

# Energy Committees Newsletter

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## **OUTER CONTINENTAL SHELF ROYALTY RELIEF: MARKET PRICES V. PRICE THRESHOLDS**

**David T. Deal**

In a closely watched Outer Continental Shelf Lands Act (OCSLA) case, whose stakes may be as high as \$60 billion, *Kerr-McGee Oil & Gas Corp. v. Allred*, No. 2:06-CV-0439LC (W.D. La.) (Mem. Ruling Oct. 30, 2007), the Western District of Louisiana held that imposition of price thresholds for OCS leases issued during the 1996-2000 period was categorically unlawful and beyond the Secretary of the Interior's authority. The government has begun its Fifth Circuit appeal and briefing should be completed well before the end of 2008.

Royalty relief authority has always been available to the Secretary under federal mineral leasing laws, including the OCSLA, but has always been subject to agency discretion and relatively little used. At issue in *Kerr-McGee*, however, are the special royalty relief provisions of the Deepwater Royalty Relief Act of 1995 (DWRRA), Public Law 104-58. Enacted in the mid-1990s when oil and gas prices were very low and OCS production in the Gulf of Mexico was falling, the DWRRA amended the OCSLA as an incentive to promote very costly and very risky deep water oil and gas development in the central and western Gulf of Mexico. Given the distance from shore and the technological challenges posed by deep water (depths of 200 meters or greater), the exploration and

development of deepwater leases is a multi-billion dollar venture. The royalty relief offered was a royalty holiday in effect until statute-prescribed suspension volumes or applicable market price thresholds were reached.

The DWRRA offered royalty relief on somewhat different terms for two lease vintage categories: DWRRA § 302 pre-Act leases (issued prior to 1996) and DWRRA § 304 eligible leases (issued in 1996-2000 period). DWRRA § 302 leases have generated little controversy and no litigation of consequence has occurred. DWRRA § 304 leases have been much more controversial.

The first DWRRA § 304 case led to the 2004 decision in *Santa Fe Snyder v. Norton*, 383 F.3d 884 (5th Cir. 2004). In *Santa Fe* the Minerals Management Service (MMS) had assigned a lease issued in 1997 to a field, which had previously produced, and denied royalty relief for that lease because its new regulations for § 304 eligible leases applied royalty relief on a field basis not an individual lease basis and included the "new production" requirement of § 302 Pre-Act Leases. Affirming a district court decision, and applying a "plain meaning" view of the DWRRA, the Fifth Circuit held that the MMS § 304 regulations were unlawful by applying royalty relief on a field instead of a lease basis and also imposing a new production requirement. The federal government took no appeal of the Fifth Circuit decision and in December 2007 undertook rulemaking to conform its regulations to the *Santa Fe* decision.

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**On behalf of the energy committees, Thomas Zeiders was editor of this issue.**

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Not addressed in *Santa Fe* was another issue, price thresholds, which has generated controversy inside and outside the courthouse. As a precursor to the *Kerr-McGee* litigation, in early 2006 the absence of price thresholds in some, but not all, § 304 leases, generated a firestorm. During House oversight hearings in March 2006, at a time when market prices continued their steep upward climb, the Department of the Interior (DOI) made the extraordinary admission that in 1998 and 1999, during the Clinton administration, price thresholds had been “inadvertently dropped out” of leasing documents for five of ten OCS lease sales (affecting issuance of about 1,100 leases to fifty-nine lessees). By Government Accountability Office (GAO) estimates in 2007 the absence of price thresholds for 1998-1999 OCS leases might ultimately cost the federal government as much as \$10 billion.

Proposed remedial legislation keyed on price thresholds surfaced almost immediately in the 109th Congress. Several oversight hearings were held, but nothing was enacted. Freestanding bills and appropriations bills were both proposed and included a range of measures directed at increasing future royalty revenues by precluding future royalty relief and/or recovering past royalty revenues associated with the 1998-1999 leases: a prospective prohibition of leasing without price thresholds, requiring the Secretary to renegotiate existing leases with royalty relief but missing price thresholds, imposing a stiff “conservation of resources fee” if companies did not renegotiate leases to include price thresholds, etc.

In the 110th Congress, the issue has renewed vigor but resolution remains elusive. New hearings were held, focusing on the Clinton administration’s omission of price thresholds for 1998-99 leases and citing recent GAO and DOI Inspector General reports. Even though the reasons for the past omission to this day remain elusive, the Department of the Interior was rebuked anew for its 2007 response once the prior administration’s omission had been discovered. In January 2007 the House of Representatives passed H.R. 6, which would have required companies to renegotiate their leases to include price thresholds for past and future production or pay a resource conservation fee to remain eligible for future leasing. As

introduced, H.R. 6 would also have repealed royalty relief incentives in the Energy Policy Act of 2005 and prior legislation facilitating oil and gas leasing in the National Petroleum Reserve in Alaska.

While the 1998-1999 price threshold issue unfolded, a more fundamental price threshold lay smoldering: Absent explicit price threshold language in § 304, does the Secretary have the authority to impose price thresholds for any OCS lease issued during the 1998-1999 period? Given the express language of DWRRA § 302, no one had disputed for pre-1996 leases the applicability of price thresholds as a limit on royalty relief in addition to suspension volumes. However, DWRRA § 304, addressing leases issued during the 1996-2000 period, conspicuously lacks express price threshold language.

Irrespective of its omission of price thresholds for 1998-1999 leases, DOI plainly believes it has such authority and, after surging oil and gas market prices exceeded price thresholds after 2000, issued orders to pay to several OCS producers in 2006, prompting many appeals. One of the producers, Kerr-McGee, received an order to pay affecting eight deepwater leases for which it had invested over \$3.5 billion to develop. The Kerr-McGee order was subject to immediate judicial review, and in its district court challenge, filed in March 2006, Kerr-McGee asserted that the Secretary had no authority to impose price thresholds for any “eligible leases.” In its October 2007 decision, *Kerr-McGee Oil & Gas Corp. v. Allred*, No. 2:06-CV-0439LC (W.D. La.) (Mem. Ruling Oct. 30, 2007), the Western District of Louisiana adopted the “plain meaning” approach it had employed earlier in *Santa Fe* and agreed with Kerr-McGee, holding that “Interior has no discretion to enact a price threshold requirement that applies to volumes below the minimum volume of royalty-free production,” that “Interior exceeded its Congressional authority,” and that “Interior’s action is unlawful because it contradicts the plain, unambiguous text of the statute.” In late 2007 the government began its Fifth Circuit appeal.

Estimates of the dollar impact of no price thresholds depend on several assumptions: market price,

production rates, and reservoir life. Whereas GAO has estimated the dollar stakes associated with the inadvertently omitted price thresholds from the 1998-1999 OCS leases at about \$10 billion, GAO’s estimate for having no enforceable price thresholds for the entire 1996-2000 OCS leasing period of the dollar stakes in this case are \$28-\$60 billion.

What does the future hold? However *Kerr-McGee* is resolved on appeal, post-2000 leases are unaffected. For post-2000 OCS leases, no one has challenged the MMS’ routine inclusion of price thresholds. Moreover, the Energy Policy Act of 2005 now expressly authorizes price thresholds, and remedial legislation may require them.

But the fate of remedial legislation is far from clear. If the *Kerr-McGee* decision is upheld, the \$10 billion omitted price threshold issue vanishes: agency failure to take action for which no authority existed is not culpable. Even if the *Kerr-McGee* district court decision is reversed on appeal, and upholds the DOI’s inclusion of price thresholds for 1996-2000 “eligible leases,” it still would not address the DOI’s exclusion of price thresholds for 1998-1999 leases.

Moreover, any remedial legislation would confront contract issues that could lead to new litigation, unless companies can be induced by lease extensions or otherwise to renegotiate the terms of their lease contracts. Irrespective of the later rise in oil and gas market prices, royalty relief at the time of leasing, when market prices were very low, was an important part of the complex economic calculus of OCS lease sale bidding and the lease contracts that were struck. In addition, DOI, itself bemoaning the past inadvertent omission of price thresholds by the Clinton administration, has opined that remedial legislation affecting how holders of 1998-1999 leases might participate in future lease sales, would probably precipitate a legal challenge that could lead to a court-imposed shutdown of OCS leasing for the duration of the litigation with a projected revenue loss more than the \$10 billion revenue loss associated with the omission of 1998-1999 lease price thresholds. To avert the sanctity of contract problem, the Bush administration has endorsed a plan that would induce

companies to renegotiate their leases by granting three-year lease extensions, an approach favored at least by some senators. To date, only six companies representing about 20 percent of the 1998-1999 vintage leases with discoveries and 23 percent of the associated production have renegotiated leases to include price thresholds prospectively. The remaining fifty-three companies presumably await final resolution of the *Kerr McGee* litigation and are watching the course of any new remedial legislation that might be enacted.

However the price threshold controversy is finally resolved, royalty relief has been a staggering success. With conventional shallow water production from older leases declining, deep water oil and shallow water deep gas prospects are the new frontier for the foreseeable future and royalty relief will remain an important tool in the MMS OCS leasing toolbox. If nothing else is clear, any royalty relief, if and when granted, will certainly have express limits such as suspension volumes and price thresholds.

**David T. Deal**, *president of Deal Consulting & Conflict Resolution, LLC, is vice chair of the ABA Section of Environment, Energy, and Resources' Global Oil and Gas Exploration and Production Committee, and is vice chair of the Department of the Interior's Royalty Policy Committee, and was vice chair of its Subcommittee on Royalty Management which in December 2007 completed a 160-page assessment of the Department of the Interior's royalty management program and identified 110 recommendations for change.*

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## **FINAL REPORT OF THE DEPARTMENT OF THE INTERIOR'S SUBCOMMITTEE ON ROYALTY MANAGEMENT**

**David T. Deal**

In December 2007 the Subcommittee on Royalty Management (SRM or Subcommittee), a subcommittee of the Department of the Interior's (Department or DOI) Royalty Policy Committee, a federal advisory committee, issued its final report, "Mineral Revenue Collection from Federal and Indian Lands and the Outer Continental Shelf."

The Subcommittee's Report was transmitted to the Secretary of the Interior in January 2008. While the Subcommittee concluded that the Minerals Management Service (MMS) is an effective steward of the Department's Minerals Revenue Management Program, the Subcommittee identified 110 concrete recommendations for change that form the core of a blueprint for agency decision making. Department implementation is already well underway and what follows is a first hand synopsis of this important development.

Fueled largely by oil and gas market prices and legal clouds that had arisen over the legality of price thresholds that could limit royalty relief based on the Deep Water Royalty Relief Act of 1995, by late 2006 longstanding and deep rooted criticisms of the federal royalty management had reached a crescendo. Against this darkening backdrop of criticism, Assistant Secretary of the Interior Allred announced in November 2006 the formation of a special Subcommittee on Royalty Management under the existing Royalty Policy Committee. Its original charge was threefold; the SRM would:

1. review existing procedures and processes for ensuring that royalty reporting and accounting for federal and Indian revenues were correct.
2. review MMS audit, compliance, and enforcement procedures to ensure that mineral companies were fully complying with relevant statutes, lease terms, and regulations.
3. review operations of the Royalty in Kind program to ensure that decisions to take

federal oil and gas royalties in kind yielded in net benefits to the American people.

Although the initial Subcommittee charge did not address royalty relief price thresholds, another element was later added:

4. review agency procedures germane to the omission of price thresholds from 1998 and 1999 Outer Continental Shelf (OCS) lease sales.

The full Subcommittee panel was announced in March 2007, naming former Sens. Bob Kerrey and Jake Garn as chairs and this author as vice chair.

Chapter 1 of the report describes the Subcommittee's charge and its information collection process. Chapter 2 offers an overview of the Department's royalty management program, showing the multi-billion fiscal magnitude of the program and also offers a capsule history of the program's last 40 years: DOI Inspector General and Government Accountability Office reports, the Linowes Commission, royalty legislation, key MMS rulemakings, and key rulemaking litigation.

Chapters 3-7 outline the 160-page report's findings and recommendations. Overall, the Subcommittee found no fundamental flaws in the Department's royalty management program's operating policies, practices, and procedures. However, the Subcommittee did identify 110 specific recommendations for program improvements.

Chapter 3 addresses *collections and production accountability*. Although product valuation issues tend to draw the most outside attention because at that point royalty dollar values first appear, the collection of base data such as production volumes, BTU values, and gas plant efficiency is the critical first link in the royalty management chain.

In addition, the area of collections and production accountability highlights the sharp differences between offshore and onshore leasing. Whereas about 2,300 offshore oil and gas leases generate about \$6.5 billion in royalties, about 23,000 onshore federal leases generate about \$2.7 billion. Offshore leases are large

tracts, often far offshore, and the lessees are large companies or combines; they are relatively modern with highly concentrated production and transportation facilities. Onshore federal leases are far more diverse, including many small properties, of old vintage and scattered around the countryside. Finally, offshore leases are regulated in all respects by the MMS whereas onshore federal leases are regulated by the Bureau of Land Management (BLM) (for site security, production verification) but regulated by the MMS (for audits, compliance, and enforcement). Onshore Indian leases involve the Bureau of Indian Affairs (BIA) as well.

Not surprisingly, many of the Subcommittee recommendations in this category have an onshore production foundation with the BLM as the most affected agency and onshore operators plainly the most affected producers.

- Recommendations 3-1 through 3-7 urge the MMS and BLM to sharpen BTU value reporting requirements.
- Recommendation 3-8, urges the Department to consider legislation allowing focusing on the designated royalty payor for debts rather than being limited to mineral interest owners,
- Recommendations 3-9 through 3-15 describe system changes that would flag reporting errors earlier and require universal use of electronic payment submission. Recommendations 3-16 and 3-17 address the review of gas processing plants.
- Recommendations 3-24 through 3-36 address MMS and BLM staffing and training to promote cost-efficiency.

Chapter 4 addresses *audits, compliance, and enforcement*. Based on MMS-prescribed data submitted by industry, the MMS at this stage assesses compliance with applicable statutes, lease terms, regulations, and guidance. At this stage royalty payments are on the screen, royalty rates are linked with production levels, and transportation and processing allowances are taken into account.

While the basic formula for calculation of royalty is simple in the abstract, as a practical matter MMS review involves a continuum of MMS compliance approaches, involving different levels of detail, effort, and engagement. At one end of the spectrum a simple MMS request for missing information may quickly resolve a question. At the other end of the spectrum, a full blown company audit (which may require a restructured accounting and consider a payor's internal controls, production and accounting systems, and royalty payments on several leases and involving several different issues) may be needed. Somewhere in the middle, an MMS "compliance review," basically a desk audit, may suffice.

The challenge for the MMS is how to choose among its choices to cost-effectively yield high revenue. The Subcommittee found that the MMS, while in the past it had concentrated (but not exclusively) on the largest royalty payors, had already launched a risk-based pilot program conceived to lead to a compliance strategy taking into account a variety of factors: size of payor, past compliance history, magnitude of the royalties at risk, and other factors. Once tuned, this compliance strategy should better match MMS review activity with the field of royalty payors being reviewed and optimize royalty revenues.

Indeed, the Subcommittee found that MMS' risk-based pilot program is a part of a much more expansive Action Plan developed in response to a December 2006 DOI Inspector General audit, which itself made several recommendations for improvement in the audit and compliance review process.

Within this context, several Subcommittee recommendations address compliance policy matters: Recommendation 4-1 suggests formation of a Compliance Strategy Council, not limited to MMS staff but inclusive of IRS staff as well.

Recommendations 4-2 and 4-3 call for an evaluation of compliance strategy resources across MMS, state and Indian tribe lines. In connection with the range of compliance activities or tools available, Recommendations 4-4, 4-5 and 4-7 directs the MMS to evaluate the relative benefits and costs associated with different tools. Recommendation 4-6 suggests consideration of a whistleblower program of the type

employed by the IRS. And, like Recommendation 3-13 applicable to royalty payments, Recommendation 4-8 urge the MMS to require electronic submission of all information relevant to royalty payments.

- Recommendations 4-9 through 4-12 underscore the value of a rigorous, risk-based compliance review approach.
- Recommendations 4-13 through 4-15 advocate the adoption of adequate performance measures to improve compliance management. Recommendations 4-16 through 4-23 advocate several measures aimed at increasing database quality, reliability and consistency.
- Recommendations 4-24 through 4-27 urge the MMS to move ahead promptly to resolve four very specific valuation matters whose resolution should streamline royalty management: the need for a revised Indian oil valuation rule, in the federal gas valuation rule, the need to reexamine use of indexing for valuation and the need to address cost bundling, and the need to review non-arm's length valuation of solid minerals.

Chapter 5 addresses *coordination, communication, and information sharing*. Although this area was not an express element of the Subcommittee's charge, it surfaced very quickly as a crucial need. Here again, offshore-onshore differences are striking. Offshore leases present few problems in this area because the MMS manages all aspects of OCS pre-leasing and post-leasing activity, including royalty obligations. In contrast, onshore federal leases involve collaboration between the BLM and the MMS; Indian leases involve the BIA as well. Onshore leasing also involves far more non-federal stakeholders than offshore leasing, namely, Western states, Indian tribes, and Indian allottees.

Subcommittee Recommendations 5-1 through 5-10, therefore, articulate a need to sharpen the overall coordination process. For example, Recommendation 5-9 urges the Department to establish a Coordinating Committee from the senior management of the MMS, BLM, and BIA vested with the authority to clarify roles, develop common data standards, and develop consistent guidelines, among other matters.

Chapter 6 addresses the *Royalty in Kind program*. Although federal mineral leasing laws have always permitted the Secretary to take royalty in kind (RIK) rather than in value (RIV), only in the mid-1990's did the Department begin to seriously explore RIK's potential.

After several pilot projects, the agency sharpened its evaluative criteria and gained marketing experience. After a major boost from presidential directives to use federal royalty oil to fill the Strategic Petroleum Reserve (SPR), a RIK program emerged and in May 2004 the MMS issued its Five Year Royalty in Kind Business Plan outlining business principles, objectives and specific action items. In addition, the Energy Policy Act of 2005 formalized RIK's passage from pilot project to an established program. RIK volumes have increased sharply; for example, for FY 2006 the MMS took in kind about 72 percent of crude oil and 45 percent of the natural gas produced in the Gulf of Mexico, the nation's highest producing and largest royalty revenue generator.

RIK is attractive because it averts the issue ridden valuation process, which is especially complex for non-arm's length transactions. With the focus on verification of volumes, MMS administration on the compliance side is simpler, and reduces administration costs, although marketing the production adds back some administrative costs and analytical complexity. Without the vagaries of valuation, royalty disputes are far less frequent, reducing appeals and litigation and thereby further reducing costs. Finally, by taking RIK to satisfy royalty obligations, and then selling the production, the Department has an opportunity to generate additional sales revenues.

Given the net revenue-increasing potential of RIK, the Subcommittee arrived at several recommendations:

- Recommendations 6-1 through 6-5 promote transparency and understanding of the RIK program (e.g., issuance of guidelines and regulations to promote understanding and transparency).
- Recommendations 6-6 through 6-10 promote exploring ways to give the MMS better flexibility

to operate a commercial activity (e.g., clarify the application of Federal Acquisition Regulations; establish an independent oversight board).

- Recommendations 6-11 through 6-15 address certain RIK crude oil-specific matters (e.g., discontinuing the onshore oil RIK the small refiners set aside programs).
- Recommendations 6-16 through 6-20 urge taking steps to maintain an effective, business-like RIK program team (e.g., examining compensation, hiring procedures, and ethics training).
- Recommendations 6-21 through 6-28 urge the MMS to adopt a rigorous set of performance measures.
- Recommendations 6-29 through 6-31 address the auction process now employed for sale of RIK production (e.g., evaluating alternative auction types to explore prospect of improved net returns).

Finally, Chapter 7 addresses *OCS royalty relief price thresholds*. Although not a part of the Subcommittee's original charge, by September 2007 reviewing the circumstances that led to the Clinton administration's unfortunate omission of price thresholds for ten OCS lease sales in 1998 and 1999 had been studied intensively by the DOI Inspector General and had already led to Secretary Kempthorne's issuance of a directive prescribing the elements of Office of the Solicitor review of any OCS lease materials.

Against this baseline, Recommendations 7-1 through 7-6 encourage the Department to pursue renegotiation of 1998 and 1999 OCS leases to collect unpaid royalties and sharpen agency review procedures to minimize the recurrence of gross agency oversight in the OCS leasing process.

None of the Subcommittee's 110 recommendations is self-executing and Department implementation efforts over the next several months are likely to attract stakeholder comments and careful scrutiny as the Department reforms its multi-billion dollar royalty management program.

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## NATURAL GAS: TODAY'S ALTERNATIVE FUEL?

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**Irma S. Russell**  
**Justin Scroggs**

Worldwide interest in natural gas is growing as supplies of oil diminish and oil prices rise. As debate continues regarding whether we have reached the peak of oil production, natural gas appears to be a likely candidate as the next major energy source. The world's supply of natural gas far exceeds the supply of crude oil, making costs for the fuel comparatively low. Proponents of renewable sources of energy see natural gas as a transitional fuel to renewable energy; a fuel that will reduce both carbon dioxide (CO<sub>2</sub>) and other harmful emissions, and buy time for technologies to develop that will make renewable energy economically viable.

Energy consumption continues to grow in the United States, despite increasing concerns about global climate change and dependence on import of energy from nations that may be hostile to the United States. "The U.S. Department of Energy estimates that over the next twenty years, U.S. oil consumption will rise by 33 percent, natural gas consumption by 60 percent and demand for electricity by 45 percent," Mark A. Stansberry & Jason P. Reimbold, *The Breaking Point: America's Energy Dreams and Global Economic Realities* 59 (2008). This growing consumption comes at the expense of the environment. Approximately 55 percent of global climate change is attributable to CO<sub>2</sub> emissions from coal and petroleum

use, [http://www.powerscorecard.org/sc\\_details.cfm](http://www.powerscorecard.org/sc_details.cfm) (visited Apr. 14, 2008). As of 2006, 80 percent of CO<sub>2</sub> emissions in the United States are attributable to burning coal and petroleum, Emissions of Greenhouse Gasses Report, <http://www.eia.doe.gov/oiaf/1605/ggrrpt/carbon.html> (visited Apr. 14, 2008). Although the United States has historically been the world's largest consumer of energy and the leading emitter of greenhouse gases (GHGs), China is now the world's leading emitter, *China Overtakes U.S. in Greenhouse Gas Emissions*, INT'L HERALD TRIB., June 20, 2007, <http://www.ihf.com/articles/2007/06/20/business/emit.php>, and other developing economies of the world are increasing their production and demand for energy at dramatic rates.

Natural gas is the fastest growing fuel in the United States. Considering the lower levels of CO<sub>2</sub> and other emissions resulting from natural gas, it creates less concern for global climate change (GCC) than coal or oil making it the most environmentally attractive fossil fuel. Nine hundred of the next one thousand power plants in the United States will use natural gas. It is also becoming more popular as a transportation fuel with manufacturers such as Honda manufacturing compressed natural gas (CNG) vehicles and more gas stations starting to carry CNG (especially in California). Companies make conversion kits that will convert gasoline or diesel engines to CNG as well as home refueling kits that will allow CNG cars to be refueled from a home gas line. The United States produces 85 percent of natural gas demand domestically. Of the 15 percent imported, 14.25 percent comes from Canada and only 0.75 percent through liquefied natural gas (LNG) imports, Natural Gas Supply, <http://www.naturalgas.org/business/analysis.asp> (visited Apr. 11, 2008). While domestic production in the United States and imports from Canada are increasing every year, increases in production will be outpaced by a growing demand for natural gas, giving rise to the need for increased LNG imports. Liquefaction makes importation of natural gas from overseas possible. It also makes natural gas viable as a major fuel of the future from a supply and economic perspective.

LNG is natural gas converted to liquid form. Cooling the gas to -259 degrees Fahrenheit compresses its

volume by approximately six hundred times for the process of transport. It is shipped in double-walled cryogenic containers and converted to its gaseous form at its point of arrival to be transported by pipeline or tankers to its ultimate destination. Several countries are developing active export programs in LNG. Until recently, the “expenses of liquefaction and transportation have discouraged the development of LNG import terminals.” Bill Trotter, Terminal Velocity LNG Industry Sets a Course for Washington County, [http://www.redorbit.com/news/science/327827/terminal\\_velocity\\_lng\\_industry\\_sets\\_a\\_course\\_for\\_washington\\_county/index.html](http://www.redorbit.com/news/science/327827/terminal_velocity_lng_industry_sets_a_course_for_washington_county/index.html) (visited June 23, 2008). Four LNG import facilities in the United States served the import market for many years. Now proposals for over forty major LNG import terminals are in the Federal Energy Regulatory Commission (FERC) pipeline. The price of other fuels and the lower transportation costs of LNG combine to make LNG the natural choice for those committed to fossil fuel as the energy of choice. Moreover, until renewable fuels become cheaper, natural gas seems to be the best choice for those who wish to reduce GHG emissions.

Although the price of LNG has risen as a result of the increase of oil prices, it remains far below the price of oil in terms of price per Btu. FERC notes it has responded to rising natural gas prices by approving “applications for a substantial expansion of the nation’s LNG terminals for overseas gas,” and by “approving applications for new pipelines both quickly and in an environmentally responsible way.” FERC, High Natural Gas Prices: The Basics, <http://www.ferc.gov/legal/staff-reports/high-gas-prices.pdf> (visited April 14, 2008). Location is a major factor—both in terms of the location of natural gas supplies and of building a supply and distribution chain for LNG. Likewise, industry interest in preparing the United States to receive imported LNG is more intense than ever.

The Natural Gas Act gave FERC lead agency status over LNG facilities for the purpose of complying with the National Environmental Policy Act. Natural Gas Act, Sec. 313. FERC asserts exclusive power in this area. “Regulatory authority for the siting and construction of LNG import terminals rests exclusively with the federal government, the FERC concluded in

an order issued today,” FERC, <http://ferc.gov/press-room/press-releases/2004/2004-1/03-24-04-lng.asp> (visited Jan. 1, 2006). FERC is currently considering about forty LNG terminals and has sixteen LNG facilities under its jurisdiction in the continental United States. FERC, <http://www.ferc.gov/industries/lng.asp#skipnavsub> (visited Apr. 14, 2008). FERC coordinates federal authorizations related to jurisdictional natural gas facilities. Transporting LNG is a safe process. The FERC Web site assesses the safety of LNG, noting that LNG is not explosive in liquid state. LNG is not flammable in liquid form. It is only flammable as a vapor under limited conditions of 5 percent to 15 percent concentration in air. If the vapor is of either higher or lower concentration than this, it will not burn, California Energy Commission, Frequently Asked Questions about LNG, <http://www.energy.ca.gov/lng/faq.html> (visited Apr. 11 2008).

FERC is not the only agency with authority over LNG offshore terminals. The Deepwater Port Act (DWPA) gives the Coast Guard jurisdiction over LNG terminals and pipelines outside of state waters. “Since the 9/11 attacks, FERC, the U.S. Coast Guard and the Department of Transportation have jointly prepared engineering and siting reviews so that LNG Terminal and LNG Vessels will operate safely and securely.” The FERC Web site notes the safety record for the LNG industry. “LNG has been transported by sea since 1959 in specially designed LNG carriers. These vessels have a remarkable safety record and provide an essential link in the movement of LNG from production locations to consumer locations. However, stakeholders recognize that there are possibilities for some serious incidents involving LNG carriers, particularly in light of increased awareness and concern about potential terrorist actions.” FERC, LNG - Safety Reports, <http://www.ferc.gov/industries/lng/safety/reports.asp> (visited Apr. 14, 2008).

Recent governmental policy statements suggest growing recognition that no single solution can solve the energy needs of the country. Depletion of fossil fuels combined with global increases in demand mean that multiple sources of energy are necessary to satisfy consumption. President Bush has emphasized that the policy of developing multiple energy sources is crucial

to the economy and security of the United States. The 2005 Energy Policy Act included measures to expand the use of nuclear power, creating loan incentives, production tax credits, and risk insurance for builders in the nuclear industry. President Bush has called on Americans to be “better conservers” and to develop “alternatives to diesel and gasoline.” The White House, President Discusses Biodiesel and Alternative Fuel Sources, <http://www.whitehouse.gov/news/releases/2005/05/20050516.html> (visited Apr. 14, 2008). President Bush has also noted that securing energy resources from some foreign countries presents security issues, The White House, President Bush Discusses Energy at Renewable Energy Conference, <http://www.whitehouse.gov/news/releases/2006/10/20061012-4.html>.

Fossil fuels can also be integrated with renewables. For example, Victorville II, a hybrid solar/natural gas power plant that is being built in California, will supplement its natural gas generation with solar electricity. Natural gas power plants can be used to supplement wind energy when the wind isn't blowing. By integrating fossil fuels with renewable energy, fossil fuel energy can be slowly phased out as it becomes more costly while renewable energy is increased as it becomes more cost efficient. Even the major energy companies recognize this. Aubrey McClendon of Chesapeake Energy has stated: “We need to move to wind power. When the wind isn't blowing, we'll be there,” Energy Incentives, Oklahoma Corporation Commission Energy Summit, Oklahoma City, Nov. 29, 2008.

A thorough assessment of all energy sources is essential to an informed energy policy. Concerns about the impacts of fossil fuel on the environment, human health, and national security are all relevant to energy policy. The costs and risks associated with discovery, extraction, transportation, and use must all be included in such an assessment. As energy consumption continues to increase, global climate change and other factors make natural gas a viable transitional fuel for reducing CO<sub>2</sub> and other harmful emissions and bridging the gap in energy need as technology and markets for renewable fuels develop.

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## LESSONS OF PRUDHOE BAY: AN EXAMINATION OF LOW-STRESS PIPELINES REGULATIONS

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**Hugh M. Robert**

### Introduction

In March 2006, large pipeline leaks caused the shutdown of the BP oil pipeline in Prudhoe Bay, Alaska. This influenced many regulators and legislators to examine the causes of the leaks in an effort to determine how similar interruptions could be avoided in the future. BP America's Chairman, Bob Malone, characterized the shutdown as an unacceptable failure that has “fallen short of what the American people expect of BP and . . . fallen short of what we expect [of] ourselves.” Aaron Smith, *BP ‘Fell Short’ on Pipeline, Execs Admit*, CNNMoney.com, Sept. 7, 2006, <http://money.cnn.com/2006/09/07/news/companies/bp/index.htm>.

The United States possesses a strong interest in ensuring domestic supplies remain uninterrupted, especially with the demand and price of oil continuing to rise. The Prudhoe Bay operations, “the largest field in North America and the 18th largest field ever discovered worldwide,” are critical to U.S. consumption. David Ellis, *Oil Falls Back Near \$67 on BP Comments*, CNNMoney.com, Sept. 7, 2006, [http://money.cnn.com/2006/09/07/markets/oil\\_eia/index.htm](http://money.cnn.com/2006/09/07/markets/oil_eia/index.htm). As a result of large pipeline leaks and spills, including the shutdown of the BP pipeline at Prudhoe Bay in Alaska, regulators (Transportation Department's Pipeline and Hazardous Materials Safety Administration (PHMSA)) and legislators are troubled by the lack of self governance and pro-active, or even minimal, maintenance of certain oil pipelines' infrastructures including those in Prudhoe Bay.

## **Pipeline and Hazardous Materials Safety Administration (PHMSA), U.S. Department of Transportation (DOT) Proposed Regulations**

Prior to the Prudhoe Bay spill, rural low-stress pipelines had been completely exempt from federal pipeline safety requirements. *See* 49 C.F.R. pt. 195.1(b)(3). Following the Prudhoe Bay spill, Peter T. Lidiak, director of the pipeline segment of the American Petroleum Institute, noted that large low-pressure pipelines are responsible for approximately 50 percent of total oil spill volume nationwide. *See* Steven Mufson, *Regulators Look to Plug Holes in Pipeline Rules*, WASH. POST, (Aug. 16, 2006), D01, available at <http://www.washingtonpost.com/wp-dyn/content/article/2006/08/15/>. PHMSA indicates the reason low-stress pipelines have been exempt from regulation is that they do “not transport a highly volatile liquid (HVL), . . . [are] located in a rural area, and . . . [are] outside a waterway currently used for commercial navigation.” *Id.* at 1. Investigators found the pipelines had not been cleaned with a smart pig or tested since 1992. *See* ASSOCIATED PRESS, *Sludge, Lack of Testing Cited in Alaska Pipeline Failure*, (2006), <http://www.msnbc.msn.com/id/14233534/>.

The legislature had an opportunity to close all gaps in the regulatory and legislative scheme when debating the renewal of the 2002 Pipeline Safety Improvement Act. However, the president signed H.R. 5782 reauthorizing the Pipeline Safety Act through 2010 leaving the large gaps in low-stress pipeline regulation. *See* The Pipeline Inspection, Protection, Enforcement, and Safety (PIPES) Act of 2006 (Pub. L. No. 109-468). The PIPES Act calls for the Secretary to “issue regulations subjecting low-stress hazardous liquid pipelines to the same standards and regulations as other hazardous liquid pipelines” which have yet to be adopted by PHMSA.

Since the PIPES Act passage, PHMSA has proposed a number of regulatory changes. According to PHMSA, it uses a risk-based approach when formulating which portions of the regulatory gap to close. Although PHMSA does not intend to regulate all low-stress pipelines, it does “intend to protect all lines

that, in the event of a failure, pose the threat of significant environmental harm to unusually sensitive areas (USAs).” Low Pressure Liquid Pipelines: In the North Slope, Greater Prudhoe Bay, Alaska: Oversight Hearing Before the H. Comm. on Transportation and Infrastructure, 109th Cong. 5 (2006) (statement of Thomas J. Barrett, USCG (ret.), Administrator, PHMSA, US Dep’t of Transp.). PHMSA goes on to explain that the “proposal addresses the most significant threats, corrosion and external damage, and applies a full range of protections known to be effective and appropriate against these risks to these lower pressure lines.” *Id.* at 5. While the proposed regulations by PHMSA would eliminate some of the exemptions, the regulations would nonetheless continue to ignore a significant portion of pipelines that do not fit PHMSA’s categorization of significant threats.

Immediately following the spill, PHMSA proposed extending safety rules for “low-stress lines . . . within 440 yards of an unusually sensitive area (USA).” Notice of Proposed Rulemaking, Pipeline Safety: Protecting Unusually Sensitive Areas from Rural Onshore Hazardous Liquid Gathering Lines and Low-Stress Lines, 71 Fed. Reg. 52, 504 (Sept. 6, 2006), *see also* 49 C.F.R. § 195.6. PHMSA continues to consider and discuss the definitions and requirements as evidenced by the recent Notice of Proposed Rulemaking on “Protecting Unusually Sensitive Areas from Rural Low-Stress Hazardous Liquid Pipelines.” 72 Fed. Reg. 28,008 ( May 18, 2007). However, the proposed regulation, which defines which low-stress pipelines would be affected, is very limited. Whereas the proposed definition would minimize the greatest risk, it does not address the other risks apparent in low-stress pipelines.

Three advocacy and education organizations—Pipeline Safety Trust, Cook Inletkeeper, and Northern Alaska Environmental Center—submitted a comment stating that “the Pipeline and Hazardous Materials Safety Administration (PHMSA) is still choosing a non-scientific approach to identify rural, low-stress pipelines that ‘could affect’ an Unusually Sensitive Area (USA), in contrast to the approach used by PHMSA for higher-stress pipelines that ‘could affect’ High Consequence Areas.” Comment to Notice of

Proposed Rulemaking, <http://www.regulations.gov/fdmspublic/component/main?main=DocumentDetail&id=09000064802ca841>, see also C.F.R. 195.452(a)). In its recent notice, PHMSA proposes to allow operators to choose between the specified distance of the buffer zone or a comprehensive spread analysis (defined by PHMSA as the analysis that would determine how far a spill would spread given the topography, etc.). See Notice of Proposed Rulemaking on “Protecting Unusually Sensitive Areas from Rural Low-Stress Hazardous Liquid Pipelines.” 72 Fed. Reg. 28,008 (May 18, 2007). This is problematic as an operator would likely choose the comprehensive spread method only if it would provide less regulation, allowing it within the half-mile proposed buffer of a USA. To provide the best level of safety, as pointed out by the three advocacy groups, PHMSA should propose the comprehensive spread analysis for all low-stress pipelines, as this would take into account the terrain around the pipeline.

### **The Need to Regulate**

Although one would like to think companies have a high standard of care, regulations should be in place to ensure protection of the environment, human safety and oil supplies. It should not have been a surprise that the major spill occurred as employees of BP have been complaining to company officials since 2001 of being “so understaffed and lacking in routine maintenance that [pipelines] are leak-prone and vulnerable to explosions.” Jim Carlton, *Oil Technology Gets Cold Reception*, WALL ST. J.; E.ED., Apr. 13, 2001, at A1. PHMSA should do more than rely on corporate beliefs of safety by regulating and verifying safety mechanisms.

PHMSA stated that the U.S. economy would be impacted by an interruption in supply (PHMSA estimates benefits of approximately \$3.3 million per year of increased regulation); interruption would also likely result in businesses and consumers paying increased prices. *Pipeline Safety: Protecting Unusually Sensitive Areas from Rural Onshore Hazardous Liquid Gathering Lines and Low Stress Lines*, Regulatory Evaluation, Docket No. PHMSA-2003-15864 (2006). Further, the study found that interruptions in supply would result in increased

importation of foreign oil, creating national security implications. *Id.* A disruption could take place outside of a USA and under PHMSA’s proposed regulation, it would not be covered. Additionally, this approach does not address the potential movement of spilled oil by flowing water or downward flows within watersheds. Therefore, it would be beneficial economically as well as environmentally to implement such regulations on all low-stress lines, not just those in USAs.

With the proposed regulations applying to only certain low-stress pipelines, it is impractical to believe that a pipeline operator would manage an integrated pipeline that falls under multiple regulatory schemes, or only have a portion of the pipeline excluded from other regulations. It is more practical to require similar testing and safety requirements on all pipelines to avoid the problems shown to occur absent regulation.

### **Corrosion and Excavation Damage Protection**

The most significant requirement of the new regulation requires corrosion and excavation damage protection (such as smart pigging, etc.). The current regulatory scheme does not require low-stress pipelines to undergo any protections. Even if no other portion of the regulation is passed, this is one requirement that is paramount as corrosion is responsible for approximately 24 percent of all pipeline accidents, by far the most common cause. See Carol M. Parker, *The Pipeline Industry Meets Grief Unimaginable: Congress Reacts with the Pipeline Safety Improvement Act of 2002*, NAT. RESOURCES J., Winter 2004, at 255. PHMSA believes that the primary cause of accidents on low-stress lines is tied to corrosion and excavation damage. See *2006 Proposed Rulemaking*, at 52,509.

The two main purposes for corrosion protection are environmental and economic. Environmentally, corrosion can cause serious leaks and ruptures that can result in contamination of drinking water, damage to wildlife, and explosions and fires. Economically, corrosion protection ensures the reliable delivery of oil. *Pipeline Safety* at 22.

## Overall Cost Benefit Analysis

Additional costs will likely be required to implement the new requirements for testing and assurance of pipeline integrity. However, “the costs for compliance with a more comprehensive regulatory scheme would not be large, particularly in comparison to the high costs to society when pipelines fail.” BP Pipeline Failure: Its Effects on Oil Supply and How to Prevent a Recurrence: Hearing Before the S. Comm. on Energy and Natural Resource, 109th Cong. 24 (2006) (statement of Peter Van Tuyn). The potentially fatal and environmental impacts far outweigh the slight increase in cost for oversight and increased safety assurances.

The cost to bring pipelines into compliance would likely be similar whether the PHMSA proposal is enacted or whether a more stringent set of regulations is approved covering all low-stress pipelines. PHMSA estimates “that its proposal will cost operators only \$17 million.” *Id.* at 25. The costs associated with pipeline failure include the shutdown of the pipeline and the clean-up costs and permanent damage suits that could arise from the accident.

PHMSA conducted an environmental assessment that indicated that most pipelines that would come under regulation are already being inspected by the pipeline operators. *See* John A. Volpe, Protecting Unusually Sensitive Areas From Rural Onshore Hazardous Liquid Gathering Lines and Low Stress Lines, Docket No. PHMSA-2003-15864 at 15 (Aug. 2006). The study also found that the “proposed rulemaking would require only limited physical modification or other work.” *Id.* at 15. Again, with the potential benefit and low projected cost of implementation, it is puzzling why PHMSA has not proposed removing the exemption completely.

A uniform regulation of all low-stress pipelines would provide uniform management requirements for both PHMSA as well as pipeline operators. If the proposed regulations containing exemptions are passed, a pipeline operator could be left with a pipeline that would be subject to different regulations (depending on the location and how close it is to a USA). It is unlikely that pipeline operators will actually construct or test a pipeline in different manners. As a practical matter,

pipeline operators are likely to adhere to the more stringent regulations for the entire pipeline rather than taking advantage of small exempt areas in the middle of their regulated pipeline. Based on the volatility of the low-stress pipeline, one would think PHMSA would err on the side of caution to protect environmental and economic interests.

## Conclusion

Due to PHMSA’s focus of regulation within the range of USAs, the proposed rule will have a limited impact on environmental and economic protection. Additionally, new pipelines covered by the regulation do not go as far as other already regulated pipelines.

Although low-stress pipelines have been thought to be low risk, recent events prove they can pose a substantial risk if a leak remains undetected for a long period of time. As such, there is a strong need for increased regulation and oversight. Historically, the public, legislators, and regulators react to major accidents by eliminating exemptions or requiring additional testing measures. It is time for the government to “take the lead in ensuring the short and long-term viability and integrity of our energy production and delivery systems.” Peter Van Tuyn, at 20. The associated cost of the increased regulation would be *de minimis* compared to the benefits of increased safety for the economy as well as the environment.

Although we cannot expect pipelines to be failsafe or leak proof, concentrated efforts must be made to avoid spills. PHMSA should be more aggressive in addressing the continued problems with pipelines by imposing regulations on all low-stress pipelines as well as imposing statutorily available civil and criminal penalties.

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**Mark D. Christiansen**

In late 2007, the Washington state Court of Appeals issued an opinion that balanced the competing interests of the public’s desire to know certain types of information in the possession of government agencies, and the need to protect domestic energy facilities from the threat of terrorists and others who might seek to damage energy facilities. The case of *Northwest Gas Ass’n v. Washington Utilities and Transp. Com’n* 168 P.3d 443 (Wash. App. 2007), involved a request by various newspapers for access to detailed information filed by various pipeline companies with the Washington Utilities and Transportation Commission (WUTC). The information sought showed the location of, and detailed information concerning, various hazardous liquid and natural gas pipelines located in Whatcom County, Washington. The pipelines had filed the information with the WUTC pursuant to the requirements of Washington’s Pipeline Safety Act, WASH. REV. CODE § 81.88 (2007).

The Pipeline Safety Act had been enacted in response to community outcry in the aftermath of a natural gas pipeline explosion in 1999 that killed a fisherman and two children playing in a nearby creek in Bellingham. The act required that certain natural gas and hazardous liquid pipeline companies provide the WUTC with “maps, drawings, and records . . . of sufficient scale and detail as is necessary to show the size and type of material of all facilities.” WAC 480-75-600.

The pipelines provided the WUTC with two tiers of information in order to fulfill their reporting requirements. The first tier consisted of “high level data” concerning the location of the pipelines and other related information. The WUTC made this information available to the public.

The second tier of information provided by the pipelines consisted of “attribute-level data” that

included “exact geographic positioning system coordinates for the pipelines and terminals, locations and types of metering facilities, taps, . . . plus information about the diameter of the pipeline, depth, and commodities transported.” 168 P.3d at 448. The WUTC, as a matter of practice, provided this attribute-level data to emergency services “first responders,” but did not make this information available to the public.

During the 2007 legislative session, a new bill was introduced that proposed to amend then-existing laws so that Washington’s Public Records Disclosure Act, WASH. REV. CODE § 42.56 (2007), would only allow the public to receive access to certain of the high-level data. The attribute-level data would be made available only to “state agencies, local governments, and ‘first-responders,’ such as firefighters and law enforcement personnel.” 168 P.3d at 449. In response to the proposal of that new law, the Bellingham Herald and other newspapers (the “Newspapers”) filed requests with the WUTC for access to and copies of the types of detailed information that would be unavailable to the Newspapers if the proposed legislation was approved and signed into law. The court indicated its belief that the request of the Newspapers presented the first request ever received by the WUTC for the pipeline companies’ attribute-level data that provided detailed information concerning the pipelines and other facilities. *Id.* at 448 (Note 3.)

The WUTC notified the affected pipelines of the Newspapers’ requests for the detailed data, as required by the Public Records Disclosure Act. Fourteen pipeline companies or associations (the “Pipelines”) promptly sued to enjoin the WUTC from disclosing the requested data.

At the hearing on the Pipelines’ request for a preliminary injunction, the Pipelines argued that three state statutory exemptions prevented the WUTC from disclosing the detailed information: (1) An exemption for financial, commercial, and proprietary valuable information; RCW 42.56.270 (2) an exemption for “information gathered or maintained to prevent or to respond to criminal terrorist acts”; RCW 42.56.270 and (3) an exemption “under which a court can



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