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North Carolina Legalizes Horizontal Drilling and Hydraulic Fracturing

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Overview and Background

The 2012 legislative session of the North Carolina General Assembly concluded with legalization of hydraulic fracturing and horizontal drilling for exploration and development of shale gas in North Carolina. Over the past year, North Carolina legislators, policy makers, scientists, independent experts, local governments, state environmental and commerce agencies, and a variety of other stakeholders have studied and debated the potential for shale gas development in North Carolina and potential enabling legislation for hydraulic fracturing and horizontal drilling. This process concluded on July 2, 2012, when the General Assembly voted to override a gubernatorial veto of the enabling legislation, Senate Bill 820 also known as the [Clean Energy and Economic Security Act](#) (the “Act”).

This process began in June 2011, when the General Assembly directed the North Carolina Department of Environment and Natural Resources (“DENR”), the Department of Commerce, and the Department of Justice to “study the issue of oil and gas exploration in the State and the use of directional and horizontal drilling and hydraulic fracturing for that purpose.”¹ Further, the 2011 law directed DENR and the other agencies to evaluate the potential shale resource in North Carolina and methods of natural gas extraction and to conduct an analysis of potential economic impacts, environmental impacts, social impacts, consumer protection issues, infrastructure issues, as well as potential oversight and administrative issues related to shale gas development in North Carolina.

These agencies completed the comprehensive study and published the report, [North Carolina Oil and Gas Study under Session Law 2011-276](#), on April 30, 2012. Most notably, the report concluded that “After reviewing other studies and experiences in oil and gas-producing states, DENR has concluded that information available to date suggests that production of natural gas by means of hydraulic fracturing can be done safely as long as the right protections are in place. Production of natural gas by means of hydraulic fracturing can only be done safely in North Carolina if the state adopts adequate safeguards in the form of regulatory standards specifically adapted to conditions in the state and invests sufficient resources in compliance and enforcement.”² In light of the DENR report, legislators introduced the Act, when the 2012 legislative session convened in May to legalize hydraulic fracturing and horizontal drilling.

Senate Bill 820 Becomes Law after Veto Override

Senate Bill 820 was the focus of significant legislative activity during the short seven-week legislative session that concluded on July 3, 2012. Many significant provisions of the bill were modified from the original version, and many provisions were deleted or overhauled completely. Legislators made several rounds of amendments to the bill that went through four official editions. Ultimately, both

¹ N.C. Session Law 2011-276.

² North Carolina Department of Environment and Natural Resources, [North Carolina Oil and Gas Study Under Session Law 2011-276](#) (April 30, 2012) at 311.

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chambers of the General Assembly ratified Senate Bill 820 and submitted the bill to Governor Beverly Perdue for action. Governor Perdue, who is not seeking a second term as Governor, seemed to support shale gas development in a statement earlier this year, when she said “From what I saw, fracking can be done safely if you regulate it and put fees in place to have inspectors on the ground.”³ However, when Senate Bill 820 was placed on her desk, Governor Perdue vetoed the bill with the explanation that “This bill does not do enough to ensure that adequate protections . . . will be in place before fracking begins.”⁴ The North Carolina Senate and House promptly voted to override the Governor’s veto the following day, and the Act became law as Session Law 2012-143.

Main Provisions of the Clean Energy and Economic Security Act

The core provision of the Act authorizes horizontal drilling and hydraulic fracturing and sets in motion an extensive process to develop “a modern regulatory program for the management of oil and gas exploration and development in the State” including these activities. However, at the same time, the Act also prohibits the issuance of permits for horizontal drilling and hydraulic fracturing until the General Assembly takes further legislative action in the future. The idea behind this unusual procedure is to give regulatory authorities time to conduct further study and then adopt comprehensive regulations for these activities. To achieve this goal, the Act reconstitutes an executive branch commission, creates a new legislative commission, and outlines a wholly new regulatory program for oil and gas production in North Carolina’s Triassic Basin.⁵

Lifting the Bans

At the heart of the Act are provisions removing statutory prohibitions on hydraulic fracturing and horizontal drilling. Effective August 1, 2012, [North Carolina General Statute 113-393](#), which currently prohibits horizontal drilling, will allow “wells drilled for the purpose of exploration or development of natural gas through use of horizontal drilling in conjunction with hydraulic fracturing treatments.” Similarly, [General Statute 143-214.2](#), which prohibits most injection wells, will contain an exemption for “injection of hydraulic fracturing fluid for the exploration or development of natural gas resources.” Again, even though these techniques are no longer prohibited in North Carolina, DENR may not issue any permits for such activities until the General Assembly takes further legislative action. The General Assembly likely will not act until regulations are in place, which may take two years or more.

New Commissions

In order to lead the development and implementation of the state’s new “modern regulatory program,” the bill reconstitutes the North Carolina Mining Commission as the Mining and Energy Commission, and establishes a Joint Legislative Commission on Energy Policy, effective August 1, 2012. The Mining and Energy Commission (the “Commission”) will be a 15-member body made up of researchers, state officials, representatives of local governments in the Triassic Basin, members of conservation groups, oil and gas professionals, and representatives of the mining industry. The Governor, the Speaker of the House, and the President Pro Tempore of the Senate each will make four (4) appointments to the Commission, with the final three seats filled by the State Geologist, the

³ *Perdue Open to ‘Fracking’ in NC* (WRAL television broadcast, March 14, 2012).

⁴ *Governor’s Objections and Veto Message: Senate Bill 820, “Clean Energy and Economic Security Act”* (July 1, 2012).

⁵ This act was drafted with North Carolina’s Triassic Basin resources in mind. The regulatory program specifically excludes off-shore oil and gas exploration, either in the coastal sounds or in the Atlantic Ocean.

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Assistant Secretary of Energy, and the Chair of the N.C. State University Minerals Research Laboratory Advisory Committee. Commission appointments are still pending at this time. The Commission will be supported by the staff of DENR's Division of Land Resources, which will be renamed the Division of Energy, Mineral, and Land Resources.

With certain exceptions, regulatory authority over shale gas production will rest with the Commission.⁶ As stated in the Act, the Commission will have the rule-making authority to "establish a modern regulatory program for the management of oil and gas exploration and development in the State and the use of horizontal drilling and hydraulic fracturing treatments for that purpose." The Act sets out certain specific elements of the regulatory program that the Commission will specifically address in the rule-making process as discussed further below.

The Act also creates a ten-member Joint Legislative Commission on Energy Policy, made up of five members each of the House and Senate, to which the Commission will be required to report on a quarterly basis. This Joint Legislative Commission will monitor and evaluate state programs and policies, existing and proposed statutes and rules, developments in energy-related industries, and changes in federal law.

Parameters of the Regulatory Program

The Act outlines with some specificity the parameters of permitting and operational regulations to be developed by the Commission. New regulations are required to cover the entire development operation, from pre-drilling exploration through well construction, drilling, operation, casing, plugging, completion, and abandonment of wells. These regulations are to be designed to protect local water supplies, preserve air and water quality, require adequate safety standards for construction, and mitigate impacts on local infrastructure and environmental resources. The Commission is to establish a permitting program that incorporates regulatory standards. Among many other requirements, the Act instructs the Commission to develop standards for:

- Collection of baseline data regarding air, surface water, and groundwater quality, including pre-drilling surveys.
- Construction of oil and gas wells, including drilling, cementing, and casing standards, taking into account high pressures associated with hydraulic fracturing.
- Appropriate siting and layout of wells and gas production equipment and operations.
- Limitations on water use during hydraulic fracturing operations. Gas producers must develop a water management plan to be approved by DENR.
- Management of wastes and wastewaters. Gas producers must develop a wastewater management plan to be approved by DENR. Waste regulations will address storage, transportation, and disposal of wastes, including those not currently subject to the federal Resource Conservation and Recovery Act (RCRA).
- Mitigation of impacts on infrastructure, including damage to roads from heavy truck and equipment usage.
- Prohibition on the use of certain constituents in hydraulic fracturing fluids, particularly diesel fuel.

⁶ The North Carolina Environmental Management Commission will retain ultimate regulatory authority over stormwater and air emissions associated with oil and gas exploration and development activities.

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- Disclosure of chemicals and constituents used in exploration, drilling and production, including hydraulic fracturing fluids, to state regulatory agencies and local government emergency response officials.
- Financial assurance for closure and post-closure activities, including any required corrective action.
- Regulation of spacing of wells and the establishment of drilling units.
- Program permitting procedures, including the amount and quality of information required to be provided in support of permit applications.

DENR will coordinate development and adoption of these new regulations and must report to the Joint Legislative Commission on Energy Policy and the Environmental Review Commission each quarter, with the first report due in 2013. The Act sets a final deadline of October 1, 2014 for adoption of required regulations.

Landowner Protections

The Act contains substantial provisions designed to protect landowners who might lease or convey subsurface rights for natural gas development. These provisions, which were developed from a report by the Consumer Protection Division of the North Carolina Department of Justice, are outlined in some detail in the Act. These provisions are effective immediately.

The substantive landowner protection provisions include the following:

- Any person who enters land on behalf of an oil and gas company is required to carry identification sufficient to identify himself and his employer or principal and to present this identification upon request.
- Oil or gas developers are presumptively liable for contamination of any water supplies within 5,000 feet of a wellhead. In addition to any other remedies, any developer liable for water supply contamination is required to provide a replacement water supply.
- Surface areas affected by oil and gas development activities must be reclaimed within two years. A reclamation bond must be obtained in favor of the surface estate owner.
- Oil and gas developers and operators are required to indemnify surface owners for claims related to the developer's or operator's activities on that property.
- All "landmen" operating in the state must be registered with DENR beginning October 1, 2012. A "landman" is broadly defined as anyone who acquires or manages oil or gas interests; performs title or contract functions related to exploration, exploitation, or disposition; negotiates the acquisition or disposal of oil or gas rights; or negotiates business agreements that provide exploration or development of oil or gas.

The Act also imposes a number of required provisions for oil and gas leases. However, before any oil and gas lease may be executed, the lessee is required to provide the lessor with a copy of a publication, to be produced by the Department of Justice, which will outline the landowner's rights and will include a copy of the provisions described in this section. Additionally, the following provisions must be included in all leases:

- Lease terms are limited to 10 years unless oil or gas is being produced at the close of the 10 year period.

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- Royalty payments to lessors must not be less than 12.5% of proceeds of sale of oil or gas, not to be reduced by pre-production or post-production costs, fees, or other charges, and payments must commence no later than six months after the date of first sale.
- Bonus payments must be made within 60 days of lease execution or the lessor is entitled to interest of 10% per annum beginning on the due date.
- A provision stating the estimated amount of water, if any, the developer or operator will withdraw from supplies on the property, and the developer's water use may not restrict the surface owner's water supply for domestic uses. In addition, full compensation of not less than fair market value must be provided to the surface owner for all water used.
- A provision regarding pre-drill testing of all water supplies within 5,000 feet of the wellhead.

Once a lease is signed, the Act gives a period of time during which either party can rescind the lease with no penalty, and all oil or gas leases must be recorded within 30 days of execution in the applicable county land records.

Open Issues for Resolution

While the Clean Energy and Economic Security Act sets the legal framework for natural gas development in North Carolina, the Act leaves three important policy issues open for resolution going forward. On these three issues – dealing with public revenue, local government regulatory authority, and compulsory pooling – the Act requires the Commission, in conjunction with other governmental and non-governmental agencies, to make additional findings and recommendations with legislative proposals. First, the Commission will undertake an evaluation of proper levels of funding and funding sources required to support local governments and infrastructure impacted by oil and gas development activities and to administer the oil and gas regulatory program, including remediation of abandoned development sites. Funding sources could include permit fees, bonds, taxes, and local impact fees. Potential public revenue generation related to natural gas development is an important issue for local governments. Second, the Commission is to evaluate the role of local governments in regulating oil and gas exploration and development activities while maintaining a uniform regulatory program on a statewide basis. The Act indicates that local governments may maintain some land use regulatory authority, but the exercise of such authority cannot have the effect of prohibiting natural gas development activities. The local government authority issue remains an important issue in jurisdictions where the shale resource is located. Third, the Commission is to review the use of compulsory pooling and integration of oil and natural gas resources in drilling units. The current oil and gas law in North Carolina includes compulsory pooling provisions, but such provisions have never been implemented. These three important policy issues were not fully resolved in the Act and may be the subject of additional debate in future legislative sessions.

Conclusion

Over the past two years, North Carolina has gradually moved toward establishing the framework for development of shale gas resources. By lifting the ban on hydraulic fracturing and horizontal drilling, the state has taken its most significant step forward. Over the next two to three years, a comprehensive regulatory program will be established to enable commercial natural gas production for the first time in North Carolina. K&L Gates will be monitoring the rule-making process and other developments every step of the way.

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