DENTON CITY COUNCIL REMARKS

July 15, 2014

Mayor and Council members, thank you for the opportunity to address the legal problems with the hydraulic fracturing ban ordinance that has been proposed, the legal costs that will be incurred by the taxpayers in defending lawsuits brought to challenge it, and the damages that might be awarded against the City at the end of such litigation.

My name is Tom Phillips. I was Chief Justice of the Supreme Court of Texas from 1988 to 2004 and am now a partner in the international law firm of Baker Botts. My client is the Texas Oil and Gas Association, or TXOGA, the largest and oldest trade association in Texas, representing more than 5000 independent and major oil and natural gas producers, who together are responsible for over 90% of the oil and natural gas produced in Texas.

I believe the proposed ordinance to ban hydraulic fracturing is unconstitutional because state regulation of oil and gas exploration and production has displaced the City's ability to ban all economically viable drilling within its borders. The legal term for this displacement is preemption, and some members of TXOGA will undoubtedly sue the City on this ground if and when this ordinance takes effect. If the ordinance is not preempted, then, as to some, it will almost surely amount to a governmental taking of private property without just compensation, resulting in damage claims by numerous mineral interest owners and operators.

Given the costs of defending this ordinance in court against both preemption challenges and takings claims, together with the likelihood that the City will lose at least some of these suits, TXOGA respectfully urges you to vote against adopting the ordinance. Moreover, we encourage you to make every effort to educate the voters about the risks they might incur as taxpayers should this ordinance become law.

PREEMPTION

The Texas Constitution states that "no charter or any ordinance passed under said charter shall contain any provision inconsistent with the Constitution . . . or . . . the general laws enacted by the Legislature . . . ." Art. XI, § 5. That inconsistency can be direct, which is called express preemption of local action. Or it can be implied, when the local action undermines or interferes with state policy (conflict preemption) or when state regulation is so pervasive that it clearly occupies the field (field preemption). This ordinance runs afoul of both types of implied preemption.[1]

No one doubts that local governments can play an important role in regulating mineral exploration and production. Local governments are, and should be, empowered to impose reasonable health and safety regulations in the valid exercise of their police powers.[2] Indeed, the Legislature expressly gives home-rule cities the rights to "regulate exploration and development of mineral interests." But absolute bans are not classic land-use regulations; rather than merely deciding where local authorities best think an activity should occur, they instead make a categorical policy decision about what sort of conduct is lawful at all. Here, the Legislature has already expressed the State's intent "that the mineral resources of this state be fully and effectively exploited."[3] In short, the mere right to "regulate" cannot encompass the power to "prohibit."

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[1] The decision to allow or prohibit hydraulic fracturing is not "a subject matter normally within a home-rule city's broad powers," so the challengers need not show preemption under the "unmistakable clarity" standard applied in *S. Crushed Concrete, LLC v. City of Houston,* 398 S.W.3d 676, 678 (Tex. 2013).

[2] *See, e.g.*, Robert H. Freilich and Neil M. Popowitz, "OIL AND GAS FRACKING: STATE AND FEDERAL REGULATION DOES NOT PREEMPT NEEDED LOCAL GOVERNMENT REGULATION: Examining the Santa Fe County Oil and Gas Plan and Ordinance as a Model," URBAN LAWYER (Summer, 2012), p. 533, 542 ("the risks from shale gas fracking can best be managed by efforts at all levels of government, including federal, state, and local regulation. Only local regulation, however, can deal with the *secondary impacts* of fracking upon the communities' roads, schools, fire, police, and emergency response systems, as well as preserving offsite environmentally sensitive lands. [The additional costs are] a small price to pay for environmental and community protection, while *preserving the well-being of a promising industry*.") (emphasis added).

[3] Tex. Nat. Res. Code § 92.001.

Yet supplanting Texas' policy choice is exactly what this ordinance purports to do. Expressly disclaiming reliance on ordinary land use restrictions,[4] the proposal says:

> [I]t is neither the intent nor the purpose of this Ordinance to rezone property and/or otherwise engage in land use regulation authorized by Chapter 211 of the Texas Local Government Code, as amended; rather, it is the intent of this Ordinance to regulate certain aspects of business operations that impact the public safety, health, and welfare[.]

It is no answer to say that the ordinance bans only hydraulic fracturing, not drilling altogether. It is beyond dispute that, without hydraulic fracturing, the Barnett Shale is wholly uncommercial or, in the best of market conditions, marginally commercial.[5]

The Legislature has accorded extensive authority to state agencies to regulate hydraulic fracturing. The Railroad Commission has "jurisdiction over all . . . oil and gas wells in Texas,"[6] with the authority to adopt "all necessary rules for governing and regulating persons and their operations."[7] The Commission is "*solely* responsible for the control and disposition of waste and the abatement and prevention of pollution of surface and subsurface water" resulting from oil and gas activities.[8] Pursuant to this authority, the Commission has adopted a comprehensive regulatory scheme,[9] including specific rules

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[4] Freilich and Neil M. Popowitz at 546 ("Since zoning is almost exclusively a local government activity, most courts find that regulation protecting the off-site environment, provision of adequate public facilities and services, and the reasonable spacing of uses under zoning is not expressly preempted.")

[5] *R.R. Comm'n of Tex. v. Tex. Citizens for a Safe Future & Clean Water,* 336 SW3d 619, 621 (Tex. 2011); *Coastal Oil & Gas Corp. v. Garza Energy Trust,* 268 S.W.3d 1, 16 (Tex. 2008); *id.* at 31-32 (Willett, J., concurring); *MDU Barnett Ltd. P'ship v. Chesapeake Exploration Ltd. P'ship*, No. CIV.A. H-12-2528, 2014 WL 585740, at *1, n.2 (S.D. Tex. Feb. 14, 2014).

[6] Tex. Nat. Res. Code § 81.051(a)(2).

[7] Tex. Nat. Res. Code § 81.052.

[8] Tex. Water Code § 26.131(a); *see also* Tex. Water Code § 26.406.

[9] Even the Commission's failure to adopt rules about certain processes is a type of regulation. As Justice Willett's concurring opinion explained in *Coastal Oil & Gas Corp. v. Garza Energy Trust,* 268 SW3d 1, 38-29 (Tex. 2008):

> Oil and gas drilling is painstakingly regulated by the Railroad Commission, which possesses sweeping jurisdiction over all Texas oil and gas wells and all persons engaged in drilling or operating such wells. . . . [T]he Commission . . . has wide discretion to weigh the competing

for various fields, such as the Newark, East (Barnett Shale) Field Rules covering Denton County. Just last year, the Commission revised its statewide well integrity rules, which should further alleviate any concerns about the possible escape of water or fluids during the drilling process.[10] Pursuant to legislative directive, the Commission requires operators to disclose the total volume of water and each chemical ingredient used in fracking each well.[11] Moreover, the Legislature empowers the Texas Commission on Environmental Quality to control air quality, including odors.[12] Just three years ago, the TCEQ added new "permit-by-rule" air quality requirements for operations in the Barnett Shale.[13]

In the face of the Legislature's stated public purposes and the many laws it has passed to further that purpose, a municipal prohibition on all viable production throughout the nearly one-hundred square miles within the city limits directly frustrates the State's goal. And a municipality's attempt to undermine or countermand state policy through a local ordinance will be preempted.[14] In short, when state policy requires a particular result, any local ordinance that mandates a contrary result is preempted.

TAKING

Alternatively, if the ordinance is not preempted, then the fiscal consequences to the City could be disastrous. As to some mineral owners and operators, the enactment of the

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> interests and strike the proper regulatory balance. . . . [T]he Commission could impose any number of . . . rules on fracked wells in order to achieve the legislative objectives . . . . But it has not done so, and this restraint, far from showing the absence of public policy, demonstrates the Commission pursues its legislative charge in a manner that facilitates technological innovation.

[10] 16 Tex. Admin. Code § 3.13 (regulating the casing, cementing, drilling, well control and completion of wells).

[11] 16 Tex. Admin. Code § 3.29, promulgated pursuant to Tex. Nat. Res. Code § 81.851

[12] Tex. Health & Safety Code § 382.001 et seq.

[13] 30 Tex. Admin. Code § 106.352(a)-(k); *see also* 36 Tex. Reg. 943 (Feb. 18, 2011).

[14] *See, e.g., Southern Crushed Concrete v. City of Houston*, 398 S.W.3d 676 (Tex. 2013) (Houston ordinance that purportedly regulated concrete-crushing facilities for purposes of land-use and property values was preempted by state laws establishing the requirements for concrete-crushing facilities); *see also Barr v. City of Sinton*, 295 S.W.3d 287, 297 (Tex. 2009) (zoning ordinance invalidated as violating the Texas Religious Freedom Restoration Act).

ordinance would amount to an inverse condemnation, which occurs when a governmental body declines to exercise eminent domain but engages in conduct that amount to a taking without compensation. The Constitution does not prohibit such takings, but it requires that property owners be compensated for them.[15]

Takings jurisprudence is complex. By no means does every government prohibition of particular economic activity require compensation. But when the government's actions deprive an owner of all economically viable use of the owner's property, or even unreasonably interfere with the owner's right to use that property, a compensable taking occurs.[16] Courts have found takings by inverse condemnation in analogous situations, as where the state of Michigan prohibited drilling in a state park whose underlying mineral interests were privately owned.[17]

Thus, if this ordinance passes, the City of Denton will almost surely face many such claims. As environmental study centers at Yale University and Pace Law School have concluded in a recent white paper, a local government that bans drilling entirely "opens itself up to a takings claim – a lawsuit that could be devastating financially and bankrupt the local government. Likewise, a ban could mean avoiding a number of economic and financial benefits."[18] And as another commentator, whose sympathy with local

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[15] *See, e.g., Sheffield Development Co. v. City of Glenn Heights,* 140 S.W.3d 660, 669 (Tex. 2004).

[16] The standards for a total regulatory taking are set forth in *Lucas v. South Carolina Coastal Council,* 505 US 1003 (1992). The standards under which compensation must be paid for other regulatory takings are articulated in *Penn Central Transportation Co. v. City of New York*, 438 U.S. 104 (1978).

[17] *Miller Bros. v. Dept. of Natural Resources*, 513 N.W.2d 217 (Mich. App.), appeal denied, 527 N.W.2d 513 (Mich. 1994)(mineral owners and lessees who were preparing to drill permitted to recover damages). The court explained:

> Plaintiffs' mineral interests in the Nordhouse Dunes Area had one, and only one, economically viable use: the extraction of any oil or gas that might be found under the land. . . . The director's action prevents plaintiffs from extracting any oil or gas from the land. Consequently, by the exercise of its regulatory power, the government had so restricted the use of plaintiffs' property rights that plaintiffs had been deprived of all economically viable use.

[18] Pace Law School Land Use Law Center, Yale Climate and Energy Institute, and Yale Center for Environmental Law & Policy, CONTROLLING THE LOCAL IMPACTS OF HYDROFRACKING, March 28, 2014, p. 3.

restrictions on drilling is apparent from his article's title, *Wrangling with Urban Wildcatters: Defending Texas Municipal Oil and Gas Development Ordinances Against Regulatory Takings Challenges,*[19] cautioned:

> [I]n enacting oil and gas ordinances, whether under police or zoning powers, municipalities should carefully characterize and factually identify the risks sought to be mitigated and craft rules to specifically address those risks without unnecessarily impinging upon otherwise permissible–and economically encouraged–mineral resource development.[20]

Courts have sometimes viewed drilling prohibitions as a permanent taking, entitling mineral owners to recover the present value of their lost mineral rights.[21] In other cases, because the minerals are still in the ground and the ordinance is subject to repeal, courts have awarded owners and operators the reasonable annual rents for the duration of the taking.[22] Either approach can be expensive.

Recently, a two million dollar inverse condemnation judgment was rendered against the City of Houston when, based on an erroneous reading of an existing ordinance, it prohibited an oil and gas operator from drilling near Lake Houston after issuing the operator a permit to do so.[23] Also, in the Michigan case referenced above, the trial court awarded $70 million for the permanent taking of minerals from the owners and operators. Because the State merely prohibited use of the minerals without assuming

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[19] Timothy Riley, *Wrangling with Urban Wildcatters: Defending Texas Municipal Oil and Gas Development Ordinances Against Regulatory Takings Challenges,* 32 Vt. L. Rev. 349 (2007).

[20] *Id*. at 404.

[21] *Haupt, Inc. v. Tarrant County Water Control and Improvement Dist. Number One*, 870 S.W.2d 350 (Tex. App.—Waco 1994, no writ), *aff'd* two million dollar award after remand, *Tarrant County Water Control and Improvement District Number One v. Fullwood*, No. 10–95–053–CV (Tex. App.—Waco June 12, 1996), writ den., 963 S.W.2d 60 (Tex. 1998) (Hecht, J., dissenting from denial of writ).

[22] *Pettro v. United States*, 47 Fed. Cl. 136 (2000); *Whitney Benefits, Inc. v. United States*, 18 Cl. Ct. 394 (1989).

[23] *City of Houston v. Maguire Oil Co,,* 342 S.W.2d 726 (Tex. App.—Houston [14th Dist.] 2011, pet. denied).

ownership of them, however, the appellate court held that the plaintiffs were merely entitled to "rent" for the delayed development. When the case returned to the trial court, the judge awarded $120 million, after which the parties settled.[24]

Some proponents of the ban point to another case from Houston to assert that the ordinance would not be a taking.[25] But that case is different in several respects: none of the owners were deprived of all economic benefit from their property;[26] the ordinance only applied around Lake Houston, an important part of the City's drinking water;[27] and there was no interference with reasonable investment-based obligations, as all owners, save one, had acquired their interests after the regulation came into effect.[28]

I come here tonight not to scare you, but to present what I believe to be a sober, realistic assessment of the legal problems that inhere in this proposal. I know the ordinance's advocates are passionate and well-intentioned, but I believe if they want Texas law to ban hydraulic fracturing, they should take their cause to the Texas Legislature. That is the only governing body in the State with authority to grant the relief they seek.

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[24] *Miller Brothers v. State of Michigan*, No. 88-11848-CC (Mich. Ct. Cl. Oct. 25, 1995); John H. Logie, *Anatomy of an Inverse Oil & Gas Case (The Nordhouse Dunes Case*), AMERICAN LAW INSTITUTE, Jan. 4, 2001.

[25] City of Houston v. Trail Enterprises, Inc., 377 S.W.3d 873 (Tex.App.—Houston [14th Dist.] 2012, pet. denied, cert. pending).

[26] *Id*. at 878.

[27] *Id*. at 879-80.

[28] *Id*. at 880.