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# Resource Law Notes Newsletter, no. 45, winter issue, 1999

University of Colorado Boulder. Natural Resources Law Center

RESOURCE LAW NOTES, no. 45, winter issue, 1999
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# RESOURCE LAW NOTES

Natural Resources Law Center School of Law University of Colorado at Boulder

Number 45 Winter Issue, 1999

# Twentieth Summer Conference Set for June 9, 10, and 11

## STRATEGIES IN WESTERN WATER LAW AND POLICY: COURTS, COERCION AND COLLABORATION

The Center's Summer Conference will return to tradition in its twentieth anniversary year with a program on western water. The program scheduled for June 9-11 (Wednesday through Friday) will be held in the Fleming Law Building on the University of Colorado campus in Boulder.

This year's program will feature the principal problem-solving strategies in Western water law and policy: courts, coercion and collaboration. David Getches will set the stage for the program with a review of the major developments in western water law in the 1990s. Among the issues to be covered in the "courts" portion of the program are Colorado water courts, the public trust, and basin-wide adjudications. We are also planning a series of presentations on the Snake River adjudication, which highlights several of the major issues in western water including federal water rights, the interaction of surface and groundwater, and Indian water rights.

Discussion of the "coercion" component will primarily focus on the changing face of command-and-control. Topics covered will include TMDL implementation under the Clean Water Act, the Clean Water Action Plan, the Endangered Species Act, and CALFED.

The final day of the conference will be devoted to collaboration. This program, which can be attended independently of the remainder of the conference, will take a critical look at collaboration—its value and limits. The morning session will examine both grassroots and state supported watershed initiatives and planning. In the afternoon, we will put collaboration in context with adjudication and regulation with a series on the Platte River watershed.

### Wednesday Evening Cookout

Barring lightning storms or snow, we will hold our traditional barbeque at the stone shelter on Flagstaff Mountain overlooking Boulder. This event is always a great opportunity to reconnect with old friends and meet other participants and speakers. Our evening speaker is not yet confirmed but we plan to again bring the literature of the West with us onto the mountain.

***Look for the full conference brochure in the next Resource Law Notes (April 1999)***

### Accommodations

As usual, blocks of rooms will be made available at special rates in area hotels and in nearby campus housing. In order to make attendance of the conference more affordable, the Center will attempt to match individuals in double accommodations at Kittredge Dorm and the University Club. A double at Kittredge will be about $23 per person per night.

### WWPRAC Evening Program

The Natural Resources Law Center and the Center of the American West will cosponsor a program, free and open to the public, on Tuesday evening before the conference. The lecture and discussion followed by a reception will focus on the Western Water Policy Review Advisory Commission and its recommendations for western water. An opportunity for early conference registration will be available before and after this program.

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For an advance copy of the agenda (available February), please complete and return the following:

Name: ______________________________

Affiliation ______________________________

Address: ______________________________

City ______________ State ________ Zip ______________

Phone: ______________ Fax: ______________

e-mail: ______________ ☐ I am interested in room sharing options.

# Comings and Goings:

## NRLC Welcomes New Board Members and Research Assistants

The Center has recently added three new members to its Advisory Board. Tracy Labin, Penny Hall Lewis, and Ann Morgan offer a wide range of experience to the Board and will contribute to our goal of maintaining diversity and balance in Board membership. We look forward to working with the new members in the coming year.

### Tracy Labin

Tracy Labin, a descendent of the Mohawk and Seneca Nations, has pursued her strong commitment to Native American rights as an attorney for the Native American Rights Fund for the past four years. She first worked for NARF in 1993 as a summer law clerk in the Washington, D.C. office. The following year, she joined NARF's Boulder office as a Skadden Fellow. The emphasis of her legal career lies in water law and on state jurisdiction in Indian lands.

Tracy received her degree in Anthropology and French from the University of Notre Dame, which included a year of study in France. While attending Stanford law school, Tracy clerked for the Seneca Nation Department of Justice, received the U.S. Department of Education Indian Fellowship, and served as the Executive Editor of *Stanford Journal of International Law.* She also developed a law school course entitled "Native American Common Law and Legal Institutions," for which she received the 1993 Lyons Award for Service.

Currently, Tracy serves on the board of the Indian Law Clinic and hopes to cultivate a closer connection between the NRLC and the Clinic.

### Penny Hall Lewis

Penny Hall Lewis has an extensive background that gives her critical awareness of agricultural issues and allows her to effectively serve her community. She is currently serving her first term on the Colorado Department of Agriculture Commission and as Director of the Middle Park Cattlemen's Association. She is also a member of the Northwest Regional Advisory Council for the BLM, Colorado Cattlemen's State Lands Committee and the National Cattlemen's Beef Association Federal Lands Committee. Penny formerly served as Summit County Commissioner and has held numerous appointments to local and state ad-hoc committees.

An active student of western issues, Penny received history and education degrees from the University of Colorado and has taken water and land use courses at the Denver University Law School.

Penny is a general partner of W.F.R., Ltd., a 3500 acre commercial cow/calf ranch in Grand County, Colorado. Penny's experience is not confined to agricultural issues. She has obtained diverse experience in the business world as a freelance writer, an accountant and Director of the Breckenridge Outdoor Education Center.

### Ann Morgan

Ann Morgan recently concluded her first year as the Director of the Colorado State Office of the Bureau of Land Management. She oversees the management of 8.3 million acres of surface BLM land with a focus on community based partnerships, multiple use management, recreation, environmental protection, and the challenges of a growing urban interface.

A native westerner, Ann spent the previous three years as BLM's State Director in Nevada where she concentrated on developing standards and guidelines for rangeland health, improving the quality and timeliness of hardrock mining environmental analysis, and securing strong working relationships with local governments in a state where the BLM manages 67% of the land.

Prior to joining the BLM, Ann was manager of the Washington State Department of Natural Resources, Division of Aquatic Lands, where she was responsible for the multiple use management of more than two million acres of lands. She directed leasing, resource inventories and harvesting, public access and recreation, habitat protection and restoration, and statewide aquatic lands enhancement programs. Prior to that she managed engineering and construction projects for geothermal power plants for the Pacific Gas and Electric Company.

Ann earned a bachelor of science degree in natural resource management at the University of California at Berkeley, and a master's of business administration degree from Golden State University in San Francisco.

The Center also introduces and welcomes five new research assistants—William (Bill) Caile, Courtney Hill, Ann Livingston, Robert (Bob) Rush, and Janea Scott.

**Bill Caile:** I was born in Boulder, Colorado, and spent my childhood going back and forth between my father's house in Denver and my mother's home in the mountains west of Boulder. I went to high school at Scattergood Friends School, a small Quaker boarding school in the rolling corn country of eastern Iowa. My undergraduate work was in Humanities at the University of Colorado where I became the third generation of my family to graduate from, and work for, the University.

My fascination with natural resources law probably began when I was very young. My mother and I lived on an unpatented mining claim, and we were involved in constant negotiations with assessors, prospectors and Forest Service personnel. My interest in land use, water and environmental law grew as Boulder—and its requisite resource issues—grew around me. I am very excited to now be involved with the Center, and natural resources law generally.

When not at school I can usually be found hiking, fishing, and watching Godzilla movies with my 5-year old son, Billy.

**Courtney Hill:** After a fulfilling four years in Fayetteville, I graduated from the University of Arkansas in 1997 with a Bachelor of Arts in English and Environmental Science. I left the Ozark Mountains and came to the Rockies to get a new perspective of environmental law and policy. As a second year law student, I hope to find a career in this area to satisfy both my desire to contribute and my search for creativity. My work with the Center has been helpful in expanding my knowledge of alternative legal careers. I have been researching issues for the upcoming Water Conference and coordinating this issue of *Research Law Notes.* When time pressures permit, I love shooting and printing photographs, mountain biking, and creative writing.

**Ann Livingston:** I was born in Sarasota, Florida, and attended the University of Florida where I majored with a focus in creative writing and minored in anthropology. While at the University of Florida I worked for the Travel and Recreation Program leading outdoor adventure trips, was admitted to the Golden Key National Honor Society and the English Honor Society, and was published in both university literary magazines. After completing my undergraduate program in December of 1995, I moved to Pueblo, Colorado, where I worked for the Pueblo Library District as an assistant librarian. The summer before I began law school I moved to Boulder and worked for the Boulder Ranger District of the USDA Forest Service. I am currently working on a pamphlet for the *Innovations in Forestry* series concerning Forest Service funding and assisting the El Paso Fellow with his research needs. Once I complete work on my JD and the certificate in environmental public policy, I plan to work in environmental public policy. My non-law public policy related interests include mountain biking, rock climbing, hiking, poetry, and cultural anthropology.

**Robert Rush:** After spending the first twenty-two years of my life in northern New Jersey, I was lured away by Colorado's mountains, the University of Colorado, and the Boulder area in general. During the past six years of living here, I never once regretted the decision to leave the Garden State and come to Colorado. I graduated with a BA in Environmental Studies and Geography from CU in 1997 and decided to move across campus to pursue a law degree. My areas of interest include population, pesticide safety and environmental and social justice. At the Center, I am working on research concerning growth in the high country. During my free time, of which I've learned a law student has virtually none, I enjoy hiking, skiing, biking, and homebrewing.

**Janea Scott:** I'm a second-year law student and am enjoying my experiences at CU law school. I was born and raised in Colorado and am proud to be a Colorado native. In my life before law school, I lived in the San Francisco Bay Area. I was fortunate enough to be there for six years. I spent the first five of those years at Stanford University earning my Bachelor's and Master's of Science in Earth Systems (Stanford's equivalent of Environmental Sciences). I spent my last year in the Bay Area working at a middle school in San Francisco with AmeriCorps. Both Stanford and AmeriCorps were excellent experiences, and though Boulder is an interesting college town, I "left my heart in San Francisco." I am very much looking forward to being a part of the NRLC and getting to know all of the people who make it the innovative and exciting place it is.

## NRLC Bids Farewell (and Thanks) to Departing Board Members

For more than 15 years, the richness and diversity of its Board has contributed to the Center's excellence. Members provide general guidance to the staff as well as specific advice on topics for legal and interdisciplinary research and education programs, ways in which the Center might collaborate with other groups, and ways the Center can continue to develop financial support for its natural resources law-related efforts. Generally, members serve a three-year term; however, some memberships date back to the Center's founding with those early members also playing key roles in the Center's initial fundraising efforts.

This year, the Center bids farewell to two Advisory Board members who both joined the Board in January 1995. State Geologist and Director of the Colorado Geological Survey, **Vicki Cowart**, and **Glenn Porzak**, managing partner for the Boulder law firm Porzak Browning & Johnson LLP, will be "moving on."

In addition to serving on the Center's Board, **Vicki Cowart's** professional activity includes serving on the Editorial Board of *Geotimes*, the popular geology magazine published by the American Geologic Institute. She has also been active in the Denver Geophysical Society, serving as both editor and treasurer, and the Society of Exploration Geophysicists, in which she has served on or chaired several committees. She founded the Denver chapter of the Association for Women Geoscientists and served as the Association's first nationally elected president. She was treasurer of the AWG Foundation for four years and is currently an Advisor to the Foundation's Board of Directors.

When he is not climbing mountains or training for an expedition, attorney **Glenn Porzak** will continue representing a number of Colorado's major ski areas and resort communities at the law firm he formed in 1996. Glenn will also be using his excellent managerial skills for an even "loftier" purpose—to raise money for the new law school as the designated leader of the Boulder Steering Committee for the Law School's Capital Campaign.

The Center thanks these former Board members for their commitment of time and talents to the Center and we look forward to interacting with them in different capacities in the future.

## New Pamphlets Available from Innovations in Forestry Series: *Sustainable Forestry and Certification* and *Stewardship*

With funding from the Ford Foundation, the Center is producing a series of pamphlets on forestry. *Innovations in Forestry: Public Participation in Forest Planning* was the first in the series.

Distributed in September, the second pamphlet in the series, *Sustainable Forestry and Certification* examines the various initiatives that promote sustainable forestry practices through certification. These initiatives focus on private and non-federal public lands both within the United States and internationally. The pamphlet examines programs sponsored by the Forest Stewardship Council, the American Forest and Paper Association, the Society of American Foresters, and the American Tree Farm System.

Released in October, the third pamphlet in the series, *Stewardship*, sets out the policy framework for stewardship contracting on National Forest lands. The pamphlet focuses on the functions and limitations of timber sale contracts and service contracts, the two primary methods available to the Forest Service for facilitating its land management policies. Additionally, the pamphlet discusses a number of proposals to increase the agency's legislative flexibility with regard to designing and funding stewardship contracts. A number of Forest Service pilot projects (which recently received congressional appropriations) serve as references for the stewardship concepts.

These pamphlets have been widely disseminated to federal, state and private forestry interests. Pamphlets may be ordered by phone or fax from the Center's publication desk (Tel: 303-492-1272; Fax: 303-492-1297). Orders of up to 10 copies are available free, and additional copies are available at a cost of 5 copies for $1.00, including postage. The entire Forestry pamphlet series may be viewed or downloaded in Adobe Acrobat format from the Internet on the Center's Recent Publications Page at: http://www.colorado.edu/Law/NRLC/recentpubs.html.

# The State Role in Western Watershed Initiatives

The Center has recently completed a report on the modern watershed management movement in the West. *The State Role in Western Watershed Initiatives* describes efforts by western states to implement watershed initiatives for resource management and discusses the socio-political context of the western watershed movement. The major ideas presented in the report follow the dominant themes drawn from diverse opinions representing federal, state, and local governments, academic institutions, interest groups, concerned citizens, watershed coordinators and other interested stakeholders in the "front lines" of the watershed movement. This research was funded by the Ford Foundation. Principal authors of the report are Frank Gregg, Douglas Kenney, Kathryn Mutz, and Teresa Rice. The report's Executive Summary is provided below.

The management of water resources in the American West raises a number of unique and complex challenges. Among these are the difficulty of coordinating diverse public and private interests and promoting water resources governance from a regional and integrated perspective. One of the most striking and innovative characteristics of water management in the 1990s is a renewed interest in local, generally sub-state watersheds as the preferred administrative unit. Also significant is the ad hoc formation of a large number of "watershed initiatives" to address water management issues through collaborative processes. Many western states are recognizing the potential of these groups to successfully address a host of water-related problems. This paper reviews the historical and ideological context for state involvement in watershed management, describes current state approaches to supporting the formation or continuation of local watershed groups, and provides general recommendations to policy-makers and watershed groups for future actions.

Section I of the report contends that the current structure of western water management is a result of experimentation and gradual change from the settlement of the "frontier" in the late 1800s through modern times. Although the idea of resource management on a watershed level was first suggested over a century ago, the boundaries of political jurisdictions were instead set up in a checkerboard pattern around land ownership, bearing very little resemblance to natural hydrologic regions. Other important legacies of 19th century western settlement and governance include the lack of coordination between land and water management institutions and the failure to accommodate public interest concerns in resource allocation decisions. Whether these elements of western water management are seen in retrospect as historical mistakes or necessary prerequisites for economic development, they are often at the root of problems modern watershed initiatives try to address.

*One of the most striking and innovative characteristics of water management in the 1990s is a renewed interest in local, generally sub-state watersheds as the preferred administrative unit.*

Traditionally, the primary state role in western water management has been water allocation under the prior appropriation system. In response to rapidly changing demands, however, the scope of western states' water management has expanded to include broad issues of watershed restoration, instream flow protection, water-use efficiency, and drought management. Broad governmental trends at the federal level have also prompted an expanded state role in water management. For example, the Clean Water Act encourages the states and federal government to combine expertise and funding to address regional water problems.

As the states position themselves to exert an increasingly strong leadership role in what promises to remain a highly intergovernmental policy area, they are faced with several significant challenges. One of these challenges is that the values and goals shaping water management have evolved over the past quarter century at a pace which has exceeded the capacity of institutional change. Incorporating the values of the New West into institutions designed for traditional western economies and lifestyles in an efficient and equitable manner is a real challenge, which is exacerbated by calls for greater local involvement in resource management decision-making. While greater local control over resource management may yield such advantages as increased accountability between resource managers and affected stakeholders, as well as a more creative, flexible, and efficient approach to natural resource management, such processes may be difficult to implement and may inadequately satisfy national resource management standards.

In light of these complex challenges, the modern "watershed movement" constitutes a broad and ambitious experiment in natural resource governance. Watershed initiatives are forcing a reexamination of several fundamental components of resource management, including: who should be involved in making management decisions; at what geographic locations should the decisions (and decision-making processes) be based; and which evaluation criteria should be used to determine appropriate water uses and management philosophies? While broad governance issues such as these are at the core of the watershed movement, most individual watershed initiatives are much more pragmatic, concerned with finding and implementing solutions to localized problems. In fact, one of the strengths of watershed initiatives is their ability to focus their activities directly at the most pressing natural resource problems of particular watersheds, often operating outside of normal governmental processes and free from the constraints of inflexible mandates or program requirements. Substantive issues frequently addressed by watershed groups include water quality, habitat protection (including endangered species concerns), and general issues of environmental degradation.

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The majority of watershed groups have a broad, balanced membership composed of representatives from federal, state, and local government agencies, local landowners, and various other stakeholders. Additionally, those watershed groups featuring a predominance of members from a particular sector or special interest frequently establish advisory or technical committees to ensure regular input from other sources. Concerns over inadequate rep-

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Continued on page 5

resentation do exist, however, especially from national environmental groups who fear some watershed initiatives are dominated by local commodity interests or parties too eager to compromise environmental standards. These concerns, whether accurate or not, are largely alleviated by the fact that watershed initiatives rarely possess independent management authority, instead relying on the coordinated application of powers held by participating entities. The form of decision-making utilized by watershed initiatives varies largely with membership characteristics, although cooperative arrangements such as consensus or super-majority are common. Several additional qualities of watershed initiatives are described in Section II.

Most activities of watershed initiatives are directed towards raising the level of understanding about the watershed. Other activities include interagency coordination of expertise and resources, conflict resolution, and on-the-ground restoration projects. Improving communication and the quality of the decision-making environment are often listed by participants as primary successes of these efforts, whether this occurs as a by-product of other activities or as an end in itself. Ultimately, all watershed initiatives should be judged by environmental, on-the-ground performance criteria; however, in the interim, the improvement of working relationships is a worthwhile accomplishment portending future successes. Qualities that appear to be conducive to success include effective leadership, participation by locally respected individuals, an appropriate focus, adequate resources, and a credible and efficient decision-making process.

*State watershed approaches differ widely and are rapidly evolving.*

The most frequently limiting resource of watershed initiatives is funding for both on-the-ground projects and group administrative tasks. Most watershed initiatives are highly dependent on federal grants, congressional appropriations, or state agency assistance. Many watershed initiatives find that governmental support, especially federal support, is essential and often available, but comes at the expense of restrictions that complicate efforts to efficiently plan and conduct restoration projects. Other sources of funding include membership contributions, private foundations and companies, and conference and publication fees. Donations of in-kind services, such as office space, equipment, and staff time, are also frequently essential to sustaining a watershed initiative. Reliance on in-kind services may help to enhance other goals such as maintaining local control and building group cooperation and trust.

State watershed approaches differ widely and are rapidly evolving. Some states have adopted formal mechanisms and comprehensive water management policies while others use a more ad hoc approach. Section III describes state legislative and agency strategies for encouraging and supporting watershed initiatives in Alaska, Arizona, California, Colorado, Idaho, Montana, Nevada, New Mexico, Oregon, Utah, Washington, and Wyoming.

States are frequent and valued participants in many watershed initiatives, bringing an increasing level of technical expertise, management authority, and occasionally financial resources to a variety of water-management issues. When designing comprehensive policies for water management, however, states should acknowledge that 1) not every watershed initiative is effective or worthy of state support, 2) a program that works well in one state may not necessarily be successful in another state, given each state's unique physical and institutional qualities, and 3) the rigidity and uniformity frequently associated with governmental activities could hinder the progress of watershed initiatives, which normally operate outside of government channels.

With these observations in mind, Section IV provides seven general policy recommendations for designing new state programs or improving existing state programs to encourage and support watershed initiatives:

*Recommendation 1: Legislative and administrative reforms should be pursued to bring an integrated geographic focus to all facets of state natural resources planning and management.*

*Recommendation 2: State agencies with water-related responsibilities should be vested with mandates and bureaucratic incentives that encourage their participation in, and support of, watershed initiatives.*

*Recommendation 3: Mechanisms that encourage or facilitate improved channels of communication and coordination among (and within) the various state agencies that interact with watershed initiatives should be provided through legislation or administrative policy.*

*Recommendation 4: As part of their overall watershed management approach, states should consider providing a legislative and/or administrative framework to encourage, in a broad way, the formation of watershed initiatives.*

*Recommendation 5: State funding programs for watershed efforts should be established where possible, and should be broad enough to include support for organizational, administrative, educational, and on-the-ground activities of selected initiatives.*

*Recommendation 6: States should establish general criteria and standards that watershed initiatives must meet in order to obtain the participation of state agencies, to compete for state funding, and to achieve state recognition.*

*Recommendation 7: Reforms that transfer the authority, responsibility, or accountability for resource management to watershed initiatives should not be pursued.*

Copies of the full report (RR18) can be purchased for $15 by contacting the Center's publication desk (see page 11 for ordering details).

# Technological Advances Streamline NRLC Research, Publicity and Publication Processes

**By: David Terner**

In addition to acquiring four upgraded research station computers with Ethernet connections and word processing software, the Center has upgraded its Web presence to allow watershed and forestry groups to fill out our questionnaires on-line. With these technological advances, the Center strives to maximize research and production efficiency, and reduce consumption of paper products to a bare minimum, while reaching the widest possible audience for Center events and publications.

While increasing enrollment for such local Center events as our law school Brown Bags, and Denver Hot Topics luncheon series, further utilization of the Webshould enable the Center to convert most of its publications to PDF format for sale over the Internet. Currently, our forestry pamphlet series and the last edition of *Resources Law Notes* are available in Adobe Acrobat ("PDF") format on-line. If you missed these publications please feel free to download copies from links on our homepage at: http://www.Colorado.edu/Law/NRLC/index.html.

We are also attempting to compile a list of e-mail addresses of parties interested in our free publications, so that we may eventually cross over to a virtual format. If interested, please take a minute and fill in the form at: http://www.Colorado.edu/Law/NRLC/One.html, as this will enable us to send you e-mail updates, virtual copies of our free publications, and invitations to Center-sponsored events.

# 1999 El Paso Energy Corporation Law Fellow

The El Paso Energy Foundation continues to fund a visiting fellow at the Center. Through the El Paso Energy Corporation Law Fellow program, the Center receives funding from the Foundation to support a visiting researcher for one semester. The funding provides the fellow with a $25,000 stipend and research assistance, as well as clerical support, and an office in the law school. The fellowship also supports various events—a reception, meeting with students, and a Hot Topics program—which facilitate the fellow's integration into the NRLC and law school community.

The 1999 Fellow is Robert Frodeman, Professor of Philosophy and Environmental Science at the University of Tennessee at Chattanooga. Bob received a BA in philosophy and history at Saint Louis University in 1980, a Ph.D. in Philosophy at Penn State University in 1988, and an MS in the Earth Sciences at the University of Colorado in 1996.

His work centers on turning philosophy outward toward community concerns, demonstrating the relevance of the tradition of philosophy to contemporary culture. In particular, he focuses on bringing together the threads of science, philosophy, and public policy to reach consensus on environmental problems. His position at the University of Tennessee at Chattanooga is distinguished by the inclusion of a public outreach component where he works with local, regional, and federal organizations such as the Tennessee River Gorge Trust and the United States Geological Survey to integrate science, ethics, and public policy.

During the spring 1999 semester Bob will write on the scientific, philosophic, and public policy issues surrounding acid mine drainage on abandoned mine lands in the West. Acid mine drainage is a problem of national and global importance, but it has particular resonance in the West, where there are an estimated five hundred thousand abandoned mines, and thousands of miles of streams with low pH and high metal content. The question of remediating these areas—to what standard, and at what cost—involves a complex mix of science, technology, and economics, combined with ethical, political, historical and cultural values.

The questions surrounding acid mine drainage include: 1) distinguishing between natural and anthropogenic acid drainage (i.e., between acid rock and acid mine drainage) and identifying what were the original natural conditions; 2) determining what degree of remediation is appropriate: are streams to be returned to natural background conditions, or to state or federal standards? 3) deciding who should bear the costs of remediation (e.g., private property land owners, mining companies, or the local, state, or federal government); 4) examining the limits of cost-benefit analysis for factoring in ethical, political, aesthetic, and natural (i.e., ecosystem) impacts; 5) identifying the means for effectively presenting scientific research to the public; and 6) including community values within the decision-making process. Research will focus on two areas in Colorado: the Summitville Superfund district in the southern San Juan Mountains, and the Animas River drainage of the central and western San Juans.

## NFMA Conference Summary Available

The Natural Resources Law Center is making available a compilation of papers presented at its public lands conference entitled, "The National Forest Management Act in a Changing Society 1976-1996," held in Boulder in September of 1996. The conference was co-sponsored with Oregon State University, Colorado State University, the Pinchot Institute for Conservation, and the Maxwell School of Citizenship and Public Affairs at Syracuse University.

The conference critically examined several key issues necessary to evaluate the success of this statute. The papers analyze the statute, based upon the expectations of its authors, as well as from the vantage point of current managers and citizens engaged in forming new kinds of relationships unimagined 20 years before.

While supplies last, a free copy of the compilation can be obtained by contacting the Center's publication desk. Please see page 11 for details.

## Updating *The Watershed Source Book* Project

**By: Sean McAllister**

The Natural Resources Law Center is in the process of revising the Watershed Source Book (1995), which currently features 76 case studies of community-based watershed initiatives in the western United States. Due to the rapid expansion of the watershed movement in the last few years, we estimate that the updated Watershed Source Book will contain well over 300 case studies. To date, we have completed an inventory of the watershed initiatives and sent initial surveys to groups in the Colorado, Rio Grande, Arkansas, Missouri, and the Great basins, and we are close to completing this work for the enormous Columbia Basin.

In an effort to reach a wider variety of groups, we have also made the survey available on the Internet. The most difficult part of the project is actually getting the extremely busy groups to respond. We encourage anyone who believes they are involved with a collaborative, intergovernmental, multi-stake holder watershed initiative to fill out the survey. As an incentive, we will be happy to provide survey respondents with a free copy of the updated Watershed Source Book (when available). Inquiries regarding the Watershed Source Book should be directed to Doug Kenney or Sean McAllister. Watershed groups can send us information on-line at: <http://www.colorado.edu/Law/NRLC/NRLC_Watershed_Survey.html>.

# UPSTREAM, MIDSTREAM, DOWNSTREAM?

## THE VALUATION OF ROYALTIES ON FEDERAL OIL AND GAS LEASES

By Joyce Colson

*Joyce Colson, a principal in the Colson-Quinn law firm in Boulder, Colorado, was the Center's El Paso Energy Corporation Fellow for 1998-1999. Her research for this article was generously supported by a grant from the El Paso Energy Foundation. This article is drawn from a more complete and substantial article appearing in the UNIVERSITY OF COLORADO LAW REVIEW 70(2)(1999).*

### Introduction

The federal government is involved in an epic struggle to redefine the very nature of the oil and gas royalties it collects from the oil and gas industry. Fueled by political outcry over inadequate collection of royalties from producers, especially as to posted prices on oil, the Minerals Management Service (MMS) has searched for a new pricing methodology and, since the adoption of comprehensive regulations in 1988 (Cite CFR Generally), has sought to expand the notion of gross proceeds upon which it assesses royalties. In 1997, MMS abandoned proposed gas valuation regulations negotiated with the gas industry, which would have based royalties on spot price indices, and in their place, enacted new gas transportation allowance rules. The MMS proposed new oil valuation regulations, which would require use of crude oil spot prices and set up different valuation methods for three geographic regions. Despite MMS's arguments to the contrary, these new and proposed regulations impose a new "federal duty to market," which demands that federal oil and gas lessees create and develop markets for products at no cost to the federal government.

Royalties on federal lands under the Mineral Lands Leasing Act are based on the amount of production removed or sold from the lease while the Outer Continental Shelf Lands Act (OCSLA) similarly provides that royalties are to be based on the amount of production saved, removed, or sold. The terms of federal leases provide for the same royalty valuation method. The regulations enacted in 1982 governing the collection of royalties on federal leases provide that the value of production for purposes of determining royalties will be based on "gross proceeds" at the time of production or sale. With the advent of the 1988 regulations, however, the MMS began to expand its concept of gross proceeds so that non-arms length transactions began to be governed by a series of benchmarks determining what constituted gross proceeds in such transactions.

With the MMS's expansion of gross proceeds and the dramatic changes in the oil and gas industry in the last decade, the MMS and the oil and gas industry have been involved in a legal tug of war over proper royalty valuations for oil and gas, ranging from take-or-pay settlements, to postproduction costs, to posted prices. At the heart of these disputes is a struggle over whether producers have an obligation to market the oil and gas for the federal government.

The MMS believes that the current oil valuation regulations, which rely heavily upon posted prices, no longer reflect the true market value of oil. Similarly, the MMS viewed the previously existing gas valuation regulations as not reflective of the true market value of gas because of aggregated gas sales and direct sales to Local Distribution Companies (LDCs) and end-users. The MMS, therefore, sought to capture what it considered to be its share of that market value through its proposed oil regulations and the amendments to gas regulations. Is the MMS, with these new and proposed regulations, properly invoking the "gross proceeds" concept to clarify the distinction between shared transportation expenses and marketing costs, which are borne by the lessee? Or, is the MMS imposing a new or expanded implied duty to market? The oil and gas industry argues the latter and contends that no such duty exists.

### The 1988 Regulations

In 1988, MMS enacted new regulations to govern the valuation of royalties on oil and gas leases. Most significantly, those regulations provided that royalties would be based on gross proceeds received by lessees under arms-length sales. Provisions were also enacted to govern the deduction of cost allowances and sales to lessees' affiliates.

The 1988 oil and gas regulations provide that royalties will be based on the price received by the lessee under an arms-length transaction. Further, the "gross proceeds" rule must be applied to determine the total value received by the lessee. Specifically, Section 206 of the 1988 oil and gas regulations provide that royalties from federal lands are to be determined as follows: "Gross proceeds (less applicable deductions) received by the lessee under its arms length contract basis for calculating the royalty due." Gross proceeds are defined broadly and are not limited solely to the product of the lessee's sale price and the sales volume. Under the 1988 regulations, gross proceeds include the total consideration obtained by the lessee including indirect forms of consideration that add value to the oil or gas, such as reimbursement for severance taxes and other taxes, and postproduction services including compression, dehydration, and gathering. Section 206 of the regulations further provide: "The lessee is required to place oil in marketable condition at no cost to the Federal Government or Indian lessor unless otherwise provided in the lease agreement or this section." The MMS takes the position that, according to these regulations, all proceeds received by the lessee are subject to a royalty, limited only by the deduction of cost allowances.

With respect to a lessee's deductible cost allowances, the 1988 regulations provide that postproduction costs will not be deductible from royalty proceeds. Based on the decision in *California Co. v. Udall*, (296 F.2d 384 (D.C. Cir. 1961)) the MMS contends that all costs of placing production in marketable condition are to be borne solely by the lessee. MMS has broadly interpreted *Udall* to exclude the deductibility of costs such as dehydration, compression, gathering, and treating. The regulations do provide, however, that MMS may have to make deductions for transportation costs, processing costs, or both in determining the value of well production and, thus, gross proceeds.

A third critical component of the 1988 regulations is that they provide a benchmark valuation system for sales to a lessee's affiliate. The MMS views sales between a lessee and its affiliate as inherently suspect and designed to minimize the price upon which royalties are valued. Therefore, under the 1988 regulations, the MMS determines value for purposes of calculating royalties by the first of the following applicable benchmarks: (1) gross proceeds provided that gross proceeds are equivalent

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to gross proceeds obtained under a comparable arms-length contract (factors in determining whether a sale is comparable include price, market served, date of contract, terms, quality, and volume); (2) consideration of relevant information including comparable arms-length contracts in the area, posted prices, and arms-length spot sales prices; and (3) value determined by use of the net-back method or any other reasonable method to determine value. Both MMS and federal lessees agree that the term "lessee" under the rule does not include the lessee's affiliate, just the company holding the lease.

The MMS position that it can define value and gross proceeds, as it deems appropriate, and allocate from an accounting standpoint postproduction costs as deductible transportation costs or non-deductible marketing costs is troublesome for several reasons. Although the agency has the authority to establish reasonable minimum value for production removed or sold from the lease, and its decisions are subject to reversal only upon abuse of discretion, statutory and contractual provisions constrain what the MMS can do. For example, the applicable statutes specifically require the valuation of royalty to be based upon production saved, removed or sold from the lease. Furthermore, the Secretary of Interior is required to establish *reasonable* values. Is it reasonable to impose an implied duty to market on a lessee whereby the lessor reaps the benefit of increased value added by valuation at a midstream or downstream point without paying any associated costs? Moreover, even if the MMS is correct that the concept of gross proceeds allows it to assess royalty valuation in whatever manner it deems appropriate, why allow transportation deductions or marketing deductions at all? What logical distinction exists between marketing and transportation costs? These are all arguably postproduction costs, which are not deductible from royalty proceeds. Other than a historical argument, there is no rational basis for differentiating between various types of postproduction costs. Therefore, such allocation of costs may be subject to attack as arbitrary.

***... these new and proposed regulations impose a new "federal duty to market," which demands that federal oil and gas lessees create and develop markets for products at no cost to the federal government.***

***Is it reasonable to impose an implied duty to market on a lessee whereby the lessor reaps the benefit of increased value added by valuation at a midstream or downstream point without paying any associated costs?***

**The Duty to Market**

Although the MMS seeks to sidestep the issue of a duty to market, this question is at the very heart of the new and proposed regulations. MMS claims that, as with the 1988 regulations, the new and proposed oil and gas regulations merely reiterate lessees duty to place oil and gas into marketable condition. Even if the MMS claims that it is only making accounting allocations as to which items can be deducted from gross proceeds, the MMS is still, nonetheless, allocating legal responsibilities and obligations. Moreover, by expanding the definition of affiliates and non-arms length sales, the MMS, without regard for common law and corporate structure, is imputing the receipts received by affiliates to the lessee. There must be some duty or obligation that allows the MMS by regulation to pierce the corporate veil and claim that the lessee is the alter ego of the marketing affiliate. Finally, the MMS itself provides in the language of the proposed oil regulations (Section 206) that a producer may not use its gross proceeds for royalty valuation purposes where there is a "breach of...[its] *duty to market* the oil for the mutual benefit of [the producer] and the lessor." In short, the duty to market is an integral part of the MMS's new regulatory scheme for oil and gas. However, that duty is wholly unsupported by any regulation, statute, lease, or common law principle.

Federal leases have not historically been subject to an express duty to market nor has there been an explicit regulation allocating costs between the lessor and lessee. From 1942 to 1987, onshore leases were subject to a duty to market, but only as an option to prevent waste of gas. Between 1936 and 1982, the regulations provided for a duty *not* to market gas. OCS lessees since 1956 have only been subject to a duty to place oil in marketable condition.

With one exception, the concept of an express or implied duty to market is not expressly stated in the 1988 regulations outlined above. Pursuant to Section 206 of the 1988 regulations, MMS can reject product value under an arms length contract if there is misconduct by the contracting parties or "the lessee [has] otherwise breached its duty to the lessor to market the production for the mutual benefit of the lessee and the lessor." These regulations, therefore, require that lessees place production in marketable condition. The new and proposed oil and gas regulations differ significantly in that they refer not only to an express duty to market but also provide that such marketing costs must be borne by the lessee at no cost to the federal government.

The statutes applicable to oil and gas leasing on federal lands do not contain references to either an express or implied duty to market. Section 226 of the Mineral Lands Leasing Act requires the payment of royalty at a percentage "in amount or value of production removed or sold from the lease." Section 8 of the Outer Continental Shelf Lands Act (OCSLA) requires the payment of royalty at a percentage "in amount or value of the production saved, removed or sold" from the lease. Moreover, the legislative history of OCSLA discusses the need for fair leasing provisions that incorporate the commonly understood terms of the leases that parties in the coastal states developed under the operations on the Outer Continental Shelf. Thus, these statutes reflect a valuation of the production at the wellhead and do not discuss the duty to market.

The leases between the federal government and lessees provide for royalty valuation at the wellhead and contain no language supporting the duty to market. The OCS lease form provides for royalties based on the "amount or value of production saved, removed or sold *from the leased area*." Similarly, onshore lease forms provide for royalties based on the "production removed or sold *from the leased lands*." These leases are binding contracts and the government is constrained by their terms. Thus, according to industry proponents, MMS's new regulations, which purport to create a duty to market, are a unilateral and unauthorized attempt to change contract terms relating to the royalty valuation point and contractual duties.

If royalty is to be valued at the wellhead, there may be no implied duty to market beyond that point. Accordingly, any activities beyond the wellhead, other than placing the product into marketable condition should not enter into the royalty calculus. The case law discussing the point at which federal royalties are to be valued and whether a duty to market exists indicates that production is to be valued at the wellhead. In *United States v. General Petroleum Corp.* (73 F. Supp. 225 (S.D. Cal. 1946)), for example, in construing the Minerals Leasing Land Act, the court concluded that royalties are payable on gas as it is produced at the well. It is the value of that gas which must be determined. Furthermore, the court noted that a departmental power respecting a lease may not be read in if the Secretary failed to include it. Therefore, this case may restrict the ability of MMS to imply a duty to market into a federal lease. Indeed, such a duty to market requiring lessees to

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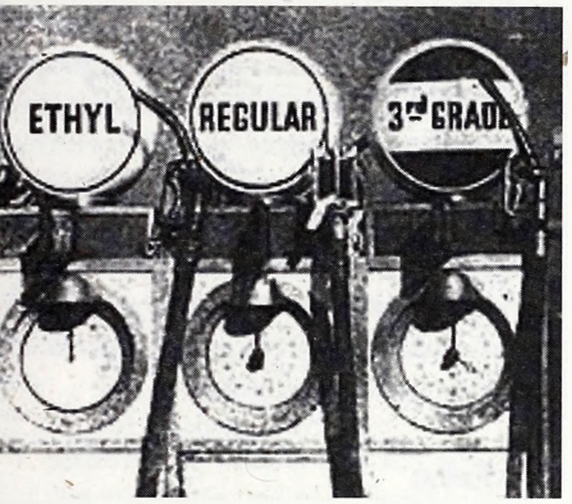


market crude oil or unprocessed natural gas at no cost to the lessor has not been included in either the federal lease forms or rules.

**The 1997 New and Proposed Regulations.**

***Gas***

Traditionally, the MMS has permitted deductions from gross proceeds for the lessee's cost of compression, gathering, transportation, and processing of gas. As many of the foregoing cases on the marketable condition rule note, the MMS has strictly limited deductions from gross proceeds in computing royalties to those specified only as transportation or gas processing allowances.

As a result of deregulation of the natural gas industry, the MMS contended that the entire gas market changed and that a new valuation rule was necessary. Specifically, because Order 636 no longer permitted pipeline companies to act as traditional merchants "buying gas at the wellhead and reselling the gas downstream" producers must now market the gas themselves. Given the ramifications of Order 636 and the increased use of spot market sales in the gas market, the MMS undertook negotiated rulemaking with the gas industry to address the valuation of federal gas production under both arms-length and non-arms length sales contracts. After working on these regulations for over three years, the MMS withdrew the resulting "Consensus Rule" in April 1997. This rule would have provided for valuation of gas based on spot price indices. The MMS justified its withdrawal of the negotiated rule on the grounds that spot price indices insufficiently reflected the prices for gas production and that the rule was not revenue neutral—in other words, the Government would lose money. Industry claimed, on the other hand, that the political outcry over MMS's performance in collecting royalties was the true cause of MMS's abandonment of this fair and reasonable proposal for a new rule on gas valuation.

Regardless of the MMS's rationale for withdrawing the Consensus Rule, MMS has adopted another approach. MMS amended the transportation allowance regulations and gas valuation regulations in what it describes as a clarification of what constitutes deductible transportation costs and nondeductible marketing costs. Once again, Order 636, which required unbundling of sales and transportation services, arguably resulted in lessees identifying cost components separately in contracts, as opposed to aggregating costs and rendering them unidentifiable. Thus, the MMS issued a new rule to clarify which costs are related to transportation, and, therefore, deductible, and which of those separate and identifiable costs are related to marketing, and, therefore, nondeductible for federal leases. Additionally, the MMS made changes to the gas valuation regulations governing those circumstances where the producer or shipper overdelivers production to a pipeline in excess of the pipeline's tolerance. If the shipper incurs a penalty in the form of a substantially reduced price for such gas, the MMS indicates that it will not accept that penalty inflicted price as the value of production.

Clearly, a producer is now obligated to market gas at no cost to federal lessors. Specifically, the MMS, in its amendments to the gas valuation regulations, adds that the lessee must "market the gas for the mutual benefit of the lessee and the lessor" at no cost to the federal government (62 Fed. Reg. 19,536 (1997)). Where the value established under this section is determined by the lessee's gross proceeds, that value will be increased to the extent that the gross proceeds have been reduced because the purchaser or any other entity has provided certain services; the cost of which ordinarily falls under the responsibility of the lessee to place the gas in marketable condition or to market the gas.

Furthermore, according to the proposed regulations, a producer cannot deduct marketing or aggregator fees paid to another entity, including an affiliate, to market gas. This limitation includes fees paid for the purchasing and reselling of the gas and for finding or maintaining a market for the gas production. The proposed regulations also provide that the producer is limited as to the transportation costs that can be deducted, such as demand charges. Finally, the MMS proposals also state that intra-hub transfer fees and long term storage fees constitute nondeductible marketing costs.

These regulations have left several open questions regarding a lessee's duty to market under federal leases. First, it is unclear whether the producer is now required to market off the lease and in downstream markets. Second, a market still arguably exists at the wellhead or at the pipeline main receipt point. However, because Order 636 gives a producer the option to market gas downstream, pipeline capacity may not be available. Third, in the preamble to the 1997 gas regulations, MMS stated, "We have not changed the principle of accepting gross proceeds under arms-length contracts and would not trace value beyond a true arms-length transaction to the burner tip, as commented." Does this mean the duty to market ends at the nearest available market? Finally, it is not known whether the MMS differentiates between the producer selling in an arms length transaction at the wellhead and the producer selling in an arms-length transaction downstream.

The gas industry argues that many of these nondeductible marketing costs, which were previously included in FERC tariffs prior to deregulation of the natural gas industry and the issuance of FERC Order 636, are transportation costs that industry is entitled to deduct. As a result, two industry organizations have filed lawsuits challenging these amendments to gas transportation allowances. Industry contends that these regulations impermissibly impose a duty to market gas at no cost to the lessor and prohibit the deduction of certain transportation costs incurred in transporting the gas off the lease to downstream markets. Further, industry argues that these gas regulations contravene the terms of pre-existing federal leases. These lawsuits may resolve the specific issues raised above and, more generally, the issue as to whether a new federal duty to market, independent of the marketable condition rule, is viable. Because the MMS should not reap the rewards of enhanced product value due to midstream and downstream activities without bearing its proportionate share of such midstream and downstream costs, the courts ultimately hearing these cases should disallow the new federal duty to market created in the amended regulations.

***Oil***

The proposed oil valuation regulations face an uncertain future. Indeed, the third version of these proposed rules was recently derailed by last-minute congressional maneuvering. Whether these valuation regulations are enacted in their latest form or not, they nonetheless demonstrate how the MMS is approaching the new federal duty to market for oil production. First, these proposed regulations contain language that federal lessees have a duty to market oil for the mutual benefit of the federal government and lessee at no cost to the United States. Second, the proposed regulations reflect the trend noted in previously discussed IBLA decisions to impute the resale price of affiliates to federal lessees. Viewing routine oil industry transactions, such as crude oil calls and exchange agreements, as suspect non-arms length transactions, MMS is moving the valuation of oil production further away from the wellhead or the lease. In non-arms-length transactions, the proposed regulations discard reliance on wellhead market and use a netback approach to value oil, employing index prices on a regional basis.

Given the intense controversy over the use of posted prices by oil companies and the alleged underpayment resulting therefrom, MMS argues that non-arms-length transactions should be governed by index prices. MMS appears willing to

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*While the MMS is increasing its royalty share of federal oil well beyond the lease line, it is taking none of the risks and responsibilities incurred in midstream and downstream production. Under the new and proposed regulations, MMS will not bear any costs for transportation, storage, marketing, or risk management. Given the amorphous nature of the new federal duty to market, lessees have no clear guidance as to how much of the midstream and downstream value MMS intends to capture.*

discard any comparison between non-arms-length transactions and other comparable transactions in the field or area. Industry, on the other hand, believes the calculation of royalties based on its transactions should be governed by comparable arms-length transactions in the field or area. Federal lessees point to numerous agency decisions that require such comparisons and contend that any data showing discrepancy between field prices and prices downstream occurs because MMS is improperly comparing transactions at different valuation points. By arguably capturing more of the midstream and downstream value of oil, industry argues that MMS is creating a new federal duty to market that is not contemplated by the parties, permitted by the lease language, or authorized by statute or case law.

In an effort to stave off what producers term a one-sided duty-to-market obligation, producers have proposed royalty-in-kind legislation. This proposed legislation essentially provides that if MMS wants to participate in midstream and downstream markets, it must participate not only in the increased value added by marketing activities, but also in the downside risks of such activity. This proposed legislation requires MMS to physically take its share of royalty-in-kind as opposed to receiving monetary payment for its royalty share. Industry maintains that in-kind sale of federal royalty oil would eliminate royalty valuation disputes and enhance the value of its royalties by forcing the government to participate in midstream and downstream activities. MMS contends such royalty-in-kind legislation is unnecessary because: (1) MMS already has the right to take in kind; and (2) based on preliminary studies by MMS, the federal government would lose revenue. Indeed, the limited ability of the federal government to sell its own royalty oil accompanied by the elimination of a large part of its agency staff and accompanying budget raise serious questions as to the viability of this royalty-in-kind legislation. Still, this proposal may be useful as a negotiating tool to reach a compromise with industry as to the appropriate valuation rules for oil.

## Alternative Approaches

A new federal duty to market is not a viable approach for revising the method of federal royalty valuation. The MMS contends that it intends to value royalties only at the first arms-length transaction, that it will not second guess lessees regarding marketing decisions, and that its recent proposed and amended rules only involve clarification of whether costs deductible from gross proceeds are deductible transportation costs or nondeductible marketing costs. The previously discussed cases and new rules, however, indicate that MMS is pushing the valuation point far downstream with its expanded definition of non-arms length sales, the use of index prices for oil, and the implementation of severe restrictions on transportation costs that can be deducted from gross proceeds. While the MMS is increasing its royalty share of federal oil well beyond the lease line, it is taking none of the risks and responsibilities incurred in midstream and downstream production. Under the new and proposed regulations, MMS will not bear any costs for transportation, storage, marketing, or risk management. Given the amorphous nature of the new federal duty to market, lessees have no clear guidance as to how much of the midstream and downstream value MMS intends to capture.

Several viable alternatives to the MMS's new and proposed regulations exist. First, the products can be valued at the wellhead or lease line. MMS, through its own records, has sufficient information to provide pricing information at the lease line, unlike producer lessees who have proprietary and antitrust concerns about disclosure of their purchase and sales contracts to competitors. The industry could also establish a centralized database, which would be used in a similar fashion to the manner in which the gas industry uses the Gas Research Institute. A defined valuation point would eliminate disputes over the proper valuation point, whether certain expenses are transportation or marketing costs, and whether net-backs properly reconstruct true market value at the wellhead or lease line. Alternatively, MMS could prospectively increase the amount of its royalty percentage in exchange for accepting the deduction of all postproduction costs. Industry might be inclined to accept the government's offer of an increased participation in profits in exchange for the certainty that valuation disputes would be eliminated and postproduction costs would be deducted. It is the MMS's unilateral attempt to increase its royalty share under the new "federal duty to market," which has no statutory or contractual authorization, that has industry in an uproar. Given the MMS's abandonment of the proposed gas valuation rules and the recently proposed oil regulation rules, both the MMS and industry need to negotiate a new royalty valuation approach that provides a fair return for both sides, allows the parties to properly allocate both risks, and provides certainty as to the correct valuation method.

## Conclusion

The MMS's creation of the federal duty to market in its new and proposed oil and gas regulations is problematic both in theory and in practice. This duty adds significantly to the legal and economic responsibilities of lessees. Ordinarily, when contracting parties bargain for a substantial increase in the burdens of one side, they also increase compensation for the party shouldering the added burdens. MMS, on the other hand, is attempting to unilaterally add to lessees' responsibilities without conceding any additional economic reward.

This federal duty to market, separate and distinct from the duty to place oil and gas in marketable condition, also is fraught with practical difficulties. It is unclear where one duty stops and the other begins. It is unclear at what point oil or gas becomes marketable. It is unclear what activities constitute marketing and what activities constitute transportation. The MMS has yet to articulate logical and reasonable ways to resolve these issues. Accordingly, one can expect further negotiation and litigation between the MMS and the oil and gas industry for some time to come.

## NRLC Director: Search Committee Update

The Search Committee established to find a new Director for the Center has been very active in recent weeks, having completed interviews with four highly-qualified candidates from academia, government and the non-profit world. While the Center hopes a decision can be made in the near future, no official closing date has been established for the search process.

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## Center Staff

**Kathryn Mutz**, Interim Director
**Doug Kenney**, Research Associate
**Donna Peavy**, Office Administrator
**Anne Drew**, Administrative Assistant


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