FIFTH JUDICIAL DISTRICT COURT

STATE OF NEW MEXICO

COUNTY OF SANTA FE

No. CV 86-1061 FR

MICHAEL L. KLEIN,
JOHN H. HENDRIX,
JOHN H. HENDRIX, CORPORATION,
and RONNIE W. WESTBROOK,

Petitioners,

vs.

NEW MEXICO OIL CONSERVATION
COMMISSION and ROBERT E. CHANDLER
CORPORATION,

Respondents.

BRIEF-IN-CHIEF OF PETITIONERS

I. STATEMENT OF THE CASE AND PROCEEDINGS.

Exhibit No. 1 in the Oil Conservation Division (Division) Case No. 8859 is the Application of Robert E. Chandler Corporation for an amendment to the Oil Conservation Division Order R-8047 which had been issued by the Division on September 25, 1985. In this Application Robert E. Chandler Corporation (Chandler) asked the Division to declare that any leasehold burdens in excess of 3/16 royaly interest against a 50% interest which was then or formally held by Sun Exploration and Production Company to be excessive and to authorize Chandler to recover out of

production its well costs and risk factor penalty prior to the payment of any such excessive leasehold burdens. The Application also asks for a drilling extension under the previous order.

After hearing this Case no. 8859 the Division issued its Order No. R-8047-A. That Order amended ordering paragraph no. 1 of Division Order No. R-8047 to pool "all mineral interests, whatever they may be,".... Order R-8047-A also contained an ordering proviso that the "Net Profits Overriding Royalty" was to be treated as a net profits interest under the terms of the previous Order, R-8047, and should bear its appropriate share of the costs of drilling and operation.

On June 13, 1986 the Division entered its Order R-8047-B upon the request of the Petitioners herein for a stay of Division Orders Nos. R-8047 and Order No. R-8047-A. This Order stayed the previous Orders of the Division.

After a hearing de novo on August 7, 1986, the New Mexico Oil Conservation Commission (Commission) issued its Order R-8047-C. This Order rescinded Orders R-8047-A and R-8047-B. The Commission, however, adopted the findings of the Division contained in Order No. R-8047-A. Order R-8047-C also required that the Petitioners herein pay their proportionate share of well costs in advance in order to

avoid an assessment of the risk penalty factor as authorized by Order No. R-8047 as to any nonconsenting working interest owner in the proration or spacing unit.

Petitioners thereafter filed their Motion for Rehearing which was not acted upon and therefore deemed denied pursuant to Section 70-2-25, N.M.S.A., 1978. Petitioners then timely filed their Petition herein on October 10, 1986.

II. ORDER R-8047-C OF THE COMMISSION GOES BEYOND THE SCOPE OF THE CHANDLER APPLICATION TO AMEND ORDER R-8047.

The Application of Chandler to amend Order R-8047 has been discussed above to some extent. The allegations contained in the Application attempt to identify the interests of the Petitioners herein and further state that the interests held by the Petitioners are excessive. The relief requested by Chandler is that the interests of the Petitioners are excessive and that such interests should be suspended until payout under the formula provided by Order R-8047 for nonconsenting working interest owners.

The findings of Order R-8047-A and R-8047-C do not contain any finding whatsoever that the interests of Petitioners make drilling of a well in the proposed proration and spacing unit uneconomical. Finding No. 6 of Order R-8047-A finds that the Applicant alleges that drilling of a well is not economical if the net profits interest were construed to be an overriding royalty.

Finding No. 9 of that Order also mentions the uneconomical nature of the proposed well. This finding, however, refers to the time delay during which the proceeding before the Division took place and finds that an extension of time for drilling the well is necessary due to the time delay.

Insofar as the Application of Chandler is concerned, the Orders issued by the Division and the Commission are defective with respect to a finding that the interests of the Petitioners make the drilling of a well uneconomical. This argument of course, assumes that the Division and Commission have statutory authority to decide whether drilling prospects are economical or uneconomical under the circumstances.

Order R-8047-C certainly makes no mention of the economics of the drilling prospect. Finding No. 13 of the Commission's Order quotes extensively from Sections 70-2-17 (C) N.M.S.A., 1978. Somehow the Commission found justification in this statutory language to convert the Petitioner's interest as defined under the terms of the instrument creating that interest (Exhibit 5 in case 8859) to a full working interest requiring Petitioners to pay for their well costs in advance of drilling a well.

III. THE OIL CONSERVATION DIVISION NOR THE OIL CONSERVATION COMMISSION HAVE AUTHORITY TO CONSTRUE AND REFORM INSTRUMENTS CREATING INTERESTS IN REAL PROPERTY.

The action taken by the Oil Conservation Division and the Oil Conservation Commission in this case is a callous disregard of the property rights of the Petitioners. Petitioners do not challenge the jurisdiction of these two administrative bodies with respect to the conservation of oil and gas. We further concede the jurisdiction which these bodies have with regard to administration of the compulsory pooling statute. There is no question but that the Division and the Commission have authority to pool or combine, for drilling purposes, oil and gas interests which have not consented to drilling of a well.

Petitioners do not challenge the authority of the Division or the Commission to pool a land owner's royalty under circumstances where such land owner has not consented, under his lease to a lessee, or some other agreement, to the creation of a spacing unit in order to conform to the well spacing requirements of the Division and the Commission. There may be other circumstances where other interests in oil and gas properties may not have consented to creation of spacing and proration units. This, however, does not change the nature of the economic interest within a spacing or proration unit, of such a royalty or other interest owner.

Pooling by a conservation agency under such circumstances has been deemed to be valid under the police power of the state. This proposition is not new and certainly does not require a citation.

It is quite a different proposition, however, for a conservation agency, as in this case, to change the nature of a property interest, within a spacing or proration unit, in order to make a drilling proposition economical. Both the Division and the Commission examined the interest under the instrument creating the interest of the Petitioners. They refuse to accept the fact that Petitioner's interest is a carried interest and that it is not a working interest.

The Commission and the Division have concurrent jurisdiction and authority under the Oil and Gas Act. Section 70-2-6 (B) N.M.S.A, 1978. In Continental Oil Company v. Oil Conservation Commission, 70 N.M. 310, 373 P.2d 809 1962 the New Mexico Supreme Court stated that the Oil Conservation Commission was "a creature of statute, expressly defined, limited and empowered by the loss creating it." The Court went on to say that the Commission has "jurisdiction over matters related to the conservation of oil and gas in New Mexico, but the basis of its power is bounded on the duty to prevent waste and to protect relative rights." It simply streches the imagination as to how and

under what authority the Commission, in its misguided quest for its assumption of equity, can exercise jurisdiction to change Petitioners' Net Profits Interest to a working interest. Exhibits 4 and 7 in case 8859 before the Division are copies of pleadings before the United States District Court for the Western District of Texas, Midland-Odessa Division. These are Plaintiff's original Complaint and Defendant's Answer and Counterclaim in Cause No. MO 85 CA 105, respectively. We are not certain as to what Chandler intended to prove by the introduction of these exhibits. Obviously, the interest of the Petitioners may have been the subject of litigation in that action. Nothing in the record of this case tells us how the litigation in the federal action is relevant to the compulsory pooling action before the Division and the Commission.

The problem is further compounded by the testimony of Chandler's expert witness at the Division hearing in case 8859. Over these Petitioner's objections (March 19, 1986 TR. P. 26-27) Mr. Savage, Chandler's expert and only witness, who was qualified as a petroleum engineer, was allowed to testify concerning his interpretation of the document creating Petitioner's interest. On cross-examination Mr. Savage testified that Chandler had not even the benefit of a drilling title opinion. (March 19, 1986

TR. P. 29.) It is evident from further cross-examination that Mr. Savage simply did not know whether the litigation in the Federal Court affected the net profits interest which he was trying to interpret before the Division. Id at P. 30-31, 34. In this regard, it is interesting to note that the perception which Mr. Savage appeared to have was that the Petitioners herein were attempting to construe their interest as an overriding royalty interest. The Division in Order R-8047-A in its finding no. 7 finds that Petitioners were advocating such an interpretation. Petitioners at no time made such a claim. Petitioners contentions were and continue to be grounded on whether the Commission could modify Petitioners' interest to require them to pay their proportionate well costs in advance of drilling the well. And further to subject their interest to a 200% penalty as stated in Order R-8047.

Chandler appears to find a grant of authority from the Legislature to the Commission under Sections 70-2-6 N.M.S.A. 1978 and under the compulsory pooling statute cited above which is Section 70-2-17 (C). As stated earlier, we do not question the Commission's authority to pool and combine 100% of all oil and gas interests and the dedication of such interests to a single spacing or proration unit under spacing requirements.

We must again turn to Continental Oil Company v. Oil Conservation Commission, supra, for guidance on the Division's authority in this case. In Continental, the New Mexico Supreme Court, at page 324, deals with the doctrine of separation of powers and whether the Oil Conservation Commission was a necessary party in that case, stating:

> If the protection of correlative rights were completely separate from the prevention of waste, then there might be no need in having the Commission as a party; but if such were true, it is very probable that the Commission would be performing a judicial function, i.e., determining property rights, and grave constitutional problems would arise. For the same reason, it must follow that, just as the Commission cannot perform a judicial function, neither can the court perform an administrative one. (Citations omitted.)

It is submitted, purely and simply, that should the Division construe Petitioners' net profits interest as a working interest, the Commission would be performing a judicial function. Let us, however, examine this situation more closely. If the net profits interest is indeed a working interest as Chandler contends, why then is it necessary to amend Order R-8047? Chandler's motive and intentions, however, were simply to eliminate the net profits interest in order to make the proposed drilling venture more desirable to a third party who would actually expend the necessary funds to drill the proposed well.

Chandler's witness at hearing testified Applicant would not be drilling the well and would be carried to casing point. Id. at 32-33.

The proposed change of Petitioner's property interest makes Chandler's anticipated transaction presumably salable -- at Petitioners' expense.

The issue concerning the authority of oil and gas conservation has been addressed by Texas courts on numerous occasions where jurisdictional issues involving the Texas Railroad Commission (the Texas oil and gas conservation agency) have arisen. Mueller v. Sutherland, 179 S.W.2d 801, 808 (1943), involving a spacing case, early decided it was fundamental that the rules and regulations of the Railroad Commission could not have the result of effecting a change or transfer of property rights. See also Whelan v. Placid Oil Company, 274 S.W.2d d125 (1954), citing Mueller v. Sutherland, which further states that the Railroad Commission had no jurisdiction to determine matters of title although in that case its action, based on conservation rules and regulations, was proper. Ryan Consolidated Petroleum Corporation v. Pickens, 285 S.W.2d 201, 207 (1956) also held that the Texas Railroad Commission was powerless to determine property rights although the Texas legislature has conferred broad, extensive, and exclusive regulatory

powers for the regulation of the oil and gas industry in Texas.

Pan American Production Company v. Hollandsworth, 294 S.W.2d (1956), like Ryan Consolidated, supra, was a "Rule 37" case and gives us exceptional guidance as to a conservation agency's role with respect to title. The Court in that case held that all the Railroad Commission was required to do was determine that the applicant for a drilling permit had a good faith claim to the tract being drilled and that the rules of the Commission were met.

Section 70-2-12(B) (8) N.M.S.A. 1978 Compilation empowers the Division to "identify the ownership of oil and gas leases, properties..." We submit that this statutory provision is a standard which goes no further than the test enunciated in Pan American Production Company v. Hollandsworth. In our case, the quoted statutory provision merely allows the Oil Conservation Division to "identify" Petitioners' interest as a net profits interest -- no more, no less.

If the instrument creating Petitioners' net profits interest is ambiguous or subject to interpretation, a court of competent jurisdiction is to determine whether such instrument is ambiguous and, if not, to determine from the terms and provisions of the instrument itself the intent of

the parties when the instrument was executed. See Pan American Petroleum Corporation v. Railroad Commission, 318 S.W.2d 17 (1958), which cites liberally from the earlier Texas case of Magnolia Petroleum Company v. [Railroad] Commission, 170 S.W.2d 189, as follows:

> The function of the Railroad Commission in this connection is to administer the conservation laws. When it grants a permit to drill a well it does not undertake to adjudicate questions of title or rights of possession. These questions must be settled in the courts. When the permit is granted, the permittee may still have no such title as will authorize him to drill on the land. ***If he has possession, or can obtain possession peaceably, his adversary may resort to the courts for a determination of the title dispute, and therein ask for an injunction or for a receivership. In short, the order granting the permit it purely a negative pronouncement. It grants no affirmative rights to the permittee to occupy the property, and therefore would not cloud his adversary's title. It merely removes the conservation laws and regulations as a bar to drilling the well, and leaves the permittee to his rights at common law. Where there is a dispute as to those rights, it must be settled in court. The permit may thus be perfectly valid, so far as the conservation laws are concerned, and yet the permittee's right to drill under it may depend upon his establishing title in a suit at law. In such a suit the fact that a permit to drill had been granted would not be admissible in support of permittee's title.
>
> * * * If the applicant makes a reasonably satisfactory showing of a

> good-faith claim of ownership in the property, the mere fact that another in good faith disputes his title is not alone sufficient to defeat his right to the permit; neither is it ground for suspending the permit or abating the statutory appeal pending settlement of the title controversary.

The foregoing language from Magnolia Petroleum Company v. [Railroad] Commission clearly establishes jurisdictional boundaries between a conservation agency and a court with respect to ascertainment of a private contractual interest. Again, we do not quarrel with a valid exercise of the State's police powers and delegations thereof to the Division and Commission resulting in issuing a compulsory pooling order such as R-8047 to prevent waste. However, for the Division to adjudicate a change of a property right is clearly beyond the scope of the Commission's authority.

IV. THE DIVISION AND THE COMMISSION ERRED IN ALLOWING THE TESTIMONY OF A PETROLEUM ENGINEER RELATIVE TO INTERPRETATION OF THE INSTRUMENT CREATING PETITIONER'S INTEREST AND THEREFORE THE FINAL COMMISSION'S ORDER IS NOT SUPPORTED BY SUBSTANTIAL EVIDENCE.

As discussed above, Mr. Savage, over Petitioners' objections was alleged to testify concerning his interpretation of the instrument (Exhibit 5 in in Case 8859) creating the net profits interest. Additionally, Mr. Savage did not even have the benefit of a competent title opinion to inform him of the exact nature of the various oil and gas interest with which he was dealing in forming his drilling

prospect. As pointed out in other portions of this brief, at no time did Petitioners advance an argument that its interest was an overriding royalty interest.

An order of an adminstrative agency which is not based on substantial evidence may properly be described as conjectural, speculative, unlawful, unreasonable, arbitrary and capricious. Ferguson - Steere Motor Co. v. State Corporation Commission, 63 N.M. 137, 314 P.2d 894 (1957).

In the Ferguson - Steere Motor Co. case the Supreme Court of New Mexico cited language from Baca v. Chaffin, 57, N.M. 17, 253 P.2d 309 (1953) involving an appeal from a state administrative agency. That language follows:

> "'There must be some substantial evidence of probative character to sustain the finding of the liquor authority, or else its decision will be set aside, but its presence is absolutely necessary. A finding without some evidence of probative value would be arbitrary and baseless. A fair trial is the antithesis of an arbitrary trial. A trial which proceeds to a conclusion resulting in a quasi-judicial determination depriving appellee of legal rights, can well be said to be unfair if the determination is necessarily based on a finding of fact which is not supported by proof of a probative character.' There must at least be such relevant evidence as a reasonable mind might accept as adequate to support the conclusion."

Rule 702 of the New Mexico Rules of Evidence requires some special knowledge, skill, experience, training or

education on behalf of the witness before that witness will be considered an expert. Duran v. Lovato, 99 N.M. 242, 659 P.2d 905 (Ct. App. 1983). The record in this case is devoid of any qualification of Mr. Savage to render an opinion interpreting the nature of Petitioners' interest. In this case, a critical distinction between his testimony concerning economics of the drilling prospect and his testimony interpreting the Exhibit 5 instrument is absolutely essential. Relevant testimony from a qualifed expert may be received if and only if that expert is in possession of such facts as would enable him to express a reasonably accurate conclusion as distinguished from mere conjecture. Id. at 246.

The real issue is whether Petitioners' interest requires payment of their proportionate share of drilling costs prior to drilling or whether such interest is a carried interest. Chandler's and Mr. Savage's preoccupation with the overriding royalty issue are totally irrelevant.

We recognize that rules governing the admissibility of evidence before administrative bodies are frequently relaxed to expedite administrative procedure, but the corollary of that rule is that rules relating to weight, applicability or materiality of evidence are thus not limited. Ferguson -

Steere Motor Co., supra; Saenz v. New Mexico Department of Human Services, 89 N.M. 805, 653 P.wd 181 (Ct. App. 1982).

The Division's and the Commission's failure to recognize Petitioners' interest as a carried oil and gas interest resulted in arbitrary and capricious orders. The Commission's action in following the Division's orders was unreasonable, not having a rational basis and the result of an unconsidered, willful and irrational choice of conduct. See Garcia v. New Mexico Human Services Department, 94 N.M. 178, 608 P.2d 154 (1979).

There simply is no basis for Mr. Savage's opinion testimony. The Exhibit 5 document, is dated April 1, 1966. The record contains no chain of title relative to the various interests created by that document. A number of real property principles, such as the doctrine of merger, could now be applicable.

V. NATURE OF A NET PROFITS INTEREST.

We are fortunate in having a recent decision of the New Mexico Court of Appeals with respect to the nature of the net profits interest Christy v. Petrol Resources Corporation, 102 N.M. 58, 691 P.2d 59 (Ct. App. 1984). In this case, the New Mexico Court of Appeals concluded that the term "net profits interest" "has no independent meaning and ... the nature of Plaintiff's interest must be

determined from the provisions of the instrument which created Plaintiff's interest." The term was found to describe an interest in cash bonus and not a royalty interest nor an interest in title to land and, thus, a quiet title action was inappropriate. The case, however, gives us considerable insight as to what a net profits interest is. Because of the clarity of the Court's discussion, we quote liberally from the opinion:

> Plaintiff suggests that we should treat a "net profits interest" in the same manner as overriding royalty is treated, citing J. Sherrill, Net Profits Interest -- A Current View, 19th Oil & Gas Inst. at 165 (Matthew Bender 1968), and 2 H. Williams & C. Meyers, Oil and Gas Law Section 424.1 (1983).
>
> Plaintiff's argument fails to recognize that both texts assign a meaning to the phrase "net profits interest" and likens the interest, as defined, to an overriding royalty. J. Sherrill, supra, explains that the "typical" net profits interest requires the working interest owner to advance all moneys necessary for the development and operation of the property, and entitles the working interest owner to receive all of the proceeds attributable to the production until he recoves all amounts previously advanced. J. Sherrill, supra, at 165, states: "Thus, traditionally, within the oil and gas industry, the 'net profits' of a net profits interest exist only when total receipts from the property exceed total expenditures with respect thereto, and it is in this sense that net profits are herein considered." 2 H. Williams & C. Meyers, supra, at Section 424 states that net profits are

> fractional interests in oil and gas property and at Section 424.1 states "[a] net profits interest is a share of gross production from a property measured by net profits from the operation of the property." See also 8 H. Williams & C. Meyers, Oil and Gas Law at 457 (1982). The definitions in both texts involve production from the property. Plaintiff's net profits interest" is not based on production. This distinction makes the definitions in the above texts inapplicable in this case.

Both of the authorities cited by the Court of Appeals in the foregoing discussion discuss basically three types of net profits interests. See J. Sherrill, Net Profits Interest -- A Current View, 19th Oil & Gas Inst. at 171-72 (Matthew Bender 1968) and 2 H. Williams & C. Meyers, Oil and Gas Law Section 424.1 (1983). These authorities indicate that all three types of net profits interests are carried interests. In other words, the working interest owner advances the cost of development and operation. By the same token, the working interest owner is allowed to receive all proceeds attributable to the production until he recovers all amounts previously advanced.

J. Sherrill, supra, at pages 170-71 makes a distinction between a net profits interest and a carried interest. That distinction is that a carried interest is a working interest or becomes one when the carrying party reaches payout upon bases previously determined by agreement between the

carrying and the carried parties. A net profits interest, on the other hand, will never be a working interest owner or have of the rights of decision incident thereto, for he occupies a passive position before, during, and after the permitted recovery of the working interest owner.

It is clear, however, from these authorities that a net profits interest is not a working interest. J. Sherrill, supra, p. 168-69 states:

> The net profits interest holder has no personal obligation or liability for any contribution with respect to the development, operation, or abandonment of the property. In effect, his capital at risk is limited to his initial capital investment. All of such development and operation costs must at all times be borne by the owner of the working interest which is burdened with the net profits interest. Likewise, the net profits interest holder has no right to participate in any of the operating decisions with respect to the property. These matters are reserved to the working interest owner who is also entitled to receive all of the production attributable to the property until he recovers his total prior advancements for development and operations. Thereafter, the working interest owner continues to advance all sums necessary with respect to the property and also to account to the net profits interest holder as to his stated percentage of any net profits.

The foregoing quotation definitely sets forth the roles of the owners of the working interest and the role of the net profits interest. To change, by administrative order,

the role and nature of the net profits interest in this case would also change the nature of the working interest in this case as well. The Commission must remember that the instrument creating the net profits interest was originally executed on April 1, 1966. Are we now going to change the nature of that instrument by administrative order? Are we now going to call the net profits interest created by that instrument a working interest and subject it to a risk penalty factor in accordance with Order R-8047?

VI. CONCLUSION.

The only conclusion we can draw from Order R-8047-C is that it illegally stretches the authority of the Oil Conservation Commission. We have never proferred an argument before the Division or Commission that the net profits interest was an overriding royalty interest which, generally, is not subjected with the cost of development and operation. The net profits interest is a carried interest which pays costs as defined in the Exhibit 5 instrument only out of production - if and when production of oil or gas or both is obtained.

The opposition to the Application before the Commission is not intended to evade drilling and development costs. Under the Exhibit 5 instrument, Petitioners are not required to advance such costs. Certainly, it is not for the

Commission to decide or construe the net profits interest on an economical basis in the interest of having a well drilled to accommodate Chandler's problem. The detailed document that has been submitted before the Commission by the Applicant should speak for itself and in developing the properties burdened by such net profits interest the operator (Chandler) of the well must abide by the letter of that document.

Accordingly, to the extent the Order of the Division changes the nature of Petitioner's interest and to the extent it assesses a risk penalty factor, we submit the Order is erroneous, arbitrary, and capricious and that it impermissibly takes property of the Petitioners herein without compensation.

Respectfully submitted,

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CERTIFICATE OF SERVICE

I hereby certify that I mailed a copy of the foregoing Brief-In-Chief of Petitioners to W. Thomas Kellahin, Esquire, Post Office Box 2265, Santa Fe, New Mexico 87504-2265 and Jeffrey Taylor, Esquire, Oil Conservation Division, Post Office Box 2088, Santa Fe, New Mexico 87504-2088 this 29th day of January, 1987.