STATE OF NEW MEXICO

ENERGY, MINERALS AND NATURAL RESOURCES DEPARTMENT

OIL CONSERVATION DIVISION

IN THE MATTER OF THE HEARING CALLED BY THE OIL CONSERVATION DIVISION FOR THE PURPOSE OF CONSIDERING:

APPLICATION OF MEWBOURNE OIL COMPANY FOR COMPULSORY POOLING, LEA COUNTY, NEW MEXICO

CASE NO. 13,359

ORIGINAL

REPORTER'S TRANSCRIPT OF PROCEEDINGS

EXAMINER HEARING

BEFORE: MICHAEL E. STOGNER, Hearing Examiner

October 21st, 2004

Santa Fe, New Mexico

This matter came on for hearing before the New Mexico Oil Conservation Division, MICHAEL E. STOGNER, Hearing Examiner, on Thursday, October 21st, 2004, at the New Mexico Energy, Minerals and Natural Resources Department, 1220 South Saint Francis Drive, Room 102, Santa Fe, New Mexico, Steven T. Brenner, Certified Court Reporter No. 7 for the State of New Mexico.

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I N D E X

October 21st, 2004
Examiner Hearing
CASE NO. 13,359

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E X H I B I T S

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* * *

Finley	Identified	Admitted
Exhibit 1	44	87

* * *

A P P E A R A N C E S

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* * *

WHEREUPON, the following proceedings were had at 9:00 a.m.:

EXAMINER STOGNER: Okay, let's go back on the record. At this time I'll call Case Number 13,359. This is the Application of Mewbourne Oil Company for compulsory pooling, Lea County, New Mexico.

Call for appearances.

MR. BRUCE: Mr. Examiner, Jim Bruce of Santa Fe, representing the Applicant. I have one witness.

EXAMINER STOGNER: Other appearances?

MR. HALL: Mr. Examiner, Scott Hall, Miller Stratvert, PA, Santa Fe, appearing on behalf of James D. Finley and Finley Resources, Incorporated. I may have one witness this morning.

EXAMINER STOGNER: That's Finley Resources?

MR. HALL: Yes, F-i-n-l-e-y.

EXAMINER STOGNER: Inc.

MR. HALL: Incorporated, yes.

EXAMINER STOGNER: Any other appearances?

MR. KELLAHIN: Mr. Examiner, I'm Tom Kellahin of the Santa Fe law firm of Kellahin and Kellahin. I'm appearing this morning on behalf of Chesapeake Operating, Inc. I have no witnesses.

EXAMINER STOGNER: Other appearances?

At this time I'd like both witnesses, or the witness and the potential witness, to stand to be sworn at this time.

(Thereupon, the witnesses were sworn.)

EXAMINER STOGNER: Is there need for opening remarks, comments at this time?

MR. BRUCE: I wasn't going to make one.

MR. HALL: No.

EXAMINER STOGNER: Mr. Kellahin?

MR. KELLAHIN: No, sir.

EXAMINER STOGNER: Okay, then we'll get right to it.

<u>STEVEN J. SMITH</u>,

the witness herein, after having been first duly sworn upon his oath, was examined and testified as follows:

DIRECT EXAMINATION

BY MR. BRUCE:

Q. Would you please state your name and city of residence for the record?

A. Steven James Smith, Midland, Texas.

Q. Who do you work for and in what capacity?

A. Mewbourne Oil Company, and I am a senior landman.

Q. Have you previously testified before the Division?

A. Yes, I have.

Q. And were your credentials as an expert petroleum landman accepted as a matter of record?

A. Yes, they were.

Q. And are you familiar with the land matters involved in this case?

A. Yes, I am.

MR. BRUCE: Mr. Examiner, I'd tender Mr. Smith as an expert petroleum landman.

EXAMINER STOGNER: Any objection?

MR. HALL: If I might briefly voir dire the witness on one point.

EXAMINER STOGNER: Voir dire away.

VOIR DIRE EXAMINATION

BY MR. HALL:

Q. Mr. Smith, the Application filed in this case indicates that you're going to be asking the Division's Examiner to issue an order that incorporates cost adjustment provisions from the COPAS bulletin.

My question to you is, are you going to render testimony, and specifically opinion testimony, about the fairness and reasonableness of the cost allocations between the upper zones and the lower zones, pursuant to the COPAS bulletin?

A. It's my understanding that we were not asking to incorporate the cost allocation formula into the order. It was offered as part of an effort to allow Finley to participate in the well on a cost-adjusted basis. I was anticipating that the Commission would issue the order in whatever fashion they chose to.

Q. Do you anticipate you'll be called on to opine about the fairness of the accounting provisions, the accounting adjustments, from your proposed allocation formula?

A. The fairness, yes, I believe so.

Q. And do you have any specific background in petroleum accounting?

A. No.

MR. HALL: Mr. Examiner, we don't object to Mr. Finley's [*sic*] qualification as an expert petroleum landman. We don't believe he's qualified to opine about the fairness and reasonableness of accounting matters that I believe will come up in this hearing. So with that caveat, we have no objection to his qualification.

EXAMINER STOGNER: So noted. Mr. Bruce, anything further?

MR. BRUCE: Not really, Mr. Examiner. I'd rather present the testimony, and if Mr. Hall has some objections at that time he could make them and you could issue a ruling at that time.

EXAMINER STOGNER: Okay. Mr. Kellahin, do you have any comments?

MR. KELLAHIN: No, sir.

EXAMINER STOGNER: Okay, please continue. And, I'm sorry, before we continue, Mr. Smith is so qualified as an expert landman.

DIRECT EXAMINATION (Resumed)

BY MR. BRUCE:

Q. Mr. Smith, could you identify Exhibit 1 and describe briefly what Mewbourne seeks in this Application?

A. Exhibit 1 is a photocopy of a Midland map. I have shown the proposed proration unit for our proposed well, being the north half of Section 9. I've color-coded and numbered it to show the tracts as they appear on the tract ownership on the next page.

The red dot in the southeast corner of the northeast quarter is the proposed location of our well, and at the time when we were preparing this we were still dealing with the potential to force pool Chesapeake.

I went ahead and showed a well on a proration unit that Chesapeake operates in the southwestern portion of Section 3, in which they have recently completed a Morrow well, and it's my understanding that it is awaiting connection to pipeline.

Q. What is the well's -- your proposed well's footage location?

A. The location of our proposed well is 1980 from the north and 660 from the east of Section 9, and we propose to drill it to a depth of 12,500 feet to adequately test the Morrow formation.

Q. Now, besides pooling the north half or 320-acre zone, is Mewbourne also seeking to pool the northeast quarter and/or the southeast quarter, northeast quarter, for 160-acre and 40-acre zones?

A. Yes, we are, we seek to pool the southeast, northeast quarter, for any and all formations developed on 40 acres, including the Undesignated Osudo-Wolfcamp and the Undesignated Osudo-Strawn Pool; as to the northeast quarter we seek to pool any and all formations pooled on 160 acres, including the Undesignated South Osuda-Wolfcamp Gas; and then as to the north-half 320 we seek any and all formations pooled on 320 acres, including the Undesignated South Osudo-Morrow Gas Pool.

Q. Now, could you turn to page 2 of Exhibit 1 and briefly discuss the interest ownership in the well units?

A. Yes, this is a breakdown of the north half. We begin with Tract 1, which is a representation of the ownership of the northeast quarter. From surface to 10,000 feet Mewbourne Oil Company has ownership of 3.125 percent interest, and James D. Finley is the record owner of 96.875 percent to that depth.

As to depths below 10,000 feet, Mewbourne owns

100, subject to a farmout from Apache.

The northwest quarter, being Tract 2 on the map, is at all depths owned by Chesapeake Oil -- Operating, Inc., 100 percent. I took the liberty to show what a pooled north-half unit ownership would be, surface to 10,000 and depths below 10,000.

Q. Okay, so as to, first, the 10,000-foot cutoff, approximately what have you been told as to what that depth cutoff is?

A. It would approximately be the base of the Bone Spring, top of the Wolfcamp, but it could be slightly off.

Q. Okay.

A. We could have part of the Wolfcamp above that.

Q. Now, insofar as pooling Chesapeake, they own 100 percent of the northwest quarter, so you would only be pooling Chesapeake -- and we'll get to that in a minute -- as to 320-acre zones?

A. That's correct.

Q. And you would be pooling Finley as to 40- and 160-acre units, and 320-acre units if there are any in at this depth?

A. That would be correct.

Q. Okay. Let's move on to your efforts to obtain the voluntary joinder of these parties, and I would refer you first to Exhibit 2. Could you briefly discuss the status of your negotiations with Chesapeake?

A. Exhibit 2 would be the total written correspondence with Chesapeake and with notations as to my phone conversations. Bottom line, we proposed the well to Chesapeake on July 23rd of '04 and offered them an opportunity to term-assign if they chose not to.

They informed us that they would participate, and on August 27th I sent them an operating agreement, being a 1989 model form JOA, for their review and consideration. As of yesterday, my office informed me that Chesapeake has signed the JOA and has fax-signed signature pages. I don't have them, but I would anticipate that there's a very high degree of -- I mean, that we've got a verbal agreement, and we simply need to finalize the paperwork, and at that point in time Chesapeake will be dismissed.

Q. And when you receive all the final documents from Chesapeake, you will dismiss them from this pooling Application?

A. Absolutely.

Q. Let's move on to your discussions with Finley. What is Exhibit 3?

A. Exhibit 3 is both written pieces of correspondence that I've had with Finley, Mr. Finley's office, and I've to some degree noted dates and conversations that I've had and voice messages that I've had with Mr. Finley's office.

The July 21st letter of '04 proposes the well to Mr. Finley, proposes the formation of a working interest unit in which their interest would be pooled across the entirety of the 320 as to depths from surface to 10,000 feet. We offer to do that based on a cost allocation formula that is attached. This cost allocation formula is one that has been used. Actually the first time I saw it was a Yates Petroleum effort, it --

Q. Was it a force pooling case or just voluntary --

A. Just a voluntary agreement. It may have involved force-pooling, but ultimately all parties ultimately agreed to participate. It's been used by our office several times before with various companies. I'm aware that Pecos Petroleum in Midland has used this form. It, I believe, after having read the COPAS Bulletin 2, which is the guideline provided by COPAS -- as the COPAS Bulletin 2 states, there's no one way to do it, but this would fall within the guidelines of reasonableness as a proposed methodology.

The next letter was written after some verbal discussions that Mr. Scott Ramsey and I had. Mr. Ramsey informed me after some conversations on the phone that they counterproposed to my July 21st letter that they wanted to trade part of their shallow rights for part of our deep rights. And after discussing with my management, due to the fact that we have a relatively -- you know, only start off with half subject to a farmout, we felt that it was not prudent to trade interest in the primary objective for interest in a potential bailout zone.

So my letter of August 18th was written after receiving Mr. Finley's proposal, and in that letter I offered another series of options to Finley Resources to entice them to either participate or grant an assignment, and in that -- in this letter we offered to let them stay whole in the northeast quarter, not pool, and so again, subject to a cost allocation formula that -- the one previously sent.

And in the alternative, if they chose not to, we offered to take a term assignment of the wellbore only. Basically, we would have rights in that well only at an 80-percent NRI, allowing them to keep an override and to pay them $150 an acre for their -- which was the equivalent of -- per acre, that we offered for the full section.

There have been numerous efforts to engage Finley Resources in negotiations over the phone. I've left numerous messages, I've had two or three conversations with Mr. Ramsey, never in substance about my proposal, other than their counterproposal to trade shallow for deep. And we finally arrived at the point where we were staring at our anticipated spud date of mid-December and needed to move forward with this proposal. We've got a farmout that has a limited shelf-life, and we got on the docket.

Q. So besides the two letters, there have been several phone calls, and you've called and left messages?

A. Yes, we've traded messages. We've had, I think, two or three actual conversations. Again, friendly, but there were never any other counterproposals from Finley, other than their proposal to trade shallow for deep, and no objection was made at any time in those conversations about our proposal.

Q. Okay. In your opinion, has Mewbourne made a good-faith effort to obtain the voluntary joinder of the interest owners in the well?

A. I do.

Q. Would you identify Exhibit 4 for the Examiner and discuss the cost of the proposed well?

A. Exhibit 4 is a photocopy of the AFE that we sent out to both Chesapeake and Finley Resources. This happens to be the one that Chesapeake has signed. Again, it is a little-over-$1.5-million-drill-and-complete AFE. We've broken it down. Dryhole cost would be $943,800, completed is $567,900.

Q. Is this cost in line with the cost of other wells drilled to this depth in this area of --

A. It is.

Q. -- Lea County?

A. It is. With increasing costs and steel costs, it is just an estimate, but we think it is certainly reasonable as of the date that it was issued.

Q. Okay, and we'll get just in -- I'd like to finish up a couple more questions, Mr. Smith, and then we'll get to the highlighted portions of this AFE.

A. Sure.

Q. Does Mewbourne request that it be designated operator of the proposed well?

A. We do.

Q. Do you have a recommendation for the amounts which Mewbourne should be paid for supervision and administrative expenses?

A. Well, in light of the fact that I believe we've reached agreement with Chesapeake and that really the only issue here now is pooling shallower depths, I would recommend that the overhead rate for the shallower interval be $5000 drilling and $500 producing.

Q. And would these amounts be equivalent to those normally charged by Mewbourne and other operators in this area for wells of this depth?

A. At 10,000 feet, yes.

Q. Okay. And would you request that the overhead rates be adjusted periodically as provided by the COPAS accounting procedure?

A. Yes, I would.

Q. And does Mewbourne request a maximum cost-plus-200-percent risk charge on a nonconsenting owner?

A. We do.

Q. Let's go back to your Exhibit 4, Mr. Smith, and talk a little bit more about the cost allocation formula. And now, this isn't a -- this cost allocation formula that you proposed to Finley was not something set forth by COPAS?

A. No, the COPAS Bulletin 2 clearly states that cost adjustments can fit within a very large realm. The bulletin is written to address any number of potential reasons for cost allocation, and they offer up a multitude of options and methodologies to arrive at adjustments, and in their conclusion they clearly state that it is up to the parties to negotiate a reasonable and acceptable cost allocation formula.

This was presented simply because it's been used. It's been accepted by industry, and I've used it very recently in a well with Hudson Oil Company, Mariah Resources, Brothers Production Company, and I'm aware that Pecos Production Company in Midland has also used it, and I know that the basis of it came from a form that I copied from Yates Petroleum.

Q. Okay, so you are familiar with the Yates form. And did you personally revise this --

A. I did -- Yates's form was one page, and it was not as in detail, it didn't attempt to address all of the potential scenarios. And you can't address all of them, because any time you do, you know you'll find one that comes back at you.

But I expanded it to try to cover all realistic potential occurrences in a situation where you have an ownership variance at depth, and you're drilling a deep well.

And again, the whole purpose of the cost allocation formula is to afford an owner in the shallow rights the opportunity to participate in a well on a cost-reduced basis at such times as the well is either initially -- subsequently completed above the ownership-change interval.

Q. Okay, and so the outlines of this cost allocation formula weren't just done for this case?

A. No, this form has been used multiple times --

Q. Okay.

A. -- multiple situations.

Q. And as part of your job, you are required to negotiate items like this with other interest owners?

A. Yes, I am.

Q. Let's -- Just so the Hearing Examiner can see how this would work in practice, I'd refer you to Exhibit 4 and your Exhibits 5A and 5B, and did you personally prepare Exhibits 5A and 5B?

A. I did, that was prepared in an XCel spreadsheet. It's in table form and it's designed to, in essence, walk you through the effect of what will happen in the various scenarios that might -- most likely will occur in a well where you're drilling a deep zone and have an ownership change above that zone.

Q. Okay, why don't you just first go through Exhibit 5A and compare that -- or discuss it, and then perhaps discuss for the Examiner the meanings of the highlighted items on the AFE?

A. Okay. First I'll just say, 5A represents -- I did 5A and 5B to show the difference that would occur in the two offers that I made Finley. The first offer was that he would pool as to all depths within the 320. So 5A represents cost allocations where the 320 acres is pooled as to all depths.

And if you'd like, you might want to refer back to cost allocation formula in the printed form, so that you can see that it tracks.

In the cost allocation form and the printed form, first thing you do is designate the shallow and deep units, based upon the point at which ownership breaks. In this case, it's -- surface to 10,000 would constitute the shallow depth or interval 1, and depths below that would be the deep unit, all depths below 10,000 feet.

In Scenario A in the cost allocation formula it's very straightforward. If a well is drilled to the shallow unit, everybody in the shallow unit just bears costs; it's straight up. There are no allocations.

Situation B is, if the well is drilled to a deep unit and the initial casingpoint election provides for a completion attempt in the deep unit, then the entire cost of drilling the well is borne by the participants in the deep unit. In other words, the shallow interest owner is at no risk, bears no cost and stays in that position until such times as the well is recompleted uphole. And at that point he's given an election under a JOA to come in or out.

Q. Okay, and let me just re-emphasize. So in other words, in this case, assuming Mewbourne drills this well, Chesapeake joins in and it's drilled to and completed in the Morrow, 100-percent of the well costs will be paid by Mewbourne and Chesapeake?

A. Correct, and Finley would be at no exposure. They would also have the benefit of getting -- if they signed the JOA and joined in the well, they would get copies of logs, well information, the daily drilling reports. In other words, they would get a free look at the well at no cost.

Q. Okay, go ahead.

A. Under B, first thing you do is that you allocate, under B1 --

Q. When you say B, you're talking about item B on the --

A. Item B on the --

Q. -- cost allocation --

A. -- formula.

Q. -- formula?

A. The first step is to deal with the drilling costs, and in drilling costs, you're going to allocate them based upon a footage basis. And those costs that are allocated are only those that are not attributable to one zone or the other; i.e., if you took cores in a deep zone, the shallow unit owner would never be asked to pay any of that. It's borne solely by the deep units. If you run specific logs for the deep, those costs are not allocated.

So under the formula -- and if you want to, you can look back and forth. The first thing you do is allocate cost to interval 1 based upon footage. In this case we're talking about a 12,500-foot well. The total -- if you add up all of the yellow costs on the AFE, they total the -- to $750,300. That is, as I've done, allocated what I believe to be drilling costs.

Now, there's some hairsplitting there. You might choose to allocate portions of these differently, but this intended to be simply an example of how it might work if my allocations were acceptable to all parties.

You allocate first by footage $602,640 of the $753,000 to interval 1, based upon footage, and then $150,660 of the total to the deep. Under the formula, the shallow participants, then, are only asked to pay half of that amount. They're getting a discounted cost to drill the shallow units, and the deep players pay the other half.

Then as to the deep participants, they pay 100 percent of the cost to go from the base of the deep -- shallow unit down. So when you allocate total costs, $301,320, really, is all that's borne by the participants in the shallow unit, and $451,980 are borne by the deep, even though the deep only is 20 percent of the wellbore.

Moving on to completion costs, completion costs are unique to a zone and not subject to allocations, so we can -- that's straightforward, we can move on.

The rest of the costs that appear on the AFE that are called allocate or downhole equipment, surface equipment, on the example AFE I've color-coded again -- and I would admit, there may be different -- some hairsplitting to be done as to what portions might go one way or the other.

But by way of example only, I've allocated $405,500, all of the costs colored in green as downhole equipment, being pipe, sub pumps, surface casing, production casing, tubing, et cetera. That is shared on a footage basis, according to the formula. And first thing you do, you've got -- if you assume you have 12,500 feet of pipe in the ground and surface -- downhole equipment, you simply take $405,500, divide by 12,500, and it comes to $32.44 a foot.

Then you allocate to the intervals based on a footage basis, and we've done it two-thirds to the shallow unit, one-third to the deep unit. In this case the justification for that is that we're talking about a tangible that has salvage value. And as such, the parties that end up owning it should have -- bear a higher cost.

Again, in the same methodology we did in the drilling costs, we allocated downhole equipment based upon the -- sharing the shallow between deep and shallow, and you're sharing -- the deep is paid wholly by the deep. In the final analysis, we allocate $216,000 and change to the shallow and $189,000 and change to interval 2.

The part that's surface equipment we would propose to allocate 50-50, and that's fairly straightforward.

On page 3 of this exhibit, we've tried now to show the effect of an election by Finley to come into a wellbore after receiving an election on a pool basis.

The first one is assuming the well is completed below 10,000 and is subsequently recompleted uphole, interval 1 and interval 2 are simply allocations. The third row there shows that the initial costs are borne totally by Mewbourne Oil Company and Chesapeake Oil Company, $618,400 each.

MR. HALL: Excuse me, Mr. Examiner, where are we exactly in the exhibit?

THE WITNESS: All right, on page 3 of the table --

MR. HALL: 5A, 5B?

THE WITNESS: Exhibit 5A, correct, we've never left 5A.

EXAMINER STOGNER: Okay, we're still on 5A.

THE WITNESS: The top half of that page is the summary of what -- total cost allocations assuming the well is drilled and completed below 10,000 and subsequently recompleted above 10,000 after elections.

Interval 1 is allocated as the ownership in the interval would be, on a pool basis. Interval 2, the costs associated with that are allocated, again, based upon the ownership in that interval. Initially the well is paid for by the deep players. At such time as Finley chose to after being given an election, if they chose to come in, they'd have to pay $269,597, which is a discounted amount of money for their share of that wellbore.

Q. (By Mr. Bruce) So -- and let me -- First of all, this is for, again, where Mewbourne, Chesapeake complete, say, in the Morrow --

A. Correct.

Q. -- produce for a while, later come back uphole?

A. Right.

Q. They would pay 100 percent of the well costs until such time as it's recompleted above 10,000 feet?

A. That's correct.

Q. And at that time Finley would be asked to pay approximately $270,000?

A. After being given an election to be in or out under the JOA.

Q. And they would also have well information?

A. And they would have a free look, full knowledge of what we're proposing to do, and a discounted opportunity to join the well.

Q. And that $270,000, $269,000-plus figure, that would -- that is not inflation-adjusted. So if the election took place five, six, eight years from now, they're still just paying that $269,000 --

A. They're paying us back with dollars worth less than what we used to pay for it, that's correct.

Q. And then the second half of that page 3 is -- Well, just briefly go over that.

A. Wait a minute. I am, okay, on 5 --

Q. -- A.

A. 5A, the next page, or the next table, deals with the situation which would apply to the second offer which we made to Finley where we offered to leave them whole in their 160, they keep their full interest. And this would be --

Q. Which exhibit are you --

A. I'm sorry, I'm on the wrong exhibit. This is on the pool basis again, that's correct.

MR. HALL: You are still Exhibit 5A --

MR. BRUCE: 5A.

THE WITNESS: Correct.

MR. HALL: -- page 3?

THE WITNESS: I had the wrong one open myself, and I've shifted and I'm now on the right one.

Q. (By Mr. Bruce) Yeah, 5A.

A. Interval 1 is allocated as shown, because it's pooled. Interval 2 shows that Mewbourne and Chesapeake pay their cost to the deep as shown. If all parties elected to be in Chesapeake -- All right, I'm turned around.

Q. Again, this is -- what you're looking at is drilling cost allocation --

A. No, no, no, here -- okay, now -- I know what it is. This is complicated, but it needs to be clear. This second summary deals with drilling costs only. It has no part of pipe, surface, downhole equipment. I'll direct you back to page 1. What we're talking about here is allocating the $753,300 that is the cost to drill to casingpoint.

Q. Okay.

A. That's what this is.

Q. Okay.

A. Assuming we have now -- after we've drilled the well to the deep, we have failed in the deep but we have identified a prospective zone in the shallow unit that is -- we desire to try to try to complete in, we would propose the well to Finley, they would have the opportunity to come in, and at that point an adjustment in the actual cost to drill the well would be made, because Mewbourne drops in this situation to a 1.5625 percent, we dropped from $618,400 to -- excuse me, $84,000. But we're paying 11 percent of the cost to get there for a 1.5625.

Because Chesapeake has no variance on either side of the equation, their costs stat the same. Finley would be at that point asked to compensate Mewbourne for coming in, they would be asked to pay $291,904. That's 38.75 percent of the cost to drill the well for a 48.4375-percent interest.

Q. Okay.

A. And then at that point -- it's a casingpoint election, and you would be in or out for the cost of the pipe and the completion effort and any surface equipment that's installed.

Q. Okay. Now, Exhibit 5B is -- we won't go into as much detail here, Mr. Smith, but this is the same type of exhibit, but for the situation --

A. It's -- the difference is that under the scenario where we've allowed -- or offered to allow Finley not to pool across. It's basically the same summary. I'll point out that the difference is, really, only above 10,000 feet. But -- and if you compare the two tables, the cost to come in after the well has already been completed at depth is the same, but I will add that Chesapeake has an ownership in some pipe in the ground, and they're going to leave the wellbore at that point. They will no longer have an interest in the wellbore if Finley decides to participate.

So in order for that to happen, we would have to compensate Chesapeake for the salvage value, before adjustments are done.

Q. Okay.

A. The difference, mainly, about this is, what happens if Finley chose to come in -- after the well is drilled to TD, there's nothing in the deep zone and we've come uphole. In this case, because Chesapeake has no interest, surface to 10,000, they'd be asked to pay none. Mewbourne and Chesapeake own their rights from 10,000 to whatever -- they pay their $150,660. In the roll-up, Mewbourne would pay $94,163. That's 12.5 percent to drill the well to casingpoint for 3.125-percent interest. Chesapeake would pay 10 percent, because they've got to pay something, they had to get there. And Finley would pay 77.5 percent, being $583,000 for a 96-percent interest.

Again, the whole purpose of my proposed cost allocation formula is to avoid -- or offer the owners in the shallow an equitable means of participating in the wellbore at such times as they have the opportunity to come in on a cost-discounted basis.

It is a proposal, we've never heard anything back from Finley, other than they wanted to trade shallow for deep. As the COPAS bulletin clearly states, it's something that parties have to negotiate, and we've offered.

Q. So assuming that Chesapeake joins in the well voluntarily, which is what you anticipate, and Finley does not, would Exhibit 5B be the situation we would be looking at under a -- in essence, under a pooling order?

A. Correct, assuming that we -- that -- yes, if an order is issued and --

Q. There would have to be some way to -- In other words, what we're not looking at under a pooling order is, assuming Mewbourne and Chesapeake drill a deep well --

A. Uh-huh.

Q. -- produce it or not in the deeper zones, and then it's later recompleted uphole, Finley doesn't get a wellbore for nothing?

A. That's correct, there's no reason they should be able to step in for nothing.

Q. And --

A. We've taken all the risk.

Q. And Exhibit 5B would be, in your opinion, a reasonable way to allocate those costs in the event a well is at some point completed above 10,000 feet, which is where Finley owns its interest?

A. It is our -- Yes, I believe it would be reasonable. It's been one we've used in the past.

Q. Okay. Were Chesapeake and Finley notified of this hearing?

A. Yes, they were.

Q. And is Exhibit 6 the notice Affidavit?

A. Yes, it is.

Q. In your opinion, is the granting of Mewbourne's Application in the interests of conservation and the prevention of waste?

A. Most certainly.

Q. And were Exhibits 1 through 6 prepared by you, under your supervision or compiled from company business records?

A. They were.

MR. BRUCE: Mr. Examiner, I'd move the admission of Mewbourne Exhibits 1 through 6.

EXAMINER STOGNER: Any objection?

MR. HALL: No objection.

EXAMINER STOGNER: Exhibits 1 through 6 will be admitted into evidence.

Thank you, Mr. Bruce.

MR. BRUCE: I pass the witness.

EXAMINER STOGNER: Mr. Hall?

CROSS-EXAMINATION

BY MR. HALL:

Q. Mr. Smith, would you explain to the Hearing Examiner and I which provisions of which exhibit you're asking the Examiner to incorporate in an order that would address cost allocations?

A. Well, in that if we -- not -- if we don't pool across -- in other words, if Finley Resources chose not to

participate, then the only one that could work would be 5B.
Q. And as I understand Exhibit 5B, as you've explained it, that is in essence a reflection of intangible drilling costs to casingpoint; is that accurate?
A. Well, it's -- there are two scenarios here. One is if the well is drilled to the Morrow or below 10,000 feet and is completed in the Morrow for any period of time, and then in that event, later, we complete it uphole, there is one set of numbers that would apply. And I would direct you to page 3 of 5B. The top half of that page addresses that scenario where the well is completed in the Morrow but subsequently completed uphole.
The bottom half of the page deals with the scenario where the well is drilled to the Morrow, or below 10,000 feet, fails below 10,000 feet, and the initial casingpoint election is above 10,000 feet, in the zone in which Finley owns. Those are the distinctions on page 3.
Q. All right. So if we were to compare them to anything else, say your Exhibit 3, your cost allocation formula --
A. Uh-huh.
Q. -- narrative, on Exhibit 5B, page 3, the top section addresses basically --
A. B, would be --
Q. -- a recompletion with production in both the

Morrow and uphole, correct?

A. It addresses a scenario where the initial casingpoint election is below 10,000 feet, whether successful or a failure.

Q. And so --

A. In other words, pipe is set, a completion rig is put on zone, and there's an effort for -- however strenuously made, to obtain production from an interval below 10,000, whether successful or not. That is the top half of the page, and if you look at the cost allocation formula narrative, that would be item B on the narrative.

Q. All right, so the top is item C, then, basically the Morrow dryhole scenario; is that right?

A. No, no, no, the top part of page 3 is C -- is B, excuse me.

Q. Right.

A. The bottom half is C.

Q. All right.

MR. BRUCE: Scott, if I may -- and again, Mr. Smith, you're referring to your cost allocation formula attached --

THE WITNESS: The narrative, and I believe that by stating there that we were talking about the written formula, yes.

Q. (By Mr. Hall) Is it Mewbourne's intention to have the terms and provisions of the cost allocation formula attached to Exhibit 3, your narrative, incorporated into an order the Examiner issues in --

A. I would propose it to the Examiner and allow him to determine if there is more -- a more reasonable way. But this is what we've proposed. It's been used in the past.

Q. Let me ask you, what are -- would Mewbourne proceed with its Morrow project if it didn't have its 3-percent interest in the bailout zones in the shallow unit?

A. Would they? It's a possibility. But we have correlative rights in the shallow. But we have standing to be asking for this, or we wouldn't be here.

Q. Do you regard your 3-percent interest in the shallow zone as critical to the success or failure of the project?

A. Critical, no. But it could potentially recoup costs, if -- I mean, we -- my job is to -- is risk management and to protect the assets of Mewbourne Oil Company at every turn, and to allow us the opportunity to make a profit or recoup costs at any opportunity.

Q. Let's go back to your Exhibit 3, which is your July 21, 2004, well proposal letter to Finley.

There the -- Let's go through some of those terms of the offer. The third paragraph --

A. Right.

Q. -- you had offered $150 per net acre to Finley to deliver their interest; is that right?

A. Correct.

Q. And you offered $200 to Chesapeake?

A. That's correct.

Q. Okay.

A. Chesapeake owned all rights at all depths and owned in the primary objective. Finley owned depths to 10,000 feet only in what we deem to be potentially productive but more of a secondary objective.

Q. I see. Then in the second paragraph on the first page there, you set out Finley's ownership down to 10,000, 96.8 --

A. There is a typographical error in that number.

Q. And what's the correct --

A. Forty -- it would be, as -- it is 48.4375, and I believe I inadvertently struck a 9 when I typed this. I'm not the best typist in the world.

Q. All right. In the shallow rights, Finley owns 96.875 percent --

A. -- unpooled in the northeast quarter.

Q. Correct. And so explain to me what the 48-percent number is. Is that on a --

A. If they --

Q. -- 320 basis?

A. If they pooled across. And it clearly states that we're proposing a pooled unit, and that's what their interest would be if they were to join, and in doing so, have not only an interest in the northeast, but they would share in the northwest quarter. That's the functioning of a working interest unit.

Q. Now, what 320-acre pool targets are there above 10,000 feet, do you know?

A. Well, there is Strawn production in the area, there's Wolfcamp production in the area, there's a little bit of Bone Spring. I will say that I am not a geologist, but --

Q. Are any of those on 320s, do you know?

A. No.

Q. So basically when you say Finley's interest above 10,000 feet, as I understand the letter -- correct me if I'm wrong, let me make sure I understand this correctly -- you're proposing that they would be reduced to 48 percent regardless --

A. In exchange for spreading their interest from the northeast into the northwest, so that they would share in any shallow production obtained in the northwest quarter, as well as the northeast.

Q. Again, presuming there's a 320-acre unit --

A. No, no --

Q. -- to pool?

A. No, a working-interest unit spreads interest across the 320. That way, if a 40-acre well were drilled in the northwest quarter, where Finley would otherwise have nothing if they didn't pool, they would have an interest in a 40-acre proration unit in the northwest quarter. A working interest unit is different than a proration unit.

Q. And there's no reference to the formation of a working interest unit in your July 21st letter, is there?

A. Yes, there is, the last sentence of the first paragraph.

Q. Okay. When you proposed the well to Chesapeake and Finley along with your cost allocation formula in July, at that time did you have what's now in the form of Exhibits 5A and 5B to discuss with them?

A. Yes, I did.

Q. Did you provide Exhibits 5A and 5B to --

A. No, I didn't.

Q. -- Finley?

A. No, I did not. About all he would have had to do is ask, inquire and engage me in discussions, and they would have been his.

Q. Well, did you inform Finley that these were available for discussion?

A. No, they were generated, really, for internal consumption and -- so that we would have a sense of what we were entering into and the effect upon our interest.

Q. Well, Exhibits 5A and 5B are dated October 21st, 2004. When were they actually generated?

A. Probably in April. In fact, if you'd like to -- well, my computer shows that they were dated -- done in April.

I have actually various scenarios. What we rolled out was the most generous one, to Finley.

Q. So there were other well proposals, there were other --

A. No, no, no, there were other --

Q. -- proposals for allocation --

A. -- tables that I ran for my management's consumption to evaluate what we were talking about doing. And in that I did one where we, in the drilling cost, split it 50-50 between the zones. I did another one where we did it 60-40, in other words, asked the shallow to pay more. I did another one at 70-30, asking the shallow rights to pay more.

But what we proposed to Finley was what we felt -- a more equitable formula for cost-sharing, which shares the cost of drilling 50-50 between the shallow and the deep.

Q. Did you discuss with you management the possibility of increasing Mewbourne's interest in the shallow rights?

A. I had authority to buy -- Oh, you're talking about the proposal that Scott Finley -- or excuse me --

Q. Ramsey.

A. -- Ramsey was made, to trade shallow for deep?

Q. Yes.

A. Absolutely, I -- absolutely.

Q. And tell me about that decision-making --

A. Well, again --

Q. -- process --

A. -- we --

Q. -- why wasn't that done?

A. -- we have 50-percent in the well with a farmout from Apache. We felt that in the Morrow and the Atoka, where we took our farmout, was certainly more valuable and deep, we were not willing to reduce our position, which was already less than what we wanted, in the primary objective, in order for an increased interest in something that is what we would call secondary.

Q. Did Mewbourne perform a geologic evaluation of the shallow unit?

A. We have maps covering the shallow, yes.

Q. Did your geologic evaluation lead Mewbourne to conclude that the shallow unit had little value to Mewbourne?

A. It has potential, but it certainly doesn't hold a candle to the value of the deep. We're drilling primarily for a Morrow well, but there's the potential uphole for zones that could, if -- on a going-forward basis, help you recoup costs.

Q. Where is that shallow unit potential, if you know?

A. There's Strawn production, there's Wolfcamp production, there's -- not Delaware, Bone Spring production in the area.

Q. Let me make sure we have a better understanding of your cost allocation formula. As I understand from what you testified, your cost allocation formula was derived from COPAS Bulletin 2; is that --

A. It is in compliance with COPAS Bulletin 2. If you've read -- and I would ask you, if you're going to quote COPAS Bulletin 2, you tell me what date you've got, because there is a very recent one out. And I am speaking of the most recent one, and I would direct you to the conclusion -- the summary at the back, where it clearly states that they in no way try to tell you how to do this. They offer options and various scenarios, and it's up to the parties to negotiate what reasonable -- I have put forth a formula that's been used and has been deemed reasonable by others. And it's in compliance with COPAS Bulletin 2?

Q. And how did you make that determination, it's in compliance with COPAS Bulletin --

A. I read the bulletin.

Q. Did you seek a review by a member of COPAS?

A. No, why would we?

Q. Do you have a petroleum accountant in-house at Mewbourne?

A. Yes, we do.

Q. And did you review your cost allocation formula --

A. As a matter of fact --

Q. Excuse me, let me just finish my question so we have a clear record.

A. Sure.

Q. Did you review your cost allocation formula with your in-house accountant?

A. Truth be known, the accountant prepared the XCel spreadsheet that ultimately resulted in Exhibit 5A and 5B.

Q. So when Mr. Bruce asked you earlier whether you had prepared Exhibits 5A --

A. -- were prepared under my supervision.

Q. So is Exhibit 5A and 5B your product or not?

A. The skeletal structure of it -- okay, it was prepared -- the formula and the table was prepared for the use of this very table in another scenario with another party. I simply took that table and plugged the numbers as I allocated them or chose to -- and again, I'll admit there's some hairsplitting here; you could choose to shift parts or all of these numbers from one category to another -- and I plugged them into the XCel spreadsheet. So that's where they came from.

Q. Just so I'm clear in my understanding, the determination that your cost allocation formula that you proposed to Finley is in compliance of COPAS Bulletin 2 was yours and yours alone?

A. Okay, I will -- the accountant did not see this table right here. I prepared that using his XCel spreadsheet formula to use this table or this summary.

So reasonableness, I would say it's reasonable in the sense that the formula has been used by other parties.

Q. Again, let me make sure you understand my question. I don't think you're responding to the question asked.

The cost allocation formula I'm asking you about is what was sent to Finley on July 21st.

A. Yes.

Q. Now, again, the question to you is, in making the determination that the cost allocation formula you proposed to Finley was in compliance with COPAS Bulletin 2, that determination was yours and yours alone; is that right?

A. I guess in a strict reading of your question, yes, no one else has been asked to review it from a compliance standpoint in this specific scenario.

Q. When you compiled your cost allocation formula -- correct me if I'm not stating your answer accurately that you said you relied on a COPAS bulletin in part?

A. I read the COPAS Bulletin 2 to try to find an answer to a problem that presented it to me. I asked friends and co-workers and associates if they had any ideas on how to do this, and I got a copy of Yates's methodology. I looked at it, I again looked at the COPAS Bulletin 2, it seemed to fit within the guidelines that say there's no one way to do this, guys, there's no one way to do this. It's a negotiated deal.

In that Yates has utilized this and it's been negotiated, we rolled it out.

Q. When you asked all your colleagues about an appropriate way to formulate cost allocations, did you get the same answer from everybody?

A. Actually, the only example I got was Yates's. This is outdated.

Q. Mr. Smith, I'm going to hand you what's been marked as Finley Exhibit Number 1. Can you identify that?

A. I have seen this bulletin too. In fact, I have a copy in my file.

Q. And this COPAS Bulletin 2 has a cover date, anyway, of September, 1965. Do you see that there?

A. Yes, I do.

Q. Did you rely on this version --

A. No.

Q. -- or another version?

A. No.

Q. What version did you rely on?

A. There is a 2003 or 2004 version available from COPAS for a fee to anyone willing to pay for it.

Q. Since you relied in part on the COPAS bulletin, can you tell us, if you can, the major differences between the 1965 version and the current version?

A. The 1965 version attempts to address the multitude of potential reasons for cost allocations that have surfaced since 1965. They expound upon the -- any number of possible reasons for it, and they clearly state that it is a complicated issue, and no two situations are the same. This is a very -- I mean, the -- let's just say that the modern version is probably four times as thick as this one.

And the substantive difference is that they do expound upon -- the reasons for it and that it is a complicated issue and that it's up to the parties to negotiate.

Q. Let's look at page 4 of Finley Exhibit 1, paragraph B.1.

EXAMINER STOGNER: Okay, which 4 are you referring to? The 4 up on the top right-hand, or the 4 on the bottom of the page.

MR. HALL: At the bottom, Mr. Stogner.

EXAMINER STOGNER: Okay.

Q. (By Mr. Hall) It's paragraph B.1.

A. (a) -- or (b) -- no, it's (a), where you've done the underlining.

Q. Yeah, I don't know the source of these markings on here, by the way, but --

A. Okay.

Q. -- I'm looking at page 4, as indicated on the bottom of the pages --

A. Uh-huh.

Q. -- so it's COPAS Bulletin, page 4, paragraph B.1, says, "The preferred method for the allocation of costs between zones is from a detailed analysis of actual expenditures when practical, utilizing well, drilling and accounting records." Do you agree?

A. I would argue that we're looking at an outdated piece of paper from which I did not rely upon to determine -- This was not even looked at.

Q. Do you know if the current COPAS bulletin contains --

A. I did not bring one with me.

Q. Do you know if the current COPAS bulletin contains language similar to --

A. Well, one thing I would point out -- and if you read the COPAS bulletin in total, that you can take a statement anywhere in the bulletin and take it out of context without reading the materials that lead up to a statement, and it -- you can't then use it to make a general statement. You have to read the allocation suggestions in context of -- for which they're put forth.

Q. All right, Mr. Smith, I'd ask that you listen to my question and wait till I'm finished asking the question before you start your answer, for the court reporter's sake.

My question to you is, do you know whether the current COPAS bulletin has language similar to what I read you?

A. Do I know? Not having memorized it, I would think that it attempts to address these same situations. But does it say the same thing? I do not know.

Q. Do you believe that this concept expressed in the

1965 version is, in fact, preferable today in that you ought to be making these allocations based on actual known well costs and expenditures?

A. Well, I'm not disagreeing that we use actual well-cost expenditures for allocation. That's -- again, I'm not saying that these numbers that I put forth are the hard numbers that all allocations -- When and if something happened, we would use real numbers, and we would decide what costs should go in -- and it would be a negotiated situation. We would propose it. If Finley said, No, that cost should be in this category -- I mean, it's -- and of course, under an order the Commission is the final arbiter of what reasonable costs are.

Q. And should a pooling order issue in this case, that would pool the shallow unit, do you understand that Finley would have the option to make an election to tender well costs in order to avoid the risk penalty and so-called election, that that election is going to be based on your AFE-estimated well costs?

A. No, at the time the election would be made, it would be based upon as much known data as we have. Assuming we've drilled and completed the well and it's produced a while, we'll have hard numbers for the actual costs.

But if we've got a drilling rig on location and we've gone out and we've bailed out of the Morrow and we're wanting to immediately move uphole, we'll have the best numbers we have.

Q. Let me ask you, then, for purposes of understanding the operation of the pooling order, is it your understanding that Finley would not be required to tender their proportional share of drilling cost, estimated cost, until after the well is drilled?

A. Hm.

Q. How do they make the election and at what point?

A. Good question.

Q. You don't know?

A. I don't know, this is -- I've never crossed this bridge before, to be honest with you. This is my first time to encounter this.

Q. Let me ask you this: Under the formula, can you tell the Hearing Examiner whether the cost to the shallow unit owners to drill to, say, the San Andres, would exceed what they would otherwise pay to drill just a stand-alone well to the San Andres?

A. Well -- can you restate -- I want to make sure I answer your question. Can you restate it again?

Q. Well, if we utilize Mewbourne's proposed formula, will the cost to the shallow interest owners to drill a San Andres well be more than had they just drilled their own stand-alone well?

A. Yes.

Q. Do you believe that's reasonable and just?

A. The difference being is that they get to drill and evaluate the entirety of the ownership interval in which they own, logs would be run across any -- any zone that might have been there that they would not have encountered would be evaluated.

Q. Let's look at, if you would, your Exhibit 3 again, your cost allocation formula, so we can understand some of these scenarios. Again, your scenario B is, if a well is drilled to the deep unit and the initial casingpoint election provides for a completion attempt in the deep unit, then it explains -- there's no obligation on the shallow --

A. To pay --

Q. -- interest owners to pay anything?

A. Correct.

Q. But then it goes on to say, first full paragraph under letter B, if there is a subsequent recompletion, that's when this reimbursement formula kicks in?

A. That's correct.

Q. And then it tries to explain how that would work, and I think it's important for --

A. Yes, it does try, and it is a proposed effort.

Q. I understand. Let's make sure the Hearing Examiner can understand this as well as I. It addresses the allocation of first drilling costs.

A. Correct.

Q. Costs under that category, drilling costs.

A. But it excludes certain costs.

Q. Right, that's what I wanted to ask you about. It says, "All pre-casing point drilling costs that can be isolated..."

A. Right.

Q. Now, isolated costs, that's not a defined term --

A. No.

Q. -- anywhere, is it?

A. No.

Q. What's your understanding of those isolated costs?

A. Well, it's -- if you were to drop a cone in the hole at 8000 feet and have to fish for it, that cost would be isolated to the shallow unit. If you take sidewall cores above 10,000 feet, that cost is isolated to the shallow unit. If you run a log specific to the shallow unit, that cost is allocated to the shallow unit. If you run a logging tool specifically designed to evaluate the Morrow, that cost is allocated to the deep. If you run a DST in the Morrow, the deep pays for it, not the shallow.

And you eliminate those costs and allocate them to the different zones before you start allocating under the formula.

Q. Well, let's talk about fishing. If, as you say, you're on your way down to the Morrow, but say at about 5000 or 6000 feet you twist off --

A. Uh-huh.

Q. -- and you have to fish at that point --

A. Right.

Q. -- even though you're drilling to the Morrow, that cost is an isolated cost attributable to the shallow?

A. Correct.

Q. Do you believe that's just as reasonable?

A. Well, if -- Yes, I do. I mean --

Q. Explain why.

A. Because it occurred in the shallow, and if you want to drill further through the shallow, you'd have to -- you would incur those costs anyway. To evaluate the totality of the shallow interval, you would have had to have incurred those costs anyway.

If it occurred at 10,000 feet, then you've got a -- you know, this can't address every possible scenario. It's an attempt.

Q. And so do you agree with me that that fishing job would benefit the owners in the deep unit?

A. Yes.

Q. And yet, as I understand it, there's no right of adjustment between units. A hundred percent of that fishing job cost is on shallow interest owners?

A. Well, I would like to offer the concept that this was put forth to Finley in an effort to get them to join in the well. I didn't even really think about it in context of it affecting an order. It was designed to be negotiated between parties who are subject to a voluntary agreement, and to do that you have to negotiate.

Q. Would Mewbourne be willing to continue the hearing in this case to allow the parties to negotiate further?

A. We have a spud date of December 15th. Our rig schedule is largely dependent upon hitting those. We have four rigs that we keep busy, we've had the same four Patterson rigs for numerous years, we're very comfortable with them. We don't want to be put in a position where we have to let a rig go in this environment, where if we let it go we might never see it again.

So how long are you asking me to negotiate?

MR. HALL: Just a minute, Mr. Examiner.

EXAMINER STOGNER: Let's take a five- or ten-minute -- let's take a 10-minute recess.

(Thereupon, a recess was taken at 10:08 a.m.)

(The following proceedings had at 10:28 a.m.)

EXAMINER STOGNER: Let's go back on the record. I believe that you were cross-examining, Mr. Hall. You may continue.

MR. HALL: Mr. Stogner, the parties during the break discussed -- and Mr. Bruce will correct me if I'm mistaken, but I believe Mewbourne is amenable to continuing the hearing for two weeks to allow the parties additional time to negotiate allocation formula, among other things, and their participation in the well. But what we'd like to do is proceed with Mr. Smith's testimony, since he's here today, and continue the case at that time.

EXAMINER STOGNER: Mr. Bruce?

MR. BRUCE: Yes, that's correct, Mr. Examiner. You know, the one issue that Mr. Smith did raise is, this is on its drilling schedule, and if the parties are unsuccessful we would like an order at some point relatively quickly after that hearing, if necessary, so that elections can be made according to the pooling order.

EXAMINER STOGNER: I will try to make myself available November 4th. That is somebody else's hearing. Please be aware -- I don't have it with me -- I have been called for jury duty in Torrance County, however feel free to subpoena me --

(Laughter)

EXAMINER STOGNER: -- and we will take that from there and see what happens.

MR. BRUCE: Well, I'll have Mr. Kellahin do the subpoenaing, because I would rather have him deal with the judge.

EXAMINER STOGNER: And he can join me at the Torrance County Detention Center for contempt.

With that, Mr. Hall?

Q. (By Mr. Hall) Mr. Smith, we were discussing the cost allocation formula attached to your letter, Exhibit 3.

A. Yes.

Q. And again, we were discussing that there's no separate definition in the document for isolated costs --

A. No.

Q. -- and remaining costs?

A. Well, remaining cost is defined, isolated are not.

Q. Remaining cost is everything other than isolated?

A. Correct.

Q. Would you agree that both the older and contemporary versions of the COPAS bulletin contain costs based on intangible drilling costs?

A. Yes.

Q. Why didn't you elect to follow those traditional definitions?

A. Well, I felt like I did. I mean, we -- to me, drilling costs are the intangibles, and they're treated one way. Downhole equipment and surface equipment are tangibles, and they are treated differently. They are separated conceptually along those lines, and we could use different terms if you'd like, but that was -- the effort was to divide between tangible and intangible.

Q. From you review of your cost-allocation formula and then your AFE which separates costs out into tangibles and intangibles --

A. Right.

Q. -- is there any overlap?

A. Like I said, when I submitted it -- this is -- there certainly could be discussions. This was simply done for discussion purposes. I did not intend for this to be concretely used as the numbers that would be used for adjustments. It was just put forward for the purposes of understanding the mechanics. There certainly would be adjustments, and what I might have colored as intangible here might have a portion or all of it, but I don't think that all of it would shift. And conversely, parts of the others could be shifted back and forth, and I would certainly be agreeable to actual costs being used.

Q. And again, in the context of a compulsory pooling order, should an order issue, when it comes time for Finley to make its election to tender its share of well costs, will we be utilizing the AFE, which is your exhibit?

A. Well, again, this is -- I would expect to either -- Under the order, I would expect Finley to either choose to participate or, if they go under the order, put us on notice that they will go under the order. If I understand the mechanisms correctly, if they choose to participate under the order, we would expect to use real costs inserted into this formula, or at the time it came to pay, yes.

Q. Well, you understand when a compulsory pooling order issues --

A. If asked -- to signify the decision as to whether or not to go under the order or be force pooled -- participate under the order or be pooled under the order, I think simply, rather than -- as the normal order says, you must pay or tender your share of the drilling costs within 30 days receipt of notice or -- of the order, I would say that he would -- Finley would simply have to issue a letter stating that I choose to participate under the order, and I agree to pay costs determined under the cost allocation formula when those numbers are made available.

Q. I guess my question is, how much will Finley be expected to tender in order to avoid the risk penalty under each of the three scenarios as laid out under your cost allocation formula?

A. Well, in that -- if we're going to use actual well costs, I can't answer that question. Again, the decision at the election point as to whether or not to participate under the -- Is that what you're asking me about, the 30-day election following receipt of an order?

Q. Yes.

A. I would say that they're not going to be expected to pay any money at that point in time, because they're not -- the proposal that we're making doesn't put the shallow unit at risk for any money up front initially, until the well is completed.

The well -- the participants in the deep will bear all costs until the outcome of the well is known.

Q. Are you asking Examiner Stogner to formulate an order that provides for an election point at some time --

A. No, they have to -- Finley would have to say I'm either going to participate now, under the order, knowing that the costs will be filtered through -- actual costs as they're known through this formula -- or elect to not participate and be force-pooled. There's no reason they would tender money within the 30-day standard period upon receipt of the order. There's no costs associated with their participation at that point.

Q. Do you understand that in order to avoid the risk penalty assessment against their interest, their 98-percent interest, they would be obliged to tender their share of well costs within 30 days of the order?

A. And that's -- well -- hm. At this point there are no costs. I think I would read that since we're proposing that there are no costs at this time, they don't have to tender any, they simply have to make an election now.

Q. What are they electing?

A. They're either going to participate outside the voluntary agreement, pursuant to an order, and at such times as they wanted to -- if they were given a -- well, this is -- When and if costs are due, they have to pay them within 30 days and put the 30-day clock upon them noticing or receiving notice of the amounts due.

Q. Let me move on. Let's stay under your scenario B under your cost allocation formula, which is your Morrow completion and a subsequent recompletion --

A. Yes.

Q. -- uphole.

A. Right, right.

Q. Under paragraph B.3 it provides for an allocation of costs for the downhole equipment --

A. Yeah.

Q. -- on the basis of two-thirds to the shallow unit and one-third to the deep unit?

A. Right.

Q. Can you tell me whether, for instance, casing costs increase incrementally with depth?

A. Incrementally?

MR. BRUCE: Do you mean --

MR. HALL: Strike that.

MR. BRUCE: -- proportionately?

Q. (By Mr. Hall) Do they increase --

A. By foot.

Q. -- exponentially?

A. No, they don't, exponentially.

Q. But do they increase on a footage basis?

A. Well, I'll say that you could -- depending on how you design, sometimes different grades of pipe are run at different points. And I have nothing to do with that, by the way; I'm just aware of the fact that you might want to run one grade here and a different, lesser grade, you might even, you know, run a liner, a less expensive section of pipe, at greater depth.

So there is the potential as you go through the depths for pipe to cost different amounts.

Q. So with the hole drilled to 12,500 as you propose, are we looking at a different casing program, then, for a hole drilled to, say, 6000 feet?

A. Undoubtedly.

Q. More costly hole?

A. No question.

Q. And more costly casing program?

A. Well, there's more steel in the ground.

Q. It's like you say, if you're drilling to 12,500 feet, you would not need -- you would need incremental -- I'm sorry, intermediate casing string --

A. Correct.

Q. -- that you wouldn't have to a hole drilled 6000 --

A. Correct.

Q. Is a bigger rig required for drilling a --

A. No question.

Q. -- deeper hole?

If we refer back to the COPAS bulletin, our Exhibit 1, on page 5 of that, if you will look at numbered paragraph 2.(a) on page 5 of Exhibit 1, it provides for a little bit different cost allocation scheme between zones. Admittedly the scenario shown on the COPAS bulletin is for three zones --

A. Right.

Q. -- but it seems to say -- see if this comports with your understanding. It seems to say that once costs have been allocated to the zones -- and let's assume that they mean what you would call isolated costs.

A. Or by foot. I mean, you can allocate any way you want.

Q. Yeah. The additional costs under COPAS, under paragraph 2.(a), contemplates that those "costs identified with the zone from the surface to the base of the first producing formation should be allocated equally to all formations..." Now, that's a departure from your proposal, isn't it?

A. We're talking about -- this is intangible drilling costs. I have apportioned the actual isolated or nonisolated drilling costs equally to the two zones under my formula.

Q. And where is that shown, so I know?

A. Well, if you look under drilling costs -- you can look at either place, but let's look at the written scenario. The shallow unit only pays one half of the footage-allocated cost to that interval, and the other half is equally borne by the deep. And then the deep zone pays 100 percent of that allocated to it.

MR. BRUCE: You're looking at item B.1 on your allocation --

THE WITNESS: B.1, correct. That's where we're talking about allocating intangible drilling costs.

Q. (By Mr. Hall) All right. Now, we were speaking about your scenario for downhole equipment casing costs and the like.

A. Well, and I would direct you back that what you're directing us to read from is talking about intangibles, not tangibles.

Q. Let's look at page 6 of COPAS Bulletin B, then. It addresses tangible costs, specifically casing costs, paragraph B.1.(a), and again it says the "Total average cost of the casing from the surface to the base of the first zone should be allocated equally to all...zones in the wellbore."

A. Okay.

Q. And then you compare that to your narrative, your allocation is two-thirds shallow, one-third deep?

A. Right.

Q. So that's a departure from --

A. It is a departure, but I would again -- this is -- they're making suggestions, and as the conclusion clearly states, they're just that, they're not telling anyone how to do it, that it's up to the parties to negotiate.

Q. Now, your depth cutoff for allocation of costs between the shallow and deep zones is the 10,000 feet?

A. Which we believe is approximately, although not known identically -- or perfectly, to be the base of the

Bone Spring and the top of the Wolfcamp, although those two could vary somewhat.

Q. Do you believe it would be more appropriate to have those costs allocated from, let's say, the bottom set of perforations for a completion in the upper zone, rather than all the way down to 10,000 feet?

A. Not -- We believe that what we proposed is equitable, based upon the conditions today. The reason we shifted this is, the tangible value of pipe is increasing daily. Steel is becoming -- You almost can't get it. If you don't have a connection to get pipe to run in the ground, you might not get it in a timely fashion.

So there is salvage value associated with all this tangible that is real and has value. And the people that own it should pay for that.

Q. That's a good point. Let me ask you about your scenario B for your casing.

A. B, okay.

Q. Downhole equipment.

A. Uh-huh.

Q. Who gets to depreciate the pipe?

A. I believe what would happen is that the parties that paid for it initially would claim it in that year's taxes. Or if you're asking to depreciate it in terms of taxation, probably them that put it there initially.

Q. Does your formula address that in any way?

A. Only in the fact that once we've allocated two-thirds, one-third, the parties then share the -- in other words, the parties in the deep pay part of shallow, even though they -- for instance, Chesapeake might own nothing. There is designed in this an effort to give Finley a chance to come in on a cost-reduced basis, because it's not a perfect scenario, but we've got to come up with something that allows them to come in on a cost-reduced basis, while addressing the ownership of the steel in the ground.

Q. Are you asking Examiner Stogner to formulate an order that addresses the ownership of the depreciation rights?

A. Am I asking him? No.

Q. So that would simply be unaddressed --

A. Correct.

Q. -- in the compulsory order?

A. In the form of the proposed. And we believe we've built in a shift in the cost to accommodate that.

Q. There's nothing preventing the operator from taking 100 percent of the depreciation?

A. I think that's what would happen. Not the operator, that would -- the working interest owners, in proportionate ownership.

Now, that's under scenario B only, and that's --

assume -- well, there's no way of knowing exactly what will happen here but, you know, let's say the well produces from the Morrow for 10 years. Of course we're going to take the depreciation.

And when Finley comes in, they're going to pay us back on a discounted basis with dollars worth less than what we used to pay to get there. The dollars repaid will be based -- will be inflation-eaten-away dollars.

Q. Let's talk about your scenario C in your Exhibit 3, on page 2 of your allocation formula. That is basically your Morrow dryhole scenario?

A. Bomb out below 10,000, no pipe is set, there's been no casingpoint election. We've got a drilling rig on location, and you're ready to try to recomplete in a zone above 10,000 feet. All you've done is drill a hole.

Q. And the precatory sentence to Section C there says, "If a well is drilled to the Deep Unit and the initial casing point election provides for a completion attempt in the Shallow Unit", then the following formula apply.

Let me ask you, what are the criteria for the casingpoint election?

A. Intangible costs to get there that are not isolatable to one zone or the other.

Q. Is that a different decision --

A. Well --

Q. -- from making a determination that the Morrow is nonproductive, you're not going to complete in the Morrow?

A. Is that a different -- Scenario C would only come into play after the parties that took the risk and paid the money to -- or in theory paid the money to get to the Morrow evaluated, decided that they had no interest in completing, and now they want to move up to a zone where the ownership is different. And at that point in time, C is intended to simply allocate the actual costs to drill the well that are not isolatable to the deep or the shallow.

If there are logs run in the Morrow, then the shallow zone pays no cost. If there's a DST done, that's isolated. If there are sidewall cores taken, that's isolated. It is not charged back to the shallow unit.

Q. So that Finley would have no say-so in that election process; is that correct?

A. Well, they own nothing in that deep right now. What would happen is, if this were attached to a JOA or a side letter agreement in connection with a voluntary agreement, Finley would be put on notice that we have bailed out, we want to complete in X zone above 10,000 feet, you have rigs on location, you've got 48 hours. In or out.

And if they're in, then they -- we would -- at the time I would think the real numbers were known, we would have close estimates, the costs would be billed out to the partners to get to that casingpoint election.

And again, the spreadsheet that I offered is just a guesstimate. It was offered to show an example of what that cost might be, actuals would be used.

Q. And you're referring to your Exhibit 5A, correct?

A. That would be under a voluntary agreement where he pooled -- 5A or 5B, we've made him two offers.

5A would be if he pooled across the entirety and formed a working interest unit at surface to 10,000 feet, that would be one set of numbers.

5B would apply to the situation in our second offer where we allow him to keep his full 90-plus-percent interest, and it comes in at that point.

Q. Let's see if I understand how this would operate under the compulsory pooling order. There's a determination that the Morrow is nonproductive?

A. That's correct.

Q. That is the casingpoint election?

A. That's the initial casing- -- well, no, the -- well, if -- no. It can happen one of two ways. When we set pipe in the Morrow and it depletes and we choose to come uphole, or we drill to the Morrow, we evaluate it as a reasonable and prudent operator whose risked his money to get their -- decide it's not productive, and we at that point, without having run pipe, all we have is a wellbore in the ground, choose to go uphole.

Q. So those deep owners make that determination, correct?

A. Yes, they're the ones that paid to not -- they own the interval that they're choosing not to complete, correct.

Q. And then Finley is the owner of 97 percent of the shallow unit?

A. If that's under 5B, yes, that's -- 97 percent.

Q. So Finley as the owner of 97 percent in the shallow unit, presuming it's a 160-acre --

A. Right.

Q. -- unit at that point, is faced with the decision to elect to do what at that point? How does this operate under the pooling order?

A. They would have to -- they're going to be getting -- I would assume in this situation, in order for them to make an informed decision, we would give them daily drilling reports. They would have to choose whether they felt it was worth their money to join in that well, and they would either agree to be subjected to those costs run through the formula, actual costs, or choose not to under an order.

Q. And under that scenario -- By the way, let me ask you, even if Finley goes nonconsent under the compulsory pooling order, would you still be providing logs and daily drilling reports to them?

A. If they chose to not have any exposure to costs and be willing to pay for it down the road, no. And -- hm.

Q. So under this scenario, casingpoint election is made by the deep owners, then it falls on Finley to make a decision under your scenario C.1 about whether it wants to incur the costs under the formula you've laid out here, and let's talk about that briefly. These are basically reimbursement costs to the deep owner, correct?

A. Correct.

Q. So the way that would work -- see if you agree with my explanation --

A. It's reimbursement if the well has been completed in the Morrow and come back. If we are the initial completion, then they're real-time costs.

Q. So regardless of the depth of the recompletion in the shallow unit -- it could be 4000 feet -- Finley would be required to reimburse the deep owners based on this formula, which is 100 percent of the footage to the base of the shallow unit, in this case 10,000 feet, times the remaining cost?

A. They were -- Yes.

Q. So it's the numerator under the formula?

A. Yes.

Q. The denominator is total depth, 12,500?

A. Correct.

Q. So generally speaking --

A. Eighty percent of the costs --

Q. -- 80 percent --

A. -- were used to evaluate surface to 10,000 feet. It was drilled through and looked at.

Q. Eighty percent is the proportionate footage share of the --

A. Correct, yes --

Q. -- shallow --

A. -- correct.

Q. -- the shallow well, or the shallow section for the full wellbore?

A. Correct

Q. And the deep owners are only bearing 20 percent of that cost?

A. That being 2500 feet over 12,500, 20 percent.

Q. In your opinion, is that allocation more just and reasonable than having the shallow owner bear deep costs measured from the bottom set of perforations in the upper unit?

A. It is an allocation that has been used. I've used it several times recently. It's been accepted by others as being equitable.

Q. Those other scenarios, if you can recall, were the allocations between formations. In those circumstances, were the formations in closer proximity than the --

A. It was a slightly shallower depth. I think the Morrow was at 11,000 and the cutoff was at 8900, where the ownership break occurred. It was in the...

Q. Let me ask you, again under your scenario in Exhibit 3, Scenario D, nonconsent elections --

A. Yeah.

Q. -- how does that work?

A. Well, let's say that -- and I ran through this morning because I knew you'd want to ask that. And again, I would offer that this was perhaps put in there for the purposes of use in a voluntary agreement where nonconsent elections occur. This was utilized last in a unit, in a voluntary agreement. It was not utilized in a compulsory pooling situation.

So as to, I assume, someone who chose to go under an order where there's really no nonconsent once you're in, it would not apply. And there might need to be some tinkering with this in a scenario where -- if this was utilized in a compulsory pooling order.

Q. I'm not sure I understood your answer, but --

A. Well, how does --

Q. -- let me ask another question first. Wouldn't D apply only in the circumstance where there was a nonconsent?

A. Yes, on it's face that's what it says. It only applies where there is a nonconsent, and it's designed to have the value of any adjustment, whether positively or negatively, applied towards any balance that there is in place at the time of that nonconsent election.

Again, it was -- I think that was something Hudson Oil wanted in there, and we thought it was equitable and we put it in.

Q. Are you asking that this nonconsent election provision be made a part of the pooling order?

A. No.

Q. You are not?

A. I don't think so. I would like to reserve that answer for further analysis. I have to admit, I didn't contemplate its use at the time it was put forth to Finley Resources for utilization in a pooling order.

Q. Let me ask you again about your scenario B. Scenario B contemplates a successful completion --

A. Yes, it does.

Q. -- or the well? A subsequent recompletion uphole?

A. Yes, that's its -- yes.

Q. There's no time limit on the operator to make that determination that the recompletion uphole occurs; is that right? The Morrow could --

A. Yes, the Morrow could last 50 years.

Q. The Morrow could deplete, and then this election could be made by the deep owners to go back uphole?

A. That's correct, and we don't know when that will be. That's an unknown.

Q. So as you say, the Morrow could produce for 50 years --

A. Correct.

Q. -- and the shallow owners would not participate in Morrow production?

A. That's correct.

Q. So after 50 years, the operator and deep owners at that time could make the election to complete uphole with by then antiquated equipment --

A. Yes.

Q. -- and the shallow owner would be obliged to reimburse the deep owners for their deep well costs?

A. With a strict read of this, that would be correct.

MR. HALL: Nothing further, Mr. Examiner.

EXAMINER STOGNER: Mr. Kellahin?

MR. KELLAHIN: Thank you, Mr. Examiner.

EXAMINATION

BY MR. KELLAHIN:

Q. Mr. Smith, perhaps I'm the only one still confused, but let me try to be concise.

A. Okay.

Q. If I understood your responses to Mr. Hall, the primary objective is the Morrow?

A. That's correct.

Q. Can you satisfy all your contract obligations and your commencement limitations that are pressing you to go forward by commencing a well that's targeted to the Morrow?

A. Yes, I can.

Q. Do you have to actually spud the well?

A. I have to spud the well to prevent the farmout from expiring.

Q. So by spudding the well that's targeted to the Morrow, you save all your contracts, or satisfy your contracts?

A. Yes, I do.

Q. And you're seeking at this time to pool what we call the shallow rights?

A. Yes.

Q. I'm trying to figure out what you're asking Mr. Stogner to write in his pooling order. Are you going to require -- or ask him to prepare a pooling order that includes a cost allocation spreadsheet like we saw in your Exhibit Number 3, subject to some modifications, I think?

A. Yes.

Q. That's what you're seeking?

A. Yes.

Q. Am I correct in understanding that it's your intent that Finley's election is going to be made at some point in time when you have abandoned or exhausted the gas out of the Morrow and are going to recomplete into the shallow zones?

A. If he were subject to a voluntary agreement, that's correct.

Q. When we look at the shallow zones, has Mewbourne targeted any specific shallow formations?

A. We've identified potential productive intervals in the area in the Strawn. There is Strawn production in the area, there's potential Wolfcamp, and there's potential Bone Spring.

Now, I don't know what is in that wellbore, but my job as a landman is to try to make sure that we can effectively and efficiently move up and down the wellbore and drill and complete, produce that product at any interval.

Q. I'm looking at the docketed advertisement of the case, Mr. Smith -- I'll give one of these to you.

A. I think I've got one.

Q. Of all these pools with which this well may be associated, it's only the Morrow that's spaced on 320 acres, correct?

A. That we're aware of. I mean -- and I think if you were to, for instance, encounter a prolific Wolfcamp zone, you might be able to justify asking for or getting 320. But as it currently stands, the known pools are as stated in the order.

Q. So if you got a Wolfcamp gas, it's going to start out at 160?

A. Well --

Q. -- that's the way this is advertised?

A. -- unless -- I guess it would. I don't -- hm.

Q. Well, let me ask you another question. If it's Wolfcamp oil, then you've satisfied yourself, at least according to this --

A. Yes.

Q. -- advertisement, that it's 40-acre oil?

A. Yeah.

Q. Do you see any problem with deferring this until after the well is drilled, and pool the Finleys after the fact?

A. The problem I see with it is, under Scenario -- we'll call it for all intents and purposes C in my formula, and that is, we have a rig on location, we've drilled a well, we've bombed in the Morrow, and we want to efficiently, cost-efficiently, move on to the next zone.

If we have to stop, if we have to let the rig go and there's another rig mobilization, that might render, on a cost-forward basis, the zone that we would like to produce uneconomic.

Q. All those shallower zones would be contained within the northeast quarter of the section, it would appear, if you're on the shallower zones, you're on 40s or 160s?

A. Correct.

Q. At least 160s or less.

And on the ownership spreadsheet, Mewbourne would only have a 3-percent interest in the 10, and the rest of that is Finley?

A. Correct.

Q. Are you proposing that Finley's election at the time that you intend to go into shallower zones be made at the time you execute that intent?

A. Are you speaking of an election, then, or a voluntary agreement, or election under an order?

Q. No, I want to know only about orders. I don't care about these voluntary things.

A. Okay.

Q. Under an order, what would happen?

A. Well, I'm not putting forth the option that he has to interact under an order.

Q. Sort of like the voluntary casingpoint election?

A. Correct.

Q. You're not suggesting that Mr. Stogner --

A. -- that be incorporated in that --

Q. -- put that in there?

A. No, no, not at all.

Q. Mr. Stogner is not being asked to incorporate a casingpoint election?

A. No.

Q. Are you aware of any pooling orders that have thus far incorporated a casingpoint election in --

A. No, I'm not.

Q. Are you aware of any pooling orders that have utilized the cost allocation method that you're proposing with some modifications, that's attached to your Exhibit Number 3?

A. No, I'm not.

Q. Are you aware of any compulsory pooling orders that use what we call the original COPAS Bulletin 2 as an allocation method?

A. No, I'm not familiar with them.

Q. Are you aware of any pooling orders that use what we'll call the new revised COPAS Bulletin 2?

A. No, no, I'm not.

Q. That COPAS Bulletin 2 as revised, you have a copy?

A. Yes, I do.

Q. You didn't bring it with you?

A. I don't have it with me in the -- no.

Q. Is there any reason you cannot furnish that to Mr. Stogner?

A. I will be glad to, more than happy, I can -- if I --

Q. We would ask that you furnish that to counsel and to Mr. Stogner.

A. Be glad to.

Q. So we don't -- Mr. Stogner is being asked to adopt a precedent under whatever you want to call it, it's going to have to be a new procedure by the Division to modify the pooling orders to include this cost allocation method, and you want that done before the well is commenced?

A. Yes.

Q. Is there something here where you can see what the approximate share is of Finley's cost for making that election?

A. Again, based upon my rudimentary effort to allocate the costs --

Q. Just give me a gross number.

A. -- and there -- there are four potential numbers. If you go to page 3 of 5A and 5B, under, let's say 5A, is a -- I think actually, if we're going to stay under a pooled order, we would go to 5B only, 5B only, page 3.

An approximation of what Finley would be asked to pay if the well were drilled below 10,000 feet, completed in the Morrow and at some later date -- or completed uphole, they would be asked to pay -- and that adjustment would go to Mewbourne --

Q. Uh-huh.

A. -- $269,597. And that would be for -- no, wait, wait, wait. I am --

Q. You've lost me, Mr. Smith.

A. Yes, I'm lost. Let's go down -- the only scenario that applies here in an order situation would be the last one on the bottom of page 3 of 5B --

Q. Uh-huh.

A. -- and the drilling cost allocation for that would be $583,800.

Q. Okay, the cost allocation. The $753,000 represents what?

A. The isolatable intangible drilling costs.

Q. And those would include from the surface down through the Morrow?

A. That would be actually -- no, that is -- yes, it is, that's correct.

Q. And if it's unsuccessful in the Morrow or depleted in the Morrow, then you would come up to a shallower zone, and that exercise, you can test -- saying this in a simple way, you can test and determine the potential productivity of the Morrow for a cost of $94,000, because everything else is going to get reimbursed by Finley?

A. That is the drill -- yes, that's correct.

MR. KELLAHIN: No, further questions.

EXAMINER STOGNER: Mr. Bruce, redirect?

MR. BRUCE: Just a few, Mr. Examiner.

REDIRECT EXAMINATION

BY MR. BRUCE:

Q. Again, Mr. Smith, what you are requesting is something like the cost allocation formula --

A. Correct.

Q. -- in Exhibit 3 to be used, and it was put out to Finley, and you've never received a response from Finley?

A. That's correct.

Q. Secondly, with respect to your Exhibit 4 and your Exhibit 5B, what you are saying, those were for illustrative purposes only?

A. They were -- yes, exactly, demonstrative, just simply --

Q. To give some idea of costs --

A. Some idea of the mechanics, not necessarily hard numbers. In fact, not hard numbers, these are just a sense of how it would work.

Q. And under the normal pooling order, if there is -- if parties are pooled, and whether or not they participate voluntarily in a completion or recompletion, those well costs can be reviewed by the Division, can they not?

A. No question, I think that's -- at the behest of Finley, they would be required to.

Q. And Mr. Hall asked you a question and you admitted that assuming the scenario in Exhibit 5B where there's a recompletion, say, in a quite shallow zone, a San Andres or Yeso, that $583,000 which Finley could pay, could be more than just drilling down to that --

A. That's -- no question, that is a potential.

Q. On the other hand, drilling a 9000- or 10,000-foot well, from the AFEs you've seen, would be quite a bit higher than $583,000?

A. Absolutely, for that interest.

Q. And just one final thing. When Mr. Hall was asking you about a casingpoint election, that's usually done when somebody actually proposes a completion in a zone, correct?

A. Under a voluntary agreement, that's correct.

Q. So when you're talking about scenario C of your cost allocation formula, the casingpoint election isn't whether to -- if you bomb out in the Morrow, there's really no casingpoint election because both parties have looked at the available data and decided not to complete it, so the casingpoint election talked about in item C is actually the casingpoint election to complete in the Bone Spring or the San Andres or something like that; is that --

A. I'm sorry, restate, please.

Q. Your item C says, "If a well is drilled to the Deep Unit and the initial casing point election provides for a completion attempt -- "

A. That's correct.

Q. " -- in the Shallow Unit -- "

A. Yes.

Q. The casingpoint election you're looking at there isn't the decision to not complete or to not test the Morrow, the initial casingpoint election is the uphole zone; is that --

A. Correct.

Q. Okay. And just one final matter. Again, the problem with respect to Finley, not pooling them now, is, if at some point you are drilling and you need to make an election whether to complete uphole, it may become -- you need to make a quick decision.

A. Correct.

Q. The rig is on site. And you might not be able to afford to move the rig off and/or move another rig on?

A. Correct.

MR. BRUCE: That's all I have, Mr. Examiner.

MR. KELLAHIN: Follow-up, Mr. Examiner.

EXAMINER STOGNER: Follow-up, Mr. Kellahin?

FURTHER EXAMINATION

BY MR. KELLAHIN:

Q. Mr. Smith, at the point where you said you don't want to pool after the fact because of this decision-making process you make on site, if you find the Morrow nonproductive --

A. Correct.

Q. -- what do you estimate to be the number of days or the period of time that Mewbourne takes to make internally a decision that they're going to come up backhole and test a shallower zone?

A. Days, 36 hours, 24 hours sometimes, depending on partners. We have Chesapeake, we would have to accommodate them.

Q. And how many days with Chesapeake in the process?

A. Forty-eight hours.

Q. Forty-eight hours?

A. Uh-huh, with the rig on location.

MR. KELLAHIN: Thank you.

THE WITNESS: I believe -- whatever the '89 form, I believe, is -- whatever the voluntary agreement provides for.

EXAMINER STOGNER: Mr. Hall?

RECROSS-EXAMINATION

BY MR. HALL:

Q. Mr. Smith --

A. Yes.

Q. -- because Finley has no interest in the Morrow anyway, Mewbourne is not going to wait for any decision from Finley before it starts drilling the Morrow well, are they? Under any scenario?

A. We would like -- the whole purpose in being here is to try to either get a decision from Finley or some sense that an order will be issued so that we will be able to efficiently move up and down the wellbore.

Q. But without a compulsory pooling order, you have 100-percent participation now in the Morrow, correct?

A. Correct.

Q. You could start drilling tomorrow?

A. We could.

Q. And commencing your well tomorrow saves your -- is it an expiring farmout?

A. It does, and protects the fleet of rigs that we've been so lucky to maintain.

Q. And does it also preserve your 3-percent interest in the shallow unit?

A. The 3-percent is not at risk at this point, it's a longer term.

Q. Okay. Under your scenario B again, there's Morrow production, subsequent recompletion uphole. Wouldn't it be the case that because the shallow unit owner has to bear a significant portion of the total depth well cost under the allocation formula, that the economics of recovering uphole reserves are significantly affected by those additional costs?

A. It depends on where and how -- what depth that -- and how prolific the production that may be found. We don't know that there's anything there. There may never be any completion above the Morrow, there may never be an attempt above the Morrow. We don't know that.

Q. Wouldn't it be a more favorable outcome economically for a separate stand-alone well to be drilled to the shallower unit where the costs do not include these additional allocated costs for the deep zone?

A. No, because then you would have drilled two wellbores in the same proration unit, when one would have been --

Q. Under a single-wellbore scenario, the owner of the deep rights is looking at having to pay out well costs that are significantly more than had he just borne well costs down to the upper completion?

A. The upper being in the shallower interval.

Q. (Nods)

A. Yes.

Q. Let me refer you back to our Exhibit 1. Do you recognize that Exhibit 1 is a true and exact copy of the September, 1965, COPAS Bulletin 2 that industry has relied on?

A. It resembles one. Having not read it word for word, I can't say that it is. But it does on its face appear to be the exact...

MR. HALL: We would move the admission of Exhibit 1, Mr. Examiner.

EXAMINER STOGNER: Any objection?

MR. BRUCE: I have no objection.

EXAMINER STOGNER: Exhibit 1 of Finley in this case will be admitted into evidence.

Any redirect?

MR. BRUCE: No more questions.

EXAMINER STOGNER: You may be excused.

Do you with to bring your witness forth?

MR. HALL: Mr. Stogner, I think we'll defer at this time and ask that the case be continued, as we've discussed earlier.

EXAMINER STOGNER: Okay, this case will be continued until the November 4th hearing, at which time I'll probably make myself available.

I believe also that Mewbourne is going to supply me a copy of the new and improved --

THE WITNESS: Yes --

EXAMINER STOGNER: -- COPAS agreement?

THE WITNESS: -- I can e-mail it to you as a --

EXAMINER STOGNER: Get with Mr. -- You're off the stand, by the way. Get with Mr. Bruce and he will decide which is the best way.

THE WITNESS: Okay.

EXAMINER STOGNER: With that, then we stand adjourned until November the 4th. Thank you. And with that, then we stand adjourned until November the 4th.

(Thereupon, these proceedings were concluded at 11:20 a.m.)

* * *

I do hereby certify that the foregoing is a complete record of the proceedings in the Examiner hearing of Case No. 13359, heard by me on 21 October 2004

, Examiner
Oil Conservation Division

CERTIFICATE OF REPORTER

STATE OF NEW MEXICO)
) ss.
COUNTY OF SANTA FE)

I, Steven T. Brenner, Certified Court Reporter and Notary Public, HEREBY CERTIFY that the foregoing transcript of proceedings before the Oil Conservation Division was reported by me; that I transcribed my notes; and that the foregoing is a true and accurate record of the proceedings.

I FURTHER CERTIFY that I am not a relative or employee of any of the parties or attorneys involved in this matter and that I have no personal interest in the final disposition of this matter.

WITNESS MY HAND AND SEAL October 25th, 2004.

STEVEN T. BRENNER
CCR No. 7

My commission expires: October 16th, 2006