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

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

CASE NO. 14744

Testimony of Harvey E. Yates, Jr. before the Commission October 20, 2011

In considering the rule changes requested by the Division for the purpose of facilitating horizontal drilling in the state, it is also necessary to consider both the initial purpose of the compulsory pooling rules in the state as well as the application of those rules by the Oil Conservation Division.

ORIGIN OF SPACING & COMPULSORY POOLING

At the oil industry's origin in this country a person generally was allowed to drill and produce a well on his land regardless of the size of his land parcel. Thus, there developed fields where rigs and pump jacks sprouted out of the ground separated often by a mere acre of land.

After consideration it was decided that this circumstance was leading to a waste of resources because one well often could remove the oil which several wells had been. drilled to produce.[1]

Hence several states imposed spacing rule requirements. Consequently, states essentially denied a landowner's the right to drill a well on his land unless he was able to gain consent for the drilling from parties owning sufficient acreage to constitute the required spacing unit.

Some potential drillers complained that the spacing unit requirement, coupled with the fact that there existed recalcitrant adjoining land owners, were keeping them from developing possible reserves under their acreage. Some states resolved this problem - which had been created by state statutes and regulations requiring spacing units - by instituting compulsory pooling rules.[2] Other states did not pass such rules and left such matters to be resolved by negotiations between the parties.

It is sometimes suggested that the capacity to adequately explore and produce in New Mexico is tied to the existence or expansion of the compulsory pooling rule. In that

[1] Pooling For Horizontal Wells: Can They Teach An Old Dog New Tricks?, Bruce M. Kramer, Law Emeritus, Texas Tech University School of Law., pg. 3.

[2] New Mexico enacted compulsory pooling legislation in 1935. See, 1935 N.M. Laws, Ch. 72.

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regard the Commission would do well to compare the exploration and production record of states such as Texas, which, effectively, has not employed compulsory pooling, with the exploration and production record of New Mexico, where such a rule has been vigorously employed.[3]

To assist the Commission in comparing production trends of the two states, we attach a graph which compares the gas production trend in the State of Texas with gas production trend of the State of New Mexico for the years 2001 through the present. The State of Texas does not seem to have been comparatively hindered by failing to use a compulsory pooling rule.

The compulsory pooling rule was intended to resolve a problem created by an earlier, or simultaneously imposed, government rule. It was never intended to put the state in the position of being a facilitator of the taking of the property of one person by another person. Yet, over time the compulsory pooling rules of the State of New Mexico have verged on doing just that. We fear that the application of the compulsory rules beyond proration units into "project areas" would be a continuation of the trend and would cause the state to cross the line from legitimately using its police power to simply facilitating "takings" in violation of the 5th Amendment of the US Constitution.

DOES THE COMMISSION HAVE STATUTORY AUTHORITY TO MOVE FROM PRORATION UNITS TO PROJECT AREAS?

We note that the statute[4] which authorizes compulsory pooling in New Mexico addresses "proration units" and does not address "project areas." We question the Commission's authority to leap from "proration units" to "project areas" without a change in the statute. The Division is authorized to, "*establish a proration unit for each pool, such being the area that can be efficiently and economically drained and developed by one well,...*"[5] We do not think that the Division has the authority under the statute to force the imposition of horizontal drilling "project areas" over the proration units it has previously established for a pool.

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[3] In 1965 Texas passed the Mineral Interest Pooling Act of 1965. As of the beginning of 2009 the Texas regulatory body, the Texas Railroad Commission, under the act had issued only one force pooling authorization. In that 2008 case an operator was allowed to force pool minor mineral interests into a spacing unit for the drilling of a Barnet Shale well. The Texas Railroad Commission provided a proportionate 20% royalty to the pooled interests and authorized the operator to recover out of pooled interests' proportionate share of working interest their proportion of the cost of the well. As to the Risk Penalty" allocated to the driller, the Commission allocated zero, because, of the generally low risk of failure associated in drilling Barnett Shale wells, **See, Application of Finley Resources, Inc., for the Formation of a Unit Pursuant to the Mineral Interest Polling Act for the Proposed East Side Unit, Newark, East (Barnett Shale) Field, Tarrant County, Texas, Oil & Gas Docket No. 09-0252373 of the Railroad Commission of Texas, Aug. 25, 2008.**

[4] See, NM Stat 70-2-17 at B & C

[5] Ibid., at B.

If a horizontal driller wishes to extend his borehole beyond a proration unit in the area of an established pool, he should be allowed to do so but he should be required to negotiate with, rather than force-pool, adjoining landowners. Hence as to the Division's suggested change at 19.15.16.15. A. (2) *"obtain a compulsory pooling order from the division,"* we request that the following be added: *"which shall not be available outside a single proration unit which would be required for a vertical well drilled to the intended productive horizon at the same location."*

We note that the industry has been quite adept at negotiating very large "Federal Units" and Working Interest Units on a voluntary basis. These often are very complicated, but are put together by negotiation rather by application of the state's police power. Thus, to extend a spacing unit into a "project area," we feel that a driller should, beyond the spacing unit, be required to negotiate to obtain his goal rather than to enlist the police power of the state to achieve it.

A TAKING, OR A LEGITIMATE USE OF POLICE POWER

Historically, the constitutional basis under which a state had the authority to facilitate compulsory pooling arose from the "police power" of the state.[6] This exercise of police power was legitimate because it was directed at avoiding waste and protecting correlative rights. The need for compulsory pooling arose because the state passed spacing requirements to avoid wasteful drilling. This was thought to create a need for compulsory pooling in order to allow owners of property within spacing unit's a means of complying with the spacing law and in order to allow those owners to protect their correlative rights.

The compulsory pooling law in the state of New Mexico is, perhaps, the friendliest in the nation to those who institute force pooling. If its purpose moves beyond the legitimate prevention of waste and protection of correlative rights to simply being a law which simply facilitates the "taking" of private property from one individual by another, the state will have breached the 5th Amendment rights of the divested person. The law was not intended to have as it's primary purpose the feeding of the covetousness of an oil operator wanting to take the property of another person.

Consider this circumstance. We believe that the Division's proposal will allow horizontal drilling into acreage covered by an existing Operating Agreement under which an existing vertical well is producing from the zone targeted by the horizontal well. We also believe that the Division's proposal would allowed horizontal drilling into acreage covered by an existing Operating Agreement under which an existing vertical well has "behind the pipe reserves" owned the parties to the operating agreement.

If this analysis is correct, a variety of problems arise. The first has to do with the constitution.

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[6] See, Patterson v. Stanolind Oil & Gas Company, 1938 OK 138, 182 Okla. 155, 77 P.2nd 83, app. dism'd, 305 U.S. 576 (1936)

If the state itself wanted to drill into the proration unit and extract the reserves, the state would have to meet the requirements of the 5th Amendment taking provision. There would have to be "due process." The state could only take the property for a "public use." The state would have to negotiate in good faith. It would have to pay just compensation. To establish the magnitude of that compensation an appraisal of the value of the property would have to be done. A court would review the matters of public use, just compensation and due process.

In 2005 the US Supreme Court expanded the former meaning of "public use" to authorize a city to take private property from one land owner and transfer it to a developer. Yet, even under this case which is know as Kelo v. New London[7] there was payment of "just compensation', there was an appraisal, there was a court review and so forth.

Consider the irony here. If the state were to drill into an established proration and take producing or behind the pipe reserves, it would have to meet the requirements of the 5th amendment. However, if you pass this regulation as it is written you would be claiming the right to facilitate the taking of the same private property and transfer it to a developer but without the need for the same due process, without the appraisal, without the need to pay due compensation, without the same judicial review and so forth.

If you allow the use of compulsory pooling to facilitate horizontal drilling into previously established proration units where there are behind the pipe reserves or producing reserves, I believe you will have crossed the line from a legitimate use of police power to facilitating a taking. The court reasoning on which compulsory pooling had stood has often been sloppy and, eventually, will be seen as such. It goes like this: the compulsory pooling is ok because all private property is subject to the state's police power.

There are other related problems:

- This would stand the initial purpose of the compulsory pooling statute on its head. It was adopted, in this state and elsewhere, along with proration unit requirements, to prevent excessive drilling or redundant wells the same area. Yet, the proposal would allow invasion of a new well (a horizontal well) into a proration unit, formed pursuant to Commission rules, which already contains a well. This may create waste, rather than "prevent waste," and we question the authority of the Commission to do that. The cost of the vertical wells has been expended. The borehole is already there for future use in multiple ways.

- Further, such action would diminish the correlative rights of the owners of the vertical well. The owners of the vertical well have tapped into the reserves on a proration unit which the Commission established pursuant to its statutory directive to create a proration unit that "*can be efficiently and economically drained and developed by one*

[7] 545 U.S. 469 (2005)

well..."[8] While a horizontal well may produce those reserves more quickly, the reserves on that proration unit belong to the owners of the vertical well.

- The parties to the Operating Agreements may have mortgaged to a bank both the producing reserves and the "behind the pipe" reserves. Such action by the Division ultimately will diminish the capacity of producers to gain financing in the State of New Mexico and thus inhibit, rather than promote, drilling. Further, such action by the Division essentially facilitates the taking by a horizontal driller of private property owned by another person or persons. This should be prohibited.

- The New Mexico Constitution at prohibits impairment of contracts by the government.[9] A bank lending to the producer would have entered into a lending contract based on an engineer's calculation of reserves which took into consideration drainage by surrounding wells on other proration units but did not take into consideration the invasion of the proration unit by a horizontal well authorized by the government. If the Commission authorizes such an invasion, it will have impaired the contract between the producer and the bank.

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

ARE THE COMPULSORY POOLING PROTECTIONS REAL?

When compulsory pooling rules were instituted to remedy the problem caused by the spacing unit requirement, it was recognized that potentially the property of one party would be taken by another party. The rules sought to balance this in a number of ways, primarily by requiring a reversion of interest after the driller received his money back for the drilling plus compensation for taking the risk of drilling the well. The statute states that the "*charge for risk shall not exceed two hundred percent...* "[10]

An examination of the record of the Division in recent years would indicates that the Division almost always maxes out by giving a 200% compensation for risk. This is unfortunate. How can the risk be the same each time a pooling takes place? The extent to which the Division overcompensates the driller for risk, the Division takes from the person who is force pooled and gives to the driller what should not be his. The law states that the Commission shall "*afford to the owner or owners of each tract or interest in the unit the opportunity to recover or receive without unnecessary expense his just and fair share of the oil or gas or both.*"[11] Constant use of the 200% risk penalty breaches this provision.

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[8] Ibid, NM Stat 70-2-17 at B & C

[9] Art. II, Sec. 19.

[10] Ibid, NM Stat 70-2-17 at B & C

[11] Ibid.

Because of the cost of horizontal wells, if this practice is extended to horizontal wells the taking from the force pooled interest will magnify.

By early 2009 the Rail Road Commission of the State of Texas had employed compulsory pooling only once. That case involved a horizontal well drilled into the Barnett Shale. In considering the Risk Penalty" allocated to the driller, the Commission allocated zero, because, of the generally low risk of failure associated in drilling Barnett Shale wells.

How is it that the geologic risk of drilling in New Mexico is always 200% and yet in Texas is as low as 0%. Oh, poor New Mexico, so far from Texas!

We note that horizontal wells usually are drilled into zones which have been penetrated by a number of wells. This has been the case 'because horizontal wells often target "source rock," such as shale. which often lies above earlier targeted porosity zones. The fact that numerous wells earlier have penetrated the zone targeted by the horizontal well means that the geologic risk being taken by the horizontal driller often is much less than the risk taken by a wildcat driller. Consequently, the reward for taking the risk should be adjusted downward where there have been a number of earlier holes which have . penetrated the targeted zone.

Consequently, at 19.15.16.15 F. Compulsory pooling, we request that the following language be added: *"During a Compulsory pooling hearing involving a horizontal/well the Division is instructed to examine closely the actual geologic risk being taken by the driller considering earlier penetrations of the zone being targeted by the driller in the area in which the driller proposes to drill and to reduce the compensation to the driller for risk taken to 50% where that more closely rewards the driller for the anticipated geologic risk of the endeavor."*

COMPULSORY POOLING TOO EASY?

The Commission should consider the fact that the use of compulsory pooling in New Mexico has become so easy and profitable to the developer that this fact impacts potential contractual negotiations between parties. Negotiations often do not take place "in good faith." The attitude of developers has become, "Well, if you don't take the deal I have offered you, we will force pool you."

Often the attempt to make a deal is cursory. Here is the time line from one deal: Drilling proposal letter July 8; Proposed Joint Operating Agreement received July 17th; Revised Operating Agreement with correct interest figures July 25; Force Pooling Application July 28th.

PURPOSE

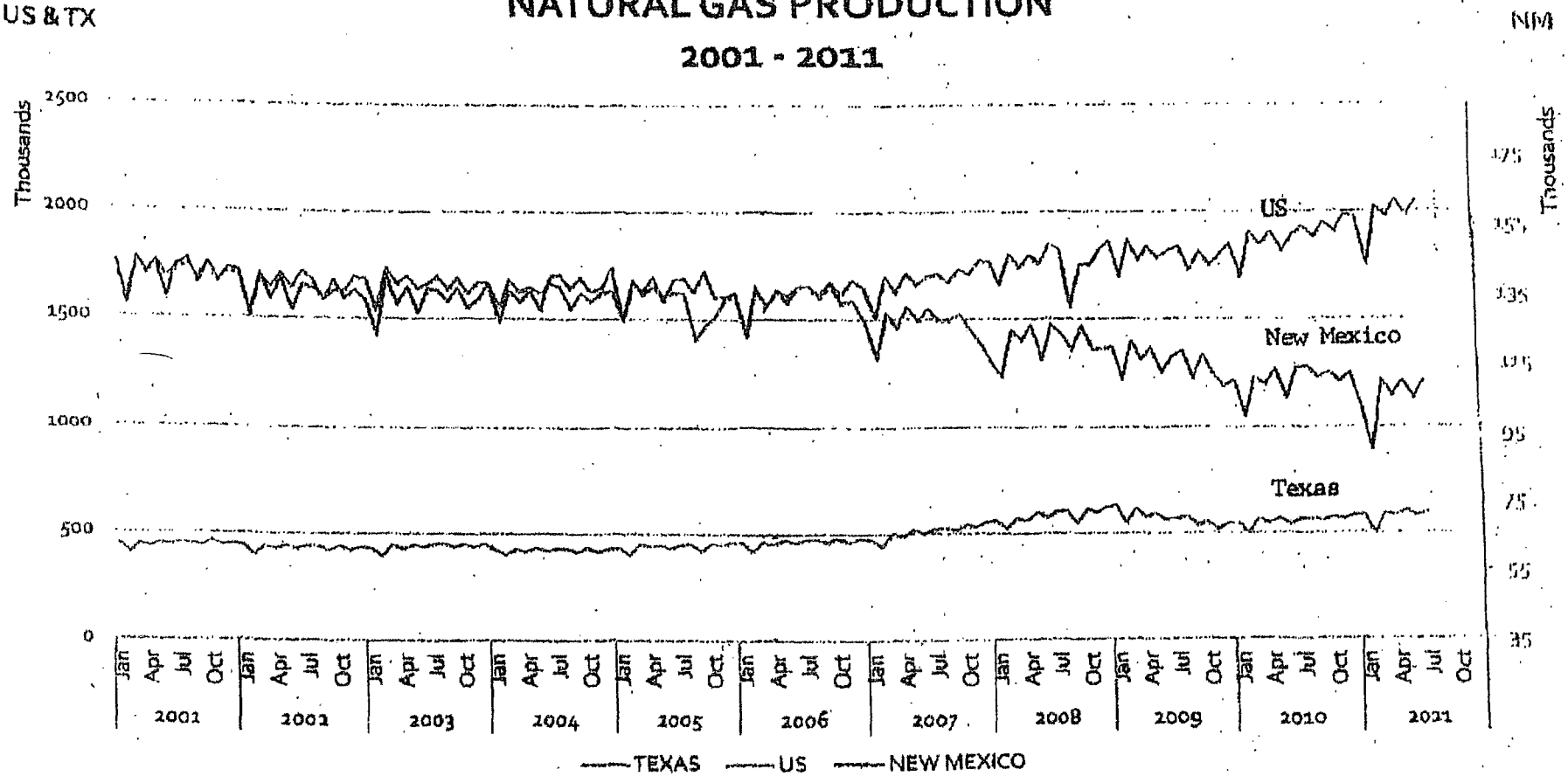
The purpose of the compulsory pooling statute is to prevent waste and protect correlative rights. Its purpose is not to make life easier for developers, or to contort the relationship between developer and land owner, or to devalue land or lease ownership while adding to the wealth of horizontal developers.

Thank you for the opportunity to address the commission.

Harvey E. Yates, Jr.

Production

NATURAL GAS PRODUCTION
2001 - 2011



Source: US Energy Information Administration - Data as of July 2011.