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Wyoming Oil and Gas Update

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WYOMING OIL AND GAS UPDATE



By Walter F. Eggers, III, & Deanna (Sami) Falzone¹

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I. BACKGROUND

Operators drilled 1,522 oil and gas wells in Wyoming in 2011, and the average monthly rig count during the year was forty nine.² In 2011, around 38,910 producing wells were active in the state with approximately 10,618 producing oil and approximately 28,292 producing

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2. *Oil & Gas Facts*, PETROLEUM ASS'N OF WYO. (PAW), <http://www.pawyo.org/facts-figures.pdf> (last visited Feb. 18, 2013).

gas.³ Of the 28,292 gas wells, 15,210 produced coal bed methane (“CBM”) gas.⁴ In 2011, 54.1 million barrels of crude oil production were sold, which was a 1.8% increase from the previous year.⁵ Natural gas sales, including sales of carbon dioxide (“CO₂”), totaled 2,143 trillion cubic feet, which represented a decrease of 14.9% from 2011.⁶

Wyoming ranked third in the nation in natural gas production in 2011 and eighth in crude oil production.⁷ Oil and gas production generated over \$633 million in Wyoming state severance taxes in 2011, which was about 65% of the total severance taxes paid for mineral production during the year.⁸

II. WYOMING SUPREME COURT CASES

A. Bowers Oil & Gas, Inc. v. DCP Douglas, LLC⁹

In 2004, oil and gas producer Bowers Oil and Gas, Inc. (“Bowers”) and midstream services provider Kinder Morgan Operating, L.P. (“Kinder Morgan”) entered into a gas purchase contract under which Kinder Morgan agreed to purchase CBM from Bowers.¹⁰ The contract included an “Economic Conditions” termination clause, which provided that either party could unilaterally terminate the contract if the party determined, in its “sole opinion,” that the sale or purchase of gas had become unprofitable or uneconomical.¹¹ After the contract was entered, Kinder Morgan sold its gas gathering and pipeline system and transferred its interests in the Bowers contract to MEG Wyoming Gas Service, LLC (“MEG”).¹²

In 2006, Bowers shut-in its wells due to expansion activities of a neighboring coal mine.¹³ Around the same time and also due to mine expansion, MEG removed and relocated its gathering lines.¹⁴ When Bowers was ready to bring its wells back on production in 2007, it requested that it be reconnected to MEG’s pipeline system.¹⁵ MEG responded that the lines had been decommissioned and refused to relocate the lines to reconnect Bowers.¹⁶ Shortly thereafter, DCP Douglas, LLC (“DCP”) acquired MEG.¹⁷

3. *Id.*

4. *Id.*

5. *Id.*

6. *Id.*

7. *Id.*

8. *Id.*

9. Bowers Oil & Gas, Inc. v. DCP Douglas, LLC, 281 P.3d 734 (Wyo. 2012).

10. *Id.* at 736.

11. *Id.*

12. *Id.* at 737.

13. *Id.* at 737–38.

14. *Id.* at 738.

15. *Id.* at 739.

16. *Id.*

17. *Id.* at 740.

Bowers sent a letter to DCP and Kinder Morgan in 2008 asserting breach of contract and demanding damages in excess of \$1.7 million.¹⁸ In response, DCP notified Bowers that it was terminating the gas purchase contract based on the Economic Conditions termination clause.¹⁹

In 2009, Bowers filed suit against Kinder Morgan and DCP claiming breach of contract and breach of the covenant of good faith and fair dealing.²⁰ At the conclusion of a bench trial in 2011, the trial court determined there was no breach of contract or covenant, and it ruled in Kinder Morgan's and DCP's favor.²¹ Bowers appealed the trial court's judgment to the Wyoming Supreme Court.²²

On appeal, Bowers argued that DCP and Kinder Morgan could not rely on the Economic Conditions clause because it was MEG's voluntary decommissioning of the pipeline system that led to the economic conditions.²³ The Wyoming Supreme Court disagreed.²⁴ It held that MEG properly refused to relocate its lines to reconnect Bowers and that DCP properly terminated the agreement because it found, in its "sole opinion," that it was no longer economical to purchase gas from Bowers.²⁵ The Court rejected Bowers's argument that the Economic Conditions termination clause should not apply because MEG's own actions caused the economic conditions.²⁶ Analyzing the contract, the Court found no duty on the part of DCP or its predecessors to maintain the pipeline connection.²⁷

The Court also rejected Bowers's breach of covenant claim because Bowers had no reasonable expectation that DCP and its predecessors would maintain the pipeline system and connection to Bowers at any costs.²⁸

B. Exxon Mobil Corp. v. Department of Revenue²⁹

In 2009, the Wyoming Supreme Court considered the point of valuation of sour natural gas production for state mineral tax purposes.³⁰ There were three possible points of valuation at issue in the case: (1) the meter at each wellhead; (2) the inlet to a facility located downstream from the well meters; or (3) the outlet of the facility.³¹ The

18. *Id.*

19. *Id.*

20. *Id.* at 741.

21. *Id.* at 736.

22. *Id.*

23. *Id.* at 740–42.

24. *Id.* at 742–43.

25. *Id.* at 743.

26. *Id.*

27. *Id.*

28. *Id.* at 743–44.

29. *Exxon Mobil Corp. v. Wyo. Dep't of Revenue*, 219 P.3d 128 (Wyo. 2009).

30. *Id.*

31. *Id.* at 135, 143 (quoting WYO. STAT. ANN. § 39-14-203(b)(iv) (West 2011)).

determination of the point of valuation would impact the ultimate taxable value of the taxpayer's natural gas production.³² Locating the point of valuation closer to the wells would lower the taxable value of the gas; locating the point of valuation further downstream from the wells would increase taxable value.³³ The State Department of Revenue argued in the 2009 case that the proper point of valuation was the outlet of the facility.³⁴ The taxpayer contended that the point of valuation should be at the well meters or, in the alternative, at the inlet to the facility.³⁵

In its 2009 opinion, the Wyoming Supreme Court analyzed the facility operated by the taxpayer and determined that it was a "processing facility" as opposed to an "initial dehydrator," as those terms are used in Wyoming natural gas tax statutes.³⁶ As a result, under the state's statutory proportionate profits valuation method for natural gas, the point of valuation would be no further downstream than the inlet to the facility (had the Court determined that the facility was an "initial dehydrator," the point of valuation would be the outlet of the facility).³⁷

The 2009 decision did not completely resolve the point of valuation issue. The Court remanded the case to the Wyoming State Board of Equalization ("Board") to consider whether meters located near the taxpayer's wells were "custody transfer meters"—another term used in the tax valuation statutes—to determine the proper point of valuation.³⁸

On remand, the Board determined that the meters did not qualify as "custody transfer meters" for the taxpayer's own share of the produced natural gas, but that the same meters were "custody transfer meters" for the share of gas owned by other working interest owners in the well.³⁹ On appeal from the Board's opinion, the taxpayer argued that the meters should be considered "custody transfer meters" because there was only one common gas stream passing through the meters.⁴⁰ The Court rejected the taxpayer's argument, finding that a meter is only a "custody transfer meter" if it measures gas passing from one party to another.⁴¹ The Court affirmed the Board's decision finding that the taxpayer had "custody of the gas both prior to and

32. *Id.*

33. *Id.*

34. *Id.*

35. *Id.* at 143.

36. *Id.*

37. *Id.*

38. *Id.*

39. *Exxon Mobil Corp. v. Wyo. Dep't of Revenue*, 266 P.3d 944, 946 (Wyo. 2011).

40. *Id.*

41. *Id.*

after the gas passes through the meters at the wells,” and therefore the meters were not “custody transfer meters.”⁴²

In addition, the Court determined that the Board should not have considered whether the meters were “custody transfer meters” for the working interest owners’ natural gas because those owners did not participate in the appeal and were not aggrieved parties.⁴³ Therefore, the Court reversed the Board’s decision with respect to the working interest owners’ gas.⁴⁴ In a footnote at the conclusion of the opinion, the Court remarked:

In reaching this conclusion the Court does not make a determination on whether different interest owners in a common gas stream can in fact have different points of valuation for tax purposes. Given that [the working interest owners] are not parties to the present action, the Court believes the answer to that question should be left for another day when it is properly before the Court.⁴⁵

C. Universal Drilling Co. v. R&R Rig Service, LLC⁴⁶

Universal Drilling Company (“Universal”) entered into a time and materials contract with R&R Rig Service (“R&R”), requiring R&R to move Universal’s drilling rig.⁴⁷ R&R hired two subcontractors to complete the work, and the move was accomplished in seven days.⁴⁸ R&R sent Universal an invoice for approximately \$209,000 for the move, but before Universal paid, it contracted with another company to move the rig again.⁴⁹

Universal tendered a check to R&R in the amount of \$97,000, as full payment and “the fair value” of R&R’s services.⁵⁰ R&R refused Universal’s offer and demanded full payment of the invoice, as well as interest.⁵¹ After Universal refused to pay the entire invoice and interest, R&R filed a lawsuit seeking payments under the time and materials contract.⁵² Universal asserted estoppel as a defense against R&R’s claim and counterclaimed for fraud and breach of the implied covenant of good faith and fair dealing.⁵³

The trial court held a bench trial on the case and eventually ordered Universal to pay R&R a total of approximately \$188,000.⁵⁴ The trial

42. *Id.* at 950.

43. *Id.* at 952.

44. *Id.*

45. *Id.* at 952 n.8.

46. *Universal Drilling Co. v. R&R Rig Serv., LLC*, 271 P.3d 987 (Wyo. 2012).

47. *Id.*

48. *Id.*

49. *Id.* at 991.

50. *Id.*

51. *Id.*

52. *Id.*

53. *Id.*

54. *Id.* at 991–92.

court found this amount to be “the reasonable amount of the services rendered to Universal”⁵⁵ The Court rejected Universal’s counterclaims, but did not squarely address Universal’s estoppel defense.⁵⁶ Both Universal and R&R appealed the trial court’s judgment to the Wyoming Supreme Court.⁵⁷

Universal claimed that the trial court miscalculated its damages.⁵⁸ Instead of applying the terms of the time and materials contract between the parties, Universal claimed that the trial court improperly imposed a “reasonableness” standard to reach its decision and also made arithmetic mistakes in its work.⁵⁹ The Wyoming Supreme Court rejected Universal’s “reasonableness” claim, finding that the trial court’s damages award reflected an accurate calculation under the contract.⁶⁰ However, the Court ruled that there were minor errors in the trial court’s calculations.⁶¹

The Court carefully analyzed Universal’s fraud counterclaim against R&R.⁶² Universal made several claims that R&R’s billing practices were fraudulent.⁶³ The Court considered each of Universal’s claims of fraud, recognized that some of R&R’s billing errors were made in Universal’s favor, and affirmed the trial court’s determination that Universal did not meet the standard of proof for fraud.⁶⁴ Similarly, the Court rejected Universal’s claim that R&R’s overbilling practices constituted a breach of the implied covenant of good faith and fair dealing.⁶⁵ The Court found that while Universal had a right to reasonably expect that R&R would not knowingly overbill Universal, any overcharges were the result of unintentional mistakes that could not form the basis for a claim of breach of the covenant of good faith and fair dealing.⁶⁶

Finally, although the Court recognized that the trial court did not rule on Universal’s estoppel defense, it concluded that the trial court would have denied the defense and should have rejected Universal’s claim that R&R was estopped from asserting a claim for payment.⁶⁷ The Court affirmed the trial court’s decision in large part, but it remanded the case to the trial court to correct minor arithmetic errors.⁶⁸

55. *Id.*

56. *Id.*

57. *Id.* at 992.

58. *Id.*

59. *Id.*

60. *Id.*

61. *Id.* at 993.

62. *Id.*

63. *Id.* at 994–98.

64. *Id.* at 996–98.

65. *Id.*

66. *Id.* at 999.

67. *Id.* at 1000.

68. *Id.* at 1002–03.

D. Powder River Basin Resource Council v. Oil & Gas Conservation Commission⁶⁹

On March 26, 2012, four environmental groups filed a lawsuit in state district court in Casper, Wyoming against the Wyoming Oil and Gas Conservation Commission (“WOGCC”) seeking disclosure of confidential information related to hydraulic fracturing.⁷⁰ In 2010, the WOGCC enacted administrative rules requiring all applicants for permits to drill wells to submit detailed information about well stimulation plans.⁷¹ Specifically, the WOGCC’s rules require disclosure of the products and chemicals used in hydraulic fracturing programs.⁷² The rules allow parties to request confidential treatment of proprietary information submitted to the WOGCC.⁷³

The plaintiffs sent requests to the WOGCC, pursuant to Wyoming’s public records statutes, asking for copies of confidential information, but the WOGCC denied portions of those requests.⁷⁴ In response, the plaintiffs filed a “Petition for Review of Administrative Action [and] Complaint for Declaratory Relief,” asking the district court to:

1. Compel WOGCC to show cause, pursuant to Wyo. Stat. § 16-4-203(f), why its partial denial of Petitioners’ public records request is lawful;
2. Declare that WOGCC’s actions were arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with the law; [and]
3. Set aside WOGCC’s approval of insufficiently supported and overly broad trade secret and confidential commercial information exemptions, and order WOGCC to make new determinations consistent with the Public Records Act and WOGCC’s Environmental Rules; . . .⁷⁵

The district court set a briefing schedule, and a decision in the case is expected in late 2012 or 2013.⁷⁶

III. LEGISLATION

The Wyoming Legislature convenes annually for either a General Session beginning in January (which normally lasts forty days), or a Budget Session beginning in early February (which normally lasts twenty days).⁷⁷ The legislature held a Budget Session in 2012. During

69. Petition for Review of Admin. Action, Complaint for Declaratory Relief, Powder River Basin Res. Council v. Wyo. Oil & Gas Conservation Comm’n, No. 94650-C (7th Jud. Dist. filed Mar. 22, 2012).

70. *Id.*

71. *Id.*

72. *Id.*

73. *Id.*

74. *Id.*

75. *Id.* at 5.

76. *Id.*

77. See WYO. CONST. art. 3, § 6; WYO. STAT. ANN. § 28-1-102 (2011).

a Budget Session, all bills require a two-thirds majority vote for introduction, which limits the number of bills actually worked on or passed during the Budget Session.⁷⁸ During the 2012 Budget Session, very few bills impacting the oil and gas industry were introduced or passed the two-thirds vote for introduction.⁷⁹

A. Taxation

The 2012 Wyoming State Legislature did not enact new taxation legislation relative to the oil and gas industry.⁸⁰ However, projections of declining revenues and deteriorating public roads may lead the legislature to consider increasing the fuel tax as a means of funding road construction and improvements.⁸¹ Wyoming's fuel tax rate of fourteen-cents per gallon for gasoline and diesel is the second lowest in the country behind Alaska.⁸² The legislature's Joint Revenue Committee and the Joint Transportation, Highways & Military Affairs Committee have announced plans to consider highway funding options including increased fuel taxes.⁸³

B. Natural Resources

A new Wyoming statute enacted in 2012 authorizes the Wyoming Governor's Office to supervise the collection of "baseline scientific assessment data on public lands which may impact" mineral resources, including oil and gas, as well as other resources.⁸⁴ The statute allows the Governor's Office to analyze air and water quality, populations of species listed as threatened or endangered, enhanced oil recovery, and other issues.⁸⁵ The Governor's Office will distribute the information to, and collaborate with, various state agencies, the University of Wyoming, and local governments.⁸⁶ The bill also appropriated \$500,000 to the Governor's Office for these studies.⁸⁷

The legislature and Governor also passed a resolution supporting Alaska's efforts to open a portion of the Arctic National Wildlife Refuge to oil and gas exploration, development, and production.⁸⁸

78. *Id.*

79. *See 2012 Bills by Subject*, WYO. LEG., 15 (Mar. 27, 2012), <http://legisweb.state.wy.us/2012/Index/subjectindex.pdf>.

80. *Id.*

81. Trevor Brown, *Mead Open to Tax Hikes to Pay for Highways*, WYO. TRIB.-EAGLE, Mar. 10, 2012, http://www.wyomingnews.com/articles/2012/03/10/news/19local_03-10-12.prt.

82. *Id.*

83. *Id.*

84. WYO. STAT. ANN. § 9-1-224 (Supp. 2012); H.B. 90, 61st Leg., 2012 Budget Sess. (Wyo. 2012).

85. WYO. STAT. ANN. § 9-1-224(a)(i)-(ix).

86. WYO. STAT. ANN. § 9-1-224(b).

87. Wyo. H.B. 90.

88. H.R.J. Res. 2, 61st Leg., 2012 Budget Sess. (Wyo. 2012).

C. Department of Environmental Quality

The legislature expanded existing statutes to allow the Department of Environmental Quality to issue general permits authorizing categories of discharges or emissions for defined geographic areas.⁸⁹ The general permits are not considered rules under Wyoming's Administrative Procedure Act. They must be issued in accordance with the Environmental Quality Council's regulations and must include public notice and an opportunity for public comment, with the right to appeal by an aggrieved party.⁹⁰

89. S.B. 59, 61st Leg., 2012 Budget Sess. (Wyo. 2012); WYO. STAT. ANN. §§ 16-3-101(b)(xi), 35-11-801(d) (Supp. 2012).

90. WYO. STAT. ANN. § 35-11-801(d) (Supp. 2012).