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

APPLICATION OF FAE II OPERATING, LLC FOR STATUTORY UNITIZATION, LEA COUNTY, NEW MEXICO.

CASE NO. 22972

NOTICE OF ERRATA

Apache Corporation, Chevron U.S.A. Inc., Citation Oil & Gas Corp., COG Operating LLC, ConocoPhillips, OXY USA Inc., XTO Holdings, LLC, and XTO Energy Inc. (collectively, "Respondents") respectfully submit this Notice of Errata to correct grammatical errors to the Response to FAE II Operating, LLC's Motion for Determination on Approval Requirements of Phased Allocation Formula Under the Statutory Unitization Act. A revised Response is attached hereto correcting the grammatical errors.

Respectfully submitted,

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CERTIFICATE OF SERVICE

I hereby certify that on October 21, 2022 I served a copy of the foregoing document to the following counsel of record via Electronic Mail to:

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RESPONSE OF APACHE CORPORATION, CHEVRON U.S.A. INC., CITATION OIL & GAS CORP., COG OPERATING LLC, CONOCOPHILLIPS, OXY USA INC., XTO HOLDINGS, LLC, AND XTO ENERGY INC. TO APPLICANT'S MOTION FOR DETERMINATION ON RATIFICAITON REQUIREMENT OF PHASED ALLOCATION FORMULA UNDER THE STATUTORY UNITIZATION ACT

Apache Corporation, Chevron U.S.A. Inc., Citation Oil & Gas Corp., COG Operating LLC, ConocoPhillips, OXY USA Inc., XTO Holdings, LLC, and XTO Energy Inc. (collectively, "Respondents") submit this Response to FAE II Operating, LLC's ("FAE") Motion for Determination on Approval Requirements of Phased Allocation Formula Under the Statutory Unitization Act ("Motion"). For the reasons discussed herein, the New Mexico Oil Conservation Division ("Division") must reject FAE's suggestion that it can satisfy the voluntary ratification requirements of the New Mexico Statutory Unitization Act ("the Act") by cherry picking tracts within the proposed unit as "Phase I" tracts and demonstrating that "75% of the cost bearing and non-cost bearing interest have approved the first phase of FAE's proposed two-phase allocation formula." FAE Motion at p. 1; *see also* FAE Motion at p. 4 (contending the Division can impose statutory unitization "when at least 75% of interest owners in the *initial phase of unit operations* have ratified the operating plan." [emphasis own]).

INTRODUCTION AND SUMMARY OF ARGUMENT

FAE suggests the Division can force Respondents into a 19,369.77-acre unit by utilizing a gerrymandered two-phase allocation formula designed such that FAE owns most of the working interest in the limited tracts falling under "Phase I." *Id.* FAE's proposed tract allocation formula (yet to be approved by the Division) places non-contiguous tracts comprising less than one-third of the proposed unit area (approximately 6,200-acres) into Phase I.[1] The owners in these disjointed Phase I tracts will pay the cost and receive the revenues of the proposed unit operations for the first three years. However, the working interest owners in the remaining Phase II tracts (comprising over two-thirds of the proposed unit) incur the costs of development for the first three years, but do not share in any of the revenue. Instead, at the end of the first three years the Phase II owners, such as the Respondents, are required to pay in full their proportionate share of all incurred costs "plus compounded interest accrued at ten percent (10.00%) per annum as of the transition date to Phase II." *See* FAE Exhibit 2 to Application (proposed Unit Operating Agreement) at Section 2.1.3. Failure to pay these lump-sum incurred costs plus interest will result in the owners in the Phase II tracts being considered "non-participating Working Interest Owners" subject to "actual cost plus three hundred percent (300%) cost recoupment of all unpaid costs on the corresponding AFE or invoice." *Id.* In addition, Operations during that three-year period "will be conducted uniformly throughout the Unit in both phases," including the tracts falling within Phase II. *See* Exhibit A to FAE's Motion (Song Affidavit) at ¶ 7. Accordingly, FAE seeks to

[1] FAE does not specifically disclose in their Application or Motion the total acreage of the tracts included in Phase I. This information has been extrapolated from the Unit Agreement's Exhibit C "Schedule of Tract Participation" filed with FAE's Application. The acreage of the tracts designated by FAE with a "Phase I Participation Factor" add up to only 6,200-acres. *See* Attachment A (highlighted tracts). As demonstrated by Attachment A-1, these Phase I tracts are not contiguous and are scattered throughout the proposed unit area.

commence development of the entire proposed unit area resting solely on the approval from working interest owners in tracts comprising less than one-third of the proposed unit.

FAE has not shared with Respondents the data or methodology used to determine the Phase I and Phase II tracts, contending that information is proprietary. Instead, FAE has simply stated the Phase I tracts are based on six months of oil production in 2021 and the Phase II tracts are based on the remaining recoverable oil in place. *See* Exhibit A (Song Affidavit) to FAE's Motion at ¶ 6. FAE has not identified a factual basis for choosing six months of production from 2021 to determine the Phase I tracts, nor has FAE disclosed the methodology, data or analysis used to determine the Phase II tracts. Further, the only evidence FAE has provided to substantiate voluntary approval from the working interest owners in these limited Phase I tracts is to summarily state they have done so. FAE has not identified the consenting working interest owners in the Phase I tracts nor has FAE accounted for depth severances and other variables in the ownership of these limited tracts.

Nonetheless, FAE's motion seeks to convince the Division that it can force Respondents into the proposed unit, and begin development of any tract within the proposed 19,369.77-acre unit, by resting on the voluntary approval from undisclosed working interest owners in tracts comprising less than one-third of the proposed unit area. For support, FAE cites to the word "initially" in the first sentence of Section 70-7-8(A). However, FAE's interpretation of this single word is not consistent with the remainder of the Act, is not consistent with prior Division orders addressing statutory unitization, is not consistent with the treatises addressing statutory unitization, and undermines the core mandate of the Act to protect the correlative rights of all working interest owners in the proposed unit area and ensure the unit is fair, reasonable, and equitable to all owners.

ARGUMENT

THE NEW MEXICO STATUTORY UNITIZATION ACT REQUIRES THE NECESSARY APPROVAL FROM THE INIITAL WORKING INTEREST OWNERS IN "THE PROPOSED UNIT AREA," NOT THE INITIAL BENEFICIARIES UNDER A GERRYMANDERED TRACT ALLOCATION FORMULA.

Citing solely to the word "initially" in Section 70-7-8(A), FAE contends the Division can force Respondents into its proposed unit by simply showing that "75% of interest owners in the *initial phase of unit operations* have ratified the operating plan." FAE Motion at p. 4 (emphasis own). However, the word "initially" in Section 70-7-8(A) cannot be read in isolation and must be interpreted in the context of the remainder of this section and other provisions of the Act. *See* ***Grisham v. Reeb***, 2021-NMSC-006, ¶ 12, 480 P.3d. 852 (courts must "construe a statute according to its obvious spirit or reason" and particular language must be read "in the context of the statute as a whole, including its purposes and consequences."); ***Key v. Chrysler Motors Corp***., 1996-NMSC-038, ¶ 14, 121 N.M. 764, 918 P.2d 350 ("[A]ll parts of a statute must be read together to ascertain legislative intent" and "[courts] are to read the statute in its entirety and construe each part in connection with every other part to produce a harmonious whole."). When viewed in the context of the entire Act, the word "initially" cannot be read to ignore the correlative rights of the Respondents and the other working interest owners in the tracts comprising over two-thirds of the proposed unit. Instead, the Division must determine whether the necessary voluntary approval has been obtained from the initial working interest owners in the entire proposed unit area.

A. The Act Requires 75% Voluntary Approval From The Initial Working Interest Owners In The Entire Proposed Unit Area.

Any application for statutory unitization must provide "a description of the proposed unit area and the vertical limits to be included therein …." NMSA 1978, § 70-7-5(A). The term "unit area" is defined as the "legal description in terms of surface area of the pool or part of the pool to

be operated as a unit and the vertical limits to be included ….” NMSA 1978, § 70-7-7(A). The Act requires the Division to ultimately enter an order ensuring “correlative rights [are] protected of all owners of mineral interests in each unitized area” and is “upon terms and conditions that are fair, reasonable and equitable” to all owners in the proposed unit area. *See* NMSA 1978, §§ 70-7-1 and 70-7-7.

A separate component of the Division’s order must also address how production and costs are “allocated to the separately owned tracts in the unit area….” NMSA 1978, § 70-7-7(C). The Division must find that the proposed tract allocation formula “allocates the produced and saved unitized hydrocarbons to the separately owned tracts in the unit area on a fair, reasonable and equitable basis.” NMSA 1978, § 70-7-6(A)(6). Ultimately, “the production allocated to each tract shall be the proportion that the relative value of each tract so determined bears to the relative value of all tracts in the unit area.” NMSA 1978, § 70-7-6(A)(6). The tract allocation formula is a different examination by the Division and independent of the voluntary approval threshold required by the Act.

Against this background, FAE conflates the tract allocation formula with the voluntary approval threshold, isolates the word “initially” from the rest of the statute and offers an interpretation that ignores—in this case—the correlative rights of working interest owners in over two-thirds of the proposed unit. The Act does not support such an absurd result.

Attachment B hereto provides a complete copy of Section 70-7-8 that highlights in yellow the phrase relied upon by FAE and highlights in blue the remaining language referencing the necessary percentage of voluntary joinder. That remaining language discusses the necessary percentage in relation to the “unit area,” defined in Section 70-7-7(A) as the “legal description in terms of surface area of the pool or part of the pool to be operated as a unit and the vertical limits

to be included." (emphasis added). The Act clearly contemplates an examination of the voluntary approval reached with the initial working interest owners in the entire surface of the proposed unit area (here, over 19,000-acres) and not just the voluntary approval of the working interest owners in tracts placed within various "phases" of a proposed tract allocation formula. The 75% approval threshold required by the Act is separate and apart from the proposed tract allocation formula, which must eventually be approved by the Division after receiving evidence on the "relative value of all tracts in the unit area." *See* NMSA 1978, Section 70-7-6(B) (emphasis added).

B. Requiring 75% Approval From The Initial Working Interest Owners In The Entire Proposed Unit Area Does Not Write The Term "Initially" Out Of The Statute.

A common sense reading of the Division's authority that protects the correlative rights of all the working interest owners in the proposed unit area does not write the term "initially" out of the statute as suggested by FAE. *See* Motion at p. 4.

1. The term "initially" cannot be read to ignore the correlative rights of the working interest owners in over two-thirds of the proposed unit area and refers to the initial working interest owners in the proposed unit area.

Section 70-7-8 is a restriction on the Division's authority to exercise the police power of the state to force mineral owners into a proposed unit. Accordingly, this restriction must be broadly construed to protect the correlative rights of the working interest owners in the proposed unit area. *See* ***Grisham v. Reeb***, 2021-NMSC-006, ¶ 12, 480 P.3d. 852 (courts "will not be bound by literal interpretation[s] of the words if such strict interpretation would defeat the intended objective of the legislature," and "where statutory language is doubtful, ambiguous, or an adherence to the literal use of the words would lead to injustice, absurdity, or contradiction, [courts] construe a statute according to its obvious spirit or reason."); 5 Summers, Oil and Gas, § 952 ("As to compulsory poolings and unitizations, no definition should be attempted beyond noting that these have the consequences imposed by law through valid exercises of the police power, and these

consequences should be held to the minimum to accomplish the police power purposes of prevention of waste and protection of correlative rights."), *id* § 962 ("As a general proposition neither voluntary nor compulsory poolings and unitizations are supposed to have any greater effect on other relationships than necessary to accomplish the operational purpose of pooled production, the former because this is the purpose of the agreement and the latter because the statutory structure should be interpreted in a manner consistent with the limited purpose of the state's police power.") (emphasis added). The objective of the legislature declared in the Act mandates that the Division's authority be used in a fashion that protects the correlative rights of all mineral interests in the proposed unit:

> **70-7-1. Purpose of act.**
>
> The legislature finds and determines that it is desirable and necessary under the circumstances and for the purposes hereinafter set out to authorize and provide for the unitized management, operation and further development of the oil and gas properties to which the Statutory Unitization Act is applicable, to the end that greater ultimate recovery may be had therefrom, waste prevented, *and correlative rights protected of all owners of mineral interests in each* ***unitized area***. It is the intention of the legislature that the Statutory Unitization Act apply to any type of operation that will substantially increase the recovery of oil above the amount that would be recovered by primary recovery alone and not to what the industry understands as exploratory units. [emphasis added]

See also NMSA 1978, Section 70-7-7 (requiring the Division to ultimately enter an order approving unitization "upon terms and conditions that are fair, reasonable and equitable" to all owners in the proposed unit area.)

The correlative rights of the working interest owners in the proposed "unitized area" are not protected by looking only at the level of voluntary participation by the working interest owners in the limited tracts comprising Phase I. Rather, the necessary protection is accomplished when the phrase "initially to pay" in Section 70-7-8(A) is construed to mean the Division examines the level of voluntary participation by the initial working interest owners in the proposed unitized area.

The phrase "initially to pay" prevents parties who may develop a future working interest in the unit area from either blocking or consenting to the proposed unit operations.

A good example is a standard farmout agreement. Under such agreements, the farmor may relinquish a working interest for a period of time or retain a non-cost bearing interest that can be converted to a working interest. Another example is provided under Attachment C, a form Assignment of Interest in Oil and Gas Leases. Paragraph 3 of this form document provides for the assignment of a working interest upon the specified payout event. These are merely examples of the various contractual arrangements that exist wherein a third-party is not required "initially to pay" the costs of development but may eventually obtain a cost-bearing interest. The phrase "initially to pay" in the first sentence of Section 70-7-8 makes it clear that future or back-in working interest owners are not considered in determining compliance with the 75% voluntary approval required by the cost-bearing owners in the unit area.

2. Under FAE's Proposed Unit Agreement, Respondents and the other working interest owners in the Phase II tracts are initially responsible for payment of unit operations.

Putting aside for a moment the statutory interpretation issue raised by FAE's Motion, it should be noted that under FAE's proposed Unit Operating Agreement the Respondents and the other Phase II owners are initially responsible for payment of the costs incurred during the three-year Phase I period. *See* FAE Exhibit 2 to Application (proposed Unit Operating Agreement) at Section 2.1.3. From the first day of unit operations, the Respondents and other Phase II owners are credited with their share of the costs "plus compounded interest accrued at ten percent (10.00%) per annum as of the transition date to Phase II." Failure of the Phase II owners to pay their share of the costs and interest imposed and credited to them from the start of unit operations at the end of the Phase I period will result in those owners being considered "non-participating Working

Interest Owners" subject to proposed cost plus 300% risk penalty. *Id.* Accordingly, under FAE's proposed Operating Agreement, Respondents and the other Phase II working interest owners in the proposed unit area will not share in the revenues for the first three years of operations, but "will be required initially to pay" the costs of the unit operations at the end of that three-year period plus yearly compounded accrued interest. *See* NMSA 1978, § 70-7-8(A).

In any event, the Act does not support FAE's suggestion that it can force Respondents into the proposed unit, and begin development of any tract within the proposed 19,369.77-acre unit, by resting on the voluntary approval from working interest owners in tracts comprising less than one-third of the proposed unit area.

C. Division Orders Have Uniformly Examined The Voluntary Approval From All Initial Working Interest Owners In The Proposed Unit Area, Not A Subset Of Owners Selected By The Applicant's Proposed Tract Allocation Formula.

In Division Case No. 15792, FAE sought approval from the Division for its proposed West Eumont Unit. In that case, FAE's landman testified that the company had obtained 80% approval of the working interest owners in the entire proposed unit, not those initially benefiting from a proposed allocation formula:

> Q. And how many interest owners of all types are there in the proposed unit?
> A. Oh, over 100.
> Q. Let's talk first about working interest owners. Does Exhibit 4 contain a listing of working interest owners in the proposed unit?
> A. Yes. Exhibit 4 is the working interest owners.
> Q. What is the approximate current approval overall unit of working interest owners? What percentage interest have currently approved the unit?
> A. Well in excess of 80 percent.

Case 15792, 9/14/17 Tr. at 10. Subsequently the Division issued its Order finding: "At the time of the hearing, Applicant had obtained approval of the Unit by more than 75 percent of the cost bearing interests." Order R-14615 at p. 3, finding 7(d).

Division Order R-10460 (issued in 1995 under Division Cases Nos. 11297 and 11298) likewise discussed the tracts and working interests in the "proposed Unit Area":

> (7) The proposed Unit Area contains twelve separate tracts of land, the working interests in which are owned by forty-eight different interest owners. Exxon operates five of the twelve tracts, five tracts are operated by Yates Petroleum Corporation ("Yates"), one tract is operated by Premier Oil & Gas, Inc. ("Premier"), and one tract operated by MWJ Producing Company. There are twenty-four royalty and overriding royalty interest owners in the proposed Unit Area. [emphasis added]

Order R-10460, at p. 3 ¶ 7 (findings). The Division ultimately issued the following ordering paragraph:

> (5) Since the persons owning the required statutory minimum percentage interest in the Unit Area have approved, ratified, or indicated their preliminary approval of the Unit Agreement and the Unit Operating Agreement, the interests of all persons within the Unit Area are hereby unitized whether or not such persons have approved the Unit Agreement or the Unit Operating Agreement in writing. [emphasis added]

Order R-10460 at p. 11, Ordering ¶ 5.

A review of the oil and gas treatises on statutory unitization confirm the Division's long-standing practice to look at the voluntary approval of the initial working interest owners in the entire proposed unit area, not the initial beneficiaries under a proposed phased-in tract allocation formula. Professor Kuntz instructs: "In those states where unitization can be imposed upon the owners of minority interests, the order has the effect of unitizing the area included after the plan of unitization has been ratified by the owners of the required percentage of the area covered by the plan." 5 Kuntz, Law of Oil and Gas, § 78.2 (emphasis added). Professors Williams & Myers similarly note that statutes forcing parties into a unit generally "require that owners of specified percentages of the operating and nonoperating interests in the unitized area join in the plan within a specified period of time (usually six months) after the entry of the unitization order." 6 Williams & Meyers, Oil and Gas Law, § 913.5 (emphasis added). None of these treatises support the interpretation of the Act offered by FAE.

The Division should not accept FAE's invitation to depart from its precedence when a wholistic reading of the Act, the legislative purpose and the treatises support these decisions.

D. Approval Of Operations Across The Entire Unit Area Based On Ratification By The Working Interest Owners In One-Third Of The Surface Acreage Is Not Only Inequitable, But Will Incentivize Gerrymandering To Meet Voluntary Unitization Threshold Requirements.

FAE admits it seeks to use the joinder of the working interest owners in the Phase I tracts where it holds most—if not all—of the working interest to commence development of the entire proposed unit area:

> Although FAE has proposed a two-phased allocation formula, development will be conducted uniformly throughout the Unit in both phases….

Exhibit A to FAE's Motion (Song Affidavit) at ¶7. During the initial three-year period, the working interest owners in the Phase II tracts (comprising over two-thirds of the development area) do not receive any revenue from unit operations on their tracts but accrue the costs of all development (plus yearly compounded interest at 10%) for a three-year period. *See* FAE Exhibit 2 to Application (proposed Unit Operating Agreement) at Section 2.1.3. Yet, FAE seeks to force these Phase II owners into the proposed 19,369.77-acre unit, and conduct operations on their tracts, by looking only to the voluntary level of approval from the working interest owners in the Phase I tracts comprising less than one-third of the proposed unit area. There is nothing "fair, reasonable, and equitable" about this interpretation of the Act, nor does FAE's interpretation protect the correlative rights of all initial working interest owners in the proposed unit area. *See* NMSA 1978, §§ 70-7-1 and 70-7-7. Rather, as the adage goes, FAE "wants to have their cake and eat it too."

New Mexico courts conduct statutory interpretation in a reasonable manner that aligns with the obvious spirit of the statute—not in a manner that results in an inequitable and absurd outcome. The Division must follow an interpretation of its authority under the Act that protects the

correlative rights of all the initial working interest owners in the proposed unit area. To adopt FAE's position on the meaning of Section 70-7-8 will incentivize operators to gerrymander tracts into "phased-in" allocation formulas designed to meet the voluntary approval threshold but, in this case, leave the working interest owners in thousands of acres with no voice in approving or disapproving the statutory unitization. FAE's interpretation of the approval threshold required by Section 70-7-8 clearly does not align with the legislative intent expressed in the Act.

III. CONCLUSION

FAE's interpretation of Section 70-7-8(A) is not correct and must be rejected by the Division.

Respectfully submitted,

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