil and gas lease (“Lease”). The Meislers were aware of the Lease when they purchased the land. Thirty-three wells have been drilled on the land during the life of the Lease, and almost one million barrels of oil, with a total value of more than \$58 million, have been produced. During the fifteen years prior to trial, the Lease produced almost thirty thousand barrels of oil that sold for more than \$600,000.

At issue in the case were 50 acres (“Acreage”) of the land covered by the Lease, and operated by Gull Oil, Inc. (“Gull Oil”), among others. During the 1990s, oil production from the Acreage was minimal overall, with periods of one to two years when no oil was produced at all. The Meislers sought to cancel the Lease with respect to the Acreage in order to plug the wells and build houses on the land. The Meislers filed suit against Gull Oil and others, seeking to cancel the part of the Lease covering the Acreage, arguing that Gull had breached an implied covenant of reasonable development by not producing more oil or gas on the land.

At trial, the parties submitted an agreed stipulation of facts to the trial court. The court found in favor for Gull Oil, holding that it did not violate the covenant of reasonable development and that Indiana law does not permit the partial cancellation of a lease. The Meislers appealed.

The court of appeals held that an implied covenant serves to obligate the lessee to use its best efforts to provide the landowner with the expected royalties that induced the lease of the land. Indiana uses an objective standard to measure the performance of an implied covenant. When the lease does not fix the number of wells that must be drilled to qualify as reasonable development, the lessee has the conclusive right to determine the number of wells or the extent of development, so long as it acts honestly and in good faith.

* The United States Oil and Gas Case Summaries were written by the following staff editors: Peter Idziak, Kristen Williams, James Spencer, Dara Magnus-Lawson, Harrison Bolling, and Davis Bradford.

Gull Oil argued that the implied covenant applied only to the drilling of wells and not to the operation and production of existing wells. The court of appeals agreed, stating that the implied covenant would apply only absent an express provision in the Lease that governs such matters. The Lease had such an express provision—a *habendum* clause—which stated that so long as oil or gas is produced from the leased property the Lease will remain in effect. The Court found that the *habendum* clause contained no language that indicated it was divisible and that so long as oil or gas was produced from the full 221 acres, there is no breach of the *habendum* clause. Furthermore, the court noted that Indiana law prohibits the partial cancellation of leases.

The court of appeals therefore held that because the Lease contained an express clause—the *habendum* clause—with regard to the production of oil or gas on the leased property, the implied covenant of reasonable development did not apply to production from existing wells.

Continental Resources of Illinois v. Illinois Methane, 847 N.E.2d 897 (Ill. App. 5th 2006)

The appellate court deals with two issues in this case: first, whether the coalbed methane gas left in coal seams or mine voids is controlled by the owners of the coal estate, the defendants Illinois Methane, LLC (“Illinois Methane”) and DeMier Oil Company (“DeMier”), and second, whether the owner of the oil and gas rights, Continental Resources of Illinois, Inc. (“Continental”), controls the rights to methane gas. The trial court dismissed Continental’s claim for failure to state a claim, and the appellate court upheld the trial court’s dismissal, holding that coalbed methane gas left in coal seams or mine voids is controlled by the coal estate and that coalbed methane gas is not included in the gas lease because it is produced as a by-product of the mineral estate.

Continental had an oil and gas lease with the right to produce all gases on the land. Continental claimed that it had the exclusive right to explore, drill, and produce coalbed methane gas from the land. Continental then sought an injunction against the defendants and a share of the proceeds from coalbed methane gas production.

The district court granted defendant’s motion to dismiss because coalbed methane gas belonged to the coal estate and is subject to the rule of capture.

This court found that because the coal owner cannot mine safely for coal without producing methane gases, coalbed methane gas is distinct because it is a by-product of coal. For this reason, coal methane gas is not included under “all gases” in Continental’s oil and gas lease.

Under Continental's oil and gas lease, Continental must plug all holes drilled into the coal seam. Thus, it cannot drill or own coalbed methane gas drilled in this manner. Continental cannot own coalbed methane gas drilled from mineral voids either, because that gas has not been produced or reduced to possession. Therefore, the rule of capture does not allow Continental to own such coalbed methane gas.

Therefore, the appellate court held that Continental does not own the methane gas produced from surrounding land and is not entitled to a share of the proceeds from methane gas production.

Tawney v. Columbia Natural Resources, L.L.C., 633 S.E.2d 22 (W. Va. 2006)

In this case, the Supreme Court of Appeals of West Virginia construed language in oil and gas lease agreements to determine whether the lessee could deduct post-production expenses from the lessors' royalties. In affirming the circuit court, the supreme court of appeals held that lease language, which states that the lessor's royalty is to be calculated "at the well," "at the wellhead," or similar language, or that the royalty is to be an amount "net all costs beyond the wellhead" or "less all taxes, assessments, and adjustments," was ambiguous, and therefore insufficient to indicate that the parties intended for the lessee to deduct post-production expenses from the lessor's royalty.

The plaintiffs in this case were the owners of oil and gas ("lessors") that had been leased to Columbia Natural Resources ("CNR"). At least since 1993, CNR had taken deductions, including both monetary and volume deductions, for "post-production" costs from the lessors' 1/8 royalty payments. Although CNR had sent royalty payments that included an accounting of the purported amount of gas produced, the price at which it was sold, and the purported amount of the royalty, CNR failed to disclose that "post-production" reductions had been taken. The lessors subsequently brought a class-action suit against CNR to recover damages for the allegedly insufficient royalty payments.

According to CNR, at least 1,382 of the 2,258 leases contained language indicating that the royalty payment was to be calculated "at the well," "at the wellhead," "net all costs beyond the wellhead," or "less all taxes, assessments, and adjustments." CNR argued that such language was clear and unambiguous, thus permitting it to deduct a proportionate share of post-production expenses from royalty payments, provided that such expenses were actual and reasonable. In contrast, the lessors contended that (a) the language at issue was either silent or ambiguous on the allocation of post-production costs, and thus should be construed against CNR, and (b) since the language of the leases did not expressly

address the allocation of post-production costs, CNR had an implied covenant to market the gas, bearing all costs involved in marketing and transporting the gas to the point of sale. The plaintiffs therefore concluded that CNR must bear all the production costs itself and could not deduct such costs from the lessors' royalty payments.

In resolving the issue of ambiguity, the court first noted that there is a general recognized rule that, absent language in the lease to the contrary, the lessee must bear all costs incurred in exploration, production, marketing, and transportation of the product to the point of sale. The rationale for this general rule is that the lessee not only has the right under a lease to produce the oil or gas but he also has a duty, either express or under an implied covenant, to market the oil or gas produced.

In finding "at the wellhead" and similar clauses ambiguous, the court pointed out that such language did not indicate *how* or *by what method* the royalty was to be calculated or the gas valued. The court also found the language inadequate to support any intent by the parties to permit CNR to deduct a proportionate share of the post-production costs. Of particular significance was the fact that, although some of the leases had been executed decades before, CNR did not begin to deduct post-production costs from the lessors' royalty payments until 1993. Having found the language ambiguous, the court adhered to its traditional rule of construing the language against the lessee and, in this case, against the party who drafted the ambiguous language, CNR.

Accordingly, the supreme court of appeals affirmed the lower court and held that language in an oil or gas lease that is intended to allocate post-production costs between the lessor and lessee must expressly (1) provide that the lessor shall bear some of the costs incurred between the wellhead and the point of sale, (2) identify with particularity the specific deductions to be taken from the lessor's royalty, and (3) indicate the method of calculating the amount to be deducted from the royalty for such post-production costs. Thus, language in an oil or gas lease that provides that the lessor's royalty is to be calculated "at the well," "at the wellhead," or similar language, or that the royalty is "net all costs beyond the wellhead" or "less all taxes, assessments, and adjustments" is ambiguous and therefore not sufficient to permit the lessee to deduct from the lessors' royalty payments any portion of the costs incurred between the wellhead and the point of sale.

Pina v. Gruy Petroleum Management, 136 P.3d 1029 (N. M. App. 2006)

In this case, the Court of Appeals of New Mexico analyzed a Master Service Contract ("MSC") to determine whether a choice of law provision was a violation of public policy under the Oilfield Anti-Indemnity

Statute, Section 56-7-2. The appellate court, in affirming the judgment of the trial court, held that the provision was void because it violated public policy and thus was unenforceable.

The controlling provision of the statute provides:

Section 56-7-2 of the Oilfield Anti-Indemnity Statute as amended in 1999, is an expression of a “fundamental principle of justice,” which is to insure the safety of persons and property at well sites within New Mexico, and that a choice of law provision applying Texas law, by which an indemnitee may be indemnified against its own negligence, is void as violative of the public policy of New Mexico.

Gruy Petroleum Management (“Gruy”), a Texas corporation entered into a MSC in July 2000 with Banta Oilfield Services, Inc. (“Banta”), a New Mexico corporation. Under this contract, Banta agreed to complete work at an oil well site managed by Gruy. Three provisions in the MSC create the controversy: (1) article 10 of the MSC provided that Banta indemnify Gruy from and against all claims of harm resulting from work of the contract; regardless if the liabilities were caused by Gruy’s negligence, (2) article 11 of the MSC required Banta to uphold a \$1,000,000 commercial general liability policy, which added Gruy as an additional insured, and to waive any rights of subrogation that Banta and its insurer, Bituminous Insurance Company (“Bituminous”), would have against Gruy, and (3) article 24 of the MSC provided that the contract is in accordance with the laws of Texas.

Banta purchased insurance from Bituminous. While employed by Banta, Daniel Pina suffered fatal burns at a well site owned and operated by Gruy. His wife, Nora Pina, filed a wrongful-death suit against Gruy, alleging wrongful conduct by Gruy’s employees. Banta intervened in the wrongful-death suit and sought declaratory judgment invalidating the indemnity provision as a violation of Section 56-7-2 of the Oilfield Anti-Indemnity Statute. Gruy cross-claimed to enforce the indemnity clause and filed for a declaratory judgment to validate the provision. The district court granted Banta’s motion for summary judgment and denied Gruy’s. Subsequently, Bituminous intervened in the wrongful death suit seeking a declaratory judgment alleviating the company from defending or indemnifying Gruy, as it was a violation of public policy according to Section 56-7-2. Gruy counterclaimed, seeking a declaratory judgment requiring Bituminous to defend and indemnify Gruy. Both companies filed for summary judgment and the district court granted Bituminous’s motion and denied Gruy’s. Gruy appealed as to both judgments.

The district court stated that the indemnity provision was a violation of public policy as articulated in Section 56-7-2, and therefore the provision was void. On appeal, Gruy claimed that the district court’s interpretation

of the 1999 version of the statute would frustrate a legitimate expectation that its indemnity agreement would be enforceable under New Mexico law.

In affirming the district court's ruling, the appellate court reasoned that the public policy underlying Section 56-7-2 was to promote safety. Also, indemnity agreements are permitted if they do not relieve the indemnitee from liability for its own negligence. The court also reasoned that the language of the clause, stating that "this provision shall not affect the validity of any insurance contract," allows a party to obtain insurance against its own negligence but does not permit indemnification agreements in which the indemnitor is forced to obtain insurance that protects an indemnitee from liability of its own negligence. Furthermore, the appellate court looked to the legislators' intent when drafting the statute. The legislature expressly determined that freedom of contract was to be subordinate to the public policies underlying the Oilfield Anti-Indemnity Statute and that promoting safety at well sites is an important public policy. The appellate court reasoned that the 2003 amendments to the statute simply clarified what was implicit in the 1999 version:

Indemnification agreements that undermine the indemnitee's incentive to promote safety at New Mexico well sites violate a fundamental public policy of New Mexico and are void and unenforceable, and further, agreements that purport to escape the effect of Section 56-7-2 by invoking foreign law, are against public policy and are void and unenforceable in New Mexico courts.

Accordingly, the appellate court upheld the district court's determination that (1) the indemnification provision in the contract between Gruy and Banta was a violation of public policy as stated in the Oilfield Anti-Indemnity Statute, and thus the indemnification provision was void and unenforceable, and (2) a choice of law provision in a contract executed after the 1999 amended version of the statute that attempts to apply Texas's anti-indemnity statute to validate a prohibited indemnification clause is also against public policy and thus void.

Schwatken v. Explorer Resources, Inc. 125 P.3d 1078 (Kan. App. 2006)

This case concerned two contradictory lease clauses: a lessee-drafted *habendum* clause extending the primary term if drilling operations commence before the end of the primary term and a lessor-drafted clause providing for termination of the lease "on all lands outside a producing unit" at the end of the primary term. The appellate court found that although there was no production on the lease at the end of the primary term, the conflicting clauses created an ambiguity in the lease. Construing

unclear provisions against the drafter, the court held that the “producing unit” clause should be narrowly interpreted to apply only when producing units had been established on the lease. The field was not unitized, so the lessor’s clause had no effect and the *habendum* clause controlled. Therefore, because drilling operations had commenced before the expiration of the primary term, the lease did not terminate.

The Schwatkens entered into a three-year oil and gas lease on 2,366 acres with Explorer Resources, Inc. (“Explorer”) on July 18, 2001. The lease, which was drafted almost entirely by Explorer, contained a *habendum* clause in Paragraph 1 that included the following provision:

If, at the expiration of the primary term of this lease, oil or gas is not being produced on the leased premises or on acreage pooled therewith but Lessee is then engaged in drilling, reworking or dewatering operations thereon, then this lease shall continue in force so long as dewatering or drilling operations are being continuously prosecuted on the leased premises or on acreage pooled therewith.

In addition to the lessee-drafted provisions in the lease, the Schwatkens added Paragraph 18, which stated, “It [sic] agreed that at the end of the primary term, this lease shall expire as to all lands located outside of a producing unit.” Explorer’s successor in interest, Quest Cherokee, L.L.C. (“Quest”), did not begin any drilling operations on the lease until ten days before the expiration of the primary term. Quest completed that first well, which produced gas in paying quantities, ten days after the end of the initial three-year term. Quest began drilling a second well on October 4, 2004. On November 23, 2004, the Schwatkens filed suit to cancel the lease. The district court granted Quest’s motion for summary judgment and the Schwatkens appealed.

Although the lessee complied with Paragraph 1 and extended the primary term of the lease by commencing drilling operations before the expiration of the three-year lease, there was no production at the end of the three-year period. Construing the provision’s language against the drafter, the court found that Paragraph 18 did not sufficiently define the “producing unit” it described. The Schwatkens argued that “unit” referred to the land covered by the lease; Quest argued that it understood “unit” in the context of Paragraph 12 pertaining to unitization, the only other provision in the lease that used the term “unit.” Due to the ambiguous meaning of Paragraph 18, the district court sided with Quest’s interpretation as a reasonable lessee that “producing unit” referred to the industry practice of pooling or unitizing lease interests. Because the Schwatken lease was never unitized, Paragraph 18 had no effect.

Affirming the district court, the court of appeals held that although leases are usually construed against the lessee, the lower court correctly

interpreted Paragraph 18 against the lessor as author of that provision. Therefore, that court properly applied a narrow interpretation of “producing unit” and the *habendum* clause in Paragraph 1 controlled. The lease did not terminate at the end of the three-year term because Quest fully complied with the requirements of Paragraph 1.

Geyer Bros. Equip. Co. v. Std. Res., L.L.C., 140 P.3d 563 (Okla. Ct. App. 2006)

The central issue in this case is whether a well operator’s failure to market oil and gas from a well, which is capable of producing gas in paying quantities, for nearly twenty years violates the implied covenant to market because it constitutes an “unreasonable length of time.”

The appellate court concluded that Geyer Brothers Equipment Company (“Geyer”) proved no compelling equitable consideration that justified up to twenty years of failure to produce and market oil and gas from the property. The trial court’s grant of summary judgment to Standard Resources, L.L.C. (“Standard Resources”) was affirmed.

Geyer was designated the operator of a “shut-in” well from November 15, 1984, until it transferred operations to Standard Resources in May 1999. Neither oil nor gas was produced while Geyer operated the well, and no ongoing drilling or reworking operations were taking place when the lease expired in 1999. In 2003 Geyer filed an action asserting ownership of leases over the well. Standard Resources moved for summary judgment, claiming all of Geyer’s leases were expired. Geyer urged that the lack of a pipeline to the leasehold and disputes over who held valid leases be considered equitable considerations justifying extensions of its leases. Neither party disputes that the well was capable of producing gas in paying quantities while Geyer operated it.

The court noted that typical oil and gas leases contain an implied covenant to market the oil and gas. When dealing with an implied covenant to market, “the controlling factual finding is whether or not the temporary cessation of marketing was for an unreasonable length of time.” Furthermore, a lessee may cease marketing for a reasonable amount of time if there are equitable considerations that justify temporary cessation.

The court found the cessation period to be unreasonably lengthy. While the absence of a pipeline to transport product has been considered an equitable consideration in the past, the court distinguished the present case because the operator failed to actively seek a pipeline solution. Geyer did not produce evidence of such efforts here. Furthermore, Geyer took no substantive steps toward resolving the disputes between the various alleged leaseholders or protecting its legal rights.

IV. RECENT DEVELOPMENTS IN INTERNATIONAL LAW

A. Venezuela: Migrating Away from the Apertura Petrolera[†]

JOHN KEFFER* AND MARÍA VICTORIA VARGAS**

Venezuela holds one of the largest hydrocarbon reserves in the world, with proven oil reserves estimated at 215 billion barrels, including heavy and extra-heavy crude, and natural gas reserves of 150 trillion cubic feet (tcf).¹²¹ It is a founding member of OPEC, one of the top world oil producers¹²² and one of the major suppliers of crude to the United States.¹²³ Under the government of President Hugo Chávez, Venezuela has assumed a leading role in the global geopolitics of oil. President Chávez is changing the dynamics for foreign investment in the oil sector in Venezuela, with repercussions already extending beyond its national borders.

[†] First published in *Oil Gas & Energy Law Intelligence (OGEL)*, Volume 4, Issue 4, November 2006.

* John Keffer is a partner in the London office of King & Spalding and an international mergers and acquisitions and corporate lawyer with considerable experience in European and Latin American transactions. He is a member of the firm's Corporate Group and Managing Partner of the London office. Mr. Keffer has substantial experience in structuring, negotiating, and documenting mergers and acquisitions, financings, and other general cross-border transactions. His work includes the drafting and negotiation of joint venture agreements, cross-border acquisition and sales agreements, shareholder agreements, joint bidding and cooperation agreements, and project-related agreements. Much of his experience is related to the energy industry. Mr. Keffer is a native speaker of Spanish, having lived in Venezuela for eleven years, and is also fluent in French and Italian.

** María Victoria Vargas is counsel of the Global Transactions Practice Group of the law firm King & Spalding L.L.P., in its Houston office. She has substantial experience in international energy contracts (oil, gas and power), project finance, mergers, acquisitions, restructurings, and international business transactions in general. Currently she concentrates her practice in advising companies doing business in Latin America, particularly in the hydrocarbons sector. Ms. Vargas obtained her J.D. with honors in 1989 from the Universidad del Rosario (Bogotá, Colombia) and an L.L.M. in 1992 from Harvard Law School. Ms. Vargas is admitted to practice law in the states of Texas and New York and in the Republic of Colombia. She is a Colombian national, fluent in Spanish and English, and a member of the Association of International Petroleum Negotiators (AIPN), of the International Law Section of the Houston Bar Association and of the Colombian Colegio de Abogados de Minas y Petróleos.

121. *Venezuela - Gearing up to face new challenges - Interview with Rafael Ramírez Carreño, Minister of Energy and Petroleum and President of Petróleos de Venezuela (PDVSA)*, SPECIAL REPORT: VENEZUELA A NEW ECONOMIC MODEL (First Magazine 2006).

122. Ranking eighth among the Top World Oil Net Exporters in 2005. U.S. Dep't of Energy, Energy Info. Admin., Top World Oil Net Exporters, 2005, http://www.eia.doe.gov/emeu/cabs/topworldtables1_2.html (last visited Nov. 13, 2006).

123. Accounting for about 11 percent of US oil imports, *General Interest - Quick Takes*, OIL & GAS J., Jul. 24, 2006, and having consistently ranked as one of the top four sources of U.S. imports along with Canada, Mexico, and Saudi Arabia, see U.S. Dep't of Energy, Energy Info. Admin., U.S. Total Crude Oil and Products Imports, http://tonto.eia.doe.gov/dnav/pet/pet_move_impcus_a2_nus_ep00_im0_mbbbl_m.htm (last visited Nov. 13, 2006).

This article analyzes such process of change and discusses the new model that has been adopted.

Background: The *Apertura Petrolera* and the Operating Services Agreements

In the decade of the nineties Venezuela opened the hydrocarbon sector to foreign investment adopting a policy known as the “*Apertura Petrolera*.” Under this policy, the national oil company, Pétroleos de Venezuela S.A. (“PDVSA”), held various international bid rounds awarding risk services contracts known as *Convenios Operativos* (Operating Services Agreements, “OSAs”), as well as several Association Agreements for the development of heavy crude projects, particularly in the Faja del Orinoco region, and some Profit Sharing Agreements.

The OSAs are risk service contracts where the contractors are given the exclusive right to provide exploration, development, and production services to PDVSA¹²⁴ within a given area. The contractor in an OSA (“OSA Contractor”) assumes all the risks and costs of the operations and is subject to certain minimum work commitments, having to comply with reporting and approval requirements, yet enjoying relative control of the operations. In consideration for its services the OSA Contractor receives a fee in cash, which is calculated pursuant to formulas that take into account (i) the costs of operating the baseline production, (ii) the net value of the incremental production, and (iii) certain chargeable expenditures specifically identified in the accounting procedures. The OSA Contractor also receives a direct reimbursement of certain advances made to acquire goods and services for the operations. All hydrocarbons produced must be delivered to PDVSA,¹²⁵ which holds all title, rights, and interests therein. According to the terms of the OSAs, all applicable royalties on the production should be paid by PDVSA.¹²⁶

The 2001 Organic Law of Hydrocarbons

Under the government of President Hugo Chávez a new hydrocarbons law was issued: the *Decreto con Fuerza de Ley Orgánica de Hidrocarburos* (Decree with Force of Organic Law of Hydrocarbons, “OLH”).¹²⁷ The OLH reasserts that all hydrocarbon reservoirs in the national territory of Venezuela, including those under the territorial seabed, the continental shelf, the exclusive economic zone, and within the national borders

124. Or in some cases to a PDVSA wholly-owned affiliate.

125. Or the relevant PDVSA wholly-owned affiliate.

126. Or the relevant PDVSA wholly-owned affiliate.

127. Decree No. 1,510, Official Gazette No. 37,323, Nov. 2, 2001.

belong to Venezuela, and are of public domain, inalienable, and not subject to adverse possession.¹²⁸

The OLH establishes that the activities related to the exploration, extraction, gathering, transportation, and initial storage of hydrocarbons (collectively defined as the “Primary Activities”) can only be carried out by the State directly, or indirectly through wholly-owned State companies, or through *Empresas Mixtas* (Mixed Companies, “MCs”),¹²⁹ which are controlled and more than 50 percent owned by the State. The OLH also provides that commercialization and export of hydrocarbons can only be undertaken by wholly-owned State companies.¹³⁰

The OLH vs. the OSAs

The issuance of the OLH gave place to a debate around the survival and legality of the preexisting OSAs. According to the Civil Code of Venezuela, which is consistent with the principles of application of the law embedded in the Civil Law Systems, the laws do not have retroactive effect¹³¹ and cannot affect previously acquired rights. Further, such principles prescribe that contracts are governed by the laws in effect at the time they are executed, and that duly executed contracts are a law for the parties. These principles are essential to preserve the legal stability and certainty required to conduct any business and particularly to undertake investments in the oil sector. However, the government adopted the position that the OSAs were illegal because privately owned oil companies were carrying out Primary Activities, which, according to the OLH, were now reserved for the State, wholly-owned State companies, or MCs.¹³²

In April 12, 2005, the Ministry of Energy and Petroleum (“MEP”) announced that the OSAs were illegal and notified the OSA Contractors that they had to migrate into MCs.¹³³ In October 2005 the MEP created Transitory Executive Committees charged with the task of planning the activities to be performed under each OSA area for the year 2006 and to coordinate the conversion into MCs. On November 4, 2005, the MEP issued further instructions indicating that the OSAs were in violation of the OLH, not binding, and should cease to exist by March 31, 2006.¹³⁴ In light of the foregoing, in December 2005 the OSA Contractors entered into so-called Transitory Agreements with PDVSA Pétroleo S.A. (a wholly-owned PDVSA affiliate, “PPSA”), which, among others, included a

128. OLH, Art. 1.

129. OLH, Art. 9 and 22.

130. OLH, Art. 27, 56, and 57.

131. CIVIL CODE OF VENEZUELA, Art. 3.

132. *Gobierno se Propone Refundar la Nacionalización Petrolera*, EL NACIONAL (Caracas) March 20, 2006.

133. *Id.*

134. *Id.*

commitment by the OSA Contractors to pay all amounts due to the Venezuelan tax authorities (*Servicio Nacional Integrado de Administración Aduanera y Tributaria - SENIAT*) and set forth the 31st of March 2006 as the deadline for the parties to reach mutual agreement on the documents required to complete the conversion process, in the understanding that any agreement would be subject to the approval of the National Assembly of Venezuela.¹³⁵

The Negotiation Process

Upon execution of the Transitory Agreements, negotiations regarding the terms and conditions for the migration into MCs began between each OSA Contractor and the government (with the participation of the MEP, PDVSA, PPSA, and the Corporación Venezolana del Petróleo S.A., another PDVSA affiliate, "CVP"). The negotiations were challenging given the need to migrate the OSA Contractors business from a sole operation to one controlled by the State. The documents being negotiated ("Conversion Documents") included the Contract for Conversion into a MC ("Conversion Contract"), the MC's Charter and Bylaws, the MC's Business Plan, Policies and Procedures, and the contract for the sale of hydrocarbons between the MC and PDVSA ("Hydrocarbons Sale Contract").¹³⁶ The negotiations were further complicated by the fact that the MEP was negotiating simultaneously with all OSA Contractors.

After a lengthy negotiation process, on the evening of the 31st of March 2006, each of the OSA Contractors, with few exceptions,¹³⁷ signed a Memorandum of Understanding ("MOU") with CVP and PPSA. Pursuant to the MOUs the OSA Contractors and CVP essentially agreed to form a MC for each OSA, which would carry out the Primary Activities within the former OSA area.

Upon execution of the MOUs, pursuant to the Law of Regularization of Private Participation in the Primary Activities (the "Regularization Law"),¹³⁸ the National Assembly established that the OSAs were extinguished effective April 18, 2006, and could no longer be performed. The Regularization Law further provides that in the future no new contract can grant participation in Primary Activities to any private individual or legal entity, except in the capacity as minority shareholder in a MC.

135. *Id.*

136. National Assembly Accord approving the Model Contract for Conversion Into Mixed Company, Official Gazette No. 38,410, Mar. 31, 2006.

137. The most notable being the French oil company Total and the Italian oil company ENI. Natalie Obiko Pearson, *Venezuela Snatches Total, Eni Oil Fields*, HOUSTON CHRON., April 4, 2006.

138. Ley de Regularización de la Participación Privada en las Actividades Primarias Previstas en el Decreto No. 1,510 con Fuerza de Ley Orgánica de Hidrocarburos, Official Gazette No. 38,419, Apr., 18, 2006.

MCs: The New Model

The terms and conditions for the creation of the MCs and its operations were approved by the National Assembly pursuant to an Accord published in the Official Gazette on the 31st of March 2006.¹³⁹ Such Accord also approved the Model Form of the Conversion Contract and Model Form of Charter and Bylaws. Subsequently, the legal procedures for the creation of the MCs and their general legal framework were established pursuant to an amendment to the OLH published in the Official Gazette on May 24, 2006.¹⁴⁰ The main characteristics of the MCs as approved by the National Assembly¹⁴¹ are discussed below.

Corporate Purpose and Activities. The main purpose of the MC is to conduct Primary Activities within a given area designated by the MEP (the "Designated Area"). The right to conduct such activities is granted to each MC pursuant to a Decree of the National Executive ("Transfer Decree"). The MC may also render services to other MCs, to State-owned companies or to other companies without detriment to the performance of the Primary Activities. It cannot, however, render petroleum services to third parties outside the Designated Area and cannot transfer technology to third parties. The MC acts as operator within the Designated Area and must sell to PDVSA, or to an affiliate designated by PDVSA, all the hydrocarbons produced and not used in its own operations, except for (i) those taken by the State as royalty in kind (if any) and (ii) any associated natural gas that PDVSA refuses to receive. Payments for hydrocarbons delivered under the Hydrocarbons Sales Contract must be in U.S. dollars, except for methane gas, which will be paid in bolivars.

Term of Duration. According to the OLH, the maximum term of duration of the MCs is twenty-five years, but can be extended by mutual agreement for up to fifteen more years. However, the conditions approved by the National Assembly on March 31, 2006, provide for only a twenty year term of duration. The MC can lose its right to conduct Primary Activities in the Designated Area if the Transfer Decree is revoked by the National Executive, which may happen if the MC fails to comply with its obligations in a way that prevents the fulfillment of the objective for which the rights were transferred.

Capital Structure. The capital of the MC is divided into Class A shares and Class B shares. Class A shares correspond to the State and are owned

139. Official Gazette No. 38.410, Mar. 31, 2006.

140. Law of Partial Amendment to the Decree No. 1510 with Force of Organic Law of Hydrocarbons, Art. 3, Official Gazette No. 38.443, May 24, 2006.

141. Model Contract for Conversion Into Mixed Company and Model Form of Charter and Bylaws of Mixed Companies approved by the National Assembly, Official Gazette No. 38.410, Mar. 31, 2006.

by CVP, and Class B shares are owned by the former OSA Contractors. By mandate of the OLH, the State, directly or through wholly-owned State companies, must always own more than 50 percent of the capital of the MC. The transfer or encumbrance of shares, or of any rights or interests pertaining to the capacity as shareholder of the MC, is subject to prior approval of the MEP, except for transfers to affiliates wholly-owned by the ultimate parent company of the transferor. In addition, the transfer of Class B shares is subject to a right of first refusal in favor of the Class A shareholder, and a second tier right of first refusal in favor of other Class B shareholders (if any), except when the transferee is an affiliate wholly-owned by the ultimate parent company of the transferor.

Changes of Control of the Class B Shareholder. Changes of control of the Class B shareholder are subject to prior approval by the MEP. If a change of control takes place without such approval, all the shares owned by the Class B shareholder must be transferred to CVP at no cost. If the change of control results from a purchase of the shares of the ultimate parent company, or from a transaction involving other substantial assets of the ultimate parent company or any of its affiliates and the MEP's prior approval is not obtained, the voting rights of the Class B shares are suspended and the Class B shareholder has twelve months to sell its shares, with prior MEP approval, to a third party not affiliated with the new ultimate parent company. If the shares have not been transferred within twelve months, CVP has the right to acquire all the shares at a price equal to the average of the valuations by two independent experts, one appointed by CVP and the other by the Class B shareholder. If a party has not appointed its expert within thirty days, the MEP makes such appointment. If the valuations of the experts differ by more than 15 percent, either party is entitled to request new valuations from two new independent experts, and this process continues until the parties agree on a price or until valuations not differing by more than 15 percent are obtained. However, CVP has no obligation to accept the valuations and the transfer of the shares, in which case the suspension of rights of the Class B shares continues.

Corporate Governance. The highest governing body in the MC is the Shareholders Meeting, formed by one representative of each shareholder with no distinction of Class. The quorum requirement for a valid meeting is a representation of at least 50 percent of the capital. Decisions are subject to either a simple majority of more than 50 percent of the capital or a qualified majority of at least 3/4 of the capital, depending on the subject matter. By mandate of the OLH the State ownership is always of at least more than 50 percent, therefore, it was agreed that matters of paramount importance would be subject to qualified majority to protect the rights of the OSA Contractors. Such paramount matters include: (i) bylaw

amendments, (ii) increase or decrease of capital altering the participation percentages of the shareholders, (iii) merger, consolidation, or any similar business combinations or spin-offs, (iv) liquidation or early dissolution, (v) sale of all or a substantial part of the assets, (vi) financings exceeding a certain threshold, (vii) approval or amendment of the financial statements, (viii) creation of reserves (other than the mandatory legal reserve), (ix) amendments to the Business Plan, (x) amendment or termination of the Hydrocarbons Sale Contract, (xi) approval of any agreements with a shareholder or any shareholder affiliate that is not at market prices, (xii) distribution of dividends, (xiii) reimbursement of capital or premium in the subscription of shares, and (xiv) changes to the dividend distribution policy.

The direction and management of the MC corresponds to the Board of Directors which is formed by five members, three appointed by the Class A shareholder and two appointed by the Class B shareholder. Each member has an alternate designated by the same appointing shareholder. The term of office of the directors and alternates is three years. A valid meeting of the Board of Directors requires the attendance of at least four members, but if no quorum is reached, a second meeting is called, which may validly meet with at least three members. The decisions of the Board of Directors require the favorable vote of at least three members, except when dealing with matters subject to qualified majority by the Shareholders Meeting, in which case the votes of four members are required.

The day to day management of the MC corresponds to the General Manager and other management personnel (Technical and Operations Manager, Human Resources Manager, Management and Finance Manager, etc.). The General Manager is appointed by the Class A shareholder and the Technical and Operations Manager by the Class B shareholder. The Class B shareholder has the right to appoint a percentage of the management equal to its capital participation; however, the appointment of all management personnel is subject to prior approval of CVP.

Business Plan, Work Programs, and Budgets. The MC will carry out its activities according to a Business Plan agreed to by CVP and the former OSA Contractor. Any changes to the Business Plan are subject to qualified majority approval of the Shareholders Meeting. All Work Programs and Budgets of the MC must be consistent with the Business Plan and approved by simple majority of the Shareholders Meeting. Funding of the MC operations by the shareholders must be in proportion to their capital participation and according to the approved Business Plan, Work Programs, and Budgets. Such funding can take the form of capital contributions and shareholder loans. If a shareholder fails to meet its funding obligations, the other shareholder has the right to deliver such contribution or loan on behalf of the defaulting shareholder, which has 120 days to re-

imburse the amount plus interest (at a rate stipulated in the Conversion Contract). The defaulting shareholder cannot receive any distributions from the MC while in default until payment of the total amount due to the curing shareholder. Any such distributions are delivered to the curing shareholder and credited against the amount due. When the defaulting shareholder is the former OSA Contractor and CVP is the curing shareholder, if the amounts due are not paid back to CVP within the 120 day term, CVP (provided it has met its own funding obligations) has the option to (i) demand the reimbursement of the amounts due or (ii) to acquire a number of Class B shares owned by the defaulting shareholder, as necessary to offset the total amount due. For this purpose the value of the shares is determined pursuant to the same valuation procedure applicable to changes of control (described above). Any Class B shares so acquired by CVP are automatically converted into Class A shares of the MC.

Sole Risk Operations. Only CVP (or a CVP designated affiliate) has the right to carry out sole risk operations in the Designated Area. In such case the MC acts as operator and CVP (or the CVP designated affiliate) assumes all risks, costs, and benefits. Neither the MC nor the former OSA Contractor receives any benefit from the sole risk venture, but the MC is entitled to compensation for the services rendered as operator. The sole risk project cannot interfere with the MC's petroleum operations, and CVP (or the CVP designated affiliate) must indemnify the MC for any losses, costs, damages, or liabilities resulting from the sole risk project and must keep the Designated Area free and clear from encumbrances related or resulting therefrom.

Policies and Procedures, Personnel and Technology. The MC shall conduct its operations according to Policies and Procedures that, to the extent possible, must be consistent with the policies and procedures of PDVSA and the ultimate parent company of the former OSA Contractor. Such Policies and Procedures shall cover areas such as human resources, health, safety and the environment, banking, finances, and treasury. Under the Conversion Contract the former OSA Contractor has a best-efforts obligation to transfer or assign to the MC the personnel employed under the relevant OSA, at the cost of the MC. In addition, the former OSA Contractor must provide technical training to the MC's personnel for the first two years of operations, assuming all training costs up to an amount set forth in the Conversion Contract. The Conversion Contract also requires that the former OSA Contractor make available to the MC, at no cost, the right to use proprietary technologies utilized for operations in the Designated Area, to the extent legally possible.

Exchange Rights and Access to Foreign Currency. The MC has the right to open and maintain bank accounts abroad and is entitled to use the U.S. currency it receives to pay obligations outside of the territory of

Venezuela, including payments for equipment acquired abroad, debt service, contractor's fees, payments to suppliers, and payments of dividends, premiums, capital reductions, and other amounts to its shareholders.

Geological and Other Technical Information. All geological, geophysical, and any other technical information obtained by the MC in the performance of its activities within the Designated Area belongs to the State. The MC only has the right to use it to conduct operations in the Designated Area and must return to the MEP all documents containing such information upon termination of the right to conduct Primary Activities.

Taxes, Royalties, and "Special Advantages." The MCs must pay all applicable royalties and taxes according to the applicable law. In addition, the MCs are subject to some additional charges payable to the State, which are called "Special Advantages."¹⁴² Such "Special Advantages" are: (i) an additional royalty of 3.33 percent on the volumes of hydrocarbons extracted from the Designated Area and (ii) an amount equal to the difference, if any, between (a) 50 percent of the value of the hydrocarbons extracted from the Designated Area during each calendar year and (b) the total amount of payments made by the MC to the State for royalties, income tax and any other taxes or charges calculated on the income (gross and net) of the MC, and the mandatory investments in development projects.

Mandatory Investments in Development Projects. The MCs must develop and put in place a policy of endogenous development based on the principles set forth in the National Development Plan of Venezuela and must carry out a social investment plan approved by the National Executive. The MC must invest in such plans each year a minimum of one percent of its profits before taxes as determined in the financial statements of the previous calendar year.

Cancellation of the OSAs

The Conversion Contract provides for the automatic cancellation of the relevant OSA upon the "Closing Date," which is the date when the former OSA Contractor and CVP must make certain cash contributions to the MC and transfer to the MC the assets, contracts, and permits related to the OSA operations.¹⁴³ Upon cancellation of the OSA the former OSA Contractor has no right to any payment or compensation thereunder except for certain amounts due for the first quarter of 2006. Moreover, the former OSA Contractor has the obligation to indemnify and

142. OLH Article 36 and Accord of the National Assembly published on the Official Gazette on March 31, 2006.

143. The actual closing date will be set by CVP within ten days from the date of publication of the Transfer Decree in the Official Gazette, and notified to the former OSA Contractor at least five days in advance.

hold harmless the State, the MC, PDVSA, PPSA, CVP, and their affiliates from and against any liability, damage, or loss related to OSA operations, except for those attributable to PPSA or resulting from circumstances or activities prior to the OSA execution date. The MC does not assume any liability for the activities, acts, or omissions of the former OSA Contractor in connection with the OSA, including without limitation labor liabilities.

Governing Law and Jurisdiction

The Conversion Contract, the MC's Charter and Bylaws, the Hydrocarbons Sale Contract and all Conversion Documents are governed by Venezuelan law, and all disputes are subject to the exclusive jurisdiction of the competent tribunals and courts of Venezuela.

Closing Comments

As of this date many OSA Contractors¹⁴⁴ have already finalized and executed the Conversion Documents, marking the beginning of a new era and of a new model for the development of upstream activities in Venezuela. The government has already announced that a similar migration process will be launched for the Special Associations operating the heavy crude and extra heavy crude fields in the Orinoco Faja. Whether this model turns out to be sustainable in the long term and a positive venture for stakeholders is yet to be seen.

144. Among the OSA Contractors that have already executed Conversion Documents are Chevron (U.S.), Perenco (France), Lundin (Sweden), Tecpetrol (Argentina), BP (UK), Repsol YPF (Spain) and Petrobras (Brazil). Further, according to the most recent information available on PDVSA's website on 9/27/06, thirteen (13) MCs had already been incorporated as of August 13, 2006. PDVSA – Petróleos de Venezuela S.A., www.pdvsa.com (last visited Nov. 13, 2006).

B. Libya: Recent Developments Impacting Foreign Investment

MARTIN HUNT,* FERAS GADAMSI,** AND TAREK M. ELTUMI***

With 39.1 billion barrels in proven reserves,¹⁴⁵ Libya is the country with the ninth-largest proven oil reserves, and its oil industry remains the country's biggest draw for foreign investors. Libya is a major producer of light crude oil, the kind favored by oil refineries because of its low wax content and ease of transportation and refining. For U.S. companies, the race to Libya started slowly, not only because of slower than anticipated developments politically, but also because of the head start that many European counterparts had before the U.S. fully normalized relations with the former pariah state. In fact, full normalization of relations did not occur until May 2006, when the United States announced its intention to restore full diplomatic relations by establishing an embassy in Tripoli and removing Libya from the State Department's list of designated state sponsors of terrorism.¹⁴⁶

For those who have never visited Libya before, reminders of its status as a third-world nation abound. There is only one Western-standard, five-star hotel in Tripoli, the capital, and visas to the country can be difficult to obtain without an official invitation from the government. Libya also has an extreme shortage of office space and skilled

* Martin Hunt is a partner in the international section of Bracewell & Giuliani LLP. He is an English solicitor and is also qualified as a New York lawyer and a Texas lawyer. Most of his practice relates to the energy industry and he is based in New York and London. Mr. Hunt can be contacted at Martin.Hunt@bgllp.com.

** Feras Gadamsi is an associate at Bracewell & Giuliani. Mr. Gadamsi represents energy companies, financial institutions, and private investors in financial transactions and a variety of other commercial transactions, with an emphasis on the energy industry. Mr. Gadamsi is a U.S.-born attorney of Libyan descent who attended Georgetown University Law Center (J.D.) and Southern Methodist University (B.S.E.E.). Mr. Gadamsi can be contacted at Feras.Gadamsi@bgllp.com.

*** Tarek Eltumi is currently practicing as an associate attorney at the offices of Tumi Law Firm in Tripoli, Libya. His main practice areas are oil and gas law, banking and finance law as well as general commercial law. Mr. Eltumi acts for several multinational companies with operations in several business sectors in Libya, such as the oil industry, telecommunications, aviation and pharmaceuticals. Mr. Eltumi was educated in the UK, where he was awarded an L.L.B. (Hons) in Law from the University of Essex, followed by an LLM in Corporate and Commercial Law (with Merit) from the University of London UK. He is fluent in Arabic and in English. Mr. Eltumi can be reached at teltumi@tumilawfirm.com.

145. U.S. DEP'T OF ENERGY, ENERGY INFO. ADMIN., WORLD PROVED RESERVES OF OIL AND NATURAL GAS, MOST RECENT ESTIMATES (2006), <http://www.eia.doe.gov/emeu/nternational/reserves.html> (last visited Nov. 12, 2006).

146. Press Release, U.S. State Dep't, U.S. Diplomatic Relations with Libya (May 15, 2006), <http://www.state.gov/secretary/rm/2006/66235.htm>. On June 30, 2006, the United States rescinded Libya's designation as a state sponsor of terrorism.

workers, with unemployment figures reportedly at least 15 percent¹⁴⁷ in 2005 and as high as 30 percent in 2004 according to the CIA World Factbook.¹⁴⁸ However, for those who have regularly visited Libya, even before sanctions began to be lifted in 2003 and especially since, dramatic changes have occurred not only with respect to a wider availability of goods and services, but also a deep penetration of modern technology. This paradox of underdevelopment juxtaposed against advanced technology is a direct result of the sanctions under which Libya lived throughout the 1990s and part of the current decade.

One example of the great changes is Libya's telecommunications industry, headed by one of Colonel Muammar Gaddafi's sons, Mohammed Gaddafi. Libya skipped over landlines almost entirely and moved into the wireless and fiber-optic world. In fact, Libya's mobile phone subscriber rate in 2005 was the highest in a study of eighteen Arab nations conducted by Dubai-based Madar Research.¹⁴⁹ Libya even outdoes the United Arab Emirates¹⁵⁰ by boasting two competing state-owned modern mobile phone networks, Libyana, which recently introduced 3G technology to the country, and Almadar. These companies are both owned by the Libyan General Post and Telecommunication Company¹⁵¹, but they compete against each other for customers by providing different pricing schemes and coverage areas.

However, despite opportunities in industries such as telecommunications, Libya's real cash cow remains its oil industry, which accounts for 95 percent of its export revenues.¹⁵² The good news for potential investors in Libya is that recent developments in this sector will greatly improve the opportunities for profitable investments and successful operations in the country.

First, Libya's National Oil Company ("NOC")¹⁵³ changed leadership with Dr. Shokri Ghanem, formerly Libya's prime minister,¹⁵⁴ taking over

147. *Libya faces the problem of escalated unemployment*, ARABICNEWS.COM, April 18, 2005, <http://www.arabicnews.com/ansub/Daily/Day/050418/2005041827.html> (last visited Nov. 12, 2006).

148. CIA, THE WORLD FACTBOOK (2006), available at <https://www.cia.gov/cia/publications/factbook/geos/ly.html>.

149. *Mobile phone use by Arabs up 70 percent in '05*, GULF TIMES, July 30, 2006, available at http://www.gulftimes.com/site/topics/article.asp?cu_no=2&item_no=99911&version=1&template_id=48&parent_id=28.

150. Currently, the UAE has only one mobile phone network—state-owned Etisalat. A second private phone network, Du, is scheduled to begin providing services in early 2007.

151. Summit Communications, *Libya Steps Into Interconnected Age*, N.Y. TIMES, Special Advertising Section (2006), <http://www.nytimes.com/global/libya/seven.html> (last visited Nov. 12, 2006).

152. CIA, THE WORLD FACTBOOK (2006), available at <https://www.cia.gov/cia/publications/factbook/geos/ly.html>.

153. National Oil Corporation – home, <http://en.noclibya.com.ly/> (Last visited Nov. 12, 2006).

as chairman of the NOC in March 2006. Dr. Ghanem, a graduate of Tufts University's Fletcher School of Law and Diplomacy, is considered progressive and has aggressively moved to restore credibility to the NOC in his bid to increase Libya's oil production to three million barrels a day by 2015.

Dr. Ghanem was one of the strongest advocates of the Exploration and Production Sharing Agreement ("EPSA IV")¹⁵⁵ bid round system which is currently in place, and it, along with resolving the lifting of sanctions, is considered one of his greatest achievements as prime minister. Now, as head of the NOC, Dr. Ghanem continues to champion the need "for transparency and fair competition by both local and foreign companies"¹⁵⁶ during Libya's EPSA IV licensing bid rounds. The NOC website¹⁵⁷ is part of a wider government initiative, also started by Dr. Ghanem during his premiership, which gives all Libyan governmental ministries a regularly updated presence on the Internet. The website is just one of the small but effective ways in which Dr. Ghanem has tried to emphasize this point through continuously updated and free-flowing access to information.

Second, there has been the creation of the Oil and Gas Council in September 2006, now known as the Higher Council for Oil and Gas ("Council"). The Council was established by General People's Committee¹⁵⁸ ("GPC") Decision No. 211/2006, giving the Council the role of monitoring, maintaining, developing, and protecting the Libyan oil and gas sector for the benefit of the country, as well as giving it a supervisory role over the NOC with respect to financial, organizational, and other such issues affecting the NOC. This decision was later amended in November 2006 (GPC Decision No. 250/2006), changing the name of the Council, and further clarifying and delineating the role of the NOC by giving it the most flexibility to address concerns over time.

The Council's creation marks a major shift in Libya's oil and gas policy. It is hoped that the Council will streamline the work of the NOC, de-

154. The title of prime minister in Libya is also known as the General Secretary of the People's Committee.

155. Libya has used EPSAs to replace concessions as the means of awarding petroleum rights and to help define the terms between the NOC and foreign oil companies under which these companies conduct exploration and production within the country. The first EPSA, EPSA I, was introduced in 1974 and was followed by EPSA II in 1980-81 and EPSA III in 1988 (which was updated in 1999). EPSA IV, based on the public bidding approach, was introduced while Dr. Ghanem was prime minister. See Dimitri Massaras, *Evolution of Libyan Petroleum Exploration and Production Contracts*, in *DOING BUSINESS WITH LIBYA*, (Jonathan Wallace ed., 2004).

156. *Ghanem: Transparency, Fair Competition Needed in Oil Business*, TRIPOLI POST, Nov. 5, 2006, available at <http://www.tripolipost.com/article/detail.asp?c=2&i=398>.

157. National Oil Corporation - home, *supra* note 153.

158. The General People's Committee (GPC) is composed of secretaries of Libyan ministries and serve as Libya's cabinet which interprets laws passed by the General People's Congress, Libya's legislative body.

spite the fact that the November 2006 decision seems to limit the Council's role further than originally anticipated. Ultimately, it is hoped that the Council's creation will ensure a higher standard of efficiency and commercial benefit to the country's oil and gas industry. Those benefits, if realized, should help foreign investors, since regulations affecting the oil and gas sector can be passed more easily, allowing for prudent changes related to exploration, production, and management to be made quickly.

Third, there has been the NOC's selection and subsequent announcement in September 2006 of the finalists chosen for the third round of EPSA IV license bids for exploration and production blocks. Seven U.S.-based oil exploration companies, including four Texas-based firms—ExxonMobil, ConocoPhillips, Marathon, and Pioneer Natural Resources—made the cut of forty-seven finalists from an original list of seventy bidders that submitted proposals in late August. The finalists are bidding for the exploration rights to forty-one blocks, which are expected to yield highly profitable oil discoveries. The forty-seven finalists will submit bids in a sealed envelope by hand on December 20, 2006, with final winners expected to be announced in January 2007.

But have these exciting developments been matched by appropriate developments in the legal framework in Libya? In 2006 there have been some important legal developments related to foreign investment in Libya. One of the biggest developments relates to another GPC decision¹⁵⁹ passed earlier this year. This decision cuts the minimum investment under Libya's Foreign Investment Laws Nos. 5¹⁶⁰ and 7¹⁶¹ from \$50 million to a much more manageable and risk-averse LYD 5 million (approximately \$3.8 million). This minimum investment capital is further reduced to LYD 2 million (approximately \$1.5 million) where the investment is a fifty-fifty partnership between a foreigner and a Libyan national. Furthermore, a foreign investor may now borrow up to 50 percent of its investment capital from local Libyan banks.

The reduction in minimum start-up capital for foreign investors and the ability to borrow at least half of the capital from Libyan banks has had the obvious effect of encouraging more foreign investment in a country that has been closed to such investment from the United States for more than fifteen years. Because of the political and investment risks involved, Libya's previous minimum capital investment hindered smaller investors from entering the marketplace. The reduction has spurred in-

159. GPC Decision No. 86/2006 Regarding the Amendment of Certain Provisions of the Executive Regulation to Law No. 5/1997.

160. Law No. 5 for the Year 1997 Concerning Encouragement of Foreign Capitals Investment, available at <http://www.cbl-ly.com/eleg31.htm>.

161. Law No. 7 of 1371 PD (2003), available at <http://www.investinlibya.com/Files/Law%20No%205%20&%20Executive%20English.doc>.

vestment in 2006, effectively breathing new life into the Libyan foreign investment sector. The Libyan government estimates that, so far, there has been approximately LYD 4 billion (approximately \$3.06 billion USD) of foreign investment in Libya since 1997. The lowering of investment hurdles will undoubtedly increase that number in 2007.

Another significant change relates to foreign ownership of Libyan companies. In July 2006 the GPC passed a decision¹⁶² providing for the creation of a new type of Libyan company. Called a *Mushtarika*, this type of company allows foreigners, for the first time, to participate in up to 65 percent of the shareholding of the company, thereby allowing the foreign entity to maintain control of the company. Furthermore, the board of directors may be comprised of a majority of foreign directors. The new company organization contrasts sharply with the old Joint Stock Companies, in which foreigners could only own a maximum of 49 percent of the shares and the board of directors was required to include a majority of Libyan directors. This marks a major change in the way foreigners can do business in Libya.

The *Mushtarika* company can be established to carry out any unified activity (as opposed to a plurality of activities), except for retail, wholesale, and import activities. Therefore, it should be possible to establish a *Mushtarika* company as, for example, an oil services company. The minimum capital of a *Mushtarika* company is LYD 1 million (approximately \$768,000), at least a third of which must be fully paid up upon incorporation, with the remainder being paid within five years of incorporation. The Company Registration Department at the Ministry of Economy is due to start accepting registration applications for *Mushtarika* companies from January 1, 2007. *Mushtarika* companies, however, may not carry out exploration and production activities. That type of activity is generally carried out under the framework of the EPSA IV agreements with the NOC. The general practice for U.S. companies such as ChevronTexaco and ConocoPhillips has been to set up a branch office pursuant to Law No. 65/1970, GPC Decision No. 3/2005 and GPC Decision No. 13/2005. This branch office is an extension of the foreign company in Libya (rather than a stand-alone Libyan entity) and is permitted to carry out only those activities contained in the law (namely GPC Decision No. 13/2005). Permitted activities that relate to the oil sector include: exploration for oil, drilling and maintenance of oil wells, and geological studies.

There are still many hurdles for U.S. investors going into Libya. It is not easy to enter the country, with visas taking months to obtain, and many allegations of corruption are still made. Additionally, Libyans are

162. GPC Decision No. 171/2006 Regarding the Executive Regulation to Law No. 21/2001 Regarding Commercial Activities As Amended by Law No. 1/2003.

still trying to overcome the gap between the country's desire to open up to foreign investment and the isolationist thinking that prevailed before sanctions were lifted. Libya has attempted to ease some of those concerns by passing laws that make it easier for investors to enter the market. In the oil and gas sector, the NOC has introduced public bidding for exploration and production rights through EPSA IV to make the process fairer and more transparent than ever before in an effort to restore confidence and credibility to the Libyan oil and gas sector. It is hoped that with the passage of each new Libyan law related to the commercial sector, U.S. investors will see that the direction Libya is taking is one toward an environment in which foreign investors can be more confident that the law will uphold their rights.