.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. 15433
ORDER NO. R-14140

APPLICATION OF MATADOR PRODUCTION COMPANY FOR A NON-STANDARD SPACING AND PRORATION UNIT AND COMPULSORY POOLING, LEA COUNTY, NEW MEXICO

ORDER OF THE DIVISION

BY THE DIVISION:

This case came on for hearing at 8:15 a.m. on January 21, 2016 before Examiner Michael A. McMillan, and again on February 18, 2016 before Examiner William V. Jones.

NOW, on this 30th day of March, 2016, the Division Director, having considered the testimony, the record and the recommendations of Examiner McMillan,

FINDS THAT:

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

(2) Matador Production Company ("Applicant" or "Matador") seeks approval of a non-standard 160-acre oil spacing and proration unit ("Unit") for oil production in the Bone Spring formation Corbin; Bone Spring, South Pool (Pool code 13160), comprising the W/2 E/2 of Section 32, Township 18 South, Range 33 East, NMPM, Lea County, New Mexico. Applicant further seeks the pooling of all uncommitted interests in the Unit.

(3) The Unit will be dedicated to Applicant's Eland State 32 18 33 RN Well No. 123H (API No. 30-025-42977), a horizontal well to be drilled from a surface location 154 feet from the North line and 1859 feet from the East line (Unit B) of Section 32 to a terminus or bottomhole location 240 feet from the South line and 1870 feet from the East line (Unit O) of Section 32. The completed interval will be orthodox.

(4) The proposed well is within the Corbin; Bone Spring, South Pool (pool code 13160). Spacing in this pool is governed by Division Rule 19.15.15.9(A). NMAC, which provides for standard 40-acre units, each comprising a governmental quarter-quarter section, and 330-feet setbacks from the unit boundaries. The proposed Unit and project area consists of four (4) adjacent quarter-quarter sections.

(5) Applicant appeared at the hearing and presented land and geological evidence to the effect that:

(a) The Bone Spring formation in this area is suitable for development by horizontal drilling;

(b) The proposed orientation of the horizontal well from North to South or South to North is appropriate for the proposed Unit;

(c) all quarter-quarter sections within the Unit are expected to be productive in the Bone Spring formation, so that formation of the Unit, as proposed, will not impair correlative rights.

(d) notice was provided for formation of the non-standard spacing unit to lessees or operators of affected tracts;

(e) notice was provided for compulsory pooling within the Unit to all interest owners subject to pooling proceedings; and

(f) Matador has a working interest in the entire Unit; however, the ownership is diverse between the W/2 NE/4 and W/2 SE/4

(g) W/2 NE/4 of Section 32 is subject to an existing voluntary Joint Operating Agreement ("JOA"), in which Nearburg Exploration Co., L.L.C. and Nearburg Producing Company (Nearburg) are not subject to;

(h) W/2 SE/4 of Section 32 is subject to a separate JOA, signed in May 28, 1998 which is in effect, which in turn Nearburg is subject to. This particular JOA includes the Bone Spring formation;

(i) No agreement exists to combine the existing W/2 NE/4 and W/2 SE/4 JOAs;

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

(k) Applicant provided notice of publication before hearing in a newspaper of general circulation in Lea County in which the property is located for Dr. Robert B. Cahan and Bernice A. Cahan, interest owners in the proposed unit who were unlocatable.

(l) Sybil Blackman Carney, an interest owner in the proposed unit, was delivered a confirmation letter for the initial well proposal; however, the mailing in Exhibit 7 for hearing notice was marked returned. Therefore, notice in a newspaper of general circulation in Lea County was published.

(6) Nearburg Exploration Company, L.L.C. and Nearburg Producing Company (Nearburg) appeared at the hearing in opposition to granting this application, and presented land, geological, and engineering evidence to the effect that.

(a) An existing JOA exists for the W/2 SE/4 to which both Applicant's and Nearburg's interests are subject;

(b) Nearburg concurred that no JOA exists to join the W/2 NE/4 and W/2 SE/4;

(c) The existing JOA provides for a 500% penalty for all costs incurred in connection with the well;

(d) The Bone Spring formation in the Unit is thinner than in higher oil and gas wells with higher cumulative production to the Northeast of the Unit, and similar in thickness to lower cumulative oil and gas wells southeast of the Unit;

(e) Engineering data suggests that the proposed well will only generate approximately $5,000,000 gross income which is less than the Authorization For Expenditure ("AFE") submitted by Matador;

(f) Further, Nearburg examined analogous off-set wells to get an estimate of oil and gas reserves in the proposed location; and

(g) Nearburg's engineer requested that the risk penalty be changed to 50% from the 200% that Matador requested.

The Division finds as follows:

(7) Nearburg filed a Motion to Dismiss the Application on the ground that a JOA exists which is binding on both Applicant and Nearburg, and which governs operations on, among other lands, the S/2 of Section 32, Township 18 South, Range 33 East, NMPM, a part of which is included in the proposed Unit. Counsel for Nearburg and for Applicant each presented arguments regarding the Motion to Dismiss.

(8) Counsel for Nearburg argued that Division precedent requires dismissal of an application for compulsory pooling if any part of the lands sought to be pooled is subject to a JOA between the owners thereof, citing Order No. R-8013, issued in Case No. 8606, *Application of Doyle Hartman, etc.*; Order No. R-9841, issued in Case No. 10658, *Application of Mewbourne Oil Company, etc.*; and Order No. R-11009, issued in Case No. 11960, *Application of Redstone Oil & Gas Company, etc.*

(9) In Case No. 8606, the party opposing compulsory pooling presented evidence of a JOA and amended operating agreement "covering the subject unit area." Order R-8013, Finding ₱₱ 5 and 6. A chain of title admitted in evidence on motion of Applicant (Hartman Ex. 2) shows that all owners of interests in the unit proposed in that case derived title from parties to the JOA or the amendment. Thus the issue of whether a unit may be the subject of the compulsory pooling where a portion only of the lands, or of the mineral interest in the lands in the unit, is the subject of a JOA, was apparently not presented in that case.

(10) Order No. R-11009 states merely that because of an agreement made between two identified parties, each of whom had filed compulsory pooling applications, the Applicant filed a Motion to Dismiss the compulsory pooling portion of its application, and the Division dismissed it. The facts regarding ownership of the proposed unit are not disclosed in the order. However, a dismissal of an application pursuant to a motion of the applicant by reason of a settlement of the issues between the parties cannot be considered binding precedent on a legal issue in the case.

(11) Order No. R-9841 issued in Case No. 10658 is where the facts closely resembled the present case. There, Mewbourne Oil Company (Mewbourne) applied for compulsory pooling of a 320-acre spacing unit. A 200-acre tract within the unit was subject to a prior JOA. Mewbourne owned an interest in the 200-acre tract derived from a party to the JOA. However, Mewbourne also owned an interest in the remaining 120 acres of the unit that was not subject to the JOA. Devon Energy Corporation, a successor in interest to a different party to the prior JOA, moved to dismiss the compulsory pooling application on the ground that the JOA constituted a voluntary pooling agreement which, under NMSA 1978 Section 70-2-17.C, precluded compulsory pooling of Devon's interest pursuant to Mewbourne's application. The Division agreed and dismissed the application.

(12) In the present case, Applicant's interest in the south half of the unit here proposed is subject to a JOA entered into by its predecessor in title with Nearburg. Nearburg owns no interest in the north half of the proposed unit. Applicant's interest in the north half tract is not subject to any JOA to which Nearburg is a party. These facts are analogous to those in the *Mewbourne* case.

(13) There is, however, a critical distinction. In *Mewbourne*, the applicant proposed a vertical well to be drilled *on the portion of the spacing unit that was subject to the JOA*. Absent voluntary or compulsory pooling, the rule of capture presumably applied. Under that rule, 100% of the production from the proposed well could be considered as production from the contract area defined in the JOA.

(14) In the present case, Applicant proposes to drill a *horizontal* well which will be completed in both the north half of the proposed spacing unit (not part of the contract area) and the south half of the proposed spacing unit (part of the contract area). The operating agreement provides that the parties will own, in the proportions set forth in Exhibit A to the agreement, "all production of oil and gas from the contract area." There is no evidence of any agreement between the parties regarding production which is not from the contract area.

(15) Although we have found no New Mexico appellate court that has addressed the question, two Texas Court of Appeals have concluded that the rule of capture does not apply to horizontal wells, so as to give any preference in allocation of production to the tract where the wellhead is located, or where the formation is initially penetrated. Thus absent an agreement or pooling order allocating production among the penetrated tracts, an owner of a tract is not entitled to any interest in the well's production except as to production derived from the portion of the wellbore underlying the owner's land. *Browning Oil Company, Inc. v. Luecke*, 38 SW3d 625, 645 (Tex. App. - Austin 2001); Springer Ranch, Ltd. v. Jones et, al., 421 S.W.3d 273 (Tex. App. – San Antonio 2013).

(16) The New Mexico Oil Conservation Commission similarly held that, absent voluntary or compulsory pooling, an owner of a tract through which a horizontal well is drilled is entitled only to that portion of the well's production properly extracted from the part of the wellbore underlying the owner's tract. Order No. R-13228-F issued in Cases Nos. 14418 and 14480. *Application of Cimarex Energy Company, etc.*

The Division concludes as follows:

(17) Since the rule of capture does not apply, production of the proposed well would be production from the "contract area" defined in the operating only to the extent extracted from the W/2 SE/4. In the absence of an agreement as to how production from the proposed horizontal well is to be divided between the lands within and without the defined contract area, the JOA does not constitute an agreement of the parties to pool their interests in such production, and accordingly does not preclude compulsory pooling under the terms of the first paragraph of NMSA 1978 Section 70-2-17(C).

(18) Nearburg's Motion to Dismiss should therefore be denied.

(19) The proposed non-standard unit should be approved in order to enable Applicant to drill a horizontal well that will efficiently produce the reserves underlying the Unit, thereby preventing waste and protecting correlative rights.

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

(21) Applicant is owner of an oil and gas working interest within the Unit. Applicant's interest is subject to both JOAs. Applicant has the right to drill and proposes

to drill the proposed well to a common source of supply within the Unit at the proposed location.

(22) To avoid the drilling of unnecessary wells, protect correlative rights, prevent waste and afford to the owner of each interest in the Unit the opportunity to recover or receive without unnecessary expense a 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 Unit.

(23) Nearburg failed to adequately explain why the risk penalty imposed on non-consenting working interest owners should be less than the 200% charge as provided in Rule 19.15.13.8 NMAC. Nearburg's witness testified that geologic risk is low but the risk of a commercial well is very high.

(24) 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 proposed well.

(25) Matador Production Company should be designated the operator of the proposed well and of the Unit.

(26) Reasonable charges for supervision (combined fixed rates) should be fixed at $7000 per month while drilling and $700 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) Nearburg's motion to dismiss is hereby **denied**.

(2) A non-standard 160-acre oil spacing and proration unit is hereby established for oil production from the Bone Spring formation, Corbin; Bone Spring, South Pool consisting of the W/2 E/2 of Section 32, Township 18 South, Range 33 East, NMPM, Lea County, New Mexico.

(3) Pursuant to the application of Matador Production Company, all uncommitted interests, whatever they may be, in the oil and gas in the Bone Spring formation underlying the Unit, are hereby pooled.

(4) The Unit shall be dedicated to Applicant's Eland State 32 18 33 RN Well No. 123H (API No. 30-025-42977), a horizontal well to be drilled from a surface location 154 feet from the North line and 1859 feet from the East line (Unit B) of Section 32 to a terminus or bottomhole location 240 feet from the South line and 1870 feet from the East line (Unit O) of Section 32. The completed location will be orthodox.

(5) The operator of the Unit shall commence drilling the proposed well on or before March 31, 2017, and shall thereafter continue drilling the proposed well with due diligence to test the Bone Spring formation.

(6) In the event the operator does not commence drilling the proposed well on or before March 31, 2017, 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.

(7) 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 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 standard spacing units included in the proposed project area (or Unit), then the operator shall apply to the Division for an amendment to this Order to contract the Unit so that it includes only those standard spacing units in which the well is completed.

(8) Upon final plugging and abandonment of the proposed well and any other well drilled on the Unit pursuant to Division Rule 19.15.13.9 NMAC, the pooled Unit created by this Order shall terminate, unless this Order has been amended to authorize further operations.

(9) Matador Production Company (OGRID No. 228937) is hereby designated the operator of the well and the Unit.

(10) 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 Unit, including unleased mineral interests, who are not parties to an operating agreement governing the Unit.) After the effective date of this Order, the operator shall furnish the Division and each known pooled working interest owner in the Unit an itemized schedule of estimated costs of drilling, completing and equipping the proposed well ("well costs").

(11) 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."

(12) 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.

(13) 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.

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

(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.

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

(16) Reasonable charges for supervision (combined fixed rates) for the well are hereby fixed at $7000 per month while drilling and $700 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.

(17) Except as provided in Paragraphs (14) and (16) above, all proceeds from production from the proposed well that are not disbursed for any reason shall be held for the account of the person or persons entitled thereto pursuant to the Oil and Gas Proceeds Payment Act (NMSA 1978 Sections 70-10-1 through 70-10-6, as amended). If not disbursed, such proceeds shall be turned over to the appropriate authority as and when required under the Uniform Unclaimed Property Act (NMSA 1978 Sections 7-8A-1 through 7-8A-28, as amended).

(18) Any unleased mineral interests 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.

(19) 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.

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

(21) 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

David R. Catanach

DAVID R. CATANACH
Director