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Client Alert Commentary

Latham & Watkins Environment, Land & Resources Practice Number 1616 | November 25, 2013

California Agency Releases Draft Rules for Fracking, Begins to Implement Recent State Legislation

Oil and gas companies and oil-field service providers with California operations should scrutinize newly proposed rules on hydraulic fracturing and well stimulation, with comments due by mid-January.

Introduction

On November 15, 2013, the California Department of Conservation, Division of Oil, Gas & Geothermal Resources (DOGGR) issued two key documents relating to hydraulic fracturing and other well-stimulation treatments: (1) proposed regulations to implement recently enacted Senate Bill 4 (SB 4) and establish a permit program for well-stimulation treatments; and (2) a notice of preparation (NOP) that initiates review of well-stimulation treatments under the California Environmental Quality Act (CEQA). These two actions mark the beginning of agency implementation of SB 4's various requirements. This regulatory activity will continue through 2015, and may be followed by possible litigation and judicial review. Energy companies and oil-field service providers engaged in California oil-and-gas extraction should scrutinize the regulations to assess whether their operations might be affected. Public comments on the draft regulations are due on or before January 14, 2014.

Neither the draft regulations nor SB 4 imposes an express moratorium on well-stimulation treatments while the regulations are being promulgated. Rather, if certain enumerated conditions are met, SB 4 explicitly allows continued use of well-stimulation treatments. DOGGR progress in developing the regulations and undertaking the CEQA review provides an important hedge against any interruption of well-stimulation treatments. Oil-and-gas operators should be able to satisfy other statutory conditions, as described in more detail below.

Though media reports regarding oil-and-gas production often focus on hydraulic fracturing, SB 4 and the draft regulations cover a variety of well-stimulation treatments, including hydraulic fracturing and acid treatments, among others. Both SB 4 and the draft regulations apply not just to the Monterey Shale oil play, but statewide to any oil-and-gas extraction involving well-stimulation treatments.

Below, we briefly describe the NOP and the CEQA process, key features of the draft regulations (and how they compare with SB 4 and DOGGR's previous draft regulations on hydraulic fracturing), interim well stimulation by operation of statute, how the draft regulations may affect well-stimulation treatments on federal lands, and opportunities for public comment.

CEQA Notice of Preparation (NOP)

The NOP marks the beginning of DOGGR's statutorily-required CEQA process. CEQA requires state and local agencies in California to identify the significant environmental impacts of their actions and, if applicable, requires that the agency undertake a detailed environmental review. SB 4 requires DOGGR to

prepare an environmental impact report (EIR) analyzing well-stimulation treatments, to be certified by July 1, 2015.

DOGGR identifies the subject of the EIR as "well-stimulation treatments of both conventional and non-conventional oil and gas resources" within California. The NOP does not explicitly state how the EIR ultimately will be used by DOGGR. This may be due to DOGGR's view that issuing permits for well-stimulation treatments is a ministerial activity (similar to the issuance of most building permits, which do not generally require CEQA review). Alternatively, DOGGR may contemplate that the EIR will form the basis for CEQA clearance of future permits, and that future permits will not require additional, individual CEQA review. As a hedge against arguments from fracking opponents that individual permits are an event that triggers CEQA, the regulated community should advocate that the EIR be broad enough to cover future permits that DOGGR issues relating to well stimulation.

The EIR will analyze well-stimulation treatments statewide; DOGGR plans to evaluate impacts by administrative district, of which DOGGR has six. The NOP lists 17 environmental resources that DOGGR expects to analyze — including air quality, biological resources, greenhouse gas emissions, and hydrology and water quality. Clearly preparing the EIR will be a major undertaking. The EIR will contain a retrospective aspect, not only looking at potential future impact, but also whether past well-stimulation activity adversely has impacted the environment.

Not addressed in the NOP is whether any CEQA review will be conducted for well-stimulation treatments that occur between now and the certification of the EIR. Similarly unaddressed is what happens if either the EIR (or the regulations) slips beyond their statutory due dates. DOGGR may address these issues, as well as details of the EIR process, in the upcoming scoping meetings.

The Proposed Well-Stimulation Regulations

SB 4 requires DOGGR to adopt regulations in order to implement the statutory requirements of SB 4 regarding well-stimulation permits, public disclosure, neighbor notification and water well testing. The November 15 draft regulations contain considerably more substance and detail than DOGGR's previously released December 2012 "Pre-Rulemaking Discussion Draft" (discussion draft), as well as a number of important changes. The significant differences between the December 2012 discussion draft and the November 15 formal draft regulations reflect the new requirements of SB 4 in addition to other changes. Given the prior intense focus on the discussion draft, principal differences between it and the new proposal are discussed below. In addition, we have prepared a table available at Appendix 1, which describes these differences, and also lists the requirements of SB 4.

First, the draft regulations expand the ***scope of activities covered*** to include all "well-stimulation activities" involving any "treatment of a well designed to enhance oil and gas production or recovery by increasing the permeability of the formation," including hydraulic fracturing, acid fracturing and acid matrix stimulation with concentrations of seven percent or more. In contrast, the discussion draft's scope was limited to only "hydraulic fracturing activities." The draft regulations cover all "well-stimulation fluids" and not just hydraulic fracturing fluids, as was the case with the discussion draft. Well-stimulation fluids are those fluids which are used "for the purpose of a well-stimulation treatment" and include "hydraulic fracturing fluids and acid stimulation treatment fluids." Importantly, the draft regulations exclude carbon dioxide injection for purposes of enhanced oil recovery from the definition of well-stimulation treatment and thus do not apply to carbon sequestration achieved through such injection.

Second, the draft regulations contain a detailed discussion of a ***permitting program*** for well-stimulation activities, in accordance with SB 4 requirements. Under the draft regulations, operators must obtain a

permit from DOGGR for all well-stimulation treatment and repeat well-stimulation treatment activities. The permits would be effective for one year. All treatments and repeat treatments must comply with the conditions attached to DOGGR's permit approval, and operators must notify DOGGR 72 hours before commencement of any permitted stimulation activity so that DOGGR may observe the stimulation activity. SB 4 and the draft regulations set out detailed permit content requirements, which include information on the stimulation activity to be performed, the location of the well and surrounding land, a water management plan, and detailed information on every chemical in the well-stimulation fluid to be used.

Third, the draft regulations mandate greater ***disclosure of well-stimulation activity*** than the discussion draft. In connection with the permitting program, operators must deliver a copy of the permit and notice of the availability of water testing and sampling to all surface property owners and tenants of land located within a 1,500-foot radius of the wellhead or within 500 feet of the horizontal projection of the well. Among other changes from the discussion draft, operators would be required to post to the Chemical Disclosure Registry the operator's name, the well's API number, lease name and number, location, and the date of the well-stimulation treatment. Both SB 4 and the draft regulations could be read to increase the trade secret procedural requirements and to limit the trade secret exemption; information not subject to a trade secret claim under SB 4 includes (1) identities of additives, (2) concentration of additives, (3) pollution monitoring data, (4) health and safety data, and (5) the chemical composition of the flowback fluid.

Fourth, the discussion draft and draft regulations both contain requirements for operators to conduct a ***well-stimulation evaluation radius analysis*** and a ***cement evaluation*** prior to commencing stimulation activities. The draft regulations, however, expand the radius that triggers geological formation review from twice the fracture length as proposed in the discussion draft to five times the length. The draft regulations allow for DOGGR to waive the cement evaluation requirement if sufficient information exists from previous well-stimulation activities in the area.

Interim Well Stimulation by Operation of Statute

Oil-and-gas activities may continue in California while the rulemaking is underway, a process which is anticipated to take about a year to complete. SB 4 provides that owners or operators may proceed with well-stimulation treatments without a permit if they comply with the specified provisions of the law. For example, the law provides that DOGGR "shall allow" such activity "upon written notification by an operator." SB4 provides no details as to the content and timing of the operator notice, but the conditions under which DOGGR "shall allow" ongoing well stimulation include operator submittals by March 1, 2015 of complete well histories which must contain the "information required by Section 3160" of SB 4. As Section 3160 goes well beyond operator information, a logical reading is that operators must provide the information required by Section 3160 that reasonably is within the province of the operator.

Another condition requires that the operator certify compliance with various provisions of Section 3160. Once again, apparently such operator certification would be limited to those elements of Section 3160 reasonably within the province of the operator.

The Section 3160 conditions also are linked to the permitting process discussed above. Operators have until December 31, 2015 to transition well-stimulation activity into the permit program DOGGR is developing; DOGGR could accept notices of intent as a sufficient basis to meet the December 31, 2015 date. Affected operators should consider applying for well-stimulation permit coverage as soon as possible under the new program.

SB 4 provides DOGGR with "emergency regulatory authority" to adopt emergency regulations to facilitate well-stimulation treatments (consistent with statutory conditions) while final regulations are developed.

Observers believe that DOGGR may release such regulations and guidance soon, possibly by year end. Under California law, the adoption of emergency regulations is not subject to the standard notice-and-comment rulemaking requirements. Instead, an agency adopting emergency regulations follows scaled-back procedural requirements, including sending notice of the proposed emergency action to persons who have filed a request for notice of regulatory action with the agency.

Implications of DOGGR Program on Federal Lands

Oil-and-gas extraction occurring under lease on federal lands in California must follow both federal and state requirements. The federal Bureau of Land Management (BLM) recently issued revised proposed rules regarding well stimulation on federal and Indian lands and is currently in the process of reviewing over one million public comments submitted on the proposal. DOGGR states that it is in "regular dialogue with BLM for the purpose of ensuring harmonized and efficient implementation of the two agencies' respective regulations." As an example of that coordination, both the California and the BLM proposed rules would require public disclosures to be made at FracFocus.org, an industry- and state-sponsored website, until DOGGR develops its own reporting website. The BLM rule may be finalized before the California rule. This scenario would give DOGGR an opportunity to adjust any operational standards as necessary to address public comments it receives with respect to operations on federal lands.

BLM's proposed rule provides, among other things, for the BLM to coordinate standards with individual states to improve efficiency. States may seek a variance from the final BLM regulations, which would allow an operator's compliance with state operational standards to be accepted as compliance with the BLM rule. Approval of the variance would be within BLM's discretion, and the alternative state standard would be required to meet or exceed the objectives of the BLM regulation. Importantly, even if a variance were granted, the operator would still need to follow BLM's notice and approval procedures.

Next Steps

Interested parties may submit comments on the proposed regulations by January 14, 2014 and on the NOP by January 16, 2014. Topics of interest may include: (1) the scope of the CEQA review in order to provide broad clearance for future permitting; (2) public disclosure requirements; and (3) the importance of permitting oil-and-gas drilling to continue by operation of statute for the duration of the DOGGR rulemaking and CEQA process without limitation.

Under its emergency regulatory authority, DOGGR also may issue interim guidance or rules implementing SB 4's provisions allowing well stimulation from now to finalization of the regulations and permit program. That interim guidance could be issued as soon as next month. The emergency regulations are likely to set out the procedures for interim stimulation and therefore companies anticipating such activities during the regulatory development period should monitor any such emergency regulations closely.

DOGGR will host a series of public meetings on the draft regulations and on the NOP and CEQA process beginning on December 10, 2013. Please see Appendix 2 for details on dates, times and locations. To be added to DOGGR's email mailing list to receive notification of ongoing activities, visit: http://www.conservation.ca.gov/index/Pages/MailingLists.aspx.

For additional milestones that SB 4 establishes, please see: Appendix 3.

Conclusion

We expect numerous states, NGOs and industry to closely watch DOGGR's implementation of SB 4 to see how California transitions from the prior period when well stimulation was not the subject of intense

legislative and regulatory focus. Of keen interest is whether this transition would permit development of California's Monterey Shale in a manner that is economically competitive with the development of oil reserves elsewhere, or whether such government involvement will present hurdles that materially delay economic development of the world's largest, deep shale-oil play.

Finally, the months ahead could see additional legislation relating to well-stimulation treatments. SB 4 was advanced as a compromise bill, and parts of it were drafted in haste. Governor Brown acknowledged in his September 20, 2013 signing statement that the "bill needs some clarifying amendments;" he pledged to "work with the author in making those changes next year." Opponents of hydraulic fracturing may try to use the legislative process to implement additional obstacles for oil-and-gas operations. Stakeholders should be sure to continue to monitor both the legislative and regulatory processes for future impacts to oil-and-gas operations in California.

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The authors would like to thank Robert Denicola for his contribution to this article.