

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

7 August 1986

COMMISSION HEARING

IN THE MATTER OF:

Application of Robert E. Chandler Corporation for an amendment to Division Order No. R-8047, Lea County, New Mexico. CASE 8859

BEFORE: Richard L. Stamets, Chairman
Ed Kelley, Commissioner

TRANSCRIPT OF HEARING

A P P E A R A N C E S

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MR. STAMETS: We'll call next Case 8859.

MR. TAYLOR: The application of Robert E. Chandler Corporation for an amendment to Division Order Number R-8047, Lea County, New Mexico.

MR. STAMETS: Call for appearances in Case 8859.

MR. KELLAHIN: Mr. Chairman, I'm Tom Kellahin of the Santa Fe law firm of Kellahin & Kellahin, appearing on behalf of the applicant.

MR. PADILLA: Mr. Chairman, my name is Ernest L. Padilla, Santa Fe, New Mexico, for Michael Klein, John Hendrix Corporation, John Hendrix, and Ronnie Westbrook, in opposition to the application.

MR. STAMETS: Mr. Padilla, this de novo application is on your application, is that not correct?

MR. PADILLA: Yes, sir.

MR. STAMETS: Normally we would expect you to go first and have you and Mr. Kellahin agreed to some other order this morning or prefer some other order?

MR. PADILLA: No, sir, the only thing that I have is that I would ask the Commission to take administrative notice and to incorporate the record in the

1 Division hearing and our position remains the same. I don't
2 have a desire to present any testimony and just to move for
3 dismissal insofar as the application forces and subjects the
4 interests of -- which is a net profits interest -- of the
5 protestants to the compulsory pooling order.

6 I believe that the basis for
7 our motion is that the net profits interest is impermis-
8 sibly subjected to the risk factor penalty and accordingly
9 we believe the action of the Division is incorrect and
10 wrong.

11 In support of that motion I
12 have a memorandum brief and I would like to hand it to the
13 Commission.

14 MR. STAMETS: Any comments you
15 would like to make relative to the Memorandum of Authority
16 presented to us by Mr. Padilla?

17 Or anything else you would like
18 to do at this time?

19 MR. KELLAHIN: Yes, Mr. Chair-
20 man.

21 I have sat here with you and
22 read Mr. Padilla's memorandum. We have in a memorandum we
23 have also prepared for submittal today the same citations of
24 authority that Mr. Padilla has utilized and we have come
25 to the opposite legal conclusion.

1 I am prepared to offer that
2 memorandum to you. It perhaps may be helpful if I could
3 give you a little of the factual background to refresh your
4 memory about why we believe that the Examiner's Division Or-
5 der on which this same issue was addressed that decided it,
6 in fact correctly decided this case. I think it would be
7 helpful for you to have available a copy of the transcript,
8 which I will offer you, as well as a copy of the specific
9 language of the Prudential-Seagrams 1966 agreement by which
10 that agreement describes what those parties intended the net
11 profits interest to be.

12 MR. STAMETS: Okay, we do have
13 the transcript here, unless you have already copied the
14 selected pages.

15 MR. PADILLA: Mr. Chairman, for
16 the record, if we're going to go into a discussion I must
17 object if the Commission is now going to entertain testimony
18 or evidence on what the intention of the instrument was in
19 1966. As pointed out in my memorandum, the document speaks
20 for itself. Prior Memorandums of Authority that I have sub-
21 mitted to the Commission indicate that -- are on the basis
22 that the Commission has no jurisdiction in construing that
23 document.

24 MR. STAMETS: Let me see if I
25 understand the facts in this case.

1 today would be that if the net profits interest is not sub-
2 ject to its proportionate share of the costs and the penalty
3 factor, then it is Mr. Savage's professional opinion as a
4 petroleum engineer of 35 years experience that the well can-
5 not be drilled if that is the type of carried interest.

6 It was also his testimony and
7 his exhibits that if the net profits interest bears its
8 share of the costs of the well and penalty, then Mr. Savage,
9 Mr. Chandler, or their designated operator, in fact could
10 drill the well.

11 Other than that additional com-
12 ment, your summary of the facts is accurate.

13 We would like to submit to you,
14 however, that Mr. Padilla has incorporated the record with-
15 out objection from the Examiner Hearing, and we feel it is
16 fair comment for us to respond in full to his position by
17 discussing with you, if you desire, what the New Mexico
18 Court of Appeals decided in the Christy case in relation to
19 the specific language of the agreement. We think that the
20 language is clear and unambiguous and that it simply says
21 that that interest will not be paid until after Mr. Chandler
22 and Mr. Savage have recovered their share of the costs of
23 the well and the penalty factors out of the entire Sun, ori-
24 ginal Sun interest without that burden, and only after that,
25 then, does this net profits interest come into play.

1 Mr. Padilla has raised for us
2 at the Division level and raises again the question of jur-
3 isdiction. We think it is very clear that the Division and
4 the Commission has the authority and certainly the obliga-
5 tion to define for us what the statute means when it says
6 compulsory pooling of the working interest. Nothing pre-
7 cludes you from telling us what that working interest defi-
8 nition will be and if your definition is one that I think is
9 consistent with the agreement, the '66 agreement, then we're
10 entitled to do what we propose to do.

11 In support of that position we
12 have cited the same authorities Mr. Padilla has and would
13 like the opportunity to submit that brief to you so that you
14 could read it the same way you read Mr. Padilla's brief.

15 MR. STAMETS: I presume that
16 the primary concern here revolves around when Mr. Padilla's
17 clients might begin to receive money from the well and in
18 its simplest terms, assume for the moment that there are two
19 working interests in the well. Mr. Chandler is one and his
20 interest is 50 percent, and the other interest is subject to
21 this -- this net profits interest is 50 percent, and under
22 normal circumstances with a forced pooling order, if we
23 granted the 200 percent risk factor, the other working in-
24 terest chooses not to pay his share, say his share is
25 \$100,000, just to keep it simple, then the issue is when is

1 that \$100,000 paid out. Is it paid out when 100,000 comes
2 in or is it paid when 300,000 comes in?

3 Is that -- is that the crux of
4 the issue, Mr. Padilla?

5 MR. PADILLA: I believe that's
6 the crux of the issue, Mr. Chairman. In our way of viewing
7 this is the Commission's action, or the Division's action,
8 has converted the net profits interest into a full working
9 interest and therefore subject to this penalty.

10 We make no bones about the fact
11 that the accounting should be made in accordance with the
12 document. In this interest the risk penalty factor of 200
13 percent is erroneous.

14 So Mr. Chandler's going to have
15 to drill the well, carry 100 percent working interest, and
16 that would pay out in accordance with the original document
17 (not clear to the reporter) should take place.

18 If it were as the applicant
19 proposes, we are converted to a net profits interest -- to a
20 working interest and it requires us in order to prevent the
21 assessment of a 200 percent risk penalty and an advance pay-
22 ment of the well costs, that's wrong.

23 MR. STAMETS: Mr. Padilla, if
24 -- if this property were to be developed by the working in-
25 terest owner who has -- who is subject to the net profits

1 interest, your clients would begin to receive money from
2 production after all well costs had been paid back.

3 MR. PADILLA: I believe so.

4 MR. STAMETS: And basically
5 your argument, then, is that this Commission is not entitled
6 to -- to say that the risk penalty is a legitimate well
7 cost?

8 MR. PADILLA: Well, it's not a
9 well cost at all and if we look at the forced pooling sta-
10 tute, it applies, as far as I can tell, with the added defi-
11 nition of the owner, that it applies to a person who has the
12 right to drill, and my clients do not have the right to
13 drill a well. A working interest is the only one who can
14 drill a well there.

15 MR. STAMETS: But your clients
16 are not going to pay anything as to the drilling of this
17 well under any circumstances, is that correct?

18 MR. PADILLA: That's correct.

19 MR. STAMETS: All right, so how
20 has the order, any order issued by the Division converted
21 your clients interest to a working interest?

22 MR. PADILLA: By assessing a
23 200 percent risk factor.

24 MR. STAMETS: Are they required
25 to pay that?

1 MR. PADILLA: In accordance with
2 the order, yes, as I understand it.

3 MR. STAMETS: Are they required
4 to pay that or is that just --

5 MR. PADILLA: It's an account-
6 ting function. It can be an accounting function but the --

7 MR. STAMETS: Well, let me
8 finish my question.

9 Now, are they actually required
10 to pay that money or is it just change the point at which
11 the well begins to make a profit?

12 MR. PADILLA: As far as my
13 clients are concerned it changes the point at which they
14 start receiving money.

15 MR. STAMETS: So it takes no
16 money from their pocket at any time during the life of the
17 well. Their -- their capital is not reduced.

18 MR. PADILLA: Oh, yes, it is.
19 It's reduced in the sense that from an accounting standpoint
20 they pay a greater share for drilling and development costs,
21 in other words, a 200 percent factor.

22 MR. STAMETS: Well, Mr. Padil-
23 la, if -- if I pay for something my bank account goes down
24 and if I just don't make any money I'm hurt in the future
25 but it's not taken away from me today.

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My understanding of what a working interest share is is that they're obligated to pay the costs of the well and I'm not clear that your clients under any circumstances would ever write a check for any well costs, under any circumstances, in this well.

To be absolutely certain that we understand where your clients would like to be, it's my understanding what you desire would be the situation where once 100 percent of the well costs attributable to the working interests has -- one 100 percent of those has been recovered, and less any applicable production costs, your clients would then wish to receive their share of the profits.

MR. PADILLA: That's correct.

MR. STAMETS: And not subject to any risk penalty.

MR. PADILLA: That's essentially correct and I think that's generally the way that instrument reads.

MR. STAMETS: And, Mr. Kella-
hin, unless there are serious objections, I think what the Commission would like to do is accept Mr. Padilla's Memorandum of Authority and the material, counter-material, written material that you would like to submit and hear what, hope-

1 fully, would be some short testimony from your witness,
2 that, as I understand it, he's going to testify that if Mr.
3 Padilla's clients got what they wanted, the well would not
4 be economic to drill.

5 Is there any objection to us
6 proceeding in that manner?

7 MR. KELLAHIN: It's already in
8 the record, Mr. Chairman.

9 MR. STAMETS: That is in the
10 record?

11 MR. KELLAHIN: Yes, sir.

12 MR. STAMETS: Well, is there
13 any objection to the Commission then reading the transcript
14 in the last hearing and the written material and making a
15 decision based upon that material?

16 MR. PADILLA: No, Mr. Chairman,
17 I don't have any problem with that. I would like to submit
18 a proposed order for the record, however.

19 MR. STAMETS: Okay. Mr.
20 Kellahin?

21 MR. KELLAHIN: I have no objec-
22 tion to that. You stated Mr. Padilla's position. Our posi-
23 tion is that unless the Sun interest had been prepaid, write
24 us a check for their 50 percent, give us the money, like you
25 do in a typical forced pooling situation, then there is no

1 reason or justification to allow the Sun interest, now owned
2 by Mr. Klein and Hendrix, to escape the penalty factor, and
3 would be unfair and burdensome to the Chandler interest to
4 in effect have us carry their share of the costs of the
5 well, recover it out of production, and let them come in at
6 that point.

7 We believe that you have the
8 full authority to define that the risk factor penalty is a
9 reasonable cost of the well in this case, and so we would
10 seek to have you affirm the Division order and to allow us
11 to recover the risk factor penalty.

12 There are a couple of house-
13 keeping chores, though, you might want to remember, is that
14 the Examiner order was stayed by consent of all parties for
15 today's hearing. If the action of the Commission is favor-
16 able to us, we would request that the stay be vacated. We'd
17 request that you give us an additional period of time in
18 which to commence the well, 90, 120 days, whatever, so that
19 we then can have time to implement the order, should we pre-
20 vail on that issue.

21 I will submit to you copies of
22 my memorandum. I also have the full copy of the Christy
23 (sic) case, which I think is important for a decision.

24 MR. STAMETS: Mr. Padilla.

25 MR. PADILLA: I have nothing

1 further.

2 MR. STAMETS: Mr. Taylor, do
3 you need some clarification?

4 MR. TAYLOR: As I recall at the
5 Examiner hearing, something we were focusing on at that time
6 was the question of whether this was a royalty interest or a
7 net profits interest and a lot of our thought, and I think
8 much discussion went to -- and I'm wondering if the testi-
9 mony went to whether it was a royalty interest.

10 I'm assuming at this point that
11 Mr. Padilla is not claiming that it is a royalty interest
12 and therefore there's no question that there will be no pay-
13 ment to his clients as soon as any production begins, and
14 did the testimony then go to just the difference between,
15 you know, how the carried interest is to work or did it go
16 to whatever is royalty interest and what the effect of that
17 is?

18 MR. KELLAHIN: Our testimony
19 then and our offer of proof today is that Mr. Savage will
20 testify that the net profits interest cannot and should not
21 be characterized as a royalty or an overriding royalty.

22 MR. TAYLOR: But for purposes
23 --

24 MR. KELLAHIN: That is not a
25 carried interest.

1 MR. TAYLOR: For purposes of
2 looking just at the record and not giving any testimony, was
3 the testimony at that time sufficient on the question of
4 whether payment should start after payout or whether it
5 should be a penalty, or did it go too much to the question
6 of a royalty, which I sense we're all agreeing that there's
7 no question any more that it's a royalty interest.

8 Is there sufficient testimony
9 on the other issues that we can go back and just use the
10 record?

11 MR. KELLAHIN: My recollection
12 is that it is sufficient.

13 MR. PADILLA: To clarify that
14 point, Mr. Taylor, we would concede that the interest of my
15 clients is not an overriding royalty interest. We have
16 never made that contention on the record.

17 MR. TAYLOR: Well, I know that
18 was some of the focus that the examiner and I had whenever
19 it came up before and that may be why the order is not suf-
20 ficiently clear on that.

21 MR. KELLAHIN: The issue is
22 whether or not the net profits interest was to be treated as
23 a carried interest. An overriding royalty is also a type of
24 carried interest.

25 I'm certain Mr. Padilla has

1 never said the net profits interest was a true royalty.

2 MR. TAYLOR: But because it was
3 not made as a net profits overriding royalty in the document
4 I know there was a lot of concern that if it was an over-
5 riding royalty or a royalty of some type, payment of his
6 clients might start immediately, and I couldn't remember if
7 we'd addressed -- it looks like there's really three options
8 here.

9 We were, I think, just looking
10 at kind of a general carried interest versus a royalty in-
11 terest before. I don't know if we were looking specifically
12 enough at what the particular issues are.

13 MR. KELLAHIN: Well, the dif-
14 ference was not between whether it was a royalty or a car-
15 ries interest. It was whether it was a carried interest or
16 a working interest.

17 MR. PADILLA: Obviously I'd be
18 delighted if they said it was an override.

19 MR. STAMETS: Thank you, gen-
20 tlemen. If there is nothing further, then, we'll take this
21 case under advisement and we'll expect to issue an order at
22 the next Commission Hearing on September 10th.

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(Hearing concluded.)

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C E R T I F I C A T E

I, SALLY W. BOYD, C.S.R., DO HEREBY
CERTIFY that 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

1 STATE OF NEW MEXICO
2 ENERGY AND MINERALS DEPARTMENT
3 OIL CONSERVATION DIVISION
4 STATE LAND OFFICE BLDG.
5 SANTA FE, NEW MEXICO

6 19 March 1986

7 DIVISION HEARING

8 IN THE MATTER OF:

9 Application of Robert E. Chandler
10 Corporation for an amendment to
11 Division Order No. R-8047, Lea
12 County, New Mexico.

CASE
8859

13 BEFORE: David R. Catanach, Examiner

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16 TRANSCRIPT OF HEARING

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MR. CATANACH: Call next Case 8859.

MR. TAYLOR: The application of Robert E. Chandler Corporation for an amendment to Division Order No. R-8047, Lea County, New Mexico.

MR. CATANACH: Are there appearances in this case?

MR. KELLAHIN: If the Examiner please, I'm Tom Kellahin of Santa Fe, New Mexico, appearing on behalf of the applicant, Robert E. Chandler Corporation.

MR. CATANACH: Are there other appearances in this case?

MR. PADILLA: Mr. Examiner, my name is Ernest L. Padilla, Santa Fe, New Mexico, for Michael L. Klein, John H. Hendrix, John H. Hendrix Corporation, and Ronnie H. Westbrook.

MR. CATANACH: Sorry, Mr. Padilla, I didn't get the last one.

MR. PADILLA: Ronnie Westbrook.

MR. CATANACH: Are there other appearances?

Any witnesses this morning?

MR. KELLAHIN: Yes, Mr. Catanach. I have Mr. John Savage, a petroleum engineer, on be-

1 half of the applicant.

2 MR. PADILLA: Mr. Examiner, I
3 have a potential witness. I don't know if we will put on
4 any testimony, but if you want to swear him in at this time
5 (inaudible.)

6
7 (Witness sworn.)

8
9 MR. CATANACH: You may proceed.

10 MR. KELLAHIN: Thank you, Mr.
11 Examiner.

12 Mr. Padilla has filed in this
13 case a motion to dismiss for lack of jurisdiction and we'd
14 request what the pleasure is of the examiner with regards to
15 proceeding in this case.

16 I have a tender of proof. I
17 wish to summarize for you not only the documentary evidence
18 I will tender but also the summary of Mr. Savage's testimony
19 that goes not only to the jurisdictional question but to the
20 substance of our case.

21 If you would prefer me to re-
22 cite that, I'll be happy to do that now. If you would pre-
23 fer Mr. Padilla to argue his motion on jurisdiction first,
24 I'd be happy to respond upon completion of his presentation.

25

1 He has filed a motion indi-
2 cating that the Commission lacks jurisdiction to hear the
3 particular case that we have filed, and we'd like an oppor-
4 tunity to respond in whichever fashion you would like to or-
5 ganize this case.

6 MR. CATANACH: I would like to
7 hear from Mr. Kellahin first.

8 MR. KELLAHIN: Mr. Examiner, I
9 have placed before you exhibits for the applicant Numbers
10 One through Number Nine. We will propose to introduce these
11 exhibits during the hearing today.

12 Exhibit Number One is the ap-
13 plication in the subject case and shows that we have noti-
14 fied, to the best of our ability, the individuals that we
15 believe had some interest in a net profits interest that af-
16 fects the property that's the subject of the pooling case.

17 Exhibit Number Two is the pool-
18 ing order that we seek to amend and have clarified.

19 The testimony of Mr. Savage and
20 the record in the forced pooling case will show you that on
21 September 25th of '85 Examiner Stogner heard a forced pool-
22 ing case to force pool a 40-acre tract in Lea County, New
23 Mexico, for an oil well.

24 The testimony was then and is
25 now that the approximate cost of that well was about half a

1 million dollars.

2 Mr. Chandler and Mr. Savage are
3 partners in this 40-acre tract and they control an undivided
4 interest in 50 percent of the minerals. They have that un-
5 der lease and they therefore have what amounts to a gross 50
6 percent working interest.

7 At the time of the hearing in
8 September the other working interest owner involved was Sun
9 Production Company, Sun Oil and Gas, I believe it is. Sun
10 was force pooled in that case and the examiner then found
11 that there was a potential for oil production in this 40-
12 acre tract from several zones. The total recoverable pro-
13 duction was estimated by Mr. Savage to be about 100,000 bar-
14 rels, and based upon that testimony the examiner approved an
15 order authorizing Mr. Chandler to proceed with the well and
16 established a 200 percent penalty factor.

17 While this case was being heard
18 and decided, the evidence will show you that the Sun inter-
19 est was subject to a controversy with regards to issues in-
20 volved in that 50 percent interest. It was Mr. Chandler's
21 and Mr. Savage's desire to try to continue to get voluntary
22 joinder for the well and not have to carry a 50 percent
23 working interest of Sun.

24 You'll see from Exhibit Number
25 Three, that the Division has extended the commencement date

1 under the pooling order to April 1st of this year.

2 One of our requests in this
3 case is to extend the commencement dates under the pooling
4 order so that we will have at least 120 days following your
5 decision in this case in which to commence the well.

6 Sun has been notified of the
7 forced pooling. The time has expired on Sun. The order has
8 expired in terms of being a final order without appeal, and
9 Sun's interest has been pooled.

10 The current controversy and the
11 reason we have filed this application is that there now is a
12 dispute about a portion of the Sun interest. To make it as
13 simple as possible and yet accurate, that 50 percent Sun in-
14 terest had involved in it a net profits interest. That net
15 profits interest was created by a document executed between
16 Prudential Life Insurance Company and Joseph Seagram and
17 others, dated in 1966.

18 That document created several
19 burdens on various properties. Sun, by subsequent convey-
20 ances, obtained the position of Seagram in that document.
21 That document therefore burdens this property with a 25 per-
22 cent net profits interest.

23 Exhibit Number Four, Exhibit
24 Number Five, Six, and Seven, are documents taken out of the
25 District Court case file in Texas in which the controversy

1 that Mr. Savage will submit to you to demonstrate the effect
2 on his correlative rights of how the net profits interest is
3 treated.

4 We contend, and we believe that
5 you need to find a disputed issue of fact. It is our evi-
6 dence and belief that the net profits interest, as described
7 in Exhibit Number Five, and you might want to turn to Exhi-
8 bit Number Five and look at the yellow tabbed page in the
9 right margin, and that will turn you to Page 10. In the
10 middle of that page it says, against the net profits ac-
11 count, this 25 percent net profits interest we've been talk-
12 ing about shall be charged the following, and it goes on to
13 describe all capital costs incurred for owning, operating,
14 exploring, developing, maintaining any part of the property,
15 any wells, et cetera.

16 It is our position that that
17 specific language is sufficient basis upon which you can
18 find that the net profits interest should bear its share of
19 the costs of this well plus the penalty factor.

20 The reason we have come before
21 you today is that under the existing order that the Division
22 has entered, the Division has retained jurisdiction of this
23 case. On Page 5, Paragraph 15, the jurisdiction of this
24 cause is retained for the entry of such other orders as the
25 Division may deem necessary.

1 We are talking about the Divi-
2 sion interpreting and applying its pooling orders under the
3 statute. We contend we have correlative rights that are at
4 issue and that you have the fundamental jurisdiction to aid
5 us and assist us in solving the problem.

6 Let me see if I can't state
7 succinctly what my position is with regards to this case,
8 and that is, first of all, that the document that created
9 the net profits interest is one that we believe supports the
10 conclusion that it could be treated like we treat a working
11 interest in a pooling order. We need that decision because
12 if it's treated as a true override and does not bear its
13 share of the cost, then Mr. Chandler and Savage cannot drill
14 the well.

15 They need to have that decision
16 made one way or another prior to drilling the well because
17 they cannot undertake the obligation and responsibility to
18 spend half a million dollars to recover 100,000 barrels of
19 oil and have someone later say, hey, that net profits inter-
20 est is an override and you pay us free of the cost and the
21 penalty.

22 Mr. Savage's testimony will
23 show you that it will not work and he cannot drill the well.

24 The reason we suggest also that
25 the Commission needs to resolve this, is that there is a

1 That solution will not work
2 here because the burden is an undivided interest in a 40-
3 acre tract and there's no way to carve it out.

4 So the threshold question is a
5 factual one for you to determine what kind of creature this
6 is, if it's a cow, a horse, or a dog. Whatever it is, you
7 have to make a finding about that net profits. If you find
8 it's a working interest, then we need that definitive deci-
9 sion so we can go forward with the drilling.

10 If you find that this is an
11 overriding royalty, that must be treated as a true overrid-
12 ing royalty and not bear its share of the costs, then we
13 would ask you to take the second level of decision making
14 and that would be to declare this an excess royalty, and
15 notwithstanding the fact that it is characterized as a roy-
16 alty, make it share its -- pay its share of the costs.

17 Now there's a two-step process
18 here and you may never reach the last step. We don't think
19 you have to. We think you can resolve this by calling this
20 what it is, what the original parties intended for it to be.
21 That is the substance of our case. We think it is abundant-
22 ly clear from that factual offer of proof, that you do in
23 fact have jurisdiction. In fact, the facts would compel you
24 to take jurisdiction and to aid us in providing a remedy for
25 the relief of (not clearly understood).

1 MR. CATANACH: Mr. Padilla.

2 MR. PADILLA: Mr. Examiner, Mr.
3 Kellahin's argument is very interesting and I'm delighted to
4 see the documents that he has submitted in this offer of
5 proof, because these documents indicate that -- and I as-
6 sume that they attempt to construe the net profits interest,
7 which was created in April 1st, 1966, under the instrument
8 of conveyance, which Mr. Kellahin has labeled as Exhibit
9 Number Five.

10 This is simply a matter that is
11 beyond the jurisdiction of this Division.

12 He's asking you, basically, to
13 decide whether or not the interest, the net profits inter-
14 est, is an overriding royalty interest or a net profits in-
15 terest.

16 You simply, the Division simply
17 does not have the authority to decide what it is; if, in
18 fact, it should be taken out at the tail end on an account-
19 ing basis, or in the front as part of a burden in a lease.
20 This is not something that the Division decides.

21 Now, I -- we don't have any
22 quarrel as to the compulsory pooling order that was issued
23 as to the working interest, Sun Oil's working interest, in
24 September of 1985. That is simply a matter that -- and Sun
25 could not consent at that time, and my clients just got sub-

1 ject to that compulsory pooling order, but it only affects
2 the working interest and not the net profits interest.

3 Now, I'm sure that Chandler and
4 Savage have the benefit or at least they should have looked
5 to see what they were getting into in September of 1985 when
6 they asked for a compulsory pooling order here in their
7 hearing. Certainly this interest was created in 1966 and
8 they should have been sufficiently aware of what burdens af-
9 fected the property.

10 If they have a gripe or they
11 want to find out, it's a matter of a court to tell them in a
12 declaratory action that can be brought in court and the
13 court can tell them, and construe these documents as to what
14 exactly they have.

15 To ask -- to ask the Division
16 here to compel the protestants in this case, my clients, to
17 -- to set aside their interest is entirely wrong. It does
18 not affect their correlative rights.

19 Mr. Savage has a 50 percent in-
20 terest in this 40-acre unit and he is entitled to his 50
21 percent interest. He can lease that and he can drill that.
22 No one is impairing his right to go and drill it. Whether
23 or not he can make a profit is an entirely different thing.
24 Obviously he's looked at the economics now and says, well,
25 they don't look so good, but as far as I can tell he's got a

1 good compulsory pooling order, which has been properly ex-
2 tended to April 1st, and he may commence drilling that well
3 prior to April 1st, 1986, and that should be where it stops.
4 He's got -- he's entitled to no more than 50 percent working
5 interest, but -- and he has the right to drill under Section
6 70-2-17; he's an interest owner, but we don't see any basis
7 at all for this hearing to proceed. It's an entirely legal
8 issue that we are presented here with today and it's cer-
9 tainly beyond the jurisdiction of the Division.

10 MR. CATANACH: Gentlemen, I'm
11 going to take about a ten or fifteen minute break.

12
13 (Thereupon a recess was taken.)
14

15 MR. CATANACH: Mr. Kellahin and
16 Mr. Padilla, the question of whether the Division has juris-
17 diction over this case is going to be taken under advise-
18 ment.

19 I would like to hear the testi-
20 mony in this case, however it is decided.

21
22 JOHN D. SAVAGE,
23 being called as a witness and being duly sworn upon his
24 oath, testified as follows, to-wit:
25

DIRECT EXAMINATION

1
2 BY MR. KELLAHIN:

3 Q Your turn, Mr. Savage. Let me ask you
4 your name, sir, and occupation?

5 A John D. Savage, petroleum engineer.

6 Q Mr. Savage, did you previously testify
7 before this Division in Mr. Chandler's application for a
8 forced pooling order at a hearing held on September 25th,
9 1985?

10 A Yes, I did.

11 Q What is your involvement with Mr. Chand-
12 ler with -- insofar as the 40-acre tract that's the subject
13 of this pooling order?

14 A We together equally share for 50 percent
15 of the tract.

16 Q Have you made an economic analysis of the
17 impact on drilling the well pursuant to the forced pooling
18 order under the assumption that the Sun net profits interest
19 can be charged with the cost and the penalty?

20 A Yes. I have -- in fact I've made two of
21 them.

22 Q All right, sir. That's one of the ones
23 that you've made.

24 A That's one of the ones, yes.

25 Q Have you also made a similar economic an-

1 analysis to determine the impact or the effect on the pooling
2 order if the Sun net profits interest is carried as a true
3 overriding royalty interest?

4 A Yes.

5 MR. KELLAHIN: We tender Mr.
6 Savage as an expert petroleum engineer.

7 MR. CATANCH: Mr. Savage is
8 considered qualified.

9 Q Let me have you summarize for us the cur-
10 rent state of your efforts and Mr. Chandler's efforts with
11 regards to the pooling order. The extension of the com-
12 mencement date to April 1st of 1986 is one that was obtained
13 at your request and Mr. Chandler's request?

14 A Yes. That was obtained, we thought, and
15 had what -- we believed we had a agreement forthcoming with
16 John Hendrix. The settlement between Hendrix and Sun was
17 still in progress and it was, I'm sure, was a delicate mat-
18 ter altogether, and therefore we requested a continuation in
19 order that these matters may be resolved.

20 Q In the present context of the pooling or-
21 der, Mr. Savage, do you have a recommendation to Mr. Cata-
22 nach of what additional time you would now need prior to
23 commencing the well?

24 A I think 120 days would do it.

25 Q Have you sought out or are you contem-

1 plating the possibility that Robert E. Chandler Corporation
2 would assign operations under the pooling order to some
3 other company?

4 A Yes. We have -- we have been talking
5 with Mabee Petroleum in this respect.

6 Q Are you requesting from the Examiner
7 approval to assign operations under the pooling order to
8 some other qualified operator other than Mr. Chandler?

9 A Yes.

10 Q Now let me focus in on the 40-acre tract
11 that's in question.

12 You testified back in September of '85
13 that you anticipated the cost of this well to be what amount
14 of money?

15 A \$500,000 plus a few dollars.

16 Q Is that still your best estimate of the
17 costs --

18 A We've not -- we've not changed that.

19 Q It hasn't been changed?

20 A No.

21 Q So that still represents a reasonable AFE
22 cost for the drilling and completion of the well?

23 A Yes, sir.

24 Q Approximately \$500,000 plus change?

25 A Yes. I think it was \$506,000 altogether,

1 as I recall.

2 Q Would you describe for the Examiner what
3 the volume of recoverable oil you have projected that this
4 well can recover?

5 A 105,000 barrels. This figure is shown, I
6 believe, in the testimony at the previous hearing and that's
7 it, out of four zones.

8 Q These are all oil zones based on 40 ac-
9 res?

10 A Yes, based on forties and in one well or
11 another they are producing.

12 Q Would you describe for the Examiner what
13 your understanding is of the ownership with regards to the
14 balance of the interest in the 40-acre tract after your 50
15 percent interest? Who has the rest of it?

16 A Well, my understanding is that John Hen-
17 drix and Michael Klein, and I believe there's this man,
18 Westbrook, who own that 50 percent.

19 Q What are you requesting the Examiner to
20 determine with regards to your ability to drill the well
21 pursuant to the pooling order?

22 A We simply want the interest burdened only
23 by the landowner's royalty and the existing override, which
24 I believe is to Gulf.

25 We want the net profits interest to be

1 noneffective.

2 Q What do you mean by noneffective?

3 A Well, it wouldn't be paid during the pay-
4 out period.

5 Q Would you turn to Exhibit Number Eight,
6 Mr. Savage, and identify that exhibit for us?

7 A Well, Exhibit Number Eight is an economic
8 projection of the operator who drills under the forced pool-
9 ing arrangement and without the net profits interest, just
10 as if the net profits interest does not come into effect in
11 this case.

12 Q Let me make sure I understand. Exhibit
13 Number Eight, then, represents the economic scenario if the
14 25 percent net profits interest in fact carries or pays its
15 share of the costs of the well.

16 A Yes. It is not, it is not paid. The
17 operator would not pay that during the payout period.

18 Q Exhibit Number Nine, then, represents the
19 economic analysis if the Commission finds the net profits
20 interest does not constitute a working interest in the typi-
21 cal fashion.

22 A Well, Exhibit Number Nine is with the net
23 profits interest paid.

24 Q And Exhibit Number Nine, then, would rep-
25 resent the position that Mr. Hendrix and Mr. Klein have as-

1 asserted before the Division.

2 A Yes, that's true.

3 Q Exhibit Number Eight represents the posi-
4 tion that you and Mr. Chandler are asserting.

5 A That's correct.

6 Q All right. Now let's go through Exhibit
7 Number Eight and talk about the conclusions and then we'll
8 go back through some of the details.

9 When we look at Exhibit Number Eight, how
10 many months or years have you estimated it will be before
11 you reach payout on the well?

12 A We estimate 5.6 years; 5.69, actually.

13 Q All right, where on the Exhibit Number
14 Eight do you find the information that reaches that conclu-
15 sion?

16 A Shown down in about the -- about the
17 seventh or eighth line from the bottom on the lefthand col-
18 umn.

19 Q All right, it says 5.699 payout years?

20 A Yes, sir.

21 Q All right. If we're looking at Exhibit
22 Number Nine, which is Mr. Hendrix and Klein's position, what
23 is the payout --

24 A On that one it is 9.68 years.

25 Q Let's do some more comparisons. If you

1 compare the rate of return, Mr. Savage, what is the rate of
2 return under Exhibit Eight versus Exhibit Nine?

3 A On Exhibit Eight it is 22.4 percent. On
4 Exhibit Nine it is 6.28 percent.

5 Q All right, and would you describe for us
6 the return on investment under each situation?

7 A The -- under -- on Exhibit Eight, in that
8 situation the net income investment ratio is 2.4.

9 On Exhibit Nine it is 1.41.

10 Q When we talk about the analysis of the
11 economics for the drilling of the well and we look at Exhi-
12 bit Number Eight as an analysis, what do you conclude as a
13 petroleum engineer with regards to that analysis in terms of
14 drilling this well?

15 A This is -- could be drilled when we do it
16 with the knowledge that it is a marginal proposition, right on
17 the edge, but you could see your way to do it.

18 Q What causes you to conclude that even un-
19 der Exhibit Number Eight situation this is a marginal pros-
20 pect?

21 A Well, the net investment or net income
22 investment ratio of 2.4 is low. The rate of return is low
23 and the payout is, again, at the ragged edge, out at the
24 end.

25 Q Under the situation described in Exhibit

1 Eight, Mr. Savage, in your opinion can you and Mr. Chandler
2 cause this well to be drilled pursuant to the forced pooling
3 order without it violating your correlative rights?

4 A Yes.

5 Q Let's turn to Exhibit Nine now, and ask
6 you whether or not, if the 25 percent net profit interest is
7 treated as a true override, whether or not even with the
8 forced pooling order and a 200 percent, you, as a petroleum
9 engineer, would recommend that this well be drilled?

10 A No, the payout is far too low, and
11 really, the rate of return too low, and the investment,
12 income/investment ratio is low. I don't believe anyone
13 experienced in the business would drill a well with the
14 indicated possibility of that order.

15 Q If the Division considered the net
16 profits interest as an override, will that violate your
17 correlative rights, Mr. Savage?

18 A Well, we won't be able to drill it.
19 We'll eventually lose our property and not be able to enjoy
20 the benefits that would be ours if the well were drilled.

21 Q You hold your interest as a result of
22 assignments or farmouts of some kind?

23 A Yes, sir.

24 Q You don't own those minerals?

25 A No, we do not own the minerals. We have

1 it under a farmout.

2 Q If you are not allowed the opportunity to
3 drill the well pursuant to this pooling order, what will
4 happen to the interest that you now own?

5 A Well, sooner or later they will expire
6 and go back -- go back to the -- expire under its own terms,
7 really.

8 Q Mr. Savage, do you make investments in
9 oil and gas leases for yourself and make recommendations for
10 others?

11 A Oh, yes, that really is our business.
12 Mostly for myself, but that's where we put our effort, real-
13 ly, acquiring leases and getting them drilled.

14 Q In acquiring leases and getting the pro-
15 perty drilled, are you familiar with examining and under-
16 standing documents such as Exhibit Number Five, which I have
17 marked as an exhibit in this case?

18 A Well, yes, sure. I've seen a good number
19 of these in one form or another during the years.

20 Q What is your understanding, Mr. Savage,
21 as a petroleum engineer, of the particular type of net pro-
22 fits interest that affects what we have characterized as the
23 Sun interest in this case?

24 MR. PADILLA: Mr. Examiner, at
25 this point I'm going to object to the nature of the ques-

1 tions, inasmuch as Mr. Savage has not been qualified as a
2 legal expert in this case to interpret this document, Exhi-
3 bit Five.

4 MR. KELLAHIN: Mr. Examiner,
5 I'm not asking for his legal opinion. This man says he's a
6 professional engineer for some thirty years. This is part
7 of his business to enter into, to examine, to understand,
8 and to operate under documents like this, and I've only ask-
9 ed him for his opinion with that expertise as to what his
10 understanding is of the document.

11 MR. CATANACH: Because it is --
12 he just asked for his opinion and not the interpretation of
13 it, we'll allow it.

14 MR. PADILLA: Mr. Examiner, if
15 I may make another point on this, I believe this goes to the
16 nature of our Motion to Dismiss and on that basis I'm going
17 to continue to object to any further testimony concerning
18 the interpretation of what this net profits interest is for
19 the record.

20 MR. CATANACH: You may proceed,
21 Mr. Kellahin.

22 A Let me preface this by saying that an
23 override is expense free. You pay none of the operating
24 costs, development costs.

25 But here, on page 10, that Mr. Kellahin

1 referred to earlier, it says, in plain black and white,
2 against the net profits account shall be charged the follow-
3 ing:

4 A. All capital costs incurred by Seagram
5 in connection with its owning, operating, exploring, devel-
6 oping, maintaining or abandoning the subject interest, or
7 any part thereof, or any wells thereon, which are incurred
8 and paid by Seagram after the effective date.

9 I think that's pretty self-explanatory
10 and inasmuch as this so described net profits interest is
11 affected by these very items in that paragraph, I believe
12 that it's working interest. Working interest involves these
13 costs.

14 Q If you and Mr. Chandler or your successor
15 in interest in the drilling order proceed with the drilling
16 of the well pursuant to the pooling order, what would you
17 recommend that you and Mr. Chandler do with regards to how
18 you treat the net profits interest that's in question here?

19 A Well, we believe this is working interest
20 and would not be paid any net profits interest until such
21 time as the penalty was relieved.

22 Q Are you and Mr. Chandler willing to un-
23 dertake the risk of drilling this well for half a million
24 dollars until that issue has been resolved by this Division?

25 A No. We can't have someone come up later

1 and say, well, now you owe us this.

2 We want-- we need an answer. That's
3 really it.

4 MR. KELLAHIN: That concludes
5 my examination of Mr. Savage. We would tender him for cross
6 examination.

7 We would at this time, Mr.
8 Catanach, move the introduction of our tendered Exhibits One
9 through Nine.

10 MR. PADILLA: No objections.

11 MR. CATANACH: Exhibits One
12 through Nine will be admitted as evidence.

13 Mr. Padilla, you may proceed.

14

15

CROSS EXAMINATION

16 BY MR. PADILLA:

17 A Mr. Savage, have you had a drilling title
18 opinion prepared for this 40-acre tract?

19 A No, but it's presently appraised.

20 Q Who do you have, who's preparing your
21 drilling title opinion?

22 A Mr. Strand in Roswell, Bob Strand.

23 Q Do you believe Mr. Strand is going to
24 tell you whether this net profits interest is a working in-
25 terest or overriding royalty interest?

1 A I've never discussed that aspect with
2 him.

3 Q You haven't asked him to pay particular
4 attention to this net profits interest?

5 A I believe one time I mentioned to him
6 that this was a concern in the overall picture.

7 Q You were aware of this net profits
8 interest in September of 1985 when he appeared here at the
9 hearing, did you not?

10 A Oh, yes, I mean we -- he was in the (not
11 clearly understood.)

12 Q You knew of the litigation between Sun
13 Oil and the various parties as shown in one of your exhibits
14 at that time.

15 A We knew that our --

16 Q Exhibit Seven is what it is.

17 A Well, the group were -- we knew a group
18 were, as I recall, sued Sun and an out-of-court settlement
19 was in the works.

20 Q Was the issue of the net profits interest
21 before the court at that time in that lawsuit --

22 A I don't know. That was not my --

23 Q -- to your knowledge?

24 A -- lawsuit. I was not part of it.

25 Q You knew that there were interests that

1 you were force pooling that were subject to or might be af-
2 fected by this litigation, did you not?

3 A We knew -- we knew it was inherent in it,
4 yes, sir.

5 Q Now you mentioned that you were not, you
6 and -- or Chandler Corporation were not going to drill the
7 well, is that my understanding?

8 A Well, we are hopeful that maybe we'll
9 drill the well.

10 Q Do you intend to retain an overriding
11 royalty interest when you do turn it over to someone else?

12 A No.

13 Q And do you get zero for your efforts?

14 A Well, we'll get something else, but not
15 an overriding royalty.

16 Q What do you intend to get?

17 A I'm rather reluctant to divulge our busi-
18 ness arrangements with Mabee, but what we'd get would have
19 to satisfy them and satisfy us.

20 Q Are you going to further burden this
21 lease in your transaction to the other operator?

22 A We would only get a piece of the working
23 interest.

24 Q Is it a carried working interest?

25 A Carried in what respect? For nothing?

- 1 Q Yeah, in other words you don't --
- 2 A No, we'd be paying something for it.
- 3 Q You don't pay your proportionate share.
- 4 A We would pay our proportionate share of
- 5 part of the well, part of the operations in the well.
- 6 Q What portion, then, do you intend to turn
- 7 over to the other operator?
- 8 A Well, we would turn over our entire farm-
- 9 out leasehold.
- 10 Q And that includes your entire 50 percent
- 11 working interest --
- 12 A That would be our 50 percent.
- 13 Q How can you then retain working interest
- 14 if -- isn't that inconsistent with your prior answer to my
- 15 question?
- 16 A Well, no, because the arrangement with
- 17 Mabee would simply be that they would take on our lease and
- 18 we would -- in turn they'd allow us to retain a certain
- 19 working interest. It's a common thing; done all the time,
- 20 every day.
- 21 Q Is a reversionary interest?
- 22 A No, not a reversionary interest.
- 23 Q Well, I don't understand, Mr. Savage,
- 24 when your interest comes into play. Is that before or after
- 25 payout?

1 A We would pay our share of the completion
2 costs of the well. We would be carried to the casing point.
3 This is a standard arrangement.

4 For our services and what we have done we
5 are given, well, you might say, a free ride to the casing
6 point. From there on we come in and pay our share of the
7 deal.

8 And that's what we have been discussing
9 with Mabee and it's not yet documented.

10 Q And you're earning -- assuming that you
11 would obtain production, it's your intention or your desire,
12 as I understand it, to do away with the net profits interest
13 until after payout?

14 A Well, no, not after payout. After penal-
15 ty payout.

16 Q That's -- oh, I see, not after payout,
17 after penalty payout.

18 A No, we're asking that the net profits in-
19 terest not be affected until the forced pool penalty would
20 be retired.

21 Q Did you in September, 1985, notify the
22 owners of the net profits interest that you were force pool-
23 ing them, their interest?

24 A Why, yes, we -- we had their understand-
25 ing with them that they would not contest our force pooling.

1 Sun knew that we were force pooling them.
2 It was no surprise. We had approached them, asked them to
3 join us. They said they would not and at that point we
4 force pooled them.

5 Q Who owned the net profits interest in 19
6 -- September of 1985?

7 A I think Sun owned it at that time.

8 Q You think?

9 A Well --

10 Q You're not sure?

11 A -- I don't know because it was part of
12 this settlement with Mr. Klein and Mr. Hendrix, and when --
13 when they and the Sun finally agreed upon it, I don't know.

14 We knew that -- we knew that something
15 was in the works.

16 Q The only conclusion, then, that -- well,
17 you don't know, in other words, whether the owners of the
18 net profits interest were actually notified of the Septem-
19 ber, 1985, hearing.

20 A Well, we made notification because at
21 that time we believed that Sun still held it. Sun was given
22 the AFE and an opportunity to join and all that, which they
23 did not accept.

24 Q But that was as to Sun's 50 percent work-
25 ing interest in the lease, --

1 A Yes.

2 Q -- isn't that correct?

3 A Yes, it --

4 Q And not as to the net profits interest.

5 A Well, the net profits interest went with
6 the 50 percent. It's part of -- it's part of the property.

7 Q And it's your testimony that you knew
8 that the net profits interest was created in April of 1966.

9 A I don't believe that at the time of the
10 hearing in late September of last year that the matter of
11 the net profits interest came into -- came into considera-
12 tion. I don't believe it was mentioned. The transcript
13 will show it. I don't recall that it was mentioned.

14 Q Well, the application that you have sub-
15 mitted appears to include -- well, strike that.

16 MR. PADILLA: Mr. Examiner, I
17 ask that the Examiner take administrative notice of the pre-
18 vious case and the application of the previous order, Case
19 R-8047. Or correction, Order R-8047, and that case.

20 MR. CATANACH: Administrative
21 notice will be taken of Order No. R-8047, and the case.

22 Q Mr. Savage, let me see if I understand
23 what your intent here today is. It is that you intend to
24 force pool the --

25 A We would invoke the forced pooling.

1 Q Okay.

2 A And the forced pooling would not involve
3 the net profits interest. The net profits interest would
4 not be paid during the penalty because the net profits in-
5 terest is really an override.

6 Q In other words that other 50 percent --

7 A Not override but a working interest.

8 Q In other words that other 50 percent
9 would not earn anything for -- until the --

10 A Well, they elected not to drill, not to
11 participate. Thereby they forgo income until the penalty is
12 met.

13 Q And that includes 200 percent for every-
14 thing, correct?

15 A That includes the well cost plus 200 per-
16 cent or a total of 300 percent.

17 Q And that affects both the working inter-
18 est and the net profits interest.

19 A Yes. Yes.

20 MR. PADILLA: Mr. Examiner, I
21 don't believe I have anything further.

22 MR. CATANACH: Mr. Kellahin?

23 MR. KELLAHIN: No, sir.
24
25

CROSS EXAMINATION

1
2 BY MR. TAYLOR:

3 Q Mr. Savage, I just -- I want you to just
4 explain for me your knowledge of some common terms used in
5 the industry. I know these are confusing because for me a
6 net profits override royalty doesn't make any sense, so I
7 know you'll bear with us.

8 What do you understand a net profits in-
9 terest to be?

10 A This is a share after -- of the income
11 after costs.

12 Q And what costs are included in that?

13 A In this particular one those ones I read
14 earlier on page 10, all capital costs.

15 Q How about just in a normal situation, one
16 that we're not -- not referring to anything in particular,
17 just normally. Would that cover --

18 A Well, it would -- if they were not speci-
19 fied it would be a share of the income after -- well, after
20 net profits, it means net. It means something is taken off
21 it.

22 Q That's after the costs of the well have
23 been paid for and after operating expenses are paid?

24 A After the costs of the well and the
25 operating expenses, workovers, and the things that are just

1 consequences of development and production of an oilfield.

2 Q Okay. Could you next tell us what you
3 understand the carried interest to be.

4 A Carried interest? Well, the example I
5 gave you. Let's say that I have a lease and I induce some-
6 one or convince someone to drill the lease and I get an in-
7 terest free as it is carried.

8 Now this can be any combination of
9 things. Generally speaking you are carried to the casing
10 point free. You pay none of the expenses to that point.
11 Then when the time comes to complete the well, you share ac-
12 cording to your agreed upon percentage.

13 The advantage of this is that you gen-
14 erally get a look at the formation and an idea what's coming
15 in before you -- before the well is completed.

16 Q Does the person that's carrying you normal-
17 ly recover the carried costs out of production before the
18 carried party starts earning?

19 A No, you're in from the very moment they
20 decide to run pipe.

21 Q How about an --

22 A That's when the bills start.

23 Q How about an override royalty?

24 A Well, let's assume a lease is burdened by
25 a standard 1/8th, like most properties are. If you have it

1 you keep 7/8ths of the production and 1/8th goes off to the
2 landowner.

3 An overriding royalty is a retention of
4 more than that 1/8th. Sometimes you keep 1/8th for yourself
5 and the party who takes the deal has a 75 percent net inter-
6 est lease. That means to say he keeps 75 out of every hun-
7 dred barrels; 12-1/2 barrels go to the landowner and 12-1/2
8 barrels go to me, or whoever promotes the deal.

9 Q Let's see.

10 A I hope that's clear .

11 Q Does a -- a net profits interest is then
12 normally carved out of a working interest? Is that where it
13 comes from?

14 A Yes. Yeah, it would have to be some
15 working interest there to set up the cost.

16 Q Where does an overriding royalty come
17 from?

18 A Well, imagine the case that I have a
19 lease and, say, 87-1/2 lease; otherwise to say 12-1/2 per-
20 cent goes to the landowner, and I interest you in the lease
21 and you want to drill it. And I say, well, I have to -- 12-
22 1/2 percent goes to the landowner, I want to keep 12-1/2
23 percent, and you get -- you keep 75 percent.

24 The 12-1/2 percent that I keep is an
25 overriding royalty.

1 Q Okay. Just a couple of other questions
2 and I want to refer more specifically to this document here.

3 How familiar are you with the terms of
4 the conveyance of the --

5 A Well, I, of course, have read it. I
6 don't say that I --

7 Q Okay. How do you understand the payment
8 of the reserve production payment for --

9 A Well, that's been paid out.

10 Q It's been paid out, and how was it paid?

11 A It was paid on -- the reserve production
12 payment is a promise to pay from subsequent oil production.

13 Q Was it paid before or after costs of
14 drilling?

15 A I don't know what the terms of this
16 specific one might be.

17 Generally it's just a cash -- it's cash
18 out of the oil.

19 Q On page nine of this document, the bottom
20 of the first paragraph on the page says that net profits are
21 whatever, on and on and on, it says, without limitations,
22 exceptions and limitations included in paragraphs 2.05 and
23 2.09.

24 To your knowledge there has never been a
25 2.09 in here? I can't find it. It goes to 2.8.

1 A 2.04, 2.07. No, apparently it does not
2 contain 2.09.

3 Q And as far as you know never has.

4 A My copy. Mine has the pages, recording
5 pages in order on it.

6 Q Okay.

7 A Now, let me -- let me --

8 Q On page 8, Section 2.01, it says that the
9 net over -- net profits overriding royalty, which is an
10 undivided 50 percent of the minerals, shall be paid after
11 discharge of the reserve production payment.

12 Could you explain to me to your
13 understanding how this -- how that was supposed to work in
14 that?

15 A Well, this follows that. Once your oil
16 payment, which was a set sum of money, net (not clearly
17 understood) disappears, and at that point the net profits
18 interest came into effect.

19 Q Okay, so it was more or less in the term
20 of this or life of this, it was replacing the reserve
21 production payment --

22 A Yes. It was follow-up on that.

23 Q -- once that was paid.

24 Okay, I think that's -- let's see.
25 That's it.

1 MR. TAYLOR: Okay, that's all
2 the questions I have.

3
4 CROSS EXAMINATION

5 BY MR. CATANACH:

6 Q Mr. Savage, if we decide, the Division
7 decides that we do have jurisdiction over this case, I
8 want you to explain to me the consequences of either -- of
9 either way that we decide this case.

10 If that we decide that the net profits
11 interest is an overriding interest, I want to be absolutely
12 sure I'll understand what the consequences of that will be.

13 A Well, if the net profits interest has to
14 be paid because it is considered an overriding royalty
15 interest, that means no well for us. That's the
16 consequence. We can't drill it and pay that net profits
17 interest, too.

18 Q Okay, but assuming that you did drill a
19 well, what -- what would that mean? Where would be -- would
20 that mean that the parties that hold that interest would not
21 have to pay any costs of drilling the well?

22 A There would be no -- there would be no
23 net profits interest and they would pay no costs. They are
24 under the penalty. When the penalty is relieved they come
25 in as partners.

1 MR. TAYLOR: Just one other
2 question.

3

4

REXCROSS EXAMINATION

5 BY MR. TAYLOR:

6 Q At the time this conveyance was made,
7 whoever made the conveyance, what was the ownership interest
8 that they had at that time, do you know?

9 A Yes, in this particular lease --

10 Q The percent; the percent of interest.

11 A It's a 50 percent interest subject to a
12 royalty and an override with a net interest being 4. --

13 Q The owner of that, the owner of the
14 interest that conveyed it to this document, at the time of
15 this document owned 24-something --

16 A Well, what happened, first he owned 50
17 percent of the working interest and .40625 of the net inter-
18 est, so he -- that is what is normally known as the net rev-
19 enue interest in the property. That's what he gets to keep
20 and the higher figure is what he pays.

21 Q How much of his interest was he convey-
22 ing, then, if he conveyed a 50 percent override? What was
23 he conveying out of his interest to them?

24 A 50 percent override?

25 Q Yeah, if it was an override; assuming

1 it's an override? What was he conveying out of what he had?
2 Could you explain to us because I don't know how to figure
3 that out.

4 A The net profit interest is 25 percent and
5 if it's not, if this is a judged the way we hope it will be,
6 that's what he gives up at that point. In fact, if the net
7 profits interest is not in effect, if this is just a pooled
8 lease, when we would have recovered our drilling costs plus
9 200 percent, then he comes in.

10 Q If it was a -- assuming that it's a 50
11 percent override, would -- would it be everything he had?

12 A Well, I don't quite get 50 percent over-
13 ride. I --

14 Q Okay, well, see, I'm -- I'm trying to
15 differentiate between a net profits interest and an over-
16 ride.

17 A The difference is, as far as this --

18 Q Well, for purposes of what he had left,
19 is what I'm trying to figure out.

20 Assuming that this thing here is not a
21 net profits interest but he's conveying a 50 percent over-
22 ride royalty, and he had 50 percent working interest in the
23 lease, what percentage of what he had did he convey through
24 this document? Just disregarding the possibility of a net
25 profits interest and --

1 A Well --

2 Q -- assuming --

3 A He conveyed a 50 percent working interest

4 and .40625 percent net revenue interest.

5 Q Is --

6 A The difference being the 50 percent work-

7 ing interest is -- that's his expense.

8 Q Uh-huh.

9 A He pays 50 percent of the expenses and

10 gets to keep 40.625 percent of the oil and the rest goes off

11 in overrides and basic royalty.

12 Q Well, I guess if he would have been in-

13 tending to convey a 50 percent override, it would have only

14 come out of his 50 percent, so it would have been 25 per-

15 cent, is that what you're saying?

16 A Well, his net interest is 25 percent,

17 yes.

18 Q Okay.

19 A Net profits interest, yes.

20 Q Do you agree with me that the net profits

21 overriding royalty doesn't make any sense? Does that make

22 sense to you, a net profits overriding royalty?

23 A Well, no, it doesn't make sense, because

24 here there is expense involved and overrides don't have ex-

25 pense.

1 Q Normally a net profits interest and an
2 overriding royalty are different in some ways.

3 A Oh, yes. That's specified here. These
4 are different.

5 Q Okay, so you can't combine the two terms
6 together into --

7 A This is not -- this is not -- your net
8 profits interest is not expense free.

9 Q A net profits -- the term net profits
10 overriding royalty is ambiguous and on its face does not ex-
11 plain what it is.

12 A Yes, related to this document, it is.

13 Q Okay.

14 MR. TAYLOR: That's all I have.

15 MR. CATANACH: I have no fur-
16 ther questions of the witness.

17 You may be excused.

18 A Thank you very much. It's been an inter-
19 esting morning.

20 MR. KELLAHIN: That concludes
21 my presentation.

22 MR. PADILLA: Mr. Examiner, I
23 renew my Motion for Dismissal on the basis of lack of juris-
24 diction and I think Mr. Savage's testimony in answer to his
25 questions, to Mr. Taylor's questions are exactly on point.

1 Is this ambiguous? It certain-
2 ly is. It's not something for the Oil Conservation Division
3 to consider.

4 This is a proper matter to go
5 before the court. If they have a question as to what the
6 exact interest ownership of this net profits interest should
7 be and at what time or in what manner it should be suspen-
8 ded, if at all. We don't believe it should be suspended at
9 all.

10 We further move at this point
11 to dismiss on the basis that there was no notice on the bas-
12 is of the application in Case 8686, which was the case under
13 which Order R-8047 was issued. That application simply
14 force pools Sun Production's 50 percent working interest.

15 I believe it that it pushes the
16 imagination to simply have a document introduced into evi-
17 dence here today and saying that this net profits interest
18 is a working interest.

19 I certainly don't want to give
20 a title opinion on the basis of -- to decide this issue, and
21 if I did give a title opinion, I think that I would say go
22 to court and find out and not go to the Oil Conservation Di-
23 vision and find out. That is not the way it should be done,
24 and I feel the exhibits that Mr. Kellahin introduced here
25 today are court documents and they reflect the considerable

1 controversy presumably over this net profits interest and
2 what its exact nature is.

3 Mr. Savage proposes to totally
4 eliminate the interest of the protestants here today and
5 subject it to a 300 percent penalty. It's not only unfair
6 but it is unlawful under -- and it would be void because the
7 Division doesn't have any jurisdiction.

8 In his opening remarks Mr. Kel-
9 lahin said this case was being brought under the retained
10 jurisdiction announced in that R-8047. Well, those things
11 simply apply to conservation of oil and gas and certainly
12 not to construction of legal documents that give rise to in-
13 terests in oil and gas properties.

14 In Exhibits Eight and Nine we
15 have been told that given two scenarios, that one is going
16 to be economic and one is not if this net profits interest
17 is not suspended.

18 In fact, on the basis of to-
19 day's hearing, these two documents are entirely irrelevant.
20 They should not be considered for economic purposes.

21 Again, Mr. Savage and Chandler
22 Corporation own the working interest of 50 percent and if
23 they feel it's not economic at this time to drill it based
24 on whatever economic criteria they intend to apply, or would
25 apply on the basis of the price of oil, on the basis of the

1 price of gas, then it probably should not be drilled. It's
2 a simple business decision that they have and they're trying
3 to attempt to have the Oil Conservation Division help them
4 in making a business decision, but I assure you that this
5 would not end here if the well would be drilled on the basis
6 of an order allowing -- of a Division order allowing suspen-
7 sion the net profits interest.

8 I would assume that my clients
9 would obviously institute legal proceedings in a court to
10 force Mr. Savage to pay net profits interest based upon what
11 they believe is there just right and interest in the oil and
12 gas property.

13 Mr. Savage and Chandler Corpor-
14 ation's correlative rights are not impaired. They own 50
15 percent and they're entitled to drill and obtain 50 percent.
16 Whether or not their 50 percent is going to give them a pro-
17 fit, that's another thing. People take risks in drilling
18 wells every day and that's just one of the risks that they
19 must assume and not shift the burden to someone else.

20 MR. CATANACH: Thank you.

21 Mr. Kellahin?

22 MR. KELLAHIN: Mr. Catanach,
23 there's no question that Mr. Chandler and Mr. Savage could
24 have gone to District Court and filed for a declaratory
25 judgment and had a judge decide what a net profits interest

1 is. That does not mean to say that the Commission in exer-
2 cising its authority and in fact interpreting its own orders
3 and statutes should not determine for us what a working in-
4 terest is that bears its share of the costs of the pooling
5 order.

6 Your statute, I think, is
7 clear. It says that you will recover the penalty and apply
8 it out of the working interest but it doesn't define the
9 working interest. There's nothing that precludes this Divi-
10 sion from finding what a working interest is. I think in
11 this case we can find that the net profits interest is a
12 working interest which can bear the costs and penalty.

13 I don't think there's any ques-
14 tion that you have jurisdiction to make that type of deci-
15 sion. We're not asking you for a declaratory judgement of
16 that document but we are asking you to find what the Commis-
17 sion will in this fact situation declare to be a working in-
18 terest. That's fully within the scope of your jurisdiction.

19 Mr. Taylor has a copy of Wil-
20 liams and Meyers treatise on oil and gas. The definitions
21 we elicited from Mr. Savage awhile ago, I will invite you to
22 look at page 102 in the manual of oil and gas terms. It
23 goes through and carefully articulates the differentiation
24 between a carried interest and a net profits interest; the
25 definitions that Mr. Savage gave you are right on point.

1 It is our contention that the
2 word "net profit override" makes no sense at all. If you
3 look at the document, it's got to be net of something and
4 it's obvious it's a net after the costs.

5 Mr. Catanach asked Mr. Savage
6 awhile ago what the effect is if the Commission finds that
7 the net profits interest must be treated as an override.

8 Its effect to him is that it
9 violates his correlative rights, he can't drill the well,
10 and whatever interest he has in the leases are gone.

11 Let me see if I can demonstrate
12 for you how that happens using some numbers that Mr. Savage
13 has given us.

14 He's told us it costs 500,000
15 to drill the well. The 50 percent Sun interest in those
16 costs would have been \$250,000. It is that quantity of
17 money that Mr. Savage and Chandler are going to have to pay
18 out of their pockets and recover out of production, plus two
19 more times for the penalty.

20 They need to recoup, then,
21 \$750,000. They can do that if the net profits interest re-
22 mains subject to the cost of the penalty. It balances out
23 and they give their fair share pursuant to the order.

24 What happens if its a net pro-
25 fit interest as to 25 percent?

1 Well, he's told us we've got
2 100,000 barrels of oil. If 25 percent of that, or 25,000
3 barrels, is going to be paid off the top to Mr. Klein and Mr.
4 Hendrix at \$17.00 a barrel, it's \$425,000.

5 That leaves remaining, then,
6 out of their share of the reserves, the other 25,000 barrels
7 at \$17.00 a barrel, or \$425,000 out of which Mr. Savage and
8 Mr. Chandler, pursuant to the pooling order, are entitled to
9 recover \$750,000 and they can't do it, obviously, because
10 it's \$300,000 short.

11 That's the problem. Over the
12 projected economic life of the project, using the two econo-
13 mic scenarios, you can see that the rate of returns are sig-
14 nificantly different. The rate of return drops to 6 percent
15 under one scenario, if we believe Mr. Klein's position. Un-
16 der Mr. Chandler's position it's 22 percent and he can do
17 the job.

18 Look at the return on invest-
19 ment. It drops to 1.4 if we have to pay the 25 percent net
20 profit interest as a royalty. Can't do it. It's barely
21 economic if you treat it as a working interest, at 2.4-to-1.

22 That's not a real good deal.
23 Look what happens to the monthly pay out, where it breaks
24 even. Under his position Mr. Savage says it takes about 66
25 months but if he has to take another 25,000 barrels and pay

1 it off the top to Mr. Klein and Mr. Hendrix, it's going to
2 take 9-1/2 years to get pay out. There's not a fellow in
3 the world that's going to drill that well under that situa-
4 tion.

5 And why should you care? Be-
6 cause it circumvents the pooling order, the one that you
7 found was necessary in order to get the well drilled. It's
8 the one Mr. Savage needs in order to protect his share of
9 the leasehold, to get this property producing.

10 We think the documents are
11 clear in what they say, that Prudential and Seagram had in-
12 tended. They did not intend the result that Mr. Klein seeks
13 to accomplish and that is to go nonconsent and yet to get a
14 windfall whereby he makes a 25 percent profit even though he
15 goes nonconsent and suffers a 200 percent penalty.

16 The reason we have forced pool-
17 ing is to -- is a penalty. It is to extract a penalty for
18 people that won't participate, pay their money, and drill
19 the well. There's not one word of testimony out of Mr.
20 Klein or Mr. Hendrix that they're ready to participate.
21 They're going to sign and join and spend their money and do
22 this deal.

23 They're sitting by the side-
24 lines waiting for a windfall and you should not let the for-
25 ced pooling order to manipulated in that way, to the expense

1 of the correlative rights of Mr. Savage and Mr. Klein.

2 We propose to you a method by
3 which the pooling statute is not circumvented; that you're
4 fully within your jurisdiction to declare a working interest
5 subject to the costs and penalty and we believe that that is
6 the only result that does equity in this case, and we would
7 ask you to enter such an order.

8 MR. CATANACH: Thank you, Mr.
9 Kellahin.

10 MR. TAYLOR: Do you guys know
11 if there's a copy of the original lease, or the lease upon
12 which all this is based in the original case file for this
13 pooling?

14 I'd like to see a copy of it.

15 MR. KELLAHIN: It's not in the
16 original case file. We'll be happy to obtain that --

17 MR. TAYLOR: Provide us with a
18 copy?

19 MR. KELLAHIN: Yes, sir. Are
20 there any other documents?

21 MR. TAYLOR: I don't think so.
22 I assume that it doesn't mention all of this but I'd just
23 like to look at it in case.

24 MR. CATANACH: Is there any-
25 thing further in Case 8859?

If not, it will be taken under
advisement.

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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

I do hereby certify that the foregoing is a complete record of the proceedings in the Examiner hearing of Case No. 5857, heard by me on April 4 1958 :

David L. [Signature], Examiner
Oil Conservation Division