

STATE OF NEW MEXICO
ENERGY, MINERALS, AND NATURAL RESOURCES DEPARTMENT
OIL CONSERVATION DIVISION
STATE LAND OFFICE BLDG.
SANTA FE, NEW MEXICO

19 November 1986

COMMISSION HEARING

IN THE MATTER OF:

The hearing called by the Oil Conser- CASE
vation Division on its own motion to 9134
consider the amendment of Rule 1207(a)7
regarding notice to royalty interest
owners.

BEFORE: William J. Lemay, Chairman
Erling A. Brostuen, Commissioner
William R. Humphries, Commissioner

TRANSCRIPT OF HEARING

A P P E A R A N C E S

For the Division:	Jeff Taylor Attorney at Law Legal Counsel to the Division State Land Office Bldg. Santa Fe, New Mexico 87501
For Sun E&P Co., Jerome P. McHugh, Dugan Production, and Benson-Montin-Greer:	W. Thomas Kellahin Attorney at Law KELLAHIN, KELLAHIN & AUBREY P. O. Box 2265 Santa Fe, New Mexico 87501

A P P E A R A N C E S

For Al Kendrick:

Robert G. Stovall
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For Meridian:

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MR. LEMAY: The meeting will
come to order.

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Our first case on the docket is
Case Number 9134.

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MR. TAYLOR: May it please the
Commission, I'm Jeff Taylor, Counsel for the Commission and
the Division.

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Vic Lyon was going to be our
witness today and he's not here, so I would propose that I
could be sworn and testify about why we are -- why the Divi-
sion proposes this rule change, or if there's any objection
we could just continue this case for another month until the
December docket or the next hearing.

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MR. LEMAY: Mr. Kellahin?

MR. KELLAHIN: Mr. Chairman,
I'm Tom Kellahin. I'd like to enter my appearance on behalf
of Jerome P. McHugh, Sun Exploration and Production Company,
Dugan Production Company, and Benson-Montin-Greer in this
case.

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As I understand from my conver-
sations with Mr. Taylor, the question about royalty notice
is more a legal proposition for the Commission to determine
rather than an engineering case, and we certainly have no
objection to having Mr. Taylor sworn and making a presenta-

1 tion to the Commission.

2 MR. LEMAY: Thank you. Are there
3 any other comments from anyone in the audience concerning
4 this case?

5 MR. PEARCE: May it please the
6 Commission, I am W. Perry Pearce from the Santa Fe law firm
7 of Montgomery and Andrews, appearing in this matter on be-
8 half of Meridian.

9 Meridian also has no objection
10 to the proposed procedure.

11 MR. LEMAY: Thank you, Mr.
12 Pearce.

13 Additional -- yes, sir.

14 MR. STOVALL: Yes, I'm Robert
15 G. Stovall from Farmington and I enter my appearances on be-
16 half of Al Kendrick, and I would like -- I have no objection
17 to the procedure proposed by Mr. Taylor; however, I would
18 like the opportunity to insure that certain items get into
19 the record and possibly ask for a continuance.

20 Having been involved in a case
21 that involves this matter, there are certain things that
22 need to be presented to the Commission in this proceeding.

23 MR. LEMAY: Thank you, Mr. Sto-
24 vall.

25 Mr. -- I assume that Mr. Taylor

1 will be available for cross examination and also we will ac-
2 cept testimony and comments from those in the audience after
3 his testimony.

4 Is there anyone that plans to
5 present any witnesses in this case besides Mr. Taylor?

6 Are there any other -- Mr. Sto-
7 vall?

8 MR. STOVALL: May I reserve the
9 option to be a witness myself?

10 MR. LEMAY: Yes, you can, sir.

11 Any other lawyers wish to tes-
12 tify? It's your only chance, now.

13 Any other appearances in the
14 case?

15 If not, we will continue on
16 with Case 30 -- 9134.

17 Mr. Taylor, please raise your
18 right hand. Mr. Taylor and Mr. Stovall, just in case.
19 Anyone else wishes to make an appearance and be a witness in
20 this case?

21 Okay.

22

23 (Mr. Taylor and Mr. Stovall sworn.)

24

25 Thank you, you may be seated.

1 Mr. Taylor, you may continue
2 with asking yourself questions.

3 MR. TAYLOR: I just propose to
4 make a statement on behalf of the Division on -- on our
5 notice rules.

6 Rule 1207 in particular is what
7 we're looking, 1207(a)7, I believe, which was adopted as of
8 September or October 17th, 1985, by Order R-8054 in Case
9 Number 8649, and these were effective, as I recall, as of
10 January 1st, 1986.

11 The rule in question, Part 7
12 reads: "In the case of any other application which will, if
13 granted, alter any working interest owner's or any royalty
14 interest owner's percentage interest in an existing well:
15 Actual notice shall be given to the operators and appli-
16 cant's royalty interest owners in such an existing well.
17 Such notice shall be provided by certified mail (return re-
18 ceipt requested)."

19 This portion of this rule has
20 caused quite a bit of confusion and ambiguity because it's
21 apparently intended as a catch-all provision, and I do have
22 a set of the notice rules for the Commission.

23 It's intended as a catch-all
24 provision but it is more strict than the provisions that it
25 is -- that it is a catch-all provision for and, in addition,

1 Subsection 9 is also a catch-all provision which, from my
2 reading of 9, is more inclusive or would be more inclusive,
3 would cover more situations than 7.

4 7 appears only to cover situations where
5 working or royalty interests percentage in existing wells
6 are altered by a proposed rule, where No. 9, I think, is
7 more clear in that it says the outcome of the hearing which
8 may affect the property owners.

9 There has been in both hearings before
10 the Commission and in the court case which Mr. Stovall al-
11 luded to, testimony to the effect that No. 7 is the control-
12 ling provision of the rules, even though 1 through 6 may
13 have particularly applied to the situation.

14 The case at bar there was a case relating
15 to special pool rules, particularly regarding spacing, and
16 one of the attorneys there was arguing that provision 7 ap-
17 plied, even though there is a particular rule, subsection 4,
18 which applies to special pool rules.

19 Moreover, it's my understanding of the
20 law, and I won't cite any cases but I will read a defini-
21 tion, that once a lease has been signed the royalty owner no
22 longer has any right to make operating decisions and it's my
23 understanding of the law that spacing and questions of that
24 nature are operating decisions. They're technical, scienti-
25 fic decisions, and I don't know that royalty owners, who,

1 obviously, would like to have well on each lease, really
2 have any need to be notified of such decisions.

3 I just want to read from a book, Oil and
4 Gas Law by John Lowe, who is a recognized authority, he de-
5 fines a royalty interest on page 383 as "A share of produc-
6 tion free of the costs of production, when and if there is
7 production; usually expressed as a fraction.

8 In most states, however, a royalty is
9 subject to costs for severance taxes, transportation, clean-
10 ing and compression unless the lease provides otherwise.

11 A royalty interest has no right to oper-
12 ate the property. Therefore, a royalty has no right to
13 lease or to share in the bonus or delay rental." And it
14 continues, but my point is that I think it's commonly accep-
15 ted in the industry and in the law that a royalty interest
16 is not an operating interest; and it's -- it's unclear to
17 me exactly why we came up with Subsection 7, but I think it
18 is causing confusion and ambiguity both here and in the
19 court cases that are involved in it.

20 Also, I think an important fact is that
21 many leases, there are many different form leases, and they
22 may determine the rights of the royalty interest and the
23 operator or the lessee differently, and I think our defini-
24 tion, or our requirement for notice in Subparagraph 7 is
25 probably too broad and that there may actually be leases

1 where it's clear that the royalty owner has delegated either
2 the lessee to be his agent or that he has no right to make
3 any decisions regarding operations.

4 One other factor that I think may be
5 important is that spacing to me would be an adjudicatory
6 function of the Commission rather than a -- or would be a
7 rule-making function rather adjudicatory function.

8 Usually in spacing questions, especially
9 statewide spacing, we're not affecting any two parties in
10 particular; we're looking at spacing for whole areas of the
11 state or pools, and in rule-making functions the notice
12 requirements imposed by the law are not nearly as strict as
13 those when two particular parties are fighting about it,
14 which would be an adjudication, an adjudication between
15 those two parties, and that's another reason why I think
16 Rule 7 is too strict.

17 A good example of a similar situation
18 would be allowables. Allowables are essentially, I think, a
19 rule-making function, where we set allowables for the whole
20 state, and if we were to require notice to everyone whose
21 production was affected by the allowables, you'd have to
22 give personal notice to every royalty owner, every operator,
23 every working interest owner in the state, which would be
24 impossible to do every month, and I think it's a spector of
25 having this kind of notice that's going to raised more and

1 more cases and I think it would be just much better if we by
2 regulation made it clear that it's our understanding that in
3 this type of case royalty owners do not have a right to not-
4 ice because of the lease provisions. They've delegated
5 operating rights to their lessee. He may be an agent for
6 them, for the royalty owner, the lessee may be, or he may
7 not be, but I think for us to require that royalty owners
8 get notice in every type of case other than the first 6 is
9 just a burden that we shouldn't be imposing. It's a private
10 contractual issue between the parties and I think it would
11 be much better left to the parties.

12 I would just -- I think I have one other
13 quote I would like to read from Lowe's oil and gas law book
14 relating to lessor's interest.

15 It says on page 281, "The reasonably
16 prudent operator must consider his lessor's interest while
17 pursuing his own. He does not owe a fiduciary duty to a
18 lessor and liability does not necessarily follow from a bad
19 decision. Indeed, the lessee's decisions may have a fore-
20 seeable adverse impact upon the lessor without triggering
21 liability.

22 What is required is that the lessee may
23 make decisions with due regard to the interests of the les-
24 sor, the nature of the long term business relationship be-
25 tween the lessee and the lessor. Though the requirement

1 is based upon business realities. A prudent business person
2 will take into account the interests of those associated
3 with him in transactions, because to do so is necessary to
4 ensure business with them and others in the future."

5 And I think that this points
6 out the fact that especially in questions of spacing a pru-
7 dent operator has to make those decisions based upon reser-
8 voir engineering data and technical and scientific data and
9 he makes those decisions on behalf of his royalty owner as
10 his agent or designee on the lease.

11 And I guess that's all I have
12 on direct but I'd be glad to answer any questions that any-
13 body has.

14 MR. LEMAY: Fine. Are there
15 questions of Mr. Taylor?

16 Mr. Stovall.

17 MR. STOVALL: Mr. Chairman,
18 might it be possible to take -- for me to take a couple
19 minutes to consult with Mr. Taylor? I've been aware of this
20 case. It's been continued for -- for numerous sessions.
21 Quite frankly, I think it's very important, having been one
22 of the attorneys involved in the leading case in New Mexico
23 on the issue of notice.

24 If I could have just a couple
25 of minutes to --

1 MR. LEMAY: All right, let's --

2 MR. STOVALL: Perhaps less.

3 There's no reason, really, to even go out of the room.

4 MR. LEMAY: All right, we'll go
5 off the record just for a minute.

6

7 (Thereupon a brief recess was taken.)

8

9 MR. STOVALL: Mr. Chairman, I'm
10 ready when you are.

11 MR. LEMAY: Okay, we'll go back
12 on the record. You're still under oath, Mr. Taylor.

13 Mr. Stovall, you have some
14 questions of the witness?

15 MR. STOVALL: Well, I -- I
16 don't at this time, Mr. Chairman.

17 As I say, I was aware of this
18 case pending for some time and quite frankly, had I known it
19 was going to be heard today, I would have prepared some ex-
20 hibits and some testimony which would be supportive of what
21 the Commission is asking in the modification of this rule.

22 My concern is there had been a
23 case, as Mr. Taylor mentioned, brought regarding the issue
24 of notice to royalty owners. There's been another case
25 filed with the Division regarding the same matter. I see it

1 as being an area that can become a problem.

2 I hate to unduly burden the
3 Commission with additional lawyerese and legal arguments,
4 but I can see at some point down the road there could be
5 some difficulties arising out of this and I would like to
6 assist the Commission in developing a very thorough record
7 in support of any action it might take.

8 MR. LEMAY: We can certainly
9 leave the record open for additional comments if you have
10 some to provide at some later date.

11 MR. STOVALL: I think I would
12 like that.

13 If there were some way we could
14 do that, and I'd like to -- for example, Mr. Taylor alluded
15 to lease language and I'd like to introduce and demonstrate
16 some lease language, which does give the operator exclusive
17 rights to operate the premises.

18 Perhaps a review of the addi-
19 tional provisions of Rule 1207, which supports the constitu-
20 tional requirements of notice to royalty owners where
21 there's a property taking issue. We're in a lawyer's world,
22 unfortunately, in this particular question. We're not in
23 the operator's world in a real sense, because we're talking
24 about procedural due process types of arguments.

25 MR. LEMAY: Well, would it

1 please the -- those present if we left the record open after
2 comments today and then I requested some draft orders from
3 those of you that make statements so that we non-lawyers on
4 the Commission can maybe pick and choose among some of the
5 brighter minds here, the legal minds available?

6 MR. STOVALL: Might we also
7 submit written comments or affidavits explaining --

8 MR. LEMAY: Certainly, that
9 would be the reason for leaving the record open. I think we
10 hope we'll hear some more testimony unless -- do you have
11 any other questions at this time, Mr. Stovall?

12 MR. STOVALL: Well, I can
13 testify to the things I'm talking about but perhaps it would
14 be just as well to put it in written form and supporting --
15 with some supporting documentation.

16 MR. LEMAY: I would be your
17 choice.

18 MR. STOVALL: I think that
19 might be better, perhaps, for the Commission as well as for
20 me.

21 MR. LEMAY: Fine. Thank you.

22 Mr. Brostuen, I think, has a
23 question for the witness.

24 MR. BROSTUEN: Just a few
25 points in clarification.

1 I'm not sure if I heard you
2 correctly or if I'm interpreting what you said correctly,
3 but are you saying that by virtue of the terms of a lease
4 and also the -- some of the information that you read to us
5 out of the publication that you introduced here, that the
6 royalty interest owner has -- has no involvement whatsoever
7 as far as correlative rights are concerned?

8 I guess -- let me restate the
9 question a little bit more clearly.

10 Are you saying that protection
11 of correlative rights is the responsibility of the operator
12 and not the Commission?

13 MR. TAYLOR: No, sir. I'm --
14 we -- I was simply talking about operating rights versus the
15 rights of a royalty owner. There are many implied covenants
16 in the lease which, if breached, will result in damages on
17 behalf of a royalty owner against a lessee.

18 For instance, they do have a
19 duty to avoid drainage and thing like that, and I really
20 wasn't relating to correlative rights at all.

21 MR. BROSTUEN: But does this --
22 this rule does speak to the -- essentially protection of
23 correlative rights, and if not directly, indirectly, giving
24 the -- giving the royalty interest owner the opportunity to
25 appear in his behalf in matters that come before the Commis-

1 sion that may affect his property rights.

2 MR. TAYLOR: Well, I certainly
3 don't think I'd argue that a royalty owner doesn't have a
4 right to appear. We're really looking at the ambiguity and
5 the confusion of the language in Number 7, which I just
6 think it would be better if Number 7 were deleted and we had
7 the catch-all be Number 9, because I think it's just better
8 worded and it's more inclusive and I think the issue of the
9 rights between a royalty interest owner and an operator
10 should in large part be left to those parties by private
11 contract, and I think Rule 7 is just too inclusive as far as
12 saying what those rights and duties are.

13 And certainly I don't think I'd
14 ever argue that even if a royalty owner may not have right
15 to notice because of signing a lease and giving operating
16 rights to a lessee, I don't think that would necessarily im-
17 ply that he doesn't have the right to come in here and pre-
18 sent a case if that's his desire.

19 MR. BROSTUEN: Okay. Thank you
20 very much.

21 MR. LEMAY: Are there addition-
22 al questions of the witness?

23 MR. PEARCE: Mr. Chairman.

24 MR. LEMAY: Mr. Pearce.

25 MR. PEARCE: No questions.

1 Just a point of clarification,
2 we certainly have no opposition to Mr. Stovall's suggestion
3 to supplement the record, if that's appropriate; however,
4 this case has been continued and been on the docket a long
5 time. Could we get some firm time line by which parties are
6 going to have to do something if they're going to?

7 MR. LEMAY: I was looking in
8 terms of two weeks.

9 MR. PEARCE: That's fine, Mr.
10 Chairman. It just hadn't been mentioned before and I would
11 like it mentioned.

12 MR. LEMAY: Thank you.

13 MR. PEARCE: Thank you.

14 MR. LEMAY: If not, the witness
15 may be excused.

16 Mr. Kellahin, did you have any
17 statements you'd like to present for the record?

18 MR. KELLAHIN; Yes, Mr. Chair-
19 man.

20 From an operator's perspective,
21 I think the Rule 7 is an unfortunate provision in the notice
22 requirements. It potentially could create a burden upon an
23 operator if he is required to undertake the responsibility
24 of not only notifying other working interest owners on which
25 his application might have an effect, but then to go beyond

1 the working interest owners ownership position and attempt
2 to notify royalty owners that are involved with another
3 operator is a burden that I don't think is justified.

4 In reviewing the transcripts of
5 the hearing by which the notice rules were presented, it is
6 not clear in that transcript the purpose for which Paragraph
7 7 was intended. As best I know, I have never utilized it in
8 filing an application. I'm not aware of anyone else that
9 has attempted to provide notice pursuant to that paragraph.

10 I can't think of a situation
11 that occurs in a hearing process where I would rely upon
12 that and say that is my notice requirement. I think all the
13 other notice requirements in the rules in the section book
14 here, 1 through 6, are the ones that we use. 7 has no use
15 for me in how I file my notices.

16 The only other mention of roy-
17 alty owner notices is in forced pooling, statutory unitiza-
18 tion. In those, those are appropriate times to notify roy-
19 alty owners. (Unclear) a royalty owner in Paragraph 7, I
20 just can't think of a reason to do it.

21 As Mr. Taylor mentioned, the
22 lease ownership arrangement with a royalty owner and his
23 lessee, creates a contractual obligation where that lessee
24 as operator or working interest owner, is obligated to pro-
25 tect his own royalty owners, so you get the notice to that

1 working interest or lessee and he then must work out his ar-
2 rangements with the royalty owners.

3 So I think it's an unnecessary
4 addition to the rules and we would concur in Mr. Taylor's
5 recommendation that Paragraph 7 be deleted from those rules.

6 MR. LEMAY: Thank you, Mr.
7 Kellahin.

8 Mr. Pearce?

9 MR. PEARCE: Nothing further,
10 Thank you, Mr. Chairman.

11 MR. LEMAY: Mr. Stovall?

12 MR. STOVALL: Nothing further.

13 MR. LEMAY: Okay, are there any
14 additional comments or statements in Case 9134?

15 We'll leave the record open for
16 two weeks for additional comments. Then we'll close it and
17 we'll try and get an order out pretty quickly.

18 I would also like to solicit in
19 this particular case draft orders from those -- those of you
20 that -- at least, if I could name Mr. Stovall and Mr.
21 Kellahin and Mr. Pearce, if you would be so kind, I would
22 appreciate it.

23 We will leave the case open for
24 two weeks and then take it under advisement.

25

(Hearing concluded.)

C E R T I F I C A T E

I, SALLY W. BOYD, C.S.R., DO
HEREBY CERTIFY the foregoing Transcript of Hearing before
the Oil Conservation Division (Commission) was reported by
me; that the said transcript is a full, true, and correct
record of the hearing, prepared by me to the best of my
ability.

Sally W. Boyd CSR

NEW MEXICO OIL CONSERVATION COMMISSION

COMMISSION HEARING

SANTA FE, NEW MEXICO

Hearing Date NOVEMBER 19, 1987 Time: 9:00 A.M.

NAME	REPRESENTING	LOCATION
LARRY Sweet	Mesa Grande, Ltd.	Tulsa
John Roe	Dugan Prod. Co-P	Farmington
Kathy Michael	Mesa Grande Resources	Tulsa
Bob Harker	Byram	Santa Fe
Alan Emmerich	Mesa Grande Resource	Tulsa
Ernie Busch	NMOCB	Flag
Ron Merrett	NMOCB	Santa Fe
Angie Broome	T. H. M. Selman & self	Santa Fe
Bob Buettner	Koch Exploration Company	Santa Fe
Dick Ellis	SELF	DENVER
Bill Hawkins	Amoco	DENVER
Kent Lund	Amoco	DENVER
Robert G. Stovall	Sever	Farmington
Greg Wexler	Kai	Tucson AZ
Heidi Kai	KAI	Tucson AZ
William J. Kai	Commercial Development	Tucson, AZ
Al Kendrick	Consultant	Any, Tex NM

NEW MEXICO OIL CONSERVATION COMMISSION

COMMISSION HEARING

SANTA FE, NEW MEXICOHearing Date NOVEMBER 19, 1987 Time: 9:00 A.M.

NAME	REPRESENTING	LOCATION
W. Kellerkin	Kellerkin Kellerkin and company	Santa Fe
Arden Kopf -	Hinkle Law Firm	Santa Fe
Ed Hartman	Manana Assoc. Inc.	Albuquerque, NM
Jack Cayman	Mintel, Inc.	Albuquerque, NM
MATT FRITHART	READING } BATES PETROLEUM	TULSA