

THE EPA SIGHTS IN ON THE UPSTREAM

The Environmental Protection Agency has sharpened its focus on all aspects of the E&P industry. Here's how to be prepared.

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The upstream oil and gas industry has never received as much attention concerning environmental, health and safety (EHS) issues as it is today. There is a renewed focus on the effects of hydraulic frac fluids, air emissions from the shale plays, green-house-gas (GHG) reporting requirements, stricter offshore rules and OSHA's view of overall safety performance.

But one little-noticed February 2010 announcement by the Environmental Protection Agency deserves the upstream sector's full attention. The EPA has decided that the upstream sector now warrants being included under what it calls a National Enforcement Initiative.

This is not good news. It adds further uncertainty in a period of rapidly evolving and new regulatory programs and fluctuating commodity prices.

Before the EPA comes knocking on their door, operators may want to take a proactive stance by understanding their compliance exposure and the ramifications of their findings, and developing a plan to deal with them.

EPA officials have said, "It is important to develop what is deemed clean energy sources that protect our air, water and land." But they also said that oil and gas extraction and coal mining pose a risk of pollution of air, surface waters and ground waters if they are not properly controlled.

The EPA went on to state that due to an "unprecedented acceleration of oil and gas leasing and development" and new threats to drinking-water supplies (read hydraulic-fracturing concerns) it will address these "emerging problems."

What does this designation, national enforcement initiative, really mean? After the EPA decides that an industry sector warrants this type of focus, it forms a task force of personnel from EPA headquarters and regional offices and from the Department of Justice to study the industry in question. This group will develop a targeted strategy including enforcement goals, and environmental areas of focus. What's more,

it creates a priority list of industry firms that will be its focus, and the resources required.

These issues are not usually published, however, so determining the areas of the EPA's new focus only becomes clear by observing the agency's actions.

Usually, there is a strong criminal enforcement component to these initiatives. Also, following past enforcement initiatives in other industries, the EPA develops new regulatory interpretations that are broader in scope than what was in place before.

An additional key component of an enforcement initiative is administrative consent orders. These can require companies to make significant capital investment and may also include significant fines and penalties.

What is the focus?

The EPA has been slow to formulate a specific E&P strategy, so far. Observers suspect that the response to the *Deepwater Horizon* incident in the Gulf of Mexico, and other regulatory initiatives, delayed the formation of the EPA's new upstream strategy. Current speculation is that the EPA is in the study phase—and it is learning from enforcement actions already occurring in its regions.

Most likely we will begin to see information requests, immediately followed by visits to specific operations in first-quarter 2011.

While there is no public information on the focus of the upstream initiative, looking at the EPA's recent efforts may provide some clues. For one thing, the new initiative may take on different characteristics depending on the oil-and-gas production area. For instance, water-discharge issues are already an area of focus in the Marcellus shale region.

We believe that the focus will include at least these areas:

Aggregation of air emissions. Currently, major permits for air emissions include only the emissions from particular operations such as a gas-processing plant or a large compressor station. The agency is pushing to expand this, to

include all air emissions from any of the operations that feed into those facilities—including producing wells, tank batteries, dehydrators and other equipment. This will change the complexity and the timing of obtaining permits in these situations.

Air toxics emissions. These would include emissions of any materials on the EPA's air toxics list such as benzene, etc., that are not currently covered by a permit or have not been previously reported.

Underground injection well permits. The EPA has previously mentioned the application of this program in relation to fracing wells with any hydrocarbon diesel products. It could even try to use this retroactively, saying previously fraced wells required a permit.

Unpermitted discharges to the land or to surface waters. This can range from uncontrolled storm-water discharges from a drilling pad to a nearby creek, to discharges of any hazardous materials to the ground. It is unclear how far-ranging the EPA may take this issue.

Observers think the EPA will also look at all other standard issues involved with oil and gas operations. These could include waste management (i.e., drums of hazardous materials sitting in equipment or rig yards), Spill Prevention, Control and Countermeasure (SPCC) Plan compliance, and air permitting of minor sources such as gas compressors, or other internal combustion engines found at a rig or production site.

Targeting industry players

Rumors abound about how the EPA will prioritize E&P industry players for this expanded attention. Upstream oil and gas operations are structured in a fundamentally different way than petroleum refining or utility facilities that it has been regulating. One issue the EPA is probably wrestling with is how to approach a

very decentralized type of E&P operation.

Most speculation focuses on two different enforcement scenarios. One is that the agency will target the major players in major plays. This is the strategy that was employed in some of the prior enforcement initiatives. The thought then was to get the industry's attention by targeting a large, well-known company and extracting from it a precedent-setting settlement. Other firms would then be obligated to negotiate similar settlements in the future.

A second scenario is to target specific E&P companies based on perceived company reputation and/or based on specific incidents (a frac-fluid release, for example) or even a single incident.

While the EPA has concerns about major players, there appears to be greater concern about the operations of smaller E&P companies. The biggest issue for the EPA is to get the biggest bang with the resources it has available. Currently, the agency does not appear to have the manpower to implement the initiative. Current thought is that it will begin to use various state agencies to leverage its numbers, but who, how and when is not clear right now.

We have never seen one of these initiatives slowed down significantly by a change of control of Congress. However, if the EPA pushes so hard that significant delays occur in the development of some of the new oil and gas plays, we believe there could be a significant backlash for the agency. Short of such a delay, we do not believe this initiative will slow down.

The enforcement process

There is no set form for an investigation, but most enforcement initiative investigations begin with either a request for information or an unannounced visit to operations. Request for information letters are authorized under provisions in the specific environmental laws. These letters are typically quite broad in scope and require the targeted company to produce thou-

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The energy extraction industry (oil and gas exploration and production and coal mining) has been selected as a National Enforcement Initiative by the EPA before. The agency has a long record of targeting industries that are "enforcement priorities" or "enforcement initiatives." Numerous industries have been impacted, including oil refining, vinyl-chloride producers, electric utilities, cement and glass manufacturers and sulfuric-acid producers.

These prior enforcement initiatives profoundly affected the targeted industries through major changes in their operations, ability to obtain permits and increased envi-

ronmental compliance costs.

As an example, the EPA's petroleum refining initiative resulted in 27 enforcement settlements or consent decrees with U.S. refiners that operate approximately 90% of the nation's petroleum-refining capacity. Negotiations are on-going with refiners that represent an additional 7%.

The settlements resulted in the refiners investing more than \$5 billion in air-emissions control technologies; paying civil penalties of more than \$75 million; and performing supplemental environmental projects costing more than \$67 million.

The approach to E&Ps is unclear as yet.

sands of pages of documentation.

Companies should be prepared for a tremendous amount of “hurry up and wait” during the enforcement process. Often, the EPA will mandate that a response to a Request for Information letter be completed in 30 or 45 days, regardless of how big or small the scope of the request. Once a firm scrambles to collect the requested information, it is often months, and in some cases years, before it hears back.

After the EPA has reviewed the documentation provided by a firm, a site investigation will often occur next. The agency calls the site investigation a Compliance Evaluation Inspection (CEI). These visits can be announced or unannounced.

After such an inspection, the EPA may take many months before it provides any results. If violations have occurred, the results of the CEI are provided. If no violations are identified, it is not uncommon for the agency not to inform the company of the lack of findings.

In the event of noncompliance, the offending company, the EPA, the Department of Justice and possibly the impacted state(s) will enter into settlement discussions. Typically the EPA leads the effort since it will be focused on identifying and implementing “template settlement agreements” or consent decrees on a national basis.

Depending on the size and complexity of the alleged noncompliance, negotiations can take months or even years to resolve. In the refining industry, settlement discussions typically took about 18 to 40 months, with some extending for almost six years.

What can an operator do?

There is no universal panacea for how to deal with an EPA enforcement initiative, just as there is no one way to run an exploration and production operation. Each company and operating unit is unique and therefore solutions must be fit for purpose. However, companies may want to make an explicit decision on how to deal with the enforcement initiative.

For some firms, no change in course is the appropriate strategy; however, that should be an explicit decision and not implicit. There are some key items a management team may want to think through. It can do this informally to get a good idea of where the company stands.

Determine the company's enforcement exposure. Don't perform compliance audits without thinking through the ramifications of the findings. Form a legal and technical strategy to deal with the findings before you perform any compliance audits.

Determine the desired risk profile. Don't let

this evolve casually without some management decisions.

Develop an action plan with input from the business, operations, legal and environmental teams. Elements from all of these areas make for the best solutions.

Understand that there may be certain issues the EPA brings up for which there is no action an E&P company can take. For example, it may assert that the company should have had a permit in the past for certain operations that have never been permitted before. For the short term, focus on the low-hanging fruit.

In general, compliance programs are much like any other business process. One gets about 80% of the benefit from focusing on the key 20% of the challenge. More importantly, solutions are usually not expensive to implement and add lasting value to the organization.

What about investors?

Investors who anticipate acquiring oil and gas operations or assets may want to review their due-diligence process, to include environmental compliance issues that are anticipated to be included in the EPA's enforcement initiative. They may also need to understand any capital or operating costs that may be associated with those issues. Many current due-diligence processes do not include much in the way of EPA compliance assessment.

E&P company managers can take away a few key lessons from other industries that have been the subject of an EPA enforcement initiative. One, they should get all their operations in compliance. Otherwise, the EPA will target their operations and leverage a few noncompliance events to mandate company-wide retrofits. The company should be able to document the compliance. Documentation is often audited by the EPA as part of the initiative. However, it quickly leaves these facilities when it sees good documentation and realizes “there is no low-hanging fruit here.”

Finally, focus on the big compliance issues. While there are literally tens of thousands of regulations, in general the EPA focuses on bigger issues. □

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