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With North Carolina's Shale Gas Study Nearly Complete, Legislation to Legalize Hydraulic Fracturing is Expected to Move Forward in 2012

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Overview and Background

North Carolina is not traditionally thought of as an oil and gas state. However, recent geological research regarding shale gas deposits and the potential authorization of shale gas extraction technologies in North Carolina could change that. Legislation enacted last year set in motion a process that could result in the legalization of horizontal drilling and hydraulic fracturing – game-changing technologies that have turned shale deposits in other parts of the country into top resource plays. The North Carolina Department of Environment and Natural Resources (“DENR”) has preliminarily concluded that hydraulic fracturing and horizontal drilling could properly be authorized if an adequate regulatory program is established and implemented. As a result of DENR’s comprehensive study, enabling legislation is expected to go forward in the 2012 legislative session that begins in May.

Final Shale Gas Study Report Due by May 1

In June 2011, the North Carolina General Assembly enacted [Session Law 2011-276](#) after substantial debate and opposition from certain citizen groups. The law directed 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.” Further, the 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.

DENR published a proposed outline of the study and held public hearings in late 2011 to solicit input on the scope of the study. One of the first steps in the study process was DENR’s request for a neutral third party review of current North Carolina environmental regulations by a group known as State Review of Oil and Natural Gas Environmental Regulations, Inc. (“STRONGER”). STRONGER is an entity formed by U.S. EPA and the Interstate Oil and Gas Compact Commission and is a multi-stakeholder group that reviews and reports on state environmental regulations pertaining to oil and gas development. STRONGER has conducted reviews of many gas producing states such as Pennsylvania (2010), Oklahoma (2011), Louisiana (2011), and Arkansas (2012). A STRONGER committee studied North Carolina’s regulations and issued a review report in February 2012. The STRONGER committee made no recommendation regarding whether North Carolina should revise its regulations to permit hydraulic fracturing and horizontal drilling, but noted that:

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“While North Carolina has mature environmental regulatory programs, the programs have not needed to focus on regulating the impacts of oil and gas development. That may change depending on decisions made by the state. If North Carolina decides to develop an oil and gas regulatory program, that program should contain criteria to address oil and gas related activities, including administrative criteria, technical criteria related to exploration and production waste management, stormwater management, abandoned sites, naturally occurring radioactive materials, and hydraulic fracturing.”¹

The STRONGER report may be viewed at: <http://portal.ncdenr.org/web/guest/public-input>.

DENR took into account the STRONGER recommendations, and after extensive additional research and review, DENR released its *Draft North Carolina Oil and Gas Study Under Session Law 2011-276* on March 16, 2012. The draft report concluded that “After reviewing other studies and experiences in oil and gas-producing states, DENR believes that hydraulic fracturing can be done safely as long as the right protections are in place. It will be important to have those measures in place before issuing permits for hydraulic fracturing in North Carolina’s shale formations.”² Following the issuance of the draft report, additional public hearings were held in Sanford, NC and Chapel Hill, NC. Issuance of the DENR draft report coincided with a statement from North Carolina Governor Beverly Perdue on March 14, 2012 in which 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 This was a dramatic and positive change in position by the Governor’s Office regarding shale gas development in North Carolina. After taking into account the public comments received through April 2, DENR will finalize the shale gas study and make its full report to the General Assembly by May 1, 2012.

While a full review of the draft report is beyond the scope of this alert, copies of the entire draft report and excerpts of the executive summary and recommendations can be found at: <http://portal.ncdenr.org/web/guest/denr-study>. It should be noted in particular that DENR’s estimates of economic development impacts and estimates of the shale gas resource itself are limited significantly because they are restricted to the Sanford Sub-basin, which is just a portion of the potential shale play in North Carolina.

DENR Recommendations in the Draft Study Report

Although DENR concluded in the draft report that hydraulic fracturing can be conducted safely with an adequate regulatory program in place, the draft report sets forth a long list of recommendations before the use of hydraulic fracturing goes forward. Specifically, DENR recommended that the state:

1. Collect baseline data including data regarding groundwater, surface water, and air quality.
2. Require oil and gas operators to prepare and have a DENR-approved Water Management Plan and limit water withdrawals to 20% of the 7Q10 stream flow.
3. Enhance existing oil and gas well construction standards to address the additional pressures of horizontal drilling and hydraulic fracturing.

¹ STRONGER, *North Carolina State Review* (February 2012) at 6.

² North Carolina Department of Environment and Natural Resources, *Draft North Carolina Oil and Gas Study Under Session Law 2011-276* (March 16, 2012) at 293.

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

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4. Develop setback requirements and identify areas (such as floodplains) where oil and gas exploration and production activities should be prohibited.
5. Develop a state stormwater regulatory program for oil and gas drilling sites.
6. Develop specific standards for management of oil and gas wastes.
7. Require full disclosure of hydraulic fracturing chemicals and constituents to regulatory agencies. With the exception of trade secrets, require public disclosure of hydraulic fracturing chemicals and constituents.
8. Prohibit the use of diesel fuel in hydraulic fracturing fluids.
9. Improve data management capabilities and develop an e-permitting program.
10. Ensure that state agencies, local first responders and industry are prepared to respond to a well blowout, chemical spill or other emergency.
11. Develop a modern oil and gas regulatory program, taking into consideration the processes involved in hydraulic fracturing and horizontal drilling technologies, and long-term prevention of physical or economic waste in developing oil and gas resources.
12. Keep the environmental permitting program for oil and gas activities in DENR where it will benefit from the expertise of state geological staff and the ability to coordinate air, land and water quality permitting.
13. Develop a coordinated permitting process.
14. Address the distribution of revenues from oil and gas excise taxes and fees to support the oil and gas regulatory program, fund environmental initiatives, and support local governments impacted by the industry.
15. Identify a source of funding for repair of roads damaged by truck traffic and heavy equipment.
16. Clarify the extent of local government regulatory authority over oil and gas exploration and production activities.
17. Complete additional research on impacts to local governments and local infrastructure.
18. Complete additional research on potential economic impacts.
19. Address the natural gas industry's liability for environmental contamination caused by exploration and development, particularly for groundwater contamination.
20. Provide additional public participation opportunities.

Draft Bill Legalizing Hydraulic Fracturing Approved by Senate Committee

On April 18, 2012, the North Carolina Senate Energy Policy Issues Committee approved a draft shale gas bill entitled the "Clean Energy and Economic Security Act" that would legalize hydraulic fracturing and horizontal drilling. This draft bill begins the formal debate of shale gas development in the General Assembly this year. The draft bill is part of the Committee's report to the General Assembly for the 2012 legislative session and can be viewed at:

<http://www.ncleg.net/gascripts/DocumentSites/browseDocSite.asp?nID=187>

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While the draft bill addresses many of the primary issues raised by the DENR draft report, it leaves some issues for further consideration. As an initial matter, the bill would make hydraulic fracturing and horizontal drilling legal by removing the current statutory and regulatory prohibitions on these practices, but would impose a "moratorium" on the issuance of permits for activities using hydraulic fracturing or horizontal drilling technology until July 1, 2014. Other legislative alternatives reported in the press recently suggested that the current legal prohibitions remain in place while DENR conducts further study and review and then establishes a strict regulatory program. This issue – whether to repeal the prohibition on hydraulic fracturing now or later after several years of rulemaking and additional study – will be the threshold issue in the debate of this bill.

Also of significance, the draft bill would create an Oil and Gas Board that would adopt regulations for oil and gas development activities. The Oil and Gas Board would be directed to develop a shale gas regulatory program during the moratorium period and adopt rules by December 31, 2013. The Oil and Gas Board would have nine members, and the Governor, the House Speaker, and the Senate President Pro Tempore would each appoint three members. DENR would no longer have the authority to adopt rules associated with gas development, but would enforce the rules established by the Oil and Gas Board. While the draft bill notes that the new Oil and Gas Board and DENR would have certain "concurrent authority," the creation of a new regulatory entity appears to contradict DENR's recommendation in its draft report to keep the oil and gas permitting program under DENR's jurisdiction.

The draft bill also addresses the allocation of regulatory authority between the state and local governments. Stating an intent to establish a uniform system for natural gas development activities, the draft bill would limit local government authority to regulate such activities. The bill would repeal and prohibit any local government effort to prohibit or effectively prohibit oil and gas exploration and development. Further, a process would be established for the Oil and Gas Board to review local government ordinances for preemption. Local land use and zoning ordinances that are generally applicable to development, such as set back and buffer requirements, would be presumed valid and not preempted. These provisions will be of great interest to local governments, which traditionally have had local land use and zoning authority and have commonly established special use permitting processes. The fact that shale gas development could have significant local impacts may favor allocating some regulatory authority to local governments. However, a permitting and approval process that is uniform and consistent would give industry players the certainty necessary to make informed business decisions.

Regarding revenue, the draft bill would allow local governments to impose impact fees on oil and gas wells drilled within a particular jurisdiction. Such impact fee would be a one-time fee with a cap of \$30,000 per well. The draft bill does not include a severance tax or any revenue generation mechanism for direct revenue to the state. Further consideration of the revenue portions of the draft bill may include review of potential restrictions on the use of impact fee revenue for site restoration, environmental cleanup, stormwater management, emergency response, education and training of inspectors, or other uses.

Conclusion

Building on the legislation from 2011, recent developments move North Carolina significantly closer to shale gas development. With the DENR shale gas study nearly complete, enabling legislation and the establishment of a regulatory program for hydraulic fracturing and horizontal drilling would be the next steps toward the realization of this significant economic development opportunity for North

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Carolina. Without question, substantial issues remain for further consideration and determination related to these important issues, and we expect these policy discussions to be on-going.

On March 29, 2012, K&L Gates LLP held the first annual Developing North Carolina Shale Gas Conference in Raleigh. The firm has vast experience assisting natural gas producers and has led the way on important legal issues in Pennsylvania and throughout the Marcellus Shale. As such, we are uniquely qualified to assist with the environmental, legal, regulatory, and policy issues related to the potential development of shale gas in North Carolina. For a copy of the conference materials, please [click here](#).

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