

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

**IN THE MATTER OF PROPOSED
AMENDMENTS TO 19.15.2, 19.15.5,
19.15.8, 19.15.9, AND 19.15.25 NMAC**

CASE NO. 24683

DIRECT TESTIMONY OF JEROME P. (JERRY) MCHUGH, JR.

Intervenor Independent Petroleum Association of New Mexico submits the following factual testimony of Jerry McHugh:

- 1 **Q:** Sir, we are submitting your written testimony to the New Mexico Oil Conservation
2 Commission which I will refer to as the "Commission" concerning a rulemaking case
3 concerning financial assurances, bonding, and other matters. Do you understand that
4 your testimony is sworn as if you were testifying live?
- 5 **A:** Yes.
- 6 **Q:** Please introduce yourself to the Commission.
- 7 **A:** My name is Jerome P. McHugh, Jr. People call me Jerry. I am the sole shareholder
8 and President of San Juan Resources, Inc. My company is based in Denver, Colorado.
- 9 **Q:** Could you briefly describe your role in the oil and gas business in New Mexico?
- 10 **A:** Yes. My father, Jerome P. McHugh, Sr., was an active operator in the San Juan
11 basin, principally in northwestern New Mexico for his career. Since I graduated from
12 college in 1980, I have worked exclusively in the oil and gas business in the San Juan
13 Basin, initially with Dugan Production, then for several years with I worked for my father's
14 company, Nassau Resources. In 1990, I incorporated San Juan Resources, Inc. and

1 went into the oil and gas business as the president and owner. San Juan Resources, Inc.
2 operates oil and gas wells exclusively in the New Mexico portions of the San Juan Basin.

3 **Q: Describe San Juan Resources, Inc.'s current oil and gas operations.**

4 **A:** We operate 45 to 50 wells. All our wells are in northwestern New Mexico. Our
5 aggregate daily production from those wells averages about 950 mcf of dry per day and
6 15 barrels per day. The barrels constitute roughly 50% oil and 50% condensate produced
7 in the natural gas stream. In addition, we have two Mancos horizontal drilling projects,
8 one in the gas window and the other in the oil window, which we are working to bring
9 online.

10 **Q: How would you describe San Juan Resources, Inc.'s current portfolio of wells? A:**

11 All our current wells are stripper wells and, currently, three would be classified as
12 "marginal" under the proposed rulemaking (i.e., those three wells produce less than 1,000
13 BOE per year and less than 180 days). San Juan Resources, Inc. is able to operate wells
14 that are in the later stages of their productive life more economically than larger operators
15 and extend the economic life of these wells. In the San Juan Basin, there are several gas
16 formations developed decades ago that continue to produce low amounts of natural gas
17 and generally qualify what is known in the industry as stripper wells.

18 **Q: Explain to the Commission why, at such low production rates, San Juan Resources**
19 **is able to remain in business producing these wells.**

20 **A:** Again, because San Juan Resources is able to operate on a much more efficient
21 basis than larger oil companies with lower overhead costs, wells can remain profitable at
22 lower production volumes, especially in favorable commodity pricing environments. The
23 industry recently emerged from a very difficult period of almost five years of low natural

1 gas pricing and now seeing margins improve as natural gas pricing has firmed up at better
2 levels. In addition to maximizing the economic life of these wells, San Juan Resources
3 is able to perpetuate the oil and gas leases on which the wells are situated. The wells
4 provide access to formations up-hole if some productive capacity for a shallower
5 formation is established. Additionally, the wells, so long as they remain somewhat
6 profitable, maintain the oil and gas lease for purposes of potential deeper and horizontal
7 development and hold valuable acreage, which, when drilled horizontally could yield
8 commercially viable volumes of natural gas and oil. In the San Juan Basin, the potential
9 is for the Mancos shale.

10 **Q: What would happen if the leases expire because the production that San Juan**
11 **Resources is achieving becomes unprofitable?**

12 **A:** Most of San Juan Resources' acreage, like most of the San Juan Basin, consists
13 of Federal oil and gas leases. Like other operators, we have some smaller fee or private
14 oil and gas leases principally along rivers or other water courses in the Basin. Although
15 San Juan Resources does not operate any State of New Mexico oil and gas leases, there
16 are State tracts interspersed in the San Juan Basin. We have no Native American leases
17 in the San Juan Basin as it is generally not available for private oil and gas leasing in my
18 experience. In brief, the largest amount of the lands in the San Juan Basin available for
19 leasing are Federal. I do not have a crystal ball, but it is no mystery that the leasing of
20 Federal lands for oil and gas development has become more difficult in recent decades.
21 The regulatory environment changes with administrations. Additionally, there is plenty of
22 news of the Bureau of Land Management (which manages Federal lands for oil and gas
23 leasing) has been sued over a number of its lease sales to prevent the issuance of oil

1 and gas leases auctioned off at those sales. Ultimately, there is a possibility that, once
2 expired, some Federal lands will not be re-leased and, if there is additional productive
3 capacity in the Mancos shale is widely believed under those lands, those valuable
4 hydrocarbons will not be produced.

5 **Q: How would you describe San Juan Resources' relative to larger oil and gas**
6 **companies, both in the San Juan Basin and other places in New Mexico?**

7 **A:** In addition to the lower margins at which we operate compared to larger
8 companies, as a smaller company we are prepared to take additional risks to develop oil
9 and gas. For instance, San Juan Resources is in the process of putting together and
10 attracting investment in a 7,000 acre Mancos shale unit in the Carson National Forest.
11 Given that the acreage is in the National Forest and abuts the Jicarilla Apache
12 Reservation, it is a smaller company like San Juan Resources that is going to take the
13 risk to unitize the acreage and develop those hydrocarbons. In addition, we are in the
14 process of developing 25,000 acres in the area of Lindrith, New Mexico, a Mancos shale
15 oil horizontal drilling project. We have unitized two Federal Exploratory Units for the initial
16 development. Like the Carson National Forest acreage, this project entails significant
17 amount of capital and risk.

18 **Q: What is your current bonding situation?**

19 **A:** As I mentioned, hopefully coming out of a very difficult pricing environment where,
20 along with other San Juan Basin producers, San Juan Resources has basically just been
21 treading water in a very poor gas pricing environment and is not able to get a private
22 company to underwrite bonds. San Juan Resources has a cash bond of \$75,000.00 with
23 the Oil Conservation Division and a \$25,000.00 cash bond with the BLM.

1 **Q: Does San Juan Resources plug and abandon wells?**

2 **A:** Yes. Our goal is to nursemaid our wells along as best as possible to extend their
3 productive life. However, San Juan Resources is probably the last operator that all our
4 current wells will ever have. In the past five years, we have plugged, abandoned and
5 reclaimed the surface for three wells in New Mexico.

6 **Q: How does the financial aspects of plugging and abandoning work for San Juan**
7 **Resources?**

8 **A:** Our wells are typically governed by what is referred to as a joint operating
9 agreement. Those operating agreements are primarily on forms which may have been
10 somewhat modified but promulgated by the American Association of Petroleum Landmen.
11 Additionally, each operating agreement has what is typically an Exhibit C related to
12 accounting procedures which exhibit which, again, can be modified, is typically on a form
13 promulgated by COPAS or the Council of Petroleum Accounting Societies. Under a
14 typical operating agreement, San Juan Resources would give notice of all of the working
15 interest owners of its intent to plug and abandon and must give each working interest
16 owner the opportunity to assume operations of the well if they think they can continue its
17 productive life. Assuming none of the non-operators so elect, everybody pays their
18 ratable share of estimated plugging and abandoning costs and San Juan Resources does
19 that.

20 **Q: Are you a lawyer able to testify to the meaning of these contractual forms?**

21 **A:** I am not a lawyer. These forms are drafted by associations that are not lawyers
22 although, some lawyers may be involved. As an operator, I must be (and I am) familiar
23 with how these forms of agreements work and implement them every day. But my

1 testimony is not intended to be legal in nature, rather I am testifying based on my
2 knowledge that I have obtained over my 45 years in the oil and gas industry working with
3 these contractual forms on a nearly daily basis.

4 **Q: How is bonding handled under a standard joint operating agreement?**

5 **A:** Typically, the operating agreement and particularly the COPAS exhibits to
6 operating agreements control. Bonding traditionally is done on a blanket basis and is an
7 expense for the operator for which the operator is compensated in part by the overhead
8 charges permitted under the COPAS exhibit where the operator is entitled to bill and
9 collect a fixed amount per month for each well from the non-operating working interest
10 owners.

11 **Q: You mentioned that San Juan Resources plugged and abandoned three wells in**
12 **the past five years. What were the wells and the costs to do that?**

13 **A:** The costs I will provide are rounded to the nearest thousand dollars and include
14 surface reclamation. We plugged the Clark 3 well which had a total vertical depth of
15 3,367 feet for \$62,000; the Clark 8 which had a total vertical depth of 7,888 feet for
16 \$104,000; and the Apperson 1 which had a total vertical depth of 6,757 feet for \$85,000.

17 **Q: Can you explain the differences in costs?**

18 **A:** In my experience, there are two big drivers in cost differences in plugging,
19 abandoning, and reclaiming. First, which we encountered in these three wells, is New
20 Mexico regulations require plugs at the top of each producing formation in the well bore
21 so the deeper the well, the more plugs that are needed to comply with those requirements.
22 Second, which we really did not face with these three wells, is that the presence of surface
23 contamination can increase reclamation costs.

1 **Q:** You earlier mentioned Mancos shale and how smaller companies like San Juan
2 Resources is going to take the risk to develop Mancos shale. First, what is the Mancos
3 shale?

4 **A:** It is a shale formation underlying much of Northwestern New Mexico in and beyond
5 what is customarily known as the San Juan Basin. Portions of the Mancos shale, such as
6 the portions underlying what is traditionally known as the San Juan Basin, primarily are
7 oil bearing. So, San Juan Resources does not have acreage in the area, my
8 understanding is that to the south and east of what is traditionally the San Juan Basin,
9 the Mancos shale eventually becomes gas bearing.

10 **Q:** Describe the quality of the Mancos shale for drilling and production.

11 **A:** Like all shale formations, the Mancos shale is very low porosity and very low
12 permeability. Those geologic characteristics meant that the Mancos shale was not
13 capable of economic development in the vertical drilling era of the oil and gas industry.
14 Relatively new technology, now highly proven in the Permian Basin, allows for vertical
15 drilling and geosteering so that the well stays in formation horizontally for two or mor miles
16 combined with sophisticated hydraulic fracturing techniques means that shale formations
17 like the Mancos shale can be developed economically.

18 **Q:** Why is there not that sort of development of the Mancos shale in Northwestern
19 New Mexico?

20 **A:** There has been some, but not a lot. In my view as an active participant in the
21 market, there are a few reasons for the small amount of Mancos development. First, the
22 largest participants in the oil and gas industry all departed the San Juan Basin and so the
23 best capitalized companies are not present. Second, perhaps most significantly, there is

1 not significant refining capacity or pipeline takeaway capacity for oil in the San Juan Basin.
2 Instead, we have tremendous amount of takeaway or pipeline capacity for natural gas
3 and natural gas liquids, but do not have the transportation ability to transport large
4 volumes of oil to market centers or refineries. It is significantly more expensive to transport
5 oil by rail tanker cars which means that the price paid to the operator and the working
6 interest owners is significantly less than someplace with significant infrastructure like the
7 Permian Base. The Mancos shale needs to be proven up more to attract investment in
8 the midstream infrastructure for oil in the San Juan Basin by which I mean refining and/or
9 pipelines dedicated to oil.

10 **Q: How does all that effect San Juan Resources?**

11 **A:** While San Juan Resources is not the only party seeking to develop Mancos shale
12 oil production, the two units we are putting together will, I hope, help prove up the Mancos
13 shale both in terms of productivity and geographic scope. That success should assist in
14 attracting investment and the type of midstream infrastructure to allow the larger
15 development of the Mancos shale.

16 **Q: How long will that take?**

17 **A:** I do not have a crystal ball, be we are talking years, not months.

18 **Q: Have you read the rulemaking proposals by Western Environmental Law Center,**
19 **et al. and by the Oil Conservation Division?**

20 **A:** I have.

21 **Q: How do you believe the rulemaking overall would affect San Juan Resources?**

22 **A:** In a word, adversely.

23 **Q: Why?**

1 **A:** I read the proposed rules to say that San Juan Resources would need a
2 \$150,000.00 bond on three wells that it operates with others that may qualify as marginal
3 wells and needing such bonds in the foreseeable future.

4 **Q:** What is the amount of bonding that you would need to come up with for three wells,
5 as you understand the proposed rules?

6 **A:** That's \$450,000.00.

7 **Q:** What options does San Juan Resources have besides posting a cash bond?

8 **A:** None of which I am aware.

9 **Q:** Where would San Juan Resources get the \$450,000.00 for bonding three wells?

10 **A:** San Juan Resources does not have that kind of cash reserves. If it could raise the
11 money, it only would be able to do so from the working interest owners in the various wells
12 or a loan that would be difficult to secure. I would certainly talk to a lawyer at that point,
13 but as I stated, I am not seeing any obvious mechanism under the forms of operating
14 agreement which San Juan Resources uses under which the working interest owners
15 could be contractually compelled to contribute to bonding.

16 **Q:** Do you think you will be able to raise that sort of money from the working interest
17 owners if such financial assurances are required by the State of New Mexico?

18 **A:** I obviously do not know for sure, but I doubt it. It makes little sense for the working
19 interest owners since the bonding is essentially a double whammy.

20 **Q:** What do you mean by double whammy?

21 **A:** As I understand the rules proposed, an operator would post a one well bond for
22 \$150,000.00 on a stripper well and get that money back sometime after the State of New
23 Mexico is assured that the well has been plugged, abandoned and reclaimed according

1 to the appropriate legal standards. That means the working interest owners would also
2 have to pay to plug, abandon and reclaim the well and well site and then those owners or
3 whoever posted the bond would wait for money to come back at some point in the future
4 after the government is sure that everything has been done correctly. While at some point
5 in the future, the working interest owners would get their money back if they paid for the
6 bond, they would have capital tied up and for some unknown period of time would have
7 basically paid the plugging and abandoning costs (or more so) twice.

8 **Q: When would they get their bond back as you read the proposed rules?**

9 **A:** It is unclear. There certainly is no regulation of which I am aware or anything in
10 this proposed rulemaking that requires releasing a cash bond in by any time certain.

11 **Q:** Would that level of bonding for "marginal wells" as that term is defined in the
12 proposed rules affect other aspects San Juan Resources, Inc.'s business?

13 **A:** Yes. It would reduce its ability to take risks in investing in older wells.

14 **Q: Can you give an example?**

15 **A:** Yes. In 2016, we bought a package of wells from another operator, which cost
16 \$200,000 for the entire package. One of those wells called the Scott #2A was not
17 producing and was a marginal well under the proposed definitions. If we had been aware
18 of a pending \$150,000 per well bonding requirement for the Scott #2A, we would not have
19 purchased it. In 2016 we were able to get it very cheaply with the idea that it may have
20 been neglected. San Juan Resources, Inc. evaluated the well and identified a few
21 potential fixes. The first fix we tried worked and it returned to be a very productive well
22 for its age and pre-acquisition profile. Under the proposed rules it ceased to be a marginal
23 well. A few years after the initial work, San Juan Resources, Inc. did some other workover

1 work on the Scott #2A well to maintain its productivity. If that well was required to be
2 bonded at \$150,000, there is no way San Juan Resources, Inc. would have taken these
3 risks.

4 **Q: What would the proposed bonding requirements mean for San Juan Resources'**
5 **wells that currently would not qualify as marginal under the proposed rulemaking?**

6 **A:** We have other wells that produce below 1,000 BOE/year but produce more than
7 180 days. Under the proposed rule, SJR would need to monitor production days closely
8 and look to plug before the well was required to be bonded.

9 **Q:** As the operator, is it not SJR's decision to produce on a given day?

10 **A:** Not always. Gas wells tend to have one outlet to market through a gathering
11 system. There are various reasons that a gas well that would otherwise produce cannot
12 produce for reasons beyond an operator's control. Those include inability of a well to
13 produce because the gathering system raises its pressure so that lower pressure wells
14 cannot "buck" or produce into the system. Also, maintenance issues on the gathering
15 system prevent wells upstream of the maintenance issue to produce. Some maintenance
16 issues are resolved relatively quickly, others linger in my experience.

17 **Q: If this proposed bonding scheme is adopted, what will happen?**

18 **A:** Otherwise economically producible hydrocarbons will not be produced because
19 operators will plug wells to avoid the well reaching marginal status. Understanding the
20 economics of operating stripper wells, I believe that some operators will go out of business
21 and thereby orphan their remaining wells.


JEROME P. MCHUGH, JR.

I hereby affirm under penalty of perjury of the laws of the State of New Mexico that the above statements are true and correct to the best of my information, knowledge and belief.

DATE: 7/30/2025



JEROME P. MCHUGH, JR.