

STATE OF NEW MEXICO
ENERGY, MINERALS AND NATURAL RESOURCES DEPARTMENT
OIL CONSERVATION DIVISION

IN THE MATTER OF THE HEARING
CALLED BY THE OIL CONSERVATION
DIVISION FOR THE PURPOSE OF
CONSIDERING:

CASE NO. 14661(Re-opened)
ORDER NO. R-13425-A

APPLICATION OF OGX RESOURCES LLC FOR APPROVAL OF A NON-
STANDARD OIL SPACING AND PRORATION UNIT AND COMPULSORY
POOLING, EDDY COUNTY, NEW MEXICO.

ORDER OF THE DIVISION

BY THE DIVISION:

This re-opened case came on for hearing at 8:15 a.m. on September 15, 2011 at Santa Fe, New Mexico, before Examiner David K. Brooks.

NOW, on this 28th day of September, 2011, the Division Director, having considered the testimony, the record and the recommendations of the examiner,

FINDS THAT:

(1) Due public notice has been given, and the Division has jurisdiction of this case and of the subject matter.

(2) OGX Resources LLC ("Applicant"), seeks approval of a non-standard 183.9-acre, more or less, oil spacing and proration unit and project area ("the Project Area") in the Bone Spring formation consisting of Lots 2, 3 and 4 of Section 30 and Lots 1 and 2 of Section 31, Township 26 South, Range 29 East, NMPM, in Eddy County, New Mexico. Applicant further seeks an order pooling all uncommitted interests in the Project Area in the Bone Spring formation.

(3) Applicant proposes to dedicate the Project Area to its Copperhead Fee A Well No. 1H [API No. 30-015-38227] ("the proposed well"), a horizontal well to be drilled from a standard surface location 480 feet from the South and West lines (Lot 2) of irregular Section 31. The well will penetrate the Bone Spring formation at a standard oil well location approximately 660 feet from the South line and 476 feet from the West line (Lot 2) of Section 31 and continue horizontally in the Bone Spring to a standard terminus,

or bottomhole location, 1650 feet from the North line and 330 feet from the West line (Lot 2 - Unit E) of Section 30.

(4) This case was originally heard on June 9 and June 23, 2011. On July 11, 2011, the Division issued Order No. R-13425, denying the Application on the grounds that the in size and configuration of the Project Area were inappropriate for establishment as a non-standard Bone Spring spacing unit, and accordingly could not be subject to compulsory pooling.

(5) Applicant petitioned to re-open this case in order to present record evidence of the reasons for the proposed size and configuration of the Project Area.

(6) This is a wildcat area in the Bone Spring formation. Accordingly, spacing is governed by statewide Rule 15.9.A [19.15.15.9.A NMAC], which provides for standard 40-acre units, each comprising a governmental quarter-quarter section or lot. The proposed Project Area consists of five adjacent lots, as platted on the official survey, each of which is a quarter-quarter section equivalent. Three of the five included spacing units are in the W/2 W/2 of Section 30, and two are in the W/2 W/2 of Section 31, which adjoins Section 30 to the south. The NW/4 NW/4 of Section 30 is not included in the proposed Project Area

(7) At the first hearing, Applicant presented geologic evidence by affidavit to the effect that:

(a) this area is suitable for development by horizontal drilling; and

(b) all lots to be included in the proposed Project Area are expected to be productive in the Bone Spring, so that formation of the non-standard spacing unit comprising the entire Project Area, as requested, will not impair correlative rights.

(8) Applicant's geologic witness did not, however, explain the reasons for the size or configuration of the proposed Project Area. Specifically, he did not testify to any geologic reason for excluding Lot 1 (NW/4 NW/4 equivalent) of Section 30, which lies immediately north of the proposed north-south oriented Project Area. Nor did he or any other witness testify that a geologic or economic basis exists for including portions of Section 31 in the proposed Project Area rather than developing the undeveloped portion of Section 31 with three-quarter mile east-west laterals.

(9) At the re-hearing, Applicant presented evidence bearing on the size and configuration of the proposed Project Area, including the following:

(a) Section 31 of Township 26 South, Range 29 East is truncated on the South due to the New Mexico-Texas state boundary. Accordingly, there is no South half of Section 31, and the South half of the North half is reduced in size.

(b) Applicant has previously drilled and completed, and is producing, its Copperhead 31 Federal Com. Well No. 1H (API No. 30-015-38227), located 480 feet from the South and East lines (Lot 7 – Unit H) of Section 31, a horizontal well which penetrates the E/2 E/2 of Section 31 and the E/2 SE/4 and SE/4 NE/4 of Section 30, but not the NE/4 NE/4 of Section 30.

(c) Applicant's geologist testified that the Bone Spring is continuous across these two sections and of substantially uniform quality. Applicant's land witness testified that Applicant's ownership extends to the entirety of both sections.

(d) Applicant plans to develop these two sections by drilling, in addition to its existing Copperhead Federal Com. Well No. 1H and its proposed Copperhead Fee A Well No. 1H, two additional five-unit, north-south horizontal wells paralleling its existing and currently proposed well, and a four-unit, east-west horizontal in the N/2 N/2 of Section 30. This plan will allow full development of the two sections with five wells. Development of both sections with east-west horizontals would require a total of seven wells. Development of Section 30 with four-unit north-south wells and Section 31 with east-west wells would require at least six wells, and would leave the NE/4 NE/4 of Section 30 stranded.

(10) Chesapeake Operating, Inc., an owner of a working interest in the proposed Project Area who appeared at the first hearing, has now committed its interest to the proposed well and did not appear at the re-hearing.

(11) There remains, however, a small unleased mineral interest in the NW/4 of Section 30 that has not been committed to the proposed Project Area.

The Division concludes that:

(12) This case involves important issues concerning the extent of the Division's authority to order compulsory pooling of "project areas" for horizontal wells and the manner in which the Division should exercise that authority.

(13) Division Rule 19.15.16.7.I [19.15.16.7.I NMAC] authorizes an operator to designate a "project area" for a "directional well" which may include multiple spacing units. This provision does not limit the size or configuration of a project area otherwise than by requiring that it include only complete, contiguous spacing units. However, by providing that a project area may comprise multiple spacing units, this rule clearly distinguishes a "project area" from a "spacing unit."

(14) The New Mexico Oil and Gas Act limits the Division's compulsory pooling authority to pooling separate, individual "spacing units". NMSA 1978, Section 70-2-17, as amended.

(15) The Supreme Court of New Mexico, in *Rutter & Wilbanks Corporation v. Oil Conservation Commission*, 87 N.M. 286, 532 P.2d 939 (1975), recognized that the Division and the Commission have power to create spacing units, including "non-standard" spacing units which may be larger than standard spacing units in the pool or area where they are located. Thus the Court in that case upheld the Commission's order establishing two non-standard gas units comprising 409.22 acres and 407.20 acres, respectively, in a single 916.42-acre, irregular section, and ordering compulsory pooling of those large units. Standard spacing for the subject pool would have been 320 acres. The non-standard units approved, however, were within a single section and only 127% of the size of standard units.

(16) The Court in *Rutter & Wilbanks* did not discuss the limits of OCD's authority to create non-standard units in compulsory pooling cases. However, it stands to reason that there must be some limits. Otherwise the Legislature's mandate that compulsory pooling be on a spacing unit basis would be defeated.

(17) In recent months the Division has been besieged with applications to establish non-standard spacing units for horizontal wells that comprise multiple standard units and to compulsory pool the non-standard spacing units so established. No existing OCD rule addresses this issue.

(18) A Division-appointed task force has studied horizontal wells and has proposed rule amendments to address this and other issues. This rule proposal is pending before the Oil Conservation Commission. In the meantime, there is a need for guidance for operators and Division hearing examiners on this subject.

(19) Most of the applications seeking establishment of non-standard spacing units for horizontal oil wells have sought to combine up to four 40-acre, more or less, units aligned north to south or east to west within a single governmental section. This configuration for horizontal well project areas has become sufficiently common in New Mexico that it can be described as approaching the status of an industry standard.

(20) In order to comply with statutory policy and to protect correlative rights, the Division Director has concluded that applications for establishment and compulsory pooling of non-standard oil spacing units departing from the parameters described in Finding Paragraph (19) should not be granted except in unusual cases where persuasive evidence demonstrates that departure from these parameters is essential to prevent waste or to protect correlative rights.

(21) After consideration of the evidence presented on re-hearing the Division concludes that an exception to the usual parameters is justified in this case because of the irregular configuration of Section 31 and the pattern of development already established by the Copperhead Federal Com Well No. 1H.

(22) In Order No. R-13425, the Division noted that Applicant's geologist did not testify to any geologic reason for excluding Lot 1 of Section 30 from the proposed

Project Area, nor did he testify that a geologic basis exists for including portions of Section 31 in the proposed Project Area rather than developing Section 31 with three-unit, east-west laterals. His testimony on re-hearing regarding the apparent uniformity of the Bone Spring in this area is consistent with that observation.

(23) However, the evidence presented on re-hearing indicates that inclusion of Lot 1 (NW/4 NW/4 equivalent) of Section 30 in the proposed Project Area could potentially cause waste by preventing the full development of the N/2 N/2 of Section 30 with an east-west horizontal lateral as suggested in Applicant's development plan. Applicant has a substantial incentive to go forward with this plan due to its ownership in the N/2 N/2 of Section 30. Furthermore, correlative rights are not adversely affected since the pooled party in this case, whose interest includes the NW/4 NW/4 of Section 30, or any other owner in the N/2 N/2 of Section 30, remains free to propose a N/2 N/2 horizontal.

(24) The reduced size of Section 31 and the fact that an existing well crosses both sections provide a reasonable basis for continuing coordinated development of the two sections.

(25) The Division accordingly concludes that establishment and pooling of the proposed Project Area as a non-standard spacing unit will prevent waste and will not impair correlative rights.

(26) Two or more separately owned tracts are embraced within the Project Area, and/or there are royalty interests and/or undivided interests in oil and gas minerals in one or more tracts included in the Project Area that are separately owned.

(27) Applicant is an owner of an oil and gas working interest within the Project Area. Applicant has the right to drill and proposes to drill the proposed well to a common source of supply within the Project Area at the proposed location.

(28) There are interest owners in the Project Area that have not agreed to pool their interests. There are no unlocated owners in the Project Area, and there is no evidence of a title dispute. However, one of the interests to be pooled is titled to a decedent whose estate has not been probated in New Mexico, and accordingly, a need may arise to escrow funds.

(29) To avoid the drilling of unnecessary wells, protect correlative rights, prevent waste and afford to the owner of each interest in the Project Area the opportunity to recover or receive without unnecessary expense its just and fair share of hydrocarbons, this application should be approved by pooling all uncommitted interests, whatever they may be, in the oil and gas within the Project Area.

(30) OGX Resources LLC should be designated the operator of the proposed well and of the Project Area.

(31) Any pooled working interest owner who does not pay its share of estimated well costs should have withheld from production its share of reasonable well costs plus an additional 200% thereof as a reasonable charge for the risk involved in drilling the well.

(32) Reasonable charges for supervision (combined fixed rates) should be fixed at \$6,000 per month while drilling and \$600 per month while producing, provided that these rates should be adjusted annually pursuant to Section III.1.A.3. of the COPAS form titled "Accounting Procedure-Joint Operations."

IT IS THEREFORE ORDERED THAT:

(1) A non-standard 183.9-acre, more or less, wildcat oil spacing and proration unit (the Project Area) is hereby established in the Bone Spring formation, consisting of Lots 2, 3 and 4 of Section 30 and Lots 1 and 2 of Section 31, Township 26 South, Range 29 East, NMPM, in Eddy County, New Mexico.

(2) Pursuant to the application of OGX Resources LLC, all uncommitted interests, whatever they may be, in the oil and gas in the Bone Spring formation underlying the Project Area, are hereby pooled.

(3) The Project Area shall be dedicated to Applicant's Copperhead Fee A Well No. 1H ("the proposed well"), a horizontal well to be drilled from a standard surface location 480 feet from the South and West lines (Lot 2) of irregular Section 31. The well will penetrate the Bone Spring formation at a standard oil well location approximately 660 feet from the South line and 476 feet from the West line (Lot 2) of Section 31 and continue horizontally in the Bone Spring to a standard terminus, or bottomhole location, 1650 feet from the North line and 330 feet from the West line (Lot 2 - Unit E) of Section 30.

(4) The operator of the Project Area shall commence drilling the proposed well on or before September 30, 2012, and shall thereafter continue drilling the well with due diligence to test the Bone Spring formation.

(5) In the event the operator does not commence drilling the proposed well on or before September 30, 2012, Ordering Paragraphs (1) and (2) shall be of no effect, unless the operator obtains a time extension from the Division Director for good cause demonstrated by satisfactory evidence.

(6) Should the proposed well not be drilled and completed within 120 days after commencement thereof, then Ordering Paragraphs (1) and (2) shall be of no further effect, and the non-standard spacing unit and project area created by this order shall terminate, unless operator appears before the Division Director and obtains an extension of the time for completion of the proposed well for good cause shown by satisfactory evidence. If the proposed well is not completed in all of the lots included in the proposed Project Area within 120 days after commencement of drilling, then the operator shall

apply to the Division for an amendment to this Order to contract the Project Area so that it includes only those lots in which the well is completed.

(7) Upon final plugging and abandonment of the proposed well and any other well drilled on the Project Area pursuant to Division Rule 13.9, the pooled non-standard spacing unit created by this Order shall terminate, unless this order has been amended to authorize further operations.

(8) OGX Resources LLC [OGRID 217955] is hereby designated the operator of the well and of the Project Area.

(9) After pooling, uncommitted working interest owners are referred to as pooled working interest owners. ("Pooled working interest owners" are owners of working interests in the Project Area, including unleased mineral interests, who are not parties to an operating agreement governing the Project Area.) After the effective date of this order, the operator shall furnish the Division and each known pooled working interest owner in the Project Area an itemized schedule of estimated costs of drilling, completing and equipping the proposed well ("well costs").

(10) Within 30 days from the date the schedule of estimated well costs is furnished, any pooled working interest owner shall have the right to pay its share of estimated well costs to the operator in lieu of paying its share of reasonable well costs out of production as hereinafter provided, and any such owner who pays its share of estimated well costs as provided above shall remain liable for operating costs but shall not be liable for risk charges. Pooled working interest owners who elect not to pay their share of estimated well costs as provided in this paragraph shall thereafter be referred to as "non-consenting working interest owners."

(11) The operator shall furnish the Division and each known pooled working interest owner (including non-consenting working interest owners) an itemized schedule of actual well costs within 90 days following completion of the proposed well. If no objection to the actual well costs is received by the Division, and the Division has not objected, within 45 days following receipt of the schedule, the actual well costs shall be deemed to be the reasonable well costs. If there is an objection to actual well costs within the 45-day period, the Division will determine reasonable well costs after public notice and hearing.

(12) Within 60 days following determination of reasonable well costs, any pooled working interest owner who has paid its share of estimated costs in advance as provided above shall pay to the operator its share of the amount that reasonable well costs exceed estimated well costs and shall receive from the operator the amount, if any, that the estimated well costs it has paid exceed its share of reasonable well costs.

(13) The operator is hereby authorized to withhold the following costs and charges from production:

- (a) the proportionate share of reasonable well costs attributable to each non-consenting working interest owner; and
- (b) as a charge for the risk involved in drilling the well, 200% of the above costs.

(14) The operator shall distribute the costs and charges withheld from production, proportionately, to the parties who advanced the well costs.

(15) Reasonable charges for supervision (combined fixed rates) are hereby fixed at \$6,000 per month while drilling and \$600 per month while producing, provided that these rates shall be adjusted annually pursuant to Section III.1.A.3. of the COPAS form titled "*Accounting Procedure-Joint Operations*." The operator is authorized to withhold from production the proportionate share of both the supervision charges and the actual expenditures required for operating the well, not in excess of what are reasonable, attributable to pooled working interest owners.

(16) Except as provided in Paragraphs (13) and (15) above, all proceeds from production from the well that are not disbursed for any reason shall be placed in escrow in Eddy County, New Mexico, to be paid to the true owner thereof upon demand and proof of ownership. The operator shall notify the Division (Attention: Records Clerk) of the name and address of the escrow agent not later than one year from the date of issuance of this Order.

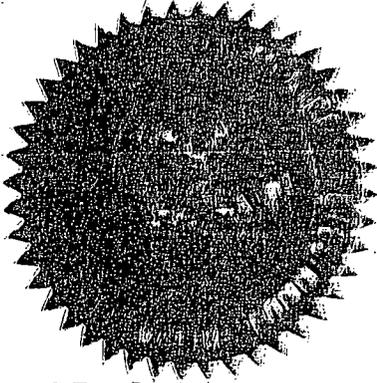
(17) Any unleased mineral interest shall be considered a seven-eighths (7/8) working interest and a one-eighth (1/8) royalty interest for the purpose of allocating costs and charges under this order. Any well costs or charges that are to be paid out of production shall be withheld only from the working interests' share of production, and no costs or charges shall be withheld from production attributable to royalty interests.

(18) Should all the parties to this compulsory pooling order reach voluntary agreement subsequent to entry of this order, this Order shall thereafter be of no further effect.

(19) The operator of the well and Project Area shall notify the Division in writing of the subsequent voluntary agreement of all parties subject to the compulsory pooling provisions of this Order.

(20) Jurisdiction of this case is retained for the entry of such further orders as the Division may deem necessary.

DONE at Santa Fe, New Mexico, on the day and year hereinabove designated.



SEAL

STATE OF NEW MEXICO
OIL CONSERVATION DIVISION

JAMI BAILEY
Director