

June 2014

*Practice Group(s):*

*Public Policy and Law*

*Energy*

*Oil and Gas*

*Environment, Land and Natural Resources*

## NORTH CAROLINA SET TO OPEN DOORS TO SHALE GAS PRODUCTION

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North Carolina has just taken significant steps forward toward potential development of the state's shale gas resources. The Energy Modernization Act (also known as [Senate Bill 786](#); the "Act"), ratified by the legislature and then signed into law by Governor Pat McCrory on June 4, 2014, is designed to be the final legislative authorization before finalization of a full modern regulatory program and issuance of state permits for shale gas development in North Carolina.

### BACKGROUND

For most of the last fifty years, North Carolina has not been on the map when it came to oil and gas production; in the case of [maps developed by the U.S. Energy Information Administration](#), North Carolina is quite literally not on the map. This status has been due partly to a lack of proven resources; partly to an outdated Oil and Gas Conservation Act; and most importantly, that horizontal drilling and hydraulic fracturing were prohibited in the state.

That all began to change in 2008 and 2009, when the North Carolina Geological Survey found evidence to suggest that commercially viable quantities of natural gas may exist in shale deposits in the state. Legislative movement immediately followed: as covered in prior alerts, the North Carolina General Assembly ordered a [study of horizontal drilling and hydraulic fracturing](#) in 2011. The [following year](#), the General Assembly passed [the Clean Energy and Economic Security Act \(S.L. 2012-143\)](#), which reconstituted North Carolina's Mining Commission as the "Mining and Energy Commission" (the "Commission") and charged it with developing "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" by October 1, 2014. S.L. 2012-143 § 2(c); N.C. Gen. Stat. § 113-391(a).

Since its formation, the Commission has been at work drafting such a modern regulatory program. As the Commission nears completion on its [comprehensive set of regulations](#), the Act sets the stage for North Carolina to begin issuing permits for horizontal drilling and hydraulic fracturing, potentially as early as mid-2015.

### KEY PROVISIONS OF THE ENERGY MODERNIZATION ACT

Below is a summary of the key provisions of the Act. In addition to the items below, the Act makes a number of other, minor changes to the administrative process for oil and gas rules, the method of appointment of Commission members, and removes a handful of antiquated concepts from North Carolina's oil and gas statutes.

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### Finalization of Rules and Potential Issuance of Permits

Perhaps most importantly, the Act sets a time table for the potential issuance of permits for oil and gas development activities using horizontal drilling and hydraulic fracturing. The Act sets out the following timetable and process:

- Rule adoption: all rules required by prior legislation must be adopted by January 1, 2015, an extension of the prior deadline of October 1, 2014.
- Rules Review Commission: once the Commission approves the proposed rules, they will be published in the North Carolina register, be open for public comment, and undergo review by the North Carolina Rules Review Commission (“RRC”), an executive agency that reviews all rules promulgated by North Carolina state agencies. The RRC has until the end of the month following the month in which it receives the rule to complete its review, which could result in procedural and technical changes.
- General Assembly review: the General Assembly has a period of 30 days (or the first 30 calendar days of the legislative session, if it has not yet begun) to introduce a bill disapproving any or all of the rules. The rules become effective if no such bills are introduced during this time, or if (1) any bills to disapprove all or part of the regulatory program receive unfavorable final action, (2) the session adjourns without ratifying a bill that disapproves a rule, or (3) 60 days pass from the RRC’s approval of the rule (or the first 60 days of the session, if the RRC approves the rules when the General Assembly is not in session) without a bill to disapprove a rule being ratified.
- Permits issue: On the 61st day after the rules become effective, Section 3 of the Act authorizes the Department of Environment and Natural Resources (“DENR”) and the Commission to issue permits for oil and gas exploration and development using horizontal drilling and hydraulic fracturing.

### New Oil and Gas Commission Established

The Act ends the terms of all sitting members of the Commission, effective July 31, 2015. Effective the following day, the current duties of the Commission will be split between a newly established nine-member North Carolina Oil and Gas Commission and an eight-member Mining Commission. The selection of members to these new commissions will be similar to the current Commission in terms of the criteria for selection and the persons and bodies making the appointments.

### Fees and Taxes

The Act alters the fee for drilling oil and gas wells, outlines a severance tax, and prohibits local taxation.

First, instead of a flat \$3,000 fee for each well drilled in search of oil and/or gas, the fee will be \$3,000 for the first well drilled on a pad and \$1,500 for each additional well on the same pad, essentially offering a 50% discount to any developer who puts multiple wells on a pad.

Second, the Act institutes a sliding-scale severance tax over the course of roughly eight years, as follows:

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- From July 1, 2015 through the end of 2018:
  - For oil and condensates, the tax is 2% of the gross price paid by the first purchaser at the wellhead;
  - For gas, the tax is 0.9% of delivered-to-market value (determined by subtracting the producer's actual costs to deliver the gas to the market from the producer's total gross cash receipts from the sale of the natural gas). Note that a producer may also apply for a determination that the well qualifies as a marginal gas well, in which case, the rate would be 0.4% of delivered-to-market value.
- From January 1, 2019 through the end of 2020:
  - The rate for oil and condensates rises to 3.5%;
  - The marginal gas rate rises to 0.6%; and
  - The rate for gas is on a sliding scale that depends on the delivered-to-market value of the gas. On the low end, the rate is 0.9% when gas is \$3 per MCF or less; at the high end, the rate is 2.9% when the delivered-to-market value is over \$4.01 per MCF.
- From January 1, 2021 through the end of 2022:
  - The rate for oil and condensates rises to 5%;
  - The rate for marginal gas rises to 0.8%; and
  - The high end of the sliding scale for gas grows—at the top end, gas with a delivered-to-market value of over \$7.01 per MCF would be taxed at 5%.
- Starting January 1, 2023, the upper end of the sliding scale grows again—the highest rate becomes 9%, applied to gas at a delivered-to-market value of over \$10.01 per MCF.

Finally, the Act prohibits local governments from taxing severance, production, processing, ownership, purchase and sale, or transportation of energy minerals produced, as well as ownership of facilities and equipment related to these practices. The Act also excludes from the property tax base energy mineral interests in property for which a development permit has not been issued. It is noteworthy that the Act gives general direction, but does not specify how severance tax revenue will be used by the State.

### Local Government Authority

In addition to the prohibition on local taxation, the Act pre-empts local governments from prohibiting oil and gas exploration, development, and production activities, and from enforcing ordinances that have the effect of prohibiting these activities. However, general local zoning and land use ordinances may still apply, as long as they do not have the effect of prohibiting the exploration, development, or production of oil and gas. The Act creates an appeal process by which any party that believes its activities to have been prevented by local ordinance may petition the Commission for a hearing to review the matter. If the ordinance prohibits or has the effect of prohibiting oil and gas exploration, development, and production activities, or use of horizontal drilling or hydraulic fracturing for that purpose, and the activity would otherwise be permitted and does not present an unreasonable health or environmental risk, the Commission may pre-empt the ordinance.

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### Environmental Issues

The Act makes several changes to statutes related to cleanup and reclamation of oil and gas development sites, including imposition of financial assurance to cover any environmental damage:

- Injection wells for waste from exploration, development, and production, or hydraulic fracturing or horizontal drilling operations are prohibited;
- Permit applicants must supply an environmental compliance history, including information related to the environmental compliance of parents, subsidiaries, officers, and other related persons, over at least the prior five years, and a history of violations, penalties, or compliance orders could result in denial of a permit;
- All persons having control over activities that contribute to contamination, property damage, or other violations of the oil and gas conservation statutes will be jointly and severally liable for recovery of cleanup costs, damages, or civil penalties; and
- Oil and gas developers or operators will be required to post a bond in an amount of no less than \$1 million, running to the State of North Carolina, to assure coverage of environmental damage costs.

### Trade Secrets and Confidential Information

Among the most-frequently discussed and most hotly debated topics related to shale gas development in North Carolina are the scope and limitations on public disclosure of information related to the contents of hydraulic fracturing fluids. Such information may constitute trade secrets or business confidential information normally protected from public disclosure. The Act provides that any person, “upon a showing satisfactory to the Commission,” may request that certain information be treated as confidential and protected from public disclosure if such information “would divulge methods or processes entitled to protection as confidential information pursuant to” North Carolina’s public records law. The public records law, N.C. Gen. Stat. § 132-1.2, protects business or technical information that derives independent actual or potential commercial value from not being generally known or readily ascertainable, and that is the subject of reasonable efforts to maintain its secrecy. Commission decisions as to confidential treatment of information may be challenged by appeal to Superior Court as a complex business case, and the court is required to award attorneys’ fees to a party that seeks disclosure and substantially prevails or against a party that institutes an action that the court determines was filed in bad faith or was frivolous.

Information that the Commission determines to be confidential will be reviewed by the State Geologist for compliance with chemical release standards and chemical prohibitions. This determination must be made and certified before a horizontal drilling or hydraulic fracturing operation using material subject to trade secret protection may commence. In addition, the State Geologist, in conjunction with the State Health Director, must inform local health departments of additional parameters that should be included in testing for nearby private drinking water wells.

Confidential information would only be permitted to be disclosed under the following conditions and to the following persons:

- To state or federal agencies where necessary to carry out a proper function of the agency;

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- To the Division of Emergency Management of the Department of Public Safety, as necessary for the purposes of emergency planning and emergency response;
- To a treating health care provider who determines that a medical emergency exists and that the information is necessary for emergency or first-aid treatment; and
- To a fire chief when necessary to address an emergency.

In the case of disclosure to a health care provider or a fire chief, DENR is required to disclose the information immediately and to inform the owner of the confidential information as soon as practicable, but no later than 24 hours after disclosure. The owner may require execution of a written statement of need and a confidentiality agreement.

### Surface Use Disturbances

The Act also requires notice to surface owners prior to commencing development activities and modifies or clarifies potential areas of liability. Any oil or gas developer or operator who leases subsurface resources must provide written notice of proposed activities to the lessor at least 30 days before operations begin. This notice must include at least a description of the plan of exploration or development, a proposed start date, and a designated contact person for communications with the lessor.

The Act also reduces the radius within which an operator is presumptively liable for any water supply contamination, down from 5,000 feet to one-half mile. It also clarifies that seismic and geophysical data collection operations will not result in liability for trespass, as long as the collector is undershooting from an off-site location with no physical entry, or they obtain the landowner's written consent. However, the data collector is still liable for physical or property damage resulting from seismic or geophysical data collection activities.

### Studies

The General Assembly has commissioned a long list of shale gas studies in recent years, and the Act adds to the list by ordering the following eight new studies related to the production of oil and gas in North Carolina:

- Property tax valuation: The Local Government Division of the Department of Revenue is to study how other states value energy minerals for property tax purposes, including guidelines for counties to ensure consistent and fair taxation. This report is due to the Joint Legislative Commission on Energy Policy by January 1, 2015.
- Property tax impact: The Joint Legislative Commission on Energy Policy is to study, for the 2015 General Assembly, how the development of an oil and gas industry in the state would affect the property tax revenues of local governments, including how the presence of oil and gas might affect property enrolled in the present use value program and how to limit the growth of property tax revenue.
- LNG Export Terminal: The Department of Commerce, in consultation with other agencies, is to study the desirability and feasibility of establishing and operating a liquefied natural gas (LNG) export terminal in North Carolina, including permitting issues; regulatory barriers; potential infrastructure needs and impacts; cost-benefit analysis; and analyses of impacts on the economy, the environment, and quality of life. A report is due to the Legislative Commission on Energy Policy and the Environmental Review Commission on or before January 1, 2015.

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- Transportation Infrastructure: the North Carolina Department of Transportation is ordered to study additional authority, permit provisions, and bonds or other surety mechanisms (including maintenance agreements) that it may need to address traffic and infrastructure impacts from the oil and gas industry. This study is due to the Joint Legislative Energy Policy Commission and the Joint Legislative Transportation Oversight Committee on or before January 1, 2015.
- Job Skills: The State Board of Community Colleges is charged with studying the feasibility and desirability of developing a program to prepare students for employment in the oil and gas industry, including an evaluation of similar programs in other states. The study report is due to the Joint Legislative Energy Policy Commission and the Joint Legislative Education Oversight Committee on or before January 1, 2015.
- Specific recommendations regarding unitization, compulsory pooling, and dormant mineral estates: the Act takes DENR to task for not providing specific recommendations regarding compulsory pooling and unitization, and requires it to study, in conjunction with the Commission and the Consumer Protection Division of the North Carolina Department of Justice, the issue of amending current dormant mineral statutes regarding extinguishment and other consumer protection issues related to split estates. Specific recommendations for legislative action are due to the Joint Legislative Commission on Energy Policy and the Environmental Review Commission on or before October 1, 2015.
- Midstream infrastructure: the Commission and DENR are tasked with studying the development of midstream infrastructure in North Carolina. A report, including specific proposals for legislative action, is due to the Joint Legislative Commission on Energy Policy on or before March 1, 2015.
- Comprehensive long-range energy policy: Finally, the State Energy Office within DENR must study and make legislative recommendations on a comprehensive long-range state energy policy to achieve maximum effective management and use of present and future sources of energy, including long-term environmental and economic impacts of conventional, renewable, and alternative sources. As part of this study, the State Energy Office is tasked with reviewing the implementation and impacts of the state's renewable energy portfolio standard. This report is due to the Joint Legislative Commission on Energy Policy on or before December 1, 2014.

## CONCLUSIONS

The Act represents a significant milestone in the potential development of a modern oil and gas industry in North Carolina. After several years of rulemaking and legislative wrangling, once the Commission finishes drafting its complete rule set later this year, the clock will begin to run toward authorizing the issuance of permits for horizontal drilling and hydraulic fracturing in North Carolina. K&L Gates attorneys and government affairs counselors have been actively involved in the legislative and regulatory processes throughout the development of the Act and legislation leading up to the Act. The firm has extensive experience advising clients across the globe on oil and gas matters, including many of those addressed by the Act, and remains closely involved in matters of oil and gas legislation and regulation in North Carolina.

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