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

APPLICATION OF NEARBURG EXPLORATION COMPANY, SRO2 LLC AND SRO3 LLC FOR AN ACCOUNTING AND LIMITATION ON RECOVERY OF WELLS COSTS, AND FOR CANCELLATION OF APPLICATION FOR PERMIT TO DRILL, EDDY COUNTY, NEW MEXICO.

CASE NO. 15441

APPLICATION OF COG OPERATING LLC FOR A NON-STANDARD SPACING AND PRORATION UNIT AND COMPULSORY POOLING, EDDY COUNTY, NEW MEXICO.

CASE No. 15481

APPLICATION OF COG OPERATING LLC FOR A NON-STANDARD SPACING AND PRORATION UNIT AND COMPULSORY POOLING, EDDY COUNTY, NEW MEXICO.

CASE No. 15482

COG's RESPONSE TO NEX'S POST-HEARING MEMORANDUM

NEX's memorandum purports to address "New Mexico law regarding title to interest in real property" but offers little on the issue properly before the Division: Whether COG had the necessary "good faith belief" at the time it drilled the SRO State Com 43H and 44H wells. The Commission Orders cited in NEX's memorandum not only confirm the "good faith" standard, but reiterate the point NEX continues to ignore: That the Division "has neither the responsibility nor jurisdiction to determine whether an applicant for permit to drill has the requisite title to the land in question" (*Pride Energy* Order R-12108-C at p. 5, ¶ 8(d)) nor does it have jurisdiction to determine the contractual rights of the parties. *See TMBR/Sharp* Order R-11700-B at p. 5, ¶ 27.

The evidence presented at the hearing demonstrates COG had either a good faith belief that held a contractual right to operate on the W/2 of Sections 17 and 20 or a good faith belief that it held an ownership interest in the W/2 of Section 20 at the time it permitted and drilled the 43H and 44H wells. Under Commission precedent, either of these circumstances results in denial of NEX's application. *See Samson Resources* Order R-12343-E at p. 6, ¶ 33. Further, since NEX continues to maintain that no voluntary agreement covers the W/2 of Section 20, compulsory pooling is required "effective from first production" to conform with the Communitization Agreements executed by NEX and filed with the New Mexico State Land Office for the acreage dedicated to these wells. See NMSA 1978, § 70-2-17(C) and § 70-2-18(A).

I. The Facts Establish *COG's* Good Faith Belief That It Is Authorized to Develop the Spacing Units Dedicated to the SRO State Com. 43H and 44H Wells.

While both the hearing and NEX's memorandum present factual assertions that remain disputed, the following facts are not disputed.

1. The SRO State Com 043H (API 30-015-41141) and the SRO State Com 044H (API 30-015-41142) are dedicated to standup 320-acre spacing units comprised, respectively, of the W/2 W/2 and the E/2 W/2 of Sections 17 and 20 of Township 26 South, Range 28 East. *See* COG Exhibits 8 and 9.

2. The surface locations for the 43H and the 44H wells are in the W/2 f Section 17, a state lease in which Yates Petroleum is the lessee of record, and the bottomhole locations are in W/2 of Section 20, a state lease in which NEX is the lessee of record. *Id.*

3. COG is the successor operator under an Operating Agreement dated May 8, 2009, that lists the state lease covering the W/2 of Section 17 (lessee Yates Petroleum Corporation) and

the state lease covering the W/2 of Section 20 (lessee NEX) as part of the contract area. *See* COG Exhibit 4 (Operating Agreement) at pp. 22 and 29.

4. Four working interest owners in the contract area (Yates Petroleum, Yates Drilling, Myco Industries, and ABO Petroleum) subscribed to the Operating Agreement by executing a New Mexico State Land Office form entitled "Ratification And Joinder Of Unit Agreement And Unit Operating Agreement." *See* COG Exhibit 4 (Operating Agreement) at p. 19; COG Exhibit 3 (state form on website). NEX executed this same New Mexico State Land Office form at a time when it held a working interest in the W/2 of Section 20. *See* COG Exhibit 2 at p. 4 and last page (Exhibit B Schedule of Ownership).

5. Marbob Energy (COG's predecessor), the New Mexico State Land Office, and the other working interest owners subject to the Operating Agreement, considered the New Mexico State Land Office form entitled "Ratification And Joinder Of Unit Agreement And Unit Operating Agreement" as sufficient to subscribe state leases to the Operating Agreement. *See* COG Exhibit 2 at pp. 1 and 2; Exhibit 5 at ¶ 22 (requiring subsequently joined working interests to be subscribe to the operating agreement).

6. The state form for the SRO State Unit Agreement required that all working interests in committed state leases to be subscribed to the Operating Agreement. *See* COG Exhibit 5 at ¶ 22.

7. On August 24, 2009, after having joined the SRO State Unit as a working interest owner, NEX executed a "Term Assignment" conveying its working interest in the W/2 of Section 20 to Marbob and retaining for NEX an overriding royalty interest. *See* COG Exhibit 1.

8. The C-102's for the 43H and the 44H wells were filed and approved by the Division in February of 2013 when the SRO State Unit was still in effect. *Id.*[1]

9. The SRO State Unit terminated on March 1, 2014, with notice to and approval by NEX as the lessee of record for the W/2 of Section 20. *See* COG Exhibits 8, 9, 10 and 11.

10. The Operating Agreement covering the W/2 of Sections 17 and 20 (the spacing units dedicated to the 43H and 44H wells) did not terminate with the expiration of the SRO State Unit and NEX was informed in March of 2014 that it remained in full force and effect for the contract area. *See* COG Exhibit 4 (Operating Agreement) at p. 16 (Article XIII); Exhibit 10 (email chain) at p. 3.

11. Following termination of the SRO State Unit, COG and NEX engaged in a prolonged period of negotiation regarding the renewal, extension or reinstatement of the Term Assignment covering the W/2 of Section 20. Tr. 173:22 – 174:2 (Howard response to question from Examiner Brooks).

12. The 43H well was drilled in August of 2014 and the 44H well was drilled in October of 2014. *See* COG Exhibits 8 and 9.

13. On May 20, 2015, NEX and Yates Petroleum executed Communitization Agreements for the spacing units dedicated to the 43H and the 44H wells that are effective prior to the drilling of these wells. *See* COG Exhibits 26 and 27.

[1] NEX mistakenly suggests the applications for permits to drill the 43H and the 44H were not filed until March of 2014. *See* NEX Memo. at p. 3, ¶ 8. However, the March 2014 filing simply effectuates a name change for each of the wells following termination of the SRO State Unit . *See* COG Exhibits 8 and 9.

14. The Communitization Agreements executed by NEX and Yates Petroleum confirms COG's status as Operator of the acreage dedicated to the 43H and the 44H, stating in bolded type:

> **COG Operating LLC shall be the Operator of said communitized area and all matters of operation shall be determined and performed by COG Operating LLC.**

Id. at ¶ 8.

15. NEX did not inform COG that it no longer wished to be paid the overriding royalty interest established by the Term Assignment until July of 2015. *See* COG Exhibit 24.

16. On November 24, 2015, NEX filed a Complaint in Santa Fe County State District Court requesting, among other relief, that the Court declare NEX is "not subject to the Operating Agreement" and that no voluntary agreement authorizes COG to develop the acreage in the W/2 of Section 20. *See* COG Exhibit 6.

II. The Commission Orders Cited By NEX.

NEX's post-hearing memorandum cites four administrative orders as providing precedent on the "good faith" issues before the Division. These orders are discussed in more detail below in chronological order.

TMBR/Sharp Order R-11700-B. This 2002 Commission Order reflects that Arrington claimed a "top lease" over acreage subject to a TMBR/Sharp lease. Unlike the situation currently before the Division, Arrington did not claim the right to operate under a voluntary agreement. Yet, even in this circumstance, the Commission concluded Arrington had the requisite "good faith belief" to drill the well until such time as the District Court found Arrington's top lease had failed. The Commission stated:

27. When an application for permit to drill is filed, the Division does not determine whether an applicant can validly claim a real property interest in the property subject to the application, and therefore whether the applicant is "duly authorized" and "is in charge of the development of a lease or the operation of a producing property." TheDivision has no jurisdiction to determine the validity of any title, or the validity or continuation in force and effect of any oil and gas lease. Exclusive jurisdiction of such matters resides in the courts of the State of New Mexico. The Division so concluded in its Order in this matter. *See* Order No. R-11700 (December 13, 2001).

28. It is the responsibility of the operator filing an application for a permit to drill to do so under a good faith claim to title and a good faith belief that it is authorized todrill the well applied for. It appears to this body that Arrington had such a good faithbelief when it filed its application, but subsequently the District Court found otherwise.

Here, COG's "good faith belief" is not dependent on any lease but instead rests in part on its status as operator under a long-standing Operating Agreement that includes the W/2 of Sections 17 and 20 within the contract area. *See* COG Exhibit 4 (Operating Agreement) at pp. 22 and 29.

Pride Energy Order R-12108-C. In this 2004 Commission Order, Yates Petroleum sought to cancel a permit issued to Pride Energy to utilize a well on acreage held by Yates Petroleum to develop a laydown 320-acre spacing unit. While Pride did not hold title to the quarter-section where the well was located, it held a working interest position in the adjacent quarter-section to be included in the pooled spacing unit. The Commission found Pride's position sufficient to meet the "good faith" requirement stating:

(i) The Commission accordingly concludes that an owner who would have a rightto drill at its proposed location in the event of a voluntary or compulsory pooling of the unit it proposes to dedicate to the well has the necessary good faith claim of title to permit it to file an APD even though it has not yet filed a pooling application.

Order R-12108-C at p. 6, ¶ 8(i). Since COG is the operator under an Operating Agreement naming the W/2 of Section 20 as part of the contract area, COG has a much stronger position of "good faith" than Pride did in Order R-12108-C.

Samson Resources Order R-12343-E. This 2007 Commission order involves a circumstance where Chesapeake drilled a vertical well on a SW/4 owned by Samson Resources

before obtaining a voluntary or compulsory pooling of the acreage to form a spacing unit. It was undisputed Chesapeake did not hold "an interest in" nor did it have any "contractual right with respect to" the minerals in the SW/4 where the well was located. *See* Order R-12343-E at p. 3, ¶ 11. Indeed, the decision reflects that Samson Resources had filed and received approval from the New Mexico State Land Office of a communitization agreement combining its SW/4 acreage with the east half of the middle third of this irregular section to form a standup, voluntary spacing unit. *Id.* at p. 5, ¶ 21 and ¶ 23. The Commission took this opportunity to clarify that the disjunctive certification found in Form C-102 incorporates its prior rulings in the *Pride Energy* and *TMBR/Sharp* cases: That the operator must either have a good faith belief to an interest in the lands or a good faith belief that it "has a right to drill this well at this location pursuant to a contract with an owner of such mineral or working interests or in a voluntary pooling agreement or compulsory pooling order hereto entered by the Division." *Samson Resources* Order R-12343-E at p. 6, ¶ 33. Thus while the *TMBR/Sharp* case initially phrased the "good faith" requirement as "a good faith claim to title *and* a good faith belief that it is authorized to drill the well applied for" (emphasis added), the Commission subsequently made it clear that either is sufficient. *Id.* Since Chesapeake had neither, the Commission removed it as operator of the acreage in favor of Samson Resources.

Chesapeake Order R-13154-A. This 2009 Division Order involved a circumstance where COG held an interest in the spacing unit for the proposed horizontal well, but it was undisputed COG did not have an ownership interest in the acreage where the horizontal well was located. *See* Order R-13154-A at p. 2, ¶ 4. Instead, COG simply held "an easement or license authorizing it use of the surface location" for drilling. *Id.* at p. 3, ¶ 12. Since ownership was not an issue, the Division addressed the second basis for "good faith" (a contractual right) and found that a

surface "easement or license" was insufficient to authorize drilling into the underlying minerals. *Id.* Accordingly, the Division confirmed what the Commission made clear in *Samson Resources* Order R-12343-E: That an operator must have either a good faith belief that it has an interest in the lands at issue or a good faith belief that it has a contractual right to develop the underlying mineral estate.

III. COG Has Established the Necessary Good Faith Belief.

Black's Law Dictionary defines acting in good faith as: "Behaving honestly and frankly, without any intent to defraud or to seek an unconscionable advantage." ACTING IN GOOD FAITH, Black's Law Dictionary (10th ed. 2014). In contrast, acting in "bad faith" requires a showing the actions are "frivolous or unfounded." *Chavez v. Cheoweth,* 1976-NMCA-076, ¶ 31, 89 N.M. 423, 553 P.2d 703. The evidence COG presented at the hearing demonstrates the necessary good faith belief.

COG has established at least a good faith belief that it has a contractual right to operate on the W/2 of Sections 17 and 20 under the long-standing Operating Agreement. *See* COG Exhibit 4 (Operating Agreement) at pp. 22 and 29.[2] Further, NEX and Yates Petroleum, the lessees of record for the two state leases, executed Communitization Agreements filed with the New Mexico State Land Office that are effective prior to the drilling of the 43H and 44H wells and confirm COG's status as operator of the acreage. *See* COG Exhibits 26 and 27. At no point during the transmittal of these Communitization Agreements, nor anytime thereafter, did NEX express any disagreement with COG's status as operator of the W/2 of Section 20. *See* TR. at

[2] NEX suggests COG's reliance on the Operating Agreement is misplaced because it failed to propose the 43H and 44H to NEX under that agreement. However, following termination of the SRO State Unit NEX led COG to believe it desired to proceed with a non-cost bearing overriding royalty interest. *See* COG Exhibits 10, 14, 15, 16, and 17. Accordingly, COG only proposed these wells and received elections under the Operating Agreement from the cost-bearing working interest owners in the contract area.

168-170. These agreements alone satisfy the operator's certification cited by the Commission as embodying prior rulings. *See Samson Resources* Order R-12343-E at p. 6, ¶ 33.

NEX appears to suggest COG's status as Operator under the Operating Agreement is insufficient as a matter of law to form the "good faith belief" necessary to file for and proceed under a Division drilling permit. *See* NEX Memo. at p. 6-7. If that was indeed the case, then no operator under any Operating Agreement could file for an application and subsequently drill within any portion of the contract area where that operator did not hold title. It is therefore not surprising that no Commission or Division authority supports NEX's contention. Instead, the Commission made it clear in the *Samson Resources* case that either a good faith belief to an interest in the lands or a good faith belief of a contractual right to drill is sufficient. Order R-12343-E at p. 6, ¶ 33.

NEX also suggests that Mr. Howard's vague contention that he verbally informed Kelly Fuchik (COG's land coordinator) sometime in July of 2014 that COG cannot operate on NEX's lease (Tr. 133) nullified COG's rights under the Operating Agreement with respect to NEX's committed acreage. NEX memo at p. 10. However, the Operating Agreement vests COG "full control of all operations on the Contract Area." *See* COG Exhibit 4 at p. 6. Nothing in the Operating Agreement authorizes a non-operator, such as NEX, to unilaterally revoke that authority or deny Operator access to acreage devoted to the contract area for development. Instead, a non-operator's options under the Operating Agreement are limited to (a) participating or not participating in a particular development plan, or (b) initiating efforts with other non-operators to remove the designated Operator. *See* COG Exhibit 4 at pp. 6-10. NEX's purported, unilateral repudiation of COG's rights under the Operating Agreement is not legally sufficient to nullify COG's contractual right to enter the W/2 of Section 20 for the purpose of effectuating a

development plan approved by the non-operators. *See C.K. Oil Properties, Inc. v. Hrubetz Operating Co.*, 2002 WL 32344609 at *9 (Tex. App. Apr. 25, 2002) (Operator under a "participation agreement" remained authorized to conduct duties as operator of contract area despite effort by non-operator to repudiate those rights for its committed leases).

Finally, COG has demonstrated NEX was "agreeable" to extending the Term Assignment and proceeding with an overriding royalty interest after termination of the SRO State Unit . *See* COG Exhibits 10, 14, 15, 16, and 17. *See also* Tr. 146:17-19 (Howard confirms Exhibit 16 contains the language he found agreeable). Even after the wells were drilled and completed, NEX continued to represent to COG that it desired to receive well information and to be paid as an overriding royalty interest owner under an extension of the Term Assignment. *See* COG Exhibit 19. It wasn't until June of 2015, months after the wells were drilled and completed, that NEX first expressed a desire to "further evaluate our working interest in the Wells" and then subsequently informed COG it no longer wished to be paid an overriding royalty interest. *See* COG Exhibits 23 and 24. Whether these facts give rise to an enforceable agreement or otherwise vest title in COG is a matter for the district court to decide, not this Division. *See TMBR/Sharp* Order R-11700-B at p. 5, ¶ 27.

In short, evidence has been presented that COG had either a good faith belief of a contractual right to operate on the W/2 of Sections 17 and 20 or a good faith belief of an ownership interest in the W/2 of Section 20. Under Commission and Division precedent, either is sufficient to meet the Division's "good faith" requirements for developing the spacing units subject to the Communitization Agreements filed with the New Mexico State Land Office. Since NEX continues to maintain that no voluntary agreement exists covering the lands currently dedicated to the SRO State Com No. 43H and No. 44H wells, compulsory pooling is required

under the Oil and Gas Act "effective from first production" to conform with these filed Communitization Agreements. *See* NMSA 1978, § 70-2-17(C) and § 70-2-18(A).

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