

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

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

CASE NO.: 14744

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**BRIEF OF JALAPENO CORPORATION AND HARVEY E. YATES
COMPANY REGARDING PROPOSED HORIZONTAL DRILLING RULES**

Jalapeno Corporation and Harvey E. Yates Company submit the following brief responding to the request of the Commission for briefs on the issue of whether the Commission has the authority to adopt amendments to its rules that provide for the forced pooling of project areas for horizontal wells.

I. THE PROVISIONS IN THE PROPOSED RULES PURPORTING TO ALLOW FOR THE COMPULSORY POOLING OF CONTIGUOUS, COMPLETE SPACING UNITS ARE NOT AUTHORIZED BY THE OIL AND GAS ACT.

At the outset of the hearing on the proposed amendments to the Division's horizontal drilling rules, the Division's lawyer alluded to the need for the Oil and Gas Act to be amended to grant the Division authority to provide for the compulsory pooling of project areas crossing multiple, standard spacing units:

[T]he Division is aware that there would be a need for Legislative change. However, the Division is not seeking to define compulsory pooling as it relates to horizontal wells, but to merely state that the current rules that we have on compulsory pooling would apply to horizontal wells in the projected formation.

See Tr. P. 12.¹ However, the proposed amendments to Rules 19.15.14.8 and 19.15.16 do not just merely provide that the Commission's compulsory pooling rules will apply to horizontal wells. Instead, the amendments specifically allow for the creation of project areas through the compulsory pooling process which combine multiple, contiguous spacing units. See Proposed Rule 19.15.16.7(K) and (L)(creating a new definition of "project area" and "standard project area.")

The Oil and Gas Act makes no mention of "project areas" or "complete, contiguous spacing units." It only grants the Commission the authority to create proration units, unorthodox spacing units and secondary recovery and pressure maintenance unit. There has been no grant of authority to create project areas for a horizontal well which is comprised of a combination of complete, contiguous spacing units. As previously ruled by the Commission in the *Cimarex* case, combining complete, contiguous spacing units is in the nature of unitization and is not properly considered the creation of a non-standard spacing unit. See Order No. R-13228-F (November 4, 2010).

By statutory definition, there may only be one well in each proration or spacing unit based on spacing rules established by the Commission through

¹ Counsel was presumably referring to the proposed Rule 19.15.16.15(F) which states that "the provision of 19.15.13 NMAC regarding compulsory pooling and proposal for additional wells in compulsory pooled units shall apply to horizontal wells and compulsory pooled project areas." Testimony during the hearing confirmed the Working Committee's view that the Division lacked the authority under the Oil and Gas Act to order compulsory pooling for project areas encompassing multiple complete spacing units. See Tr., Vol 1... pp. 70-71, 73, lines 12-16, 75, lines 4-7; Vol. 2, pp 22-23.

statewide or special field rules to prevent waste and protect correlative rights. *See* NMSA 1978 1978, §70-2-17 (defining proration unit as “the area that can be efficiently and economically drained by one well.”) However, the Legislature has not authorized the creation of hybrid super-spacing units which pool multiple contiguous spacing units and which utilize surface acreage to allocate the share of production from the unit.

“The Oil Conservation Commission is a creature of statute, expressly defined, limited and empowered by the laws creating it.” *Continental Oil Co. v. Oil Conservation Comm’n*, 70 N.M. 310, 318, 373 P.2d 809, 814 (1962); *see also* *Marbob v. Oil Conservation Comm’n*, 2009-NMSC-13, 46 N.M. 24, 206 P.3d 135 (2000). Although the Division has been granted the authority to order the compulsory pooling of separately owned tracts of land in order to form a spacing unit for a well, in doing so must strictly comply with the provisions of the pooling statute. Compulsory pooling under Section 70-2-17(C) of the Oil and Gas Act involves an extraordinary exercise of the police power of the state which results in a forced taking of property rights. If a pooling order entered by the Division is not within the limits of the statutory pooling authority, then there is a taking of property rights without just compensation in violation of the 5th Amendment of the U.S. Constitution and Article II, Section 20 of the New Mexico Constitution.

The Oil and Gas Act authorizes compulsory pooling in specific, limited circumstances--where an operator lacks sufficient acreage to meet the acreage required by the spacing rules to form a spacing unit for a well. In those circumstances the owners of separate tracts, either voluntarily or by using the compulsory pooling power of the Division can combine their acreage for common development:

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

NMSA 1978, §70-2-17(C)(emphasis added).

Under a plain reading of the unambiguous language of the Pooling Statute, pooling of acreage is allowed to form a spacing unit or proration unit for a well in accordance with established spacing rules and not to create super-sized units that combine the acreage across preexisting, complete contiguous spacing units. The statute repeatedly refers to the pooling of lands to form a “spacing or proration unit” and directs the Division to “pool all or any part of such lands or interest or

both in the spacing or proration unit as a unit.” It says nothing about “project areas” or combining lands for project areas which may cross existing, multiple spacing units. Nor can the Division change this result by amending its rule to delete the traditional definition of “spacing unit” from its rules.² The statutory language is clear and unambiguously limits the compulsory pooling to form a single spacing unit for a well.

The basic differences between pooling and unitization have been recognized by the New Mexico Supreme Court:

In the mid-1950s, the term "pooling" referred to "small units, usually of the one well-drilling unit variety, and the term "unitization" referred to "units covering large land areas, particularly the fieldwide or poolwide unit." Nevertheless, the relevant legal principles generally related "to any type of voluntary combination or consolidation of ownership interests for development and production purposes, regardless of the size of the area that may be involved." Today, the terms are used to refer to different procedures. *See Amoco Prod. Co. v. Heimann*, 904 F.2d 1405, 1410 n.3 (10th Cir. 1990) (describing "pooling" as referring to "the combination of several small tracts of land to meet the spacing requirements for a single well" and "unitization" as referring "to fieldwide or partial fieldwide operation of a producing reservoir involving multiple adjoining land tracts"). The terms are described as having different, but related, purposes. The purpose of pooling is to create "sufficient acreage to receive a well drilling permit under the relevant state or local spacing laws and regulations." "The objective of unitization is to provide for the unified

² The Division's Rules define a "spacing unit" as both "the acreage dedicated to a well in accordance with 19.15.15 NMAC" and "the acreage allocated to a well under a well spacing order or rule." *Compare* 19.15.16.7(K) NMAC with 19.15.30.13(C) NMAC. Spacing units have been established for a pool based on the acreage a vertical well in that pool was presumed to drain. *See* NMSA 1978, §70-2-17(B). By contrast a "proration unit" is defined as "the area in a pool that can be effectively and efficiently drained by one well" and "should be the same size and shape as a spacing unit." 19.15.2.7(5)(17). The proposed amendments seek to delete the definition of spacing unit in 19.15.16.7(K).

development and operation of an entire geologic prospect or producing reservoir so that exploration, drilling and production can proceed in the most efficient and economical manner by one operator."

Kysar v. Amoco Prod. Co., 2004 NMSC 25, 93 P.3d 1272, 135 N.M. 767 (citations omitted). The power to pool multiple, separate and distinct contiguous spacing units to form a super unit involves unitization and not pooling.

Combining multiple contiguous units essentially accomplishes statutory unitization for primary production in violation of the limitations of the Oil and Gas Act and the Statutory Unitization Act. NMSA 1978, §§70-7-1 to 70-7-21. Under the Act, acreage may be combined for common development that embraces multiple units for secondary and tertiary recovery purposes. In granting the unitization power, the Legislature imposed two important limits on the power. First, at least 75% of the owners of acreage in the proposed unit must agree to unitization. Second, the applicant must show that the plan of unitization is "fair and reasonable." See NMSA 1978, §70-7-6(B); see also, NMOCC Order No. R-13228-F. The Division must determine that the participation formula allocates unitized hydrocarbon in a fair, reasonable and equitable basis and make its own determinations about the relative value of each tract and how production should be allocated. *Id.*

By contrast, the pooling power of the Division doesn't require approval of a super-majority of working interest owners in the proposed unit and production is

allocated strictly on the surface acreage each tract contributes to the spacing unit. See NMSA 1978, §70-2- Where a single spacing unit is involved, the risk that correlative rights will be impaired is small because there is a high likelihood that there will be consistent porosity and thickness of producing sands in the unit. However, for larger areas the Legislature recognized that a strict acreage-based allocation formula does not adequately protect correlative rights. The Division would violate the correlative rights of interest owners in each spacing unit being combined by forcing the inclusion of the mineral interests into super units which production is allocated on a straight acreage basis without consideration of the relative value of each tract.

In *Rutter & Wilbanks Corp. v. Oil Conservation Comm'n*, 87 N.M. 286, 532 P.2d 582 (1975), the New Mexico Supreme Court upheld the Division's authority to create a non-standard spacing unit under what is now NMSA 1978, §70-2-18(C). However, a "non-standard spacing unit" is a spacing unit which deviates in acreage or conformation from the standard units established by the Division's spacing rules. See Kramer 7 Martin, Williams & Meyers, MANUAL OF OIL AND GAS TERMS, §701 (2000); Order No. R-13228-F. The non-standard spacing unit in the *Rutter* case did not encompass multiple, existing spacing units but an oversized unit that was 27% larger than the standard 320 acre spacing unit. Section 70-2-

18(C) cannot be read to authorize the creation of super units which combine complete, contiguous spacing units.

The Division's Rules mandate that a developmental oil well in a defined pool "shall be located on a spacing unit consisting of approximately 40 contiguous surface acres substantially in the form of a square that is a legal subdivision of the United States public land surveys. 19.15.15.9(A) NMAC. The authority granted by Section 70-2-18(C) to create a non-standard spacing unit was designed to address unique situations where insufficient acreage due to surveying problems or topography created the need to establish a unit of unorthodox shape or size.³ It is not a blanket authority to create special spacing orders for horizontal wells that traverse multiple, complete units.

II. THE DIVISION CANNOT FORCE POOL LANDS ALREADY COMMITTED TO A PLAN OF DEVELOPMENT THAT EMBRACE EXISTING SPACING UNITS.

The proposed amendments also need to address other limitations on the pooling power set forth in the Oil and Gas Act. When the owners of separate tracts have previously agreed to a plan of development pursuant to a joint operating agreement, the Oil and Gas Act also requires the Division to adopt their plan of

³ The Division can approve an application for a non-standard spacing unit after notice and hearing in only three circumstances where: (1) the unorthodox size or shape is necessitated by a variation in the legal subdivision of the United States public land surveys; (2) the non-standard spacing unit consists of a single quarter-quarter section or lot or quarter-quarter sections or lots joined by a common side; and (3) the unit lies wholly within a single quarter section if the well is completed in a pool where 40 acres is the standard spacing unit size.

development agreed to by working interest owners as long as it has the effect of preventing waste and is fair to the royalty owners in the pool. *See* NMSA 1978, §70-2-17(E). An compulsory pooling order which allows a non-JOA operator to produce the reserves previously committed to a plan of development that embraces a proper spacing unit for a well is an unconstitutional impairment of the joint interest owners obligations under the JOA as well as other contracts in which their reserves have been committed. *See* N.M. CONST., ART. II, BILL OF RIGHTS, §19; *Temple Baptist Church, Inc. v. City of Albuquerque*, 98 N.M. 138, 147, 646 P.2d 565, 574 (1982). Therefore, the Division has no authority to force pool acreage to form a project area which embraces the acreage previously committed to joint development which is adequate to form a spacing unit for a well in the target formation. In those circumstances, the Division has no discretion but mandates that the joint plan of development “*shall be adopted* by the Division” under the Act if it is fair to royalty owners and prevents waste. *Id.* (emphasis added). The proposed special rule for horizontal wells should reflect this statutory command.

III. THE PROPOSED SPECIAL RULES FOR HORIZONTAL WELLS SHOULD LIMIT THE RISK PENALTY TO 50% AND PLACE THE BURDEN ON THE PARTY SEEKING COMPULSORY POOLING TO JUSTIFY THE CHARGE.

The Commission has recognized that under New Mexico law a cotenant has “the right to produced minerals from the co-owned property without the consent of the non-joining owner by allowing a cotenant who produced oil from co-owned

premises to recover its development cost out of the share of production allocable to a non-joining cotenant in the absence of either an agreement or a pooling order.” NMOCC Order No. R-12093-A, ¶18 (citing *Bellet v. Grynberg*, 114 N.M. 690, 845 P. 2d 784 (1992)). Under New Mexico law, a cotenant can always drill at its own risk and has no right to recover any costs beyond its actual operating costs incurred in drilling a well.

In accordance with the common law rule that an operator can recover the cost of drilling a well from its co-tenants, the Legislature has mandated that compulsory pooling orders “*shall* include a reasonable charge for supervision.” But the decision to include a charge for risk under the pooling statute is purely discretionary, stating that the order “*may include* a charge for the risk of drilling ... which *shall not exceed two hundred percent...*” NMSA 1978, § 70-2-17(C) (emphasis added). The Commission’s rule that automatically establishes a risk charge of 200% and places the burden on the party opposing pooling to present geologic or technical evidence in support of a lower charge is ill-suited to horizontal wells drilled in historically productive formation and amounts to a mandatory risk charge in violation of Section 70-2-17(C).

Where an area has a long history of productive drilling and an operator has enjoyed a high level of success rate, even a 100% risk charge has been deemed excessive by the courts. *See Windsor Gas Corp. v. Railroad Comm’n.*, 529 S.W.2d

834 (Tex. Civ. App. 1975) (refusing to order compulsory pooling because the operator had not made a reasonable offer to pool since its offer included a 100% risk charge). Moreover, courts in other states have routinely upheld the decision of oil and gas commission not to include any charge for the risk of drilling in a compulsory pooling order. *See Texas Oil & Gas Corp. v. Rein*, 534 P.2d 1280, 1282 (Okla. 1974); *Ranola Oil Co. v. Corporation Comm'n*, 460 P.2d 415, 417 (Okla. 1969); *Wakefield v. State*, 306 P.2d 305, 308 (Okla. 1957). Therefore, in its special rules for horizontal wells the Commission should limit any default risk penalty to 50% and place the burden on the party seeking compulsory pooling to support the imposition of a charge up to the 200% statutory maximum risk charge.

Respectfully Submitted,

MODRALL, SPERLING, ROEHL, HARRIS
& SISK, P.A.

By: Ausan R. Stockwell for Earl E. DeBrine, Jr.
Earl E. DeBrine, Jr.

Post Office Box 2168

Albuquerque, New Mexico 87103-2168

Telephone: 505.848.1800

Email: edebrine@modrall.com

ATTORNEYS FOR HEYCO CORPORATION

and

Patrick A. Fort
6725 Ophelia Ave. NE
Albuquerque, New Mexico 87109-6935
Telephone: (505) 828-0323
Email: patrickfort@msn.com

ATTORNEY FOR JALAPENO CORPORATION

CERTIFICATE OF SERVICE

I certify that on November 21, 2011, I served a copy of the foregoing documents by U.S. Mail to the following:

Gabrielle A. Gerholt
Assistant General Counsel
ENERGY, MINERALS AND NATURAL
RESOURCES DEPARTMENT
1220 S. St. Francis Drive
Santa Fe, NM 87505

Karin V. Foster
CHATHAM PARTNERS, INC.
5808 Mariola Place, NE
Albuquerque, NM 87111
*Attorneys for the Independent
Petroleum Association of New Mexico*

William H. Carr
Ocean Munds Dry
HOLLAND & HART, LLP
P.O. Box 2208
Santa Fe, NM 87504-2208
*Attorneys for the New Mexico Oil and
Gas Association and Lynx Petroleum
Consultants, Inc.*

MODRALL, SPERLING, ROEHL,
HARRIS & SISK, P.A.

By: *Earl E. DeBrine, Jr.* *for Susan R. Atchskill*
Earl E. DeBrine, Jr.