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SEP 1 1986
OIL CONSERVATION DIVISION

September 10, 1986

**HAND DELIVERY**

New Mexico Oil Conservation Commission
Post Office Box 2088
Santa Fe, New Mexico 87504

RE: Case No. 8859 (DeNovo)
Order R-8047-C

Members of the Commission:

Enclosed for your consideration is the Motion for Rehearing of Michael L. Klein, et al. in relation to the above referenced Order recently issued by the Commission.

Thank you for your assistance.

Very truly yours,

Ernest L. Padilla

ELP:rmm

Enclosure

cc: Michael L. Klein, et al. (w/enclosures)

STATE OF NEW MEXICO
DEPARTMENT OF ENERGY AND MINERALS
OIL CONSERVATION COMMISSION

IN THE MATTER OF THE APPLICATION
OF ROBERT E. CHANDLER CORPORATION
FOR AN AMENDMENT TO DIVISION ORDER
R-8047, LEA COUNTY, NEW MEXICO. CASE NO. 8859

MOTION FOR REHEARING

Pursuant to Section 70-2-25, NMSA, 1978 Comp., and Rule 1222 of the Rules on Procedure of the Oil Conservation Division, Michael L. Klein, John H. Hendrix, John H. Hendrix Corporation, and Ronnie H. Westbrook (hereinafter Klein, et al.), by their undersigned attorney, hereby apply for rehearing of Order R-8047-C issued by the Commission upon the following grounds:

1. The net profits interest of Klein, et al. in the proposed spacing unit is not a working interest or other operating interest pursuant Section 70-2-17(C) under which a risk factor penalty may be assessed by the Order.

2. The interest of Klein, et. al. in the proposed proration unit is a carried interest whereby Klein, et al. are not required to pay their proportionate share of well costs in advance of drilling and completing the proposed well; in order to prevent application of the risk factor

penalty, the Order requires Klein, et al, to pay their proportionate share in advance.

3. The Commission lacks authority and jurisdiction to subject the Klein, et. al. interest to any cost, or other expense, including the risk factor penalty under the Order or Order R-8047, which is not specifically covered by the instrument creating the Klein, et. al. net profits interest.

4. The action by the Division in issuing the Order constitutes an unlawful and unconstitutional taking of property without just compensation because such action impermissibly changes the nature of the Klein, et. al. interest from a carried interest to a full working interest.

5. The effect of the Order irreparably damages the Klein, et. al. interest because such interest covers not only the proposed proration unit, but other lands as well.

6. The Commission should adopt and enter the Klein, et. al. Proposed Order which is attached hereto as Exhibit A and incorporated herein as if set forth in full detail.

Respectfully submitted,

PADILLA & SNYDER

By _____

Ernest L. Padilla
Post Office Box 2523
Santa Fe, New Mexico 87504-2523
(505) 988-7577

This is to certify that the undersigned caused a true and correct copy of the foregoing Application for Hearing De Novo and Motion for Stay to be mailed first class and postage prepaid to:

W. Thomas Kellahin, Esq.
Kellahin & Kellahin
Post Office Box 2265
Santa Fe, New Mexico 87504-2265

this 10th day of Sept., 1986.

Ernest L. Padilla

STATE OF NEW MEXICO
ENERGY AND MINERALS DEPARTMENT
OIL CONSERVATION COMMISSION

IN THE MATTER OF THE HEARING
CALLED BY THE OIL CONSERVATION
COMMISSION FOR THE PURPOSE OF
CONSIDERING:

CASE NO. 8859 (DeNovo)
ORDER NO. R-8047-C

APPLICATION OF ROBERT E. CHANDLER
CORPORATION FOR AN AMENDMENT TO
DIVISION ORDER NO. R-8047,
LEA COUNTY, NEW MEXICO

KLEIN, et al. PROPOSED
ORDER OF THE COMMISSION

BY THE COMMISSION:

This cause came on for hearing at 8:15 a.m. on August 7, 1986, at Santa Fe, New Mexico, bofore the Oil Conservation Commission of New Mexico, hereinafter referred to as the "Commission".

NOW, on this ____ day of _____, 1986, the Commission, a quorum being present, having considered the testimony presented and the exhibits received at said hearing, and being fully advised in the premises,

FINDS THAT:

1. Due public notice having been given as required by law, the Division has limited jurisdiction of this cause and the subject matter thereof.

2. The applicant, Robert E. Chandler Corporation, seeks amendment of Order No. R-8047 entered October 3, 1985 which pooled the NE/4 SW/4 of Section 4, Township 23 South, Range 38 East, NMPM, Lea County, New Mexico, to extend the effective date thereof including the commencement date of the well to be drilled, and to clarify the treatment of various interests subject to the forced pooling for purposes of allocation of costs and application of the penalty provisions.

3. That the matter came on for hearing at 8:15 a.m. on March 19, 1986, at Santa Fe, New Mexico, before Examiner David R. Catnach and, pursuant to this hearing, Order No. R-8047-A was issued on May 9, 1986, which granted the application.

EXHIBIT A

4. That on June 2, 1986, application for hearing De Novo and a Motion For Stay was made by Michael L. Klein, John H.Hendrix, John H. Hendrix Corporation, and Ronnie H. Wentbrook (hereafter Klein, et al.).

5. That the Motion For Stay was granted by the Oil Conservation Division in Division Order R-8047-B staying Division Orders R-8047 and R-8047-A.

6. That the application of hearing De Novo was set for hearing before the Commission and hearing held on the matter on August 7, 1986.

7. That Division Order R-8047-A, in Amending Division Order R-8047, subjects the net profits interest owned by Klein, et al. in the proration or spacing unit pooled in Division Order R-8047 to risk penalty factor assessed in Order R-8047 under Ordering Paragraph 7(B) against each non-consenting working interest owner.

8. That the net profits interest owned by Klein, et al. is not a working interest or other oil and gas operating interest which is subject to assessment of a risk penalty as mandated by Orders R-8047 and R-8047-A.

9. That the effect of Order R-8047-A changes and amends the net profits interest of Klein, et al., which is a carried interest, by requiring such interest owners to pay their proportionate share of well costs in advance of the drilling and completing the proposed well in order to prevent an assessment of the risk penalty factor.

10. That the Oil Conservation Division and the Commission lack statutory authority and subject matter jurisdiction to subject the net profits interest of Klein, et al. to take risk factor penalty imposed on non-consenting working interest owners by Orders R-8047 and R-8047-A.

11. Division Orders R-8047 and R-8047-A should be reversed and rescinded, ab initio, insofar as they order, require, or in any other manner whatsoever effect a change or amendment to the Klein, et al. net profits interest and subject it to the risk penalty set forth in Order R-8047.

12. That the stay ordered in Order R-8047-B no longer is required as should be rescinded.

**IT IS THEREFORE ORDERED THAT:**

1. Division Orders R-8047 and R-8047-A are hereby reversed and recinded, ab initio, insofar as they order, require, or in any other manner whatsoever, effect a change or amendment to the Klein, et. al. net profits interest and subject it to the risk penalty set forth in Order R-8047.

2. Division Order R-8047-B is hereby rescinded and the stay imposed by it is vacated on the effect or date of this order.

Done at Santa Fe, New Mexico on the day and year hereinabove designated.

STATE OF NEW MEXICO
OIL CONSERVATION COMMISSION

Jim Baca, Member

Ed Kelly, Member

Richard L. Stamets, Chairman
and Secretary

STATE OF NEW MEXICO
# ENERGY AND MINERALS DEPARTMENT
## OIL CONSERVATION DIVISION

TONEY ANAYA
GOVERNOR

August 25, 1986

POST OFFICE BOX 2088
STATE LAND OFFICE BUILDING
SANTA FE, NEW MEXICO 87501
(505) 827-5800

Mr. Thomas Kellahin
Kellahin & Kellahin
Attorneys atLaw
Post Office Box 2065
Santa Fe, New Mexico

Re: CASE NO. 8859
ORDER NO. R-8047-C

Applicant:

Robert E. Chandler Corporation

Dear Sir:

Enclosed herewith are two copies of the above-referenced Commission order recently entered in the subject case.

Sincerely,

R. L. STAMETS
Director

RLS/fd

Copy of order also sent to:

Hobbs OCD x
Artesia OCD x
Aztec OCD

Other Ernest L. Padilla

BEFORE THE OIL CONSERVATION COMMISSION

IN THE MATTER OF THE APPLICATION
OF ROBERT E. CHANDLER CORPORATION
FOR AN AMENDMENT TO DIVISION ORDER
R-8047, LEA COUNTY, NEW MEXICO. CASE NO. 8859

MEMORANDUM OF AUTHORITY

I. Introduction.

The issue presented by the Application in this case is whether or not a net profits interest owned by the protestants to the Application of Robert E. Chandler Corporation may be force pooled and subjected to the risk factor penalty imposed by Order R-8047. It is our contention that Order R-8047 may not make the grand leap encompassing such net profits interest and to further convert such net profits interest to a complete working interest.

II. Statutory Authority.

Section 70-2-17C, N.M.S.A. 1978 Comp. states in pertinent part:

> When two or more separately owned tracts of land are embraced within a spacing or proration unit, or where there are owners of royalty interest or undivided interest 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 division, 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 interest or both in the spacingn or proration unit as a unit.

* * *

Such pooling order of the division shall make definite provision as to any owner, or owners, who elects not to pay his proportionate share in advance for the prorata 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 risk involved in the drilling of such well, which charge for risk shall not exceed two hundred percent of the nonconsenting working interest owner's or owners' prorata share of

the cost of drilling and completing the well.

Section 70-2-33E, N.M.S.A. 1978 Comp. defines owner as "the person who has the right to drill into and to produce from any pool, and to appropriate the production either for himself or for himself and another."

The foregoing definitions, when used in the context of compulsory pooling, would indicate that risk factor penalties and assessment thereof apply only to those owners and working interest owners who have the right to drill into and to produce from any pool.

Historically, the Oil Conservation Commission has had no cases that we can find which addressed issues similar to the one in the instant case. There have been, however, issues that have arisen with respect to the compulsory pooling of royalty owners. See Morris, Compulsory Pooling of Oil and Gas Interests in New Mexico, 3 Natural Resources Journal, p. 316 (1963). The author indicates that opposition to applications for compulsory pooling were made by royalty owners on the grounds that the word "owner" in the then pooling statute as defined in another section of the conservation law (now Section 70-2-33E, N.M.S.A. 1978) related only to a working interest. Evidently, the

particular case cited by the author of the article did not go to the appellate courts for decision. It is clear, however, that the nature of the opposition to the particular compulsory pooling Application, grounded on the lack of statutory authority of the Commission, was an attempt by the royalty owners not to be bound by spacing orders. Obviously, if a royalty owner is not bound by spacing orders as is any other interest owner in a spacing or proration unit, the entire effect of conservation of oil and gas would be defeated. In other words, royalty owners (oil and gas lessors) of irregular or small tracts, or owners of undivided interests could require an oil and gas working interest owner (oil and gas lessee) to conform to the oil and gas lease and drill excessive wells in violation of spacing orders.

To the extent that a royalty owner, an owner of an overriding royalty interest, or an owner of a net profits interest as in this case, must conform to spacing orders, it is unquestionable that pooling of all such interests must occur in order to conform to spacing orders. However, to change the nature of the private contractual interest or interest in oil and gas as a result of a conveyance through an order of a conservation agency, beyond the requirement of

a spacing order, is quite a stretch of the administrative power of an administrative oil and gas conservation agency.

III. 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 Corp., 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 recovers 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 tests 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 role 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?

IV. Conclusion.

The only conclusion we can draw from Order R-8047-A is that it illegally stretches the authority of the Oil Conservation Commission. We have never proferred an argument before the Division that the net profits interest was an overriding royalty interest. However, that distinction is academic because both of those interests are carried interests in the sense that they are not subjected with the cost of development and operation. The net profits interest under consideration here does not convert to a working interest. Certainly the issue of whether or not the net profits interest here converts or should convert to a working interest at a particular time has never been an issue in proceedings before the Oil Conservation Division.

The opposition to the Application before the Commission is not intended to evade drilling and development costs. Certainly, it is not for the Commission to decide whether or not it was the intention of the creators of the net profit interest to change the characteristics of the net profits interest so that it would not be called a working interest. 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 of the well or wells must abide by the letter of that document.

Accordingly, to the extent the Order of the Division changes the nature of the instrument and to the extent it assesses a risk penalty factor, we submit the Order is erroneous, arbitrary, and capricious because it

impermissibly takes property of the protestants without due process of law.

Respectfully submitted,

PADILLA & SNYDER

By _____

Ernest L. Padilla
Post Office Box 2523
Santa Fe, New Mexico 87504-2523
(505) 988-7577
Attorneys for Protestants

STATE OF NEW MEXICO
DEPARTMENT OF ENERGY AND MINERALS
OIL CONSERVATION DIVISION

IN THE MATTER OF THE APPLICATION
OF ROBERT E. CHANDLER CORPORATION
FOR AN AMENDMENT TO DIVISION
ORDER R-8047. CASE: 8859 (DeNovo)

MEMORANDUM IN SUPPORT OF ROBERT E. CHANDLER'S
APPLICATION FOR AN AMENDMENT TO
DIVISION ORDER R-8047

The application of Robert E. Chandler Corporation ("Chandler") seeks to have the Commission determine what leasehold interests are operating interests from which Chandler can collect the costs of the well and the risk factor penalty pursuant to Division Pooling Order R-8047.

Michael L. Klein and other owners (hereinafter "Klein") have a net profits interest in the affected acreage and contend that such interest is not subject to its share of the costs of the well or penalty because it is not a working interest. Klein contends that the Commission lacks jurisdiction to determine if the net profits interest is subject to the costs of the well and the risk factor. Chandler maintains that such a determination is exactly what the Commission has been instructed by the Legislature to do. It is the Commission's job to determine the working interests under a Division pooling order.

FACTS:

Chandler seeks to drill an oil well on a 40-acre tract in which he owns 50% of the leasehold working interest. The remaining 50% working interest in the 40-acre tract was owned by Sun Exploration and Production Company.

Despite Chandler's efforts, Sun refused to voluntarily participate in the drilling of the well and on September 25, 1985, the Division held a hearing in Case 8686 on Chandler's application to force pool the balance of the interest in this tract. The testimony established that the well would cost approximately $500,000 and that Chandler anticipated recoverable reserves of 100,000 barrels of oil. The Division entered Pooling Order R-8047 pooling the Sun interest and granting Chandler a 200% risk penalty.

Sun was notified, pursuant to the Pooling Order, and failed to participate within the time limits required by the order. During this period, Sun and Klein, with others, were in litigation over the Sun interest in this acreage and other acreage. Further, the Sun interest was subject to an April 1, 1966 Agreement between Prudential Insurance Company and Seagram & Sons, which among other things, created a 50% net profits interest.

Chandler sought and obtained an extension of the Pooling Order drilling date to April 1, 1986 in order to

await the settlement of Sun-Klein litigation. That litigation is being settled and as a result Sun is to assign its interest in this tract along with the net profits interest to Klein.

Klein has asserted that if Chandler drilled the oil well pursuant to the Pooling Order that he will demand that the net profits interest which he obtained from Sun must be paid to him from initial production and is not subject to share in the costs of the well and penalty.

On March 19, 1986, the Division held a hearing upon Chandler's application for a decision by the Division to define what constitutes a working interest against which the costs and penalty can apply. Mr. John Savage, a petroleum engineer with 35 years of experience, testified that if the Klein 25% net profits interest was treated like a true overriding royalty then it would constitute an excessive burden upon Chandler and he could not drill the well despite having a pooling order.

Mr. Savage testified that if the 25% net profits interest was subject to the costs of the well (see Chandler Exhibit 8), then one-half of the costs of the well would be charged to Klein ($250,000) and Chandler would have one-half of the reserves (50,000 barrels x $17/per barrel) at a value of $850,000 from which to recover the Klein cost that Chandler would have to carry. If the net profits interest is charged with its share of the costs and penalty, the economics of the project show

it is only marginally profitable taking 66 months to payout, showing a return on investment of 2.4 to 1 and a rate of return of 22.4%. However, if the 25% net profits interest is NOT subject to pay its share of the costs and penalty, then there will only be available $425,000 from Klein's share of production from which Chandler can recover $750,000 to which Division Order R-8047 says he is entitled.

NET PROFITS INTEREST:

The question before the Commission is clear. Is the net profits interest to be considered a working interest for the purpose of drilling the proposed well? That the Commission has the authority to make such a determination is also clear.

Klein is attempting to muddy the waters by arguing, in essence, that the question before the Commission is one of contract construction and interpretation which must be determined by the courts. This is simply not the case. While the term "net profits overriding royalty" may be ambiguous, the language stating how this particular net profits interest is to be calculated is not. Indeed, the interest, which was created by the Prudential-Seagram Agreement (the "Agreement"), is expressly defined on page 10 of that document as follows:

> (a) All capital costs incurred by Seagram in connection with its owning, operating, exploring, developing, maintaining or abandoning the Subject Interests or any part thereof or any wells thereon which are incurred and paid by Seagram after the Effective Date;

(b) All direct costs of operation of the Subject Interests (including all wells located thereon) which are incurred and paid by Seagram after the discharge of the Reserved Production Payment.

(c) That portion of the reasonable district office expenses of Seagram incurred after the discharge of the Reserved Production Payment for any district of Seagram in which any of the Subject Interests are located which is properly allocable to the Subject Interest, such allocation to be made on the basis of the ratio of the number of producing wells in such district subject to the Net Profits Overriding Royalty which are operated by Seagram to the total number of producing wells in such district operated by Seagram, provided, however, that the charges to the net profits account for district expense shall not duplicate any charges for district expenses receivable by Seagram as operator under any operating agreement or any charges properly made under any other clause hereof.

Prior to 1984, the phrase "net profits interest" had not been defined in New Mexico. But in that year, the New Mexico Court of Appeals decided that the phrase "net profits interest" has no independent meaning, rather the nature of such interest must be determined from the provisions of the instrument which created the interest. Christy v. Petrol Resources Corp., 102 N.M. 58, 691 P.2d 59 (Ct. App. 1984) at 60. (Copy attached).

There is no ambiguity about how the Agreement describes the net profits interest. It is to be paid only AFTER the operator has recovered the costs of the well and its operations. As defined by the Agreement, the net profits interest of Klein is not a "carried interest," and therefore is not to be treated like an overriding royalty.

The compulsory pooling statute does not define working interest or royalty interest. Klein wants net profits interest defined as an overriding royalty interest. Chandler wants it defined as an interest paid only after recovery of costs and penalty under the pooling order. The Commission has the authority and responsibility to determine how it will define what interests are carried interests and what interests are working interests.

The Commission is not diminishing Klein's interest by doing so. Rather, Klein attempts to enhance his own interest by making it something it is not. It is not an overriding royalty. It is an interest subject to "all capital costs of owning, operating, exploring, developing, etc., and direct costs of operation." This fact neither the Commission nor Klein can change.

Clearly the Commission does not have the authority to determine title or adjudicate property rights. But neither of these issues is before the Commission.

JURISDICTION:

Pursuant to Section 70-2-6 NMSA-1978, the New Mexico Legislature has delegated to and charged the Oil Conservation Division of New Mexico with the jurisdictional authority over all matters relating to the conservation of oil and gas:

> It shall have jurisdiction, authority, and control of and over all persons, matters or things necessary or proper to enforce effectively the provisions of this act or any other law of this state relating to the conservation of oil or gas...

More specifically, in Section 70-2-17(c) NMSA-1978, the New Mexico Legislature has explicitly granted to the Oil Conservation Division the jurisdiction to decide the terms and conditions of forced pooling orders "[F]or the purpose of determining the portions of production owned by the persons owning interests in the pooled oil or gas or both..."

It is basic Hornbook Law that where a court or administrative body is dealing with a controversy of the kind it is authorized to adjudicate, and has the parties before it, it has jurisdiction. In this case we have the parties before the Commission to discuss the terms and conditions of a pooling order entered by the Commission, so that the Commission can define the types of non-consenting working interests, which are subject to paying costs and penalty under such an order. See Thermoid Western v. Union Pacific Railroad Company, 365 P.2d 65 (Utah 1961).

The forced pooling statutes and orders of this Commission become useless if non-consenting working interest owners can avoid the cost and penalty factors of a pooling order simply by declaring their working

interest to be subject to excessive overriding royalty burdens. In this case Klein seeks to escape the effects of the pooling order by declaring its 25% net profits interest to be of the same nature as an overriding royalty. Klein then argues that the Division has no jurisdiction to modify its interest. Chandler contends that the question before the Commission is not the modification of Klein's interest, whatever it may be, but whether or not it is a working interest subject to its share of well costs. This the Division may do under Mitchell v. Simpson, 493 P.2d 399 (Wyo. 1972).

> In order to effectuate such powers (prevent waste and protect correlative rights), the Commission had jurisdiction and authority over all persons necessary for such effectuation, including oil and gas lessor or one having only royalty interests.

As the Commission has jurisdiction to determine the allocation of drilling costs among working interest owners, surely it has jurisdiction to determine who those working interest owners are.

The evidence at the March 19, 1986 hearing was that if the 25% net profits interest is treated as an overriding royalty, then that excessive royalty burden would be too high and the entire spacing unit uneconomic, thus precluding Chandler from drilling the well despite having obtained a pooling order.

It is the practice of this Commission that the consenting owners may recover the non-consenting owner's

share of costs plus risk penalty only out of the non-consenting owners share of production and not out of the share allocated to royalty owners and overriding royalty owners. In order to take advantage of that practice, Klein declares its "net profits interest" not to be a "working interest" and thus free of the costs. Obviously, the larger the royalty interest and other non-working interest burdens are, the smaller is the remaining production that is attributable to the non-consenting owners and to which the participating owners must look in order to recover the non-consenting owner's share of costs plus the appropriate penalty.

The undisputed testimony in this case is that the 25% net profits interest was made subject to the cost in the original 1966 Agreement with Prudential and Seagram and must be subject to the costs and penalty or the well cannot be economically drilled, thus violating the correlative rights of Chandler and circumventing the Division's pooling order.

Kellahin & Kellahin

By _____
W. Thomas Kellahin
P. O. Box 2265
Santa Fe, New Mexico 87501

STATE OF NEW MEXICO
ENERGY AND MINERALS DEPARTMENT
OIL CONSERVATION DIVISION

IN THE MATTER OF THE HEARING CALLED BY THE OIL CONSERVATION COMMISSION OF NEW MEXICO FOR THE PURPOSE OF CONSIDERING:

CASE NO. 8859 DE NOVO
Order No. R-8047-C

APPLICATION OF ROBERT E. CHANDLER CORPORATION FOR AN AMENDMENT TO DIVISION ORDER NO. R-8047, LEA COUNTY, NEW MEXICO.

ORDER OF THE COMMISSION

BY THE COMMISSION:

This cause came on for hearing at 9 a.m. on August 7, 1986, at Santa Fe, New Mexico, before the Oil Conservation Commission of New Mexico, hereinafter referred to as the "Commission."

NOW, on this 22nd day of August, 1986, the Commission, a quorum being present, having considered the testimony presented and the exhibits received at said hearing, and being fully advised in the premises,

FINDS THAT:

(1) Due public notice having been given as required by law, the Commission has jurisdiction of this cause and the subject matter thereof.

(2) By Order No. R-8047, entered on October 3, 1985, all mineral interests, whatever they may be, from the surface to the base of the Granite Wash formation underlying the NE/4 SW/4 of Section 7, Township 22 South, Range 38 East, NMPM, Lea County, New Mexico, were pooled to form a standard 40-acre oil spacing and proration unit to be dedicated to a well to be drilled at a standard oil well location thereon.

(3) Robert E. Chandler was designated the operator of said well and unit.

(4) Said order further provided in decretory paragraph (7) that:

"The operator is hereby authorized to withhold the following costs and charges from production:

(A) The pro rata share of reasonable well costs attributable to each non-consenting working interest owner who has not paid his share of estimated well costs within 30 days from the date the schedule of estimated well costs is furnished to him.

(B) As a charge for the risk involved in the drilling of the well, 200 percent of the pro rata share of reasonable well costs attributable to each non-consenting working interest owner who has not paid his share of estimated well costs within 30 days from the date the schedule of estimated well costs is furnished to him."

(5) On March 10, 1986, Robert E. Chandler made application seeking amendment of said Order No. R-8047 to extend the effective date thereof including the commencement date of the well to be drilled, and to clarify the treatment of various interests subject to the forced pooling for purposes of allocation of costs and application of the penalty provisions.

(6) The matter came on for hearing at 8:15 a.m. on March 19, 1986, at Santa Fe, New Mexico, before Oil Conservation Division Examiner David R. Catanach and, pursuant to his hearing, Order No. R-8047-A was issued on May 9, 1986.

(7) On June 2, 1986, application for Hearing De Novo was made by Michael L. Klein, John H. Hendrix, John H. Hendrix Corporation, and Ronnie Westbrook and Order No. R-8047-A was stayed by Order No. R-8047-B.

(8) The matter came on for hearing de novo before the Commission on August 7, 1986.

(9) The Findings in Order No. R-8047-A should be incorporated by reference into this order.

(10) De Novo applicants, Klein et al, are owners of a net profits interest in the pooled unit as referred to in Finding No. (5) in said Order No. R-8047-A.

(11) De Novo applicants contend that the 200 percent risk charge imposed under the terms of Order No. R-8047 is not a well cost for determining when well costs have been paid and for determining when they should begin to receive income from the subject well and unit under their net profits overriding royalty referenced in Finding No. 5 of said Order No. R-8047-A.

(12) The compulsory pooling of the subject acreage was ordered under provisions of Section 70-2-17(c) (NMSA 1978).

(13) That Section of the Oil and Gas Act provides in part that:

"All orders effecting 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."..."Such pooling order of the division shall make definite provision as to any owner, or owners, who elects not to pay his proportionate share in advance for the prorata 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 two hundred percent of the nonconsenting working interest owner's or owners' prorata share of the cost of drilling and completing the well."

(14) It appears clear that the statutes intend for the risk charge to be considered a well cost chargeable to the interest of any owner who elects not to pay his share in advance and as such must be factored in when determining when and if such interest has paid out and when profits begin to accrue thereto.

(15) Under the terms of Order No. R-8047, as amended, any well costs, attributable to any non-consenting owner, including risk charges and reasonable charges for well operations, should be recovered before profits accrue for which any associated net profits interest would be eligible.

(16) The terms of Finding No. (15) above should not apply to any royalty interest.

(17) Because of the delay resulting from the De Novo hearing in this case, the date for beginning drilling operations on the subject well and unit should be further extended to December 1, 1986.

(18) Order No. R-8047-A and Order No. R-8047-B should be rescinded.

IT IS THEREFORE ORDERED THAT:

(1) Ordering Paragraph No. (1) of Division Order No. R-8047 is hereby amended to read as follows:

"(1) All mineral interests, whatever they may be, from the surface to the base of the Granite Wash formation underlying the NE/4 SW/4 of Section 7, Township 22 South, Range 38 East, NMPM, Lea County, New Mexico, are hereby pooled to form a standard 40-acre oil spacing and proration unit to be dedicated to a well to be drilled at a standard oil well location thereon.

PROVIDED HOWEVER THAT, the operator of said unit shall commence the drilling of said well on or before the 1st day of December, 1986, and shall thereafter continue the drilling of said well with due diligence to a depth sufficient to test the Granite Wash formation;

PROVIDED FURTHER THAT, in the event said operator does not commence the drilling of said well on or before the 1st day December, 1986, Ordering Paragraph No. (1) of this order shall be null and void and of no effect whatsoever, unless said operator obtains a time extension from the Division for good cause shown.

PROVIDED FURTHER THAT, should said well not be drilled to completion, or abandonment, within 120 days after commencement thereof, said operator shall appear before the Division Director and show cause why Ordering Paragraph No. (1) of this order should not be rescinded."

(2) The findings contained in Order No. R-8047-A are hereby adopted by the Commission.

(3) Except as provided in decretory Paragraph (2) above, Order No. R-8047-A is hereby rescinded.

(4) Order No. R-8047-B is hereby rescinded.

(5) Distribution of proceeds to the Klein et al net profits interest shall be made in accordance with Findings Nos. (14) and (15) of this order and appropriate terms and conditions of Order No. R-8047 as amended.

(6) Jurisdiction of this cause is retained for the entry of such further orders as the Commission may deem necessary.

DONE at Santa Fe, New Mexico, on the day and year hereinabove designated.

STATE OF NEW MEXICO
OIL CONSERVATION COMMISSION

JIM BACA, Member

ED KELLEY, Member

R. L. STAMETS, Chairman and Secretary

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