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

IN THE MATTER OF THE APPLICATION OF
McELVAIN OIL & GAS PROPERTIES, INC.
FOR COMPULSORY POOLING,
RIO ARRIBA COUNTY, NEW MEXICO — CASE NO. 12,635 *De Novo*

Consolidated with:

IN THE MATTER OF THE APPLICATION OF
D. J. SIMMONS, INC. FOR COMPULSORY POOLING,
RIO ARRIBA COUNTY, NEW MEXICO — CASE NO. 12705

D.J. SIMMONS, INC.'S HEARING MEMORANDUM

D.J. Simmons, Inc., ("Simmons"), through its counsel, submits this memorandum of points and authorities for consideration by the Commission in conjunction with the November 6, 2001 hearing on these consolidated applications. This memorandum addresses two points: (1) The use of the Division's powers to force-pool interests for purposes not authorized by the compulsory pooling statute; and (2) the applicable standards of "diligence" and "good faith" that an operator must meet in its efforts to obtain the voluntary participation of other interest owners as a pre-condition to filing a compulsory pooling application.

INTRODUCTION

McElvain Oil and Gas Properties, Inc., ("McElvain"), initiated this force-pooling proceeding on November 10, 2000 when it sent a perfunctory and uninformative well proposal to Simmons, followed by the filing of an Application for Compulsory Pooling on March 15, 2001 seeking to pool the **SE/4** of Section 25, T-25-N, R-3-W to create a

320 acre **S/2** lay-down spacing unit for the re-entry and re-completion of its Naomi Com No. 1 well. McElvain's application is unnecessary because it already owns 100% of the oil and gas leases underlying the **W/2** of Section 25, and is free to dedicate that acreage to its well located at an unorthodox location 450' from the west line in the **SW/4** of the section. McElvain proposes to re-complete its well in the Blanco-Mesaverde pool only; it has no plans to develop the Gallup-Dakota reserves underlying the **SE/4**. McElvain's proposal to ignore its pre-existing **W/2** unit and instead initiate compulsory pooling proceedings to dedicate a **S/2** unit to its well makes little sense and is contra-indicated by the known geology and the prevailing north-south drainage patterns in the area. Moreover, McElvain's proposal would disrupt and likely prevent the further development and recovery of Blanco-Mesaverde and Gallup-Dakota reserves in the remainder of the section.

Simmons opposed McElvain's application for the reasons, among others, that given the availability of a pre-existing **W/2** unit, the compulsory pooling proceedings would result in the unnecessary expenditure of time, effort and legal expense. McElvain's force-pooling effort would also interfere with Simmons's plans to dedicate an **E/2** unit to the drilling of its Bishop 25-1 No. 1 well by which it proposes to evaluate both the Blanco-Mesaverde and Gallup-Dakota formations.

At the May 17, 2001 examiner hearing on its Application, McElvain's motives were made clear: During cross-examination, all of McElvain's witnesses admitted that the reason they weren't dedicating their 100% owned **W/2** unit to the well and were instead asking the Division to force-pool the **SE/4** of the section for a **S/2** unit was to require others to bear the costs of their operation. As was said during the hearing,

McElvain is using the Division's compulsory pooling process as a tool for "mitigating its risk". (See Excerpts from May 17, 2001 Hearing Transcript, Ex. "A", attached.) In other words, by forsaking its pre-existing stand-up spacing unit and forcing the interest owners in the **SE/4** of the section into a lay-down **S/2** unit, McElvain was engaging in a risk-mitigation scheme: same well, same location, but at a fraction of the cost to it. According to McElvain's witnesses, this was the "primary" reason for force-pooling the other interest owners.

1. The Use of the Compulsory Pooling Statute for purposes of "Risk-Mitigation" is Impermissible.

McElvain's invocation of the compulsory pooling statutes[1] for the purpose of mitigating its economic risk is an abusive and impermissible use of the Division's police powers. McElvain can point to no provision in those statutes that authorizes the Division to utilize risk mitigation as a basis for the forced-pooling of a third party's property interests. Indeed, no such provision exists, either express or implied, under even the broadest reading of the law.[2] An examination of the language of the Oil and Gas Act ("the Act") demonstrates that McElvain's application is inappropriate because it requests the Commission to act beyond the scope of its statutory authority. "The starting point in every case involving the construction of a statute is an examination of the language utilized by [the legislature] when it drafts the pertinent statutory provisions. *State v. Johnson*, 2001-NMSC-001, P.6, 15 P.3d 1233 (2001) quoting *State v. Wood*, 117 N.M. 682, 685, 875 P.2d 1113, 1116 (Ct. App. 1994). "When a statute contains language which is clear and ambiguous, we must give effect to that language and refrain from

[1] NMSA, 1978, §§ 70-2-17 and 70-2-18

further statutory interpretation." *Id.* quoting *State v. Jonathan M.*, 109 N.M. 789, 790, 791 P.2d 64, 65 (1990). "The Oil Conservation Commission is a creature of statute, expressly defined, limited and empowered by the laws creating it." *Santa Fe Exploration Co. v. Oil Conservation Comm'n*, 114 N.M. 103, 113, 835 P.2d 819, 829 (1992) quoting *Continental Oil Co. v. Oil Conservation Comm'n*, 70 N.M. 310, 318, 373 P.2d 809, 814 (1962).

The Act gives the Oil Conservation Commission ("the Commission") and the Oil Conservation Division ("the Division") two major duties: the prevention of waste as well as the protection of correlative rights. *Id.* citing NMSA 1972, §70-2-11(A); *Continental Oil Co.*, 70 N.M. at 323, 373 P.2d at 817. Correlative rights are defined as:

> The opportunity afforded . . . to the owner of each property and a pool to produce without waste his just and equitable share of the oil . . . in the pool being an amount, so far as can be practicably determined and so far as can be practicably obtained without waste, substantially in the proportion that the quantity of recoverable oil . . . under the property bears to the total recoverable oil . . . in the pool and, for such purpose, to use his just and equitable share of the reservoir energy.

NMSA 1978, §70-2-33(H). In addition to its ordinary meaning, waste is defined as "the locating, spacing, drilling, equipping, operating or producing, of any well or wells in a manner to reduce or tend to reduce the total quantity of crude petroleum oils . . . ultimately recovered from any pool." NMSA 1978 §70-2-3 (A).

Additionally, in NMSA 1978, § Section 70-2-17 (C), the New Mexico Legislature has specified the circumstances where the Division is authorized, not mandated, to exercise its compulsory pooling powers. That authority is limited to the following circumstances:

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[2] The non-consent risk penalty provision of Section 70-2-17(C) is entirely separate and wholly inapplicable to a discussion of the basis and extent of the Division's authority to force pool working interests.

- Where there are two or more separately owned tracts within a spacing unit;
- One of the owners who has a right to drill proposes to drill on the unit to a common source of supply.

If the separate owners have not agreed to pool their interests, the Division or Commission is mandated to pool interests ***only*** in the circumstance where:

- The Division of Commission finds pooling is necessary to:
- - avoid the drilling of unnecessary wells,
- - protect correlative rights, or
- - to prevent waste.

NMSA 1978, ss70-2-17(C).

The mitigation of risk is not included within the enumerated circumstances where the compulsory pooling authority may be invoked. Moreover, the Commission is constrained from reading such a provision into its authority. "The Oil Conservation [Division] is a creature of statute, expressly defined, limited and empowered by the laws creating it." *Continental Oil Co. v. Oil Conservation Commission*, 70 N.M. 310, 318, 373 P.2d 809, 817 (1962). Instead, the Commission is obliged to follow the "plain meaning" of the statute. This plain meaning rule, is a guideline for determining legislative intent. *Johnson, 2001-NMSC-001, P.6,* citing *Junge v. John D. Morgan Constr. Co.*, 118 N.M. 457, 463, 882 P.2d 488, 54 (Ct. App. 1994). It is actually the responsibility of the court or in this case, the Commission, to search for and effectuate the purpose and object of the underlying statutes. *Id.* citing *State ex rel. Helman v. Gallegos*, 117 N.M. 346, 353, 871 P.2d 1352, 1359 (1994). Additionally, statutes should be harmonized and construed together when possible, so that the achievement of their goals is facilitated. *Id.* citing

State ex rel. Quintana v. Schneder, 115 N.M. 573, 575-76, 855 P.2d 562, 564-65 (1993). Further, "statutes must be construed so that no part of the statute is rendered surplusage or superfluous." In *Re Rehabilitation of W. Investor's Life Ins. Co.*, 100 N.M. 370, 373, 671 P.2d 31, 34 (1983).

More importantly the Commission may be in violation of the principal of separation of powers if it grants the McElvain's application because, "an unlawful conflict or infringement occurs when an administrative agency goes beyond the existing New Mexico statutes or case law it is charged with administering and claims the authority to modify this existing law or to create new laws on its own." *State ex rel. Sandel v. New Mexico Public Utility Commission*, 1999-NMSC-19, P.12, 980 P2d 55. When reading the language of a statute and attempting to ascertain and give effect to the intention of the legislature, the language of the statute must be considered as a whole; however, a literal reading must give way to a reasonable construction when the literal reading leads to injustice, absurdity, or contradiction. *State v. Romero*, 2000-NMCA-029, P.27, 999 P.2d 1038.

It would be absurd to think that the Act was enacted in order to mitigate the economic risk of parties like McElvain. It is not the function of the Commission to make it more economically and financially lucrative for McElvain to operate its unit. McElvain's use of the Division's processes and the compulsory pooling statutes as a means to reduce its economic risk is wholly outside the agency's statutory authority. Risk mitigation is a complete misapplication of the law and should not be allowed. Were it to grant McElvain's application, the Commission would be acting in excess of its clearly delineated authority and will be in violation of the separation of powers doctrine.

The Commission should put all operators on notice by way of specific findings in an order stating that the use of the compulsory pooling process for such unauthorized purposes shall not be permitted.

2. The Applicable Standards of Diligence and Good Faith.

McElvain has approached this proceeding as if the granting of a compulsory pooling order were its entitlement. In so doing, it has failed to make a good faith effort to obtain an agreement for the voluntary participation of Simmons.

As McElvain would have it, under the compulsory pooling statute, an operator need do nothing more than appear at a hearing and show (1) it has the right to drill, (2) that there are two or more interest owners in a spacing unit, (3) that the owners have not agreed to pool their interests, and (4) it made a well proposal to the other owners, as perfunctory as that effort might have been.

Under NMSA 1978, §70-2-18(A), an operator proposing to dedicate separately-owned lands to a proration unit has an "obligation" to negotiate a voluntary agreement with the other interest owners to pool their lands. The Division and the Commission require operators to show that they have made a "diligent" and "good faith" effort to negotiate a voluntary agreement before a compulsory pooling application may be filed.[3]

The historic treatment by the agency of its compulsory pooling powers is revealing: The first compulsory pooling orders made by the Commission were made with some reluctance. In many instances, the Commission ordered pooling but further ordered that a continuing effort be made to secure the consent of all the interests involved. Morris, Richard, *Compulsory Pooling of Oil and Gas Interests in New Mexico*, 3 Nat.

[3] Indeed, the "good faith" requirement has been expressly codified in the compulsory unitization procedures of the Statutory Unitization Act at NMSA 1978, §70-7-6-A(5).

Resources J. 316 (1963). (Exhibit B, attached.) After a few cases had been decided, the Commission adopted the attitude toward compulsory pooling that still remains today. In each case there is an inquiry concerning the efforts made by the operator to secure the consent of the interests being pooled. The reasonableness of the offer may also be questioned. Morris, Richard, *Compulsory Pooling of Oil and Gas Interests in New Mexico*, 3 Nat. Resources J. 316, 318 (1963). The Commission continues to recognize the importance of good faith efforts to negotiate before commencing compulsory pooling actions, and uses it as one criterion to determine if the application will be accepted or denied.

While the parameters of what constitutes a "good faith" effort have not been precisely defined in any order of the Commission or the Division, or in any reported court decision, the procedure of compulsorily pooling the interests of landowners in order to drill wells is strikingly analogous to the procedure of eminent domain, where one, who seeks to invoke the state's police power of eminent domain, can condemn or expropriate private lands for public use. Both compulsory and eminent domain dramatically effect the rights landowners have in their land, and both compel the landowner into an action that was not of his/her own desire. One of our most basic liberties is the right to property, and it must be guarded. Actions like eminent domain and compulsory pooling must be carefully scrutinized. Enforcing a good faith effort to negotiate is one way the Commission and the courts can slow the imposition on private citizens' rights to property. While eminent domain dissolves all rights of the property owner, its procedure and effect are very similar to the action of compulsory pooling, and can shed light on the proper procedure of conducting these acts in accordance with the right to property.

Eminent domain is the power of a government entity to take private lands and convert them for public use, with just compensation. Eminent domain is liberally interpreted in New Mexico. *Landavazo v. Sanchez*, 111 N.M. 137, 140, 802 P.2d 1283, 1286 (1990). The decision of the grantee of the power of eminent domain as to the necessity, expediency, or propriety of exercising that power is political, legislative, or administrative and its determination is conclusive and not subject to judicial review, absent fraud, bad faith, or clear abuse of discretion. *Id.* at 140, 1286; *North v. Public Service Co. of New Mexico*, 101 NM 222, 680 P.2d 603 (N.M. App. 1983). While eminent domain is not often subject to the judicial review, it is expressly subject to the courts supervision when it has been exercised in bad faith, or when one has exercised the power and has failed to make a good faith effort to negotiate with landowners commencing the action. NMSA 1978 § 42-A-1-4A states, "A condemnor shall make reasonable and diligent efforts to acquire property by negotiation." NMSA 1978 § 42-A-1-6A further states "...an action to condemn property may not be maintained over timely objection by the condemnee unless the condemnor made a good faith effort to acquire the property by purchase before commencing the action." (emphasis added). Just as NMSA 1978 § 70-2-1 et. seq. sets out the requirements before commencing compulsory pooling, the eminent domain statutes stress the importance and lay out the requirement of good faith negotiations with the landowners before any further action is taken.

There are many eminent domain cases that analyze good faith efforts in negotiations. "What constitutes a good faith offer must be determined in light of its own particular circumstances." *Unger v. Indiana & Michigan Electric Co.*, 420 N.E.2d 1250, 1254 (Ind. App. 1981). A good faith offer is one where a reasonable offer is made in

good faith and a reasonable effort is made to induce the owner to accept it. Perfunctory offers are not sufficient. *Id.* at 1254 (emphasis added.) In the *Unger* case, the Indiana & Michigan Electric Company, (I&M) did not make a good faith effort to purchase the property of Unger. In that case, I&M failed to form an opinion on the fair market value of the easement they sought to acquire. Similarly, in the present case, McElvain failed to make any reasonable offer in good faith and failed to make an effort to induce Simmons to accept it. Furthermore, McElvain's uninformative proposal was merely a perfunctory offer. Had McElvain in good faith been attempting to persuade Simmons to agree, it would have included all the relevant information in order to achieve that goal.

Similarly, the city of Detroit's offer to purchase land owned by non-interested parties did not constitute a good faith offer in *Matter of Acquisition of Land for Cent. Indus. Park Project*, 338 N.W.2d 204 (Mich. App. 1983). Their offer did not include either lesser of appraised detach-reattach costs of movable trade fixtures or their value in place. Because the city did not include in its offer all relevant elements, the court found that it was not a good faith effort. An offer must be fair and reasonable, not wholly inadequate. *Chambers v. Public Service Co. of Indiana, Inc.*, 335 N.E.2d 781 (Ind. 1976).

The question to be asked in determining whether the condemnor engaged in good faith is whether the condemnor made a good faith effort to acquire the property or rights by conventional agreement before the expropriation suit was filed. *Transcontinental Gas Pipeline Corp. v. 118 Acres of Land, etc.* 745 F.Supp. 366 (1990). In that case, Transcontinental (Transco) negotiated with the defendants on numerous occasions, made numerous offers in proportion to appraisals, and when the negotiations reached a point

where Transco concluded that any further attempt would be useless, stopped. Transco's efforts were found to be in good faith. In the present case, however, McElvain only contacted Simmons once with an inadequate proposal. It did not make any further contacts with Simmons in order to obtain his participation before filing an application for compulsory pooling. Furthermore, McElvain had no indication from Simmons that further negotiations would prove futile. Rather, it was Simmons who initiated further contacts with McElvain, in order to obtain specific geological, engineering, and cost information. Simmons's action of seeking more information gave the indication that it was considering the proposal, and McElvain's failure to follow up before filing its application for compulsory pooling are all evidence of McElvain's lack of a good faith effort to negotiate.

Here, McElvain made only a token, cursory effort to obtain Simmons's participation in its re-completion proposal. On November 10, 2000, McElvain sent a bare-bones proposal to Simmons, but failed to include either a drilling and completion procedure or an AFE, which is a standard part of any proposal. After its November 10th letter, McElvain initiated no further contacts before filing its compulsory pooling application on March 15, 2001. All other contacts were initiated by D.J. Simmons's staff, primarily for the purposes of obtaining specific geologic, engineering and cost information, as well as some justification for a S/2 unit. It was not until the evening before the hearing on its application that McElvain's landman made any effort to initiate a discussion on her own.

These efforts fall far short of the standards that the industry and the Division expect an operator to meet when negotiating for an interest owner's voluntary participation in a well proposal.

CONCLUSION

McElvain invokes this agency's compulsory pooling powers not for the purposes of preventing waste or protecting correlative rights, but simply to reduce its exposure to risk. The Commission lacks the authority to grant such relief. In addition, McElvain has failed to demonstrate adequate diligence or that it made a reasonable, good faith effort to obtain the voluntary agreement of Simmons. For these reasons, McElvain's Application must be denied.

Respectfully submitted.

MILLER, STRATVERT & TORGERSON, P.A.

By _____

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Certificate of Mailing

I hereby certify that a true and correct copy of the foregoing was hand-delivered to counsel of record on the 6th day of November, 2001, as follows:

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_____
J. Scott Hall

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. 12,635
APPLICATION OF McELVAIN OIL AND GAS PROPERTIES, INC., FOR COMPULSORY POOLING, RIO ARRIBA COUNTY, NEW MEXICO	)	

REPORTER'S TRANSCRIPT OF PROCEEDINGS

EXAMINER HEARING

BEFORE: MICHAEL E. STOGNER, Hearing Examiner

May 17th, 2001

Santa Fe, New Mexico

This matter came on for hearing before the New Mexico Oil Conservation Division, MICHAEL E. STOGNER, Hearing Examiner, on Thursday, May 17th, 2001, at the New Mexico Energy, Minerals and Natural Resources Department, 1220 South Saint Francis Drive, Room 102, Santa Fe, New Mexico, Steven T. Brenner, Certified Court Reporter No. 7 for the State of New Mexico.

* * *

EXHIBIT A

I N D E X

May 17th, 2001
Examiner Hearing
CASE NO. 12,635

(Continued...)

Q. Couldn't McElvain have dedicated a west-half unit to the Naomi?

A. That's certainly a possibility, yes, we could have dedicated the west half.

Q. And why didn't it do so?

A. Its choice was based on the fact that it wanted to share the risk of the test, as well as closely identify a drainage pattern for a geologic position as we could. So for those combination of reasons we chose the south half.

Q. Would you agree that by dedicating a west-half unit to the well, which McElvain owns 100 percent of, McElvain could have avoided the administrative, overhead and legal expense associated with this compulsory pooling proceeding?

A. I assume that would have been the case, yes.

Q. As a landman familiar with compulsory pooling proceedings before the New Mexico Oil Conservation Division, can you point to any provision in the compulsory pooling statute that allows risk as a basis for pooling another interest party? In other words, where is it in the compulsory pooling statute that authorizes an operator to seek to mitigate its risk in drilling a well by pooling another interest owner?

A. I would have to defer to our attorney to give me better advice on that. I couldn't tell you specifically.

Q. So you don't know of any such provision in the compulsory pooling statute?

A. I can't tell you that there is or there isn't. I'm not familiar enough with the actual wording within the provision to be able to tell you that, so no.

Q. So the record is clear, you do agree with me that the primary motivation for dedicating a south-half unit to the Naomi well was risk mitigation?

A. Primary could be, yes. Yes.

Q. What is the prevailing spacing pattern for the Blanco-Mesaverde in the area, if you know?

A. I am not aware that there is a prevailing spacing pattern for the Blanco-Mesaverde. I'm not aware that there's much production right here in this specific area, this general vicinity --

Q. Does -- I'm sorry?

A. -- for this particular zone, for Blanco-Mesaverde, I don't think that there has been a pattern established in this immediate vicinity.

Q. Does McElvain offer another Blanco-Mesaverde well scenario?

A. Yes, we do.

Q. And can you tell us, if you know, how those spacing units are oriented to those --

A. I can tell you that some are north-south and some

are east-west. I can tell you they go both ways --

Q. So -- I'm sorry.

A. -- 320-acre north-south in some cases, and 320-acre east west. So there's laydown and standup both.

Q. All right, so geology wasn't necessarily the prime consideration in orienting --

A. Geology is a consideration in each one of them. Geology, land, ability, surface restrictions. There's a lot of different factors that are taken into account in forming the spacing patterns.

Q. Including mitigation of risk?

A. Certainly.

Q. When did McElvain acquire the Kai interest?

A. Recently, in the last week.

Q. All right.

A. We had been negotiating for the purchase of that interest for several months.

Q. Did McElvain acquire the Kai interest for its Gallup-Dakota potential?

A. No.

Q. Did it evaluate the Gallup-Dakota potential in the southeast quarter?

A. That I'm not qualified to answer. I can tell you that we previously had Gallup-Dakota production in the Wynona Number 1 well and it was uneconomic and it was

A. It could.

Q. Have you undertaken a study of any of the literature done evaluating formational fracturing in the Blanco-Mesaverde formation in this area?

A. Not in the Mesaverde. I've looked at in other formations, but not in the Mesaverde.

Q. All right. Do you know that it exists for --

A. Yes, I do.

Q. The Naomi Number 1 in its unorthodox location, in your view, is it better situated to drain reserves from the south half or the west half of Section 25?

A. In my opinion, I would say the south half.

Q. And what's the basis of your opinion?

A. The trend goes east-west on the isopach.

Q. What other data or information would you evaluate to make a determination whether that well would drill west-half as opposed to south-half reserves?

A. I would think that that would -- I would talk to the engineer about it, because I think that's an engineering issue.

Q. All right. You don't feel that you're qualified to answer?

A. That's correct.

Q. Is it your understanding from your employment as a geologist at McElvain that geology was not the primary

consideration for dedicating a south-half unit to this well?

A. Yes.

MR. HALL: Nothing further.

EXAMINER STOGNER: Any redirect?

MR. FELDEWERT: No.

EXAMINATION

BY EXAMINER STOGNER:

Q. If the Naomi Number 1 turns out to be a commercial producer in the Blanco-Mesaverde, where do you feel would be the best place for the infill well, or for a second well in that section to be placed?

A. In the southeast quarter.

Q. And why is that?

A. Because I think the trend goes east-west, based on the limited subsurface data that we have.

Q. On Exhibit Number 10, how was the information obtained? Was this -- any 3-D seismic involved --

A. No --

Q. -- or was this just the well?

A. -- it's strictly from log data, porosity logs.

Q. Now, is this the only well control you have, is what's shown on the map? Or are there any other wells out there that --

A. The wells that are shown on this map are all

Q. Do you agree with the testimony of the other two McElvain witnesses here that mitigation of risk is a primary consideration in dedicating a south-half unit to the well?

A. I don't think mitigation of risk is the exact term. I like to call it sharing of the risk. But more to the point, proving up your neighbor's reserves, that is a consideration, yes.

Q. Proving up your neighbor's reserves in the southeast quarter?

A. Yes, sir.

Q. And you would be proving up McElvain's reserves in the southeast quarter as well, correct?

A. To some extent, yes.

MR. HALL: I have nothing further, Mr. Examiner.

EXAMINER STOGNER: Any redirect?

MR. FELDEWERT: Just one question.

REDIRECT EXAMINATION

BY MR. FELDEWERT:

Q. Mr. Steuble, looking at McElvain Exhibit Number 11, given the information that you have today, is it your opinion that there are commercially recoverable Gallup-Dakota reserves anywhere in Section 25?

A. In my opinion, no.

MR. FELDEWERT: Okay, that's all I have.

COMPULSORY POOLING OF OIL AND GAS INTERESTS IN NEW MEXICO

RICHARD S. MORRIS*

In 1935, the New Mexico Legislature passed the Oil Conservation Act[1] to require the conservation of oil and generally to provide for the regulation of the oil industry. Although this action followed closely the pattern of legislation then developing in other states, notably Texas[2] and Oklahoma,[3] the New Mexico Oil Conservation Act is distinctive in being the first truly comprehensive conservation law to be adopted in any state. The Act remains substantially unchanged today.[4]

The Act defines and prohibits the waste of oil,[5] requires the proration of oil to market demand,[6] and establishes the Oil Conservation Commission[7] to administer and enforce its provisions. Among the broad powers given the Commission is the authority to establish for each oil pool the size of proration unit which one well can efficiently and economically drain.[8] Also, the Commission is authorized to enforce development on the size proration unit it prescribes as standard in a pool by requiring whatever diverse interests might exist in such a unit to join for the purpose of drilling a well.[9]

The role of the proration unit in the orderly development of oil and gas properties is well established.[10] But the power of compulsory pooling, by which this orderly development may be enforced, is not well established and in many quarters appears to be misunderstood as to both its purpose and the method by which it is effected.

Twenty-four states, including New Mexico, now have some form of com-

* Member of the New Mexico bar.

1. N.M. Laws 1935, ch. 72; now N.M. Stat. Ann. §§ 65-3-1 to -34 (1953).

2. Tex. Acts 4th Called Sess. 1932, ch. 2 at 3; Tex. Acts 1935, ch. 76 at 180.

3. Okla. Laws 1933, ch. 181.

4. For a history of this legislation see Conservation of Oil and Gas: A Legal History, 1958 at 155-57 (Sullivan ed. 1958).

5. N.M. Stat. Ann. § 65-3-3 (1953), defines "waste" to include both surface and subsurface waste, as well as waste in its ordinary meaning. This section also defines waste to be the production of oil or gas in excess of reasonable market demand, or the non-ratable taking of oil.

6. N.M. Stat. Ann. §§ 65-3-2 to -3 (1953).

7. N.M. Stat. Ann. § 65-3-4 (1953). The Commission is composed of the Governor, the Land Commissioner, and the State Geologist.

8. N.M. Stat. Ann. § 65-3-14(b) (1953).

9. N.M. Stat. Ann. § 65-3-14(c) (1953) (amended by N.M. Stat. Ann. § 65-3-14(c) (Supp. 1961)).

10. See Legal History of Conservation of Oil and Gas—A Symposium (Published by Mineral Law Section, A.B.A., 1938); Conservation of Oil and Gas: A Legal History, 1948 (Murphy ed. 1949); Conservation of Oil and Gas: A Legal History, 1958 (Sullivan ed. 1958).

EXHIBIT

B

pulsory pooling law.[11] In a few states, notably Oklahoma and Mississippi, the compulsory pooling laws have received considerable attention in the courts.[12] Without exception they have been upheld against attacks of unconstitutionality.[13]

In New Mexico, however, there has been no judicial recognition or interpretation of the compulsory pooling law even though it has been in effect since 1935—the year in which Oklahoma adopted its pooling law.[14] The lack of New Mexico cases involving compulsory pooling is no indication that this provision of the law has not been invoked. Many cases have been considered by the New Mexico Oil Conservation Commission, and they have resulted in orders requiring the pooling of oil and gas interests, and, in many of these cases, novel legal questions have arisen.

I

POOLING PRIOR TO 1961

A. Non-Consenting Working and Unleased Interests

New Mexico's original compulsory pooling law[15] remained unchanged until

11. See Myers, The Law of Pooling and Unitization, Voluntary—Compulsory § 8.01(4) (1957, Supp. 1961).

12. See, *e.g.*, Patterson v. Stanolind Oil and Gas Co., 182 Okla. 155, 77 P.2d 83 (1938), *appeal dismissed*, 305 U.S. 376 (1939); Superior Oil Co. v. Foote, 214 Miss. 857, 59 So. 2d 85 (1952).

13. See Annot., 37 A.L.R.2d 434 (1954).

14. Only two cases involving orders of the Oil Conservation Commission have been appealed to the New Mexico Supreme Court. The first, Continental Oil Co. v. Oil Conservation Comm'n, 70 N.M. 310, 373 P.2d 809 (1962), 3 Natural Resources J. 178 (1963), concerned a change of the proration formula in the Jalmat Gas Pool of Lea County, New Mexico. The second, Sims v. Mechem, 382 P.2d 183 (N.M. 1963), concerned a change in the configuration of a proration unit, and incidentally involved the compulsory powers of the Commission. In *Sims* the court stated that the Commission has unquestionable power to require pooling of properties where the owners have failed to agree. But the court held the pooling order invalid since the Commission had made no finding of waste.

15.

> The pooling of properties or parts thereof shall be permitted, and, if not agreed upon, may be required in any case when and to the extent that the smallness or shape of a separately owned tract would, under the enforcement of a uniform spacing plan or proration unit, otherwise deprive or tend to deprive the owner of such tract of the opportunity to recover his just and equitable share of the crude petroleum or natural gas, or both, in the pool; Provided, that the owner of any tract that is smaller than the drilling unit that is established for the field, shall not be deprived of the right to drill on and produce from such tract, if same can be done without waste; but in such case, the allowable production from such tract, as compared with the allowable production therefrom if such tract were a full unit, shall be in ratio of the area of such tract to the area of the full unit. All orders requiring such pooling shall be upon terms and conditions that are just and reasonable, and will afford to the owner of each tract in

1961.[16] It contained a provision authorizing the Commission to require pooling "when and to the extent that the smallness or shape of a separately owned tract would, under the enforcement of a uniform spacing plan or proration unit, otherwise deprive or tend to deprive the owner of such tract of the opportunity to recover his just and equitable share of the crude petroleum or natural gas, or both, in the pool . . . ." The law further provided "that the owner of any tract that is smaller than the drilling unit established for the field, shall not be deprived of the right to drill on and produce from such tract, if same can be done without waste . . . ." The Commission was authorized to adjust allowables proportionately to the size of the tract when a small tract owner insisted on his right to develop his own property and, further, to determine costs between interests pooled by Commission orders.

The first compulsory pooling orders entered by the Commission showed a reluctance to use the full authority of the law. In several instances the Commission required pooling but further ordered that a continuing effort be made to secure the consent of all interests to a communitization agreement.[17] In one case,[18] the Commission ordered pooling but required that all interests be signed to a communitization agreement as a condition to the effectiveness of the order.

After the first few cases had been considered, the Commission adopted a basic attitude toward pooling which, in most aspects, remains unchanged. In each case inquiry is made by the Commission concerning the efforts of the applicant for compulsory pooling to secure the consent of the interests being pooled.[19] Where unleased interests are to be pooled, the reasonableness of the offer to lease may be questioned.[20] Whether active protest to pooling is voiced[21] and whether the protestant appears at the Commission hearing[22] are

the pool the opportunity to recover or receive his just and equitable share of the oil or gas, or both, in the pool as above provided, so far as may be practicably recovered without waste. In the event such pooling is required, the costs of development and operation of the pooled unit shall be limited to the lowest actual expenditures required for such purpose including a reasonable charge for supervision; and in case of any dispute as to such costs, the commission shall determine the proper costs.

N.M. Stat. Ann. § 65-3-14(c) (1953) (amended by N.M. Stat. Ann. § 65-3-14(c) (Supp. 1961).

16. N.M. Stat. Ann. § 65-3-14(c) (Supp. 1961). See note 41 *infra*.

17. See, *e.g.*, Texas Co., Case No. 117, Order No. R-739 (N.M. Oil Conservation Comm'n 1948).

18. C. H. Sweet, Case No. 427, Order No. R-284 (N.M. Oil Conservation Comm'n 1952).

19. See, *e.g.*, El Paso Natural Gas Co., Case No. 595, Order No. R-396 (N.M. Oil Conservation Comm'n 1953).

20. *Ibid.*

21. See, *e.g.*, Blackwood and Nichols Co., Case No. 566, Order No. R-357 (N.M. Oil Conservation Comm'n 1953).

22. *Ibid.*

strongly considered factors. Also, the economic feasibility of a second well on a proration unit is considered a factor in ordering pooling,[23] and in many cases orders have been entered based on a finding that waste would be caused by the drilling of a second well on the acreage to be pooled.[24]

An examination of these cases reveals that "waste" as used in this context meant *economic* waste rather than the *physical* waste of oil and gas. The protection of correlative rights and the prevention of economic waste caused by the drilling of unnecessary wells were the chief considerations in ordering pooling, and physical waste became a factor only where it appeared that without pooling no well would be drilled to develop the proration unit.

One of the major problems of compulsory pooling in New Mexico is the determination of costs between the operator on the one hand and the non-consenting working interest owner or unleased interest owner on the other. Where a working interest or an unleased interest has not agreed to voluntary pooling and an operator seeks compulsory pooling of that interest with interests of his own, usually amounting to most of the acreage in the proposed unit, that operator will seek to have the interest being pooled charged with its share of the costs of unit development and operation. The non-consenting interest may not object to being pooled but may object to the operator's proposal for the apportionment of costs. This dispute has occurred in numerous pooling cases[25] and is probably the reason for most cases being brought before the Commission.

In early cases involving disputes of this nature the Commission again was reluctant to use the full authority of the pooling law. Many orders merely required pooling and left to the operator and the non-consenting interest owner the problem of working out costs between them the best they could.[26] In later cases the Commission, in its pooling orders, began providing alternative courses of action for the non-consenter to follow. In the first case providing such alternatives,[27] an owner of an unleased interest involuntarily pooled was allowed to share in the production from the unit from such time as he had (a) paid his proportionate share of the well costs, or (b) made other arrangements satisfactory to the operator. The Commission retained jurisdiction to determine well costs in the event of a dispute. It seems apparent now, with the experience of more recent cases, that this order was inadequate to protect a non-

23. See note 37 *infra*.

24. See, *e.g.*, Phillips Petroleum Co., Case No. 978, Order No. R-747 (N.M. Oil Conservation Comm'n 1956).

25. See, *e.g.*, Saul A. Yager and El Paso Natural Gas Co., Case Nos. 1000-1001 Consol., Order No. R-795 (N.M. Oil Conservation Comm'n 1956).

26. See, *e.g.*, Blackwood and Nichols Co., Case No. 566, Order No. R-357 (N.M. Oil Conservation Comm'n 1953).

27. Phillips Petroleum Co., Case No. 978, Order No. R-747 (N.M. Oil Conservation Comm'n 1956).

consenting interest owner who might have been unable to pay his share of well costs.

Following closely on this case the Commission considered another pooling application involving a non-consenting unleased interest.[28] At the hearing the operator proposed that the pooling order should provide the non-consenter with the alternative of paying his share of well costs in cash or allowing recovery out of production to the extent of 150 per cent of his share. The non-consenting interest opposed this method of allocating costs, contending that no penalty should be assessed against him as a "carried" interest due to the statutory requirement that the costs be "limited to the lowest actual expenditures required . . . ."[29] for drilling the well. The non-consenting interest further contended that his unleased interest should be considered seven-eighths working interest and one-eighth royalty interest and, accordingly, that costs should be withheld only from seven-eighths of the proceeds attributable to his interest. The Commission's order[30] provided that the non-consenter pay his share of well costs in cash within fifteen days from the date of the order or, as an alternative, that the operator be allowed to withhold from production attributable to the full eight-eighths of his interest 125 per cent of his share of well costs.

The recovery of 125 per cent allowed in this order set the pattern for future orders which pooled non-consenting working or unleased interests. Since by statute costs were limited to "lowest actual expenditures . . . including a reasonable charge for supervision . . . ."[31] the additional twenty-five per cent must be justified as a charge for supervision. Charges for interest or for risk, although not disallowed, were not expressly authorized by the terms of the statute.[32]

So far in this discussion the cases mentioned have been those where the party bringing the pooling case before the Commission was an operator who owned most of the working interest in the proposed unit and who had been unsuccessful in leasing or communitizing the remainder. This is the typical case for which the pooling law was created. Some cases, however, have not fit neatly into this category; consider, for example, the following situation.[33]

Upon a showing that a small unleased interest not only refused to lease or

28. Saul A. Yager and El Paso Natural Gas Co., Case Nos. 1000-1001 Consol., Order No. R-795 (N.M. Oil Conservation Comm'n 1956).

29. N.M. Stat. Ann. § 65-3-14(c) (1953) (amended by N.M. Stat. Ann. § 65-3-14(c) (Supp. 1961)). See note 15 *supra*.

30. Saul A. Yager and El Paso Natural Gas Co., Case Nos. 1000-1001 Consol., Order No. R-795 (N.M. Oil Conservation Comm'n 1956).

31. N.M. Stat. Ann. § 65-3-14(c) (1953) (amended by N.M. Stat. Ann. § 65-3-14(c) (Supp. 1961)). See note 15 *supra*.

32. See note 48 *infra*.

33. W. H. Swearingen, Case No. 2080, Order No. R-1748-A (N.M. Oil Conservation Comm'n 1960).

join an operator's proposed unit but actively opposed being pooled into the unit on any terms, the Commission created a non-standard proration unit which excluded the unleased interest.[34] After the order was entered, but before the unit well was drilled, the owner of the unleased interest reconsidered and applied to the Commission for an order requiring the pooling of his acreage with the acreage previously included in the non-standard unit.

This type of an application raised several important questions: Inasmuch as the owner of the unleased interest did not protest, but rather endorsed the order establishing the non-standard unit which excluded his acreage, was his pooling application a collateral attack upon the prior order? May the compulsory pooling law be invoked by an interest other than the operator who proposes to drill the unit well? Should a pooling order enforce the assumption of dry hole risk upon the owner of a small unleased interest solely because he is the applicant for compulsory pooling?

Little consideration was given the first two questions. The application was heard and the dispute was narrowed to the question of how the costs and risk of drilling the unit well should be allocated. The Commission's order allowed the owner of the unleased interest the alternative of either paying his share of well costs in cash by a certain date, subject to a subsequent adjustment to actual cost, or allowing his share of well costs, plus twenty-five per cent thereof as a charge for supervision, to be paid out of the production attributable to his entire interest. No effective separation of the unleased interest into working and royalty interests was recognized. A proviso was attached to the latter alternative that in the event the well was a dry hole the unleased interest should bear its share of well costs.

The Commission evidently required the unleased interest to take the risk of paying dry hole costs due to the absence of statutory authority to provide for an increased percentage to be withheld from production for risk. It should be noted that in this case there was little dry hole risk.

The practice of allowing the operator to withhold from eight-eighths of the proceeds attributable to an unleased interest was not continued beyond this case; in all subsequent cases involving the involuntary pooling of unleased interests, the interests were treated as being separated into working and royalty interests—the royalty interests were paid free of costs.

In most cases where the owner of some interest in a proposed proration unit has opposed the pooling of his interest, such as in the last-mentioned case, the Commission has excluded it, if practicable, and formed a non-standard unit. Most cases of this sort have involved small, unleased interests which have opposed pooling on any terms due to their own ignorance or stubbornness, or both.

34. Charles Loveless, Case No. 2036, Order No. R-1748 (N.M. Oil Conservation Comm'n 1960).

Nevertheless, where opposition to pooling has amounted to something more than passive non-consent, interests have been excluded from the unit even though the correlative rights of the owners of those interests were impaired by their own position.[35] In some cases where it appeared that upon reconsideration the non-consenting interest would wish to join the unit, a non-standard unit was established subject to the condition that the non-consenting interest could join at a later time.[36]

In some cases, however, substantial interests have been involuntarily pooled over their vehement protestations. In one case,[37] the working interest owner in an eighty-acre tract sought the compulsory pooling of the unleased interest in an adjoining eighty-acre tract to form a standard 160-acre gas proration unit. The pooling application was brought after all of the owners of the undivided, unleased interest had been offered, and had refused, the opportunity to lease or to join the unit voluntarily. At the hearing of the pooling application, the owner of an undivided 17/30ths interest in the unleased eighty acres appeared and actively protested the inclusion of his interest in the proposed unit. The protest may have been due to the protestant's misconception of the effect of pooling, which was fancied as some form of uncompensated confiscation, but may have had some reasonable basis in as much as the eighty-acre tract being involuntarily pooled had better productive potential than the tract owned by the applicant. The applicant proposed to locate the unit well on the protestant's land after a pooling order had been entered, but there was evidence showing that the entire 160 acres was productive of gas. There was also evidence that a well drilled on either eighty-acre tract as a non-standard unit would be uneconomical due to the proportionately decreased allowable it would receive, and no proposal was made by the applicant or the protestant to form two eighty-acre units.

This situation presented the problem of how to protect the correlative rights of everyone concerned and, at the same time, prevent the waste that might occur if the lands involved were not developed. The correlative rights of both the applicant and the protestant dictated that a well be drilled to prevent drainage by other wells in the reservoir, yet the rights of the protestant, as voiced by him, included the right to refuse to commit his acreage to the proposed unit.

Since there were other owners of unleased interests in the tract owned partially by the protestant, who had not voiced active non-consent to pooling, and since a well could not economically be drilled on an eighty-acre tract, the

35. See note 33 *supra*.

36. See, *e.g.*, El Paso Natural Gas Co., Case No. 986, Order No. R-737 (N.M. Oil Conservation Comm'n 1955).

37. Southern Union Prod. Co., Case No. 2249, Order No. R-1960 (N.M. Oil Conservation Comm'n 1961).

Commission ordered pooling as the solution best designed to protect the correlative rights of all affected parties.

The pooling order allowed the operator to withhold 110 per cent of the proceeds attributable to seven-eighths of the non-concerning interest until the pro rata share of well costs were paid, and required the operator to submit an itemized schedule of well costs to the Commission. The well was drilled and completed at a location on the protestant's eighty-acre tract with the full 160-acre unit dedicated to the well.

B. Non-consenting Royalty Interests

No discussion has been offered, so far, of the problems involved in pooling non-consenting royalty interests as such, considered apart from their recognition as a portion of an unleased interest. Many pooling cases considered by the Commission have been occasioned by non-consenting royalty interests. But few of these cases have presented any problem because in most of them, even though the royalty owner would not consent to voluntary pooling, no objection was made to compulsory pooling. There have been a few notable exceptions, however.

In one case,[38] the application for compulsory pooling was opposed by royalty owners on the grounds that (1) the Commission had no statutory authority to require the pooling of royalty interests, (2) pooling, whether voluntary or involuntary, was merely a lease-holding and contractual-avoidance device, and (3) since the oil pool involved was governed merely by temporary rules providing for eighty-acre proration units, and since the royalty owners intended to object to the establishment of permanent rules to that effect, the pooling of an eighty-acre unit would be prejudicial to their cause.

The Commission ordered pooling based on its standard finding that "denial of the subject application would deprive, or tend to deprive the mineral interest owners in the said eighty-acre tract of the opportunity to recover their just and equitable share of the crude petroleum oil or natural gas, or both, in the . . . Pool."[39]

The contention made in this case concerning the lack of statutory authority requiring the pooling of royalty interests had been anticipated but never raised directly in a previous case. Its basis lay in the use of the word "owner" in the pooling statute which is defined in another section of the conservation law in terms relating only to a working interest.[40]

The Commission managed to operate successfully under the original form of the pooling law, and in spite of the inadequacies that appeared no litigation

38. Cities Serv. Oil Co., Case No. 2101, Order No. R-1801 (N.M. Oil Conservation Comm'n 1960).

39. *Id.*, Finding No. 6.

40. N.M. Stat. Ann. § 65-3-29(e) (1953).

resulted. In 1961, however, the law was revised to clarify the power of the Commission and to remedy some of the problems which threatened its effectiveness.[41]

41.

When two [2] or more separately owned tracts of land are embraced within a spacing or proration unit, or where there are owners of royalty interests or undivided interests in oil and gas minerals which are separately owned or any combination thereof, embraced within such spacing or proration unit, the owner or owners thereof may validly pool their interests and develop their lands as a unit. Where, however, such owner or owners have not agreed to pool their interests, and where one such separate owner, or owners, who has the right to drill has drilled or proposes to drill a well on said unit to a common source of supply, the commission, to avoid the drilling of unnecessary wells or to protect correlative rights, or to prevent waste, shall pool all or any part of such lands or interests or both in the spacing or proration unit as a unit.

All orders effecting [affecting] such pooling shall be made after notice and hearing, and shall be upon such terms and conditions as are just and reasonable and will afford to the owner or owners of each tract or interest in the unit the opportunity to recover or receive without unnecessary expense his just and fair share of the oil or gas, or both. Each order shall describe the lands included in the unit designated thereby, identify the pool or pools to which it applies and designate an operator for the unit. All operations for the pooled oil or gas, or both, which are conducted on any portion of the unit shall be deemed for all purposes to have been conducted upon each tract within the unit by the owner or owners of such tract. For the purpose of determining the portions of production owned by the persons owning interests in the pooled oil or gas, or both, such production shall be allocated to the respective tracts within the unit in the proportion that the number of surface acres included within each tract bears to the number of surface acres included in the entire unit. The portion of the production allocated to the owner or owners of each tract or interest included in a well spacing or proration unit formed by a pooling order shall, when produced, be considered as if produced from the separately owned tract or interest by a well drilled thereon. Such pooling order of the commission shall make definite provision as to any owner, or owners, who elects not to pay his proportionate share in advance for the pro rata reimbursement solely out of production to the parties advancing the costs of the development and operation which shall be limited to the actual expenditures required for such purpose not in excess of what are reasonable, but which shall include a reasonable charge for supervision and may include a charge for the risk involved in the drilling of such well, which charge for risk shall not exceed fifty per cent [50%] of the nonconsenting working interest owner or owners' pro rata share of the cost of drilling and completing the well.

In the event of any dispute relative to such costs, the commission shall determine the proper costs after due notice to interested parties and a hearing thereon. The commission is specifically authorized to provide that the owner or owners drilling, or paying for the drilling, or for the operation of a well for the benefit of all shall be entitled to all production from such well which would be received by the owner, or owners, for whose benefit the well was drilled or operated, after payment of royalty as provided in the lease, if any, applicable to each tract or interest, and obligations payable out of production, until the owner or owners drilling or operating the well or both have been paid the amount due under the terms of the pooling order or order settling such dispute. No part of the production or proceeds accruing to any owner or owners of a separate interest in such unit shall be applied toward the payment of any

II

THE 1961 AMENDMENT

A. Problems Solved by the Amendment

Under the new law the pooling of royalty interests and undivided working or unleased interests may be required. Also, when an unleased interest is pooled, seven-eighths of the interest is considered working interest and one-eighth is considered royalty interest to be paid free of costs. The proviso in favor of the small tract owner was written out of law, thereby eliminating an ever present threat to the effectiveness of the pooling law.

The Commission is specifically authorized to require pooling to prevent economic waste caused by the drilling of unnecessary wells—a basis for pooling previously recognized by the Commission but without clear statutory foundation.

The Commission is expressly required to provide for the withholding of proceeds from production attributable to a working interest which has not paid its share of well costs. Such costs are limited to actual costs including costs of supervision, as under the previous law, but costs may now be assessed for the risk involved in drilling up to an additional fifty per cent of the non-consenting working interest's share. A provision for interest charges was proposed, but not included in the revision.

B. Problems Created by the Amendment

The revised law eliminated many threats to the effectiveness of compulsory pooling, but it has not proved to be a panacea for all pooling problems. New problems have been created in the area of assessing charges for risk. The proper determination of supervisory costs continues to be a problem, and new questions have been posed concerning the nature of compulsory pooling which would have been applicable to the law before as well as after its revision.

Some confusion presently exists concerning the risk for which a charge may be made and added to a non-consenting interest's share of the development costs. The risk for which a charge properly may be made is, in the words of the statute, "the risk involved in the drilling of such well."[42] There are,

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cost properly chargeable to any other interest in said unit.

If the interest of any owner or owners of any unleased mineral interest is pooled by virtue of this act . . . . seven-eighths of such interest shall be considered as a working interest and one-eighth shall be considered a royalty interest, and he shall in all events be paid one-eighth of all production from the unit and creditable to his interest.

N.M. Stat. Ann. § 65-3-14(c) (Supp. 1961).

42. *Ibid.*

however, at least three forms of risk inherent in every oil or gas prospect: (1) the risk of encountering unusual and expensive mechanical problems in the drilling of the well, (2) the risk of a dry hole, and (3) the risk of obtaining an uneconomical well—a risk which may not be resolved for years and which depends on such factors as market demand and the ability of the operator of the well to make a successful technical evaluation of the reservoir.

It has been argued[43] that all three forms of risk should be considered in fixing costs. But it cannot be ascertained from Commission orders to date upon what basis risk is to be charged, because the specific issue has not been presented for determination. The standard Commission order finds merely, without amplification, that risk should be assessed at a certain percentage of well costs.[44]

One difficulty in assessing costs for risk as a percentage of well costs is that there is no actual relationship between the two items. Few would argue that risk should not be compensated for in some manner, however, and the assessment of such costs has found general acceptance in the industry as a percentage of drilling costs. It has been shown to the Commission by those seeking fifty per cent as a risk factor that in "arms-length" transactions, *i.e.*, communitization agreements, it is customary to provide a risk charge on "carried" interests of 100 per cent.[45] And such charges are occasionally 200[46] and even 300,[47] per cent of drilling costs.

It should be borne in mind that risk charges are made only against "carried" interests, *i.e.*, those working interests which elect to pay their proportionate share of costs out of the proceeds from production rather than in advance of the drilling of the well. Where a working interest owner refuses to pay his share of costs in advance of drilling, his share of costs must be paid by the remaining working interests participating in the well. This situation, which may result either from compulsory pooling or from agreement, causes the remaining working interests to assume the burden of having their capital tied up for years until well costs can be recovered as well as the burden of all of the risk involved in the drilling of the well. Without any provision in communitization agreements or in compulsory pooling orders which allows the participating working interests to charge the non-participating owners for interest on their

43. Southwest Prod. Co., Case Nos. 2415, 2416, 2446 and 2453 (N.M. Oil Conservation Comm'n 1962) (heard *de novo*).

44. See, *e.g.*, S. P. Yates, Case No. 2655, Order No. R-2339 (N.M. Oil Conservation Comm'n 1962), in which order the maximum factor of fifty per cent was allowed.

45. See Southwest Prod. Co., Case Nos. 2415, 2416, 2446 and 2453 (N.M. Oil Conservation Comm'n 1962).

46. Pan American Petroleum Corp., Case No. 2500, Order No. R-2226 (N.M. Oil Conservation Comm'n 1962).

47. *Ibid.*

proportionate share of drilling costs, it is apparent that some portion of the so-called risk charge should actually be considered a charge for interest. The exact amount of this charge cannot be fixed either before or after drilling since it must depend upon the length of time required for well costs to be recovered which, in turn, depends on many variable factors such as well reserves and market demand.

Therefore, much of the clamor for an adequate risk factor is due, at least in part, to a desire to be compensated for interest.[48] Viewed in this light, the fixing of risk charges by the Commission would amount to an adjustment of equities between participating and non-participating interests. If this is the aim of the Commission, independent consideration should be given to the two factors, risk and interest, and each must be assessed as realistically as possible.[49]

Practical difficulties encountered in assessing risk and interest as separate costs may justify the Commission's current practice, and it may be that additional legislation would be necessary to permit the assessment of interest charges as such. In any event, charges should be assessed in such a manner as to treat the non-consenting interest owner who must be pooled by compulsion the same, but no better, than his counterpart who voluntarily pooled his interest but elected to be "carried." Certainly, no incentive should be provided for an interest owner to refuse to join voluntarily in an agreement offering fair and equitable terms because he may obtain an advantage by being pooled by order of the Commission.

Another problem is that of assessing costs of supervision. The law provides that charges shall be made for supervision,[50] a term which, like "risk," may assume several forms. There are costs of supervision incurred in the drilling of a well, and, also, there are costs involved in supervising the well throughout its productive life.

Until recently, costs of supervision have been assessed by the Commission as an additional percentage of well costs.[51] No attempt to fix actual costs has been made in the Commission's orders.

If costs of supervision are to be considered as only those incidental to the drilling of the well, they might be reasonably related to well costs and assessed

48. In Oklahoma, interest may be recovered as an item of well costs, but only if the operator has actually paid the interest. See Wood Oil Co. v. Corporation Comm'n, 268 P.2d 878 (Okla. 1953).

49. There is no specific provision in the pooling law allowing a charge to be made for interest; there is, however, the general expression: "All orders effecting [affecting] such pooling . . . shall be upon such terms and conditions as are just and reasonable . . . . " N.M. Stat. Ann. § 65-3-14(c) (Supp. 1961).

50. *Ibid.*

51. See, *e.g.*, Order No. R-1883 (N.M. Oil Conservation Comm'n 1961), allowing ten per cent of well costs as an additional charge for supervision.

as a percentage. However, if costs of supervision are considered also to include operating costs over the life of the well, then they do not appear to be reasonably related to well costs.

The orders entered by the Commission in recent pooling cases indicate a change in its interpretation of the term "supervision." Costs now are fixed at a certain monthly figure,[52] and each non-consenting working interest is assessed with its proportionate share to be paid out of production. Thus it now appears that no consideration is being given to supervisory costs incurred in the drilling of the well, unless the Commission is recognizing that such costs may properly be included as well costs without being specifically recognized and authorized as such in the pooling order.[53]

Aside from those questions involving the allocation of costs, others have arisen concerning the compulsory pooling process. In a series of cases[54] arising after the 1961 revision of the pooling law, the nature and operation of compulsory pooling were considered anew with questions concerning the Commission's power and discretion in such matters.

Following hearings before an Examiner where it was shown that certain specified interests refused to join in a proration unit, the Commission entered its orders pooling those specific interests with the remainder of the working interest in the proposed unit owned by the applicant.[55] By specifying each interest to be pooled as to identity and amount of ownership, the Commission departed from its previous practice of pooling "all mineral interests" within the unit.[56]

These cases were taken before the full Commission on hearings *de novo* where legal, equitable and practical arguments were made for both methods of effecting compulsory pooling. In support of specifying the interests to be pooled, the argument was advanced that only in that way could the Commission be reasonably sure all interests being pooled had been given the opportunity to join, lease or sell upon fair terms. In support of pooling all interests, whatever they might be, it was argued that only in that way could the Commission be absolutely sure that its order would be effective to form the unit, since the possibility of error in identifying the ownership or the extent of an interest would always be inherent in the other manner. Further, it was argued, the nature of

52. See, *e.g.*, Order No. R-2068-B (N.M. Oil Conservation Comm'n 1962), fixing $75.00 per month as the cost of supervision.

53. May interest (the cost of money) also be considered a proper item of well cost and included as such by the operator without the express approval of the Commission? See note 49 *supra*.

54. Southwest Prod. Co., Case Nos. 2415, 2416, 2446 and 2453 (N.M. Oil Conservation Comm'n 1962).

55. Order Nos. R-2150, R-2151, R-2068-A and R-2152 (N.M. Oil Conservation Comm'n 1961).

56. See, *e.g.*, Order No. R-2027 (N.M. Oil Conservation Comm'n 1961).

the proceeding, being *in rem* rather than *in personam*, would dictate the method of effecting pooling.

As the result of the hearings *de novo*, the Commission entered its orders[57] which pooled "all mineral interests, whatever they may be"[58] in each unit, thereby recognizing the *in rem* nature of the proceeding. The orders were based, however, on findings that the applicant had made "diligent effort to identify and to locate all owners of interest in the proposed proration unit . . . ,"[59] that the applicant had made "fair and reasonable offers to lease, to obtain quit claim deeds, or to communitize with respect to each non-consenting interest owner whose identity and address [were] known . . . "[60] and that, in spite of these efforts, there remained non-consenting interests.[61]

By the inclusion of these findings in the pooling orders, it is apparent that the diligence of the applicant was a factor considered by the Commission in ordering pooling. To what extent an applicant might relax his leasing practices, his title search and his curative procedures and still obtain a compulsory pooling order has not been determined. The Commission has indicated, however, that it will demand at least "good faith" efforts in this regard, and that it will not allow compulsory pooling to be used as a substitute for prudent leasing practices.

The proposition has been urged that the Commission has no discretion in a pooling case—where there are non-consenting interests, they obviously "have not agreed,"[62] and the Commission must order pooling.[63] This view would deny the Commission the prerogative of refusing to order pooling if it found evidence of imprudent leasing practices; indeed, it would deny the Commission the right to inquire into the diligence of the applicant's efforts to form a unit by negotiated means. It would deny to the pooling procedure any equitable qualities, even though such procedure necessarily involves adjusting the rights and equities of the various interests.

Such arguments notwithstanding, the Commission considers itself endowed with equitable powers in pooling matters and continues to require a showing of diligent effort by the applicant before ordering pooling. It should be noted,

57. Order Nos. R-2150-A, R-2151-A, R-2068-B and R-2152-A (N.M. Oil Conservation Comm'n 1962).

58. *Id.*, para. 1.

59. *Id.*, Finding No. 3.

60. *Id.*, Finding No. 4.

61. *Id.*, Finding No. 5.

62. The pooling law provides: "Where, however, such owner or owners have not agreed to pool their interests . . . the commission . . . shall pool all or any part of such lands or interests or both in the spacing or proration unit as a unit." N.M. Stat. Ann. § 65-3-14(c) (Supp. 1961).

63. In accordance with this view, see Superior Oil Co. v. Foote, 214 Miss. 857, 59 So. 2d 85 (1952).

however, that in every case brought before the Commission upon an application for compulsory pooling, pooling eventually has been ordered.[64]

SUMMARY

From the foregoing discussion the reader may have become aware of the basic nature of compulsory pooling in New Mexico. He may also have become aware of certain inadequacies in the pooling law and its administration. Some of these inadequacies might be remedied by new approaches to the administration of the law, and others might be cured only by new legislation. One thing is certain: new problems will continue to arise and old problems will assume new forms. The solutions to these problems will continue to come from the petroleum industry and those charged with the administration of the law. If these problems are resolved by the application of equitable principles and by the determination, in each case, of the reasonableness of the compulsory pooling order toward all concerned, the compulsory pooling law, with its avowed purposes of avoiding the drilling of unnecessary wells, of protecting correlative rights and of preventing waste, should continue to serve the cause of petroleum conservation in New Mexico.

64. In some instances, applications for pooling were denied folowing an examiner hearing. But they were granted following hearing *de novo* before the Commission where it appeared that additional efforts to lease or communitize had been made in the interim. See, *e.g.*, Southwest Prod. Co., Case Nos. 2415, 2416, 2446 and 2453 (N.M. Oil Conservation Comm'n 1962).

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