Natural Resources, Energy and Environmental Law Section

Vista

State Bar of New Mexico

Winter 2005

Greetings Section Members,

Welcome to the Oil and Gas issue of the SONREEL Newsletter. In an effort to broaden this publication's scope and topics, the next several issues will focus on a particular practice area. Please do not hesitate to contact me if you have a request or suggestion for an issue, or if you would like to write an article. Currently, the Section pays law students to research and write articles, but welcomes input and contributions from Section members as well. Our next issue will cover the nexus between water and energy, and will coordinate with a conference on the same topic sponsored by the Utton Center in the spring of 2006. There are many research possibilities in this timely topic, so we expect an interesting issue in the spring.

Happy reading and best wishes for 2006,

Jennifer J. Pruett, Editor

Negotiating "Pipeline" Dreams

by Alex Beattie

According to the New Mexico Oil and Gas Association, there are more than 25,000 miles of pipelines stretching across the state, exceeding the combined mileage of New Mexico's highways and railroads.[1] The Pipeline Eminent Domain statute provides that "Any person, firm, association or corporation may exercise the right of eminent domain to take and acquire the necessary right-of-way for the construction, maintenance and operation of pipelines ..."[2] Any such action will require compensation for the property loss, which may be negotiated in a settlement agreement or litigated in court. Practicing attorneys, hoping to avoid expensive litigation, need to understand how compensation values are judicially determined as a foundation for settlement offers.

The New Mexico Supreme Court addressed the constitutionality of the Pipeline Eminent Domain statute in *Kennedy v. Yates Petroleum Corp.*, and held that; "It is not unconstitutional for the legislature to create a private right of condemnation in a private entity, where the purpose is beneficial use of a vitally important natural resource."[3] The court further held that any party seeking to utilize the Pipeline Eminent Domain statute must demonstrate to the court that its use is consistent with "that public purpose."[4] Whether the condemning party is private or public, the United States[5] and New Mexico[6] constitutions require that any taking or damage to private property for public use be compensated.[7] Therefore, the creation of a right-of-way or easement for the construction, operation or maintenance of a pipeline, which requires a condemnation proceeding, will also have to provide compensation for the taking.

"The Eminent Domain Code, NMSA 1978, § 42A-1-1 to -33 … sets the procedure to be followed in all condemnation actions conducted in New Mexico."[8] Condemnation 'takings' can be either whole or partial.[9] Both types of takings utilize the "fair market value" basis for determining compensation.[10] "In its essence a condemnation action is a proceeding *in rem* to appropriate property and pay for it, creating a new title in the process."[11]

"Fair market value is theoretically what a willing seller would take and a willing buyer offer."[12] In making a determination of fair market value, all the considerations that would influence a willing buyer and willing seller in coming to terms on a price should be considered by the court. Additionally, the value of the property is determined by considering not merely the uses to which it was applied at the time of condemnation, but the highest and best uses to which it could be put.[13]

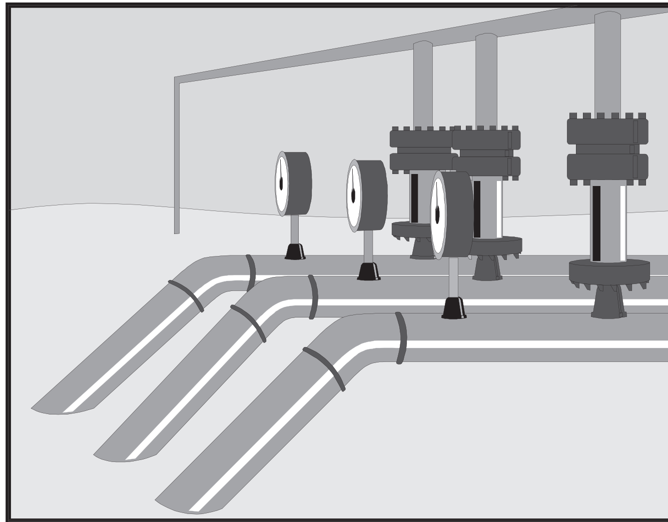
The New Mexico Supreme Court has held that if loss of value can be proven, it should be compensable regardless of its source.[14] Traditional approaches to establishing the fair market value, which have gained wide acceptance in New Mexico courts, include: examining recent sales or purchases of the property involved in the condemnation proceeding, comparing the condemned property to similarly situated property[15] and

continued on page 2

examining the highest and best of use of the condemned property. Typically, a certified or licensed real estate appraiser is hired to examine recent or comparable sales to estimate the fair market value.[16] However, as our state Supreme Court has stated, rural states such as New Mexico may find it "difficult to prove market value when there are no actual sales of comparable property."[17] Considering the possible lack of resources available for determining market value, the Court stated compensation should not be denied just "because they are difficult to prove."[18] In such circumstances, the owner of the property may testify as to the fair market value of his/her property.[19] Expert testimony may also be employed, as well as non-expert testimony used to provide the foundation for subsequent experts.[20] However, attempts at valuation such as: evidence of property sales, which are too speculative or too remote from the condemned property; non-accepted offers on similar property; and tax assessments, have not been accepted in New Mexico.[21]

Condemnation actions for pipeline easements typically involve only partial takings. The Eminent Domain Code, *supra*, statutorily provides for the "before and after" rule for calculating damages.[22] According to this rule, as stated in § 26, compensation will be based on the "difference between the fair market value of the entire property immediately before the taking and the fair market value of the property remaining immediately after the taking."[23] If the remaining property is actually enhanced by the condemnation, enhancement can only be used to offset damages to the value of the remaining property.[24] To illustrate, if a condemnation action eventually resulted in an increase of value to the remaining property, perhaps a valuable interstate interchange, the resulting increase of value in the remaining property may not be used to offset compensation for the actual loss of property. It may be used to show that the remaining property did not suffer additional loss due to being separated.[25]

Partial takings may also be subject to the "unity rule."[26] The unity rule is used to determine whether two or more tracts of land constitute one unified tract in the determination of its fair market value.[27] This rule examines whether the tracts are contiguous, in close proximity and united in ownership.[28] Under certain circumstances, the simultaneous application of all three factors may not be required; the court has held that such an inquiry should be determined by the circumstances of the case.[29] "The purpose of the unity rule is to ensure that the landowner is justly compensated by awarding him any damages that result from condemning a portion of his property that is integral to the value of the highest and best use of the remainder."[30]



Summary

An award of damages pursuant to the Eminent Domain Code will be based on a valuation of the fair market value of the property. The doctrine of fair market value is an evidentiary element, to be proven by the property owner. Being able to anticipate compensation awards is an essential element of settlement proposals. Should litigation be unavoidable, attorneys that are equipped to handle New Mexico's valuation approaches will be able to reduce some of the litigation dangers and costs for their clients.

Endnotes

1 http://www.nmoga.org/nmoga/impact.html – last visited November 11, 2005
2 NMSA (1978) § 70-3-5; See also NMSA (1978) § 70-6-7 (right of eminent domain for underground storage tanks).
3 104 N.M. 596, 599 (1986).
4 *Id.*
5 U.S. Const. amend. V; *Kelo v. City of New London*, 125 S. Ct. 2655 (2005).
6 N.M. Const. art. II § 20.
7 *City of Sunland Park v. Santa Teresa Servs. Co.*, 2003 NMCA 106, ¶ 43 ("The primary condition to the exercise of eminent domain is the constitutional requirement to pay just compensation.")
8 *Id.* at 253.
9 *State ex rel. State Highway Dep't v. Strosnider*, 106 N.M. 608, 610 (N.M. Ct. App. 1987) ("… determination of the condemnation award is made within the analytical framework of whether the taking is "entire" or only "partial".")
10 UJI 13-703 (when entire parcel is taken, damages equal fair market value of the property on the date of taking); UJI 13-704 (in partial taking, damages equal the difference between the fair market value before and after taking).
11 *City of Sunland Park v. Santa Teresa Servs. Co.*, 134 N.M. 243, 254 (N.M. Ct. App. 2003)
12 *Board of Comm'rs v. Gardner*, 57 N.M. 478, 485 (1953); UJI 13-711
13 *Clovis v. Ware*, 96 N.M. 479, 480 (1981); UJI 13-714.
14 *Santa Fe v. Komis*, 114 N.M. 659, 662 (1992) (compensation for loss of value based on "public fear").
15 UJI 13-717
16 *Id.*; 7A-9A Nichols on Eminent Domain § 9A.04
17 *Santa Fe v. Komis*, 114 N.M. 659, 665 (1992).
18 *Id.*
19 *Leigh v. Village of Los Lunas*, 2005 NMCA 25; UJI 13-716
20 *Santa Fe v. Komis*, 114 N.M. 659, 665 (1992)
21 *El Paso Elec. Co. v. Landers*, 82 N.M. 265 (1970).
22 *Yates Petroleum Corp. v. Kennedy*, 108 N.M. 564, 567 (1989).
23 *Id.*
24 *Id.*
25 UJI 13-704
26 *Yates Petroleum Corp. v. Kennedy*, 108 N.M. 564, 568 (1989)
27 *Id.*
28 *State ex rel. State Highway Dep't v. Strosnider*, 106 N.M. 608, 611 (N.M. Ct. App. 1987)
29 *Id.*
30 *Yates Petroleum Corp. v. Kennedy*, 108 N.M. 564, 569 (1989)

Breaking Ground in New Mexico: The Role of the Accommodation Doctrine in Determining a Mineral Estate Owner's Obligation to Compensate Landowners for Damage to the Surface

by Mark S. Barron

Consistent with the clear common law principle that ownership of land in fee simple incorporates the rights to develop and exploit the minerals under that land, it is a well-established principle of Anglo-American property law that a mineral estate may be severed and held independently from the surface estate. Historically, this understanding has been accompanied by a general recognition of implied rights that are attached to surface and mineral estates in the same tract of land—a position that has been incorporated by American courts. Among the most important and controversial of these implied rights is a right endowed upon the owner of the minerals to use so much of the surface as necessary to develop the mineral estate.[1] This right, which can be fairly characterized as an easement, is based on the premise that a reservation of minerals is worthless without a corresponding right to enter the land and extract the minerals and is recognized by the law of New Mexico.[2]

Characterizing a mineral estate owner's right to develop as an easement has important implications because it necessarily designates the mineral owner's interest as a dominant estate and the surface owner's interest as a servient estate. As a result of this relationship, the rights of mineral owners have traditionally superseded the interests of surface owners when the two have come into conflict.[3] Over the last three decades, however, the rights of mineral owners have been acknowledged as less than absolute, and have been modified to create an interplay of rights between the various owners of the mineral estate and the surface estate known as the accommodation doctrine.

I. New Mexico Adopts the Accommodation Doctrine

In *Amoco Production Co. v. Carter Farms Co.* ("*Carter Farms*"),[4] New Mexico joined a growing list of oil and gas producing states to have adopted at least some form of the accommodation doctrine.[5] In *Carter Farms*, the presence of ground water two feet below the surface forced Amoco, the oil and gas lessee, to construct the reserve pit for its drilling operation partially above the surface in an effort to contain spillover drilling fluid, salt water, mud, and other solids. The nature of this construction, however, meant that the leveling procedure traditionally conducted at

the conclusion of drilling operations would have resulted in spreading out the construction materials over a surface area larger than for a typical well. Carter Farms, as owner of the surface estate, refused to allow Amoco to level the reserve pit in the customary manner and insisted that Amoco completely restore the surface area to its original condition.

In considering the case, the New Mexico Supreme Court reaffirmed the rule that a mineral lessee "is entitled to use as much of the surface as is reasonably necessary for its drilling and production operations,"[6] but tempered that rule with the caveat that the lessee's "surface rights and the servitude it holds, however, must be exercised with due regard for the rights of the surface owner."[7] Accordingly, the court in *Carter Farms* recognized a cause of action in negligence and held that a mineral estate owner may be liable for damages to a surface estate owner when use of the surface estate is "unreasonable, excessive, or negligent."[8] Unfortunately, the court provided little explanation as to what type of uses might fall into these categories, noting only that the trial court had determined the nature of the use in question was "reasonable" and that "Amoco's variation in the normal construction of the reserve pit was *necessary* because of the presence of the underground water near the surface of the test well area."[9]

Despite acknowledging a cause of action available to surface estate owners, however, the supreme court's result in *Carter Farms* seems to do little to shift the balance of power between mineral estate owners and surface estate owners. First, the court acknowledged that alternative causes of action—both in public nuisance and statutory law—are available to surface estate owners in other jurisdictions and expressly denied their applicability in New Mexico. Secondly, and more importantly, in evaluating Amoco's actions the court treated the question of reasonableness as it would in any negligence action: as a question of fact for the jury.

To the extent that the leveling and cleaning operation would have spread the mud and organic materials over a wider area causing further damage, the jury could have determined that these actions by Amoco would have been unreasonable. The jury having determined that the land taken or used by Amoco was reasonably required for its drilling operation, we decline to remand this issue to the trial court for the taking of further evidence on the question of the "reasonableness" of Amoco's actions.[10]

In reaching this result, the supreme court denied an affirmative duty to restore the surface area to its original condition (a duty recognized by the New Mexico Court of Appeals in its consideration of the case), and expressly refused to impose upon mineral owners any duty to pay restorative costs "where the use of the surface area is reasonably necessary and the operator has exercised due regard for the rights of the surface owner."[11]

II. Conclusion

By announcing theoretical limits on a mineral estate owner's right to use the surface to explore and develop the minerals contained therein, New Mexico is one of several jurisdictions that have articulated support for the accommodation doctrine. Never-

continued on page 5

“At the Well” in New Mexico- Current Court Interpretations of the Definition of “At the Well” in Natural Gas Royalty Clauses

by Jennifer Hower

New Mexico is home to two significant natural gas fields: the Permian Basin and the San Juan Basin. Both have been fairly prolific producers, and as a result is the source of multitudes of gas wells. As of September 2005, the state contained 25,241 completed natural gas wells, and had 730 registered oil and gas operators[1].

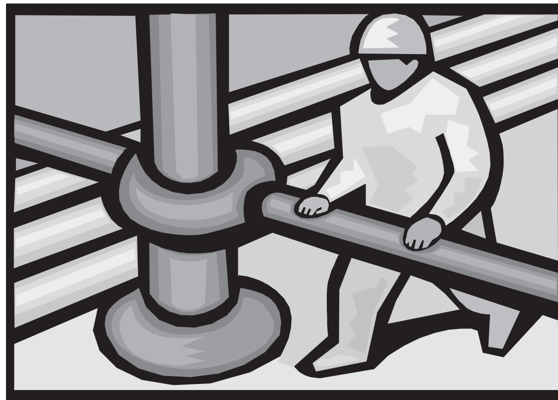
The majority of the wells in New Mexico are connected to oil and gas leases, in which the owner of the mineral rights for the land grants the producer/operator the right to place wells on the property for compensation. The lease contains a royalty clause, which will commonly provide that the royalty paid will be 1/8 of the value of the gas “at the well”. For example, an excerpt from a sample Oil, Gas and Mineral Lease includes the following standard lease language:

> Subject to the provisions of Paragraphs 2 and 10 hereof the royalties to be paid by Lessee are: … (b) on gas, one-eighth (1//8) of the market value ***at the well*** [Emphasis Added] of the gas used by Lessee in operations not connected with the land leased or any pooled unit containing all or a part of said land; the royalty on gas sold by Lessee to be one-eighth (1//8) of the amount realized at the well from such sales;…[2]

The term “at the well” has been a point of contention between producers and royalty owners. This is in part because, in general, natural gas is much more valuable after it has been processed (e.g., removal of natural gas liquids and compression) than it is when it exits the ground. In order to determine the value of the gas at the wellhead, producers often take the market price of the gas and subtract various costs such as transportation costs and processing costs. It is the contents of these “netback” calculations that notoriously create disputes between the parties.

It is important to determine the varying stances taken by courts in individual producing states. Two cases that have been decided within the past five years clearly show New Mexico’s judicial direction in regards to “at the well” valuation cases. On September 14, 2000 the New Mexico Court of Appeals issued an opinion in *Creson v. Amoco* (deriving from a case in Quay County district court) which has subsequently been cited in several other cases. The issue in *Creson* was whether the terms of the unit agreement[3] allowed for the deduction of unit expenses from the sales price of the gas before calculating royalties defendants must pay to plaintiffs.

The defendant Amoco operated the unit in question, and was also a working interest owner along with Amerada Hess. The plaintiffs all possessed overriding royalty interests. The unit agreement contained a royalty provision, which was unusual since royalty provisions are normally found in leases. The royalty provision stated:



> Article 6.3
> Basis of payment to royalty owners. It is recognized by the parties hereto that there is no preeminent market for Carbon Dioxide Gas. Therefore, the parties hereto agree that, as further consideration for entering into this agreement, royalties paid upon the Unitized Substances allocated to each tract shall be based on the greatest of the following:
>
> The net proceeds derived from the sale of Carbon Dioxide Gas at the well whether such sale is to one or more parties to this agreement or to any other party or parties.

The defendants, as is standard practice, calculated royalties using a netback method in which operating costs, capital costs, and expenses for gathering, compressing and dehydrating facilities and functions were subtracted.

The court, in reaching its decision, offered a thorough examination of the meaning of “at the well”. In doing so, it looked for guidance in Williams & Meyers preeminent oil and gas treatise[4]. The court affirmed the trial court’s decision because it found that “net proceeds…at the well” was an unambiguous phrase and that it was proper to deduct “post-production, value-enhancing costs” in the calculation of royalties for gas sold downstream.[5] Therefore, the plaintiffs were entitled to royalties based on the value of the carbon dioxide gas as it emerged at the wellhead and royalty owners were not to gain benefits from the “enhanced value” of the gas as it is sold downstream.[6] Based on this decision, the plaintiffs (and others in similar positions) receive a lower amount of royalties due to the ability of producers to subtract costs from the price of natural gas to derive an “at the well” valuation, which is significantly different than the actual market price of the gas that the producers sell the product for.

Following *Creson*, the U.S. Court of Appeals for the Tenth Circuit ruled in 2005 on a similar New Mexico Case originating in the U.S. district court for the State of New Mexico. *Elliott v. BP America*[7] was based on a May 2000 filing by the plaintiffs in U.S. district court alleging nine different issues pertaining to the payment of royalties. The plaintiff, Elliott Industries, was the owner of royalty and overriding royalty interests in oil and gas units, leases and wells owned or operated by Conoco and Amoco in the San Juan Basin. Gas from the San Juan Basin is conventional gas which must have natural gas liquids removed for it to be allowed to enter the pipeline. The gas from the units in question was processed at defendants’

San Juan New Blanco Gas Processing Plant. In determining the value of the gas "at the well", defendants deducted post-production expenses, including processing, marketing, transportation, and fractionation costs. Amoco and Conoco also deducted a 39% in-kind assessment for compensation for processing the gas, derived from an agreement with El Paso at the opening of the plant.

The New Mexico United States district court granted summary judgment to defendants. Plaintiffs then sought review by United States Court of Appeals for the Tenth Circuit. One of the issues touched on by the appellate court was related to the of definition of "at the well" and whether the 39% processing charge included in the netback calculation was allowed in the determination of the value of gas "at the well".

Of significance was that the district court based its summary judgment ruling on *Creson*, stating that, as in *Creson*, the meaning of "at the well" in this case was clear and unambiguous and "royalties are to be paid on the value of the gas in it's unprocessed state as it comes to the surface at the mouth of the well before it is transported and processed." Therefore the 10th Circuit found the district court's reliance on *Creson* to be correct regarding the definition of "at the well". However, in order to determine if the 39% was consistent with royalty obligations, three questions must be answered: 1) Was the 39% fee properly characterized as a processing cost, 2) Whether such costs must be actual and reasonable, and 3) Whether the gas was marketable at the wellhead.[8] The court held that without resolution of the factual questions, it was unable to determine if the adjustments were consistent with royalty payments. However, the court affirmed the district court's summary judgment ruling because, based on Elliott's non-contractual claims, an interpretation of "at the well" language is neither a genuine nor material issue.[9]

Both *Creson* and *Elliott* illustrate the current legal trend in New Mexico regarding the definition of "at the well" in natural gas royalty clauses. "At the well" is an unambiguous phrase that allows for the deduction of post-production, value enhancing costs from gas sold downstream.[10] Royalty owners may not gain from the enhanced value. Therefore, when a producer is using a netback method for the calculation of royalties, the "at the well" value is created through the subtraction of dehydration, compression, transportation and other "value-adding" costs. When consistency in royalty obligations is questioned, three questions must be answered regarding the deduction: 1) is it properly characterized as a processing cost, 2) is the cost actionable and reasonable, and 3) was the gas marketable at the wellhead.[11] Due to the relative newness of *Elliott*, the courts have yet to give further guidance on how these questions should be analyzed. However, as more cases are filed contesting deductions to derive "at the well" value, the New Mexico definition of "at the well" will be further refined.

Endnotes

1 New Mexico Energy Minerals and Natural Resources Department, New Mexico Well Statistics, September 30, 2005

2 7-Topic 1 Williams & Meyers, Oil and Gas Law 5

3 A unit agreement is defined in Williams & Meyers as "An agreement or plan of development and operation for the recovery of oil and gas made subject thereto as a single consolidated unit without regard to separate ownerships and for the allocation of costs and benefits on a basis as defined in the agreement or plan." 8-U Williams & Meyers, Oil and Gas Law 34.

4 Williams & Meyers § 645.2- ("A royalty or other non-operating interest in production is usually subject to a proportionate share of the costs incurred subsequent to production where the royalty or nonoperating interest is payable 'at the well'" and "In the absence of an express agreement to the contrary, such post-production costs generally include transportation posts, expenses of treatment such as dehydration, expense of compressing gas so that it can be delivered into a pipeline, and other 'costs incurred in adding value to the wellhead product'").

5 *Creson v. Amoco*, 129 N.M. 529(2000).

6 *Creson v. Amoco*, 129 N.M. 529, 537(2000).

7 *Elliott v. BP America*, 407 F.3d 1091 (10th Ct. App. 2005).

8 *Elliott v. BP America*, 407 F.3d 1091, 1111 (10th Ct. App. 2005).

9 *Elliott v. BP America*, 407 F.3d 1091, 1111 (10th Ct. App. 2005).

10 *Creson v. Amoco*, 129 N.M. 529, 537(2000).

11 *Elliott v. BP America*, 407 F.3d 1091, 1111 (10th Ct. App. 2005).

Breaking Ground in New Mexico

continued from page 3

theless, despite the admonition of the New Mexico Supreme Court in *Carter Farms* that a mineral operator must act with due regard for the interests of the surface estate owner, it is unclear whether this standard expands a mineral estate owner's liability for damage to the surface. The burden of proof that must be met to invoke the application of this doctrine continues to be with the surface estate owner and evidence that the mineral operator's use of the land was necessary to develop the mineral estate is likely a powerful affirmative defense. Consequently, absent an affirmative statement by either the supreme court or the New Mexico Legislature imposing specific obligations on mineral estate owners, the determination of whether a mineral operator's conduct has been unreasonable should continue to be a case-by-case analysis conducted by individual juries and this balance of power is unlikely to change.

Endnotes

1 *See generally* Christopher M. Alspach, *Surface Use By the Mineral Owner: How Much Accommodation is Required Under the Current Oil and Gas Law?*, 55 Okla. L. Rev. 89 (2002).

2 *See Kysar v. Amoco Prod. Co.*, 2004-NMSC-25, ¶ 24, 93 P.3d 1272, 1278 ("[W]hen an oil and gas lease grants to the lessee a particular tract of land for the purpose of exploring, drilling, mining and producing oil and gas, the lessee gains by implication the right to enter upon and use as much of the surface as may be necessary for the lessee's operations.").

3 *See* Alspach, *supra* note 1, at 91.

4 103 N.M. 117, 703 P.2d 894 (1985).

5 *See* Alspach, *supra* note 1, at 92 (citing to cases in UT, ND, AR, NM, WV, CO, and WY).

6 *Carter Farms*, 103 N.M. at 119, 703 P.2d at 896.

7 *Id.*

8 *Id.* at 120, 703 P.2d at 897; *See also Kysar*, 2004-NMSC-25, ¶ 24, 93 P.3d at 1278.

9 *Id.* at 119, 703 P.2d at 896 (emphasis added).

10 *Id.* at 120, 703 P.2d at 897 (internal citations omitted).

11 *Id. See also McNeill v. Rice Eng'g & Operating Co.*, 2003-NMCA-78, ¶ 39, 70 P.3d 794, 804-05 (declining to impose liability on oil and gas producers for damage to surface estate absent a finding of recklessness).

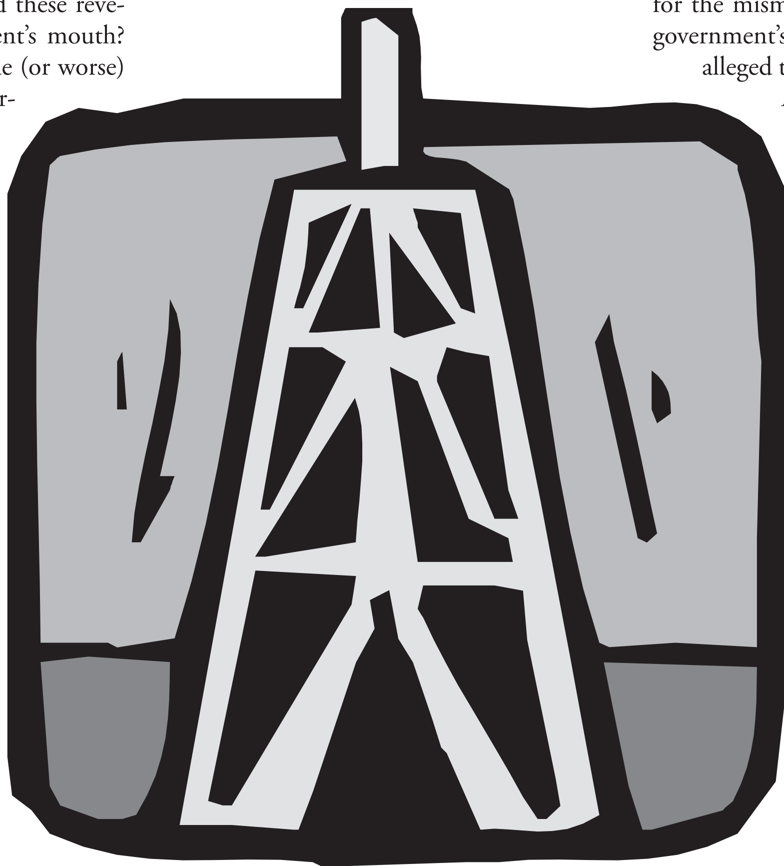
Blowing in the Wind: How Many Generations Must Pass Before Indians Receive Proper Royalties on Their Oil and Gas?

by Josh Mann

"As all of us saw on television, there's… some deep, persistent poverty in this region…. That poverty has roots in a history of racial discrimination, which cut off generations from the opportunity of America. We have a duty to confront this poverty with bold action. So…let us rise above the legacy of inequality."[1] Was it the 165 mile-per-hour winds of Katrina blowing away pieces of the American dream, or was it the flood of images pouring forth from television screens across the nation, that pressured these revelatory words out of the President's mouth? Consider the storm of ineptitude (or worse) pounding upon another of America's unseen.

Native American Tribes, who suffer from some of the most severe poverty in this country, have been deprived of billions of rightfully due royalty payments from oil and gas leases on their land. Since the General Allotment Act of 1887[2], the federal government has assumed trust responsibility for the management of natural resources on Tribal and allottee lands. Indian oil and gas production is the single largest trust resource that is used or disposed of, which result in trust funds. Whenever the government authorized money-producing transactions, such as from oil and gas leases, it was supposed to hold the revenue in individual accounts for the Indian owners of the beneficial interests in the lands. However, from then until now the government has failed in its trust responsibility by grossly mismanaging Tribal and allottee natural resources.

"[I]t is not disputed that the government failed to be a diligent trustee…[R]eport after report [has] excoriated the government's management of the IIM [Individual Indian Money] trust funds."[3] The General Accounting Office (GAO) began issuing reports on the supervision of oil and gas operations on Indian lands in 1959 detailing a long list of "deficiencies" and "inadequate procedures." The Office of the Inspector General (OIG) issued similar reports starting in 1969.[4] In 1982, the Commission on Fiscal Accountability of the Nation's Energy Resources issued a lengthy report identifying chronic oil theft and underpayment resulting in losses as high as "several hundred million dollars a year.[5]" The problems were due to gross mismanagement of operations at the drilling site and in the accounting.



The report recommended that the government improve its internal controls, site security, enforcement and royalty management. The Congress responded by enacting the Federal Oil and Gas Royalty Management Act of 1982 (FOGRMA)[6], which moved management of royalties from the USGS to a new agency under the DOI, the Minerals Management Service (MMS). However, the problems persisted. "Embarrassed by this record, Congress in 1994 passed legislation, the American Indian Trust Fund Management Reform Act of 1994, reaffirming the government's obligation to 'account for the daily and annual balance of all funds held in trust by the United States'…pursuant to [The Indian Mineral Leasing Act of 1938[7]]." Things still have not changed.

In 1996, Eloise Cobell from the Blackfeet Indian Tribe filed a class-action lawsuit against the federal government on behalf of 300,000 past and present IIM Trust beneficiaries for the mismanagement of funds under the government's trust responsibility. Plaintiffs alleged the government deprived Native Americans of $100 billion. The district court has twice held the Secretary of the Interior in contempt of court for unlawfully delaying a congressionally mandated accounting. In July of 2005, Senators John McCain and Byron Dorgan introduced a bill to settle the Cobell lawsuit and to provide measures for reforming the manner in which the DOI administers the Indian trust.

To understand how the Tribes have been denied their monies and the myriad ways that thieves have taken oil and gas from Tribal lands without tendering royalty payments, one must consider government policy, lease provisions, physical management of the wells and accounting systems. The Secretary of the Interior has a fiduciary duty to the Tribes, which derives from a complex network of statutes and regulations.[8] The lease terms reflect the Secretary's duty. Form 5-157 was the oil and gas mining lease for Tribal Indian lands for most of the last 40 years, and section 3(c) Rental and Royalty, contains several provisions, whose meaning is determinative of many Tribes' royalty claims. The major portion clause, which determines the value of production, requires that the Secretary use discretion in a manner that maximizes royalty returns to

allotees.[9] Additionally, the dual accounting clause requires that the Secretary consider the value of gas both at the gas head and after processing, and choose the *greater* amount upon which to base the value of the gas for royalty purposes. Further, the Secretary is responsible for establishing procedure and enforcing controls to fulfill his fiduciary obligation.

There is the general failure of the Secretary, as trustee, to account for production volumes of oil and gas because he is not enforcing the controls. Oil companies calculate royalties due based on a percentage of oil or gas extracted. Controls at the well site are designed to ensure that the government can accurately measure the volumes extracted. There are several ways that operators transfer minerals to buyers, and there are specific controls for each method. Generally, operators use seals[10] to insure that they can properly account for all minerals extracted. The lease automatic custody transfer system (LACT), which is one system measuring minerals extracted, has non-resettable meters to prevent theft.[11] Operators using other methods are required to use run tickets, which detail among other things the Indian lease number, the seal number and the quantity taken.[12] The operators verify the accuracy of the information when they sign the ticket. However, these controls are defeated when seals and the LACT system are rigged and bypassed and the operators do not sign when the oil is removed. These are just a few of the controls designed to secure proper information upon which the accounting system is based.

Accordingly, MMS's accounting system designed to calculate Indian royalties is in disarray. The MMS system monitors payor accounts rather than lease accounts. Therefore, payor/lessees submit a single royalty report and a single payment covering all Indian leases. In a lease-based system, payors submit monthly reports and payment for each lease. The MMS system is supported by major automated functions, such as verification, audit and valuation functions, which ideally insure correct royalty payment to the correct IIM account. Unfortunately the system does not work. In just one example, line by line of allegedly clean reports state that thousands of dollars were paid for zero BTUs of gas.[13] Moreover, the system does not track quality of oil or gas, which is crucial to determining value. Experts estimate that the under payment is approximately 40 percent, before interest.[14] Should not the generally accepted principles of accounting and standards of auditing, applicable to the strictest of trust, apply here?

Satisfactorily resolving the royalties due is going to require the federal government pay for its gross mismanagement; however, landing on a number will not come easily. Although good intentions may underlie the proposed McCain/Dorgan bill and a subsequent House bill, neither suggests a number for settlement. The plaintiffs in Cobell offered to settle for $27.5 billion, but House and Senate lawmakers said that was too high. Most recently in Cobell, a U.S. Court of Appeals for the District of Columbia overturned a lower court ruling that required the government to provide a detailed historical accounting. The court was sympathetic to the government argument that it had already spent over $100 million on the accounting and the end was nowhere in sight. However, the entire trust system and the trustee's duties were unilaterally created and self-imposed by the United States. It would seem that at a minimum, the government should make and keep accurate records and make them available to the trustees.

What will it take before the government fulfills its promise? The government handling of the Federal Savings and Loan crisis of the 1980's provides a striking contrast. In that situation, the government was merely a guarantor rather than a trustee with a fiduciary duty. Nonetheless, it paid off the full amount of money lost, over and above the amounts actually insured. The Congress quickly appropriated $88 billion for the bailout and the whole mess ultimately cost American taxpayers $175 billion or more.[15] The Tribes and allottees have asked the government to pay only a fraction of that.

There is no question that this manmade disaster has denied a tremendous amount of money vital to Native Americans. Have not the Native Americans prepaid the costs of keeping an accurate accounting over a hundred years ago with the cessation of billions upon billions of dollars in valuable land and resources to the U.S. government? How many more reports, commissions and legislation will it take? Or, is there some underlying reason why the government cannot get this right? What if there were cameras rolling? The answer it seems is blowin' in the wind.

Endnotes

1 Presidential Address Discussing Hurricane Relief, New Orleans, LA (Sept. 15, 2005).

2 ch. 119, 24 Stat. 388.

3 *Cobell v. Norton*, 96cv01285 (D.C. Ct of Appeals, Nov. 15, 2005).

4 GAO Reports: Review of Supervision of Oil and Gas Operations and Production on Government and Indian Land (1959); Certain Deficiencies in Financial Management of Oil and Gas Activities (1964); More Specific Policies and Procedures Needed for Determining Royalties on Oil from Leased Federal Lands (1972); Coal, Oil and Gas: Better Management Can Improve Development and Increase Indian Income and Employment (1976); Oil and Gas Royalty Collections—Serious Financial Management Problems Need Congressional Attention (1979); Oil and Gas Royalty Collections—Longstanding Problems Costing Millions (1981).

5 OIG Reports: Review of Oil and Gas Lease Revenue (1969); Review of Royalty Accounting System for Onshore Oil and Gas Leases (1975); USGS Royalty Accounting System Study of Solid Minerals Leasing Activities (1975).

6 Pub.L. No. 97-451, 96 Stat. 2447 (1983).

7 25 U.S.C. § 396.

8 *Id.*

9 *Id.*

10 "Seal means a device. uniquely numbered. which completely secures either a valve or those components of a measuring system that affect the quality and/or quantity of the liquid being measured." Onshore Oil and Gas Operations; Federal and Indian Oil and Gas Leases; Onshore Oil and Gas Order No. 3, Site Security, 43 CFR 3160 (1989).

11 43 CFR 3160.

12 43 CFR 3160.

13 Conversation with Alan Taradash, November 16, 2005.

14 Conversation with Alan Taradash.

15 Bert Ely, *Savings and Loan Crisis*, *available at* http://www.econlib.org/library/Enc/SavingsandLoanCrisis.html (November 20, 2005).

Natural Resources, Energy & Environmental Law Section

2005 Board Officers

Daniel W. Long, Chair
A. Kyle Harwood, Chair-elect
Karen L. Fisher, Budget Officer
Lucas Williams, Secretary

Board Members

Alletta D. Belin, Santa Fe
Karen L. Fisher, Santa Fe
Richard T. Tully, Farmington
A. Kyle Harwood, Santa Fe
Christopher Graham Schatzman, Santa Fe
Lucas Williams, Roswell
Cheryl L. Bada, Santa Fe
Steven L. Hernandez, Las Cruces
Daniel W. Long, Albuquerque
J. Brent Moore, YLD Liaison, Santa Fe

Message from the Section Chair

I am pleased to serve as the Section chairperson for calendar year 2006 and would like to thank the 2005 Section chairperson Dan Long and Board members for their time and energy.

Outgoing Board members who deserve special thanks are Alleta D. Belin, Richard T. Tully and Daniel W. Long. I look forward to working with the 2006 Board and especially the new Board members: Jennifer J. Pruett, Steven Hattenbach, Charles E. Roybal and returning Board member Karen L. Fisher. We have several exciting Section activities planned, including the continuation of collaboration with the Utton Center and the expansion of Section conferences and publications. I welcome you to contact me with any questions or ideas that you might have.

Kyle Harwood, Assistant City Attorney, City of Santa Fe

State Bar of New Mexico

Natural Resources, Energy and Environmental Law Section

Vista

Non-profit Organ
U.S. POSTAGE
PAID
Permit No. 275
Albuquerque, N.M.

PO Box 92860
Albuquerque, NM 87199
www.nmbar.org

Designed and printed by the State Bar of New Mexico