

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

IN THE MATTER OF CHI OPERATING, INC.,

NMOCD - OGA 04- 82

Respondent.

Agreed Compliance Order

Pursuant to the New Mexico Oil and Gas Act, NMSA 1978, Sections 70-2-1 through 70-2-38, as amended ("Act"), the Director of the Oil Conservation Division ("OCD") enters this Agreed Compliance Order ("Agreed Order") with Chi Operating, Inc. ("Chi"), directing compliance with the Act and the OCD Rules. Further, the OCD and Chi enter into this Agreed Order to resolve all possible civil penalties against Chi related to the acts further described below for possible violations of the Act and OCD Rules.

Findings

1. The OCD is the state division charged with administration and enforcement of the Act and OCD Rules.
2. Chi is a foreign corporation authorized to do business in New Mexico under SCC number 1399054.
3. Chi is the operator of record for the Merland No. 2 Well, API# 30-015-33181, located in Section 30, Township 22 South, Range 27 East, within the city limits of Carlsbad, Eddy County, New Mexico (hereinafter "Well").
4. On Thursday morning, March 11, 2004, the Well experienced a flow of gas that vented into the atmosphere. Gas continued to escape from the Well over a nine-day period due to both venting and flaring. This incident caused the evacuation of many residents of Carlsbad and disrupted local business due to concerns about the possibility of explosion and fire.
5. An OCD investigation of the incident established the following:
 - a. When Chi's drilling contractor, Patterson-UTI/Tmbr Sharp Drilling Company ("Patterson"), first attempted to use the blowout preventer equipment during the incident, two leaks were discovered in the discharge line (also called the "blooey line" or the "panic line"), requiring those connections to be re-tightened. As drilling fluid was diverted through the discharge line the line broke loose at its connection to the manifold, and the force of the drilling fluid pushed the pipe aside. The line had not been secured to keep it from moving. The discharge line is designed to handle

the force of drilling fluid moving at high speed through the pipe. Had that line not come loose, the impact of the sudden gas flow would have been minimal because the line would have diverted the gas away from the rig to a flare pit where it could have been safely burned.

- b. Documentation provided by Chi demonstrates that ten pound per gallon drilling fluid did not allow gas to come into the hole while the hole was full. When the Well emergency contractor stabilized the Well it also used ten pound per gallon drilling fluid. It appears that Patterson did not adequately monitor the drilling fluid to see if it was flowing back and did not maintain the height of the drilling fluid sufficiently to control the pressure in the Well.
- c. The subsequent escape of 48.7 million cubic feet of gas occurred over a nine-day period starting March 11, 2004 and ending on March 19, 2004.
- d. The OCD interviewed some of the members of the Patterson drilling crew and also reviewed documentation from Patterson concerning whether "BOP [blowout preventer] Drills" were conducted on the Well. Based upon that investigation, the evidence and statements from witnesses raises doubts as to the frequency those BOP drills were conducted.
- e. According to information provided by Chi, the blowout preventer equipment was owned and maintained by Patterson during the incident.
- f. Although Chi began drilling this Well on February 6, 2004, Chi did not file a form C-103 reporting the commencement of drilling operations until it faxed the report to the Artesia district office on March 12, 2004, after being reminded of that reporting requirement by an OCD employee.
- g. The surface casing on the Well was set and tested on February 8, 2004. The intermediate casing was set and tested on February 19, 2004. The C-103 reporting these activities was submitted with the C-103 faxed to the Artesia district office on March 12, 2004. The C-103 did not include a report of the testing of the casing.

6. OCD Rule 109.B [19.15.3.9.B NMAC] states:

"Blowout preventers shall be installed and maintained in good working order on all drilling rigs and workover rigs operating within the corporate limits of any city, town, or village, or within 1320 feet of habitation, school, or church, wherever located."

7. OCD Rule 114.B. [19.15.3.114.B NMAC] states:

"When coming out of the hole with drill pipe, drilling fluid shall be circulated until equalized and subsequently drilling fluid level shall be maintained at a height sufficient to control subsurface pressures. During course of drilling blowout preventers shall be tested at least once each 24-hour period."

8. OCD Rule 13.B [19.15.1.13.B NMAC] states, in relevant part:

“All operators ... shall at all times conduct their operations in or related to the drilling, equipping, operating, producing, plugging and abandonment of oil, gas, injection, disposal, and storage wells or other facilities in a manner that will prevent waste of oil and gas, the contamination of fresh waters and shall not wastefully utilize oil or gas, or allow either to leak or escape from a natural reservoir, or from wells, tanks, containers, pipe or other storage, conduit or operating equipment.”

9. OCD Rule 1103.C [19.15.9.1103.C NMAC] states:

“Information to be entered on form C-103, subsequent report, for a particular operation is as follows: Report of commencement of drilling operations. Within ten days following the commencement of drilling operations, the operator of the well shall file a report thereof on form C-103 in triplicate. Such report shall indicate the hour and the date the well was spudded.”

10. OCD Rule 1103.D [19.15.9.1103.D NMAC] states:

“Report of Results of Test of Casing and Cement Job; Report of Casing Alteration: A report of casing and cement test shall be filed by the operator of the well within ten days following the setting of each string of casing or liner. Said report shall be filed in triplicate on form C-103 and shall present a detailed description of the test method employed and the results obtained by such test and any other pertinent information required by Rule 107. The report shall also indicate the top of the cement and the means by which such top was determined. It shall also indicate any changes from the casing program previously authorized for the well.”

11. NMSA 1978, Section 70-2-31(A) authorizes the assessment of civil penalties of up to one thousand dollars per day per violation against any person who knowingly and willfully violates any provision of the Oil and Gas Act or any rule adopted pursuant to the Act.

12. NMSA 1978, Section 70-2-33(A)(1) defines “person” as:

“any individual, estate, trust, receiver, cooperative association, club, corporation, company, firm, partnership, joint venture, syndicate or other entity...”

13. On May 7, 2004, OCD mailed “Notice of Violation (3-04-05)” to Chi, stating that Chi was in violation of OCD Rules 109.B, 114.B (two separate provisions), 13.B, 1103.C and 1103.D and 102.

14. Chi and its contractors cooperated fully with the OCD’s investigation of the Incident.

15. Chi takes the position that it did not violate OCD Rules 109.B, 114.B (two separate provisions), 13.B, 1103.C. and 1103.D, as alleged in “Notice of Violation (3-04-05).”

Conclusions

1. The OCD has jurisdiction over the parties and subject matter in this proceeding.
2. Chi is a “person” as defined by NMSA 1978, Section 70-2-33(A) that may be subject to civil penalties under NMSA 1978, Section 70-2-31(A).
3. For purposes of the OCD’s enforcement of the Oil and Gas Act (the “Act”) and OCD Rules, the actions and knowledge of Chi’s contractors may be imputed to Chi as the operator of record for the well.
4. Chi, although it disagrees that it violated OCD Rule 109.B, acknowledges that if this case went to hearing, the examiner or commission may find that Chi, by virtue of the actions of its independent contractors, is subject to civil penalties under NMSA 1978, Section 70-2-31(A) for violating OCD Rule 109.B’s requirement that blowout preventers be installed and maintained in good working order on all drilling rigs and workover rigs operating within the corporate limits of any city.
5. Chi, although it disagrees that it violated OCD Rule 114.B, acknowledges that if this case went to hearing, the examiner or commission may find that Chi, by virtue of the actions of its independent contractors, is subject to civil penalties under NMSA 1978, Section 70-2-31(A) for violating OCD Rule 114.B’s requirement that drilling fluid be maintained at a height sufficient to control subsurface pressures.
6. Chi, although it disagrees that it violated OCD Rule 13.B, acknowledges that if this case went to hearing, the examiner or commission may find that Chi, by virtue of the actions of its independent contractors, is subject to civil penalties under NMSA 1978, Section 70-2-31(A) for violating, over a nine-day period, OCD Rule 13.B’s requirement that operators conduct their operations in or related to drilling in a manner that will prevent waste of gas, or allow gas to leak or escape from a natural reservoir.
7. Chi, although it disagrees that it violated OCD Rule 114.B, acknowledges that if this case went to hearing, the examiner or commission may find that Chi, by virtue of the actions of its independent contractors, is subject to civil penalties under NMSA 1978, Section 70-2-31(A) for violating, on 23 separate occasions, OCD Rule 114.B’s requirement that blowout preventer equipment be tested daily.
8. Chi, although it disagrees that it violated OCD Rule 1103.C, acknowledges that if this case went to hearing, the examiner or commission may find that Chi is subject to civil penalties under NMSA 1978, Section 70-2-31(A) for violating OCD Rule 1103.C’s requirement that an operator file a report within ten days following the commencement of drilling operations.

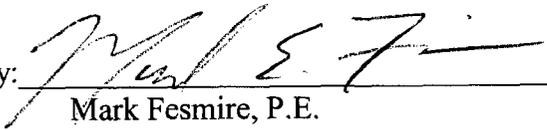
9. Chi, although it disagrees that it violated OCD Rule 1103.D, acknowledges that if this case went to hearing, the examiner or commission may find that Chi is subject to civil penalties under NMSA 1978, Section 70-2-31(A) for violating, on two separate occasions, OCD Rule 1103.D's requirement that an operator file a report of casing and cement test within ten days following the setting of each string of casing or liner.
10. Chi further acknowledges that judicial review of an agency decision is especially deferential where the agency interprets its own regulations, and courts will confer a heightened degree of deference to legal questions that implicate the determination of fundamental policies within the scope of the agency's statutory function.
11. Chi and the OCD agree that it is in the best interest of both entities to enter into this Agreed Order rather than to litigate the issues through administrative proceedings or the courts.
12. Notwithstanding the Findings and Conclusions of this Order, Chi acknowledges that for purposes of the OCD's enforcement of the Act and OCD Rules only, the actions and knowledge of Chi's contractors, including but not limited to Patterson, may be imputed to Chi as the operator of record for the Well and for this reason agrees to the terms of this Agreed Order; however, Chi denies any an all civil liability and wrong doing including liability for the acts of its independent contractors, including but not limited to Patterson.
13. Chi's entering into this Agreed Order is not to be construed as an admission of any civil liability or wrong doing on the part of Chi. Chi appreciates and recognizes the importance of the OCD in fulfilling its duty to prevent waste, and to protect human health and the environment, and accepts this Agreed Order to demonstrate its resolve to guard against waste, and protect human health and the environment in the future.

Agreed Order

1. Chi and the OCD enter into this Agreed Order to resolve all potential civil penalties that may have been considered and pursued by the OCD against Chi related to the events and alleged violations of OCD Rules set forth above. Chi and the OCD enter into this Agreed Order to avoid the burden and expense of additional administrative hearings and possible litigation between the parties.
2. Chi and the OCD agree that Chi shall pay \$34,000 to resolve the alleged violations of OCD Rules 109.B, 114.B, and 13.B. Taking into account Chi's cooperation during the investigation of the incident, no penalty is assessed for Chi's alleged administrative violations of OCD Rules 1103.C, 1103.D and 102, which did not contribute to the incident. Chi is, however, admonished to comply with OCD Rules 1103.C, 1103.D and 102 in the future on this Well and all other wells operated by Chi.

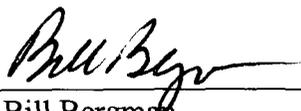
3. The thirty-four thousand dollar (\$34,000) amount shall be paid at the time this Order is executed. Payment shall be made by certified or cashier's check made payable to the "New Mexico Oil Conservation Division," and mailed or hand-delivered to the New Mexico Oil Conservation Division, Attention: Director, 1220 South St. Francis Drive, Santa Fe, NM 87505.
4. Within five days of the date this order is signed by the Director of OCD, Chi shall submit to the Artesia district office:
 - a) a plan for testing and maintaining blowout preventers; and
 - b) a plan for maintaining the drilling fluid levels at a height sufficient to control subsurface pressures.
5. By signing this Agreed Order, Chi expressly states the following:
 - a) Chi acknowledges the correctness of the Findings and Conclusions set forth in this Agreed Order;
 - b) Chi agrees to comply with all terms and orders contained herein;
 - c) Chi waives any right, pursuant to the Oil and Gas Act or otherwise, to a hearing either prior or subsequent to the entry of this Order or to an appeal from this Order; and
 - d) Chi agrees that if it fails to comply with this Agreed Order, the Order may be enforced by suit or otherwise to the same extent and with the same effect as a final Order of the Division entered after notice and hearing in accordance with all terms and provisions of the Oil and Gas Act (NMSA 1978, Sections 70-2-1 through 70-2-38, as amended).
6. Entry of this Agreed Order and receipt of the \$34,000 shall fully resolve and satisfy any and all alleged claims that have been brought by the OCD against Chi as set out in the Notice of Violation (03-04-04) or that may have been brought by the OCD against Chi for alleged violations of the Act and OCD Rules connected with the events described in the Findings above. Nothing in this Agreed Order relieves Chi of responsibility for investigation and remediation of environmental contamination arising from the events described in the Findings above should such contamination, if any, be discovered in the future. In addition, nothing in this Agreed Order relieves Chi of other federal, state or local laws and/or regulations.

Done at Santa Fe, New Mexico this 19th day of August, 2005.

By: 
Mark Fesmire, P.E.
Director, Oil Conservation Division

Acceptance

Chi Operating, Inc. hereby accepts the foregoing Agreed Order, and agrees to all of the terms and provisions set forth in that Order.

By: 
Bill Bergman
President, Chi Operating, Inc.

Date: 8/18/05