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

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

Case No. 15363
Order No. R-14053
Order No. R-14053-B

JALAPENO'S REPLY IN SUPPORT OF MOTION TO DISMISS AND DECLARE THE RIGHTS AND OBLIGATIONS OF PARTIES IN A POOLING APPLICATION UNDER NMSA 1978 § 70-2-17

Jalapeno Corporation ("Jalapeno") by and through counsel the Gallegos Law Firm, P.C., submits this Reply to respond to arguments raised by applicant Matador Production Company ("Matador") in its Response to the Motion filed August 15, 2016.

Jalapeno's motion seeks three forms of relief. First, it requests that the New Mexico Oil Conservation Commission enter its order dismissing this proceeding on the grounds that the Commission has no authority under statute or rule to enter a compulsory pooling order on Matador's application under NMSA 1978 § 70-2-17(C). The Commission's pooling authority by statute and as construed by the New Mexico Supreme Court is limited to circumstances involving a single spacing unit.

Second, Jalapeno requests that the Commission should hold that Rule 19.15.13.8(A), (C) and (D) NMAC is invalid and contrary to § 70-2-17 to the extent it (a) authorizes the assessment of a 200% risk penalty without the need for the applicant to provide evidence supporting the penalty and (b) puts the burden on the party opposing the application to justify a lower risk penalty. Finally, Jalapeno asks that the Commission hold that pursuant to § 70-2-17 any risk penalty assessed can only be

charged on the costs of drilling and completing the well, and that Rule 19.15.13.8(A) and (B) is invalid to the extent it authorizes a risk penalty to be charged on costs in excess of those provided by statute.

Matador opposes the Motion. Matador's Response suggests that the Commission should overturn the Division's long-standing methodology for assessing risk penalty. Matador advises it intends to present evidence at the hearing on the merits of its application that will involve factors other than geologic, operational and reservoir risk.

A. The Commission has no mandatory duty to commit an ultra vires act.

Matador opens its argument with the contention that the Commission is required to force pool a nonstandard unit such as that proposed in its application. Response, p. 4. Jalapeno does not contest the Commission's mandate to force pool in Section 70-2-17(C). Jalapeno does not contest the Commission's authority to establish nonstandard units. These principles do not, however, authorize force pooling of multiple, contiguous and existing spacing units.

The Legislature has limited the Commission's power to force pool to interests within a unit. § 7-0-2-17; *Rutter & Wilbanks Corp. v. Oil Conservation Comm'n,* 1975-NMSC-006, ¶ 15, 87 N.M. 286, 532 P.2d 582. The non-standard spacing units in *Rutter* were created pursuant to the well spacing rule, then Rule 104. Spacing for oil wells in the Wolfcamp formation in New Mexico is 40 acres. The Commission has never amended or modified that spacing rule notwithstanding the technical developments associated with horizontal drilling. Thus, Matador's request that the Commission force pool across four contiguous oil spacing units asks the Commission to act in excess of its statutory authority and its authority as recognized by the courts.

The Commission itself recognized the limits of its authority as set forth in Jalapeno's motion when it issued Order R-13499 in January 2012. In that rulemaking proceeding, the Commission considered the Division's request that the Commission amend its rules and adopt rules applicable to horizontal well drilling in New Mexico. It determined, 35 years after the *Rutter* decision, that "the extent of the Commission's and the Division's authority to establish non-standard spacing or proration units or special spacing or proration for horizontal wells has not been clearly established by either judicial or Commission precedent." The Commission refused to adopt proposed rule 19.15.16.14F in order "to forestall any possibility that the rule amendments being adopted would be construed to authorize compulsory pooling of horizontal well 'project areas' without regard to applicable statutory and regulatory limitations." Order R-13499, p. 11, ¶¶ 73-75.

It is understandable that Matador fails to address these critical provisions of the Commission's order. The Commission realized in 2012 that it lacked the authority to do what Matador requests in this proceeding. The fact that the agency has been granting unopposed force pooling applications for horizontal well projects does not cure the lack of statutory authority for such action. Jalapeno agrees that the statute should be amended to address horizontal wells. However, industry need and convenience cannot trump the Legislature's explicit and limited grant of authority.

The Commission's horizontal well rules do not solve the problem. First, the rules do not, as Matador contends, provide for compulsory pooling of "horizontal well units." Response, p. 10. They define "project area," a term not found in § 70-2-17. Project areas consist of "one or more complete, contiguous spacing units . . . that are developed by the horizontal well." Rule 19.15.16.7L NMAC. There is no standard

spacing acreage for a horizontal well. Instead, the acreage is established by the operator who designates the project area, which the agency reviews on an ad hoc basis. The rules call for "consolidation of project area" by voluntary agreement or "if applicable, compulsory pooling." Rule 19.15.16.15.F.

The "if applicable" qualifier is significant. There is no problem if the project area comprises a single spacing unit. There is a problem where the project area comprises multiple spacing units. There is no authority to force pool such a project area under § 70-2-17. The Commission's rules cannot support a different result.[1]

Matador accuses Jalapeno of conflating (combining) the concepts of unitization and pooling. Response, p. 7. Nothing could be further from the truth. There is no statutory authority to create a non-standard spacing unit comprised of existing spacing units. Such an order would be in the nature of unitzation, not pooling given the standard definition of the term unitization:

> A term frequently used interchangeably with POOLING but more properly used to denominate the joint operation of all or some portion of a producing reservoir as distinguished from pooling, which term is used to describe the bringing together of small tracts sufficient for the granting of a well permit under applicable spacing rules.

Williams & Meyers, 8 OIL AND GAS LAW, Manual of Terms, p. 1109.

The point Jalapeno made was simply that what Matador is requesting, and what the agency has been approving, is in the nature of unitization, which is not authorized in New Mexico for exploratory operations. NMSA 1978 § 70-7-1 et seq.

[1] Matador also contends that Jalapeno has misread Rule 19.15.15.11(B)(1) NMAC. Response, p. 10. In fact, Jalapeno did not rely on that rule, it argued in the Motion that neither of the two conditions for approval of non-standard spacing units in Rule 19.15.15.11(B)(2) apply here. See Motion, p. 6. Matador does not address the relevant rule in its Response.

B. The authority to create non-standard units and to carry out the purpose of the Oil and Gas Act does not override express limitations on the Commission's pooling authority.

Matador cites to the Commission's general authority to create non-standard spacing units. It also cites to NMSA 1978 § 70-2-11(A) which authorizes the Commission to do whatever may be reasonably necessary to carry out the purpose of the Oil and Gas Act. Response, pp. 4-7. The implication is that these grants of authority support the granting of Matador's application notwithstanding the lack of express authority to force pool across multiple, contiguous spacing units.

The argument fails on its face. Section 70-2-17(C) limits the Commission's pooling authority to lands within a spacing unit. If Matador's argument were correct, the relevant language in the statute would be unnecessary, because the Division or Commission could ignore existing spacing rules and create any spacing unit it desired on an ad hoc basis to support a force pooling application. The Legislature imposed the limitation in § 70-2-17(C) for a reason, and the Commission has a duty as a creature of statute to give effect to that limitation. *Continental Oil Co. v. Oil Conservation Comm'n,* 1962-NMSC-062, ¶ 11, 70 N.M. 310, 373 P.2d 809; *Marbob Energy Corp. v. N.M. Oil Conservation Comm'n,* 2009-NMSC-013, ¶ 23, 146 N.M. 24, 206 P.3d 135. Section 70-2-11(A) was not intended, and cannot be reasonably construed, to extend the Commission's authority beyond the legislative grant in § 70-2-17 to any act or order it deems appropriate.

C. Collateral estoppel does not apply.

Matador argues that because Jalapeno participated in the rulemaking proceeding for the adoption of horizontal well rules, Case No. 14744, it is collaterally estopped from challenging the Commission's authority "to compulsory pool and authorize nonstandard

units in the same proceeding." The statement carries its own refutation. This adjudicatory proceeding on Matador's application is obviously not the "same proceeding" as the 2011 rulemaking proceeding.

Collateral estoppel is a doctrine designed to preclude relitigation of an ultimate fact or issue previously decided. *Shovelin v. Central New Mexico Electric Coop., Inc.*, 1993-NMSC-015, ¶ 10, 115 N.M. 293, 850 P.2d 996. A necessary element is that the moving party must show that "the cause of action in the case presently before the court is different from the cause of action in the prior adjudication." In *Shovelin,* the Court held that issues resolved in an administrative agency **adjudicative decision** can be given effect in later civil trials under specific conditions. *Id.* at ¶ 12; *See also Southworth v. Santa Fe Services, Inc.,* 1998-NMCA-109, ¶ 12, 125 N.M. 489, 963 P.2d (preclusive effect may be given to administrative body's findings of fact while acting in a judicial or quasi-judicial capacity).

The rule of collateral estoppel has no application here. First, the Commission's rulemaking proceeding is not an adjudicative decision, it was a rulemaking proceeding. No "cause of action" was asserted in the rulemaking proceeding, and no "cause of action" is asserted in this proceeding. Second, collateral estoppel applies to factual determinations, not legal or jurisdictional decisions. Matador does not cite to any ultimate fact determined in the rulemaking proceeding which is raised in this case.

Matador cites the legal conclusions in paragraphs 72, 73 and 78 of the Commission's Order R-13499. Response, p. 12. Matador has misquoted the paragraph numbers. It actually means paragraphs 71, 72 and 78. In any event, the paragraphs concerning the power to approve a non-standard spacing unit in a compulsory pooling proceeding, the power to establish non-standard spacing units, and

the duty to compulsory pool where the prescribed predicate facts are shown do not support collateral estoppel.

More importantly, the conclusions stated in paragraphs 71, 72 and 78 are not the subject of Jalapeno's jurisdictional challenge. As Jalapeno has previously noted, the Commission in the rulemaking proceeding expressly held that its authority in force pooling proceedings like that at issue here has not been clearly delineated, and that the order the Commission entered should not be construed to authorize compulsory pooling of horizontal well project areas without regard to applicable statutory and regulatory limitations. Thus, the Commission's conclusions in that case are consistent with and support Jalapeno's jurisdictional challenge. Jalapeno had no reason to appeal Order R-13499 because it did not adopt a rule which authorized force pooling applications like that Matador filed in this case.

D. The Commission cannot expand the statutorily-defined costs upon which a risk penalty may be assessed.

In Section 70-2-17(C), the Legislature provided that pooling orders "may include a charge for the risk involved in drilling of such well, which charge for risk shall not exceed two hundred percent of the nonconsenting working interest owner's or owners' pro rata share of the cost of drilling and completing the well." *See also Viking Petroleum, Inc. v. Oil Conservation Com'n of New Mexico,,* 1983-NMSC-091, ¶ 21, 100 N.M. 451, 672 P.2d 280 (confirming charge is for risk involved in drilling a well and is a percent of owner's pro rata share of drilling and completion costs). The Commission's attempt to expand the definition of costs upon which a risk penalty may be assessed by defining "well costs" to include the cost of equipping a well is improper.

Matador contends that the Commission can expand the statutory designation of "the cost of drilling and completing the well" by definition to include the cost of equipping the well. The argument is wrong for two reasons. First, such a definition is contrary to the legislative authorization in § 70-2-17. The Legislature did not authorize a risk penalty on "well costs." Instead, the Legislature expressly provided that the charge is for the risk involved in drilling the well. Consequently, it has properly limited the costs upon which a risk penalty may be assessed to the cost of drilling and completing the well. Once the well is completed, the drilling risk has been eliminated. Matador concedes that the cost of equipping the well has nothing to do with drilling and completion, but is necessary to produce the well. Response, p. 13. The non-consent party must bear its share of that expense, but is not required to pay additional costs in the form of a risk penalty.

Second, the Commission's expansion by definition of the costs upon which a risk penalty may be assessed impairs the correlative rights of owners who go non-consent with respect to the well. In many cases, non-consent owners have already been forced to commit their interests to a unit for a well to be operated by another entity. They have lost their right to develop their own acreage. In addition, they are forced to give up their interest until their pro rata share of costs are recovered by the consenting parties. Then, they lose their interest for an additional period until the consenting parties recover any assessed risk penalty. In this era of $6 to $10 million wells, the non-consenting owner may never reach payout and may lose its interest forever.

By imposing the risk penalty on costs beyond those approved by the Legislature, the Commission is causing non-consenting owners to lose their property interests for a

longer period than authorized by statute. That is the very definition of the impairment of correlative rights.

E. Matador must bear the burden of supporting any risk penalty.

The Legislature intended, and the New Mexico Supreme Court has confirmed, that a party requesting imposition of a risk penalty is required to appear before the Division or the Commission and support the request with competent evidence. *Viking Petroleum, Inc. v. Oil Conservation Com'n of New Mexico,,* 1983-NMSC-091, ¶ 20, 100 N.M. 451, 672 P.2d 280 (substantial evidence must be presented to support a risk determination). Rule 19.15.13.8(A) is invalid to the extent it provides for the imposition of a 200% risk penalty without requiring the applicant to present technical evidence justifying the 200% risk charge.

In its Response, Matador advises for the first time in these proceedings that it intends to ask that the Commission jettison its established methodology for considering risk based on geological, operational and reservoir factors, and adopt some new, unidentified standard for the allocation and categories of risk Matador believes are appropriate. This is not an issue raised in Matador's Application. Matador did not raise the issue before the Division. Consequently, the Commission should not entertain Matador's new, undisclosed risk penalty proposal, and should not entertain it in any event unless Matador timely discloses its intended risk penalty standard sufficiently prior to the September 6, 2016 hearing so that Jalapeno and the Commission have an opportunity to review the proposal and prepare for hearing on the merits.

If the Commission hears Matador on its new risk factor methodology, Matador must bear the burden of supporting a risk penalty based on unidentified factors which do not conform to the established risk penalty analysis.

WHEREFORE, on the basis of the foregoing points and authorities, and the points and authorities in the original motion, Jalapeno requests that the Commission dismiss Matador's Application in this proceeding. If the matter proceeds to hearing on the application, Jalapeno requests that the Commission impose on Matador the burden to justify any requested risk penalty, and limit the application of any risk penalty awarded to the costs of drilling and completing the well.

Respectfully submitted,

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CERTIFICATE OF SERVICE

I hereby certify that a true and correct copy of the foregoing was served on the following counsel of record by electronic mail this 22nd day of August, 2016.

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