

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

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

ORIGINAL

APPLICATION OF THE NEW MEXICO OIL CONSERVATION DIVISION FOR
THE AMENDMENTS OF 19.15.14.8 AND 19.15.16 NMAC.

CASE NO: 14744
VOLUME 2

REPORTER'S TRANSCRIPT OF PROCEEDINGS
October 21, 2011
Santa Fe, New Mexico

BEFORE: JAMI BAILEY, DIRECTOR
SCOTT DAWSON, COMMISSIONER
ROBERT BALCH, COMMISSIONER
SHERYL BADA, COMMISSION COUNSEL

This matter came on for hearing before the New Mexico Oil Conservation Commission, JAMI BAILEY, Director, SCOTT DAWSON, Commissioner, ROBERT BALCH, Commissioner, October 21, 2011, at the New Mexico Energy, Minerals and Natural Resources Department, 1220 South St. Francis, Drive, Room 102, Santa Fe, New Mexico.

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1 MADAM CHAIR: Back on the record. Today is Friday,
2 October 21, 2011. This is the continuation of Case Number
3 14744, which is the application of the New Mexico Oil
4 Conservation Division, notice of rulemaking concerning the
5 repeal, adoption, and amendment of rules issued pursuant to
6 the Oil and Gas Act NMSA 1978, Section 70-2-1 through
7 70-2-38.

8 All Commissioners are present, so we do have a
9 quorum, and there are questions that arose in the
10 Commissioners' minds last night where we would like to recall
11 certain witnesses, if they are available. Commissioner
12 Balch?

13 COMMISSIONER BALCH: Mr. Brooks.

14 MADAM CHAIR: I need to remind you, you are still
15 under oath.

16 MR. BROOKS: I am so admonished. I had a court
17 reporter who used to say that he was waiting all the time for
18 a witness, when the judge gave him that admonition, to say,
19 "Darn, I thought I could lie now."

20 DAVID BROOKS

21 (Previously sworn, testified as follows:)

22 EXAMINATION

23 BY COMMISSIONER BALCH:

24 COMMISSIONER BALCH: In regards to 19.15.16.7E --

25 MR. BROOKS: 16.7E?

1 COMMISSIONER BALCH: 7E.

2 MR. BROOKS: Yes, sir.

3 COMMISSIONER BALCH: I'm wondering if designating
4 the well with several multilaterals would impact current
5 regulations regarding multiple completions in a wellbore or
6 impact commingling. I understand that there would probably
7 be different production tubulars for laterals, but there
8 still could be a surface measurement or mixing issues.

9 MR. BROOKS: Madam Chair, Commissioner Balch, I'm
10 not -- I have no expertise as a drilling engineer, and I have
11 only limited understanding of what goes on downhole, so I
12 don't know that I'm the appropriate person to rely -- to
13 address that question to.

14 I do believe we have something somewhere in the rule
15 that I vaguely remember, but I don't remember where -- in our
16 rules that I remember, but I don't remember where it is that
17 states a -- something about a horizontal well or a
18 directional well will not be considered a dual completion,
19 but that's in some part of the rules that we did not change,
20 so I'm not really -- I can't even find it without the benefit
21 of what we have all become -- the crutch we have all come to
22 rely on in finding things in electronic searching, so I'm
23 sorry that I can't give a very adequate answer. Like you, I
24 assume that they -- that they are going to be producing
25 through different channels, or, if not, that they will apply

1 for downhole commingling under the Division's rules, they
2 would have to.

3 COMMISSIONER BALCH: Could I ask the same question
4 of Richard?

5 MADAM CHAIR: Sure. You can recall Mr. Ezeanyim, or
6 is that the only question?

7 COMMISSIONER BALCH: That's the only question.

8 MADAM CHAIR: Do you have any additional questions?

9 COMMISSIONER DAWSON: I don't have any questions.

10 MADAM CHAIR: I don't, either. You may be excused.
11 We would recall Mr. Ezeanyim, and you too are still under
12 oath.

13 RICHARD EZEANYIM

14 (Previously sworn, testified as follows:)

15 EXAMINATION

16 BY COMMISSIONER BALCH:

17 MR. EZEANYIM: Good morning.

18 COMMISSIONER BALCH: Good morning. My question
19 really was designating the single horizontal well with
20 multiple laterals -- I'm sorry -- designating a well with
21 multiple laterals or potentially multiple pools or formations
22 into a single well. Are there already existing rules to deal
23 with multiple provisions in the same well, or do we get into
24 problems with commingling?

25 MR. EZEANYIM: No. We routinely approve

1 commingling, downhole commingling, completions, so there are
2 no other rules that you adopted and we go with the current
3 rule, which, if you have -- for example, if I have a vertical
4 well, I use very different pools, you do downhole commingling
5 if you have to -- to go through the same wellbore, the same
6 wellbore. This does not apply to horizontal wells with
7 multiple laterals. Like I said yesterday, those multiple
8 laterals could go through different sources of supply, and if
9 an operator decides to do that, and they have to get -- apply
10 to the Commission for downhole commingling application.
11 Those are the rules. They are, you know, if you want to
12 produce different pools at the same time through a single
13 wellbore, you apply for downhole commingling. We do that.
14 Most of applications we get, they are the NSL, so we do
15 downhole commingling every day.

16 COMMISSIONER BALCH: Okay.

17 MR. EZEANYIM: Because there is multiple laterals
18 and they go into different pools, and why the operator may
19 want to do it in one swoop, it might try to get different
20 sources of supply and the multiple laterals produce through
21 one wellbore, and that's what we saw yesterday, other than
22 multiple laterals, because it's one well. So the only -- the
23 only way to deal with this is to do the downhole commingling,
24 if you want to put it through the same pool.

25 Because most interest owners, if they -- while we do

1 downhole commingling is to make sure the product is not
 2 divided. I don't want my product to be divided. I want to
 3 downhole commingle. I don't want to do that. If you want to
 4 choose to downhole commingle, any product that you violated,
 5 the violate operator, and you know, as long as -- as all the
 6 interest owners agree to downhole commingling. So those are
 7 the criteria I would deal with multiple laterals.

8 COMMISSIONER BALCH: So you think the existing
 9 regulation already covers that -- that issue?

10 MR. EZEANYIM: Yeah.

11 COMMISSIONER BALCH: Thank you. No more questions.

12 MADAM CHAIR: Do you have any questions?

13 COMMISSIONER DAWSON: I have no questions.

14 MADAM CHAIR: You may be excused.

15 MS. GERHOLT: If I may interrupt, Madam Chair,
 16 before Mr. Ezeanyim is excused, I believe he can give
 17 Commissioner Balch the exact rule. May I ask that
 18 Mr. Ezeanyim?

19 MADAM CHAIR: Sure.

20 MS. GERHOLT: May I approach the witness?

21 MADAM CHAIR: Yes.

22 FURTHER REDIRECT EXAMINATION

23 BY MS. GERHOLT:

24 Q. Mr. Ezeanyim, I hand you what is 19.15.12 of the OCD
 25 rules. Do you recognize that?

1 A. Yes.

2 Q. If I could draw your attention to the underlined
3 portion, would you please read for the record what that
4 underlined portion is?

5 A. Okay. It says, "The combination commingling of
6 production before marketing with production from other pools
7 without Division approval is prohibited." That's -- that's
8 what I say, it's prohibited. Once that is prohibited, the
9 only way you can deal with anything is to ask for exception,
10 and then with the -- with the engineers we have -- we have to
11 conduct a lot tests before we give you that exception. Like
12 I mentioned in my original answer is the way you apply for a
13 downhole commingling application, we have to look at the --
14 we are talking about gas. We look at the BTUs, the energy
15 content of the BTUs. If my gas is going to sell, for
16 example, \$5 an MCF, and yours are going to sell for \$2 an
17 MCF, I don't want that to commingle. And that is making sure
18 we do public notification when the operator wants to do that,
19 and if there is no objection, based on what I'm trying to
20 say, then they can apply. That's not enough. Then we look
21 at engineers and look at what are the -- is this really wise
22 to commingle these two pools without waste? At that point
23 that's really our job, to make sure there is no waste. Once
24 we determine there is no waste and there is no objection from
25 the interest owners, we approve the commingling application.

1 And then, if not, we -- we deny it. Or if somebody is
2 objecting, we will go to hearing, and then, you know, conduct
3 the hearing to determine what we should do next, if there is
4 no objection. We can also deny them on the technical
5 background. So that's the -- so that's the existing rule,
6 like I said.

7 MS. GERHOLT: Thank you. No further questions.

8 MADAM CHAIR: You may be excused.

9 MR. EZEANYIM: Thank you.

10 MADAM CHAIR: Mr. Fort, would you like to call your
11 witness?

12 MR. FORT: Yes, I would. I would like to call
13 Harvey E. Yates, Junior.

14 (Witness sworn.)

15 HARVEY E. YATES, JR.

16 (Sworn, testified as follows:)

17 DIRECT EXAMINATION

18 BY MR. FORT:

19 Q. Would you please state your name?

20 A. Harvey E. Yates, Junior.

21 Q. Okay. Who are you employed by?

22 A. Jalapeno Corporation.

23 Q. What is your position with them?

24 A. I'm the president.

25 Q. What's your educational background?

1 A. I graduated from the University of Texas with a BA
2 degree, though I spent most of my time studying geology, and
3 then was in the oil industry, but I decided to go to law
4 school. Went to Cornell Law School, graduated there with a
5 JD. Came back to New Mexico and have essentially been in the
6 oil business since.

7 Q. Okay. And how long have you been in the oil and gas
8 business?

9 A. Well, extracting legal education time, probably 45
10 years or so.

11 Q. Okay. And what phase of the oil and gas industry
12 have you primarily been in those 45 years?

13 A. I started as a tool dresser on a cable tool rig, I
14 roughnecked. I worked on pulling units. I have been -- been
15 landman, done legal work on oil and gas matters. I have done
16 my own engineering, my own geology and so forth, so all parts
17 of the business.

18 Q. So are you primarily in exploration and
19 production?

20 A. Yes, we're Wildcatters, primarily.

21 Q. Okay. Were you licensed to practice law here in New
22 Mexico?

23 A. Yes.

24 Q. How long were you licensed to practice?

25 A. From -- well, I retired two or three years ago, but

1 from, I think, 74.

2 Q. Okay. And have you ever published any articles?

3 A. Yes. I wrote and published an article in a law
4 journal, a Latin American law journal which dealt with the
5 comparison of expropriation in Latin America and condemnation
6 in this country.

7 Q. Okay. I have given you a copy of a document that's
8 entitled, your "Testimony Before the Commission." Obviously
9 today is the 21st. Do you recognize this?

10 A. Yes, I do.

11 Q. Okay. And how do you recognize it?

12 A. I prepared it.

13 Q. You prepared that document. Did you prepare that
14 document for your testimony today?

15 A. Yes, I did.

16 Q. Does that document include the three recommended
17 modifications that we put in the notice of recommended
18 modifications that Jalapeno filed in this case?

19 A. Yes, it does.

20 Q. Is that what you are prepared to discuss today?

21 A. Yes.

22 Q. What's your experience with forced pooling in New
23 Mexico?

24 A. Well, that -- at one time I thought I had the forced
25 pooling record as a forced pooler, but all of that experience

1 had to do with proration units as we had always understood
2 them. I subsequently have been not the forced pooler but the
3 forced poolee once horizontal drilling started.

4 For instance, Mr. Scott, yesterday testified, and I
5 was with Mr. Scott, I was a non-operator under the operating
6 agreement there as well, but I have --

7 Q. Well, was this --

8 A. Pardon me.

9 Q. Was this in the south half of that section that he
10 talked about?

11 A. Yes.

12 Q. That they -- he said he lost before the OCD, and
13 then the decision was overturned by the OCC?

14 A. Yes, later.

15 Q. Okay.

16 A. I have been involved in other comparable
17 circumstances.

18 Q. With horizontal drilling?

19 A. Yes.

20 Q. Okay. So would you say that you have been involved
21 with forced pooling, at least the vertical -- or I should say
22 the spacing units for vertical wells? So that --

23 A. Yes.

24 Q. -- so that you are very familiar with the forced
25 pooling rules here in New Mexico?

1 A. I have -- yes, I think I am.

2 Q. Do you want to tell me a little bit about what you
3 know the purpose of forced pooling is in New Mexico?

4 A. Well, I would like to start with this: I appreciate
5 the Commission allowing us to go into the forced pooling
6 matters because the greatest abuse of forced pooling has to
7 do with horizontal drilling, and the Commission is -- the
8 Division is attempting to -- has included language which, to
9 me, would put the Commission's stamp of approval on what's
10 going on, and so I appreciate being able to talk about that.

11 But I do not want you to construe that we oppose the
12 horizontal drilling. I think that the technical things that
13 were talked about yesterday, such as correcting for location,
14 where a location of a well can be, the offsets and so forth,
15 the laterals, are all necessary and we strongly support that.
16 We just simply think that we cannot overstep -- and as I go
17 through this, I will explain to you why I think you have
18 approached, if you pass this without dealing with the
19 compulsory pooling, that you will have overstepped the bounds
20 from using your police power to taking.

21 And so because later I am going to suggest to you
22 that in certain circumstances the original purpose of the
23 forced pooling will be stood on its head, I want to go
24 through with you the original purposes of the forced pooling
25 historically.

1 Originally everyone has seen probably photographs of
2 Signal Hill and other places like that where you had
3 multiple -- where people were drilling on acre lots, and that
4 was because of the rule of capture. You got down there, you
5 got the hydrocarbons, you suck them out before your neighbor
6 got to them, and so in places like Oklahoma, Texas, and other
7 places, you had multiple rigs and pump jacks and so forth
8 within a very small area.

9 In Kansas this went on and actually the forced
10 pooling, the spacing unit rules, which were necessary to
11 avoid this practice, which obviously was wasteful and could
12 be seen as wasteful by everybody there, were instituted in a
13 couple of communities in Kansas. And the force of the first
14 spacing units were, I think, was 90,000 acres, which, by my
15 calculation, would be a little over two acres, maybe two and
16 a half acres, but it -- things went on from there, and the
17 states of Oklahoma and New Mexico, I believe, established
18 spacing in about 1935, and with that, or shortly therefore,
19 the forced pooling.

20 The idea was that if people were not going to be
21 able to drill on their own land within an area, that there
22 had -- that the -- the state -- the states of Texas and
23 Oklahoma -- New Mexico and Oklahoma, for instance, had
24 prohibited people from drilling unless they could assemble a
25 specified number of acres, say 40 acres in the state of New

1 Mexico for drilling an oil well.

2 And so people complained that, well, I have land
3 there, and I can't drill, and I have tried to assemble the
4 land, get people to agree, but there are obstinate people
5 here, and we can't get it done. So in order -- you are
6 denying me the right to access the oil and gas under my
7 property, and so there needs to be some way to access it.

8 So forced pooling came into existence, and so it
9 was -- it came in hand in hand, so to speak, with spacing
10 requirements. Well, it's sometimes suggested here that -- I
11 have heard it suggested or implied that the capacity of the
12 state to adequately produce its reserves is tied to forced
13 pooling, and I want to point out that there are some states
14 that did not, though they established spacing, they did not
15 go to the second step, which was to establish forced pooling.

16 I think Kansas is one of those, though it -- which
17 is odd because I think this movement started in Kansas or the
18 spacing started in Kansas, but another was, essentially,
19 Texas. Now, Texas, as I'm going to discuss later, had
20 established spacing, but they have essentially not used
21 forced pooling. And I gave you -- I think attached to the
22 back of this is a graph showing the gas that New Mexico
23 mostly -- there is a graph attached --

24 Q. Yes. Yes.

25 A. -- a graph showing the production in the state of

1 Texas, and the production in the state of New Mexico, and you
2 will note that the production in the state of New Mexico has
3 declined, and in the state of Texas the opposite has
4 happened. Well, in the state of New Mexico the story, of
5 course, goes beyond that, and at some future hearing we will
6 get into part of the reason for that. But the point I'm
7 making here is that the availability of forced pooling in the
8 state of New Mexico has not solved the problem, has not
9 allowed New Mexico to produce more, to access its reserves
10 more readily than Texas. Do not think I do not support
11 forced pooling. I do support forced pooling as long as it's
12 limited to its intended purpose.

13 Now, it's my understanding that the Commission, or
14 the Division -- pardon me -- is attempting to superimpose
15 project areas over proration units. And while I support the
16 notion of creating project areas so you can see what is going
17 on, and I support the notion that horizontal -- they ought to
18 be able to -- we ought to be able to drill horizontally in
19 project areas and so forth, I think the Commission, without a
20 legislative change, has a great problem, because, it seems to
21 me that you have proration units which have been established
22 by the Commission, and under the law, they have established a
23 proration unit for each pool such being the area that can
24 efficiently and economically drain and develop by one well.

25 So people have gone out and they have drilled, under

1 those rules, a well or more if allowed by the Commission in
2 order to exploit those reserves under there, and that's a
3 proration unit. And you are attempting -- you would be
4 superimposing over that another proration unit, so to speak,
5 and I am particularly troubled, and will go into a
6 circumstance where there is a vertical well, and then it's
7 invaded by another proration unit, so to speak, in unlimited
8 number, as we learned yesterday. So that creates a problem.

9 And consequently, it -- the problem, in my view,
10 arises because you can have a well that you drill, and yet --
11 and that well, having -- may have been drilled as a
12 consequence even using forced pooling on a spacing unit, and
13 yet, forced pooling can be taken here to extract the rights,
14 the property rights there. I find that extremely troubling,
15 and, consequently, the -- we -- you have language at 19 --
16 or -- pardon me -- the Division has language -- suggested
17 language, 19.15.16.15A(2), which states, "Obtain a compulsory
18 pooling order from the Division," we request that the
19 following be added: "which shall not be available outside a
20 single proration unit which would be required for a vertical
21 well drilled to the intended productive horizon at the same
22 location."

23 In other words, we are recommending that the forced
24 pooling part of this be limited to the circumstances that
25 exist today, where, if you are going to -- if you are going

1 to start your horizontal well, you would -- you could use
2 forced pooling there and you could extend beyond that, but it
3 would be by agreement with the folks who own the land beyond
4 that. You would not be able to use forced pooling all the
5 way.

6 Now, our recommendation is that -- is because there
7 is certain protections there, for instance, in order to
8 utilize forced pooling in a proration unit, you've got to own
9 part of the acreage; you can't just invade it. And if there
10 is a pre-existing operating agreement there, we learned
11 yesterday that the Commission will not or the Division will
12 not allow a forced pooling of an area where there is already
13 an operating agreement for where you are going to start a
14 well.

15 Now, at this point, I would like to point out that
16 the industry has been quite adept at negotiating very
17 complicated agreements. I personally have been involved in
18 putting together two large federal units over the years.
19 Everyone here is aware -- knows about the Big Eddy Unit which
20 covers lots and lots of areas -- lots and lots of area. What
21 has happened is that because of the easy availability of
22 forced pooling, negotiations have been affected, the capacity
23 to negotiate, because these forced pooling rules set a limit.
24 They set the terms of negotiations out there, but I will go
25 into that a little later.

1 I'd like to use this and talk a little bit about
2 some things that we learned yesterday. We learned this --
3 this is a vertical cross-section of this Unit C, if you don't
4 mind here. And this is a well on Unit C, and this well may
5 have been drilled -- it's drilled under an operating
6 agreement. Here is the well, and it may have been drilled
7 by -- by utilizing an earlier forced pooling, for instance,
8 if someone who owned part of that -- I'm going to use 40-acre
9 block -- was not willing, then that -- then forced pooling
10 earlier may have been utilized.

11 We learned that if there is an operating agreement
12 here, then this cannot be invaded by additional forced pool
13 wells drilled here. But what we learned yesterday is that,
14 under the proposed rules, an unlimited number of horizontal
15 wells could be drilled seeking the pool for which that well
16 was drilled.

17 Now, we also learned that if this well right here
18 was drilled and was producing less than the allowable before
19 and -- before this new act, proposed act was drilled, that
20 the operator and the people operating could come in and drill
21 up to three additional wells, seeking to reach the allowable
22 on this area right here. But we also learned that if this
23 act goes through -- and I believe I quote Mr. Brooks
24 correctly -- that these wells could not -- let's assume,
25 rotate this for me, here are the horizontal wells drilling

1 into this, that these additional wells could not be drilled
2 seeking this pool without the permission of the majority --
3 or without the permission of these folks, and I'm not sure
4 whether it's the majority or all of them.

5 So two things have happened -- would have happened.
6 This, the reserves would have been assaulted and you would
7 have taken away the right to further exploit those without
8 the permission of these folks, and if this has happened
9 through forced pooling, then this operator and these folks
10 are going to an adversarial party, seeking permission to
11 drill additional wells on a proration unit that was
12 established under the rules of this Commission. I find that
13 quite troublesome -- troubling.

14 Now, the basis for -- there were attacks early on on
15 forced pooling, and I'm speaking, of course, of attacks on
16 the right of the state to tell someone in a proration area
17 that another person could drill wells in that proration unit
18 and maybe even on its own acreage without his permission, and
19 it was found that the state had the power to do that under
20 the police power of the state in order to avoid waste and
21 protect correlative rights.

22 Now, one can easily see the waste inherent in
23 multiple drilling rigs on a spacing unit like in the Kansas
24 example that I gave. Now, the state of New Mexico has
25 adopted, perhaps, the most friendly compulsory pooling rules

1 in the nation, though someone might argue otherwise, but we
2 believe that it verges on crossing the line between the
3 proper use of its police powers into a breach of Fifth
4 Amendment Rights of people, that is condemnation. And I want
5 to go through that using an example back here.

6 This person right here, assume that there is one
7 well that has -- and these are examples that are -- have been
8 before the Division or on their way to the Division right
9 now. There -- if a horizontal well is drilled into that pool
10 where there is either behind-the-pipe reserves or actually
11 producing reserves, then what is being done is the property
12 of the people right here is being taken, and there are a
13 number of problems with it.

14 In the first place, it has the risk of standing the
15 original purpose of the rules on their heads. For instance,
16 yesterday we learned that -- that an unlimited number of
17 horizontal wells can be drilled here. Is this an underground
18 Signal Hill, would be one question.

19 And consider -- consider this: Let's say the state
20 of New Mexico wanted to establish a state oil company --
21 follow Lybia's example -- wanted to establish a state oil
22 company. If the state itself sought to do this where there
23 is an established proration unit, established rights here,
24 what would the state of New Mexico have to do?

25 First off, it would approach the matter -- have to

1 approach the matter under a condemnation. It would have to
2 show that this is being done for public use. It would have
3 to utilize due process. It would have to negotiate in good
4 faith. It would have to pay just compensation. There would
5 have to be an appraisal of the value of this, and a Court
6 would review all of these matters.

7 Now, in 2005 there was a case called Kelo versus New
8 London, and everyone here has probably heard of that case,
9 and it's remarkable how close that approaches this
10 circumstance. Let's say that New Mexico -- New Mexico wanted
11 to take these rights and give them to a better, larger
12 developer, which is essentially what's going on here. The
13 waste -- when you talk about -- there was testimony related
14 to protecting correlative rights and protecting waste, in
15 fact, what is the waste here?

16 This operator, is the waste that the operator is not
17 producing these -- this production fast enough to suit you?
18 What is the waste? Take the example of a building, a little
19 building, wherever, commercial building somewhere, can the
20 state go in and say, "Well, you know, that's not being run
21 efficiently enough. If you had a better building, it would
22 be better for the state." I mean that's the -- "And we can
23 use our police power to do that."

24 Under Kelo, the Supreme Court decided that public --
25 they expanded the meaning, whether they will admit it or not,

1 of the word "public use." And they decided that it was a
2 legitimate public use under the Fifth Amendment to take from
3 one individual and give into the state, and then for the
4 state to transfer that property to a developer.

5 Well, I suggest to you that what is going on in this
6 circumstance right here is that many things are being
7 avoided, though its essentially the same thing. This is
8 being done without the same due process. It is being done
9 without an appraisal. It is being done without the
10 necessary -- necessity of paying just compensation, and it's
11 being done without the same judicial review.

12 Our view is that if you allow compulsory pooling in
13 this circumstance to facilitate horizontal drilling into
14 previously established proration units, you will have crossed
15 the line from legitimate use of your police power.

16 Now, I would be the first -- I've read many
17 condemnation cases, and I've also read forced pooling cases,
18 I would be the first to say that the courts have generally
19 upheld the state's authority to use police power, but the
20 reasoning of those courts has often been very sloppy,
21 amounting to something like this: "It's okay because all
22 private property is subject to the state's police power."

23 Now, think about that, and think about how long that
24 will stand up. All private property subject to -- that's a
25 statement out of a recent, relatively recent -- the recent

1 North Dakota case. All private property -- of course it is.
2 Police can chase a criminal into that property -- into your
3 property. They can go get you on your property. They can
4 keep you from issuing -- emitting toxic substances out of
5 your private property and so forth.

6 So, in that sense, of course it is, but does that
7 mean that the state can use its police power going into
8 somebody's property and saying, "This property isn't being
9 used effectively enough. We are going to see it is
10 transferred over here."

11 That is a massive extension of police power, and if
12 you're going to do that, you at least ought to go through the
13 condemnation process because there would have been
14 constitutional protections.

15 Now, there are other related problems. Waste will
16 be created, not diminished, in my view. There is already a
17 borehole there. It is already producing. And what happens
18 to that borehole? Now, there's been -- there have been
19 suggestions that everything will be just fine because these
20 folks will have their prorata share, having been forced into
21 this.

22 Well, I can give you examples. You heard Mr. Scott
23 yesterday. His example wasn't this, though there are
24 examples of exactly this. But the borehole is here. It is
25 producing, and let's -- let's assume for a minute -- and this

1 is -- this is an example. We can find real-life examples of
2 this. There are wells here, and these wells historically
3 have produced 100,000 barrels. And so this new well is
4 drilled pursuant to your approach, the Commission-approved
5 proration unit, and the expected production from it is
6 100,000 barrels, but it is invaded by an infinite number of
7 horizontal wells. Now, who -- and this is done through
8 forced pooling.

9 And let's say this well gets 10,000 barrels and then
10 jumps the borehole. For you to say that there -- or for the
11 Division to say that there would not be waste and that
12 these -- these private property rights weren't taken, it
13 would require them saying that these folks are going to get
14 the same amount without expenditure that they were producing
15 in the first place.

16 Well, they would be, in the state of New Mexico, as
17 it stands right now, face paying out of their reserves their
18 prorata share of the reserves, 100 percent of the cost of
19 this well prorata, plus 200 percent penalty. Do you really
20 think -- does anyone really think that their correlative
21 rights are protected? There are -- so I thought it -- at the
22 end of all testimony of someone involved, the lawyers very
23 efficiently asked a roped question, is waste -- is this
24 preventing waste, is it protecting correlative rights, and
25 the answer is always yes. I don't see how that's possible.

1 Let's assume another example. I have a small oil
2 company. What we do is drill wells, and I'm joined by a
3 number of other small oil companies. They are not the
4 industry people who have been behind this, necessarily. They
5 take that parcel to a bank in order to go on and drill the
6 next well. And the bank looks at those reserves and the
7 value of them. This, if this is allowed -- and they loan on
8 those reserves -- if this is allowed, it's going to upset
9 such banking arrangements for operators.

10 But I also want to point out that the New Mexico
11 Constitution prohibits the impairment of contracts, and
12 that's exactly what this will do. How does the bank decide
13 on a lending value? Well, an engineer will go in here and he
14 will decide how rapidly out of this well these reserves will
15 be produced. Now, he will -- and he will look at the
16 joint -- at the proration unit within the joint operating
17 area. Now, he will take into consideration a well -- wells
18 that may be drilled outside the proration unit which he
19 thinks are draining, and he will give an estimate to the bank
20 as to the value of those reserves.

21 What will he not in this contractual relationship
22 between the producer and the bank, what will the reserve
23 engineer not have considered, he would not have considered
24 the invasion of an infinite number of other wells coming in
25 horizontally into those reserves. Consequently we believe

1 that if this is done, that there will have been -- the state
2 of New Mexico will have impaired contracts.

3 Hence, as to the Division's suggested language at
4 19.15.f6.15G(4), we request that the following language be
5 added: "Nor may a project area be extended to include
6 acreage dedicated to an existing operating agreement without
7 the consent of that portion of the parties to the operating
8 agreement which is required under the operating agreement to
9 change the terms of the operating agreement."

10 Now, the benefit of that is that a banker -- people
11 have been operating on this operating agreement, and so --
12 but the banker and the operator and all the non-operators
13 understand that that operating agreement might be changed
14 because it's right there in front of them. They can take a
15 look at it.

16 And I -- yesterday I became concerned about this one
17 individual rule, and my understanding is that the horizontal
18 wells could be drilled either pursuant to forced pooling, to
19 which we are objecting today in this circumstance, or if a
20 single individual.

21 So if there is a one percent interest in the
22 operating agreement area that says, "Okay, you can come on,"
23 that will become a very valuable one percent interest because
24 the -- I hate to call them exprocreators, but the developers
25 relying on forced pooling will come in and price that one

1 percent very high in order to be able to invade that property
2 without forced pooling.

3 Now, there are a number of problems with the forced
4 pooling. The state -- Gabrielle suggested yesterday that the
5 OCD rules require -- I think is what you said. Please
6 correct me if I'm wrong -- that there be a 200 percent
7 penalty imposed. I'm just asking you as to what you said.
8 I'm not sure I'm at liberty to ask questions.

9 MADAM CHAIR: That's what I'm debating. That's why
10 I was looking over to the Commission.

11 A. Let me go on then. That's what I understood her to
12 say. The statute itself says the charge per risk shall not
13 exceed 200 percent, which implies that the Division is to
14 make a decision as to risk. Now, my experience is that years
15 ago, and by that I mean in the 70s, 80s and so forth, that
16 there would be a 100 percent risk assessment for development
17 wells and a 200 percent risk assessment for wildcat wells.
18 Now, I want to point out to you that, first off, if it is
19 true, as I believe it to be, that the Division is constantly
20 assessing a 200 percent penalty for a risk, that is a
21 remarkable thing. That means that everywhere the risk is
22 essentially the same, or that the risk is at least 200
23 percent or more.

24 Now, I think that if the Division is doing that, it
25 is overcompensating drillers, and to the disadvantage -- it

1 is actually taking from those who are forced pooled because
2 the notion of this risk -- of this risk is that, well, the
3 party will eventually come back in -- the party will
4 eventually own his interest, that is, the party who is forced
5 pooled, but, in the meantime, the party who drills has to
6 have his money back for drilling, and he needs to have a risk
7 assessment which is generally considered to be geologic risk.

8 The extent to which that risk is expanded takes from
9 the party who has been taken from. And the law states that
10 the Commission shall afford to the owner or owners of each
11 tract or interest in the unit the opportunity to recover or
12 receive without unnecessary expense his just and fair share
13 of the oil and gas below. So if the risk penalty is beyond
14 what the risk actually is, then the Division or Commission
15 has breached that provision of the law.

16 Now, the -- I want to point to, in my statement
17 earlier I said that the state of Texas has almost never used
18 forced pooling. It has used forced pooling. Let me give you
19 the history of it. In 1965 it passed an act related to
20 forced pooling. It related to also the capacity of people
21 who were left out of a spacing unit to use the act to bring
22 themselves in it, and that was its primary purpose. For
23 something like 43 years there had never been a forced pooling
24 in the state of Texas.

25 And finally, in 2008, a company applied for forced

1 pooling under these circumstances. They were drilling a
2 horizontal well under Ft. Worth, under a subdivision in Ft.
3 Worth, and to look at the diagram of that, it looked like
4 there were 100, 150 houses out there. So the driller had to
5 get a lease or some kind of agreement from all of those
6 people, and it was successful in doing that for all but five,
7 that is by voluntary action, successful for doing that for
8 all but five. And so they used forced pooling as against the
9 remaining five. And the Railroad Commission decided that it
10 was appropriate that they use forced pooling, and the
11 Railroad Commission awarded the driller his cost prorated out
12 of their interest, prorated the cost of drilling the well.

13 Then it came to risk assessment, and the Commission
14 decided that in drilling the Barnett Shale, there was zero
15 risk and allocated a zero geologic risk.

16 So should I say, "Oh, poor New Mexico, so far from
17 Texas," we assess here constantly a 200 percent risk. I
18 would like the Commission also to note that horizontal wells
19 are often drilled into what are called source plays. That
20 was addressed yesterday by one of the individuals. Wonderful
21 advance, and, in fact, the increase in gas production for the
22 nation as you see on this -- pardon me -- on this graph right
23 here has to do with horizontal drilling into shale,
24 primarily.

25 And what has happened in many places, New Mexico

1 would be an example -- New Mexico did not participate in
2 this, incidentally, for reasons unrelated to this -- but the
3 shale zones have been penetrated over and over and over, and,
4 consequently, the thickness of those shale zones, the nature
5 of those shale zones and so forth can be -- shale zones, we
6 have always known, were source rock, but they were a vein of
7 the industry for years because you would drill through them,
8 and if you used fresh water to drill through them and so
9 forth, you would often get your pipes stuck, you would have
10 caving and so on and so forth, but drilling through from time
11 to time there were shows.

12 Well, now they have been able to come back and
13 horizontally drill that, and you're not going to be able to
14 obtain the same, generally, the same production by drilling a
15 series of vertical wells; you are going to have to drill them
16 horizontally, and that has been shown. But my point is that
17 the geologic risk is generally -- this is not wildcat -- the
18 geologic risk is generally much, much less because of the
19 earlier information.

20 Consequently -- and because we think that this
21 200 -- automatic 200 percent business is effectively a taking
22 from those who are forced pooled, we suggest this: During a
23 compulsory pooling hearing, involve the addition -- and this
24 would be in addition to 19.15.16.15F, during a compulsory
25 pooling hearing involving a horizontal well, the Division is

1 instructed to examine closely the actual geologic risk being
2 taken by the driller considering earlier penetrations of the
3 zone being targeted by the driller in the area in which the
4 driller proposes to drill and to reduce the compensation to
5 the driller for the risk taken to 50 percent. Now, maybe it
6 should be closer to zero, I don't know, but where that more
7 closely rewards the driller for the anticipated geologic risk
8 for the endeavor.

9 Lastly, I would like to ask whether compulsory
10 pooling is too easy. Mr. Scott suggested yesterday one thing
11 that I would like to affirm and accentuate. There are
12 companies that seem to have moved into the state and utilize
13 forced pooling as a means of gathering leases. They don't go
14 to a state land sale, necessarily, and they don't go to a
15 federal land sale, they don't go negotiate, they use forced
16 pooling, and negotiations are often not conducted in good
17 faith, though I know that that is, as in condemnation
18 hearings, that is supposed to be part of the deal, but it is
19 often not what happens.

20 The attitude of developers has become, well -- of
21 some developers -- "If you do not take the deal I've offered,
22 we will force pool you." That is because the advantages of
23 forced pooling have been so great, and they set the limits of
24 the contracts that can be negotiated in this state.

25 I want to give you an example here as related to

1 good faith. Here is a time line of one deal that -- where we
2 were forced pooled. Drilling proposal letter came in July
3 the 8th. Proposal of the joint -- the proposed joint
4 operating agreement came in July the 17th. Revised operating
5 agreement with correct interest figures came in July the
6 25th. Forced pooling application July the 28th.

7 The purpose of forced pooling is, as I explained
8 earlier, it is to prevent waste. It is not to make life
9 easier for these developers, and it is not to contort the
10 relationship between the developer and landowner or to
11 devalue the land or lease ownership.

12 Now, I want to point -- there were a number of folks
13 who talked about the industry, yesterday, industry did this,
14 industry did that. The industry that you are listening to or
15 hearing from primarily are companies that are probably
16 billion dollar companies. The people who aren't here are the
17 small land owners, small operators, or the farmer who may
18 know nothing about this, but subsequently will have forced
19 pooling used against him if this problem isn't solved.

20 I appreciate greatly the opportunity to testify
21 here.

22 Q. Mr. Yates, the document that I handed to you
23 entitled, "Testimony of Harvey E. Yates, Junior, before the
24 Commission," does say, "October 20, 2011," is this, based on
25 your testimony today, this is the narrative of your

1 testimony?

2 A. Yes, generally.

3 MR. FORT: I would move for the admission of the
4 exhibit entitled, "Testimony of Harvey E. Yates, Jr. Before
5 the Commission, October 20, 2011."

6 MADAM CHAIR: Are there objections?

7 MS. GERHOLT: No objection.

8 MR. CARR: No objection.

9 Q. Mr. Yates, since you used this board, and you've
10 used it based on what you have heard in the hearing
11 yesterday, would you mark -- and I need to ask you a couple
12 of questions about this, because there were some drawings up
13 here before. Did you prepare all of these?

14 A. Yes, I did.

15 Q. So this subdivision you laid out behind this and
16 that you had shown the vertical and horizontal wells in this
17 little graphic up here at the top, is that correct?

18 A. That's correct.

19 Q. So you prepared this today based on what you learned
20 yesterday?

21 A. Yes.

22 Q. Would you mark this, "Harvey E." -- you can put your
23 initials and put Exhibit 2.

24 (Exhibit HY 2 marked.)

25 Q. And this is -- you used this to illustrate to the

1 Commission what you observed and how this interplays, and you
2 are looking at -- the two issues are, as I understand it, how
3 this, in terms of does not prevent waste, and how it does
4 impair the correlative rights of those who exist in the
5 proration unit.

6 A. That's correct.

7 MR. FORT: I would move for admission of Harvey E.
8 Yates Exhibit Number 2.

9 MADAM CHAIR: Are there any objections?

10 MS. GERHOLT: No objection.

11 MADAM CHAIR: I would like to make a statement that
12 all of the exhibits that have been introduced and accepted,
13 we will accept Mr. Yates' exhibits as we did others.

14 However, OCD Rule 19.15.3.11A(2) requires attachments of all
15 exhibits that are to be offered at the hearing, to be
16 attached to the prehearing statements. This was ignored by
17 quite a few of the attorneys and the witnesses in this case.

18 I would like to make a statement now that we will
19 not allow this rule to be challenged except for extraordinary
20 cases for any further hearings before this Commission.

21 Because we accepted the others that came late, we will accept
22 Mr. Yates' exhibits, but this practice needs to stop here now
23 and observance of OCD Rule 19.15.3.11A(2) needs to be
24 observed for Commission hearings. With that said, are
25 there --

1 (Exhibits Yates 1 and 2 admitted.)

2 MR. FORT: I pass the witness.

3 MADAM CHAIR: You pass the witness. Are there any
4 questions?

5 MS. GERHOLT: I have just a couple of brief
6 questions for Mr. Yates.

7 CROSS-EXAMINATION

8 BY MS. GERHOLT:

9 Q. Good morning, Mr. Yates.

10 A. Good morning.

11 Q. You spoke on direct examination about risk
12 allocation, did you not?

13 A. Yes, I did.

14 Q. You are aware that the Oil Conservation Division has
15 a rule, 19.15.13, compulsory pooling, does it not?

16 A. Could I see that?

17 Q. You may.

18 A. You are talking about the Division or the
19 Commission?

20 Q. The Division has a rule, 19.15.13, compulsory
21 pooling.

22 A. Yes.

23 Q. And that rule sets forth that there is a rebuttable
24 presumption that a 200 percent is the risk allocation. And I
25 would draw your attention specifically to point E(8), that's

1 the general rule which has been underlined for you, sir, in
2 that first page, is 200 percent.

3 A. Unless otherwise ordered pursuant to subdivision,
4 the charge of risk is 200 percent. Is that what you are
5 talking about?

6 Q. Yes, sir. And that D is an exception to that risk
7 allocation, correct?

8 A. You are saying D?

9 Q. If you will read --

10 A. Oh, yeah. Unless -- yes, uh-huh.

11 Q. And D is the exception?

12 MS. GERHOLT: May I approach the witness?

13 A. Sure.

14 MS. GERHOLT: Thank you, Madam Chair.

15 MADAM CHAIR: I get to say that, Mr. Yates.

16 Q. Mr. Yates, I have now handed you what was marked
17 Exhibit 1B. That is the notice of rulemaking. Have you seen
18 that notice previously?

19 A. I likely have.

20 Q. Would you please read the underlined -- and this
21 rulemaking notice were for changes in Title 19, Chapter 15,
22 of the New Mexico Administrative Code, Parts 14 and 16, does
23 it not?

24 A. Yes.

25 MS. GERHOLT: I have no further questions.

1 MADAM CHAIR: Mr. Feldewert?

2 MR. FELDEWERT: Yes, if it please the Commission, I
3 have a couple of questions.

4 CROSS-EXAMINATION

5 BY MR. FELDEWERT:

6 Q. Mr. Yates, if I'm understanding what you have said
7 prior to your start of your discussion, you don't disagree
8 that, generally, horizontal drilling is more efficient than
9 vertical drilling?

10 A. I do disagree with that. I think it depends on the
11 particular zone. There are some zones where horizontal
12 drilling would be ineffective, and that's been shown in --
13 that's true in Texas, and that would be true in New Mexico.

14 Q. So that you at least acknowledge that there are some
15 zones in which horizontal drilling are more efficient than
16 vertical?

17 A. Yes. I have given examples such as the shale.

18 Q. So in that case horizontal drilling would recover
19 more reserves and thereby prevent waste, correct?

20 A. Generally, yes.

21 Q. Be good for the producers and good for the state?

22 A. Generally, yes.

23 Q. Okay. Has --

24 A. In terms of waste, you have to look at the
25 particular example, for instance, I could --

1 Q. Agreed.

2 A. -- imagine someone who had drilled into a shale zone
3 and encountered natural fractures and be producing that shale
4 zone from a proration unit approved by this unit, and, in
5 that circumstance, I dispute whether horizontal drilling is,
6 in that circumstance, necessary.

7 Q. I agree. I think we have already established there
8 are circumstances where horizontal drilling is more efficient
9 than vertical drilling. That was the --

10 A. I'm talking about the zone -- we are talking about
11 shale zones --

12 Q. Okay.

13 A. -- as well.

14 Q. Has Heyco drilled any horizontal wells?

15 A. I don't own any interest in Heyco.

16 Q. I'm sorry. Has Jalapeno drilled?

17 A. We have participated in. We have not been the
18 operator.

19 Q. Okay. But you agree that horizontal drilling makes
20 sense in certain circumstances?

21 A. Yes.

22 Q. Okay. Now, if I'm understanding your amendments,
23 and I'm looking in particular at the amendment to 16.15A(2),
24 which currently indicates on the draft of the rule that a
25 party could obtain a compulsory pooling order from the

1 Division in the appropriate circumstance, you are proposing
2 an amendment which would limit that or essentially would say,
3 "Which shall not be available outside a single proration unit
4 which would be required for a vertical well drilled to the
5 intended productive horizon at the same location." That's
6 the language you are proposing to add?

7 A. Yes, I would like to -- in the same way that
8 yesterday a witness -- and I would like to suggest that
9 really what we are intending --

10 Q. Let me stop you right there.

11 MR. FORT: Let him finish.

12 Q. I can only go by the language that you have
13 proposed. If I look at that language, essentially what you
14 are saying here is that the Commission should not be allowed
15 to compulsory pool outside of a standard spacing unit, right?

16 A. That's right.

17 Q. That's what you're proposing?

18 A. That's right.

19 Q. So if it's 40-acre oil, you would have to stay
20 within a 40-acre spacing unit if you couldn't reach an
21 agreement would your adjacent landowners?

22 A. Yes, you would have to use negotiations, rather than
23 police power of the state.

24 Q. And if you couldn't reach an agreement, you wouldn't
25 be able to drill a horizontal well, correct?

1 A. Well, you may or may not, depending on the
2 circumstances.

3 Q. But under your language you couldn't --

4 A. You could not --

5 Q. -- come to the Commission?

6 A. You could not use forced pooling to do that.

7 Q. And if you had 80-acre spacing and you couldn't
8 reach an agreement with an adjacent landowner, you wouldn't
9 be able to drill a horizontal beyond the 80-acre spacing?

10 A. That's true.

11 Q. So essentially you're proposing a scenario where
12 your adjacent landowner could effectively prevent horizontal
13 drilling by refusing to reach an agreement?

14 A. That is true, if negotiations fail. That's the same
15 circumstances in Texas.

16 Q. You want then the Commission to say here now in this
17 forum that they are not going to allow compulsory pooling for
18 horizontal drilling outside of a spacing unit? That's a
19 decision you want them to make now, correct?

20 A. That is correct.

21 Q. Which would be a change in policy, because currently
22 they do allow compulsory pooling in certain circumstances
23 outside of a spacing unit.

24 A. I think that --

25 Q. Correct?

1 A. That is -- that is correct, though I do think that
2 the view that what has been going on is probably contrary to
3 law.

4 Q. Okay. But there are differences of opinion on that.

5 A. (Nodding.)

6 Q. Now, another way they could do that is address your
7 issues, could they not, Mr. Yates, on a case-by-case basis as
8 they did in your particular matter?

9 A. Yes, they could. I was about a minute ago to
10 suggest another alternative, too.

11 Q. Well, let me get through mine, and you can come up
12 with yours.

13 A. Okay.

14 Q. So they could do it on a case-by-case basis as they
15 did in your circumstance, correct?

16 A. That is correct.

17 Q. They could also address all of your concerns about
18 compulsory pooling, the risk penalty, when it should be
19 apply, whether there should be additional good-faith
20 requirements, and they could do all of that under a proposal
21 to amend a compulsory pooling rule?

22 A. They could.

23 Q. We could tee it all up, provide notice, let
24 everybody come in and talk about all of your issues in that
25 circumstance, could we not?

1 A. Yes, we could.

2 Q. Also they could go, if you wanted to or anybody else
3 wanted to go seek a legislative change to clarify the
4 compulsory pooling power, we could do that as well?

5 A. That's right. Go to court.

6 Q. What's your fourth scenario?

7 A. That the Commission adopt what we have proposed here
8 pending change of the Commission rules to comply with the
9 law -- we go through circumstances where I believe they are
10 not complying with the law -- in order to make sure that the
11 compulsory pooling is not used in the offensive ways I have
12 suggested.

13 In other words, this could be -- the language we
14 have suggested could be put in, clearly pending those other
15 things, and consequently --

16 Q. All right. So we would have to go get some kind of
17 change in the law or some legislative change to accept your
18 language?

19 A. We would have to go through the forced pooling stuff
20 first.

21 Q. Okay. All right.

22 MR. FELDEWERT: That's all the questions I have.

23 MADAM CHAIR: Do we have any of the parties --

24 MADAM CHAIR: Commissioner Dawson?

25

EXAMINATION

1

2 BY COMMISSIONER DAWSON:

3

COMMISSIONER DAWSON: The one question I have, on
your scenario that you drew up on the map there, why couldn't
you just go in and drill your own acreage for another well --
with another well?

7

MR. YATES: You mean after the horizontal well?

8

COMMISSIONER DAWSON: No. I mean before that. When
they send you the letter, you go in non-consent and go in and
drill your own well there in there, vertical well.

11

MR. YATES: I'm not -- Commissioner, I'm not sure
that will, in fact -- I very much doubt that that will
forestall the forced pooling which results in these
horizontals. Maybe I don't understand your question.

15

COMMISSIONER DAWSON: Well, to me it seems like
you're afraid that they are going to come in and invade your
property and produce your product --

18

MR. YATES: Right. That's right.

19

COMMISSIONER DAWSON: -- that's rightfully yours on
that property. What's to stop you from going in and drilling
a vertical well if you want to drill a vertical well?

22

MR. YATES: Well, I'm assuming that there is already
a vertical well that is producing this, and so if this
vertical well is producing at allowable, for instance, then
the Commission will not allow you to go drill another well.

1 If it's producing under allowable, then you can go drill
2 another well. Nothing -- nothing is to -- to keep you from
3 doing that, but once these horizontal wells invade it, the
4 reserves that you have are going to dissipate.

5 COMMISSIONER DAWSON: Well, you have the right to go
6 in there and drill another well, a vertical well, if you
7 wanted to before they drill the horizontal well because you
8 own the lease?

9 MR. YATES: Well, you have the right only if you're
10 not -- if you are producing at allowable well, at allowable,
11 you don't have the right without --

12 COMMISSIONER DAWSON: I mean, if you are under the
13 allowable. I understand if you are under the allowable and
14 you want to drill into the well, you have the opportunity to
15 do so, correct?

16 MR. YATES: Yes. Yes, you do, if you are under the
17 allowable, that's right. No question about that. The right
18 disappears, as I understand it, once this quasi proration
19 unit by whatever name is put in place because then you would
20 have to go get permission to do it, not from the Commission,
21 but from these folks.

22 COMMISSIONER DAWSON: You are saying after they
23 forced pooled you, right?

24 MR. YATES: Right.

25 COMMISSIONER DAWSON: After that?

1 MR. YATES: Right.

2 COMMISSIONER DAWSON: Well, if you want to go
3 non-consent on that and decided to drill your own vertical
4 well into that pool, yourself, couldn't you do so before they
5 started drilling their well?

6 MR. YATES: I'm not --

7 COMMISSIONER DAWSON: If you were below the
8 allowable?

9 MR. YATES: Yes, you could. If you are not
10 producing allowable, then you could file a drilling
11 application and go drill, and you might get that second well
12 down about the time the horizontal well gets there. I'm --
13 yes, you could.

14 COMMISSIONER DAWSON: That's all the questions I
15 have.

16 MADAM CHAIR: Commissioner Balch?

17 EXAMINATION

18 BY COMMISSIONER BALCH:

19 COMMISSIONER BALCH: I'm a little new at the
20 regulatory game, so excuse me if I ask a naive question.
21 What is the strength of a proration unit contractually?

22 MR. YATES: What is the benefit of it?

23 COMMISSIONER BALCH: The strength of it. How it can
24 be combated or taken away or adjusted.

25 MR. YATES: By the proposed rules or --

1 COMMISSIONER BALCH: Under current rules.

2 MR. YATES: Under current rules?

3 COMMISSIONER BALCH: If you have a proration unit
4 and somebody else wants to take your proration unit and make
5 it into something larger --

6 MR. YATES: You would have to go to the Commission
7 to get -- or to the Division to expand it. For instance, if
8 you -- if you drilled a well, an oil well, and the spacing
9 for that would be 40 acres, and you found it was actually
10 draining more than that, you might go to the Commission and
11 request an 80 -- that that be amended to an 80-acre spacing.
12 What often you see, I think, under the rules, generally, the
13 spacing for gas is 160 acres, but you will see 320-acre
14 spacing overlying much of the Southeast New Mexico because
15 someone has convinced the Commission that it -- the well will
16 actually come closer to draining 320 acres. I'm not sure I'm
17 answering your question.

18 My point, if this will help, is that, you have
19 property rights vested in this. People have acted. They
20 have drilled. They have gone out to the bank on this.
21 Underlying the whole asset -- their assets in their company
22 are these proration units scattered around Eddy County, Lea
23 County, San Juan County, and so forth, and they are about to
24 be invaded, perhaps. The Commission -- Oklahoma -- there are
25 states that had not decided that 40 acres is the best

1 spacing, that 10 acres is the best spacing, so they vary in
2 different jurisdictions.

3 COMMISSIONER BALCH: Thank you.

4 MADAM CHAIR: Commissioner Dawson?

5 FURTHER EXAMINATION

6 BY COMMISSIONER DAWSON:

7 COMMISSIONER DAWSON: I had one more question. You
8 said you could drill your own well there if you are below the
9 allowable. If somebody forced pooled you in your scenario
10 you have there from the south, and you went consent with
11 them --

12 MR. YATES: And you did what?

13 COMMISSIONER DAWSON: And you agreed to participate
14 in the well, don't you think -- you agreed to participate in
15 those four wells, maybe, or maybe just the first one, don't
16 you think that would give benefit to you and possibly look
17 better for your banker if you could -- if you could
18 participate in those wells and retract reserves from those
19 other three quarter-quarters that they are crossing?

20 MR. YATES: Well, you may or may not. There was
21 testimony yesterday that the cost of these horizontal wells
22 are two or three times. I've received \$8 million AFEs for
23 doing these wells, and so I'm not sure. I question that the
24 two or three times is right. You may have, right here in
25 this circumstance, you may have a well that is producing

1 allowable that is going -- and why would you take that
2 circumstance -- and you may want to do just exactly what you
3 are talking about. If you believe -- I hate to mark on this
4 exhibit, but if you believe that the pool extends here, but
5 yesterday you heard a circumstance where the pool didn't
6 extend down here, where it was invaded in order to get to
7 those reserves, so it depends on the circumstance, but that,
8 yes, you could do that, even if there were no forced pooling
9 statutes in the state. Even if we were Texas, essentially
10 Texas, you could do that, and you would make the decision
11 based on your --

12 COMMISSIONER DAWSON: On the reserves --

13 MR. YATES: Yeah.

14 COMMISSIONER DAWSON: -- on the geology and
15 reserves. And also on this case that you presented
16 yesterday, couldn't you also, instead of drilling from the --
17 yesterday it was the north-south scenario and you said the
18 south half had the best reserves? On the scenario --

19 MR. YATES: I think the north half had the best
20 reserves, if I remember correctly. And that's Mr. Scott you
21 are talking about.

22 COMMISSIONER DAWSON: Yeah, okay.

23 MR. FORT: It was the south half where you had the
24 interest in that had the best reserves. The north half had
25 two dry holes.

1 MR. YATES: That's right. I need to turn this up.

2 COMMISSIONER DAWSON: So what would be -- couldn't
3 you go ahead and drill like an east-west lateral on your
4 south half to recoup those reserves?

5 MR. YATES: Yes. And Mr. Scott was thinking about
6 that when he was forced pooled -- or we were thinking about
7 that when he was forced pooled.

8 COMMISSIONER DAWSON: No further questions.

9 FURTHER EXAMINATION

10 BY COMMISSIONER BALCH:

11 COMMISSIONER BALCH: I'm sorry, when you answered my
12 question last time, I wasn't talking about proration units.
13 What I was really talking about was forced pooling and pools.
14 If you have a pool, whether it was consensual or forced, and
15 somebody wants to build a larger pool, including your pool,
16 what would be the current method for accomplishing that?

17 MR. YATES: If they think this extends -- turn this
18 around, say out here, then they would drill here in that
19 pool, the information related to the pool would be expanded,
20 and they would drill on this spacing unit.

21 COMMISSIONER BALCH: What is the mechanism for
22 expanding that pool? Is it the same as the mechanism for
23 forming it in the first place? Essentially an agreement or
24 forced pooling?

25 MR. YATES: No. They could drill under -- they

1 could drill it in cooperation with this person, or they could
2 drill it on their own and have their own joint operating
3 agreement, so forth. Typically what happens is this
4 offsetting acreage owned by other people or may be owned by
5 ten other people, and they form a joint operating agreement,
6 and then they go drill it. And once the information becomes
7 available, if they are successful, and it's out of the same
8 zone and so forth, then the pool is expanded. I hope I'm
9 answering your question.

10 COMMISSIONER BALCH: Maybe I'm not being clear.
11 What I'm trying to get at is your assertion, I believe, that
12 allowing a project area to come into an existing pool
13 agreement is essentially forcing them -- forcing that first
14 pool agreement to be superceded by the new project area. Is
15 there a way now, if you have an existing pool, and someone
16 wants to make a much larger pool agreement around that, to
17 force those people into an agreement?

18 MR. YATES: Well, you are using the word forced.
19 There is a way by cooperation, and that is by reaching unit
20 agreements.

21 COMMISSIONER BALCH: Okay. Unitization?

22 MR. YATES: That's right. And there are a variety
23 of unit -- types of units. Those that we typically think of
24 because of so much federal land around here that incorporate
25 the royalty owner as well are called federal units, there are

1 provisions for just state units that would affect royalty
2 owners. If they don't involve the royalty owners, then they
3 are generally called working interest units, and we engage in
4 those all the time by cooperative action.

5 COMMISSIONER BALCH: Now, from your testimony, I'm
6 inferring that you think that would be a better approach to
7 take --

8 MR. YATES: Yes.

9 COMMISSIONER BALCH: -- in this situation where you
10 have a horizontal well going into an existing pool?

11 MR. YATES: A horizontal --

12 COMMISSIONER BALCH: Or a project area going into an
13 existing.

14 MR. YATES: A horizontal into an existing?

15 COMMISSIONER BALCH: Yes.

16 MR. YATES: Yes.

17 COMMISSIONER BALCH: Thank you. That's all I have.

18 EXAMINATION

19 BY MADAM CHAIR:

20 MADAM CHAIR: I have follow-up questions concerning
21 project areas. Do you have a copy of the proposed rule?
22 Didn't your attorney give you a copy of the proposed rule?

23 MR. FORT: Yes, ma'am.

24 MADAM CHAIR: If would you look at 19.15.16.7K for
25 the definitions of project areas.

1 MR. FORT: It's right here.

2 MADAM CHAIR: Did you find it there?

3 MR. YATES: Yes, ma'am.

4 MADAM CHAIR: Would you feel more comfortable if

5 K(1) read, "One or more complete contiguous spacing units in
6 one section or in more than one section that are developed by
7 the horizontal well"?

8 MR. YATES: Yes, ma'am.

9 MADAM CHAIR: Which would confine the project areas
10 to the combination of the spacing units that actually
11 contribute production to the well?

12 MR. YATES: May I take a moment?

13 MADAM CHAIR: Yes.

14 MR. YATES: I'm sorry, would you mind repeating the
15 alterations you were asking?

16 MADAM CHAIR: Okay. Where K(1) --

17 MR. YATES: Yes, ma'am.

18 MADAM CHAIR: -- would read: "One or more complete
19 contiguous spacing units in one section or in more than one
20 section that are developed by the horizontal well."

21 MR. YATES: I suspect that would be an improvement,
22 but that does not solve the compulsory pooling problems that
23 I've addressed.

24 MADAM CHAIR: But it confines a project area to
25 those acres that actually contribute --

1 MR. YATES: Yes. You don't --

2 MADAM CHAIR: -- to that well.

3 MR. YATES: Yes, you don't have the L shaped
4 circumstance that we saw yesterday in that circumstance, as I
5 understand.

6 MADAM CHAIR: That would necessitate that L(4), just
7 down below, would read: "Consist of a combination of two or
8 more otherwise standard project areas if the resulting area
9 is substantially in the form of a rectangular and all spacing
10 units are developed," which confines it to a rectangular
11 shape combining spacing units.

12 MR. YATES: I -- I think that -- our purpose, my
13 purpose is not -- I think that in an area going across a
14 section diagonally ought to be allowed if that can be done,
15 if that's -- if that's the question. I don't have -- I do
16 think that only that acreage that relates to the horizontal
17 well should be allocated to it, and I'm not sure about this,
18 the effect of innumerable wells going -- going through. My
19 concern has to do with allowing compulsory pooling under the
20 existing -- existing compulsory pooling practice and law to
21 make that happen.

22 But I support what has been presented here as the
23 industry's position to be able to drill across a section
24 line, to be able to drill diagonally, and all of those things
25 because I think sometimes the nature -- what mother nature

1 presented us cannot be dealt with adequately by a
2 checkerboard. I'm not sure that I'm answering your question.
3 I'm trying to.

4 MADAM CHAIR: No. There were other questions
5 concerning the criteria by which a non-standard project area
6 would be either approved or denied. There has been very
7 little testimony concerning that.

8 MR. YATES: I would say that the fewer times a
9 company has to come up here, the better on the whole,
10 because, well, for several reasons. One, I don't want
11 Mr. Carr to expire. But also coming up here is expensive,
12 and the small operator, the small operator, a number of them
13 have never made their way up here just because of the cost of
14 it. So the more these rules can be put in place where they
15 are fair and allow the industry to operate without the
16 necessity of coming up here for special rules, the better.

17 MADAM CHAIR: That's all I have. Do you have any
18 redirect?

19 MR. FORT: I have a few questions. May I approach
20 the witness?

21 MADAM CHAIR: Yes.

22 REDIRECT EXAMINATION

23 BY MR. FORT:

24 Q. Mr. Yates, I do want to ask you, you were asked a
25 question by Ms. Gerholt about the notice, and I wanted you to

1 -- I believe you were -- here, compulsory pooling, these are
2 the rules, and this was the one that you were looking at
3 regarding the risk charge that you wanted to see the
4 amendment to. And what I would like for you to do is to
5 read -- it's 19.15.16.15, under special rules for horizontal
6 wells, Subsection F.

7 A. These are the proposed?

8 Q. These are the proposed.

9 A. "Compulsory pooling, the provision of 19.15.13 NMAC
10 regarding compulsory pooling and proposal of additional wells
11 in compulsory pooled units shall apply to horizontal wells
12 and compulsory pooled projects areas."

13 Q. Is that where you propose to have your amendment?

14 A. Yes.

15 Q. The proposed modification?

16 A. Yes.

17 Q. To that section?

18 A. Yes.

19 Q. Okay. Thank you. I think you just touched on it.

20 I believe you were asked about -- what about -- aren't you --
21 can't you come up here on a case-by-case basis. What's the
22 problem?

23 A. Time, I mean, time, money, and so forth. The --
24 yesterday Mr. Scott testified that he wears a hard hat, he
25 wears an engineer's hat, he does all of this. It's a

1 difficult thing. And so what you generally find is that the
2 folks who can come up here all the time are the larger
3 companies, and so we're -- it's difficult.

4 Q. And are you going to be coming back here on another
5 horizontal compulsory pooling?

6 A. Yes, one or more.

7 Q. The question that was asked on your diagram, if you
8 were not reaching your allowable on your proration -- on
9 your -- yes, proration unit up there, could you not drill
10 another horizontal well -- excuse me -- vertical well. What
11 is the -- what kind of economics would you be looking at in
12 drilling a second well to get to your allowables?

13 A. Well, you would -- you might have additional --
14 there are lots of variables there; geology is one of them.
15 You may feel that in that first well you might have drilled
16 in the wrong location and that the second well might come
17 close to a full allowable producer, in which case you're
18 going to look at the economics of drilling that well as
19 compared to -- to the return.

20 Q. Let's say that -- so you are looking at a well that
21 you're -- if I understand what you are saying, if that, if
22 the first well is a poor producer, you probably will look at
23 drilling a second well. But if that first well is a good
24 producer, maybe not reaching your allowable, are you going to
25 still think about drilling that second well?

1 A. Well, at some time. The general practice is to let
2 it decline. The Commission has established 40-acre proration
3 units, and its authority to do that is based on the notion
4 that they have established the most effective way to drill
5 that reservoir. So they will allow you, if you drill -- if
6 you feel that you're really draining ten acres, you have two
7 choices. One is to come up here and ask that the spacing be
8 modified, and that is not customary. The other thing you can
9 do is wait until that first well has -- is a long way down in
10 its life, and then go drill on another part of that proration
11 unit where you feel that you might get great -- additional
12 reserves that justify the drilling.

13 Q. Would the factor that you are being taken in for a
14 forced pooling contribute to you at that point of drilling
15 another vertical well at that time?

16 A. Well, the problem is that it may be money just
17 dissipated because if they can come in with horizontal wells
18 and take from your new well or your -- and your old well or
19 an unlimited number of horizontal wells, it may be a fool's
20 errand to drill that second well.

21 Q. You mentioned that you are going to be coming back
22 up here on another forced pooling matter that's been filed
23 before the Commission -- before the OCD. Are you considering
24 drilling another vertical well in that space?

25 A. Well, it would be, I think, a fool's errand until we

1 know what's going on.

2 MR. FORT: I have no further questions.

3 MADAM CHAIR: No other witnesses?

4 (No response.)

5 MADAM CHAIR: The Commission counsel advised us that
6 the Commission needs to confine itself to the case that was
7 brought before it as advertised, however, and not to address
8 the issues that were brought up in the larger questions
9 concerning forced pooling. Is that right?

10 MS. BADA: Yes.

11 MADAM CHAIR: But there were legal issues that were
12 brought up during Mr. Yates' testimony and incorporated in
13 these exhibits that no one objected to, and so we are not
14 able to close the record or to debate and rule. At this time
15 we need to leave the record open so that the Division and
16 other parties can brief the issues that were presented in
17 this exhibit concerning this case. So with that in mind, the
18 transcript will be ready in two weeks. I'm sure the
19 attorneys would like to use that transcript for developing
20 their briefs, and so I would like to see briefs submitted to
21 us, as well as proposed findings and conclusions concerning
22 this case that was brought. Three weeks? A month? Is a
23 month adequate time?

24 MS. GERHOLT: Yes, Madam Chair.

25 MR. CARR: May it please the Commission, are we

1 going to be allowed to make closing statements?

2 MADAM CHAIR: Oh, yes.

3 MR. CARR: At this point, before we get into that,
4 it would be helpful, if we are asked to brief the issues, if
5 we know what issues were on the table that need briefing.

6 MADAM CHAIR: The legal issues concerning -- do you
7 want to answer this?

8 MS. BADA: Essentially whether the Commission -- the
9 issue has been raised by Jalapeno whether the Commission has
10 authority to adopt a new rule that allows forced pooling for
11 horizontal wells given the use of project areas.

12 MR. BROOKS: Given what?

13 MS. BADA: Given the use of the term project area.

14 MADAM CHAIR: So one month from today, November 21,
15 and then the Commission will be able to address deliberations
16 at the following Commission hearing which would be December.

17 Closing statements?

18 MS. GERHOLT: Madam Chair, I would respectfully
19 request a five-minute break.

20 MADAM CHAIR: Certainly.

21 MS. GERHOLT: Thank you.

22 (Recess taken.)

23 MADAM CHAIR: Back on the record. Ms. Gerholt, you
24 were about to give your closing statement?

25 MS. GERHOLT: Madam Chair, I'm -- unfortunately I'm

1 not as familiar with the rulemaking procedure as I should be
2 at this point. Mr. Carr stated that the applicant presents
3 its closing last.

4 MR. CARR: Usually.

5 MADAM CHAIR: Mr. Fort, would you like to give your
6 closing statement?

7 MR. FORT: I kept thinking I was the last guy to go,
8 but I will be happy to. It was brought out in the brief
9 opening that I had in that the concern of this Commission is,
10 yes, project area is not defined in New Mexico statutes, and
11 it's not found in the New Mexico statutes in the Oil and Gas
12 Act. It's not there, so -- and I got to thinking about this,
13 that the project area being a contiguous group of spacing
14 units or proration units, as the case may be, and what you
15 have is -- and I thought, well, why -- why do we call it a
16 project area? What's the reason for that, because there is
17 nothing in the law that defines that, and that's the whole
18 crux of what we are doing.

19 And if you -- because what we are doing is we are
20 superimposing -- we've got a project area, 40 acres, and so
21 we've got A, B, C, and D, using my example from the other
22 day, you've got four 40-acre tracts on the top, A, B, C, and
23 D, and somebody wants to come in and say, "Okay. Now, you've
24 got a proration unit in A, but I'm in D, and, oh, by the way,
25 I want to create a project area." So what you do, you

1 superimpose this project area over on top of a proration
2 unit.

3 And I thought, what authority do you have to do
4 that? Well, then I went to the statute itself under what
5 is -- and I thought, "Well, wait a minute, isn't this" --
6 because what they describe in their proposal, just talking
7 about the standard project areas, was some form of a
8 rectangle, and I thought, "Well, how come the Commission
9 hasn't established a proration unit for that rectangle or any
10 of the rectangles that they propose?" And I thought, "Why
11 haven't they done that?"

12 That would be the easiest thing to do is go in and
13 establish a proration unit. But here -- and then I thought
14 it through, and the interesting thing about a proration unit,
15 it covers your duty. You have a statutory duty to prevent
16 waste and protect correlative rights, and now this statutory
17 duty is embodied in 70-2-17B, "The Division may establish a
18 proration unit for each pool such being the area that can be
19 efficiently and economically drained and developed by one
20 well."

21 There's one well. It doesn't say it has to be a
22 vertical well. It doesn't say it has to be a horizontal
23 well. You can do either. But, guess what, you can't
24 overlay. You can't include another proration unit, because
25 if I had my -- let me just use this real quick. If I have --

1 I guess I'm going to have to follow this. As I understand
2 it, I've got A -- sorry about my -- this should be squares.
3 This is A, B, C, and D. I am in A, and that's what this was,
4 was a vertical well. I'm in A with this vertical well, and I
5 got B, and I got C, and I got D.

6 And then over here -- and there is an interest --
7 they own an interest in D. Okay. They want to now create a
8 proration unit, which you're allowed to do. Okay. So they
9 could come back across here and come in and ask that D, C,
10 and B, be prorated. And, guess what, you put in one well,
11 and that meets the statutory definition.

12 Now, can you go into A? No. You've already
13 created -- this is a proration unit of itself. By statute
14 you've said that this unit protects correlative rights and
15 prevents waste.

16 Here is the problem: When you come outside and use
17 the project area -- I'll just call it PA -- that's where the
18 problem is, and that's why it's always going to, in my
19 opinion, create a -- you're not preventing waste. You can
20 have, as Mr. Yates was showing in the testimony, you can have
21 multiple horizontal wells going through that.

22 You are always going to have competition. You have
23 set up a scenario that you are going to be dealing with
24 conflicting parties all the time. They are going to be up
25 here every day trying to protect their rights, but you have a

1 duty to prevent waste and protect correlative rights, and you
2 cannot do it with a PA and the way it's designed. And the
3 statute doesn't let you do it. The statute would allow you
4 to have -- go in and do proration units for a horizontal
5 well, but they cannot overlap, and that's the problem.

6 And, again, that's why I believe that the statute
7 never intended this. You can't do what they want to do in
8 terms of a project area. It can be a proration unit, but it
9 has to be effectively and economically drained and developed
10 by one well. It doesn't matter if it's a horizontal well.
11 It doesn't matter if it's a vertical well, but you can't
12 overlap these things. As soon as you overlap them, you have
13 brought in waste, and you've impaired correlative rights.
14 The guy that's got the -- when he goes out and gets a loan on
15 A, and he's got the reserves, the producing reserves, and the
16 reserves behind the pipes, well, you've impaired the security
17 of that bank, and you have impaired his contract rights.

18 So that's why we can't do this. We -- but you can
19 do -- you can have proration units for one well, and that one
20 well can be a horizontal well under the statute, but it has
21 to be one well that economically and efficiently drains and
22 develops that proration unit. You can do this, but you can't
23 overlap, and that's the problem we see. That's why we are
24 going to be up here every day fighting for our proration
25 unit, but we're looking to you to carry out your statutory

1 duty that's in law to protect our rights and prevent waste.

2 The other matter is over the notice about we were
3 looking at Rule 14 and Rule 16. And the -- what I want to
4 call to the Commission's attention is the fact that under --
5 I thought I had it printed out here -- under F -- here it is.
6 Under F, under 19.15.16.15F, special rules for horizontal
7 wells, it states, "Compulsory pooling. The provisions of
8 19.15.13 NMAC regarding compulsory pooling and proposal of
9 additional wells in compulsory pooled units shall" not --
10 excuse me -- "shall apply to horizontal wells and compulsory
11 pooled project areas."

12 We're amending 13 by this. We don't have 13 in the
13 notice, and maybe that's part of the problem here, but we're
14 amending 13. We're not just amending 14 and 16, we're
15 actually amending 13 as well. And, therefore, because it's
16 in the notice, and that notice included that we were amending
17 13, maybe the notice is invalid, maybe we can all go home,
18 but we do -- we are amending 13, regardless of what the
19 notice says. And if the notice is sufficient for this, for
20 Subsection F, it is sufficient for us to make an amendment to
21 this to make sure that they take in our proposed modification
22 on the assessment of the risk, the charge for the risk in
23 developing one of these horizontal wells.

24 But, again, I think it becomes very, very clear, you
25 can do a proration unit for a horizontal well. You cannot do

1 a project area unit for a horizontal well. We can look at
2 the statute and see what it entails.

3 MADAM CHAIR: Mr. Carr, you have a closing
4 statement?

5 MR. CARR: Yes, ma'am, I do. May it please the
6 Commission. I have been working on this issue of how to
7 amend the OCD rules to accommodate horizontal drilling for
8 over four years. It started here, and then the Division
9 director requested that the NMOGA Regulatory Practices
10 Committee take it up, and so we struggled with it for a
11 number of years. And, as you know, we proposed this year, it
12 was a workgroup that worked from that NMOGA group and
13 developed what is before us today.

14 I want one thing to be clear, and that is that,
15 through this long, slow process, we didn't come up with a
16 rule that we feel was not well thought out and designed to
17 not only accommodate the industry's concerns, but also was
18 consistent with the duties of the Oil Conservation Division.

19 And we didn't come before you with a rule that was
20 thin on standards and checks in the rule itself to be sure
21 that it wasn't used to violate correlative rights and cause
22 waste. We have a rule and proposal that we think will work,
23 recognizing that no rule covers all situations, and that
24 exceptions to these provisions will have to be decided on a
25 case-by-case basis and you will have to be involved and

1 operators will have to come up here before you and present
2 evidence on waste and correlative rights.

3 The first time I appeared before Dr. Lee, I gave a
4 closing statement, and several days after I got a letter from
5 him thanking me for the lecture. And I'm going to try to say
6 the same thing in a softer tone. But I think it's important
7 that when the Commission starts deliberating this or any
8 other issue, that you keep in mind, you are a creature of
9 statute. You were created by the New Mexico legislature, and
10 you have definite functions as defined and are limited by the
11 laws that create you.

12 When you start there, you realize or will find that
13 your duties are primarily the prevention of waste of oil and
14 gas and the protection of correlative rights. I teach oil
15 and gas law at the University of New Mexico School of Law,
16 and the one thing that is clear to me after that is that no
17 one understands protection of correlative rights, and no one
18 really understands waste. But to do your job you have to
19 consider what those terms mean, and those terms are, in fact,
20 defined by statute.

21 Yesterday when Arlene Rowland started the
22 presentation for Heyco, she quoted the definition of a
23 statute of correlative rights, and I think this is where we
24 need to start, because this term is kicked around and has
25 been kicked around for a few days.

1 Correlative rights means, "The opportunity afforded
2 as far as it is practicable to do so," not absolute, "as far
3 as it is practicable to do so to the owner of each property
4 in a pool to produce without waste. The owner's just and
5 equitable share of the oil and gas that can be practicably
6 obtained without waste."

7 The importance there is, no one is guaranteed
8 anything except an opportunity, and that opportunity is
9 conditioned on what can be practicably and reasonably be
10 done, and that all this play out within the context of
11 prevention of waste, which is your primary duty. The Supreme
12 Court of New Mexico has said that. So looking at correlative
13 rights, knowing it's subject to waste, subject to waste and
14 underground waste as defined by statute.

15 Underground waste is defined in several ways, one of
16 them is: The locating, spacing, drilling, equipping,
17 operating, and/or producing a well or wells in a manner to
18 reduce or tend to reduce the total quantity of oil or gas
19 ultimately recovered from a pool. Waste means efficient
20 operations that maximize recovery. So that is where we
21 start.

22 If you look at the exhibits presented yesterday by
23 Mr. Ezeanyim, he listed the advantages of horizontal
24 drilling, and one of his points was, production factor can be
25 enhanced as much as 15 to 20 times to one as compared to

1 vertical wells. There are always circumstances where you are
2 better with a vertical where you may not be in shale, but as
3 a general principal, horizontal development is more efficient
4 and it results in drilling and operating and producing wells
5 in a manner which will not reduce the total quantity of oil
6 and gas recovery.

7 So I would suggest that if you look at this, that
8 phrase, you need to stop -- or we need to start. I would
9 also suggest that if you consider -- if you don't adopt our
10 rule, hoping there will be a change in the underlying law. I
11 have been to the legislature before, and I think that would
12 render this entire effort meaningless. So we believe we have
13 a proposal before you that facilitates horizontal drilling.
14 There may need to be other hearings on related issues,
15 correlative rights, other things that pop up, just technology
16 changes or compulsory pooling, but we have a proposal we
17 think is an important first step, and to really get the
18 state's hands around this new technology will probably
19 require legislative changes as well, but that doesn't mean
20 that what is being proposed is wrong or is inadequate. It
21 does not contain appropriate standards.

22 So we ask you, as you start, to look at the purpose
23 of this proposal, and not be sidetracked by various
24 exceptions, not be derailed by an example of a project area
25 that looks like a saucepan with a handle and no well in the

1 handle. That's an exception. And I will tell you,
2 Commissioner Bailey, that your proposed amendment to the
3 language would give the agency the vehicle by which they
4 could deny that well.

5 I would suggest, however, that since I have been
6 before you with applications for as many as five horizontal
7 wells at one time within a section, that it might be the area
8 developed by the wells that are proposed that would allow
9 larger project areas for larger development.

10 But questions have been raised here about the checks
11 and standards, and maybe the lack of checks and standards in
12 what has been proposed by this workgroup. In particular, we
13 are talking about the formation of the project areas. Under
14 the rules, if you come in with a proposed project area that
15 looks like a saucepan with a handle and no well in the
16 handle, that would be approved. It would be approved because
17 I have come in and proposed that to you and otherwise met the
18 very scant requirements in the section for approval of the
19 project area.

20 But there is another very important thing in the
21 proposal that catches that. You cannot drill -- you cannot
22 produce until you have an approved C-104, and that means you
23 have consolidated the interest in that spacing unit. Okay.
24 Put that aside for a second. I have correlative rights. I
25 have an opportunity to produce my just and fair share without

1 committing waste as far as practicable. That's where we
2 start.

3 How do I do that? Well, I don't have to drill a
4 well. I can sit there and be drained. That's my right. But
5 if I want to avail myself of that opportunity, I have to do
6 something. I have to drill a well, or I have to enter an
7 agreement with someone else to go out and develop those
8 reserves. And, under these rules, I can't come back and
9 produce that well, if I haven't either dedicated to the well
10 as a project area the only acreage that I own, or in a
11 situation where I have every single solitary operator commit
12 by agreement or by compulsory pooling.

13 So before we start, I have to get -- producing that
14 well -- it has to be consolidated. And we talk about
15 compulsory pooling. Now, you know, meaning, I can say no,
16 and you can say yes. That's exactly what compulsory pooling
17 is all about. That's what statutory unitization is all
18 about. And those two concepts, compulsory pooling and
19 statutory unitization, are rooted in proper exercise of the
20 police power of the state.

21 What that means is the State of New Mexico and the
22 Oil and Gas Act by adopting the pooling statute said, yes, we
23 have an interest in having the minerals in the state
24 produced. And we have adopted the statutory scheme that says
25 if Gabrielle and David and Richard and I own interest in a

1 spacing unit, and we want to develop that land, and Richard
2 just won't go, we have to talk to Richard.

3 And, if we can't reach an agreement, we come to you,
4 and you say, "We will pool those lands," and David and I
5 always argue about the language in statute. The statute says
6 you shall pool, and he wouldn't give me a cite yesterday,
7 like he said he would.

8 MR. BROOKS: I will by e-mail.

9 MR. CARR: So I went back, without the help of
10 Richard, and I looked at the language and statute. And it
11 says, to prevent waste and protect correlative rights, the
12 Division shall pool -- David's probably right. But let me
13 tell you, we talked a lot about, Mr. Scott and the Lynx case,
14 well, Ocean and I represented Mr. Scott in the Lynx case.
15 It's not a failure of the agency, it's a testament to the
16 success of the agency in the current statutory scheme. Why?
17 When there wasn't evidence on the spacing unit and it came to
18 an Examiner, you pooled the land.

19 Mr. Scott appealed, and when it came back, the
20 technical evidence showed the pooling of that horizontal well
21 would deny him his opportunity to produce without waste his
22 fair share of the reserves, and you denied that application.
23 You did what you are supposed to do. You entered an order in
24 a unique case, not the general case, in a unique case, and
25 you acted to prevent waste and to protect correlative rights,

1 and you did what you were charged by statute with doing.

2 And every exception to this rule -- and there is no
3 way to draft a rule that's not going to address one right
4 after the other and has exceptions that come forward. That's
5 the nature of it. You are not addressing every situation,
6 you're setting the framework that will allow horizontal
7 drilling to go forward.

8 And if there are exceptions, and they don't like to
9 come here and they want to spend \$3 million on -- on a
10 horizontal well, they are -- they are going to have to hire
11 Jim Bruce because I'm not going to be here to come over here
12 and present their case. That's just the way it is, that
13 their concerns that what they are proposing is going to
14 impair Mr. Yates' rights, and you are the people who decide
15 that, and you decide it on a case-by-case basis. That's your
16 role under the Oil and Gas Act.

17 Now, Section 13, the pooling portion of the Oil and
18 Gas Act, you have been told we are expanding that. I see
19 that differently. You have authority to compulsory pool, and
20 it doesn't say you pool vertical wells, and you don't pool
21 horizontal wells. It says that if certain conditions are
22 met, and it will prevent waste and protect correlative
23 rights, you shall pool. All we are asking you to do is
24 exercise your existing authority for horizontal wells like
25 you do for vertical.

1 I listened to Mr. Fort. It was interesting. I
2 thought Mr. Yates said we only wanted to pool up to spacing
3 units for a vertical well. Mr. Fort says, yeah, but you
4 could create a spacing unit for a horizontal well. That's
5 what we do every time we go through this little sham
6 transaction, we create a non-standard unit for a horizontal
7 well and then we pool it. We wouldn't have to do it anymore.

8 But when you listen to what Mr. Fort says, he is
9 right, you pool to combine the acreage that is going to be
10 drained by well. A vertical well drains a circle, in theory.
11 A horizontal well drains a long ellipse, and all we are
12 asking you to do is to combine by exercise of the police
13 power of the State the tracts that are going to be drained by
14 your horizontal well. This does not change the pooling
15 power.

16 Take that one section out of this rule and throw it
17 away. It's simply an acknowledgement, if you adopt that,
18 that makes it clear you intend to use pooling. Drop it out
19 and go to work under your statute because you do have that
20 authority, and it has not changed by what is before you.

21 I don't really disagree with a lot of what Mr. Yates
22 said. I do agree that under the current system compulsory
23 pooling is outright being abused to tie up lots of acreage.

24 Envision this: You have a section of land, and you
25 have one operator who owns a partial interest in the east

1 half of the east half, and he comes in -- and this has
2 happened -- and he files applications to pool or lay down
3 compulsory pooling or horizontal project areas, north half
4 north half, south half north half, north half south half,
5 south half south half, and he shows to an Examiner, that this
6 will prevent waste and protect correlative rights and he gets
7 those orders.

8 And he may drill one 11 months from now, and then he
9 comes in and he says, "Well, I'm trying to get these things
10 together and drill them," so you give him another extension
11 in his order, and he ties up acreage for years and there may
12 not be wells.

13 One of the things that creates these situations are
14 some changes that have been made internally at the OCD that
15 you made without hearing and you can correct without hearing,
16 Years ago if I came in and sought a pooling order, that was
17 effective for 90 days. If I didn't drill the well, I came in
18 and had to show you why I hadn't drilled for good cause
19 shown.

20 I cantell you right now, good cause shown, it's in
21 my computer, boom, there's your letter, and then I have it
22 for another year, because the time that pooling order exists
23 is a year, and getting it extended to a second or third year
24 is as easy as pulling it up on my computer, signing it,
25 running it over here. You ought to require, if somebody gets

1 you to exercise your police power, that they intend to drill
2 a well.

3 And there are a lot of issues with correlative
4 rights that could be addressed, and I think should be
5 addressed by you, but the notice on this case is inadequate,
6 and if we don't like it at the end, the next step is another
7 trip to the courthouse to horse around over a notice, when
8 the objective of everyone in this room is to get rules that
9 actually work for the long haul, and not going to be changed
10 as we are here for. We would to have a rule entered.

11 Now the joint operating agreements. Now, Richard,
12 David, Gabrielle, and I have three sections of land, and we
13 want to contractually enter an operating agreement and
14 address a lot of the complicated issues that exist between
15 us, and now somebody wants to force pool again for a vertical
16 or a horizontal well under that acreage. You know, Richard,
17 David, Gabrielle and I cannot enter into a private contract
18 that absolves from complying with your pit rule, your
19 allowables, your setbacks are on the outside of a unit we
20 might form, and we can't come in here and prevent you from
21 exercising the police powers of the state, pooling rights
22 need to be drilled within the confines of your pooling order.
23 We can agree to anything and everything, but we can't agree
24 that you don't have authority and that your rules don't apply
25 to us. The issue with the JOA doesn't apply differently

1 today for horizontal wells than it did five years ago with
2 the pooling for vertical wells.

3 Statutory unitization, in concept, it is a good
4 idea. In theory it fails. I hate to admit to this, but we
5 adopted the Statutory Unitization Act of 1974, and I was the
6 attorney for the Commission, and I drafted it, and I was the
7 witness, and it was my idea that you ought to be able to do
8 this voluntary explore -- I mean for exploratory units as
9 well, and it was an idea that then was dead on arrival. I
10 don't know how it would play today, but everyone was
11 concerned it would be abused.

12 And because of that, a current statute limits
13 statutory unitization to enhance pre -- projects, things of
14 that nature, and so we would have to change that, and it
15 would apply to all units, you would have to include
16 exploratory units as well. There was a tremendous outcry
17 about that 40 years ago. It may not be the same now.

18 There were also issues concerning joinder
19 ratification and approval hearings that I think need to be
20 considered. So in concept it might work, but I would suggest
21 that a current law might be a starting point for a rule that
22 would be much easier for operators to work under and for this
23 agency to administer without unitization hearings every time
24 we have a project area.

25 We think what we have proposed encourages horizontal

1 development in New Mexico. We think it prevents waste. We
2 think what we proposed is not without standards because
3 before we can produce one barrel or one MCF, we either have
4 to have a complete agreement, or your approval that we are
5 preventing waste and protecting correlative rights.

6 We would ask you to look at the whole of what we are
7 proposing, not isolated exceptions and exemptions, which can
8 always be raised. We believe what we're proposing will
9 encourage horizontal drilling and at the same time keep it
10 completely under your supervision. Thank you very much.

11 MS. GERHOLT: Madam Chair, Commissioners, the
12 legislature set forth the Division to prevent waste and to
13 protect correlative rights. Several new concepts have been
14 proposed during the course of this hearing, which the
15 Division believed would prevent waste and protect correlative
16 rights. Those concepts included completed interval, project
17 areas and formation of project areas.

18 The formation of project areas, there is no notice
19 that is built in, even though the rule doesn't necessarily
20 specify. If it is a standard project area which is created,
21 it is uncontested and no notice is required by the rule.
22 However, you heard Ms. Spradlin testify to the fact that the
23 only way you would get that standard project area is by
24 obtaining the consent, thereby the necessary parties would
25 have notice.

1 If the standard project area is contested, then
2 notice would apply pursuant to the rule because, in order to
3 compulsory pool, an operator must notify affected persons.
4 If it is not within your project area, the rule specifically
5 requires notice be given to affected parties. So the
6 affected persons are getting notice, and they are given even
7 more notice when there is consolidation of project areas
8 because before an operator can produce the well, the
9 operators will notify all mineral interest owners in order to
10 hopefully obtain a voluntary agreement. That is the hope,
11 that there is a voluntary agreement. If the operator is
12 unable to obtain voluntary agreement, the operator may seek a
13 compulsory pooling order, which again requires notice.

14 There has been a lot of discussion throughout this
15 hearing about compulsory pooling. The division has proposed
16 only to make clear in 16.15F that the current OCD compulsory
17 pooling rule would be a tool that could be used, it would be
18 a procedure, not to set forth the circumstances where the
19 Division may or would compulsory pool project areas. I'm in
20 agreement with Mr. Carr. If that is troublesome, then use
21 the statutory authority that has been given under the Oil and
22 Gas Act and to delete 16.15F.

23 I would remind the Commission, any modifications
24 proposed by Jalapeno and Heyco directly affect the OCD
25 compulsory pooling rule at 19.15.13 and would be better

1 addressed in a rulemaking specifically for the OCD compulsory
2 pooling rule and not be a part or brought into this
3 rulemaking hearing.

4 There has also been discussion by the engineers and
5 others that a number of horizontals in a project area would
6 be controlled by the setbacks and allowables. This is a
7 built-in control for horizontal well development. There
8 would not be an octopus-like look underground, because, if
9 you are only given certain allowables and you have certain
10 setbacks, you can only drill a certain number of horizontals.

11 We thank the Commission for the opportunity to
12 present proposed findings and conclusions of law, and we will
13 get our brief to the Commission by November 21. We also
14 appreciate the Commission taking all of this evidence and
15 weighing it. We look forward to a rule that may be adopted.
16 Thank you for your time.

17 MADAM CHAIR: Thank you very much. That concludes
18 the case to be ruled. Expect findings of fact and
19 conclusions and the briefs by the 21st. Are there any other
20 issues before the Commission today?

21 (No response.)

22 MADAM CHAIR: Are there any non-technical public
23 testimony to be given to the Commission?

24 (No response.)

25 MADAM CHAIR: Then we are looking for a motion to

1 adjourn.

2 COMMISSIONER BALCH: I will motion to adjourn.

3 COMMISSIONER DAWSON: I will second.

4 MADAM CHAIR: All those in favor.

5 COMMISSIONER BALCH, COMMISSIONER DAWSON, MADAM

6 CHAIR: Aye.

7 MADAM CHAIR: All those opposed?

8 (No response.)

9 MADAM CHAIR: We are done. Thank you.

10 (Concluded at 11:21 a.m.)

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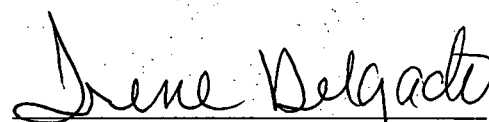
REPORTER'S CERTIFICATE

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I, IRENE DELGADO, New Mexico CCR 253, DO HEREBY
CERTIFY THAT ON October 21, 2011, proceedings in the
above-captioned case were taken before me and that I did
report in stenographic shorthand the proceedings set forth
herein, and the foregoing pages are a true and correct
transcription to the best of my ability.

I FURTHER CERTIFY that I am neither employed by nor
related to nor contracted with any of the parties or
attorneys in this case and that I have no interest whatsoever
in the final disposition of this case in any court.

WITNESS MY HAND this _____ day of November
2011.


Irene Delgado, CCR 253
Expires: 12-31-2011