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. 11,837
APPLICATION OF BURLINGTON RESOURCES OIL AND GAS COMPANY FOR COMPULSORY POOLING, EDDY COUNTY, NEW MEXICO	ORIGINAL

REPORTER'S TRANSCRIPT OF PROCEEDINGS

EXAMINER HEARING

BEFORE: MICHAEL E. STOGNER, Hearing Examiner

August 21st, 1997

Santa Fe, New Mexico

This matter came on for hearing before the New Mexico Oil Conservation Division, MICHAEL E. STOGNER, Hearing Examiner, on Thursday, August 21st, 1997, at the New Mexico Energy, Minerals and Natural Resources Department, Porter Hall, 2040 South Pacheco, Santa Fe, New Mexico, Steven T. Brenner, Certified Court Reporter No. 7 for the State of New Mexico.

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I N D E X

August 21st, 1997
Examiner Hearing
CASE NO. 11,837

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A P P E A R A N C E S

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ALSO PRESENT:

HARDEMAN L. STONESTREET
Kerry Petroleum and KP Acquisition Corporation
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* * *

WHEREUPON, the following proceedings were had at 11:05 a.m.:

EXAMINER STOGNER: Hearing will come to order. I'll call next case, Number 11,837.

MR. CARROLL: Application of Burlington Resources Oil and Gas Company for compulsory pooling, Eddy County, New Mexico.

EXAMINER STOGNER: Call for appearances.

MR. KELLAHIN: Mr. Examiner, I'm Tom Kellahin of the Santa Fe law firm of Kellahin and Kellahin, appearing on behalf of the Applicant.

EXAMINER STOGNER: Any other appearances?

Please stand up -- In fact, why don't you come up here and take one of these seats?

MR. STONESTREET: My name is Stonestreet, Hardeman L., Kerry Petroleum and KP Acquisition Corporation.

EXAMINER STOGNER: I'm sorry, repeat your name again?

MR. STONESTREET: My name?

EXAMINER STOGNER: Yes, sir.

EXAMINER STOGNER: Hardeman, H-a-r-d-e-m-a-n, Stonestreet, S-t-o-n-e-s-t-r-e-e-t.

MR. CARROLL: And who -- On behalf of what companies?

MR. STONESTREET: Kerry, K-e-r-r-y, Petroleum and KP Acquisition Corporation.

MR. CARROLL: And those are your corporations?

MR. STONESTREET: KP, and Kerry is a corporation too.

MR. CARROLL: They're both your corporations?

MR. STONESTREET: Yeah, I'm...

MR. CARROLL: You're the principal officer or owner?

MR. STONESTREET: I'm not an owner. Officer.

MR. CARROLL: The second one was KP what?

MR. STONESTREET: Acquisition.

MR. CARROLL: Acquisition.

Mr. Stonestreet, are you going to be testifying?

MR. STONESTREET: I will if you want me to.

MR. CARROLL: Yeah, we'll swear you in at the same time as the other witnesses.

MR. STONESTREET: Okay.

EXAMINER STOGNER: Are there any other appearances besides Mr. Stonestreet and Mr. Kellahin?

Okay. Will all the witnesses please stand to be sworn at this time?

(Thereupon, the witnesses were sworn.)

EXAMINER STOGNER: Mr. Kellahin?

MR. KELLAHIN: Thank you, Mr. Examiner.

Mr. Examiner, my first witness is Rick Gallegos. Mr. Gallegos is a landman who resides in Midland, and he's employed by Burlington Resources Oil and Gas Company.

RICK GALLEGOS,

the witness herein, after having been first duly sworn upon his oath, was examined and testified as follows:

DIRECT EXAMINATION

BY MR. KELLAHIN:

Q. Mr. Gallegos, for the record, sir, would you please state your name and occupation?

A. My name is Rick Gallegos and I'm a landman.

Q. Where do you reside, sir?

A. In Midland, Texas.

Q. On prior occasions have you testified before the Division?

A. No, I have not.

Q. Summarize for us your education and your employment experience.

A. I am a graduate of the University of Colorado. I've got a minerals land management degree.

Q. In what year, sir?

A. In 1987. I have worked as a landman for Phillips Petroleum Company for over five years and as a landman with Burlington Resources for three years.

Q. All right. Have you assumed the responsibilities

in this portion of Lea County, New Mexico, on behalf of your company, having taken over this area from Leslyn Swierc?

A. Yes, I have, and it's Eddy County, New Mexico.

Q. I'm sorry, Eddy County, New Mexico.

As part of your efforts, have you become familiar with the title opinions and the division of interest within the proposed spacing unit that you're trying to form here?

A. Yes.

Q. In addition, have you assumed her duties of negotiating with the various working interest owners in an effort to obtain their voluntary agreement?

A. Yes.

Q. Have you been the principal landman responsible for this project since Leslyn was transferred to other duties?

A. Yes, I have.

MR. KELLAHIN: We tender Mr. Gallegos as an expert petroleum landman.

EXAMINER STOGNER: Mr. Gallegos is so qualified.

Q. (By Mr. Kellahin) Let me have you turn your attention, sir, to what we've marked as Burlington Exhibit 1. Let's unfold the map area.

When we're looking at this portion of the properties involved in Eddy County, New Mexico, what's the

significance of the area shaded in yellow?

A. The yellow represents Burlington Resource leasehold, either partial or 100-percent leasehold. And the red outline there is the outline for the proposed unit, which is composed of the north half of Section 23.

Q. This is identified as Burlington's proposed El Paso 23 Federal Well Number 2?

A. Yes, it is.

Q. This is a well that is proposed to be a multilateral directional wellbore; is that not true?

A. Yes, sir.

Q. The proposed target interval, as you understand it, is to be principally the Wolfcamp formation?

A. Yes, sir.

Q. And within the Wolfcamp formation it's what we characterize as the Wolfcamp A?

A. That is correct.

Q. All right. Also shown on this display are locations for other wells. Do you know if these are displaying wells below 11,000 feet?

A. Yes, to my knowledge they are.

Q. All right. Let's set aside the locator map for a moment.

When you look within the area to be investigated by you, were you utilizing -- in order to tabulate the

various interest owners, were you utilizing title opinions?

A. Yes, I was. I was utilizing a title opinion done by the law firm of Turner and Davis.

Q. What's the approximate of that title opinion?

A. That opinion was dated December 18th, 1996.

Q. At that time, what percentage interest had Burlington acquired or accumulated when we look at working interests?

A. Right at 52.5 percent.

Q. Do you remember or recall what is the approximate cost of this well?

A. It is a -- Total to drill and complete was about $1.987 million.

Q. When you received, Burlington received, the title opinion in December of 1996, approximately how many record title owners and working interest owners had an interest below the Bone Springs formation?

A. Eighteen.

Q. On July 29th, 1997, the compulsory pooling Application was filed; is that not true?

A. That is correct.

Q. By that time, had you obtained voluntary agreement of any of these working interest owners?

A. Yes, I had. By that time I had obtained a voluntary agreement of seven of the working owners, which

represented 64 percent of the working interest in the unit.

Q. So including Burlington, you had, during the course of that period of time, increased the committed interest up to about 64 percent?

A. That's correct. And including Burlington, it would have been eight parties.

Q. As of last week on August 15th, what was the status of your efforts to obtain voluntary agreement?

A. As of last week, I had obtained the voluntary agreement of 13 parties total -- that's exclusive of Burlington -- representing approximately a 74-percent working interest in the unit.

Q. Let's turn to Exhibit 2 for a moment and have you identify for the record what is tabulated on these two pages.

A. What is tabulated on these two pages is the various working owners that hold a working interest in their unit. Also, it's their working interest ownership within such unit.

And the parties that have an asterisk by them, that asterisk represents the parties which have elected to participate. And you can see, of the parties involved we've got 14 parties that have elected to participate, an overwhelming majority.

Q. All right, let me make sure I understand the

display. The working interest percentage is the working interest in relation to the spacing unit, the 320 acres?

A. That is correct.

Q. And if we read down the list and we find an asterisk, it indicates that that company has agreed to participate?

A. Yes, sir.

Q. As we look at the names with asterisks, in what ways have they elected to participate?

A. They've elected to participate in two ways. They've elected to participate by executing our AFE, and in addition to that they've signed our operating agreement.

Q. Have any of these interest owners thus far committed their interest in any other way, such as a term assignment, a farmout agreement, a sale?

A. No.

Q. So when we look at participating here, we're looking at a particular category in which everyone thus far has agreed to pay their share of the well and participate as a working interest owner?

A. That is correct.

Q. Of all those interest owners that have signed your operating agreement, has anyone objected to the terms of the operating agreement?

A. No, they haven't, and there has been no

alterations to our operating agreement. Each one of those parties has signed our operating agreement as it was presented to them.

Q. Okay. Under the terms of your operating agreement, what are you proposing and what have they agreed to for overhead rates?

A. What we're proposing is an overhead rate of $650 producing well rate and $5500 drilling well rate.

Q. Okay. Have any of those parties, prior to signing your AFE, objected to any of the costs set forth in that AFE?

A. No, they have not.

Q. The AFE submitted to them was one that detailed the proposed plan to take this as a horizontal multilateral wellbore?

A. That is correct.

Q. What is the status of your approvals of the horizontal multilateral directional well, pursuant to Division Rule 111?

A. We have received those approvals.

Q. Okay. When we go down the list here, give us a short summary on where we stand with those parties that are not yet committed, starting with the first entry on Exhibit 2, the Geodyne Nominee Corporation.

A. Geodyne Nom- -- Geodyne, I've had several

conversations with them, and their last response to me was that until such time that we push them into making a decision one way or the other, it really wasn't worth their time to evaluate, and they weren't going to be able to get their management's response until such time as they're forced to make such an election.

The second party, Ralph E. Williamson, we've spoke with him and I've also sent him a letter, and we're -- at this point we're not there on the terms. He's wanting one term, and we're offering another.

Q. Now, as to the Geodyne interest, your understanding is, they -- you're going to need a force-pooling application in order that interest?

A. Yes, it is.

Q. All right. And as to Ralph E. Williamson, what's the position there?

A. That's -- I'm taking the same position there.

Q. All right. As we flip to the next page, then, we get down to Finwing Corporation?

A. Yes.

Q. What's the status of that effort?

A. I've spoke with Mr. John Stark on several occasions, and his reply to me was that he didn't want to be the last one. If it was just him we were force-pooling, he would make an agreement with us based on the terms that

we've offered. However, he wants to go ahead and -- We're leaving this open, our offer open to these parties, to give them a chance to take our offer while this pooling process is ongoing, and he said either way, that he would either take our offer or go under the pooling order. He just kind of wanted to wait and have a little more time to think about it.

Q. When we get down to the next two entities, they are separated on this spreadsheet as KP Acquisition Corporation and then Kerry Petroleum Company, Inc. At the time you began negotiations and efforts, with whom were you dealing on behalf of both of those interests?

A. My initial talks were with Lynn Scharek, a geologist, and then I also spoke with Mr. Hardeman Stonestreet.

Q. Okay. Let's go back, then, and look at the title information that you have assimilated and for which you can express opinions. As of July 25th, then, of 1997, describe for us what is the total federal lease burden on the north half of 23.

A. On the north half of 23 the federal lease burden is one-eighth.

Q. All right, so it's 12.5 percent?

A. That is correct.

Q. When we look at the KP/Kerry interest, that

collective interest, were there burdens on that interest in terms of overriding burdens?

A. Yes, there were. In addition to the one-eighth royalty -- now, this is just dealing with the KP Acquisition Corporation interest -- there is also a one-sixth royalty that all the parties in the unit have.

And unique to KP Acquisition's interest is an additional 3-percent override. So there's a one-eighth royalty, then a one-sixth royalty, and an additional 3.25-percent royalty.

Q. When we translate these into percentages, the northwest quarter of 23 for the KP/Kerry interest has an underlying overriding royalty burden of 6.25? Did I get that right?

A. No, it has an underlying burden of -- that would be --

Q. 9.25?

A. Nine -- Yeah.

Q. Of which 3 percent represents an overriding royalty burden shared among certain interest owners of KP and Kerry Petroleum?

A. I can't speak to Mr. William -- and I don't know if I'm pronouncing this right -- Ahern --

Q. Ahern.

A. -- and C.T. Richmond, but the other royalty

overriding is to Mr. Stonestreet --

Q. All right.

A. -- a one-third of that 3 percent.

Q. In addition, what investigations have you concluded to determine if the KP interest had any additional kinds of burdens?

A. We've checked the federal records and we checked the county records, and in the county records we found a net proceeds interest that was attached to this interest. It's a 50-percent net proceeds interest. And we find that, based on our review of the county records, that this interest is in force and effect.

Q. All right, let's go back and summarize this, then. When we look at Kerry Petroleum's interest at this time, what is their percentage of net revenue? What's their net revenue interest in the spacing unit?

A. KP Petroleum's --

Q. No, the other one, Kerry Petroleum.

A. Okay, Kerry Petroleum, they have a one-eighth royalty and a one-sixth royalty attached to their interest. So their net revenue would be -- It would be 81.25 percent.

Q. Okay, that would give --

A. On and 8/8 basis.

Q. All right. So they're dealing with an 81.25-percent net working interest, is the way I would describe

that.

A. That is correct.

Q. Okay.

A. While KP is dealing with a 78.25 percent.

Q. All right. And the reason the KP interest is slightly less is, there's an additional 3-percent overriding royalty burden, of which 1 percent Mr. Stonestreet controls?

A. That is correct.

Q. All right.

A. And in addition to that the net proceeds interest, 50 percent.

Q. All right. Let's go through the sequence of correspondence so that you can describe for me Ms. Swierc's efforts and your efforts to obtain voluntary agreement, starting with what we've identified as Exhibit Number 3. Identify and describe that document.

A. Exhibit Number 3, dated June 2nd, 1997, is our original well proposal that we sent out to the parties that we identified as having a working interest within the unit.

Q. Okay. Attached to this proposal to participate in this well is an AFE?

A. Yes, it's an AFE in the amount of $1,987,300. And this same AFE is the one that we've had parties, thirteen other parties, execute and return to us.

Q. All right, let's start with your efforts to negotiate an agreement with KP and Kerry. I collectively refer to them together because that's how you negotiated them, is it not?

A. That's correct.

Q. So following June 2nd, 1997, and prior to July 21st of 1997, which is your next letter, summarize for me how many conversations you had, who you had them with, and what resulted.

A. I spoke with Mr. Lynn Scharek -- and I don't know if I'm pronouncing that one right either -- on probably three different occasions, and this was prior to July 14th. He then -- My initial conversations with him were to see whether or not they were going to participate or not. He said they were looking at it.

Then I called him back a few weeks later to bump him, to see where he was. He is in the Midland office. He then referred me to Mr. Stonestreet, who I reached at a Salt Lake number or -- It's Area Code 801, a Utah number. And I spoke with Mr. Stonestreet on July 14th.

Q. Summarize your conversation with Mr. Stonestreet concerning your negotiations in an effort to get his commitment of his interest, the KP/Kerry interest, to this project.

A. I basically offered, as I've offered all the

parties -- I offered them all the same thing, that we would be willing to purchase their interest for $250 an acre or take a net -- or take a farm-in, which would deliver to us a 78-percent net revenue interest, proportionately reduced. This 78 percent is the level which enables us to realize a profits-to-investment ratio of 10 percent.

And Mr. Stonestreet had countered to me he wanted to deliver to us a 75-percent net revenue interest, subject to a 50-percent back-in, proportionately reduced.

Q. Were you authorized or allowed to accept his counteroffer?

A. Absolutely not.

Q. It was below this threshold?

A. It was below the threshold. Not only was that below the threshold, but then when you bring on that net profits interest that is attached to that interest, it was very uneconomic at that point.

Q. All right. Did you continue to offer to Mr. Stonestreet the opportunity to pay his share and participate in the well --

A. Yes, we did.

Q. -- as an option?

A. That has always been an option and still is an option.

Q. On July 21st, did you communicate in writing this

verbal proposal on participation or acquisition of his interest by a farm-in?

A. On July 21st, I sent a letter out where I did offer to either purchase the interest for $250 per net acre or farm it in on a 78-percent net revenue basis.

Q. Let's have you identify and describe Exhibit 4, then.

A. Exhibit 4 is the letter dated July 21st, 1997, and on that letter were all those parties that had not elected to participate at such time as the letter went out. I offered an opportunity to either sell their interest or farm out their interest.

Q. On August 8th of 1997, did you receive a copy of Mr. Stonestreet's written opposition to the Application?

A. Yes, I did.

Q. And did you execute an affidavit on behalf of your company on August 15th, which was filed with the Division as part of its prehearing statement in response to Mr. Stonestreet's affidavit?

A. Yes, sir.

MR. KELLAHIN: All right. Mr. Examiner, I don't know if that's available in front of you as part of the case file, but I have an additional copy here. It should be attached -- There it is.

Q. (By Mr. Kellahin) The items in Mr. Stonestreet's

opposition was a request to have a continuance in order to continue with further negotiations with you on behalf of his company; that was one of the items he was concerned about.

Are you willing to continue negotiations with him, despite the fact we're at a pooling hearing today?

A. Yes, I'm willing to continue negotiations. I don't foresee that -- I think we've offered our best deal, and Mr. Stonestreet has offered what his company, I guess, can authorize him to offer, but we -- our offer is open, and it will stay open.

Q. All right. You're unable to improve the offer that you've made to him; you've made your best offer?

A. That is correct.

Q. At this point do you believe that it's necessary to have a force-pooling order issued in order to have his interest committed so that he can either participate under a pooling order, or to go nonconsent under that pooling order?

A. Yes, I do.

Q. In addition, Mr. Stonestreet raises some questions about having the availability of 3-D seismic information. Are you allowed to release to Mr. Stonestreet any of your 3-D seismic data?

A. No, I am not.

Q. In addition, Mr. Stonestreet is concerned about marketing his share of gas as a working interest owner. Have you made any investigations in determining whether or not he has reasonable access to a gas market?

A. Yes, I have. The gas that will come from that well will most likely, as the -- There's a well that's located in the same section that's dedicated to the Sid Richardson Gasoline Plant, some of the production from that. That's a market right there in itself, the Sid Richardson Gasoline Plant.

In the event that you didn't want sell to Sid Richardson, at the tailgate of Sid Richardson is an El Paso Natural Gas main line. And I've spoke with El Paso Natural Gas. They will take as little as 15 MCF per day on that line. However, there is a market with no limiting constraints there to the Sid Richardson Plant.

Q. Do you have an opinion, Mr. Gallegos, as to whether or not you've exhausted good-faith opportunities to negotiate voluntary agreements with all of these remaining interest owners who are not yet committed?

A. Yes, I feel I have.

MR. KELLAHIN: Mr. Examiner, we submit to you Mr. Gallegos's exhibits, which have been marked as Exhibits 1 through 4.

EXAMINER STOGNER: Exhibits 1 through 4 will be

admitted into evidence.

MR. KELLAHIN: That concludes my examination of Mr. Gallegos.

EXAMINER STOGNER: Mr. Stonestreet, do you want to -- ?

EXAMINATION

BY MR. STONESTREET:

Q. Yes, do you remember our first conversation?

A. We've had a couple, but I believe I do.

Q. During that conversation, did you mention at all that if we can't go along with, don't go along with, that you would just go to the Commission and have us force-pooled and get 300-percent penalty? Did you ever say anything like that?

A. I did mention that we would try to work a deal, but at last result, if we cannot arrive at a deal, we will have to go to the force-pooling.

Q. Why did you say that?

A. I basically said it that first we want to give you the opportunity. I reiterated it in writing. But the reason I said that was, we have -- We've got certain time constraints to get this well drilled under, and that was part of the reason.

Q. But why did you say it?

A. Just to advise you that we were probably going to

be filing such an application.

Q. Were you attempting to hold a club over my head?

A. No, I don't feel I was.

Q. If you can't get what you want from us this way, you can get it from the Commission here, the Division?

A. With you and the other working interest owners that elected not to participate, that at a certain point we negotiate in good faith, and when we're able to come to terms, that is our last outlet.

Q. I guess we don't agree on negotiations in good faith, Mr. Gallegos.

You made an offer, we countered, and on the phone you refused to go along or even talk about anything in between; is that right?

A. I made my best first, that is correct.

Q. Have you bought any property up there in the last year or two in this area?

A. Yes, we -- I have.

Q. What do you pay an acre for it?

A. We pay anywhere from a range of $150 to $500 an acre. It varies.

Q. What kind of burdens?

A. It -- At the sale, if we go pick it up at a federal sale, it's a one-eighth burden.

And those burdens also vary. We'll see anywhere

from -- they vary anywhere -- I've seen them from 75 percent to 87.5 percent.

Q. We're not talking about buying them from the federal government or winning the lease; we're talking about buying them from some party who may own the lease, and he'll sell it to you for X amount, reserve an override or whatever. Have you done any of that?

A. No, I have not, because I've worked the area two months, and I have not bought from any other party.

Q. Do you know anybody in your company or anywhere who's bought it and what they had to pay for it, the consideration, cash, override or anything?

A. The considerations that I've seen are around that. They're around $250 an acre for an 80-percent net revenue interest delivered.

Most of the HBP leases out there do have overrides, but they're not as heavily burdened as I see here.

Q. Do you consider it, or does Burlington consider this well, the 2-23, a wildcat, development, or what have you?

A. We consider it a wildcat, an exploratory well.

Q. In your AFE it's shown as a development well. I just wondered how that...

A. And I will --

Q. It says development well, so you have a different opinion, which is fine. But the people who made the AFE up show it as a development well, I believe.

A. And that will be addressed --

MR. KELLAHIN: Mr. Examiner, we have the man that wrote the AFE and other experts to address these concerns.

Q. (By Mr. Stonestreet) Do you remember another conversation we had, on the telephone?

A. Yeah, I remember. We had a couple.

Q. And what were you asking me to do in the second conversation?

A. I was asking for the same thing, that we were willing to purchase your interest or take it on the basis of the 78-percent net revenue interest.

Q. Do you remember asking us to go ahead and sign the operating agreement but not join in the well, and we'd get all the information on the well as it was drilled, because you're going to get 300 percent from the Oil and Gas Division anyway?

A. Yes, we did say and I did represent that if you sign the operating agreement and participate in it, you would get all well information; that is correct.

And that is correct for any other party that's signed our operating agreement to participate in this well: You will get all the -- We will give the well information.

However, we will not give well information to a party that does not participate in the well.

Q. In your earlier testimony, you indicated you would be willing to negotiate, quote, unquote, further on this deal?

A. Negotiate further --

Q. What does that mean?

A. That means we'll be -- this offer stands open, the offer made by -- in writing by letter dated July 21st, 1997, will stay open. It's got a date till -- It will expire on October 1st of 1997, and I guess we're willing to leave that open.

But when I say negotiate further, I do not mean better terms than the 78-percent net revenue delivered to Burlington.

Q. Does "negotiate" mean give and take?

A. I -- Yeah, "negotiate" means "negotiate", and I think what we did is, we started and we offered our best terms that we can and still have an economically viable project.

MR. STONESTREET: That's all I have.

EXAMINER STOGNER: Thank you, Mr. Stonestreet.

Mr. Kellahin, any redirect?

MR. KELLAHIN: No questions.

EXAMINER STOGNER: Mr. Carroll?

EXAMINATION

BY MR. CARROLL:

Q. I notice in the June 2nd letter, the attached list of interest owners sent the proposal, Kerry is not listed but KP is?

A. At that -- Yeah, at that time the title opinion that we had did not show Kerry Petroleum with an interest. I do have an updated title opinion that was updated in July of this year that does show Kerry with an interest. However, at that time, that title opinion did not.

Q. Okay. And in your negotiations with KP and Kerry, with Mr. Stonestreet, you didn't back off your initial offer. Did Mr. Stonestreet offer -- make another offer besides his offer?

I guess my question is, you both -- There's been an offer and counteroffer. Have either of your budged off each of your --

A. That's correct, we did not back off and neither did Mr. Stonestreet.

And I would like to point out here that we're looking at an interest that has, in addition, a 50-percent net proceeds interest attached to it.

We are going to be taken -- At a 78-percent net revenue interest, if we take that deal there and then you attach the 50-percent net-proceeds interest -- which is

only unique to KP's interest, to no other parties in the unit -- that is -- that in itself is uneconomical. And we're willing to take that and take it at a loss to get this well drilled.

Q. You're willing to take what?

A. The interest of KP Acquisition Corporation is subject to a 50-percent net-proceeds interest. And the way I interpret this net-proceeds interest is that 50 percent of your profits goes to another party, the holder of that net-proceeds interest.

So this 4 percent, the approximately 3.9-percent working interest of KP's, even if we're delivered a 78-percent net revenue interest farmout, we'll be uneconomical on a stand-alone basis.

Q. Maybe I heard you incorrectly. It sounds like you're willing to accept Mr. Stonestreet's counteroffer.

A. No, our offer is the 78 percent. We've offered to farm in to his interest, having them deliver to us 78-percent net revenue interest.

MR. KELLAHIN: Mr. Carroll, if I may interrupt, Mr. Stonestreet wants to retain after payout a 50-percent working interest option, which is a different critter --

MR. CARROLL: Oh, than the net proceeds --

MR. KELLAHIN: -- than the 50-percent --

THE WITNESS: Yes.

MR. KELLAHIN: -- net proceeds paid to a third party, not --

THE WITNESS: Yeah, I'm sorry --

MR. CARROLL: And he also wants to retain an

MR. KELLAHIN: Just --

THE WITNESS: Yeah, that --

MR. CARROLL: -- additional 3-percent --

MR. KELLAHIN: Rick --

THE WITNESS: Fifty -- Okay.

MR. KELLAHIN: -- one at a time. Let him finish --

MR. CARROLL: Okay.

MR. KELLAHIN: -- his question. What's the question?

Q. (By Mr. Carroll) Okay, I think I understand. And he also wants to retain an additional 3-percent override?

A. Yes, and in addition to a 50-percent back-in, or there is that net-proceeds interest hanging out there.

MR. CARROLL: Okay.

MR. STONESTREET: May I say something?

MR. CARROLL: Sure, go ahead.

MR. STONESTREET: We want to reserve an overriding royalty with election to exchange the override for a working interest at payout.

This 50-percent net proceeds -- I don't know who did your title opinion -- is not correct. It's not totally correct. It doesn't apply.

THE WITNESS: Well, we find it of record when we run the records, and there is nothing in the County records to say that is no longer valid. That's based on the evidence we have --

MR. STONESTREET: There's other instruments to look at.

THE WITNESS: There may be, but they may not be of record. And that's what we found of record, based on the title opinion we had done.

Q. (By Mr. Carroll) Mr. Gallegos, do you know the relationship between KP and Kerry? Kerry is the parent company of KP?

A. They have -- They've got the same address, and Mr. Stonestreet represents both of them. The exact relationship, I don't know.

EXAMINATION

BY EXAMINER STOGNER:

Q. Mr. Kerry, what is the --

MR. CARROLL: Mr. Stonestreet.

Q. (By Examiner Stogner) Mr. Stonestreet, I'm sorry. What is the relationship between KP and Kerry?

A. Kerry owns approximately 80, 81 percent of KP.

But we have control and authority over KP.

EXAMINER STOGNER: I'm going to call about a five-minute recess at this point.

(Thereupon, a recess was taken at 11:42 a.m.)

(The following proceedings had at 11:52 a.m.)

EXAMINER STOGNER: Hearing will come to order.

Mr. Carroll?

FURTHER EXAMINATION

BY MR. CARROLL:

Q. Mr. Gallegos, just for clarification, will you lead us through an example of what exactly Burlington offered as to that interest and what Mr. Stonestreet counteroffered? The 78-percent net revenue interest subject to the 50-percent net proceeds, and then the counteroffer from Mr. Stonestreet?

A. Okay, our offer to them was to either, one, purchase their interest for $250 an acre or, two, take a farm-in of their interest where they would deliver to us a 78-percent net revenue interest, proportionately reduced to their working interest.

MR. KELLAHIN: With no back-in?

THE WITNESS: Yeah, with no back-in. And that, according to the County records, would be subject to a 50-percent net profits interest that we would have to bear, Burlington Resources.

Q. (By Mr. Carroll) Okay --

A. Mr. --

Q. -- how does that work, then? Give an example of some revenue figures.

A. Okay, I'll give you an example, just assuming that KP Acquisition owned 100 percent of the working interest.

Q. Okay.

A. They would deliver to us a 78-percent net revenue interest, so we'd be getting 78 percent of the stream.

And then they would reserve an override, being the difference between burdens, existing burdens, and that 78 percent.

Q. Okay, and then how is the 50-percent net profits interest, how is that affected?

A. Okay, how that would affect it -- and this is based on my reading of the net proceeds instrument is that from day one when our well starts producing, if we make $200 profits, after we paid all the royalties and everybody else and paid all our expenses, then whatever's profit, we give 50 percent of that to the party that holds the net proceeds interest.

Q. Okay.

A. So essentially we'd be giving away 50 percent of our profits.

Q. And Burlington is willing to accept that burden?

A. Yes, we are. We would not be willing to if we were doing this and had 100-percent working interest. It would be an unecon- -- it would be nonviable project for us.

But in this circumstances, since we're only dealing with about 3.9-percent working interest, we're willing to do so to get the well drilled.

Q. Okay, and Mr. Stonestreet's counteroffer is delivering you a 75-percent net revenue interest --

A. That's correct.

Q. -- with a right of conversion to 50 percent --

A. That would -- at payout, at such time that we paid out 100 percent of our costs.

Q. Okay, and that's not acceptable?

A. That is unacceptable. That alone, as a stand-alone proposal goes below our economic parameters. That doesn't even include adding on that 50-percent net proceeds interest.

Q. Uh-huh.

A. It would be ludicrous for us to take such a risk to drill a well and then give half of it away at payout and during the whole time be giving half away -- away half of the profits.

It just -- We wouldn't stay in business long,

doing that.

EXAMINER STOGNER: Anything further?

You may be excused.

Mr. Kellahin?

KEITH WINFREE,

the witness herein, after having been first duly sworn upon his oath, was examined and testified as follows:

DIRECT EXAMINATION

BY MR. KELLAHIN:

Q. Mr. Winfree, for the record would you please state your name and occupation?

A. My name is Keith Winfree and I'm a geologist.

Q. Where do you reside, sir?

A. Midland, Texas.

Q. And by whom are you employed?

A. Burlington Resources.

Q. Have you testified on prior occasions before the Division?

A. No, I have not.

Q. Summarize for us your education and employment.

A. I received a bachelor's degree in geology in 1981 from LaMar University, received a master's degree in geology from the University of Wisconsin in 1983, and in 1983 I began employment as a geologist with Exxon, and resigned from Exxon approximately two months ago and came

to work for Burlington Resources.

Q. As part of your preparation for today's hearing, have you made a review of the Wolfcamp geology that is the target portion of this wellbore?

A. Yes, I have.

Q. And while you're recently involved in the project, have you reviewed the work product of others that was developed in a geologic sense for your preparation?

A. Yes, I have.

Q. Have you satisfied yourself that you have sufficient data upon which to express opinions?

A. Yes, I do.

MR. KELLAHIN: We tender Mr. Winfree as an expert geologist.

EXAMINER STOGNER: So qualified.

MR. KELLAHIN: Mr. Examiner, we have a number of exhibits. We're not going to spend much time on each one. The built-in sequence to give you a general picture of what Burlington's strategy is in this Wolfcamp play, the first part of the puzzle, obviously, is Mr. Winfree, and then we'll follow him up by Mr. Doug Seams who is the reservoir engineer.

Q. (By Mr. Kellahin) All right, Mr. Winfree, let's turn to what is marked as Exhibit Number 5 and have you identify and describe this display.

A. This is the Wolfcamp completion zone map. The scale is one inch equals 2000 feet. The yellow indicates the Burlington leasehold in the area, whether it be a partial interest or a full interest.

Q. At this point, regardless of the color code of these various dots, those represent producing Wolfcamp wells in one or more of the three Wolfcamp zones?

A. That is correct.

Q. And you have identified for the Division three Wolfcamp zones, with the higher one being labeled the "A", the lower the "B", and finally the deepest is the "C"?

A. That is correct.

Q. All right. When we look at the Burlington acreage, but for your interest in the southwest of 23 with that El Paso well, you do not yet have producing Wolfcamp wells on your acreage; did I read that right?

A. That's correct to the best of my knowledge.

Q. All right. Part of the exploration strategy, then, for the development of Wolfcamp on your acreage is to commence with a well in the north half of 23?

A. That is correct.

Q. All right. The plan for this wellbore is for it not to be a vertical well but for it to be a directional well, insofar as it will be drilled vertically to a point to intersect the top of the Wolfcamp A, and then you're

going to have two laterals that would access the Wolfcamp A, right?

A. That is correct.

Q. All right. Let's set this aside and go to the next display.

In the southwest quarter of 23, you've got a Wolfcamp well?

A. That's correct.

Q. And Exhibit 6 is the type log for that well; is it not?

A. That is correct.

Q. Identify for us how you have separated the Wolfcamp into these three different intervals.

A. The entire Wolfcamp section consists of limestones interbedded with shales. The limestones have a relatively low gamma ray, and we can recognize them on this compensated neutron formation density log. The shales have a relatively high gamma-ray.

And as you can see, what we've colored in blue are three thick limestone layers, or three limestone layers of varying thickness. The uppermost of those is called the "A", the second is the "B", and the third is the "C". And you can see that the "A" is the thickest and the "B" and "C" are not as thick.

Q. All right. Does Burlington operate this well?

A. Yes.

Q. Give us a short history of the sequence in which this well was produced in the Wolfcamp interval.

A. It was first completed in the Wolfcamp B and it produced approximately 200 million cubic feet, and then depleted, and it's subsequently been recompleted in the Wolfcamp A just recently. The IP was approximately 2 million a day. And we believe the EUR to be approximately 1.6 BCF.

Q. You're looking for further opportunities in the Wolfcamp in this vicinity in which you have acreage position?

A. That's correct.

Q. The logical place to look is an opportunity in the north half of 23?

A. That's correct.

Q. Which portion of the Wolfcamp will you attempt to access with this well that's the subject of this case?

A. The initial completion will be in the A, as we mentioned before, with the horizontal laterals.

Q. Okay. Do you have a series of displays where we can first of all see the structural component of the Wolfcamp?

A. Yes, I do.

Q. Let's start with that. If you'll turn to Exhibit

7, let's look at your interpretation of the structure.

The type of wells identified on the display are what, sir?

A. These are the wells in the area that have total depths greater than 11,000 feet.

Q. And this log data was available to you?

A. Yes.

Q. You constructed a structure map?

A. That's correct.

Q. Any importance to structure in determining the location of the well?

A. No.

Q. Does structure affect decisions about risk for drilling in the Wolfcamp in this immediate vicinity?

A. No.

Q. All right, sir, let's set that aside and go to Exhibit 8.

Exhibit 8 represents to be a Wolfcamp "A" limestone isopach, right?

A. That is correct.

Q. When you're isopaching this "A" interval in relation to the type log, are you isopaching the entire Wolfcamp limestone interval shown on the type log?

A. That's correct, the Wolfcamp "A".

Q. So it would be a gross number, if you will, in

the Wolfcamp "A"?

A. Yes.

Q. All right, sir. You had certain data points that went into that effort, and the data points are the log information shown on wells that are illustrated on this display?

A. That is correct. The actual thickness value is posted just to the right of the well symbol, with the blue numbers.

Q. There's a green cross-section, A-A'. If you use that as a reference point and look at everything north and east of that reference point, you have a total absence of Wolfcamp well control, don't you?

A. That is true.

Q. Is this an isopach computer-generated, or did you hand-draw this?

A. It was generated by the computer.

Q. So what does the computer do if you put in this minimal number of data points, how does the computer, by its program, draw the contours?

A. It extrapolates away from the well control to areas where there are no well control, using the well control as a guide, basically, and it does it in a very speculative manner, obviously, since there's no data up there. It's a pure extrapolation.

Q. All right, sir. You're not representing to us, then, that you're going to rely on this with your expertise to determine thickness of the Wolfcamp "A" using that computer-generated isopach, are you?

A. Well, I can't really speculate what the exact value will be at that point. It's too speculative. I interpret there could be a range of values at that point.

Q. All right. It's simply a general indication of where you might go with another well location?

A. Right.

Q. All right, it's not intended to represent that that is going to be a well located where it's going to have 75 feet of Wolfcamp "A"?

A. I would never testify that I could guarantee that.

Q. All right. How do you then decide for yourself what is the likely size and shape of a Wolfcamp "A" reservoir?

A. There's a process where you look at a range of values and you assess the risk, based on your data points, and you essentially take an average value.

Q. All right. Is the next step in the sequence, then, to determine the potential size and shape of these reservoirs, is to look at some cross-sections?

A. That's true.

Q. Before we leave the isopach, though, can you demonstrate for us, at least in the vicinity of Section 15 to the south and west, the magnitude of range of thickness of the Wolfcamp even within that section?

A. Yes, as you can see, if you follow the cross-section line, B-B' on the map, as you move away from the type log in the southwest of Section 23, which has 78 feet, the next well, which would be in the next proration unit, only has 48 feet. And then the next well -- That was the Florida Exploration Number 8 Ross Draw. The next well down there, indicated as the Baxter Number 5 Ross Draw unit, only had 15 feet of limestone.

So it's easy to conclude that any one given well does not guarantee you're going to have a similar-looking well in the adjacent proration unit.

Q. Let's take a quick look at your series of cross-sections so we can get an illustration of how this is depicted in a vertical sense. If you'll take Exhibit 9, which is the A-A' cross-section, you're dealing with wells on this cross-section that are more than a mile apart?

A. That's true.

Q. And within that interval, then, as depicted, describe for us what you see in the Wolfcamp "A".

A. Okay. These wells represent the two wells nearest to the location in a northwest and southeast

direction. The type log we've looked at before, the El Paso 23, is in the center.

The well to the left, to the northwest, is the Adams Exploration well in Section 16, and it has about 48 feet of limestone on it, indicated in blue, which is significantly less than what we saw in the El Paso.

The well on the right is the Florida Gas Ross Draw Number 7, down in Section 25, indicated on the map as the Adobe. That well only has 15 feet of lime.

So you can see that in both directions away from the type log the limestone is thinner, and it's dramatically thinner in one direction.

Q. When we look for Wolfcamp production in the "A", what kind of reservoir do we have here? What is the trapping mechanism?

A. It's a stratigraphic trap. The trap is caused by a loss of porosity.

Q. So as we move from location to location, the reservoir quality of the Wolfcamp deteriorates to some point that, while you're in the Wolfcamp, the containers are erratic in size and shape?

A. That's correct.

Q. Geologically, have you found that these Wolfcamp containers are small and disconnected?

A. Yes, that is true.

Q. Let's look at the B-B' cross-section. As you -- Let's start the other way around. Let's start at the right side and go from B' to B. If you start with the well in the southwest quarter, what do you see in terms of Wolfcamp "A" thickness?

A. It's 78 feet.

Q. Okay, as you move to the southwest, though, what happens to the Wolfcamp?

A. You only have 48 feet in that well. And then as you go down to the far end of the cross-section, down in the southwest quarter of Section -- I believe that's Section 27, that well down there only has 15 feet of lime.

And again, this cross-section illustrates this rapid change in thickness in the lime reservoir.

Q. With this limited well data, are you able to at least hypothecate the likely direction that you would place a well for offsetting the well in the southwest quarter of 23?

A. I don't think so.

Q. All right, you just -- you don't -- Too speculative at this point?

A. It is very speculative.

Q. All right, let's go to C-C' and see what that shows. All right, give us your conclusions about C-C'.

A. C-C', the left-hand well is in the northwest of

Section 27, the center well is in the southwest of Section 27, and the right-hand well is just to the south of there, indicated on the map as the Williamson well.

All three of these wells have very thin limestones. The thickest one is the one on the left, which has 34 feet.

The importance of this cross-section is that it shows that you can't extrapolate this thick onto the south, which you might be tempted to do in normal geologic contouring. It really shows that this thick comes to a complete end in this area and points out that going to the north in Section 23, up to our proposed location, you could have exactly the same situation, where there was essentially no reservoir at all.

Q. That is all the available log data and information that you have available to analyze, right?

A. That's correct.

Q. Does Burlington have access to any seismic information and, if so, is it useful in the Wolfcamp?

A. Yes, we do have seismic -- 3-D seismic in this area, and no, it has not helped us mitigate the risk for this location at all.

Q. That 3-D seismic was utilized for Delaware play, was it not?

A. That's correct.

Q. And you're not able to use it for any useful purpose in the Wolfcamp?

A. That's correct.

Q. All right, set aside for a moment your involvement with Mr. Seams as a reservoir engineer, and let's just look at the exploration risk involved as a geologist with this amount of data.

Do you have an opinion as to what the geologic risk is in terms of a risk-factor penalty that is accessible for interest owners that won't commit to this well?

A. Yes, it's my opinion that the cost plus 200 percent is justified.

Q. Now, at this point, you as a geologist have a real dilemma, don't you? Because you don't know the size and the shape of these Wolfcamp reservoirs, and you're not sure, if you hit one, how good it's going to be?

A. That's correct.

Q. What is the typical thing you do now when you ask the reservoir engineer to examine it? What are you looking for?

A. I'm looking for an estimate of risked reserves.

Q. All right. You're going to get a reservoir to tell you that when you find a Wolfcamp interval, how much gas you can expect to recover?

A. That is correct.

Q. Okay. And with that, then, you can work with him and try to approximate the size and the shape of these containers that contain the Wolfcamp gas?

A. That's true.

Q. Have you attempted to determine whether or not, based upon his reserve calculations, it's useful to further explore for Wolfcamp using vertical wells in this area?

A. Yes.

Q. And what is your conclusion?

A. They are noncommercial and too much risk.

Q. And generally why is that so?

A. They don't drain a large enough area to recover an economic volume of gas.

Q. As a strategy, then, for attempting further Wolfcamp exploration, what have you and Mr. Seams agreed to try to do?

A. Attempt some horizontal drilling.

Q. All right, what would be the potential advantage of a horizontal wellbore, as you see it as a geologist?

A. There really are -- There are two advantages.

One, in this laterally discontinuous reservoir you have a greater chance of finding more porosity by reaching out through the reservoir.

And secondly, we have indication that there are

fractures, and by going horizontal, we should be able to intersect some fractures, which should dramatically improve our permeability.

Q. All right, let's talk about your database for a speculation that you have a fractured reservoir. Do you have core data?

A. No, no core data.

Q. Do you have any of those core-imaging log stuff?

A. There are no image logs.

Q. What do you utilize to come to any conclusion or belief that this might be a fractured reservoir?

A. We have well cuttings, and we hired a consultant to describe these well cuttings for us.

And he found ample evidence of free calcite crystals in the samples, and free calcite crystals are an indication of fractures.

Q. Based upon his information and your own study, how would you characterize the reservoir in terms of its reservoir characteristics?

A. Well, geologically I'd say a deep-water limestone deposit. It tends to have low permeabilities, except in the vicinity of fractures where your permeabilities should be greater.

Vertically and laterally, the good porosity and permeability intervals are discontinuous, and there's no

predictive style to how these reservoirs are laid together in what we call reservoir architecture. The reservoir architecture does not seem to be organized in a predictable manner, laterally or vertically.

Q. Based upon that assessment, what's your conclusion about the risk?

A. I think to quantify it, we probably have about a one-in-two chance, and I think that justifies the cost-plus-200-percent penalty.

Q. Okay. There's still a significant risk. This is not a step-out Wolfcamp well that you're going to be able to play off the first well and make the second one commercial?

A. Right, I think the isopach and the cross-sections demonstrate that clearly. With no well control to the north, you have no indication at all what you'll find at that location.

MR. KELLAHIN: Mr. Examiner, at this point we move to introduce Mr. Winfree's Exhibits 5 through 11.

EXAMINER STOGNER: Exhibits 5 through 11 will be admitted into evidence at this time.

MR. KELLAHIN: That concludes my examination of Mr. Winfree.

EXAMINER STOGNER: Thank you, Mr. Kellahin.

Mr. Stonestreet, your witness.

EXAMINATION

BY MR. STONESTREET:

Q. Who picked the location of this Number 2-23 well?

A. I don't know if I know of all the people that were involved in the location.

I know Doug Seams was involved and Markus Thomerson.

That's the best that I can answer to my knowledge.

Q. Are you afraid that going to the northeast, then, this Wolfcamp section is going to thin out insofar as porosity is concerned?

A. I really don't have any opinion about the variation of thickness in any particular part of the section, because I have no data, and anything I say there would be pure speculation.

However, we will talk about the location more when Mr. Seams testifies.

Q. This map indicates there's about 78 feet in the 1-23, in the "A" zone; is that --

A. That's correct.

Q. -- is that correct?

Could you have brought this location closer, or did you have to go that far up in the north part of Section 23 to conform with the State rules and regulations, or

could you have brought it closer to the 1-23?

A. Again, I don't know all the details here, but I would like to try to answer your question.

We did move the location because of some archeological sites.

But again, we'll give you more detail on that in further -- later testimony.

Q. Would you feel more comfortable if you moved it closer to the 1-23, as far as you could, based on the state regulations?

A. As I said before, any change in that location is equivalent to me, because I can't speculate about what the thickness is going to be at any one given point, relative to another.

Q. Did you use any data from your 3-D seis to do these isopachs?

A. No.

Q. You didn't use any data, huh?

EXAMINER STOGNER: I'm sorry, I didn't hear the answer.

THE WITNESS: The answer was no.

Q. (By Mr. Stonestreet) When the seis was done, did they know ahead of time that you couldn't get a good picture of the Wolfcamp?

A. I don't know that.

MR. STONESTREET: That's all, thanks.

MR. KELLAHIN: No.

EXAMINATION

BY EXAMINER STOGNER:

Q. The well to the south in Unit M of Section 23, that's presently producing from Wolfcamp "A"; is that what I understand?

A. The El Paso Number 1-23 Federal in the southwest of 23?

Q. Yes, sir.

A. Yes, that is currently completed in the "A" zone.

Q. Okay, but it was initially completed in the "B" zone --

A. Right.

Q. -- and how long did it produce from the "B" zone?

A. I don't know that exact number, but it was not a long time.

Q. How was the "A" sand of the Wolfcamp -- Do you have any idea how that was stimulated?

A. No, I do not.

EXAMINER STOGNER: Okay. I have no other questions of this witness.

You may be excused.

MR. KELLAHIN: Mr. Examiner, at this time we would call Doug Seams.

DOUG SEAMS,

the witness herein, after having been first duly sworn upon his oath, was examined and testified as follows:

DIRECT EXAMINATION

BY MR. KELLAHIN:

Q. Mr. Seams, for the record would you please state your name and occupation?

A. My name is Doug Seams. I'm a reservoir engineer employed by Burlington Resources in Midland, Texas.

Q. On prior occasions, Mr. Seams, have you testified as an expert in reservoir engineering in the State of New Mexico?

A. Yes, I have.

Q. And as part of your duties as a reservoir engineer, have you worked with Mr. Winfree and others to develop this prospect that is now known as the El Paso 23 Federal Well Number 2?

A. Yes, I have.

Q. In addition, have you prepared engineering calculations and reached engineering conclusions concerning the appropriate risk factor penalty to apply in this case?

A. Yes, I have.

MR. KELLAHIN: We tender Mr. Seams as an expert reservoir engineer.

EXAMINER STOGNER: Mr. Seams is so qualified.

Q. (By Mr. Kellahin) Mr. Seams, let's talk about the parts of your technical work. First of all, in order to aid Mr. Winfree and Burlington to determine how big a reservoir you have here, have you gone through the conventional reservoir calculations and databases to determine what you project to be the actual and estimated ultimate recoveries for these Wolfcamp wells in this area?

A. Yes, I have gone through all the Wolfcamp wells in this area and estimated their ultimate recoveries.

Q. In order to depict that as an illustration, have you created what I'd call a bubble map?

A. I have.

Q. All right, let's do that. Let's go to Exhibit 12. When we look at the red circles on Exhibit 12, have you confined your calculations to just the Wolfcamp "A", or does it include all Wolfcamp production from that well?

A. Mr. Examiner, the bubbles on this map represent all Wolfcamp zones. And of course, the larger the bubble the larger would be the EUR. And the EUR would be noted there, just to the right of the circle.

Q. Obviously, these wells don't drain in circles; it's simply a depiction, if you will, to give the Examiner a sense of the relative relationship of the size of the drainage areas; is that not true?

A. This is true.

Q. All right. Give us a sense of what you're seeing in the estimated ultimate recoveries here in relation to the Wolfcamp pay interval in the "A"?

A. Mr. Examiner, as you take a look at this bubble map, the average -- or the estimated recoveries vary anywhere from 32 million, there kind of the left in the Federal BF Com Number 1, all the way up to 3.2 BCF there in the Phantom Draw Unit Number 1 there to the right.

Now, if you look at just the "A" recovery in our El Paso 23 Federal Number 1, that's going to be 1.6 BCF in that particular well.

Q. Describe for us how you determine an estimated ultimate recovery for these wells.

A. I determine the estimated ultimate recovery through these wells using decline-curve analysis, and most of these wells were in probably the last 10 percent of their reserve life, so the bulk of that number is actual cumulative production, so there's very little actual forecasting added to that.

Q. When we look at the well in the southwest of 23, the closest offsetting producing well, how did you forecast your ultimate recovery on that well?

A. We did actually forecast the reserves on the El Paso 23 Federal Number 1 in a different way. We obtained the initial pressure buildup on that well after completing

the well, and then about three to four months down the line, after a period of sustained production, we got another pressure buildup to where we saw an actual pressure depletion throughout the reservoir. And then being able to extrapolate that fresh completion versus the amount of gas that we produced, we can estimate that that well will produce about 1.6 BCF out of the "A" zone in the Wolfcamp in the El Paso 23 Number 1 well.

Q. All right. Are you satisfied that that's an accurate and reliable way to forecast an EUR for a well like this?

A. I am. And in fact, the current well rates probably reflect that.

Q. All right. Now you know you've got the potential to recover 1.6 BCF. The next challenge is to figure out, using certain assumptions, what the likely drainage area would be. Do you have a drainage map?

A. Yes, I do.

Q. Let's turn to Exhibit 13 and look at that.

In addition, before we look at how this is illustrated, let's look at Exhibit 14, which shows the Examiner how you went about the calculation.

A. Yes, Exhibit 14 shows the way that I estimated the drainage area for each one of these wells. And what I did was, I took the estimated ultimate recovery for each

one of these wells and then divided it by the porosity and the height of the pay zone, the gas saturation, and then a function of the initial gas formation volume factor minus a function of the final gas formation volume factor.

And as you look at the inputs there in the middle of the page, you can see a couple notables that I use, such as an initial reservoir pressure of 9200 pounds and a final abandonment pressure of 500 pounds.

This particular calculation on the bottom of the page is based on the El Paso 23 Number 1 in the "A" zone of the Wolfcamp, which calculates out to 67 acres.

Q. In addition, to show the Examiner the specific details of the drainage circle map on 13, you have a supporting document that's marked 15?

A. Yes.

Q. Let's look at Exhibit 15 and have you show us the specific values in the actual information.

A. Exhibit 15 is the actual calculations through a spreadsheet on what the drainage areas are. The well names are listed there on the left, followed by the originating company. And some other interesting facts there would be the IP, and then the EUR, and then the producing zone in the Wolfcamp, and then the feet of pay and the average porosity.

One thing to note, Mr. Examiner, is, on the

drainage areas, is the wide variance of the drainage areas in here, which is also indicative of a fractured, very heterogeneous-type reservoir.

Q. Let's take an example here. Let's look at the second well down on this spreadsheet, the Phantom Draw 21, Texas Pacific well.

A. Yes.

Q. Where is that well on Exhibit 13?

A. The Phantom Draw 21 Number 1 has a drainage area of 149 acres and is located over on the right-hand side of the drainage-area map near the bottom.

Q. All right, it's in Section 20, it's in the southwest of 20?

A. It's in the southwest of Section 20.

Q. All right. You read over, its initial potential was -- what, 10 million a day?

A. Yes.

Q. 10.5 million a day?

A. Yes.

Q. And as you run through the calculation, you had calculated an EUR of what? 3.2 BCF?

A. Yes.

Q. It's out of the "B" zone, you give it 30 feet, and its drainage area is only 149 acres?

A. That's correct.

Q. Is there a relationship -- Well, let's look down at another one, the El Paso 23-1, the one you just described, which is the fourth well down, has an IP of 2.5 million, EUR of 1.6 BCF, and the "A" zone was 60 feet, and its drainage area is only 67 --

A. That's true.

Q. -- acres. What accounts for this, Mr. Seams?

A. Well, the wide divergence in drainage areas is caused by the type of reservoir that we're producing in, and this reservoir is fractured not throughout the reservoir but only in patches, and is very laterally and vertically heterogeneous. So these drainage areas will vary upon the extent that the porosity is present.

Q. Do you have an opinion as to where it is economically practical to explore for Wolfcamp production in this area with further vertical wells?

A. We've done extensive work on that, and we do not see it economically practical to continue development of this field with vertical wellbores.

Q. How have you recommended and how has Burlington decided to explore for Wolfcamp production in this area?

A. We recommend exploring the Wolfcamp in this area using horizontal extensions.

Q. Has anybody yet to do that here in the Wolfcamp, in this portion of the Wolfcamp area?

A. No, they haven't. We would be the first.

Q. Let's turn to 16 and have you illustrate for the Examiner using this cartoon how you think you want to go about doing this.

A. Mr. Examiner, what we propose is that we will take a vertical drill well, and we will drill a vertical section through the Wolfcamp "A" zone, and during that we'll core that pay zone. We'll then take that core to the surface and we'll determine fracture azimuth.

Once we determine fracture azimuth, we'll then orient two 1000-foot horizontal extensions perpendicular to those fracture azimuths. Now, these horizontal extensions won't be true horizontal; they'll be between 84 and 87 degrees off of the vertical scale, or off of the vertical plan. So actually we'll start at the top of the Wolfcamp "A" zone, and we'll terminate 1000 feet later at the base of the Wolfcamp "A" zone.

Q. The process would be to drill one lateral, and then you come back and drill the other one?

A. Yes, we will. We'll do the vertical well, look at the core, get the fracture azimuth, drill the first lateral and then come back and drill the second lateral.

Q. Okay. The hope, then, would be to access more of the Wolfcamp reservoir, connect the fracture system and open up a potential drainage contribution area that would

be larger than available to a conventional vertical well?

A. Yes, it is.

Q. Do you have an illustration that shows the potential comparison of drainage areas between a vertical and a horizontal well?

A. I do.

Q. Let's look at Exhibit 17 and have you identify and describe that exhibit.

A. Mr. Examiner, shown on Exhibit Number 17 at the top is an estimated drainage area of the El Paso 23 Number 1 in the Wolfcamp "A" zone. That represents 67 acres. And with a 67-acre drainage area, if it was circular, it would be 964 feet at the radius.

Q. All right, we've already got that information shown on Exhibit 15, and you've simply taken the radius for a 67-acre drainage circle?

A. Yes, I have.

Q. All right. Is it appropriate engineering methodology to apply that drainage distance from a vertical well to a horizontal wellbore?

A. Yes, it is.

Q. And so have you done that?

A. I have. Located in --

Q. The resulting calculation shows an expectation of a larger drainage area?

A. Yes, it does.

Q. And what doe the calculation conclude?

A. The calculation shows that we can increase the drainage area from 67 in a vertical well to 156 total acres of drainage in a horizontal application.

Q. This is where you get your potential 3.7 BCF for the horizontal well?

A. Yes.

Q. All right. Let's go to the cost comparisons involved. One of the things the Examiner must do is make a judgment that your proposed AFE is fair and reasonable before he assesses those amounts against any nonconsenting interest owner. To demonstrate that comparison, let's have you turn to Exhibit 18A and identify and describe what you're showing.

A. 18A is a cost estimate for a vertical Wolfcamp well. Now, this vertical Wolfcamp well would penetrate all of the available Wolfcamp pay zones, the "A", the "B" and the "C", and has a total cost estimate to drill, complete and equip of $1.7, just shy of that.

Q. When we turn over to Exhibit 18B, what is your forecast of the estimated cost of a directional well with the two laterals?

A. It's just under $2 million, $1.987 million.

Q. Okay. How can you drill a directional well with

two laterals that's only $340,000 more than a conventional vertical well in the Wolfcamp.

A. The convertical well --

Q. Yeah.

A. The conventional vertical well in the Wolfcamp is very expensive and slow drilling through the Wolfcamp. Hence the costs rise considerably.

If we limit that to drilling just to the top of the Wolfcamp "A" and drilling our horizontals within the porosity section of the Wolfcamp "A", our time is greatly reduced. Hence, it's not much more expensive than a vertical well.

Q. Let's go to the comparison of the economics, then. If you'll turn to Exhibit 19, identify and describe here what you're concluding.

A. Mr. Examiner, this is a spreadsheet showing the difference in economics between a vertical Wolfcamp well and a horizontal application, where you can see the gross investment for the vertical well is $1.7 million, unrisked reserves of 1.8 BCF. That's a combination of 1.6 BCF in the Wolfcamp "A" and about 200 million in the lower zones.

We have a negative rate of return on the vertical prospect and, you know, of course a negative net present value.

If you look at the horizontal well, it has just

under a $2-million cost where we'll recover -- have unrisked reserves of 3.7 BCF as positive economics of a 24-percent rate of return and a discounted profit-to-investment ratio of 10 percent.

Q. Is this the kind of analysis, then, that was given to Mr. Gallegos from which Burlington concluded that in order to negotiate with uncommitted interest owners, you were not able to offer better terms than keeping a 78-percent NRI?

A. Yes, it was.

Q. Even despite this effort to try to produce Wolfcamp gas with this directional multilateral well, does that reduce the risk?

A. No, it does not.

Q. In terms of the penalty the Division is allowed to award, the maximum is cost plus 200 percent. Do you have an engineering opinion as to what the appropriate penalty should be in this case?

A. The appropriate penalty on this project should be cost plus 200 percent.

Q. Describe for us why you support that opinion.

A. I support this opinion for several different reasons.

Number one, we're going to be the first operator in the area drilling horizontals in a Wolfcamp that has

high reservoir pressure of 9200 pounds.

The second reason is geologically, is, we stand a chance of having a high risk of even finding the gross lime. And then once we find the gross lime, we have the reservoir characteristics within it of having the permeability and porosity present.

So we have three levels of risk which form together to be a very high level of risk for this prospect.

Q. Let's turn to Exhibit 20 and have you identify and describe what we're seeing here.

A. The top page on Exhibit 20 is a seven-day letter from the BLM showing their acceptance of our application of the APD, and then following that is our completed APD, which is currently residing with the BLM.

Q. Mr. Stonestreet asked a question a while ago about why this well is located where it is. Let's use this as an illustration. If you'll turn to page 3 of Exhibit 20, there is a survey plat that gives you a point of reference as to how you might have an opportunity to put the laterals into this producing window allowed pursuant to the Division Rules 111?

A. Yes.

Q. All right, what's the strategy?

A. The strategy here was to place the well as close as possible to the center of that applicable window. We

did have to move the well several times in different locations in order to avoid both archaeologically sensitive sites and some environmentally sensitive sites.

Q. Turn to the next page, which is page 4. It gives you a wellbore diagram. Again, summarize for us how you propose to do this.

A. We propose to drill the vertical well, set casing on top of the Wolfcamp. We'll then drill with a core down through the Wolfcamp "A" pay zone, determine that fracture azimuth, and then orient our horizontal extensions perpendicular to that.

We'll drill one extension 1000 feet, and then we'll come in and drill the second extension 1000 feet, 180 degrees opposed to the first. And then we'll complete the well, either through natural process or using an acid stimulation.

Q. Finally, let's turn to Exhibit 21 and have you use this illustration to show us how you will abide by the setback requirements of a directional wellbore approved pursuant to Rule 111.

A. Yes, the actual position of this well is going to be 1120 feet from the north line, 2630 from the east line. And as you can see, I have highlighted the 320-acre north-half gas proration boundary.

Within that is a window that's 650 feet [*sic*]

from both the east and the west lines and 660 feet from the north and the south lines, which is the window that our horizontal well must reside within. We cannot go outside of that window.

Q. As a reservoir engineer, do you see that the proximity of this location to the El Paso Natural well in the southwest of 23 diminishes your risk?

A. No, it does not.

Q. Mr. Stonestreet made a point of looking at the AFE, and it had been characterized as a development well. In reflection, when you look at all this information, is this a conventional development well?

A. No, it is not.

Q. And why would it not be?

A. There is -- As I referred to, there's really three large elements of risk.

You have the mechanical, you have the geological risk from finding the gross lime, and then you have the reservoir risk of finding porosity and permeability within that gross lime.

Q. Okay. Do you have an engineering opinion as to whether approval of this Application with your requested penalty factors would be appropriate?

A. Yes, it will be.

MR. KELLAHIN: All right. That concludes my

examination of Mr. Seams.

We move the introduction of his Exhibits 12 through 21.

EXAMINER STOGNER: Exhibits 12 through 21 will be admitted at this time.

Thank you, Mr. Kellahin.

Mr. Stonestreet, your witness.

EXAMINATION

BY MR. STONESTREET:

Q. Exhibit 19 uses the term "unrisked reserves". What does that mean?

A. Unrisked reserves is the target that we see if we capture the zone that we hope to find.

Upon that you would, of course, use additional risk factors, depending on if you're able to find that zone.

Q. Do you really mean there's no risk here? Is that what "unrisked" means?

A. Oh, absolutely not.

Q. It's a term with which I'm not familiar. That's why I was wondering.

A. When you heard Keith Winfree's testimony earlier, part of the process that we went through is, he said, If I could find you a certain type of rock with this type of porosity, what type of reserves would that have in it?

That would be the unrisked reserves.

MR. STONESTREET: No further questions, thank you.

THE WITNESS: Okay.

EXAMINATION

BY EXAMINER STOGNER:

Q. Your Exhibit Number 20, has this been approved by the BLM Office in Roswell, this well location?

A. No, it hasn't. We're expecting approval either late this week or early next week.

We have gotten verbal approval from Mr. Gum in the Artesia Office.

Q. And that was essentially for the C-102, your directional drilling portion of the Application?

A. Yes.

Q. On your drilling well cost estimate, is there a cost in there or an estimated cost as far as wellbore stimulation?

A. Yes, there is.

Q. And where is that?

A. If you'll look at -- Let's take a look at the horizontal well cost estimate. The first page would be the actual drilling cost estimate, the next page would be the drilling time --

Q. Okay, okay.

A. -- and the following --

Q. What exhibit are you looking at?

A. I'm looking at Exhibit Number 18B.

Q. Exhibit Number 18B.

A. If you'll flip back to the fourth page, there's one called "Well Cost Estimate Completion". Listed there, just down from the middle of the page, called "Stimulation" we have $33,300 estimated for the stimulation cost for this particular well.

Q. And what's that going to entail?

A. What we currently have planned is, we're going to run into each horizontal wellbore with tubing and acidize as we're pulling the tubing out of the hole so we can effectively stimulate the entire section.

Just above that you see "Swabbing and Coiled Tubing", Mr. Examiner? That's the coiled-tubing part of that acid job.

Q. In a vertical wellbore, is this well stimulation cost normally passed on through the well cost estimate and to the parties that are being force-pooled?

A. Yes.

Q. And that would be fracturing, acidizing, other normal -- what you consider normal stimulations?

A. Yes, these wells are typically acidized.

Q. After you've drilled your cored area -- that's

the vertical portion --

A. Yes.

Q. -- will that portion of the wellbore remain open?

A. We'll cement that off, and we'll do that for two reasons, is, there's some pressure considerations with having that part of the formation open.

And then, two, we'll need something to physically use to kick off of with our whipstock, to start the horizontal process.

EXAMINER STOGNER: Any other questions of this witness?

You may be excused.

Mr. Stonestreet --

MR. STONESTREET: Uh-huh.

EXAMINER STOGNER: -- do you have anything at this time that you would like to present?

MR. STONESTREET: No.

EXAMINER STOGNER: Do you have any closing statements or anything that you would like to --

MR. STONESTREET: Well --

EXAMINER STOGNER: And I believe Mr. Carroll has some questions here of you, though.

THE WITNESS: Okay.

EXAMINER STOGNER: Let's have that out of the way first.

HARDEMAN L. STONESTREET,

the witness herein, after having been first duly sworn upon his oath, was examined and testified as follows:

EXAMINATION

BY MR. CARROLL:

Q. Mr. Stonestreet, what is Tureck Energy, Inc.?

A. Tureck, that's a company by which we had financed some property through a bank in London, and they were - and Tureck is the agent for that bank.

That bank -- I don't think under federal law that they could get the money, so they had to have another company to pay rather than to bank directly. I'm really not certain about all of this stuff.

Q. But you don't own an ownership interest in Tureck Energy?

A. Oh, no.

Q. And what exactly is your position with KP and Kerry?

A. I'm a senior vice president with Kerry and vice president with KP.

Q. Do you have an ownership interest in each too?

A. I do not.

MR. CARROLL: That's all I have.

EXAMINER STOGNER: Thank you, Mr. Carroll.

You may have your statement at this time, Mr.

Stonestreet.

MR. STONESTREET: There are several reasons why we don't want to join in this well, and as I mentioned in my letter to all of you, that in past -- I've been with Kerry since 1980, since we formed the company, and during that period of time we acquired a bunch of property in New Mexico, Eddy County, particularly.

And one of the wells we acquired was the Federal 1-23, a part interest in it, a little interest in it. And for maybe two or three or four months, shortly, why, we were getting funds.

And then later on we weren't getting anything, and the operating expenses were up. This was when it was Meridian Oil. Had a whole bunch of companies, El Paso, Meridian, Meridian Oil and Trading Company, whatever.

And I talked to people down -- I wrote letters to Houston, Forth Worth, talked with them. I said, The operating expenses are running a lot more than the gross value of the gas being produced in the well. I said, This is a noncommercial well; let's flood the sucker.

And I got no response from anybody, and it kept going on and on. Finally we quit paying our operating expenses and -- It went on for years.

And the next thing we knew, they wanted to go in there and rework that well. And we didn't want to mess

with it anymore, so we just signed our interest to them. That's why we're not in the 1-23.

Our problem is that the -- is the whole company. They don't want to cooperate, they won't negotiate. You do it their way, or it's no way. And that's my problem.

And worse, they're trying to rely on the Commission, Division here, to save them on -- from all this stuff.

That's it.

EXAMINER STOGNER: Thank you, Mr. Stonestreet.

Mr. Kellahin?

MR. KELLAHIN: To his last point, the testimony has been -- Let me put it succinctly for you.

I'm disappointed that Mr. Stonestreet didn't stay in that El Paso well, because had he waited it out, it was recompleted and it now produces at 2.5 million a day. There was an opportunity there that he let pass that is a disappointment, I'm sure, to him.

Be that as it may, it's not relevant to the case before you, which is an opportunity for him to participate in this well.

Mr. Gallegos has told you that all the interest owners, with the exception of these four, have signed to participate. They want to pay their share. They've signed an operating agreement. Mr. Stonestreet has another

position, another point of view.

Mr. Gallegos gave him his first and his best offer. They are apart. It's a disappointment that they can't agree, but they cannot, and we have no recourse but to ask you to enter a pooling order in this case.

These are the circumstances that require and invite such an order when the parties cannot agree, and we think this is one of those cases.

Thank you, Mr. Examiner.

EXAMINER STOGNER: Thank you.

(Off the record)

At this time I will take Case Number 11,837 under advisement.

(Thereupon, these proceedings were concluded at 12:50 p.m.)

* * *

I do hereby certify that the foregoing is a complete record of the proceedings in the Examiner hearing of Case No. 11837, heard by me on 21 August 1997.

, Examiner
Oil Conservation Division

CERTIFICATE OF REPORTER

STATE OF NEW MEXICO)
) ss.
COUNTY OF SANTA FE)

I, Steven T. Brenner, Certified Court Reporter and Notary Public, HEREBY CERTIFY that the foregoing transcript of proceedings before the Oil Conservation Division was reported by me; that I transcribed my notes; and that the foregoing is a true and accurate record of the proceedings.

I FURTHER CERTIFY that I am not a relative or employee of any of the parties or attorneys involved in this matter and that I have no personal interest in the final disposition of this matter.

WITNESS MY HAND AND SEAL August 26th, 1997.

STEVEN T. BRENNER
CCR No. 7

My commission expires: October 14, 1998