LOS ANGELES
Daily Journal
www.dailyjournal.com
TUESDAY, JUNE 24, 2014

PERSPECTIVE

Legal risks of fracking bans are real

By Jeffrey Dintzer and Nathaniel Johnson

The hydraulic fracturing ("fracking") industry — one of many advanced well stimulation techniques used for conventional well work by the oil and natural industry — is growing in California, with substantial benefits for the state. Fracking and other advanced techniques promise to unlock previously inaccessible oil and natural gas from California's shale formations, which are possibly the largest deep-shale reserves in the world.

To support growth of the fracking industry, California recently passed broad, progressive regulations with Senate Bill 4. SB 4 requires the secretary of the Natural Resources Agency to complete an independent scientific study of well stimulation techniques, including fracking. While the study is conducted, California wisely is allowing fracking to continue under a state-wide permitting scheme. By permitting fracking, California has effectively balanced the powerful economic benefits of fracking with concern for its citizenry. Moreover, by vesting authority in a state regulator, California avoided the uncertainty that would plague a fracking industry exposed to a patchwork of local regulations.

Unfortunately, some parties are unsatisfied with the comprehensive system of regulations developed under SB 4. Municipalities have rushed into the fray by proposing local bans or moratoria on fracking and other well stimulation techniques. Earlier this year, the city of Los Angeles went so far as to adopt recommendations requesting the city attorney to prepare an ordinance to prohibit the use of any well stimulation technique, including fracking.

Invariably, these prohibitive ordinances are based on ill-informed concerns about the possible environmental consequences of fracking.

JEFFREY DINTZER
Gibson Dunn

NATHANIEL JOHNSON
Gibson Dunn

AP Photo

Rush hour traffic passing operating crude oil pumps at the Inglewood Oil Field in the Baldwin Hills area of Los Angeles, March 6.

Despite the dubiousness of these concerns — concerns that have been repeatedly dismissed by state regulators and experts — municipalities are charging forward. The imposition of draconian bans on fracking and other well stimulation techniques could quickly entrench municipalities in costly legal battles. The Los Angeles ordinance, for example, effectively spells the end of even century-old conventional oil and gas production. If adopted, the city's ban would be susceptible to a facial legal challenge for overbreadth, and potentially cost the city billions of dollars in legal liability ("Fracking Ban Will Have Consequences," Daily Journal, March 19, 2014).

While some commentators have hastily dismissed the legal risks of local fracking ordinances ("Fracking Bans Respond to Real Concerns," Daily Journal, May 29, 2014), municipalities should be wary of letting uncertain environmental claims cloud otherwise sound legal judgments. Not only are local prohibitions or moratoria likely preempted by expansive state regulations, they impose unjust economic consequences on companies in the fracking industry. A court could easily conclude that broad prohibitions or unworkable restrictions on fracking operations unconstitutionally take the right to extract natural resources from private property without just compensation.

As an initial matter, fracking operators or royalty owners could bring a preemption challenge against local bans or moratoria. Municipal regulations of the fracking industry are likely preempted by the comprehensive scheme established by the state in SB 4. Local laws are preempted by state laws through either explicit language in the state law, a conflict between the municipal and state law, or a state law so comprehensive there is no room for additional regulation. SB 4 does not contain an explicit preemption clause, but local bans on fracking both conflict with the clear California-wide policy to promote fracking and enter a regulatory field occupied by state regulations.

While fracking raises local concerns, natural resource regulations are traditionally conducted by state agencies. The state is tasked with the regulation of "downhole" operations, such as the extraction of shale oil or natural gas. Moreover, municipalities are themselves creatures of state law, which means they only have as much authority as the state provides. This hierarchy is why municipal ordinances can be preempted by state laws in the first place.

Ordinances that prohibit fracking conflict with SB 4 by banning an activity expressly permitted by the state, and are thus preempted by state law. As an obvious example, California could decide to permit a particular fracking

operation that is otherwise prohibited by municipal ordinance. Even if the municipality limited its ordinance to prohibition of "above-ground" fracking activities, the law would undoubtedly undermine the propriety of "downhole" extraction of shale oil and natural gas.

Even those local regulations that avoid a direct conflict with SB 4 would unquestionably intrude on an area of industry comprehensively regulated by the state. California has decided to institute regulations that protect its citizens and environment while simultaneously supporting a booming industry. Interference with California's state-wide regulatory scheme by municipal prohibitions would probably support a successful preemption challenge.

Even worse for municipalities, local bans on fracking could result in significant legal liability. Acquiring the land rights and operational capacity necessary to engage in fracking can be an expensive investment for fracking operators, while substantially benefiting royalty owners. Overbroad municipal regulations threaten the integrity of these investments, and municipalities may be vulnerable to claims that the regulations have deprived fracking operators and royalty owners of the economically beneficial use of their property. After all, fracking is a means to access energy resources that cannot otherwise be extracted from the land. This kind of government action could violate the takings clause of the U.S. Constitution, which forbids all levels of government from taking private property without just compensation.

The most obvious form of taking involves a permanent physical occupation of private property by the government. But the Supreme Court has recognized the existence of a "regulatory taking," where instead of physical dispossession, the government deprives the owner of all economically beneficial use of their property. By eliminating the benefit of energy extraction from private property, municipal prohibitions on fracking could effect a "regulatory taking," and municipalities would be required to provide costly just compensation to fracking companies.

While takings claims are not usually easy to prove, complete bans or unworkable restrictions on fracking could easily implicate regulatory takings issues. Known as the "denominator problem," courts tend to analyze regulatory takings claims by assessing the economic value of the property as a whole, rather than considering distinct profitable activities, such as fracking. In other words, the whole property interest is often the "denominator" courts use to assess deprivation of economically beneficial use, not the particular interest in energy extraction.

To prove a regulatory taking, the owner would have to establish the only economically beneficial use of the land is energy extraction through fracking. But given the fact that fracking is used on otherwise inaccessible resources, it is not difficult to imagine just such an owner.

Moreover, some courts have begun to analyze the denominator problem more favorably for the fracking industry. The Ohio Supreme Court decided that a "mineral estate," such as the interest in shale oil or natural gas extraction, could be considered the relevant property interest for a regulatory taking analysis, where the mineral estate was purchased separately from other interests in the property. State ex rel. *Shelly Materials Inc. v Clark Cnty. Bd. of Comm'rs*, 875 N.E.2d 59, 67 (Ohio 2007). If fracking operators or royalty owners can prove their interest in fracking was purchased independent of the other interests in the property, they could establish a colorable regulatory takings claim. California does not have clear precedent on the proper approach to the denominator problem, and this shift in doctrine could open the door to a successful regulatory taking challenge.

Some municipalities have reacted to the fracking controversy by banning all well stimulation techniques, not just fracking, which endangers an even greater interest in oil and natural gas extraction. In this way, the proposed Los Angeles moratorium could be a prime target for a regulatory taking lawsuit. If enacted, the ordinance would prohibit "all activity associated with well stimulation." Such a broad prohibition eliminates the distinct economic benefits of extracting energy resources for the owner, and absent just compensation by Los Angeles, could be held to effect an unconstitutional taking. The city's liability to provide just compensation for such a taking could be significant — several billions of dollars by some estimates.

Fracking offers enormous economic potential for California, and the state has enacted comprehensive regulations to sustainably develop the industry. Reactionary municipal regulations threaten to undermine the growth of this increasingly vital industry. Bans or moratoriums on fracking could subject municipalities to costly legal battles over preemption, as well as liability for taking private property without just compensation.

California has acted to seize the opportunity offered by the fracking industry. Municipalities should, at the very least, let the process unfold before needlessly risking significant legal consequences, and passing over the substantial benefits to our economy that fracking promises.

Jeffrey Dintzer *is a partner and* **Nathaniel Johnson** *is an associate in Gibson, Dunn & Crutcher LLP's Los Angeles office.*