STATE OF NEW MEXICO
ENERGY, MINERALS AND NATURAL RESOURCES DEPARTMENT

OIL CONSERVATION COMMISSION

IN THE MATTER OF THE APPLICATION OF THE NEW MEXICO OIL CONSERVATION DIVISION FOR ADOPTION OF AMENDMENTS TO 19.15.14.8 AND 19.15.16 NMAC

CASE NO. 14744

BRIEF FOR THE DIVISION

The Division files this post-submission brief pursuant to the Commission's directive, as follow:

I.

The Commission's Question

A. The Question to Be Briefed and the Short Answer

The Commission has invited the parties to brief the following question:

> . . . whether the Commission has authority to adopt a new rule that allows compulsory pooling for horizontal wells given the use of project areas?

The short answer is that the Commission probably ***does not*** have the power to provide by rule that any and all project areas for horizontal wells may be the subject of compulsory pooling. The Division did not intend to imply through its proposals that compulsory pooling of project areas exceed existing statutes, rules and case law. Accordingly, the Division now proposes that the Commission modify its proposed amendments to conform to this intent.

This does not mean that the Commission and the Division do not have power to compulsory pool project areas for horizontal wells. The Commission and the Division have power to compulsory pool project areas that constitute standard spacing or proration units under

existing or subsequently adopted spacing orders. The Commission and the Division also have the power to compulsory pool project areas in particular approved non-standard spacing or proration units. That authority does not depend on any provision of the proposed amendments or of portions of the New Mexico Administrative Code to which the proposed amendments relate.

B. The Commission's (and the Division's) Compulsory Pooling Power

The Commission's and the Division's power to order compulsory pooling is prescribed in the New Mexico Oil and Gas Act ("the Act"), in NMSA 1978, Section 70-2-17(C):

> C. When two or more separately owned tracts of land are embraced within a spacing or proration unit, or where there are owners of royalty interests or undivided interests in oil and gas minerals which are separately owned or any combination thereof, ***embraced within such spacing or proration unit***, the owner or owners thereof may validly pool their interests and develop their lands as a unit. ***Where, however, such owner or owners have not agreed to pool their interests***, and where one such separate owner, or owners, who has the right to drill has drilled or proposes to drill a well on said unit to a common source of supply, the division, ***to avoid the drilling of unnecessary wells or to protect correlative rights, or to prevent waste, shall pool all or any part of such lands or interests*** or both in the spacing or proration unit as a unit. [Emphasis added]

There are thus three prerequisites for any exercise of the compulsory pooling power: (1) the lands to be pooled must be "embraced within a spacing or proration unit", (2) there must be an owner or owners who have not agreed to pool their interest, and (3) compulsory pooling must be necessary to "prevent the drilling of unnecessary wells or to protect correlative rights, or to prevent waste."

Although the Act allows compulsory pooling only of lands embraced within a spacing or proration unit, it does not prescribe the size or configuration of spacing or proration units. Further, the Act expressly provides for "non-standard" spacing or proration units and clearly contemplates that the compulsory pooling power may apply to such units. NMSA 1978 Section 70-2-18(C) provides:

> Nonstandard spacing or proration units may be established by the division and all mineral and leasehold interests in any such nonstandard unit shall share in production from that unit from the date of the order establishing the said nonstandard unit.

The Act does not prescribe the procedure by which the Division or the Commission may establish non-standard spacing or proration units, other than that it must act after appropriate notice and hearing. NMSA 1978 Section 70-2-23[1].

If the Act leaves any doubt that the compulsory pooling authority may apply to a non-standard spacing or proration units of larger size than the standard spacing or proration unit for the pool or area, that doubt is dispelled by the Supreme Court's decision in *Rutter & Wilbanks Corporation v. OCC*, 87 N.M. 286, 532 P.2d 582 (Sup. Ct. 1975). There the Supreme Court, over objection, approved a compulsory pooling order that did just that. Furthermore, the Commission, in *Rutter & Wilbanks*, approved the non-standard units and ordered compulsory pooling of those units in the same proceeding. *Id.* at 287. Thus the Supreme Court's affirmance establishes that an operator may apply for approval of a proposed non-standard spacing unit and for compulsory pooling of that unit simultaneously.

It is true that the non-standard units approved in *Rutter & Willbanks* were not hugely larger than the standard unit size prescribed for the pool involved.[2] However, the *Rutter & Willbanks* opinion does not state that the Court's approval of the non-standard units is limited to units bearing any particular mathematical relationship to the size of standard units. Instead the opinion cites NMSA 1953 Section 65-3-11 (now NMSA 1978 Section 70-2-12(B)), which provides generally that the Commission "is authorized to make rules, regulations ***and orders*** . . . [t]o fix the spacing of wells" 87 N.M. at 288 [emphasis added], and NMSA 1953, Section 65-3-

[1] This section provides that all Commission and Division orders, except emergency orders, require notice and hearing.

[2] The applicable spacing rule provided for 320-acre units. The two approved non-standard units consisted of 409.22 acres and 407.2 acres, respectively.

10 (now NMSA 1978, Section 70-2-11.A)[3] which provides the standard to govern the Commission in the exercise of its discretionary powers, *i.e.,* to prevent waste and to protect correlative rights. The Court concludes:

> Recognizing the Commission's power to pool separately owned tracts "within a spacing or proration unit" (Sec. 65-3-14(c) [now NMSA 1978 Section72-2-17.C][4] supra), as well as its concomitant authority to establish oversize non-standard spacing units (Sec. 65-3-14.5(C) [now NMSA 1978, Section 70-2-18.C][5] supra, Rule 104(L), supra) ***it would be absurd to hold the Commission does not have authority to pool separately owned tracts within an oversize non-standard spacing unit.*** *Id.* at 289 [emphasis added].

Although the *Rutter & Wilbanks* case did not involve a non-standard spacing unit that combined multiple standard spacing units, the Court's reasoning supports the Commission's and the Division's authority to create non-standard spacing units regardless of size where necessary to prevent waste and to protect correlative rights, at least so long as the Commission finds that the area included within the non-standard unit can be efficiently and economically drained and developed by one well.[6] If, in a subsequent proceeding, the evidence demonstrates that a horizontal well is the efficient way to develop a particular area, and that combining four, or

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[3] The language the Court quotes from NMSA 1953 Sections 65-3-10 and 65-3-11 has undergone no material change.

[4] The present compulsory pooling statute, NMSA Section 702-17.C, was enacted in 1961. Laws 1961, Ch. 65, Section 1. Although the language has been changed slightly, the only material change since that time was an increase in the maximum authorized risk charge from 50% to 200%. Laws 1973, Ch. 250, Section 1.

[5] Present Section 70-2-18 was enacted in 1969. Laws 1969, Ch. 271, Section1. Except for substitution of "the division" for "the commission," it has not been since amended.

[6] NMSA 1978 Section 70-2-17.B defines a "proration unit" as "the area that can be efficiently and economically drained and developed by one well." The Act allows compulsory pooling of a "spacing or proration unit." The Act does not include a definition of "spacing unit." An OCD rule defines a spacing unit as "the area allocated to a well under a spacing order" [Rule 19.15.2.7.S(9) NMAC], a definition that is circular and accordingly not helpful. Thus, it is not clear whether the statutory definition of a "proration unit" also limits the area that may constitute a "spacing unit". However, applying the statutory definition of proration units also to spacing units in the context of compulsory pooling would be consistent with the industry understanding of what constitutes "pooling," as described in the Williams & Myers treatise. The authors of that treatise say:

> Although the terms "pooling" and "unitization" are frequently used interchangeably, more properly "pooling" means the bringing together of small tracts sufficient for the granting of a well permit under applicable spacing rules whereas "unitization," or, as it is sometimes described, "unit operation," means the joint operation of all or some part of a producing reservoir. 6 Williams & Myers, *Oil and Gas Law*, Sec. 901, pp. 1-2.

more, standard spacing units is necessary to provide enough acreage to support the drilling of an economical horizontal well that will prevent waste, the logic of *Rutter & Wilbanks,* and the apparent intent of NMSA 1978 Section 70-2-17 and 70-2-18 support the Commission's authority to establish such a unit.

Doubtless, the statutory definition of "proration unit" as "the area that can be efficiently and economically drained and developed by one well" originally contemplated a vertical or directional well, since no other type was known in 1961. However, the statute should be, and we think would be, construed to allow the agency flexibility to accommodate subsequent technological changes. Nor is there any reason why NMSA 1978 Section 70-2-17 should be construed as preventing the Commission from establishing different sizes or configurations of spacing units for different types of wells. Throughout the history of oil and gas development, both in New Mexico and elsewhere, different size spacing units have been established for oil wells and for gas wells, even for the same pool.[7] Logically the Division and the Commission have power, if presented with evidence of the need for such action, to establish different size spacing units, either generally or in specific situations, for horizontal wells than for vertical wells.

C. Some Suggested Limitations that Do Not Apply

Neither OCD Rule 19.15.15.11.B(2) NMAC, nor Commission Order R-13228-F, precludes the Division or the Commission from establishing non-standard spacing units for horizontal wells, and compulsory pooling those units, after hearing, in appropriate cases with findings supported by evidence. As pointed out in the testimony of David Brooks, Tr. at 79. Rule 19.15.15.11.B(2) prescribes only what the Division Director may do "administratively,"

[7] *See, e.g.,* Special Rules and Regulations for the Blinebry Oil and Gas Pool, Rule 2.A, which provides that a gas unit within that pool shall consist of 160 acres, while an oil unit in the same pool shall consist of 40 acres.

that is, without hearing. For further confirmation of this interpretation of the word "administratively" as used in OCD rules, see Rule 19.15.26.8 NMAC, where, in another context, the distinction between what may be done "administratively" and what may be done by hearing order is clearly drawn.

Order R-13228-F is a fact-driven order. Although the Commission's Findings (4) through (6) may suggest that the Commission questioned its power to compulsory pool a combination of complete, contiguous spacing units, Findings (8) through (12) indicate that those questions were not decisive in the Commission's resolution of that case. Finding No. (12) states that "the Commission must determine whether granting the applications . . . will prevent waste and protect correlative rights." Order R-13288 F, page 5 [emphasis added]. If the Commission had concluded that it had no legal authority to grant the applications, it would not have been necessary, nor would it have been appropriate, for it to make that determination. The critical finding in Order R-13288-F is Finding (13) (at Page 6) in which the Commission concludes that the applicable standard for compulsory pooling of a project area comprising multiple standard spacing units cannot be met in that case based on the evidence.

There is Commission precedent, outside the horizontal well context, for establishing a non-standard spacing unit comprising the area of two standard spacing units, and compulsory pooling that non-standard spacing unit. The Commission did just that in Order R-12343-E, where, after finding inadequate the geologic evidence presented by both parties seeking rival configurations for a 320-acres standard spacing unit for a well, it decreed the creation of a 640-acre non-standard unit for the well, a unit it proceeded to compulsory pool. Order R-13243-E, page 8.

Furthermore there is no statutory prohibition against increasing the size of a spacing unit including an existing, producing well. Indeed the second sentence of NMSA Section 70-2-18.A[8] expressly recognizes that this may be done in appropriate cases.

D. Recommendations

There can be no question that ***some*** horizontal well project areas, as defined by proposed Rule 19.15.16.7.K, can be the subject of compulsory pooling. One option for a project area is that it may consist of one standard spacing unit. In such cases, absent voluntary pooling, the unit could unquestionably be compulsory pooled.

It is almost equally certain, however, that not ***all*** project areas can be compulsory pooled. Proposed Rule 19.15.16.7.K does not require that the size or configuration of a project area be such that it can be efficiently and economically drained and developed by one horizontal well. Even more cogently, Proposed Rule 19.15.16.15.G, which prescribes the procedure for establishing project areas, does not require a hearing, or even, in the case of "standard project areas," notice, nor does it require Division approval. Appropriate notice, a hearing, and Division findings based on sufficient evidence are all necessary before the Division can approve a non-standard spacing unit which may then be the subject of compulsory pooling.

Since not all project areas may be compulsory pooled, the Commission should not adopt rule provisions which might suggest the contrary. The Division and its workgroup, recognizing legal uncertainty, did not intend to propose rules to delineate the circumstances in which this could be done. (Testimony of David Brooks, Tr. V.1, p. 71). The Commission cannot determine in this proceeding the appropriate size of spacing units for horizontal wells, or the circumstances

[8] That sentence reads, "Any division order that increases the size of a standard proration unit for a pool, or extends the boundaries of such a pool, shall require dedication of acreage to existing wells in the pool in accordance with the acreage dedication requirements for said pool, and all interests in the spacing or proration units that are dedicated to the affected wells shall share in production from the effective date of said order." [emphasis added].

in which such units should be compulsory pooled, because there is almost no evidence in this record addressing those issues.

In the light of the evidence presented, and particularly the testimony of Mr. Harvey Yates, the Division is now concerned that certain provisions of the proposed amendments could be construed as providing for compulsory pooling of project areas beyond statutory authorization and thereby exceeding the Commission's rulemaking power. *See generally, Marbob Energy Corp. v. OCC*, 09-NMSC-013, 146 N.M. 24, 206 P.3d 135 (Sup. Ct. 2009). The Division, as applicant in this proceeding, is authorized to recommend changes at any time. Rule 19.15.3.11.C(1). Accordingly, in order to be certain that the rule that the Commission adopts does not transgress statutory limits, the Division now proposes two changes:

(1) Proposed Rule 19.15.16.15.F, entitled "Compulsory pooling" should be deleted. 19.15.16.15.G and 19.15.16.15.H should be re-numbered as 19.15.16.15.F and 19.15.16.G, respectively.

(2) Proposed 19.15.16.15.H (re-numbered as 19.15.16.15.G) should be changed to read, in lieu of "voluntary agreement for compulsory pooling", "voluntary agreement or, if applicable, compulsory pooling".

These changes would not change the intended effect of the proposed amendments. Proposed 19.15.16.15.F only provides that the provisions of 19.15.13 NMAC, regarding compulsory pooling will apply to compulsory pooling proceedings involving project areas for horizontal wells. To the extent that such proceedings are allowed by existing statutes and rules, 19.15.13 will apply thereto by its own terms, and proposed 19.15.16.15.F is unnecessary. Proposed 19.15.16.15.H is intended to require consolidation of ownership of a project area prior to production. In cases where the project area can be compulsory pooled, consolidation can be effected either by agreement or compulsory pooling. Where the remedy of compulsory pooling

is unavailable, as will doubtless be the case for some project areas, consolidation by agreement will be required.

II.

Proposals Filed by Heyco and Jalapeno

The Division urges the Commission not to adopt the proposed changes suggested by Harvey E Yates Company ("Heyco") and by Jalapeno Corporation ("Jalapeno). As a preliminary matter, the Division objects to the Commission's consideration of these proposed changes because they address compulsory pooling issues. Since the Division did not intend to propose, and did not propose, any provisions prescribing the circumstances in which project areas could be compulsory pooled, proposals on that subject would not be a "logical outgrowth" of the Division's proposal, and it would accordingly be inappropriate for the Commission to adopt such proposals in this proceeding. Subject to, and without waiving, this objection, the Division responds as follows.

A. Heyco's proposals

1. Heyco has proposed modifying the Division's proposed 19.15.16.15.A(1) by adding, presumably at the end, ***"and in which each tract is not included in an existing operating agreement covering the proposed geological interval."***

If adopted exactly as proposed, this change would prohibit the drilling of a horizontal well through any tract covered by an operating agreement, **even with the consent of all parties to the operating agreement.** Presumably what was intended was to require the consent of all parties to the operating agreement prior to drilling into a tract covered by an operating agreement. This provision would be more difficult to administer for the operator and the Division due to the necessity of determining exactly whose consent was required prior to APD

filing. Furthermore, the requirement likely would in some instances require consent of parties whose consent is not otherwise required under applicable law, depending on the provisions of particular operating agreements, how those provisions were construed in the context of horizontal wells, for which New Mexico authority is lacking, and whether the party authorizing drilling had complied with the notice and proposal requirements of the operating agreement. The Division generally does not have jurisdiction to construe contracts, and should not be placed in a situation where it would be required to do so.

The proposed change is not necessary for the protection of the owners of tracts subject to operating agreements. If a well is drilled into a tract without the consent of a working interest owner, presumably that constitutes a trespass. If consent is obtained from a working interest owner, but that owner breached a contract by consenting, then presumably the other parties to the operating agreement would have a remedy for any damages they might suffer by suit against the breaching party. In most cases, probably there would be no damages because proposed 19.15.16.15.H will require consolidation of all interests prior to production of the horizontal well. If the correlative rights of the parties to the operating agreement could not be protected in a compulsory pooling proceeding, compulsory pooling would be unavailable, as was decided in Order R-13288-F, and the drilling party could not produce the well without obtaining voluntary agreement of all owners. The parties to the operating agreement could in that circumstance protect their correlative rights by negotiation, and the fact that an operator had drilled a well it could not produce without their consent would presumably improve their negotiating position.

2. Heyco has proposed modifying the Division's proposed 19.15.16.15.A(2) by adding:

> ***If an existing Joint Operating Agreement is in place covering the proposed producing unit for any length of the lateral, in order for the Division to***

consider compulsory pooling, the consent of that portion of parties to the Operating Agreement which is required under the Operating Agreement to change the terms of the Operating Agreement must consent.

In addition to other objections, this proposal would violate the compulsory pooling statute. In NMSA 1978 Section 70-2-17.C, the Legislature has directed that the Division ***shall*** compulsory pool a spacing or proration unit if the legislatively directed prerequisites, including that the pooling is necessary to prevent waste or protect correlative rights, are shown. Let us consider the simplest case. Suppose that an existing operating agreement covers a 40-acre wildcat unit. Subsequently, the Division adopts pool rules changing the standard spacing unit to 160 acres. Then a party proposes a horizontal well designating the 160 acres as a project area. In that case, or in any case where the remedy of compulsory pooling were available by statute and required by the evidence, the Division would have a mandatory duty by statute to compulsory pool the unit. Any rule provision which would give a party a veto power over the exercise of the compulsory pooling power in a case where that power is legally available, would thus contravene the Act.

3. Heyco has proposed modifying the Division's proposed 19.15.16.15.G(4) by adding:

Nor may a project area be extended to include acreage dedicated to an existing Operating Agreement without the consent of that portion of parties to the Operating Agreement which is required under the Operating Agreement to change the terms of the Operating Agreement.

The second paragraph of the Division's response to Heyco's proposed Change No. 1 is applicable to this proposal also, and reference is made thereto.

4. Heyco has proposed modifying the Division's proposed 19.15.16.15.F by adding:

During a compulsory pooling hearing involving a horizontal well the Division is instructed to examine closely the actual geologic risk being taken by the driller considering earlier penetration of the zone being targeted by the driller in the

area in which the driller proposed to drill and to reduce the compensation to the driller for risk taken to a 50% where that more closely rewards the driller for the anticipated geologic risk of the endeavor.

This proposal clearly seeks to amend 19.15.13.8 NMAC, a portion of OCD rules not noticed for amendment in this proceeding. The proposal should accordingly not be considered. If the Commission does consider this proposal it should reject it because there is no evidence, much less substantial evidence, to support its adoption. Mr. Harvey Yates testified in very general terms that risk would often be less for horizontal wells than for vertical wells. However no party presented any statistical evidence by which the level of risk could be compared or any evidence that would support a presumption that 50% would be an appropriate risk penalty level.

B. Jalapeno's Proposals

1. Jalapeno has proposed modifying the Division's proposed 19.15.16.15.A(2) by adding, after ***"obtain a compulsory pooling order from the division",*** the following: ***"which shall not be available outside a single spacing unit which would be required for a vertical well drilled to the intended productive horizon at the same location."***

This proposal should not be adopted because there is no evidence in this case, much less substantial evidence, that a spacing or proration unit for a horizontal well should be the same size as a spacing unit for a vertical well in the same producing zone. Absent such evidence, adoption of this provision would contravene the provisions of NMSA 1978 Section 70-2-17.C permitting compulsory pooling of a proration unit and of 70-2-17.B, defining a proration unit as "the area that can be efficiently and economically drained and developed by one well."

2. Jalapeno's second and third proposals are almost identical to Heyco's third and fourth proposals, and the Division's responses to the Heyco proposals apply also to the corresponding Jalapeno proposals.

III

Conclusion

The Division accordingly urges the Commission to adopt the amendments to 19.15.14 and 19.15.16 it has proposed in this proceeding, with the changes proposed in this brief and in the Division's accompanying Supplemental Application, and to reject the proposals filed by Heyco and Jalpeno. This course will enable the Commission to proceed with the adoption of provisions of the proposed amendments that will facilitate horizontal drilling, and which Mr. Harvey Yates indicated that he supports. Tr. V.2, p. 14. It will also enable the Division to continue addressing compulsory pooling issues on a case-by-case basis, subject to *de novo* review by the Commission, and to legal review by the courts of New Mexico, which have the ultimate authority to interpret the statutes, on fully developed factual records. The Division would also suggest that, since the industry needs certainty to proceed with this highly beneficial form of development, application should be made to the Legislature to clarify the applicable statutory directives and limitations.

RESPECTFULLY SUBMITTED,

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CERTIFICATE OF SERVICE

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