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

2005 SEP 14 PM 3 35

IN THE MATTER OF THE APPLICATION OF SAMSON RESOURCES COMPANY, KAISER-FRANCIS OIL COMPANY, AND MEWBOURNE OIL COMPANY FOR CANCELLATION OF A DRILLING PERMIT, AND APPROVAL OF A DRILLING PERMIT, LEA COUNTY, NEW MEXICO. **CASE NO. 13492**

IN THE MATTER OF THE APPLICATION OF CHESAPEAKE PERMIAN, L.P. FOR COMPULSORY POOLING, LEA COUNTY, NEW MEXICO **CASE NO. 13493**

2005 SEP 14 PM 3 35

POST-HEARING STATEMENT
ON BEHALF OF
MEWBOURNE OIL COMPANY, SAMSON RESOURCES COMPANY
AND KAISER-FRANCIS OIL COMPANY

Mewbourne Oil Company, ("Mewbourne"), Samson Resources Company, ("Samson"), and Kaiser-Francis Oil Company, ("Kaiser-Francis"), submit this Post-Hearing Statement on the relevant evidence in the record in these conolidated cases.

Case No. 13492: APD Cancellation

I. INTRODUCTION

There is no dispute concerning the ownership of the minerals or of the oil and gas leasehold interests in the SE/6 of irregular Section 4, Township 21 South, Range 35 East, NMPM, Lea County, New Mexico as of March 10, 2005. On that date neither Chesapeake Operating, Inc., nor any other Chesapeake entity, had any interest whatsoever, surface or subsurface, in that quarter-section. The surface and minerals are owned by the State of New Mexico. They were leased for oil and gas development on December 19, 1932 in Lease No. B-

1481. By mesne assignments the State lease interest in the SE/6 on March 10, 2005 was held **12.5% by Samson Resources Co.** ("Samson") and **87.5% by Kaiser-Francis** Oil Company ("K-F"). Applicant's Ex. A and E.

On March 10, 2005, Chesapeake Operating, Inc. electronically filed a Form C-101 Application for Permit to Drill for the KF "4" State Well No. 1. (API No. 30-0253-37129) (the "KF4 Well") at the OCD Hobbs district office. That very day Chesapeake staked the subject well. Chesapeake Amd. Pre-Hearing Statement, p. 3. The Application for Permit to Drill ("APD") was electronically approved the next day, Friday, March 11, 2005 by Paul Kautz. Apps' Ex. I. Forms C-101 and C-102 in paper form bear submission dates of March 10, 2005; the C-102 bears an approval stamp dated March 11, 2005, signed by Paul Kautz. The subject of all of these forms is the KF4 Well.

On April 27, 2005 Chesapeake Operating spudded the KF4 Well, obviously having built a well location before that date.[1]

Chesapeake was and is a trespasser on the mineral rights of the State of New Mexico and the mineral development rights of the Applicants in Case No. 13492, who hold exclusive oil and gas rights under the subject lands. Chesapeake has to this day no ownership or use interest whatsoever in the surface or in the minerals underlying the SE/6 of irregular Section 4.

As authority for spudding the KF4 Well on April 27, 2005, Chesapeake relies on the March 11, 2005 APD as "approval from the Division to drill the well and form a proration unit for the well . . ." Amd. Pre-Hearing Statement, p. 3. During the hearing Chesapeake also

[1] By that day the working interests in Lease B-1481 were and are held Samson 12.5%, KF 72.70813% and Mewbourne 14.79187%. App.s' Ex. I.

introduced as evidence of its purported right to enter the surface a surface damage and easement instrument provided by the grazing lessee[2] of the State of New Mexico lands.

II. THE EVIDENCE

A. The APD

The subject APD (C-101) and the C-102 "Well Location and Acreage Dedication Plat" contain a data field labeled "Consolidation Code." Chesapeake provided no information called for by those forms to show ownership and the status of the leases in the dedicated 320 acres. NMAC 19.15.13.1102A. The regulations mandate that *"All information required on form C-102 shall be filled out and certified by the operator of the well."* NMAC Id. B. The C-102 instructions provide the code letters to be entered in the Consolidation Code box (e.g. "C" – Communitization, "F" – Forced pooling). Applicants' Exs. L and M. The Consolidation Code boxes are blank on both forms.

The Hobbs office disregarded the regulations with respect to the requirement for an operator to show ownership and consolidation of leases to be dedicated to the spacing unit. On line electronic APD submissions have been in effect for about one year according to Paul Kautz. He testified that Jane Prouty, the individual responsible for the Division's "IT" systems, told the district office that the Consolidation Code information is not essential and that the Division's regulations and instructions could be overridden. The APD on the KF4 Well was issued with no regard as to whether Chesapeake had any property rights to drill a well in the SE/6 of irregular Section 4.

[2] Chesapeake refers to this agreement as being "from the surface owner . . ." Amd. Pre-Hearing Statement, p. 3. In fact it is undisputed that the surface is public land owned by the State of New Mexico and administered by the Commissioner of Public Lands. App. Ex. Q.

B. Surface Damage Agreement

Chesapeake introduced a document entitled "Surface Damage Release and Grant of Surface Easement," dated June 3, 2005 (the "Surface Release"). Chesp. Ex. 13. The Surface Release was made between Chesapeake Operating, Inc. and Merchant Livestock Company, who is described in the document as the "Surface Lessee." In the Surface Release Merchant Livestock Company purports to grant Chesapeake an unrestricted easement over the SE/6 of irregular Section 4 and set surface damage rates, such as $5,000 for each well location.

Merchant Livestock Company rights to the SE/6 of irregular Section 4 are by way of "grazing lease" Number GT2533 from the Commissioner of Public Lands covering 81,894.22 acres, including the SE/6 of irregular Section 4 (the "Grazing Lease"). The "G" designation in the lease number refers to the fact that the lease is for grazing purposes. The Grazing Lease expressly provides that the permitted use of the Lessee, Merchant Livestock Company, is to:

> ". . . use the leased premises only for such operations and activities as are necessary to carry out the purposes for which the lease is granted as specified in Exhibit A . . ."

Section 4. Applicants' Ex. Q. Exhibit A of the Grazing Lease specifies that the allowed use is grazing. Moreover, Section 11A of the Grazing Lease expressly provides,

> "A. Lessor reserves the right to execute leases on the land granted by this lease for mining purposes and for the extraction of oil, gas, salt, geothermal resources, and other mineral deposits therefrom and **the right to go upon, explore for, mine, remove and sell same."**

Emphasis added.

C. The Rescinded Participation Election

On March 11, 2005, Samson received Chesapeake's March 9, 2005 well proposal letter for the KF4 Well. The Chesapeake proposal letter suggested that Samson would not be excused from making the "required election" under the well proposal. The letter was accompanied by an

AFE, but no operating agreement was included. One of Samson's land personnel, obviously believing that the election was in fact required, executed Chesapeake's well proposal on March 16th. Samson did not tender its share of well costs, however. Subsequently, on investigation, it was determined that there was no operating agreement between the parties that would support the election. Correspondingly, on March 30, 2005, Samson notified Chesapeake by fax letter that the earlier election was invalid and was accordingly rescinded and revoked.

III. POINTS AND AUTHORITIES

The APD was improvidently issued to Chesapeake. The practice of issuing APD's to a party without any inquiry into the applicant's rights to drill the well applied for requires cancellation of the permit. Chesapeake's absolute lack of ownership or rights within the SE/6 of irregular Section 4 is a fact. Where an applicant who lacks a good faith claim to the tract has been issued a permit to drill a well the permit should be cancelled. *Humble Oil & Refining Co. v. MacDonald*, 279 S.W.2d 914 (Tex. App. 1955). The APD should have never been issued in the first place and is a nullity. *Superior Oil Co. v. Railroad Comm.*, 571 S.W.2d 51, 55 (Tex. App. 1978) ("The Commission should deny the permit if it does not reasonably appear to it that the applicant has a good-faith claim in the property.")

The Oil Conservation Commission's Order R-12093-A in the *Valles Caldera Trust* Case (Case No. 13215) is highly instructive on the issues here.

> 11. [A]n approved APD is merely an authorization to conduct an activity presumed to be otherwise lawful. It does not require an operator to drill. If drilling in accordance with the APD violates federal law or a property right, approval of the APD does not constitute any colorable authority for such violation. *See Magnolia Petroleum Co. v. Railroad Commission*, 170 S.W.2d 189 (1943) where the Texas Supreme Court discussed the effect of a Texas Railroad Commission permit to drill:
>
> > "[T]he order granting the permit is a purely negative pronouncement. It grants no affirmative rights to the permittee to

> occupy the property, ... It merely removes the conservation laws and regulations as a bar to drilling the well . . ." at ¶ 11 (citing *Magnolia Petroleum Co.*, 170 S.W.2d at 191).
>
> * * *
>
> 23. The right to exercise mineral rights arises, if at all, from the ownership of the mineral interest, and not from the approval of an APD which merely confirms that the specific operation complies with OCD's spacing and technical requirements.

Order No. R-12093-A, at 4 and 5.

The Surface Release obtained by Chesapeake from Merchant Livestock Company is a red herring. First, Chesapeake confuses trespass regarding the rights to develop the subsurface for oil and gas with trespass on the surface. *Hartman v. Texaco*, 123 N.M. 220, 224, 937 P.2d 979 (Ct. App. 1997) ("[I]n New Mexico an action for common law trespass does provide relief for trespass beneath the surface of the land."). Next, the state grazing lessee can only make an agreement to the extent of his limited agricultural permissive use and had no authority to bestow any rights whatsoever on Chesapeake to conduct any operations on the State land to "go upon, explore for, mine, remove and sell [oil and gas]." That authority is expressly reserved to the State as surface owner in the Grazing Lease.

On March 11, 2005 Chesapeake sent to Samson and Kaiser-Francis a well proposal stating that they must make a "required election" within 30 days. As Samson's land witness testified, Samson believed that, based on the phrasing of this letter, an operating agreement was in place. As a result, Samson returned an election letter to Chesapeake, with a signed AFE, to avoid being a non-consenting interest owner. Samson subsequently determined that there was no operating agreement covering a S/3 unit and notified Chesapeake in writing that it was rescinding its "election."

First, by seeking to force pool Samson, Chesapeake admits that Samson did not voluntarily join in Chesapeake's proposed well. If Chesapeake truly thought Samson had joined in its well, it would not have included Samson in its pooling request.

Second, the "election" letter signed by Samson gives Chesapeake no rights to drill a well on the lease owned by Samson, *et al.* A signed AFE with an accompanying election letter has no force and effect absent Samson signing an operating agreement. In *Sonat Exploration Company v. Mann*, 785 F.2d 1232 (5th Cir. 1986), an operator sued to recover well costs from a non-operator who had executed an AFE but not an operating agreement. The court refused to order reimbursement to the operator, stating there is "no authority for the proposition that an AFE is enforceable against one who has not signed an accompanying operating agreement." An AFE is merely an estimate of costs without binding effect in the industry. *Cleverock Energy Corp. v. Trepel*, 609 F.2d 1358 (10th Cir. 1979). If a signed AFE is non-binding, it cannot, as a matter of law, grant Chesapeake the right to trespass on the lease owned by Samson, *et al.* This would be true even if Samson had not rescinded the election letter

The testimony in the case established that there were no circumstances that required Chesapeake to drill: there was no expiring lease or farm-out affecting any party's interest; Chesapeake had any number of other locations with approved drilling permits to which it could have moved its drilling rig; and finally, there was no evidence presented establishing that Chesapeake's acreage in the SW/6 of irregular Section 4 was being drained by the Osudo "9" State Well No.1 in the NE/4 Section 9, a well in which Chesapeake owns a 40 percent interest.

Chesapeake purposefully misconstrued the authority set forth in the *TMBR/Sharp* case (Order No. R-11700-B) and the *Pride* case (Order No. 1208-C) to justify its actions after the fact.

It is now clear that by drilling the KF4 Well, Chesapeake was gaming the system in hopes it could prevail in these cases by presenting the Division with a *fait accompli*.

Earlier in this proceeding, Chesapeake contended that "[t]he Commission's Order in Pride tells us, as a matter of administrative law, that Chesapeake can rely upon its valid and approved APD as the "good faith" basis for doing what it did and continues to do." Chesapeake *Motion To Dismiss*, pg. 2. However, Order No. R-12108-C from the *Pride* case says no such thing. Rather, the Commission in *Pride* said, citing to Order No. R-11700-B from *TMBR/Sharp,* "That an applicant for permit to drill must have a good faith claim of title."

Further, Order No. R-11700-B in the *TMBR/Sharp* case set forth the two criteria under which the Division may make a determination whether an APD was properly or improperly approved: "It is the responsibility of the operator filing an Application for a Permit to Drill to do so under [1] a good faith claim to title and [2] a good faith belief that it is authorized to drill the well applied for." (emphasis added). In this case, Chesapeake was unable to show either one.

As further evidence that Chesapeake's reliance on *Pride* and *TMBR/Sharp* is misplaced is the fact that in neither of those cases did the applicants enter onto lands it did not own and begin drilling before a compulsory pooling order was entered. Even as its landman witness acknowledged, Chesapeake's conduct here "is unprecedented".

The March 11, 2005 "approval of the APD does not constitute any colorable authority for such violation [of a property right]. . ." *Application of Valles Caldera*, Order R-12093-A. The APD must be revoked as having been improvidently issued in contravention of the Division's own regulations and in order that it no longer be available to Chesapeake as an alleged mitigation of its trespass.

Case No. 13493: Compulsory Pooling

Chesapeake Permian, L. P.'s ("Chesapeake") application for compulsory pooling must be denied for five separate but equally compelling reasons:

1. ***Granting Chesapeake's Application would destroy the pre-existing voluntary unit formed under the Operating Agreement signed by Mewbourne Oil Company, Samson Resources Company, and Kaiser-Francis Oil Company as well as the Communitization Agreement approved by the Commissioner of Public Lands.***

2. ***Chesapeake did not make a good faith effort to obtain the voluntary participation of the other interest owners.***

3. ***Chesapeake failed to make any well proposal to Mewbourne Oil Company.***

4. ***The Division is prevented from making the statutorily mandated findings with respect to well costs due to Chesapeake's failure to offer any evidence thereon.***

5. ***The geologic evidence supports the creation of a stand-up 320-acre unit, not the lay-down unit proposed by Chesapeake.***

1. *Chesapeake Seeks the Division's Revocation of Pre-Existing Voluntary Agreements*

Chesapeake's own landman testified that Chesapeake took the unprecedented step of drilling a well on acreage where it had no interest and where Chesapeake had known for at least three weeks that a voluntary unit had been formed. In undertaking this action, Chesapeake gambled that the Division would take the extraordinary step of rescinding the voluntary agreements and acreage trades negotiated at arms-length among private parties. This, the Division should avoid doing at all costs.[3]

The testimony at the hearing made clear that as early as April 5, 2005, Chesapeake was well aware that the SE/6 and "CE/6" of irregular Section 4 were the subject of a pre-existing operating agreement between Samson Resources Company ("Samson"), Mewbourne Oil Company ("Mewbourne") and Kaiser-Francis Oil Company ("Kaiser-Francis") establishing a

[3] Notably, Chesapeake's Application failed to include a prayer for such relief pursuant to NMSA § 70-2-17 E.

320 acre voluntary unit for which a Communitization Agreement was subsequently approved by the Commissioner of Public Lands on April 27, 2005. Were the Division to grant Chesapeake's Application for a laydown 320 acre spacing unit, the voluntary standup unit would be destroyed and the Operating Agreement, along with the state-approved Communitization Agreement, would be rendered meaningless.

Consistent with precedent established in previous cases, the Division should take all appropriate measures to avoid such a result. The orders demonstrating those precedents were cited and discussed at greater length in the *Joint Hearing Memorandum (Compulsory Pooling)* submitted on behalf of Kaiser-Francis, Samson, and Mewbourne at the close of the hearing in Case No. 13493.[4] Those cases establish that pre-existing voluntary agreements and units are not to be disregarded when an outside third-party attempts to force pool previously committed interests.

Further, Chesapeake's own landman and geology witnesses confirmed that there was nothing to prevent Chesapeake from forming a stand-up unit consisting of the "SW/6" and "CW/6" of irregular Section 4 which would not have interfered with the voluntary unit formed by Mewbourne, Samson, and Kaiser-Francis. This was and continues to be the case. The Division should, therefore, follow the precedent established in Order No. R-9992 and direct the parties to develop their own logical units. (Case No. 10823, *Application of Nearburg Producing Company for Compulsory Pooling, Eddy County, New Mexico.*)

2. *Chesapeake did not make a good faith effort to obtain the voluntary participation of the other interest owners.*

When a party invokes the State's compulsory pooling authority, in effect a police power, it is incumbent upon the Division to determine that the party does so in good faith. The Division

must examine whether the applicant (1) acted with diligence and (2) made a good faith effort to solicit the voluntary participation of the other interest owners. Where the evidence does not support such a finding, then a compulsory pooling application should not be granted. The requirement for good faith negotiations is a pre-condition to compulsory pooling relief. The legal support for this precept is discussed at greater length in Section 3 of our earlier *Joint Hearing Memorandum (Compulsory Pooling).*

Here, while Chesapeake made efforts to gain a voluntary pooling, its conduct in doing so was not in good faith. More accurately, Chesapeake's conduct was preemptive and ultimately culminated in knowing trespass. The testimony and evidence at hearing irrefutably established the following: (1) Samson, Kaiser-Francis and Mewbourne began negotiating as early as September 2003 for the development of their Morrow prospects in Sections 9 and 4. By March 8, 2005, those negotiations led to a letter agreement among the parties for the exchange of leasehold interests between Kaiser-Francis and Mewbourne. (2) Chesapeake's first action was to obtain Division approval of an APD for a well in the SE/6 of irregular Section 4, with knowledge that Kaiser-Francis or anyone else would then be automatically prevented from obtaining their own drilling permit. (3) Next, on March 11th, Chesapeake sent to Samson and Kaiser-Francis a well proposal dated March 9th that was purposefully vague about a well location and improperly suggested that a "required election" would not be excused. (Exhibit O-6.) The well proposal was sufficiently deceptive to cause Samson land personnel to make an initial election to participate which it subsequently revoked. (4) On March 14th, responding to a telephonic inquiry about the well proposal from Kaiser-Francis, Chesapeake represented that the well would be drilled on its acreage in the SW/6 of irregular Section 4. Chesapeake was then informed that Kaiser-Francis

[4] Kaiser-Francis, Samson and Mewbourne submitted two separate briefs during the hearing: *Applicants' Joint Hearing Memorandum* (Case 13492), and *Joint Hearing Memorandum (Compulsory Pooling)* (Case 13493).

was making plans to drill on the SE/6 of irregular Section 4. Chesapeake did not disclose to Kaiser-Francis that it had already obtained an approved APD for the SE/6 location. (5) On April 5, 2005, Chesapeake called to solicit Kaiser-Francis's support for a S/3 unit. Chesapeake was informed that Kaiser-Francis had a pre-existing agreement with Samson and Mewbourne to form a voluntary stand-up unit for a Morrow well to be drilled on Kaiser's lease in the SE/6 or irregular Section 4. (Exhibit O-5.) Chesapeake urged Kaiser-Francis to "abandon" its agreement with Samson and Mewbourne. (6) Also on April 5th, Chesapeake threatened to move a drilling rig onto the SE/6 of irregular Section 4. Kaiser-Francis cautioned Chesapeake not to trespass on its acreage. (7) On April 18, 2005, Chesapeake's chief operating officer received written e-mail confirmation of Kaiser-Francis's pre-existing agreement with Samson and Mewbourne. (8) On April 26th Chesapeake filed this Application to force pool its SW/6 with the SE/6. (9) On April 27th, without notice, Chesapeake moved a rig onto the SE/6 of irregular Section 4 and began drilling.

While Chesapeake's did make some nominal efforts to obtain voluntary pooling, under these established facts, the Division is unable to find that Chesapeake's conduct constitutes good faith. These are ample grounds for denying Chesapeake's compulsory pooling application. See, Order No. R-10545; Case No. 11434, *Application of Meridian Oil, Inc. for Compulsory Pooling, San Juan County, New Mexico.* (Failure to negotiate in good faith resulted in dismissal of compulsory pooling application.)

3. ***Chesapeake failed to make any well proposal to Mewbourne Oil Company.*** On March 16, 2005, Mewbourne acquired a 14.8% interest in the SE/6 of irregular Section 4. The assignment into Mewbourne was filed of record on April 18, 2005, and Chesapeake was accordingly charged with notice. (See Order No. R-10672-A De Novo; Case No. 11510,

Application of Branko, Inc. et al. To Reopen Case No. 10656, Lea County, New Mexico.) Further, Mewbourne's interest in the acreage was discussed with Chesapeake's landman on April 5th and was confirmed to Chesapeake's COO on April 18th.

NMSA 1978 §70-2-18.A requires an operator to make a good faith effort to obtain the voluntary joinder of an interest owner in a well unit. Chesapeake, as noted above, had knowledge of Mewbourne's interest, and Mewbourne was notified of the pooling application. However, Chesapeake has admitted that it failed to make a well proposal to Mewbourne or otherwise attempt to negotiate with Mewbourne to obtain its voluntary participation. This, alone, is grounds to deny Chesapeake's compulsory pooling application.

There is no Division precedent that would allow an application for compulsory pooling to be maintained under these circumstances. Instead, the agency precedent is clear: The compulsory pooling application must be denied. (Order No. R-10545, supra.)

4. *The Division is prevented from making the statutorily mandated findings with respect to well costs due to Chesapeake's failure to offer any evidence thereon.*

In the very first paragraph of its Application in Case No. 13493, Chesapeake explained the scope of evidence it would present at the hearing on its Application:

> "Also to be considered will be the costs of the drilling and completing this well and the allocation of the costs thereof as well as actual operating costs and charges for supervision, designation of Chesapeake Operating, Inc. as the operator of the well, and, pursuant to Commission Order R-11992, a risk charge of 200% for the risk[5] involved in this well."

Either through neglect or design, Chesapeake failed to put on any evidence of the costs incurred in drilling and completing the KF4 Well. Chesapeake did testify that the cost to drill and complete the proposed vertical well to a measured depth of 12,100' was $2,012,000 per the AFE submitted with Chesapeake's well proposal letter to Samson and Kaiser-Francis on March

11, 2005. Chesapeake further testified that the KF4 Well wellbore was deviated to a different location below the depth of 10,300' without any geologic or mechanical reason to do so. The costs to accomplish this deviation as well as those to drill and complete the well were not presented into evidence.

Under these circumstances the Division cannot establish if the costs incurred to drill and complete this well meet the statutory requirements of being *"without unnecessary expense"*, and therefore precludes the Division from approving Chesapeake's pooling application

NMSA 1978 § 70-2-17 C states, in part, as follows:

> All orders effecting such pooling shall be made after notice and hearing, and shall be upon such terms and conditions as are just and reasonable and will 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. ... Such pooling order of the division ***shall make definite provision as to any owner, or owners, who elects not to pay his proportionate share in advance for the prorata reimbursement solely out of production to the parties advancing the costs of the development and operation, which shall be limited to the actual expenditures required for such purpose not in excess of what are reasonable, but which shall include a reasonable charge for supervision*** and may include a charge for the risk involved in the drilling of such well, which charge for risk shall not exceed two hundred percent of the nonconsenting working interest owner's or owners' prorata share of the cost of drilling and completing the well.

Under the terms of the statute, the Legislature has mandated the Division make findings that the interest owners in the proposed unit are receiving their fair share of the oil or gas production "*without unnecessary expense*". The statute also contemplates that the Division hear proof of "*actual expenditures...not in excess of what are reasonable...*". At the time of the hearing, the actual costs of drilling and completing the KF "4" State Well No. 1 were known to Chesapeake. Given Chesapeake's wholesale failure to adduce evidence on any well costs in general, and the

[5] In the *Joint Hearing Memorandum (Compulsory Pooling)*, pg. 13, Samson, Kaiser-Francis and Mewbourne set forth the reasons why Chesapeake is not entitled to recover the 200% risk penalty assessment.

reasonableness or necessity of costs incurred as a consequence of the unexplained well bore deviation in particular, the Division simply has no basis on which to make the required findings.

Similarly, because of Chesapeake's failure, Samson, Kaiser-Francis and Mewbourne were deprived of the opportunity of rebutting any claims of the reasonableness of the well costs. This is no small omission on the part of Chesapeake, for the burden of establishing that its substantial costs were incurred "*without unnecessary expense*" falls on it, not on the parties from whose interests it seeks reimbursement for such costs and charges.

Having failed to satisfy the required elements of proof under the compulsory pooling statute, NMSA 1978 §70-2-17 C, the Division has no choice but to deny Chesapeake's Application.

5. *The geologic evidence supports the creation of a stand-up 320-acre unit, not the lay-down unit proposed by Chesapeake.*

Samson's geologic analysis best honors the available data and supports the establishment of a stand-up 320 acre gas spacing and proration unit consisting of the SE/6 and CE/6 of irregular Section 4 ("Unit C", as shown on Memorandum Exhibits 1, 2 and 3, attached) which conforms to the voluntary unit formed by Mewbourne, Samson, and Kaiser-Francis. The geologic evidence submitted by Chesapeake further supports the formation of said standup "Unit C" in that the gas reserves to be recovered by Chesapeake in Section 4 per their Exhibit 25 are greater under this configuration than that from the formation of Chesapeake's proposed laydown unit comprised of the SE/6 and SW/6 of irregular Section 4 ("Unit F", shown on Memorandum Exhibits 1, 2 and 3, attached).

Chesapeake's geologist testified that Chesapeake hearing Exhibit 25 depicted his interpretation of the sand deposition in and around Section 4, including the log information from

the KF4 Well and its recent offsets. Chesapeake was instructed to determine the sand volume and/or the gas in place by quarter section for Section 4 per Exhibit 25 as an aid to the resolution of the spacing question in this hearing. Exhibit 1, attached, submitted by Mewbourne, Samson, and Kaiser-Francis represents our calculation of the gas volumes per quarter section in Section 4 per Chesapeake's hearing Exhibit 25. These calculations indicate that Section 4 is underlain by 12,804 MMCF (RGIP of 1,180 MCF/acft at a 90% recovery factor). Further, by applying the appropriate ownership for each quarter section it is demonstrated that the spacing configuration proposed by Mewbourne, Samson, and Kaiser-Francis for Section 4 yields greater gas reserves (6,970 MMCF) for Chesapeake from the Middle Morrow sands than does Chesapeake's proposed laydown configuration (6,402 MMCF) for the SW/6 and SE/6 (shown as "Unit F" on Exhibit 1, attached.)

Samson's geologist testified that hearing Exhibit C represents his interpretation of the net Middle Morrow sand underlying Section 4 and its offset sections. Exhibit 3, attached, represents the gas volume calculations by quarter section by owner for Section 4 based upon Samson's hearing Exhibit C. The gas volume underlying Section 4 as shown on attached Exhibit 3 attributable to Chesapeake's ownership is calculated to be 1,178 MMCF. The standup spacing unit configuration recommended by Mewbourne, Samson and Kaiser-Francis results in Chesapeake being able to recover 95% of its calculated recoverable gas in place in Section 4 while Mewbourne, Samson and Kaiser-Francis are able to recover 101% of their calculated recoverable gas in place in the section. Attached Exhibit 3 also shows Chesapeake's proposed spacing unit configuration ("Unit F") would result in Chesapeake reaping a windfall of 352% of their calculated recoverable gas in place in Section 4 at the expense of Mewbourne, Samson and

Kaiser-Francis. Those parties would be able to recover only 58% of their calculated recoverable gas in place in Section 4 under Chesapeake's proposed "Unit F" configuration.

Therefore, under either the Chesapeake or Samson geologic testimony, the spacing configuration proposed by Mewbourne, Samson, and Kaiser-Francis as established by their voluntary unit formed from SE/6 and CE/6 of irregular Section 4 ("Unit C"), best preserves equities, prevents waste, and protects correlative rights. Correspondingly, the Division should deny Chesapeake's pooling application and permit Chesapeake to drill the Middle Morrow tests its geologist stated were prospective on their acreage in the SW/6 (Unit B) and NW/6 (Unit A) of irregular Section 4.

Samson's Geologist testified that the geologic data and literature for the area does not support Chesapeake's theory that the Middle Morrow sands are aligned along an east-west depositional axis. Rather, the preponderance of the evidence shows that a closed structural high located to the northwest of Section 4 and the proximity of the north-south trending Central Basin Platform in conjunction with local faulting strongly influenced the depositional trend in a north-south direction in the Osudo Field. Moreover, Samson's NW to SE, SW to NE, and W to E cross sections (hearing Exhibits E, F and G) reveal the existence of little or no continuity of the primary producing Morrow Sands from east to west. The north-south depositional alignment is further corroborated by the recently drilled Apache dry hole in the NW/4 of Section 10. In fact this dry hole was a major reason why the Chesapeake geologist reduced his sand/gas volumes in Section 4 as depicted in Chesapeake's Exhibit 22 by more than 55% as compared to Exhibit 25. Memorandum Exhibit 2, attached, indicates that the gas volumes underlying Section 4 per Chesapeake's hearing Exhibit 22 was 28,824 MMCF vs the 12,804 MMCF per Chesapeake Exhibit 25. This 55% reduction in gas volume is a direct result of the Chesapeake geologist's

flawed east to west depositional analysis. As noted by the Samson geologist the Central Basin Platform at Morrowan time was a low relief feature with no exposed granite or sandstone deposits and would therefore not represent a source of sediments for the Middle Morrow sands in an east to west alignment as the Chesapeake geologist testified.

The Samson and Kaiser-Francis witnesses further testified that the available pressure data confirms that these Middle Morrow sands were laid down as a series of on-lapping point-bar sands within an overall north-south channel. The recent drilling of the wells in Sections 4 and 9 confirm that production of wells in Sections 10, 15 and 16 have only marginally depleted the sands found in the wells in Sections 4 and 9, confirming that interwell communication is limited. This reservoir pressure distribution is consistent with a series of onlapping sand deposits from fluvial/deltaic deposition as Samson's geologist testified. The pressure distribution would not be consistent with "nearshore" deposition from the nearby Central Basin Platform. Further, the pressure data suggests that the depletion effects are shown by the bottom hole reservoir pressure to decrease with distance from the established producing wells.

However, the most telling geologic evidence is that all the parties believe the Middle Morrow sands are aligned in a north-south direction in Sections 4 and 9. This belief is clearly demonstrated by the fact that the operators in Sections 4 and 9 have located the Hunger Buster State No. 3, the Osudo "9" State No. 1 and the KF "4" State No. 1 wells in a near-vertical alignment along a north-south axis only 660' to 990' from the east lines of those two sections. But the most compelling disavowal of the Chesapeake's east-west geologic interpretation is the fact that it abandoned its original purported location for a Morrow well in the SW/6 of irregular Section 4. Instead, Chesapeake preferred to place the KF4 Well along the north-south alignment only 990' from the east line of Section 4 and only 1,980' west of the CC 3 State No. 1 well, a

Morrow dry hole which Chesapeake's geologist and reservoir engineer testified had only a limited sand area.

Further evidence of Chesapeake's belief in a north-south depositional trend rather than the east-west trend testified to by their geologist is demonstrated by the fact that Chesapeake obtained an approved APD for the Cattleman 4 State No.1 Well at a location along the same north-south alignment as the KF4 Well only 990' from the east line in CE/6 of irregular Section 4 in March, 2004 before they drilled the KF4 Well. Moreover, at the hearing it was noted that Chesapeake's Exhibit 25 reflects a location for yet an additional Morrow well along the north-south alignment in NW/4 NE/6 (lot 2) of irregular Section 4.

Also telling is the fact that Mewbourne and Kaiser-Francis continue to oppose Chesapeake in this matter in order to retain their ability to participate in a Morrow test at a location in CE/6 of irregular Section 4 that would be a part of the voluntary unit they have formed with Samson. Mewbourne and Kaiser-Francis are entitled to the same ownership in the KF4 Well regardless of the outcome of this hearing. They are truly disinterested in the ownership aspects of this hearing – their only interest being a unit configuration most closely aligned with the true geology so as to give them an interest in the subsequent unit well with the most geologic potential for success.

As described above, the testimony of both the Chesapeake and Samson geologists confirm that the preferred orientation for development of the SE/6 of irregular Section 4 is on a stand-up basis which best protects correlative rights, preserves equities and prevents waste. As a result the Division should deny the application of Chesapeake to form a laydown 320 acre spacing unit for development of the Middle Morrow sands.

Respectfully submitted,

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Certificate of Service

I hereby certify that a true and correct copy of the foregoing was faxed to the following counsel of record on this the 14 day of September:

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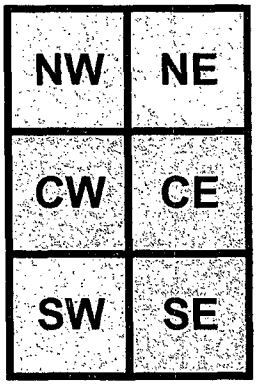
_____

J. Scott Hall

Section 4-21S-35E, Lea County, New Mexico
Protection of Correlative Rights
Per
Chesapeake Hearing Exhibit 25

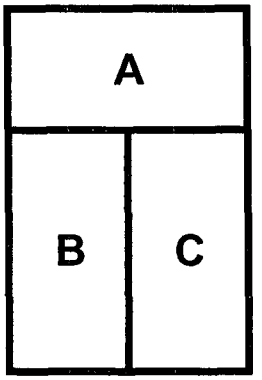
Ownership/Volumes by 1/6 Section

		Chesapeake		SRC/KFOC/MOC	
	Volume	%	Volume	%	Volume
NW	2,658	100%	2,658	0%	0
NE	785	100%	785	0%	0
CW	1,056	0%	0	100%	1,056
CE	0	0%	0	100%	0
SW	6,001	100%	6,001	0%	0
SE	2,305	0%	0	100%	2,305
Total By Leases	12,804		9,443		3,361



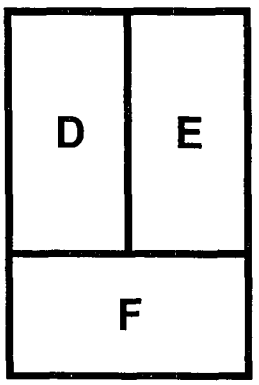
Ownership/Volumes by SRC/KFOC/MOC's Unit Configuration

	Volume			Chesapeake		SRC/KFOC/MOC	
	N or E	S or W	Total	%	Volume	%	Volume
Unit A	784.82	2657.58	3442.4	100	3442.4	0	0
Unit B	1056	6000.54	7056.54	50	3528.27	50	3528.27
Unit C	0	2305.37	2305.37	0	0	100	2305.37
Total By Units	1840.82	10963.49	12804.31		6970.67		5833.64
Total By Leases			12804.31		9442.94		3361.37
Percent Recovered					74%		174%



Ownership/Volumes by Chesapeake's Unit Configuration

	Volume			Chesapeake		SRC/KFOC/MOC	
	N or E	S or W	Total	%	Volume	%	Volume
Unit D	2657.58	1056	3713.58	50	1856.79	50	1856.79
Unit E	784.82	0	784.82	50	392.41	50	392.41
Unit F	2305.37	6000.54	8305.91	50	4152.955	50	4152.955
Total By Units	5747.77	7056.54	12804.31		6402.155		6402.155
Total By Leases			12804.31		9442.94		3361.37
Percent Recovered					68%		190%

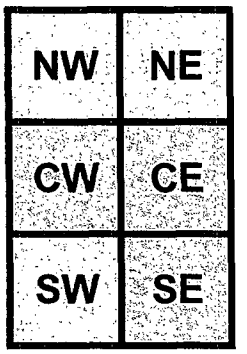


MEMORANDUM
EXHIBIT 1

Section 4-21S-35E, Lea County, New Mexico
Protection of Correlative Rights
Per
Chesapeake Hearing Exhibit 22

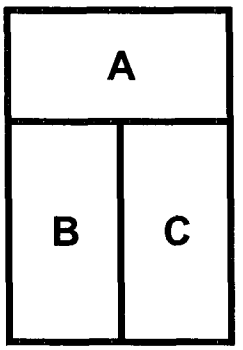
Ownership/Volumes by 1/6 Section

		Chesapeake		SRC/KFOC/MOC	
	Volume	%	Volume	%	Volume
NW	3,499	100%	3,499	0%	0
NE	1,572	100%	1,572	0%	0
CW	3,391	0%	0	100%	3,391
CE	4,752	0%	0	100%	4,752
SW	7,284	100%	7,284	0%	0
SE	8,326	0%	0	100%	8,326
Total By Leases	28,824		12,355		16,469



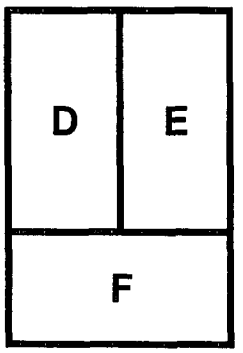
Ownership/Volumes by SRC/KFOC/MOC's Unit Configuration

	Volume			Chesapeake		SRC/KFOC/MOC	
	N or E	S or W	Total	%	Volume	%	Volume
Unit A	1571.76	3498.7	5070.46	100	5070.46	0	0
Unit B	3391	7284.14	10675.14	50	5337.57	50	5337.57
Unit C	4752	8325.96	13077.96	0	0	100	13077.96
Total By Units	9714.76	19108.8	28823.56		10408.03		18415.53
Total By Leases			28823.56		12354.6		16468.96
Percent Recovered					84%		112%



Ownership/Volumes by Chesapeake's Unit Configuration

	Volume			Chesapeake		SRC/KFOC/MOC	
	N or E	S or W	Total	%	Volume	%	Volume
Unit D	3498.7	3391	6889.7	50	3444.85	50	3444.85
Unit E	1571.76	4752	6323.76	50	3161.88	50	3161.88
Unit F	8325.96	7284.14	15610.1	50	7805.05	50	7805.05
Total By Units	13396.42	15427.14	28823.56		14411.78		14411.78
Total By Leases			28823.56		12354.6		16468.96
Percent Recovered					117%		88%

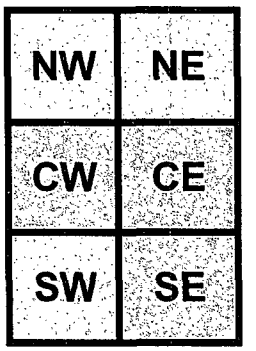


MEMORANDUM
EXHIBIT 2

Section 4 - 21S - 35E, Lea County, New Mexico
Protection of Correlative Rights
Per Samson Hearing Exhibit C

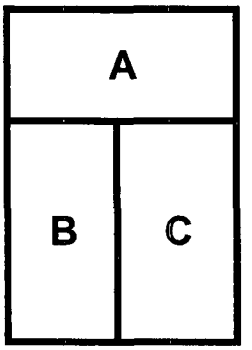
Ownership/Volumes by 1/6 Section

		Chesapeake		SRC/KFOC/MOC	
	Volume	%	Volume	%	Volume
NW	0	100%	0	0%	0
NE	1063	100%	1063	0%	0
CW	0	0%	0	100%	0
CE	3048	0%	0	100%	3048
SW	115	100%	115	0%	0
SE	4072	0%	0	100%	4072
Total By Leases	8298		1178		7120



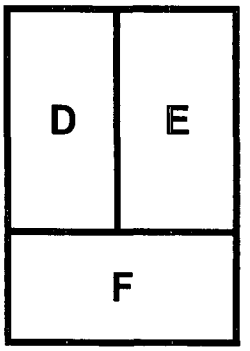
Ownership/Volumes by SRC/KFOC/MOC's Unit Configuration

	Volume			Chesapeake		SRC/KFOC/MOC	
	N or E	S or W	Total	%	Volume	%	Volume
Unit A	1063	0	1063	100	1063	0	0
Unit B	0	115	115	50	57.5	50	57.5
Unit C	3048	4072	7120	0	0	100	7120
Total By Units	4111	4187	8298		1120.5		7177.5
Total By Leases			8298		1178		7120
Percent Recovered					95%		101%



Ownership/Volumes by Chesapeake's Unit Configuration

	Volume			Chesapeake		SRC/KFOC/MOC	
	N or E	S or W	Total	%	Volume	%	Volume
Unit D	0	0	0	50	0	50	0
Unit E	1063	3048	4111	50	2055.5	50	2055.5
Unit F	4072	115	4187	50	2093.5	50	2093.5
Total By Units	5135	3163	8298		4149		4149
Total By Leases			8298		1178		7120
Percent Recovered					352%		58%



MEMORANDUM
EXHIBIT 3

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

IN THE MATTER OF THE APPLICATION OF CHESAPEAKE PERMIAN, L.P. FOR COMPULSORY POOLING, LEA COUNTY, NEW MEXICO **CASE NO. 13493**

JOINT HEARING MEMORANDUM

(Compulsory Pooling)

Kaiser-Francis Oil Company, ("Kaiser-Francis"), Samson Resources Company, ("Samson"), and Mewbourne Oil Company, ("Mewbourne"), submit this memorandum of issues in connection with the hearing on the merits on the Application For Compulsory Pooling in this matter.

SUMMARY

On April 27, 2004, Chesapeake Operating, Inc. trespassed onto Kaiser-Francis's oil and gas lease on the SE/4 of Section 4, T –21-S, R-35-E and, without notice, commenced drilling the KF "4" State Well No. 1. Chesapeake cites as its authority to do so incomplete C-101 and C-102 forms purporting to establish a 320-acre lay-down gas spacing and proration unit comprised of the SW/4 and SE/4 of irregular Section 4. However, Kaiser-Francis's lease covering the SE/4 of Section 4 is the subject of an operating agreement and a Communitization Agreement approved by the Commissioner of Public Lands establishing a 320-acre stand-up unit comprised of the SE/4 and Lots 9, 10, 15 and 16. On May 9, 2005, after it began drilling, Chesapeake filed its Application in this case seeking the forced-pooling of interests in the S/2, designation of Chesapeake as operator, recovery of costs, and assessment a risk penalty.

The Division cannot grant the relief requested by Chesapeake's Application for the following reasons:

(1) Chesapeake's Application seeks to pool uncommitted interests in the SW/4 and the SE/4 of Section 4. However, the lease interests in the SE/4 are the subject of a pre-existing voluntary agreement. Under Division precedent, they are not available to be force pooled.

(2) Chesapeake's Application requests only that the Division exercise its authority to pool the SW/4 and the SE/4 under the authority of NMSA 1978 § 70-2-17 C. Although not expressly pleaded in its Application, Chesapeake is also asking the Division to rescind the voluntary agreement under which Kaiser-Francis's lease is committed to the communitized unit.

(3) Chesapeake cannot establish that it made a good faith effort to obtain the voluntary participation of Kaiser-Francis in the drilling of the subject well.

(4) Chesapeake's conduct should preclude the assessment of a risk penalty. Further, the additional costs attributable to the deviated well bore should not be recoverable.

BACKGROUND FACTS

1. Kaiser-Francis, Samson Resources Company and Mewbourne Oil Company are the working interest owners in Lots 9, 10, 15, 16, and the SE/4 of Irregular Section 4, T. 21 S., R. 35 E., NMPM, Lea County, New Mexico (the "Subject Lands"). The mineral interests under the Subject Lands are owned entirely by the State of New Mexico and are subject to State Oil and Gas Lease Nos. V-7054 and B-1481-14.

2. Under that Communitization Agreement approved by the Commissioner of Public Lands on April 27, 2005, effective April 1, 2005, and pursuant to that Joint Operating Agreement dated March 24, 2005, the subject lands were consolidated to form a standard 320-acre stand-up

gas spacing and proration unit comprised of Lots 9, 10, 15, 16 SE/4 of Section 4. Further, pursuant to the Joint Operating Agreement the Movants designated Samson Company as operator and have agreed to drill the Osudo "4" State Com Well No. 1 at a standard gas well location 660 feet from the south line and 1,650 feet from the east line of said Section 4.

3. On March 30, 2005 Mewbourne filed with the Division's Hobbs District Office its Request for Approval of its Application for Permit to Drill ("APD") for the Osudo "4" State Comm Well No. 1. The APD was returned to Mewbourne by the Hobbs District Office without approval for the reason that the District Office had previously approved an APD submitted on behalf of Chesapeake Operating, Inc. on March 11, 2005 for Chesapeake's KF State "4" No. 1 Well in said Section 4. The C-102 form that accompanied Chesapeake's APD purported to show the dedication of a 320-acre lay-down gas spacing and proration unit consisting of the SW ¼ and SE ¼ equivalents of Section 4.

4. Chesapeake Operating, Inc. owns no interest in any portion of the Subject Lands. However, Chesapeake Permian, L.P., purports to own the lease outside the Subject Lands covering the SW/4 of Section 4.

5. On approximately April 27, 2005, without notice, Chesapeake moved a drilling rig onto the location for the KF State "4" No. 1 Well and commenced drilling operations that same day. It is undisputed that Chesapeake trespassed onto the Subject Lands.

6. On May 9, 2005, Chesapeake Permian filed its Application in this case seeking to force-pool the SE/4 of Section 4 to form a 320-acre lay-down unit dedicated to its KF "4" State Well No. 1. Chesapeake does not allege that it has "the right to drill" the well.

POINTS AND AUTHORITIES

1. The SE/4 Of Section 4 Is The Subject Of A Pre-Existing Voluntary Pooling Agreement.

Under Division precedent interpreting the operation of NMSA 1978 § 70-2-17 (C), there is no basis for the exercise of the Division's compulsory pooling authority in this case, and consequently, Chesapeake's Application must be denied.

§ 70-2-17 (C) provides, in part, as follows:

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

The pooling statute does not squarely address the situation where, as here, a portion of the lands embraced within a proposed spacing or proration unit are the subject of a pre-existing voluntary agreement such as a communitization agreement or an operating agreement. However, disputes of this nature are not new to the Division. In similar cases in the past, the Division has made clear it will interpret its statutory pooling authority in such a way that voluntary pooling agreements and private operating agreements will be honored. The Division will correspondingly deny those applications requesting relief that would effectively undo voluntary agreements.

Precedent from a number of compulsory pooling cases establishes that the facts present here require the denial of Chesapeake's Application. The Division is requested to take administrative notice of the record and orders in the following cases:

Case No. 8606; Order No. R-8013; Application of Doyle Hartman for Simultaneous Dedication and Compulsory Pooling, Lea County, New Mexico. In 1985, the Applicant, Doyle Hartman sought to force pool lands that were subject to a 1951 Operating Agreement entered into by the parties' predecessors in interest. The compulsory pooling portion of the application was denied due to the Applicant's failure to provide evidence to refute that the operating agreement was not binding.

Case No. 10658; Order No. R-9841; Application of Mewbourne Oil Company for Compulsory Pooling, Eddy County, New Mexico. In 1993, the Applicant, Mewbourne Oil Company, sought to pool the interests of Devon Energy Corporation to form a 320-acre W/2 unit. Devon opposed the application on the grounds that the parties were bound to operating agreements entered into by their predecessors in 1953 and 1958 that covered a portion of the lands (200 acres) in the W/2 unit. Order No. R-9841 dismissing the Application provided as follows: "*FINDING: Since under the "force pooling" statutes (Chapter 70-2-17 of the NMSA 1978) there exists in this matter an agreement between the two parties owning undivided interests in a proposed 320-acre gas spacing and proration unit, an order from the Division pooling said parties is unnecessary.*" The comments of the Division's counsel in the transcript of hearing are notable as it is expressed that, in such cases, the Division makes no determination on the merits of the terms of the operating agreement, but determines only whether the agreement exists.

Case No. 11434; Order No. R-10545; Application of Meridian Oil, Inc. for Compulsory Pooling and Unorthodox Well Location, San Juan County, New Mexico. In 1995, the applicant, Meridian Oil, Inc., sought to force pool the working interests of Doyle Hartman, Four Star Oil & Gas (Texaco) and others. Hartman and Four Star opposed the application on the grounds that the lands were subject to a pre-existing 1953 Communitization Agreement and an Operating Agreement pooling their interests and governing the drilling and development of the lands. The hearing examiner recognized the applicability of the 1953 agreements and dismissed the case due to the applicant's failure to exercise good faith in negotiations.

Case No. 11960; Order No. R-11009; Application of Redstone Oil and Gas Company for Compulsory Pooling and Unorthodox Well Location, Eddy County, New Mexico (Consolidated for hearing with Case No. 11927; Application of Fasken Land & Minerals, Ltd. for Compulsory Pooling, etc.; and Case No. 11877; Application of Fasken Land & Minerals, Ltd. for Compulsory Pooling, etc.) These 1998 cases involved the efforts of the applicants to force pool lands into 640 and 320 acre spacing and proration units that were covered, in part, by a 1970 operating agreement governing operations in

the Rock Tank Unit and certain adjoining leases. Whether the 1970 agreements were applicable was a threshold issue to be decided before the Division exercised its compulsory pooling authority. In Case No. 11877, Fasken attempted to pool the interests of Redstone in the E/2 of Section 12 into a 640-acre unit. The E/2 of Section 12 was already dedicated to the Rock Tank Unit and Redstone contended the pooling was unnecessary and improper. Prior to the issuance of the final orders in these cases, the parties were able to negotiate an agreement for the development of the acreage and consequently, the compulsory pooling portions of the cases were dismissed.

Where the evidence clearly supports a finding that the commitment of working interests is governed by an operating agreement, farmout, communitization or other similar agreement, then those interests should not be subject to compulsory pooling. In each of those cases cited above, the applicant failed to make the showing required by the statute. Each time, the applicant either failed to obtain the compulsory pooling relief sought or the application was denied outright. This case is no different and the Division should not hesitate to deny Chesapeake's Application.

It is not disputed that the SE/4 and Lots 19, 10, 15 and 16 of Section 4 are voluntarily committed to the communitized spacing and proration unit approved by the Commissioner of Public Lands on April 27, 2005. Neither is it disputed that these same lands are the subject of the March 24, 2005 Operating Agreement approved by the interest owners. Consequently, under the operation of both §70-2-17 C and Division precedent, the SE/4 of Section 4 is not available to be compulsorily pooled.

Under the pooling statute, the Division must address the matter of the pre-existing voluntary agreements. It is a non-delegable function that the pooling statute expressly directs the Division to perform. Kerr-McGee Nuclear Corp. v. New Mexico Environmental Imp. Bd., 97 N.M. 88, 97, 637 P.2d 38, 47 (Ct. App. 1981). (Duties which are quasi-judicial in nature, and which require the exercise of judgment cannot be delegated.) Id. For this reason, the Division

must note that the dispute precipitated by Chesapeake's Application pits a *proposed* spacing unit against an *existing* spacing and proration unit created under voluntary agreements.

Kaiser-Francis asks that the Division do nothing more than make a proper finding consistent with agency precedent that its working interests are not subject to pooling as they were voluntarily committed under a pre-existing agreement. A finding otherwise would operate as an effective nullification of a private agreement that far exceeds the invocation of the Divisions authority under § 70-2-17 (C). The finding requested by Kaiser-Francis does not have such an effect. To the contrary, a finding that the lands are committed under the Communitization Agreement and Operating Agreement maintains the status quo and does not upset the pre-existing contractual relationship of the parties. If there is any doubt about the effect of the Division's order in this case, then such doubt must necessarily be resolved in favor of preserving agreements that were negotiated at arms-length between private parties.

2. Chesapeake May Not Effect the Revocation of Voluntary Agreements by Compulsory Pooling.

Chesapeake's Application requests the Division pool the SW/4 and the SE/4 under the authority of NMSA 1978 § 70-2-17 C. Although not expressly pleaded in its Application, Chesapeake is also asking the Division to rescind the voluntary agreements, a Communitization Agreement and a Joint Operating Agreement, under which Kaiser-Francis's lease is committed to the communitized unit. The Division may have the basis to grant such relief under NMSA 1978 § 70-2-17 E, but Chesapeake has not invoked the agency's authority to do so.[1] Nevertheless, the compulsory pooling relief requested by Chesapeake, if granted by the Division,

would have the practical effect of modifying and revoking the voluntary agreements of the parties under the Communitization Agreement and Operating Agreement.

It is indisputable that the efforts of Kaiser-Francis, Samson and Mewbourne to negotiate a development agreement and to consolidate their lease interests predate Chesapeake's trespass onto the SE/4 of Section 4. Those efforts led to the execution of a Joint Operating Agreement on March 24, 2005 and a Communitization Agreement on April 4, 2005. These agreements resulted in the establishment of the 320-acre stand-up unit. The Communitization Agreement was submitted to the State Land Office on April 20, 2005 and was approved by the Commissioner of Public Lands on April 27, 2005, with an effective date of April 1st.

The State Land Commissioner's authority to approve development agreements and communitization agreements affecting State Trust Lands is set forth at NMSA 1978 § 19-10-45 and § 19-10-53. In approving such development agreements, the Commissioner is required by statute to make certain findings:

> 19-10-46. [Cooperative agreements; requisites for approval.] *No such agreement shall be consented to or approved by the commissioner unless he finds that:*
> *A. such agreement will tend to promote the conservation of oil or gas and the better utilization of reservoir energy;*
> *B. under the operations proposed the state and each beneficiary of the lands involved will receive its fair share of the recoverable oil or gas in place under its lands in the area affected; and*
> *C. the agreement is in other respects for the best interests of the state.*

Those findings were made by the Commissioner here and are reflected on the Approval of Communitization Agreement, Exhibit 1, attached.

[1] Samson, Kaiser-Francis and Mewbourne do not consent to the amendment of Chesapeake's Application by implication or otherwise.

In the administration of the State's oil and gas lease lands, NMSA 1978 § 19-10-48 recognizes that the Land Commissioner and the Division are each to execute their respective functions with due regard for the other's authority. That statutory provision states:

> 19-10-48. [Effect of provisions on powers of oil conservation commission and commissioner of public lands.*] Nothing herein [19-10-45 to 19-10-48 NMSA 1978] contained shall be held to modify in any manner the power of the oil conservation commission under laws now existing or hereafter enacted with respect to the proration, and conservation of oil or gas and the prevention of waste, nor as limiting in any manner the power and the authority of the commissioner of public lands now existing or hereafter vested in him.*

By virtue of NMSA 1978 § 19-10-31, Chesapeake was charged with notice of the Communitization Agreement. Further, the testimony establishes that as early as April 5, 2005 Chesapeake had knowledge of the actual and prospective contractual relationships among Samson, Kaiser-Francis and Mewbourne. These circumstances preceded the filing of Chesapeake's Application in this case on May 9th.

3. Chesapeake Cannot Demonstrate It Made a Good Faith Effort to Obtain Voluntary Participation.

The Applicable Standards of Diligence and Good Faith.

Chesapeake has approached this proceeding as if the granting of a compulsory pooling order were its entitlement. In so doing, it has failed to make a good faith effort to obtain an agreement for the voluntary participation of Kaiser-Francis, et al.

As Chesapeake would have it, under the compulsory pooling statute, an applicant need do nothing more than appear at a hearing and show (1) there are two or more interest owners in a

spacing unit, (2) that the owners have not agreed to pool their interests, and (3) it made a well proposal to the other owners, as perfunctory as that effort might have been.[2]

Under NMSA 1978, §70-2-18(A), an applicant proposing to dedicate separately-owned lands to a spacing and proration unit has an "obligation" to negotiate a voluntary agreement with the other interest owners to pool their lands. The Division and the Commission require operators to show that they have made a "diligent" and "good faith" effort to negotiate a voluntary agreement before a compulsory pooling application may be filed.[3]

The historic treatment by the agency of its compulsory pooling powers is revealing: The first compulsory pooling orders made by the Commission were made with some reluctance. In many instances, the Commission ordered pooling but further ordered that a continuing effort be made to secure the consent of all the interests involved. Morris, Richard, *Compulsory Pooling of Oil and Gas Interests in New Mexico*, 3 Nat. Resources J. 316 (1963). After a few cases had been decided, the Commission adopted the attitude toward compulsory pooling that still remains today. In each case there is an inquiry concerning the efforts made by the operator to secure the consent of the interests being pooled. The reasonableness of the offer may also be questioned. Morris, Richard, *Compulsory Pooling of Oil and Gas Interests in New Mexico*, 3 Nat. Resources J. 316, 318 (1963). The Division and the Commission continue to recognize the importance of good faith efforts to negotiate before commencing compulsory pooling actions, and use it as one criterion to determine if the application will be accepted or denied.

While the parameters of what constitutes a "good faith" effort have not been precisely defined in any order of the Commission or the Division, or in any reported court decision, the

[2] Notably, Chesapeake does not allege that it has "the right to drill".

procedure of compulsorily pooling the interests of landowners in order to drill wells is strikingly analogous to the procedure of eminent domain, where one, who seeks to invoke the state's police power of eminent domain, can condemn or expropriate private lands for public use. Both compulsory and eminent domain dramatically effect the rights landowners have in their land, and both compel the landowner into an action that was not of his/her own desire. One of our most basic liberties is the right to property, and it must be guarded. Actions like eminent domain and compulsory pooling must be carefully scrutinized. Enforcing a good faith effort to negotiate is one way the Division, Commission and the courts can slow the imposition on private citizens' rights to property. While eminent domain dissolves all rights of the property owner, its procedure and effect are very similar to the action of compulsory pooling, and can shed light on the proper procedure of conducting these acts in accordance with the right to property.

Eminent domain is the power of a government entity to take private lands and convert them for public use, with just compensation. Eminent domain is liberally interpreted in New Mexico. *Landavazo v. Sanchez*, 111 N.M. 137, 140, 802 P.2d 1283, 1286 (1990). The decision of the grantee of the power of eminent domain as to the necessity, expediency, or propriety of exercising that power is political, legislative, or administrative and its determination is conclusive and not subject to judicial review, absent fraud, bad faith, or clear abuse of discretion. *Id.* at 140, 1286; *North v. Public Service Co. of New Mexico*, 101 NM 222, 680 P.2d 603 (N.M. App. 1983). While eminent domain is not often subject to the judicial review, it is expressly subject to the courts supervision when it has been exercised in bad faith, or when one has exercised the power and has failed to make a good faith effort to negotiate with landowners

[3] Indeed, the "good faith" requirement has been expressly codified in the compulsory unitization procedures of the Statutory Unitization Act at NMSA 1978, §70-7-6-A(5).

commencing the action. NMSA 1978 § 42-A-1-4A states, "A condemnor shall make reasonable and diligent efforts to acquire property by negotiation." NMSA 1978 § 42-A-1-6A further states "...an action to condemn property may not be maintained over timely objection by the condemnee unless the condemnor made a good faith effort to acquire the property by purchase before commencing the action." (emphasis added). Just as NMSA 1978 § 70-2-1 et. seq. sets out the requirements before commencing compulsory pooling, the eminent domain statutes stress the importance and lay out the requirement of good faith negotiations with the landowners before any further action is taken.

There are many eminent domain cases that analyze good faith efforts in negotiations. "What constitutes a good faith offer must be determined in light of its own particular circumstances." *Unger v. Indiana & Michigan Electric Co.*, 420 N.E.2d 1250, 1254 (Ind. App. 1981). A good faith offer is one where a reasonable offer is made in good faith and a reasonable effort is made to induce the owner to accept it. Perfunctory offers are not sufficient. *Id.* at 1254 (emphasis added.).

The authorities cited above indicate that the Division may consider whether Chesapeake has acted in bad faith. Chesapeake's first well proposal was purposefully deceptive: Chesapeake intentionally led Kaiser-Francis to believe that well it was proposing would be located on the SW/4 of Section 4. Then, Chesapeake sought to interfere in the contractual relationship of Kaiser-Francis, et al. Chesapeake's subsequent April 4th proposal, accompanied for the first time by a standard form operating agreement, was merely a perfunctory offer made after it had obtained its approved APD, knowing full well that Mewbourne, et al., would thus be precluded from obtaining their own drilling permit.

Chesapeake's conduct here falls far short of the standards that the industry and the Division expect an operator to meet when negotiating for an interest owner's voluntary participation in a well proposal.

4. Chesapeake Should Not Recover the Risk Penalty; Well Costs Attributable to the Deviated Well bore Exceeding Reasonable Costs Are Not Recoverable.

In the event, the Division determines a lay-down spacing unit should be dedicated to the KF "4" State Well No. 1 and that Chesapeake should be designated operator, under the circumstances of this case, no risk penalty should be assessed. Further, the Division should deny the recovery of well costs exceeding reasonable well costs, due particularly to Chesapeake's unilateral decision to deviate the wellbore to a new bottom hole location,

Risk Penalty.

Chesapeake asks to be compensated for the risks it assumed in drilling the well. It seeks to recover the risk in the form of a penalty against owners who previously dedicated their interests to their own drilling project under a voluntary agreements and under a Communitization Agreement. In making its request, Chesapeake comes before the Division as a trespasser. As fully explained above and in our separate Hearing Memorandum in Case No. 13492, there is inadequate legal support for Chesapeake's request to recover a risk penalty. Under the circumstances of this case, Chesapeake assumed all of the risk when it entered onto the communitized unit and drilled its unauthorized well. In doing so, Chesapeake knew full well from past experience that its request for the 200 percent risk penalty might not be granted.

In 1999, Chesapeake re-entered the College of the Southwest "17" Well No. 1 and deepened it to the Strawn formation where all interests in an 80-acre spacing unit had been

consolidated. Finding nothing there, Chesapeake continued drilling down to the Wolfcamp and Atoka-Morrow formations without consolidating the interests in those respective 160 and 320-acre units. After drilling the well, Chesapeake sought to force-pool the interest in those units and applied for a 200 percent risk penalty. In Order No. R-11327,[4] the Division denied Chesapeake's request. Instead, it found that Chesapeake had assumed the risk drilling to the Atoka-Morrow formation without first consolidating the interests of the other owners. Under the circumstances, the Division reduced the risk penalty to 100 percent, but further limited the penalty to only the completion costs. *Id.*, at Finding 28.

A 200 percent risk penalty is discretionary, not mandatory. By the express terms of NMSA 1978 § 70-2-17.C, the Division "...may include a charge for the risk involved in drilling the well... ." (emphasis added).

In view of the circumstances of this case, Samson, Kaiser-Francis and Mewbourne request that Chesapeake be awarded no risk penalty.

Reasonable Well Costs.

Again, only in the event the Division determines a S/2 unit should be formed and that Chesapeake should be entitled to recover well costs, Chesapeake should not be allowed to recover well costs exceeding reasonable well costs, particularly those additional costs attributable to Chesapeake's unilateral decision to change bottom hole locations from 660' FSL and 990' FEL to 668' FSL and 1947' FEL, resulting in a deviated well bore. Primarily as a result of this change, Chesapeake spent 70 days drilling the KF "4" State Well No. 1.

Under Rule 35 and pursuant to NMSA 1978 §70-2-17.C, an applicant may only seek reimbursement of those costs that are "...not in excess of what are reasonable... ." Consequently,

[4] Case No. 12325; *Application of Chesapeake Operating, Inc. for Compulsory Pooling and An Unorthodox Well*

the burden should be placed on Chesapeake to demonstrate the reasonableness of all its well costs and why the deviation was warranted.

CONCLUSION

For the foregoing reasons, Kaiser-Francis Oil Company requests the Division enter its order denying Chesapeake's Application and granting such other relief deemed appropriate.

Respectfully submitted,

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Certificate of Service

I hereby certify that a true and correct copy of the foregoing was hand-delivered to counsel of record at the time of the hearing on the merits in this matter as follows:

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NEW MEXICO STATE LAND OFFICE

CERTIFICATE OF APPROVAL

COMMISSIONER OF PUBLIC LANDS, STATE OF NEW MEXICO

Mewbourne Oil Company
Osudo 4 State Com. Well No. 1
Lea County, New Mexico
Lots 2, 10, 15, 16, and SE4, Section 4, Township 21 South, Range 35 East
Pennsylvanian

There having been presented to the undersigned Commissioner of Public Lands of the State of New Mexico for examination a Communitization Agreement for the development and operation of acreage which is described within the referenced agreement, dated April 1, 2005 which has been executed, or is to be executed by parties owning and holding oil and gas leases and royalty interests in and under the property described, and upon examination of said agreement, the Commissioner finds:

(a) That such agreement will tend to promote the conservation of oil and gas and the better utilization of reservoir energy in said area.

(b) That under the proposed agreement, the State of New Mexico will receive its fair share of the recoverable oil or gas in place under its lands in the area.

(c) That each beneficiary institution of the State of New Mexico will receive its fair and equitable share of the recoverable oil and gas under its lands within the area.

(d) That such agreement is in other respects for the best interests of the State, with respect to state lands.

NOW, THEREFORE, by virtue of the authority conferred upon me under Sections 19-10-45, 19-10-46, 19-10-47, New Mexico Statutes Annotated, 1978 Compilation, I the undersigned Commissioner of Public Lands of the State of New Mexico, for the purpose of more properly conserving the oil and gas resources of the State, do hereby consent to and approve the said agreement, and any leases embracing lands of the State of New Mexico within the area shall be and the same are hereby amended to conform with the terms thereof, and shall remain in full force and effect according to the terms and conditions of said agreement. This approval is subject to all of the provisions of the aforesaid statutes.

IN WITNESS WHEREOF, this Certificate of Approval is executed, with seal affixed, this 27th day of April, 2005.

COMMISSIONER OF PUBLIC LANDS
of the State of New Mexico