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

APPLICATION OF FAE II OPERATING, LLC FOR STATUTORY UNITIZATION, LEA COUNTY, NEW MEXICO. **CASE NO. 22972**

FAE II OPERATING, LLC'S REPLY IN SUPPORT OF MOTION FOR DETERMINATION ON RATIFICATION REQUIREMENT OF PHASED ALLOCATION FORMULA UNDER THE STATUTORY UNITIZATION ACT

FAE II Operating, LLC ("FAE") submits the following reply in support of its Motion for Determination on Approval Requirement of Phased Allocation Formula Under the Statutory Unitization Act ("Motion").

I. INTRODUCTION

FAE's application seeks approval of the proposed South Jal Unit ("Unit") and proposes to allocate costs and revenues among the tracts in the Unit using a two-phase methodology *that was required by the Bureau of Land Management* ("BLM") and that has been approved by the New Mexico State Land Office. *See* Affidavit of H. Song, Motion Exh. A. FAE has secured the ratification of its plan for unit operations from the interest owners who will initially pay 75% of the costs of operation. Because the Unit Agreement has been approved by those persons who will be required to initially pay at least 75% of the costs of the unit operations, and also by the owners of at least 75% of the non-cost bearing interests, the ratification of the required Phase I interest owners meets the 75% approval requirement of Section 70-7-8(A) and permits the Division to enter an order approving the plan for unit operations, provided the other requirements of the Act are met.

Although Respondents[1] do not express any intent to develop this acreage for the benefit of the interest owners or the state, they lodge unfounded accusations of "gerrymandering" and "nondisclosure" and oppose FAE's proposal based on a misinterpretation of the Act, the Unit Operating Agreement, and Division precedent. Specifically, they argue that the 75% threshold included in Section 70-7-8(A) can only be met if the owners of 75% of the unit area approve and that the Unit Operating Agreement does in fact require the Phase II owners to pay the full costs of the Phase I development. Neither argument is correct.

In fact, Section 70-7-8(A) requires approval by "those persons who, under the Division's order, will be required initially to pay at least seventy-five percent of the costs of the unit operations," rather than the owners of 75% of the unit area. And the Unit Operating Agreement requires the Phase II owners to pay the *net book value* of the unit equipment that will be used to develop their interests at the beginning of Phase II – not the costs of Phase I operations as Respondents claim. The Division decisions cited by the Respondents are inapposite and similarly fail to support their position. Respondents' arguments lack merit and FAE's Motion should be granted.

II. ARGUMENT

A. The Unit Operating Agreement does not require the Phase II owners to bear the full cost of Phase I operations.

Respondents' arguments are premised on a fundamental misinterpretation of the Unit Operating Agreement. *See* Response at 2, 8-9. Respondents argue that the Phase II owners are responsible for paying the full costs of unit operations incurred during the three-year Phase I period when that is not the case. Section 2.1.3 of the Unit Operating Agreement provides:

[1] Respondents include 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.

> upon transition from Phase I to Phase II, the Phase II Working Interest Owners will participate at their Phase II working interest and pay their proportionate share of the *current net book value of invested unit capital spending* plus compounded interest accrued at ten percent (10.00%) per annum as of the transition date to Phase II.

See Unit Operating Agreement at Section 2.1.3, Application Exh. 2 (emphasis added). The invested unit capital consists of the equipment and facilities used for the unit, and the Phase II owners only pay for the *net book value* of those assets at the beginning of Phase II. It is unclear why Respondents believe they should get a free ride from the Phase I owners and have their interests produced without paying for any of the equipment used to do so. That, of course, would be neither fair nor equitable. Furthermore, the assets will have depreciated for three years before the Phase II interest owners begin to pay the net book value, so they will benefit from the assets at a reduced cost. Respondents' argument that the Phase II owners pay the full Phase I costs misconstrues the plain language of the Unit Operating Agreement.

B. The Statutory Unitization Act authorizes the Division to approve a proposed unit that has been ratified by the interest owners who will initially bear 75% of the costs of unit operations.

As an initial matter, Respondents' allegations of "gerrymandering" and nondisclosure are as unsubstantiated as their flawed argument regarding the Unit Operating Agreement. As explained by Mr. Song, *the BLM required FAE to implement the phased allocation and tract participation formula*. *See* Motion Exh. A. FAE did not, in any respect, seek to "gerrymander" its proposed unit. Respondents' claim that FAE did not provide them with information regarding the methodology used to develop the formula also lacks merit, as FAE provided information regarding the formula at its working interest owner meetings, and the tract participation formula was again provided with FAE's Application. Although Respondents appear to claim that FAE tried to "hide" the information, they then attached it to their Response. *See* Response at Exh. A.

Respondents' hyperbole aside, FAE's application for statutory unitization meets the threshold criteria for approval under Section 70-7-8(A) because the owners who will pay more than 75% of the Phase I costs, and more than 75% of the non-cost bearing interests, have approved the plan for unit operations. Section 70-7-8(A) provides:

> No order of the division providing for unit operations shall become effective unless and until the plan for unit operations prescribed by the division has been approved in writing by those persons who, under the division's order, *will be required initially to pay at least seventy-five percent of the costs of the unit operations, and also by the owners of at least seventy-five percent of the production or proceeds thereof* that will be credited to interests which are free of cost such as royalties, overriding royalties and production payments, and the division has made a finding either in the order providing for unit operations or in a supplemental order that the plan for unit operations has been so approved.

See § 70-7-8(A) (emphasis added). The plain language of this provision establishes that the Division may approve a statutory unit when the interests who will initially be required to pay at least 75% of the costs of operations, and 75% of the non-cost bearing interests, have approved the unit agreement. "When statutory language is clear and unambiguous, [this Court] must give effect to that language and refrain from further statutory interpretation." *Marbob Energy Corp. v. New Mexico Oil Conservation Comm'n*, 2009-NMSC-013, ¶ 9, 146 N.M. 24. Moreover, the words contained in a statute are presumed to have been intentionally used, and all words included in a statute must be given effect. *See, e.g., Baker v. Hedstrom*, 2013-NMSC-043, ¶ 24, 309 P.3d 1047. The plain language of Section 70-7-8(A) only requires ratification by those interest owners who are *initially* required to bear 75% of the costs of unit operations.

Respondents argue that despite the plain language of the statute, the Legislature must have meant that 75% of the owners of the *unit area* must approve a proposed unit. *See* Response at 4-6. But that is not what the Legislature said. FAE does not dispute that the unit area includes all tracts or that other provisions of the Act refer to the unit area, but the Legislature chose in Section

70-7-8(A) to instead require approval by the owners who will initially bear 75% of the costs. That the Legislature specifically referred to owners of the unit area in other portions of Section 70-7-8 only highlights its use of different language in the first sentence of the statute. Respondents write the term "initially" out of the statute *and* ignore the Legislature's deliberate decision to require approval by the parties who will bear 75% of the costs of unit operations. Under New Mexico law, clear statutory language must be applied. *See, e.g., Marbob Energy Corp.*, 2009-NMSC-013, ¶ 9, 146 N.M. 24.

Respondents are also incorrect that FAE's application of the statute's plain language would lead to absurd results by allowing "gerrymandering" of units. Contrary to Respondents' claim, the Legislature's decision to require ratification by the parties who will initially bear 75% of the costs makes perfect sense. Numerous methodologies may be used to allocate costs and revenues in a proposed unit, and the allocations may or may not be based on the percentage of ownership in relation to total surface acreage. By requiring approval of the parties who will initially bear 75% of the costs, the Legislature recognized this fact. If costs and revenues are not allocated based on surface acreage, it would be illogical, and even unfair, to require ratification based on surface acreage. In essence, Respondents seek to preclude an operator from using any methodology to allocate costs other than surface acreage when the Act contains no such restriction. And adopting Respondents' interpretation of the statute would limit operators in a manner that is inconsistent with the Legislature's policy decision to support enhanced recovery projects for the benefit of the interest owners and the state. *See* NMSA 1978, § 70-7-1 (recognizing that enhanced recovery projects result in greater recovery, thereby preventing waste and protecting correlative rights).

Respondents' argument that FAE conflates the allocation formula with the approval requirement misunderstands the Act. *See* Response at 5-6. Section 70-7-8(A) requires approval by

the parties who will initially bear at least 75% of the unit costs, and in this case, the allocation and tract participation formula controls that determination. If the allocation of costs and revenues was based on surface acreage, then the parties who would pay 75% of the costs would also be based on surface acreage. But that is not the case here.

Although Respondents attempt to raise other issues, such as whether the allocation formula is fair and equitable and whether other requirements of the Act have been satisfied, those matters are not at issue here. FAE's Motion does not seek approval of the proposed Unit but rather a legal ruling that ratification by the Phase I interest owners who will initially bear 75% of the costs meets the threshold approval requirement of Section 70-7-8(A) and permits the Division to enter an order approving the plan for unit operations after a hearing, provided the other requirements of the Act are met.

As explained by Mr. Song, FAE has obtained the required approval of its plan for unit operations from the owners who will pay at least 75% of the Phase I costs. *See* Motion Exhibit A. In accordance with the clear and unambiguous plain language of Section 70-7-8(A), the approval of the interest owners who will pay at least 75% of the Phase I costs is sufficient to establish ratification of the unit under Section 70-7-8(A) of the Act.

C. The Division decisions cited by Respondents do not support their position.

Respondents cite several Division decisions where the 75% ratification requirement was applied based on the percentage of ownership in the unit area. *See* Response at 9-10. But as discussed above, in some cases, costs and revenues are allocated based on surface acreage. In that scenario, the 75% approval threshold would necessarily also be based on surface acreage ownership. That is not the case here, where costs and revenues are allocated based on other criteria. The Legislature specifically determined that the 75% approval threshold applies to the persons

who will initially bear 75% of the costs of operations, not the owners of 75% of the acreage. As a result, the cases cited by Respondents are inapposite.

III. CONCLUSION

FAE's proposed unit accomplishes exactly what the Legislature intended—it will increase production of the underlying reserves for the benefit of all interest owners and the state. Because FAE has obtained approval from the requisite percentage of interest holders for the first phase of unit operations, FAE has satisfied the threshold requirement of Section 70-7-8(A) and the Division should issue an order to that effect.

Respectfully submitted,

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Certificate of Service

I hereby certify that a true and correct copy of the foregoing motion was sent by electronic mail on this 28th day of October, 2022, to the following counsel of record.

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