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

IN THE MATTER OF THE APPLICATION OF NEARBURG EXPLORATION COMPANY, L.L.C., SRO2 LLC AND SRO3 LLC FOR AN ACCOUNTING AND LIMITATION ON RECOVERY OF WELL COSTS, AND FOR CANCELLATION OF APPLICATION FOR PERMIT TO DRILL, EDDY COUNTY, NEW MEXICO **CASE NO. 15441**

IN THE MATTER OF THE APPLICATION OF COG OPERATING LLC FOR A NON-STANDARD SPACING AND PRORATION UNIT AND COMPULSORY POOLING, EDDY COUNTY, NEW MEXICO **CASE NO. 15481**

IN THE MATTER OF THE APPLICATION OF COG OPERATING LLC FOR A NON-STANDARD SPACING AND PRORATION UNIT AND COMPULSORY POOLING, EDDY COUNTY, NEW MEXICO **CASE NO. 15482**

POST-HEARING MEMORANDUM

This Hearing Memorandum is submitted by Montgomery and Andrews, P.A. (J. Scott Hall) on behalf of Nearburg Exploration Company, L.L.C., SRO2 LLC and SRO3 LLC ("NEX"). The purpose of this Hearing Memorandum is to further develop, beyond the contents of the respective Applications of NEX and COG Operating, LLC, the relevant New Mexico law regarding title to interests in real property and its application to this dispute over whether COG had the right to permit and drill two wells drilled onto NEX's lease acreage in Eddy County.

I.

The Cases before the Division

In Case No. 15441, NEX seeks an order that COG did not have the right to drill two two-mile long lateral wells that COG drilled and completed in the Bone Spring formation from surface locations in Section 17 onto unconsolidated and unpooled lease acreage owned by NEX in the W/2 of Section 20, Township 26 South, Range 28 East: The SRO State Com 043H (API 30-015-41141) located in the W/2 W/2 of Sections 17 and 20 ("043H") and the SRO State Com 044H (API 30-015-41142) located in the E/2 W/2 of Sections 17 and 20 ("044H"). Both wells were drilled to and completed in the 2nd Bone Spring Sand. NEX also seeks the cancellation of the application for permit to drill the COG SRO State Com 069H Well (API 30-015-43093) projected to be drilled to the 3rd Bone Spring formation in the E/2 W/2 of Sections 17 and 20.

In cases 15481 and 15482, COG in-turn seeks an order retroactively approving of two non-standard, 320-acre spacing and proration units in the W/2 of Section 17 and the W/2 of Section 20, Township 26 South, Range 28 East, and pooling all mineral interests in the Bone Spring formation underlying this acreage. The Examiners should note that COG's Applications in cases 15481 and 15482 do not outline any basis for COG's ***right to drill*** – yet attempt to convince the Division its actions were justified based on a "good faith belief" that it had the right to drill.

II.

Key Background Facts

1. NEX is the owner of New Mexico State Oil and Gas Lease No. V-7450-0001 (the "Lease").

2. On June 12, 2009, the Division approved the SRO State Exploratory Unit established by the Unit Agreement (Order No. R-13136).

3. The Unit Agreement, by its own terms, did not become effective until approval by the Commissioner and the Division. The Commissioner of Public Land approved the Unit Agreement effective as of August 1, 2009.

4. NEX term-assigned its lease acreage in Section 20 to Marbob, effective July 1, 2009, reserving an overriding royalty interest.[1] The Term Assignment was limited to a term that extended only so long as the Lease was subject to the Unit Agreement.

5. COG initiated the process of terminating the Unit Agreement.

6. Effective March 1, 2014, COG voluntarily terminated its right to drill and produce oil and gas from the Lease.[2]

7. When the Unit Agreement terminated on March 1, 2014, all parties agree that the NEX-Marbob Term Assignment terminated automatically.[3] The lease acreage in Section 20 simultaneously reverted to NEX.

8. Five days after having voluntarily terminated its right to drill on NEX's Lease, COG filed C-102s for the SRO State Com 043H well and for the SRO State Com 044H well.[4]

9. COG certified and filed these C-102s without an updated title opinion on the SRO Unit wells.[5]

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[1] NEX Hearing Exhibit 2

[2] NEX Hearing Exhibit 11.

[3] NEX Hearing Exhibit 15; Testimony of Ryan Owen, Hearing on May 4, 2016, 247:11-19; 260:17-23 (in response to Examiner Brooks's question regarding the termination of the Term Assignment when the unit terminated: "I don't believe anybody's arguing with that.").

[4] NEX Hearing Exhibits 29 and 30.

[5] COG Hearing Exhibit 13 (March 20, 2014 email from COG's Brent Sawyer – "our title lawyer is working on getting supplementary opinions for each individual well's proration unit, since the SRO state unit has terminated"; May 5, 2014, COG's Brent Sawyer tells NEX that "We are still waiting to get updated title opinions on all 23 SRO wells . . .Hopefully we will get those opinions this month . . ."; September 30, 2014, COG's Brent Sawyer tells NEX that COG is still waiting on updated title opinions, "Latest word from the attorney is they will be ready next week.").

10. In July 2014, NEX received a proposed communitization agreement from COG.[6] The day that NEX received that proposed agreement, Randy Howard called COG's Kelly Fuchik and explained that NEX could not agree to the communitization agreement because the Term Assignment had expired.[7] Further, NEX expressly told COG that COG was not authorized to operate on NEX's Lease.[8]

11. In spite of the Term Assignment's expiration and NEX's express refusal to execute the communitization agreement and assertion that COG had no right to operate on NEX's Lease, COG spud 043H on August 2, 2014. COG still did not have an updated title opinion on the SRO Unit wells.[9] COG admits that at no time prior to August 2, 2014, did COG provide NEX with "written notice of the proposed operation, specifying the work to be performed" (as required by the Operating Agreement)[10] nor did COG provide NEX with 24-hour notice of spudding (as required by the then-terminated Term Assignment).[11]

12. COG received a drilling title opinion on other wells in the SRO Unit on October 8, 2014. That drilling title opinion made clear to COG that all of the interests under the Lease had reverted back to NEX.[12]

13. COG spud 044H on October 10, 2014. COG admits that at no time prior to October 10, 2014, did COG provide NEX with "written notice of the proposed operation,

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[6] COG Hearing Exhibit 12.
[7] Testimony of Randy Howard, Hearing on May 4, 2016, 131:13-19; 132:2-6.
[8] Testimony of Randy Howard, Hearing on May 4, 2016, 132:7-10.
[9] COG Hearing Exhibit 13 (March 20, 2014 email from COG's Brent Sawyer – "our title lawyer is working on getting supplementary opinions for each individual well's proration unit, since the SRO state unit has terminated"; May 5, 2014, COG's Brent Sawyer tells NEX that "We are still waiting to get updated title opinions on all 23 SRO wells . . .Hopefully we will get those opinions this month . . ."; September 30, 2014, COG's Brent Sawyer tells NEX that COG is still waiting on updated title opinions, "Latest word from the attorney is they will be ready next week."); Testimony of Ryan Owen, Hearing on May 4, 2016, 247:2-10.
[10] Testimony of Ryan Owen, Hearing on May 4, 2016, 246:2-8.
[11] Testimony of Randy Howard, Hearing on May 4, 2016, 66:25-67:6.
[12] NEX Hearing Exhibit 21.

specifying the work to be performed" (as required by the Operating Agreement)[13] nor did COG provide NEX with 24-hour notice of spudding (as required by the then-terminated Term Assignment).[14] COG further admits that when 044H was drilled, it had title opinions that informed it that the Term Assignment (and therefore, COG's right to drill) had expired.[15]

14. 043H is completed on February 25, 2015. COG places 043H on production on March 1, 2015.

15. 044H is completed on March 4, 2015. COG places 044H on production on March 5, 2015.

16. Throughout these periods, COG did not inform NEX that it had drilled any wells on the former unit other than certain Avalon wells.

III.

Points and Authorities

At the May 4, 2016 hearing on the NEX and COG Applications, COG asserted that its actions were justified based on a "good faith belief that it had *the right to drill*" the 043H and 044H wells at the time. But COG misstates the standard. Both the Division and Commission have specified that an operator seeking to permit a well must have a good faith claim to title ***and*** that it must have the right to drill on the lands involved at the time a well is drilled. COG failed to establish that it satisfied either element.

A. COG Held No Right, Title, or Interest in Section 20.

To invoke the Division's compulsory pooling authority, an applicant must have the "right to drill." NMSA 1978 §70-2-17 C. Further, an applicant for a permit to drill "must have a good

[13] Testimony of Ryan Owen, Hearing on May 4, 2016, 246:2-8.
[14] Testimony of Randy Howard, Hearing on May 4, 2016, 81:4-21.
[15] Testimony of Ryan Owen, Hearing on May 4, 2016, 247:15-18.

faith claim to title." Order No. R-12108-C, *Rehearing*, Findings ¶ 8(e) (December 9, 2004).[16] In this instance, COG had neither one.

An interest in an oil and gas lease is an interest in real estate. *See Angle v. Slayton,* 102 N.M. 521, 523, 697 P. 2d 940, 942 (1985). Real property laws, therefore, govern COG's claim to title.

When COG finalized the termination of the Unit Agreement, COG lost any vestige of an interest to the Lease. On March 1, 2014, SRO State Exploratory Unit terminated and NEX's interest in the Lease automatically reverted to NEX.[17] COG's title in Section 20 was not "free from any encumbrances, burdens, or other limitations" and was neither clear nor marketable. *See* Black's Law Dictionary, 1522 (8th ed. 2004). *See also Campbell v. Doherty,* 53, N.M. 280, 286, 206 P.2d 1145, 1148 (1949) ("a 'marketable title' is not subject to such reasonable doubt as would create a just apprehension of its validity in the mind of a reasonable, prudent, and intelligent person.").

B. COG has no good faith claim to title in the Lease.

An applicant for a permit to drill must have a good faith claim to title. *See* Order No. R-11700-B. COG does not have record title. Neither can it reasonably claim that it had a good faith claim to title at the time the wells were drilled.

"Title" to real property is evidenced by a conveyance "*which shall be subscribed by the person transferring his title or interest in said real estate, or by his legal agent or attorney.* " NMSA 1978 § 47-1-5. *See Kysar v. Term Production Co.*, 135 N.M. 767, 93 P3d 1272 (2004). Likewise, NMSA 1978 § 37-1-21 requires a claimant to hold or claim "by virtue of a deed or deeds [of] conveyance, ... purporting to convey an estate in fee simple." *See also Quarles v.*

[16] Application of Pride Energy Company for Cancellation of a Drilling Permit and Reinstatement of a Drilling Permit, etc., Lea County, New Mexico; Case No. 13153 de novo.
[17] NEX Hearing Exhibit 21 – COG's own title opinion.

Arcega, 114 N.M. 502 (N.M.App., 1992). Therefore, a claim to title must be based on a written deed, with a legal description contained therein that is easily ascertainable on the ground. *See Esquibel v. Hallmark*, 92 N.M. 254 (1928); *Cox v. Hanlen*, 1998-NMSA-015; *Ritter-Walker Co. v. Bell*, 46 N.M. 125 (1942).

As the New Mexico Court of Appeals has pointed out, Black's Law Dictionary defines "title" as: *"The union of all elements (as ownership, possession, and custody) constituting the legal right to control and dispose of property; the legal link between a person who owns property and the property itself." Santa Fe County Bd. Of County Com'rs v. Town of Edgewood*, (2004-NMCA-111) (quoting Black's Law Dictionary at 1493).

Neither the NMOCD nor the New Mexico courts have defined what exactly it means to have a "good faith claim to title." One Washington court, in the context of adverse possession, has articulated: "claimant must have an honest belief, based on reasonable grounds, that he or she has acquired a valid legal title." *Williams v. Striker*, 627 P.2d 590, 29 Wash. App. 132 (1981). Case law originating from the Texas Railroad Commission also establishes that an applicant for a permit to drill must make "a reasonably satisfactory showing of a good-faith claim of ownership." *Magnolia Petroleum Co. v. Railroad Com'n.*, 170 SW2d 189 (Tex. 1943). A finding of a good faith assertion of title must be based on substantial evidence.).

New Mexico does not adhere to a single definition of good faith, recognizing that the concept arises in a variety of disparate situations. *See Ambassador Ins. Co. v. St. Paul Fire & Marine Ins. Co.*, 102 N.M. 28, 31, 690 P. 2d 1022, 1025 (1984). New Mexico's analysis of "good faith belief" in other areas of the law, it appears that the legal definition of good faith is a belief based upon a reasonable assessment of the facts. *See e.g., State v. Sanchez*, 88 N.M. 378, 382, 540 P. 2d 858, 862 (1975) ("by a good faith belief, we mean a reasonable belief, one resting

on a reasonable assessment of the facts"); *Fife v. Barnard*, 186 F. 2d 655, 660 (10th Cir. 1951) (good faith in asserting color of title in an adverse possession case must be based upon an honest belief based on reasonable grounds).

A reasonable assessment of the facts in this case would have easily uncovered (and actually did uncover) that the Term Assignment rights had terminated. COG had no coherent answer when asked: "how [did] the 43H well [get] drilled without a drilling title opinion?"[18] COG's own title opinions, received at least twice before either well was completed, emphasized to COG what it already knew: it no longer had an interest in Section 20 as of March 1, 2014. In addition, prior to spudding the 043H and 044H wells, NEX had refused to agree to a communitization agreement and expressly told COG it had no right to operate on NEX's Lease.[19]

COG may have hoped that it was going to work out something with NEX, but that is not a "good faith claim to title." In order to meet the standard, COG had to actually believe it had acquired an interest in title. In light of NEX's express objections and COG's own lawyers recognizing it did not actually have title, any claim to title by COG is unreasonable under the facts of this case and does not meet a good faith standard.

C. Applicable Regulatory Law Precedent.

In *Pride Energy*, the Oil Conservation Commission, citing to Order No. R-11700-B,[20] said "[t]hat an applicant for permit to drill must have a good faith claim of title." Order No.R-12108-C, Findings ¶ 8(e) (December 9, 2004). A copy of the order is attached. The agency then

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[18] Testimony of Ryan Owen, Hearing on May 4, 2016, 247:2-10.

[19] Testimony of Randy Howard, Hearing on May 4, 2016, 131:14-19; 132:2-10.

[20] *Case No. 12731, Application of TMBR/Sharp Drilling, Inc. For An Order Staying David H. Arrington Oil and Gas, Inc. From Commencing Operations, Lea County, New Mexico; Case No. 12744, Application of TMBR/Sharp Drilling, Inc. Appealing The Hobb's District Decision Approval Of Two Applications For A Permit To Drill filed by TMBR/Sharp Drilling, Inc., Lea County, New Mexico.*

established a specific administrative procedure to make a determination whether or not a good faith claim of title exists:

> "(f) Although the Division can and should cancel an APD when it properly determines that no such good faith claim exists 'as the Commission determined, based a District Court judgment, in Order No. R-11700-B', it should not make that determination, which necessarily cannot be made on the face of the APD or from Division records, without first giving the Applicant notice and an opportunity for a hearing. Although the Division doubts that the right conferred by an approval of an APD is properly characterized as "property," it nevertheless concludes that such approval confers rights that should not be revoked arbitrarily." Order No. R-1208-C, ¶ 8.

The Division and Commission followed this procedure in the *TMBR/Sharp* case, where, after the administrative challenge to Arrington's APD's, TMBR/Sharp Drilling was able to prove-up that it had title to support the issuance of its APD's. Further, Order No. R-11700-B in the *TMBR/Sharp* case set forth the two criteria under which the Division may make a determination of a properly or improperly approved APD: *"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 to drill the well applied for." Order No. R-11700-B, Finding ¶ 28 (April 26, 2002).

In 2007, the Commission clarified *Pride* and made clear that its findings related to the order of approval (pooling then APD or APD then pooling) only applied ***before*** work began – "[the Commission] did not find that an operator could actually drill a well on acreage in which it had no interest before the Division or Commission decided a pooling application."[21] There, Chesapeake drilled a well on acreage it did not have an interest in. The Commission went on to state: "An Operator shall not file an application for permit to drill or drill a well unless it owns an

[21] Application of Samson Resources, Kaiser-Francis Oil Company and Mewbourne Oil Company for Cancellation of Two Drilling Permits and Approval of a Drilling Permit, Lea County, New Mexico, Case No. 13492; Application of Chesapeake Operating, Inc. for Compulsory Pooling, Lea County, New Mexico.; Case No. 13493, de novo (consolidated), Order No. R-12343-E, Conclusions ¶ 30, (March 16, 2007). A copy of the order is attached.

interest in the proposed well location or has a right to drill the well as stated in Division Form C-102." Order No. R-12343-E, Conclusions ¶ 33 (March 16, 2007). The Division's Form C-102 now provides for Operator Certification:

> *"I hereby certify that the information contained herein is true and complete to the best of my knowledge and belief, and that this organization either owns a working interest or unleased mineral interest in the land including the proposed bottom hole location(s) or has a right to drill this well at this location pursuant to a contract with an owner of such a mineral or working interest, or to a voluntary pooling agreement or a compulsory pooling order heretofore entered by the Division."*

Prior to drilling, Samson had elected to participate in the well and had approved an authorization for expenditures. Samson rescinded both of those before Chesapeake drilled the well. Because the off-lease vertical well on that tract had already been drilled and completed by the time the case was heard, the Commission's solution in-part was to remove Chesapeake as operator. Order No. R-12343-E, Conclusions ¶ 3.

NEX's position in this matter is similar to Samson's. COG owns no interest in Section 20. NEX did not enter into to an Operating Agreement with COG. Even if the Examiners find that NEX is bound by the Operating Agreement, in July 2014, NEX expressly told COG that COG was not authorized to operate on NEX's Lease.[22] Like Samson, any implied right COG might have had was rescinded prior to either 043H or 044H being drilled (043H was spud on August 2, 2014).

In 2009, Case No. 14323[23] was one of the first disputes to come before the Division addressing the certification of a drilling permit for a horizontal well. There, COG obtained the Division's approval of an APD for a project area comprised of the S/2 S/2 of Section 11 prior to obtaining voluntary or compulsory pooling. Order No. R-13154-A (September 21, 2009). A

[22] Testimony of Randy Howard, Hearing on May 4, 2016, 132:7-10.
[23] Application of Chesapeake Energy Corporation for Cancellation of a Permit To Drill (APD) Issued To COG Operating, LLC, Eddy County, New Mexico. A copy of the order is attached.

copy of the order is attached. It was undisputed that COG's only "ownership interest" in the S/2 SW/4 area was a contractual license or easement to utilize the surface. Order No. R-13154-A, Finding ¶ 4(a). The working interest was owned by Chesapeake. Because COG proposed to complete a well in Chesapeake's area, Chesapeake sought cancellation of COG's APD.

The Division found its prior ruling in *Chesapeake/Samson* controlled and accordingly cancelled COG's APD. ("COG's ownership of an easement or license authorizing its use of the surface location of the proposed well does not distinguish this case from the case decided in Order No. R-12343-E because a surface easement or license does not, and cannot, authorize the drilling and completion of a horizontal well in the subsurface without the approval (actual or compelled) of at least one owner of oil and gas rights in each tract to be included in the project area.") Order No. R-13154-A, Findings ¶ 12. In this matter, COG does not own title to the minerals in Section 20, it has no contractual right and even if it had, it was revoked before it drilled the first of the two wells.

D. Right to Drill

Even if a "good faith right to drill" were the standard, COG's reliance on the Ratification and Joinder of Unit Agreement and Operating Agreement (the "Ratification") is unfounded. The Division's approval of APDs does not determine whether an applicant can validly claim the right to drill. It is the operator's responsibility to do so.

COG's Ryan Owen testified that COG believed it had the right to drill both 043H and 044H based on the Ratification and Unit Operating Agreement and correction or amendment of the Term Assignment.[24] The text of the Ratification, signed by NEX on June 26, 2009, does not address the operating agreement. Instead, the Ratification specifically states that NEX "expressly

[24] Testimony of Ryan Owen, Hearing on May 4, 2016, 254:6-15 and 260:5-10.

ratifies, approves and adopts said **Unit Agreement**."[25] COG could not have good faith belief in its right to drill based on an Operating Agreement that NEX was not a party to. If "good faith" means anything, it must mean a simple reading of the Ratification. In addition, it is undisputed that COG did not follow the notice requirements of the Operating Agreement before drilling 043H and 044H.[26]

Finally, COG's reliance on an extension of Term Assignment is unfounded and COG's own actions show that this is an afterthought in an attempt to support its improper actions. An interest in an oil and gas lease is real property and therefore the statute of frauds applies. To satisfy the statute:

> A memorandum, in order to make enforceable a contract within the statute, may be any document or writing, formal or informal, signed by the party to be charged or by his agent actually or apparently authorized thereunto, which states with reasonable certainty, (a) Each party to the contract either by his own name, or by such a descriptions as will serve to identify him, or by the name or description of his agent, and (b) the land, goods, or other subject-matter to which the contract relates, and (c) the terms and conditions of all the promises constituting the contract and by whom and to whom the promises are made.

Piteck v. McGuire, 1947 -NMSC- 053, ¶29. There is no writing here.[27] COG's Ryan Owen was asked "what did you have in writing from Nearburg that you would have relied on to believe that Nearburg had agreed to extension of the – the Term Assignment?" In response, Mr. Owen simply stated "We believed we had the right to drill the two wells due to the Ratification and Joinder of the Operating Agreement" – ignoring any explanation of the title claim.[28] COG's own lawyers recognized that if COG "considered" the Term Assignment either extended or in full force and effect, it had to get a written amendment to the Term Assignment and if it could not,

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[25] NEX Hearing Exhibit 10.
[26] Testimony of Ryan Owen, Hearing on May 4, 2016, 245:15-19 and 246:2-8 (COG never sent well proposals to NEX).
[27] Testimony of Ryan Owen, Hearing on May 4, 2016, 271:12-15 (confirming that Nearburg never delivered a signed Corrected Term Assignment or extended Term Assignment).
[28] Testimony of Ryan Owen, Hearing on May 4, 2016, 260:5-10.

the title opinions would change.[29] COG cannot have a "good faith" basis to drill based on an alleged agreement that expressly violated the statute of frauds and that its attorneys expressly required but COG failed to negotiate.

III.

Conclusion

These matters were succinctly summed up by Examiner Brooks:

> Examiner Brooks: And if neither the operating agreement nor the Term Assignment applies, then COG would not have a right to drill, right?
>
> COG's Ryan Owens: Without an order, no.[30]

NEX respectfully requests that the Examiners find that in 2014, COG did not have the right to permit or drill the SRO State Com 043H or 044H wells onto NEX's lease in Section 20 and that COG did not have the right to permit the SRO State Com 069H well. NEX further requests that COG's applications for compulsory pooling be denied.

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[29] NEX Hearing Exhibit 22.
[30] Testimony of Ryan Owen, Hearing on May 4, 2016, 264:4-7.

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CERTIFICATE OF SERVICE

I hereby certify that a true and correct copy of the foregoing was served on counsel of record by electronic mail on May 26, 2016:

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

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

CASE NO. 13153, Rehearing

APPLICATION OF PRIDE ENERGY COMPANY
FOR CANCELLATION OF A DRILLING PERMIT
AND REINSTATEMENT OF A DRILLING
PERMIT, AN EMERGENCY ORDER HALTING
OPERATIONS, AND COMPULSORY POOLING,
LEA COUNTY, NEW MEXICO

ORDER NO. R-12108-C

ORDER OF THE OIL CONSERVATION COMMISSION

BY THE COMMISSION:

THIS MATTER originally came before the Oil Conservation Commission (the Commission) on August 12, 2004, and the Commission entered Order No. R12108-A disposing of this application on September 10, 2004. Pursuant to the application of Yates Petroleum Corporation for rehearing, and the order of the Commission granting same (Order No. R-12108-B, issued on October 14. 2004), this matter came again before the Commission for rehearing on November 10, 2004 at Santa Fe, New Mexico, and the Commission, having heard the evidence and arguments of counsel and carefully considered the same, now, on this 9th day of December, 2004,

FINDS:

1. Notice has been given of the application and the hearing of this matter, and the Commission has jurisdiction of the parties and the subject matter.

2. In the original application in this case, Pride Energy Company (Pride) sought an order canceling a permit issued to Yates Petroleum Corporation (Yates) to re-enter the

abandoned State X Well No. 1 (API No. 30-025-01838) (the subject well), located 1980 feet from the North line and 660 feet from the West line (Unit E) of Section 12, Township 12 South, Range 34 East. NMPM, Lea County, New Mexico. Pride also sought reinstatement of a drilling permit previously issued to it to re-enter the same well, and an emergency order preventing Yates from conducting any operations on the well.

3. Pride additionally sought an order pooling all uncommitted mineral interests underlying the W/2 of Section 12, Township 12 South, Range 34 East, NMPM, Lea County, New Mexico, from the surface to the base of the Mississippian formation, forming a standard 320-acre gas spacing and proration unit (the Unit) for all formations or pools spaced on 320 acres within this vertical extent, which presently include, but are not necessarily limited to, the undesignated Four Lakes-Mississippian Gas Pool and the undesignated Four Lakes-Morrow Gas Pool, such unit to be dedicated to the well.

4. Both Yates and Pride appeared at the original Commission hearing on August 12, 2004 through counsel and presented land and technical testimony. Pride presented the testimony of John W. Pride, a petroleum landman and one of the principals of Pride, and Jeff Ellard, a geologist employed by Pride. Yates presented the testimony of Charles E. Moran, a landman employed by Yates, John Amiet, a geologist employed by Yates, and David F. Boneau, a petroleum engineer employed by Yates.

Undisputed Facts

5. Based on the statements of counsel and testimony offered by the parties, the Commission concludes that the following facts pertinent to this case are undisputed:

(a) Yates is the owner of the entire working interest in the north half and southeast quarter of Section 12, Township 12 South, Range 34 East.

(b) Pride is the owner of the entire working interest in the southwest quarter of Section 12.

(c) The subject well is located in the northwest quarter of Section 12 on land leased exclusively to Yates.

(d) Pride is the operator of the State M Well No. 1 (API No. 30-025-20689) (the State M), located 660 feet from the south and west lines of Section 1, Township 12 South, Range 34 East, which well is completed in, and producing from, the Mississippian formation. That well is dedicated to a spacing unit comprising the west half of Section 1, pursuant to a voluntary unit agreement to which Pride and Yates are both parties.

(e) On May 24, 2001 Yates filed an Application for Permit to Drill (APD) to re-enter the subject well, which it designated the "Limbaugh AYO State Well No. 1", and to which it proposed to dedicate a spacing unit comprising the north half of Section 12. The Division approved that APD on May 25, 2001.

(f) On April 15, 2002, in anticipation of the forthcoming expiration of its APD, Yates filed a sundry notice to extend its APD for an additional year, until May 25, 2003. The Division approved the requested extension on April 18, 2002.

(g) On May 25, 2003, Yates' APD to re-enter the subject well expired.

(h) On July 10, 2003, Pride filed an APD to re-enter the subject well under the name "State X Well No. 1," to which it proposed to dedicate a spacing unit comprising the west half of Section 12, including the southwest quarter, which is leased to Pride.

(i) Pride's APD was approved by the Division on July 16, 2003.

(j) On August 25, 2003, Yates filed a new APD to re-enter the subject well, again designating the well as the "Limbaugh AYO State No. 1" and again proposing to dedicate to the well a spacing unit comprising the north half of Section 12.

(k) On August 26, 2003, the district supervisor of OCD District 1, approved Yates' APD for the subject well, and prepared a letter to Pride canceling Pride's APD.

(l) Yates has stipulated that it will undertake no operations with respect to the subject well pending the Commission's decision, thereby mooting Pride's request for an emergency order prohibiting such operations.

Technical Evidence

6. Although the history and land ownership are undisputed, as indicated in the foregoing findings, there exists controversy concerning the technical aspects of the case.

7. At the August 12, 2004 Commission hearing, the parties presented the following technical evidence:

(a) Mr. Ellard, Pride's geologist, testified that the objective in re-entering the subject well would be the Austin cycle of the upper Mississippian (the target reservoir), in which production was encountered in the State M, to the north of the subject well.

(b) Mr. Ellard further testified that the target reservoir was formed by shedding of fragmented rock from a raised fault block produced by faults lying to the west of these two wells. In wells farther to the south and east, away from the faulting, where the rock was not fragmented, the formation is present, but with insufficient porosity to be productive.

(c) Mr. Ellard opined that producible hydrocarbons would most likely be located closest to the fault because, of the material shed from the upthrown side of the fault, that material composed of larger particles, and therefore characterized by greater porosity and permeability, would be deposited in close proximity to the fault.

(d) Mr. Ellard placed the fault that created the target reservoir on a bearing more or less north to south and located a short distance to the west of the State M and the subject well, generally along and close to the section line between Section 12 and the adjacent Section 11. On this basis, he opined that the subject well would more likely drain producible hydrocarbons from the quarter section lying south of the subject well (the southwest quarter of Section 12), than from the quarter section lying east of the subject well (the northeast quarter of Section 12).

(e) Mr. Ellard testified that it is not possible to determine with any degree of accuracy the extent of the target reservoir with the information presently available. However, he opined, based on comparison of the old log of the subject well with the old log of the State M, that the subject well would likely encounter a comparable thickness of pay in the target reservoir (25 feet as compared to 30 feet in the State M).

(f) Mr. Amiet, Yates' geologist, agreed generally with Mr. Ellard's interpretation of the nature of the target reservoir and the mechanism of deposition, including the assessment that the extent of the target reservoir could not be determined with available information, but disagreed with Mr. Ellard's placement of the fault that produced the up-thrown block from which the reservoir material was presumably eroded.

(g) Mr. Amiet testified that 3D seismic run along a west-to-east bearing close to the location of the subject well, and which was admitted in evidence, demonstrated that no significant fault down-thrown to the east existed in the westward proximity of the subject well. He opined that the fault that controls the location of the target reservoir runs to the north of the State M and trends northeast to southwest. Accordingly, he concluded that the subject well is more distant from the fault than is the State M, and the Pride acreage in the southwest quarter of Section 12 is yet more distant.

(h) Mr. Amiet interpreted the logs from the subject well to show no more than 10 feet of reservoir in the target formation (as compared to 30 feet in the MI), confirming his conclusion that the subject well is more distant from the fault.

(i) Mr. Amiet testified that Yates had other 3-D seismic runs that tended to confirm his placement of the controlling fault, but Yates did not offer this other seismic information in evidence.

(j) Mr. Amiet further testified that the prevailing contours on the down-thrown side of the controlling fault favored the flow of eroded material to the east, rather than to the south. On this basis, he opined that the Yates acreage in the east

half of Section 12 is more likely to contain reservoir rock that might be drained by the subject well than is the Pride acreage in the southwest quarter.

(k) Dr. Boneau, Yates' engineering witness, calculated the probable drainage area of the State M based on production data and log analysis, to be 145 acres. Assuming that the drainage characteristics of the subject well would be otherwise similar to those of the State M, he calculated that 97% of production in the target reservoir from the subject well would be drawn from Yates acreage if Yates assumptions were correct, and 65% if Pride's assumptions were correct.

Analysis of Legal Issues

8. Based on the evidence and arguments at the August 12, 2004 hearing, the Commission finds and concludes concerning the legal issues presented as follows:

(a) This case requires an analysis of the effect of the Division's action in approving an APD.

(b) Pride filed an APD proposing a well at an orthodox location, and attached thereto a Dedication Plat (C-102) proposing to dedicate thereto a standard unit which was not then dedicated to any other well in the pool. Accordingly, Pride's APD was *prima facie* valid, and the Division properly approved it.

(c) The Division, through its district supervisor, subsequently purported to revoke its approval of Pride's APD on the ground that Pride did not own an interest in the drill-site tract.

(d) As this Commission observed in Order No. R-11700-B, entered in Cases No. 12731 and 12744, the Division has neither the responsibility nor jurisdiction to determine whether an applicant for a permit to drill has the requisite title to the land in question. Order No. R-11700-B, Finding 27.

(e) The Commission further stated in Order No. R-11700-B that an applicant for a permit to drill must have a good faith claim of title. Order R-11700-B, finding 28.

(f) Although the Division can and should cancel an APD when it properly determines that no such good faith claim exists (as the Commission determined, based on a District Court judgment, in Order No. R-11700-B), it should not make that determination, which necessarily cannot be made on the face of the APD or from Division records, without first giving the applicant notice and an opportunity for a hearing. Although the Commission doubts that the right conferred by approval of an APD is properly characterized as "property," it nevertheless concludes that such approval confers rights that should not be revoked arbitrarily.

(g) In any event, a determination that Pride did not have a good faith claim could not have been made in this case. Here, unlike Cases No. 12731 and 12744, there is

no title dispute. It is undisputed that Pride owns a working interest in the unit proposed in its APD, *i.e.*, the west half of Section 12, and that the west half of Section 12 is a standard unit permitted by applicable spacing rules. It is likewise undisputed that, at the time Pride filed its APD, Yates' previously approved APD calling for a north half spacing unit had expired.

(h) Again, the Commission said in Order No. R-11700-B:

> An operator may first apply for a permit to drill a well and may thereafter pool (on a voluntary or compulsory basis) separately owned tracts to the well. Alternatively, the operator may first pool and later seek a permit to drill. The two are not mutually exclusive, and there is no preferred methodology.
>
> Order R-11700-B, finding 35.

(i) The Commission accordingly concludes that an owner who would have a right to 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. If an owner uses this right to "tie-up" acreage without proceeding diligently to seek voluntary or compulsory pooling, or if the acreage can more properly be developed by inclusion in a different unit, an aggrieved owner can file an application with the Division to cancel its approval of the APD, which the Division can do after notice and hearing.

(j) It follows that Pride's approved APD in this case was improperly revoked, and Yates' subsequent APD was improperly approved. It does not necessarily follow, however, that Pride is entitled to the relief it seeks in this case.

(k) As the Commission stated in Order No. R-11700-B:

> An application for a permit to drill serves different objectives than an application for compulsory pooling and the two proceedings should not be confused.
>
> Order No. R-11700-B, finding 33.

(l) In Order No. R-11700-B, the Commission ordered cancellation of an APD based on a judicial determination that the party who filed the APD had no title to the subject unit and therefore could not be an operator of a well within that unit. The Commission further ordered approval of an APD subsequently filed by a party whose title the court had approved. However, the Commission deferred the issue of the proper configuration of the unit to be dedicated to the proposed well for determination in a pending compulsory pooling proceeding.

(m) Thus the existence of a properly approved APD should not be a basis for prejudging the issues in a compulsory pooling application. If the applicant prevails on its compulsory pooling application and is appointed operator in a compulsory pooling order, it is entitled to approval of an APD in any case. If the compulsory pooling application is denied, the applicant having in this case no other basis for a claim of title to the drill-site tract, cancellation of the APD would be a necessary consequence.

(n) Ordinarily, Division precedent would require an owner opposing a compulsory pooling application on the ground that prudent development would counsel the formation of a different unit to file a competing application. However, in this case, compulsory pooling would be unnecessary to form a north half unit, as Yates proposes. Accordingly, Yates should be permitted to offer evidence in support of its proposal as a defense to Pride's compulsory pooling application.

(o) The Commission accordingly concludes that its decision in this case must be based on its evaluation of the technical testimony presented in support of, and against, Pride's compulsory pooling application, irrespective of the circumstances with regard to the approval of the respective APDs.

Analysis of Technical Issues

9. Based on the evidence and arguments at the August 12, 2004 hearing, the Commission finds and concludes concerning the technical issues presented as follows:

(a) Expert witnesses for both parties concurred that, on the basis of the information presently available, the total quantity of reserves in the Mississippian formation underlying Section 12, or particular quarter sections thereof, cannot practicably be determined.

(b) None of Yates' witnesses offered any convincing reason for supposing that the east half of Section 12 would be productive in the Mississippian. Dr. Boneau testified that the State M well would have a drainage area of 145 acres, and that the subject well is likely to be only half as good a well, suggesting a drainage radius for the subject well of less than 160 acres. Although Mr. Amiet projected the target reservoir into the northeast quarter of the section, he also testified that porosity would fall off rapidly as the distance from the fault increased, and he conceded that his projection of the alluvial fan that produced the target reservoir to the east depended upon the unproven assumption that the observed contours of the formation corresponded to the contours existing at the time of deposition.

(c) If Pride's placement of the controlling fault as bearing north to south, and in close proximity to the subject well, is correct, then its conclusion that the southwest quarter of Section 12 will likely be productive in the Mississippian, and the east half of the section will not be productive, accords with the understanding of both geologists of the nature of this reservoir.

(d) Although no good logs of the subject well are available, the Commission concludes that Mr. Pride's interpretation that there is likely a comparable amount of reservoir footage in the subject well to that encountered in the State M well is more convincing, and that interpretation is consistent with the north-south alignment of the controlling fault, and with the conclusion that the southwest quarter of Section 12 is likely to be productive.

(e) Both geologists predicted that the east half of the section is less likely to be productive from the target reservoir than the west half. The southwest quarter, however, is quite likely productive if the controlling fault actually exists in the north-south orientation as Pride's evidence suggests that it does.

(f) If the southwest quarter proves to be productive, and the east half of the section does not, then the establishment of lay down units in this section would violate Pride's correlative rights. If Pride drilled a well in the southwest quarter, such well would have to be included in a south-half unit, and Yates would be entitled to one-half of the production therefrom based on its ownership of the unproductive southeast quarter. If, on the other hand stand up units are established, and the east half proves to be productive, Yates can recover for itself all of the east half production by drilling on the east-half unit.

(g) Yates relies principally on its 3-D seismic to demonstrate that the critical fault is oriented northeast-southwest, and not north-south. Though Mr. Amiet testified that Yates has seismic data that confirms his suggested location of the fault, Yates did not offer any such seismic data in evidence.

(h) Though Mr. Amiet testified that he interpreted the seismic data offered in evidence as disproving the existence of a north-south fault in the location suggested by Pride, he conceded that a small fault with a throw of as much as 100 feet might exist that might not be apparent from the seismic data. The existence of a fault with much reduced throw compared to that farther to the north would be consistent with Mr. Pride's testimony that the fault "dies" to the south.

(i) The Commission concludes that Pride's geologic interpretation is, on the whole, more convincing that Yates' interpretation.

10. The Commission accordingly concludes that:

(a) A compulsory-pooled unit should be established consisting of the west half of Section 12, Township 12 South, Range 34 East. NMPM, Lea County, New Mexico, and that such unit should be dedicated to the subject well;

(b) Pride should be designated operator of the subject well and of the unit.

(c) Yates APD for re-entry of the subject well should be cancelled.

(d) The order should provide that any pooled working interest owner in the proposed unit who does not pay its share of estimated well costs should have withheld from production its share of reasonable well costs plus an additional 200% thereof as a reasonable charge for the risk involved in re-entering and re-completing the well.

(e) Reasonable charges for supervision of unit operations (combined fixed rates) should be fixed at $5,000.00 per month while drilling and $600.00 per month while producing, provided that these rates should be adjusted annually pursuant to Section III.1.A.3. of the COP AS form titled *"Accounting Procedure-Joint Operations."*

(f) Yates commenced operations to re-enter the subject well prior to the filing of this application, based on an APD reflecting Division approval.

(g) Pride should reimburse Yates for reasonable costs incurred by Yates in connection with such operation.

11. The Commission entered Order No. R-12108-A on September 9, 2004 granting the application of Pride Energy Company but authorizing Yates to recover the actual well costs incurred by Yates in conducting re-entry operations on the subject well after August 25, 2003 and "prior to the time when Yates received notice of the filing of the original application in this case".

12. Yates filed its Application for Rehearing in this case on September 29, 2004 in which it requested a new hearing on, among other issues, the portion of Order No. R-12108-A that limited Yates' recovery of costs to those costs incurred prior to the time it received notice of Pride's original application in this case.

13. On October 14, 2004, the Commission entered Order No. R-12108-B that granted Yates' Application for Rehearing but limited the issues for consideration on rehearing to the determination of costs for which Yates shall be allowed reimbursement.

14. On NovemberlO, 2004, this case came on for re-hearing before the Commission on the issue of costs for which Yates shall be allowed reimbursement.

15. Yates appeared at the hearing through counsel and presented the testimony of Charles E. Moran, a landman employed by Yates and Tom Wier, an accountant employed by Yates. Pride appeared through counsel but did not present testimony.

16. Mr. Moran testified that Yates had commenced operations on the subject well in August 2003, and that these operations had continued until Yates voluntarily stopped operations pending a decision of the Division in this case. Mr. Moran further testified that, although Pride had filed an application seeking an emergency order directing Yates to cease operations on this well, the Division had deferred action on Pride's application and found, on September 12, 2003, that "Yates should not be required to cease all re-entry operations of the State "X" Well No. 1." Mr. Moran requested that Yates be authorized to recover the actual

costs it incurred in the re-entry of the subject well prior to the time it voluntarily ceased operations on the well or October 7, 2003.

17. Mr. Moran also testified that Yates had complied with the provisions of ordering Paragraph 9 of Order No. R-12108-A by providing a schedule of all actual well costs it had incurred in conducting re-entry operations on the well by letter dated October 8, 2004, that it had received an AFE for the well from Pride by letter dated September 14, 2004; and, to be certain that it was not in a non-consent position under Commission Order No. R-12108-A, on October 13, 2004, Yates had paid to Pride its share of these AFE costs.

18. Mr. Wier reviewed the schedule of well costs submitted to Pride and the Commission on October 8, 2004, identified items that had occurred after October 7, 2003 and provided supporting information for the costs incurred prior to that date.

19. Pride requested that it be allowed time to review and object to the costs on the schedule provided by Yates and the supporting information submitted at the hearing.

20. Yates should be reimbursed for all reasonable costs incurred through October 7, 2003 in furtherance of the re-entry of the subject well, and the time for objections to those costs should be extended through December 31, 2004.

IT IS THEREFORE ORDERED THAT:

1. Pursuant to the application of Pride, all uncommitted interests, whatever they may be, in the oil and gas from the surface to the base of the Mississippian formation underlying the W/2 of Section 12, Township 12 South, Range 34 East, NMPM, Lea County, New Mexico, are hereby pooled to form a standard 320-acre gas spacing and proration unit (the Unit) for all formations or pools spaced on 320 acres within this vertical extent, which presently include, but are not necessarily limited to, the Undesignated Four Lakes-Mississippian Gas Pool and the Undesignated Four Lakes-Morrow Gas Pool. The Unit shall be dedicated to the subject well, located 1980 feet from the North line and 660 feet from the West line (Unit E) of Section 12.

2. The operator of the Unit shall commence re-entry operations on the subject well within 90 days after issuance of this order, and shall thereafter continue such operations with due diligence to test the Mississippian formation. If this order is suspended pending any further appeals, the ninety-day period provided in this paragraph shall be tolled during the time of such suspension.

3. In the event the operator does not commence re-entry operations within the time provided in ordering paragraph 2, this order shall be of no further effect, unless the operator obtains a time extension from the Division Director for good cause.

4. Should the subject well not be completed within 120 days after resumption of re-entry operations pursuant to this order, then this order shall be of no further effect, and the

unit created by this order shall terminate, unless the operator obtains a time extension from the Division Director following notice and hearing.

5. Upon final plugging and abandonment of the subject well, the pooled unit created by this Order shall terminate unless this order has been amended to authorize further operations.

6. Pride is hereby designated the operator of the subject well and of the Unit.

7. After pooling, uncommitted working interest owners are referred to as pooled working interest owners. ("Pooled working interest owners" are owners of working interests in the Unit, including unleased mineral interests, who are not parties to an operating agreement governing the Unit.) After the effective date of this order, the operator shall furnish the Division and each known pooled working interest owner in the Unit an itemized schedule of estimated costs of re-entering, completing and equipping the subject well ("well costs").

8. Within 30 days from the date the schedule of estimated well costs is furnished, any pooled working interest owner shall have the right to pay its share of estimated well costs to the operator in lieu of paying its share of reasonable well costs out of production as hereinafter provided, and any such owner who pays its share of estimated well costs as provided above shall remain liable for operating costs and charges for supervision but shall not be liable for risk charges authorized by paragraph 14 of this order. Pooled working interest owners who elect not to pay their share of estimated well costs as provided in this paragraph shall thereafter be referred to as "non-consenting working interest owners."

9. Within 5 days after the issuance of this order, Yates shall furnish the Division and Pride an itemized schedule of actual well costs incurred by Yates in conducting re-entry operations on the subject well after August 25, 2003 and prior to October 7, 2004, the time when Yates voluntarily ceased operations on the subject well. If no objection to such actual costs is received by the Division, and the Division has not objected on or before December 31, 2004, such costs shall be deemed to be the reasonable well costs. If there is an objection to the reasonableness of such costs within the time allowed by this order, the Division will determine the amount thereof that constitutes reasonable well costs after notice and hearing.

10. If Yates elects to pay in advance its share of costs of the re-entry of the subject well pursuant to this order, Yates may deduct the amount of such actual costs from its share of estimated well costs to be paid pursuant to ordering paragraph 8. If the amount to be paid by Yates pursuant to this provision is less than the amount paid by Yates to Pride at the time of its election pursuant to Order No. R-12108-A, Pride shall refund such excess to Yates within 45 days after receiving notice of Yates' election pursuant to this Order No. R-12108-C. If the Division subsequently determines that any amount of actual costs for which Yates claims reimbursement does not constitute reasonable well costs, Yates shall, within 60 days after such determination, pay to Pride the amount that such actual costs previously reimbursed to Yates exceed the amount thereof that the Division determines to be reasonable.

11. If Yates elects not to pay in advance its share of costs of the re-entry of the subject well pursuant to this order, Pride shall refund all amounts paid by Yates at the time of its election pursuant to Order No. R-12108-A, and shall pay to Yates the amount of actual costs incurred by Yates, within 45 days after the later of (a) receipt of the schedule of such costs as required by ordering paragraph 9 or (b) the expiration of the time provided by ordering paragraph 8 within which Yates could elect to pay its share of well costs in advance. If, however, Pride files an objection to the reasonableness of such actual costs, Pride shall, in lieu of paying actual costs claimed by Yates at the time provided in the preceding sentence, pay to Yates the amount thereof that the Division determines to be reasonable within 60 days after such determination.

12. The operator shall furnish the Division and each known pooled working interest owner (including non-consenting working interest owners) an itemized schedule of actual well costs within 90 days following completion of the proposed well. If no objection to the actual well costs is received by the Division, and the Division has not objected within 45 days following receipt of the schedule, the actual well costs shall be deemed to be the reasonable well costs. If there is an objection to actual well costs within the 45-day period, the Division will determine reasonable well costs after notice and hearing.

13. Within 60 days following determination of reasonable well costs, any pooled working interest owner who has paid its share of estimated costs in advance as provided above shall pay to the operator its share of the amount that reasonable well costs exceed estimated well costs and shall receive from the operator the amount, if any, that the estimated well costs it has paid exceed its share of reasonable well costs.

14. The operator is hereby authorized to withhold the following costs and charges from production:

(a) the proportionate share of reasonable well costs attributable to each non-consenting working interest owner; and

(b) as a charge for the risk involved in drilling the well, 200% of the above costs.

15. The operator shall distribute the costs and charges withheld from production, proportionately, to the parties who advanced the well costs.

16. Reasonable charges for supervision (combined fixed rates) are hereby fixed at $5,000.00 per month while drilling and $600.00 per month while producing, provided that these rates shall be adjusted annually pursuant to Section III.1.A.3. of the COPAS form titled *"Accounting Procedure-Joint Operations."* The operator is authorized to withhold from production the proportionate share of both the supervision charges and the actual expenditures required for operating the well, not in excess of what are reasonable, attributable to pooled working interest owners.

17. Should all the parties to this compulsory pooling order reach voluntary agreement subsequent to entry of this order, this order shall thereafter be of no further effect.

18. The operator of the well and Unit shall notify the Division in writing of the subsequent voluntary agreement of all parties subject to the forced pooling provisions of this order.

19. Pride's APD for the State "X" Well No. 1 dated July 10, 2003 is hereby re-instated, and shall continue in effect for one year from the date of this order, unless this order sooner terminates.

20. Yates Petroleum Corporation's APD for the State "X" Well No. 1 dated August 25, 2003 is hereby cancelled *ab initio*.

21. Order No. R-12108-A is hereby rescinded in its entirety, and this Order No. R-12108-C is substituted therefor.

22. Jurisdiction of this case is retained for the entry of such further orders as the Commission may deem necessary.

DONE at Santa Fe, New Mexico, on the day and year hereinabove designated.

STATE OF NEW MEXICO
OIL CONSERVATION COMMISSION

MARK E. FESMIRE, P.E., CHAIR

JAMI BAILEY, CPG, MEMBER

FRANK T. CHAVEZ, MEMBER

SEAL

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

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

APPLICATION OF TMBR/SHARP DRILLING, INC. FOR AN ORDER STAYING DAVID H. ARRINGTON OIL & GAS, INC. FROM COMMENCING OPERATIONS, LEA COUNTY, NEW MEXICO. CASE NO. 12731

APPLICATION OF TMBR/SHARP DRILLING, INC. APPEALING THE HOBBS DISTRICT SUPERVISOR'S DECISION DENYING APPROVAL OF TWO APPLICATIONS FOR PERMIT TO DRILL FILED BY TMBR/SHARP DRILLING, INC., LEA COUNTY, NEW MEXICO. CASE NO. 12744

ORDER NO. R-11700-B

ORDER OF THE OIL CONSERVATION COMMISSION

BY THE COMMISSION:

THIS MATTER came before the Oil Conservation Commission (hereinafter referred to as "the Commission") on March 26, 2002, at Santa Fe, New Mexico, on application of TMBR/Sharp Drilling Inc. (hereinafter referred to as "TMBR/Sharp"), *de novo*, and opposed by David H. Arrington Oil and Gas Inc. (hereinafter referred to as "Arrington") and Ocean Energy Inc. (hereinafter referred to as "Ocean Energy") and the Commission, having carefully considered the evidence, the pleadings and other materials submitted by the parties hereto, now, on this 26th day of April, 2002,

FINDS,

1. Notice has been given of the application and the hearing on this matter, and the Commission has jurisdiction of the parties and the subject matter herein.

2. In Case No. 12731, TMBR/Sharp seeks an order voiding permits to drill obtained by Arrington and awarding or confirming permits to drill to TMBR/Sharp concerning the same property.

3. In Case No. 12744, TMBR/Sharp appeals the action of the Supervisor of District I of the Oil Conservation Division denying two applications for permit to drill.

4. Arrington and Ocean Energy oppose[1] both applications.

5. The cases were consolidated by the Division for purposes of hearing and remain so before the Commission.

6. Still pending before the Division are two applications for compulsory pooling. They are: Case No. 12816, Application of TMBR/Sharp for compulsory pooling, Lea County, and Case No. 12841, Application of Ocean Energy Inc. for compulsory pooling, Lea County.

7. The Commission conducted an evidentiary hearing on March 26, 2002, heard testimony from witnesses called by TMBR/Sharp, and accepted exhibits. The Commission also accepted pre-hearing statements from TMBR/Sharp and Arrington and heard opening statements from TMBR/Sharp, Arrington and Ocean Energy and accepted brief closing statements from TMBR/Sharp and Arrington.

8. Following the hearing, TMBR/Sharp filed a Motion to Supplement the Record to include the April 10, 2002 letter of Arrington to the Oil Conservation Division's Hobbs District Office and a portion of Arrington's Supplemental Response to Plaintiff's Motion for Reconsideration in Lea County Cause No. CV-2001-315C. Ocean filed a response to that motion that argued the items add nothing to the record, and Arrington filed a response arguing that the supplemental material is not new or inconsistent. The Motion to Supplement the Record should be granted as no party seems to object to review of the documents; the objections seem to relate only to the significance of the documents to this matter.

9. Applications for permit to drill were filed with the Division in Sections 23 and 25 by Arrington and TMBR/Sharp. The applications filed by TMBR/Sharp and Arrington both proposed a well in the NW/4 of in Section 25. In Section 23, the application for permit to drill filed by TMBR/Sharp proposed a well in the NE/4, and the application of Arrington proposed a well in the SE/4.

10. Arrington's application in Section 25 was filed on July 17, 2001 and sought a permit to drill its proposed "Triple-Hackle Dragon "25" Well No. 1." This application was approved on July 17. On or about August 7, 2001, TMBR/Sharp filed its application for a permit to drill its proposed "Blue Fin "25" Well No. 1" in the same section. That application was denied on August 8, 2001.

11. Arrington's application in Section 23 was filed on July 25, 2001 and sought a permit to drill its proposed "Blue Drake "23" Well No. 1." This application was

[1] On April 10, 2002 Arrington agreed to release its permit to drill to TMBR/Sharp. A dispute may no longer therefore exist concerning Section 23 although the parties apparently do not agree with this assessment.

approved on July 30, 2001. On or about August 6, 2001, TMBR/Sharp filed its application for a permit to drill its proposed "Leavelle "23" Well No. 1" in the same section. That application was denied on August 8, 2001.[2]

12. TMBR/Sharp's applications in Sections 23 and 25 were denied on the grounds of the permits previously issued to Arrington for the "Triple-Hackle Dragon "25" Well No. 1" and the "Blue Drake "23" Well No. 1." The Townsend Mississippian North Gas Pool, the pool from which the wells are to produce, is governed by the spacing and well density requirements of Rule 104.C(2) [19 NMAC 15.C.104.C(2)]. That rule imposes 320-acre spacing on wells producing from that pool. TMBR/Sharp's applications were denied because, if granted, more than one well would be present within a 320-acre spacing unit, in violation of Rule 104.C(2).

13. Before an oil or natural gas well may be drilled within the State of New Mexico, a permit to drill must be obtained. See NMAC 19.15.3.102.A, 19 NMAC 15.M.1101.A. Only an "operator" may obtain a permit to drill, 19 NMAC 15.M.1101.A, and an "operator" is a person who is "duly authorized" and "is in charge of the development of a lease or the operation of a producing property." NMAC 19.15.1.7.O(8).

14. The central issue in this case is whether Arrington was eligible to become the operator of the wells in question. If not, Arrington should not have received the permits to drill. If Arrington was eligible to become the operator, then the permits were properly issued to Arrington.

15. A dispute exists concerning the validity of Arrington and TMBR/Sharp's mineral leases in Sections 23 and 25. As will be seen below, resolution of this dispute in favor of Arrington or TMBR/Sharp determines which party is eligible to be the operator and thus, who should receive the permits to drill.

16. TMBR/Sharp is the owner of oil and gas leases comprising the NW/4 of Section 25 and the SE/4 of Section 23 (along with other lands) pursuant to leases dated August 25, 1997 granted by Madeline Stokes and Erma Stokes Hamilton. TMBR/Sharp Exhibit 6. The leases were granted to Ameristate Oil & Gas, Inc. (hereinafter referred to as "Ameristate") and were recorded respectively in Book 827 at Page 127 and in Book 827 at Page 124 in Lea County, New Mexico.

17. TMBR/Sharp and Ameristate entered into a Joint Operating Agreement along with other parties on July 1, 1998 and TMBR/Sharp was designated as the operator in Section 25. See TMBR/Sharp Exhibit 7.

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[2] Apparently TMBR/Sharp reapplied for the permits to drill that were previously denied, and the Division approved those permits on March 20, 2002.

18. Although the primary terms of the TMBR/Sharp leases have apparently expired, TMBR/Sharp alleges that the leases were preserved by the drilling of the "Blue Fin 24 Well No. 1" and subsequent production from that well. The Blue Fin 24 Well No. 1 is located in the offsetting section 24.

19. Subsequent to Stokes and Hamilton's execution of leases in favor of Ameristate Oil & Gas Inc., they granted leases in the same property to James D. Huff on March 27, 2001. See TMBR/Sharp Exhibit 9. The leases to Mr. Huff were recorded in Book 1084 at Page 282 and in Book 1084 at Page 285 in Lea County, New Mexico. The parties referred to these leases as "top leases," meaning that according to their terms, they would not take effect until the prior or "bottom" leases became ineffective. See TMBR/Sharp Exhibit 9, ¶ 15.

20. Arrington alleges Mr. Huff is an agent of Arrington but presented nothing to support that contention.

21. In July and August 2001, Ocean acquired a number of farm-out agreements in Section 25. See TMBR/Sharp Exhibit 10, Schedule 1. By an assignment dated September 10, 2001, Ocean assigned a percentage of the farm out agreements to Arrington under terms that require Arrington to drill a test well in Section 25 known as the Triple Hackle Dragon "25" Well No. 1 in the NW/4 of that section.

22. On August 21, 2001, after receiving the denials of the applied-for permits to drill from the District office, TMBR/Sharp filed suit against Arrington and the lessors of its mineral interests in the Fifth Judicial District Court of Lea County, New Mexico. In that case, styled "TMBR/Sharp Drilling, Inc. v. David H. Arrington Oil & Gas, Inc., *et al.*", TMBR/Sharp alleged that its leases were still effective and the Arrington top leases were ineffective. The District Court, in its Order Granting Partial Summary Judgment, dated December 24, 2001, agreed with TMBR/Sharp's contention. See TMBR/Sharp's Exhibit No. 12,

23. During the hearing of this matter, TMBR/Sharp argued that because the Fifth Judicial District Court found that Arrington's "top leases" had failed, TMBR/Sharp was entitled to permits to drill in Sections 23 and 25 and Arrington was not entitled to permits to drill and its permits should be rescinded. TMBR/Sharp also argued that Arrington had filed applications to prevent TMBR/Sharp from being able to drill and to place its obligations under the continuous drilling clauses of the oil and gas leases in jeopardy. TMBR/Sharp argued that Ocean Energy's letter agreement with Arrington could not revive Arrington's claim of title and that Ocean Energy's pending pooling application with the Division is essentially irrelevant to the question of whether TMBR/Sharp should have been granted a permit to drill.

24. Arrington argued in response that the title issue ruled upon by the District Court with respect to section 25 is irrelevant because Arrington acquired an independent

interest in that section by virtue of a farm out agreement in September of 2001. Arrington also argued it was willing to assign the disputed acreage in Section 23 to TMBR/Sharp in order to resolve the present controversy. Arrington also argued that it doesn't intend to actually drill at the present time under either approved permit to drill and argued, citing Order No. R-10731-B, that the Commission's practice has not been to rely on "first in time, first in right" principles in deciding competing applications on compulsory pooling, but instead on geological evidence. Arrington seemed to argue that a compulsory pooling proceeding is the place to present such geologic evidence. Arrington argues that these proceedings are unnecessary and that the Commission should rely upon the Division's pending pooling cases to decide who of the various parties should properly possess the permit to drill.

25. *Ocean Energy argued that since its farm out agreement terminates on July 1,* 2002 time is of the essence and that the matters at issue here should be resolved in the pending compulsory pooling proceeding instead of this proceeding. Ocean Energy argued that the permit to drill is meaningless in this context, that TMBR/Sharp is essentially asking the Commission to determine pooling in the context of the permit to drill, and that the dedication of acreage on the acreage dedication plat should not determine what acreage would be pooled to the well. If the Commission were to adopt this approach, Ocean Energy argues, the compulsory pooling statutes would be written out of existence.

26. The parties seem to agree that in a situation where the bottom lease has not failed, a person owning a top lease is not a person duly authorized to be in charge of the development of a lease or the operation of a producing property, and is therefore not entitled to a permit to drill. NMAC 19.15.1.7(O)(8). See also 1 Kramer & Martin, The Law of Pooling and Unitization, 3rd ed., § 11.04 at 11-10 (2001). Moreover, because only an "owner" may seek compulsory pooling, it seems that a person owning a top lease where the bottom lease has not failed might not be entitled to compulsory pooling either. See NMSA 1978, § 70-2-17(C).

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." The Division 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 to drill the well applied for. It appears to this body that Arrington had such a good faith belief when it filed its application, but subsequently the District Court found otherwise.

It is not within the purview of this body to question that decision and it should not do so in this case.

29. As of the date of this order, TMBR/Sharp, by Court declaration, is the owner of an oil and gas lease in both Section 23 and Section 25, and Arrington, also by Court declaration, is not an owner in those sections. Therefore, Arrington, who the Court has now decreed has no authority over the property, should not have been granted permits to drill in those sections and TMBR/Sharp should have been granted a permit.

30. Both Arrington and Ocean Energy imply that an appeal will be filed of the District Court's decision. Until the issue of title in Sections 23 and 25 is finally resolved by the courts or by agreement of the parties, the outcome of this proceeding is therefore uncertain. As of the present time, TMBR/Sharp has prevailed on the title question and this Order reflects that (present) reality. However, as an appeal could change that conclusion, jurisdiction of this matter should therefore be retained until matters are finally resolved.

31. The permits to drill issued by the Division in July 2001 to Arrington were issued erroneously and should be rescinded *ab initio*. The applications to drill submitted by TMBR/Sharp in August 2001 should have been processed within a few days of receipt. Arrington's later acquisition of an interest in section 23 and 25 through a farm out agreement doesn't change this analysis; Arrington had no interest by virtue of farm out as of the date of TMBR/Sharp's applications.

32. On another issue, Arrington and Ocean Energy have both urged this body to stay these proceedings pending the resolution of the applications for compulsory pooling, arguing that a decision on those matters will effectively resolve the issues surrounding the permits to drill.

33. Arrington and Ocean Energy's conclusion does not necessarily follow. An application for a permit to drill serves different objectives than an application for compulsory pooling and the two proceedings should not be confused. The application for a permit to drill is required to verify that requirements for a permit are satisfied. For example, on receipt of an application, the Division will verify whether an operator has financial assurance on file, identify which pool is the objective of the well so as to identify the proper well spacing and other applicable requirements, ensure that the casing and cementing program meets Division requirements and check the information provided to identify any other relevant issues. The acreage dedication plat that accompanies the application (form C-102) permits verification of the spacing requirements under the applicable pool rules or statewide rules. Compulsory pooling is related to these objectives in that compulsory pooling would not be needed in the absence of spacing requirements. 1 Kramer & Martin, The Law of Pooling and Unitization, § 10.01 (2001) at 10-2. But its primary objectives are to avoid the drilling of unnecessary wells and to protect correlative rights. NMSA 1978, § 70-2-17(C).

34. It has long been the practice in New Mexico that the operator is free to choose whether to drill first, whether to pool first, or whether to pursue both contemporaneously. The Oil and Gas Act explicitly permits an operator to apply for compulsory pooling after the well is already drilled. See NMSA 1978, § 70-2-17(C) (the compulsory pooling powers of the Division may be invoked by an owner or owners "... who has the right to drill *has drilled* or proposes to drill a well [sic] ..."). Issuance of the permit to drill does not prejudge the results of a compulsory pooling proceeding, and any suggestion that the acreage dedication plat attached to an application to drill somehow "pools" acreage is expressly disavowed. If acreage included on an acreage dedication plat is not owned in common, it is the obligation of the operator to seek voluntary pooling of the acreage pursuant to NMSA 1978, § 70-2-18(A) and, if unsuccessful, to seek compulsory pooling pursuant to NMSA 1978, § 70-2-17(C).

35. Thus, where compulsory pooling is not required because of voluntary agreement or because of common ownership of the dedicated acreage, the practice of designating the acreage to be dedicated to the well on the application for a permit to drill furthers administrative expedience. Once the application is approved, no further proceedings are necessary. An operator may first apply for a permit to drill a well and may thereafter pool (on a voluntary or compulsory basis) separately owned tracts to the well. Alternatively, the operator may first pool and later seek a permit to drill. The two are not mutually exclusive, and there is no preferred methodology.

36. Thus, the process fosters efficiency by permitting a simple approach in cases where ownership is common and pooling, voluntary or compulsory, is not necessary.

37. Ocean's expiring farm-outs present a difficult problem because the delay occasioned by this proceeding and any delay that might occur in the pending compulsory pooling cases may place Ocean's interests in jeopardy. It is worth noting that Ocean's interests seem to be free of the title issues plaguing the other parties, but since Ocean Energy intended that Arrington drill and become operator, Ocean isn't planning on preserving its rights by drilling a well itself and hasn't applied for a permit to drill. Unfortunately, this body is without authority to stay expiration of the farm-outs; Ocean should petition the District Court for relief if the expiring farm-outs are a concern.

CONCLUSION OF LAW:

The Oil Conservation Commission 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.

IT IS THEREFORE ORDERED:

1. *The portion of TMBR/Sharp's application in Case No. 12731 seeking to void* permits to drill obtained by Arrington is granted. The permits to drill awarded to

Arrington shall be and hereby are rescinded *ab initio* and the applications originally filed by TMBR/Sharp in August, 2001 shall be and hereby are remanded to the District Office for approval consistent with this Order provided the applications otherwise meet applicable Division requirements.

2. TMBR/Sharp's application in Case No. 12744, appealing the decision of the Supervisor of District I of the Oil Conservation Division, is granted and the decision shall be and hereby is overruled.

3. The motions of Arrington and Ocean to continue this proceeding until after the decision in Cases No. 12816 and No. 12841 shall be and hereby are denied.

4. The motion of TMBR/Sharp to Supplement the Record is hereby granted.

5. Jurisdiction of this case is retained for the entry of such further orders as may be necessary given subsequent proceedings in TMBR/Sharp Drilling, Inc. v. David H. Arrington Oil & Gas, Inc., *et al.*

DONE at Santa Fe, New Mexico, on the day and year hereinabove designated.

STATE OF NEW MEXICO
OIL CONSERVATION COMMISSION

LORI WROTENBERY, CHAIR

JAMI BAILEY, MEMBER

ROBERT LEE, MEMBER

S E A L

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

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

APPLICATION OF SAMSON RESOURCES COMPANY, KAISER-FRANCIS OIL COMPANY AND MEWBOURNE OIL COMPANY FOR CANCELLATION OF TWO DRILLING PERMITS AND APPROVAL OF A DRILLING PERMIT, LEA COUNTY, NEW MEXICO — CASE NO. 13492 (De Novo)

APPLICATION OF CHESAPEAKE OPERATING, INC. FOR COMPULSORY POOLING, LEA COUNTY, NEW MEXICO — CASE NO. 13493 (De Novo)

ORDER NO. R-12343-E

ORDER OF THE COMMISSION

THIS MATTER, having come before the New Mexico Oil Conservation Commission (Commission) on January 11, 2007 at Santa Fe, New Mexico, on application of Samson Resources Company (Samson), Kaiser-Francis Oil Company (Kaiser-Francis) and Mewbourne Oil Company (Mewboume) (Samson et al) for cancellation of two drilling permits and approval of a drilling permit and application of Chesapeake Operating, Inc. (Chesapeake) for compulsory pooling, Lea County, New Mexico, and the Commission, having carefully considered the evidence, the pleadings and other materials the parties submitted, now, on this 16th day of March, 2007,

FINDS THAT:

PRELIMINARY MATTERS

1. Notice has been given of the applications and the hearing on this matter, and the Commission has jurisdiction of the parties and the subject matter.

2. The New Mexico Oil and Gas Act, NMSA 1978, Section 70-2-17, provides that "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 interest or both in the spacing unit or proration unit as a unit".

3. NMSA 1978, Section 70-2-17, also provides that "For purposes of determining the portion of production owned by persons owning interests in the pooled oil or gas, or both, such production shall be allocated to the respective tracts within the unit in the proportion that the number of surface acres included within each tract bears to the number of surface acres included in the entire unit. The portion of production allocated to the owner or owners of each tract or interest included in a well spacing or proration unit formed by a pooling order shall, when produced, be considered as if produced from the separately owned tract or interest by a well drilled thereon. 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 prorated 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 . . "

4. Case No. 13492 concerns Samson et al's application before the Oil Conservation Division (Division) seeking cancellation of the Division's approval of an application for permit to drill filed on March 10, 2005 by Chesapeake for the KF 4 State Well No. 1 and an application for permit to drill filed on March 18, 2005 by Chesapeake for the Cattlemen 4 State Com Well No. 1. The Division permitted the KF 4 State Well No. 1 (KF 4 well) for a location in the southeast quarter, 660 feet from the South line and 990 feet from the East line of irregular Section 4, Township 21 South, Range 35 East, NMPM, in Lea County. The Division permitted the Cattleman 4 State Com Well No. 1 for a location 3300 feet from the South line and 990 feet from the Rast line in the east half of the geographical middle third of irregular Section 4, Township 21 South, Range 35 East, NMPM.

5. Samson et al sought cancellation of the applications for permit to drill (APD) for the KF 4 well and the Cattleman 4 State Com Well No. 1 on the ground that they own the entire working interest in the quarter sections containing the KF 4 well and the Cattleman 4 State Com Well No. 1.

6. Case No. 13493 concerns Chesapeake's application to create a compulsory pooled lay-down unit consisting of the south half (geographical south third) of irregular Section 4, Township 21 South, Range 35 East, NMPM and dedicate it to Chesapeake's KF 4 well.

7. As a result of the factual relationship between the two cases, the Division and subsequently the Commission combined the two cases for hearing purposes.

8. The parties appeared at the hearing and presented evidence. Samson et al presented evidence in support of its application in Case No, 13492 and in opposition to

Chesapeake's application in Case No. 13493. Chesapeake presented evidence in support of its application and in opposition to Samson et al's application.

UNDISPUTED EVIDENCE

9. Section 4 of Township 21 South, Range 35 East, NMPM, in Lea County, is an irregular section consisting of approximately 950.8 acres, more or less, and is approximately one mile wide from east to west, and one and one-half miles long from north to south. The subdivisions of Section 4 are as follows:

a. the southeast quarter (geographically, the east half of the south one-third), consisting of lots 17, 18, 23 and 24;

b. the southwest quarter (geographically, the west half of the south one-third), consisting of lots 19 through 22;

c. Lots 9, 10, 15 and 16, being the quarter section immediately north of the southeast quarter, hereinafter called "the east half of the middle one-third";

d. Lots 11 through 14, being the quarter section immediately north of the southwest quarter, hereinafter called "the west half of the middle one-third";

e. Lots 1 through 8, consisting of 310.8 acres, more or less, being the two northern most quarter sections. Stipulation by the Parties as to Undisputed Evidence to be Considered by the Commission filed August 9, 2006 (Stipulation), pages 1 and 2.

10. The State of New Mexico owns the oil and gas minerals within the entire Section 4, Township 21 South, Range 35 East, NMPM (as well as the surface), and all acres have been leased. Lease status and ownership are as follows:

a. The southeast quarter is leased under State of New Mexico Lease No. BO-1481-14. Kaiser-Francis, Samson, and Mewbourne own all the working interest.

b. The southwest quarter is leased under State of New Mexico Lease No. VO-7063-2. Chesapeake owns all the working interest.

c. The middle one-third is leased under State of New Mexico Lease No. VO-7054. Samson owns all the working interest.

d. The northern one-third is leased under State of New Mexico Lease No. VO-7062-2. Chesapeake owns all the working interest. Stipulation, page 2.

11. Chesapeake does not own an interest in the southeast quarter of Section 4, Township 21 South, Range 35 East and has not owned such interest at any time relevant to this case. Chesapeake has no contractual right with respect to the mineral estate in the

southeast quarter of Section 4, Township 21 South, Range 35 East, NMPM. Stipulation, page 2.

12. On February 27, 2005, Mewbourne ran electric logs showing over 40 feet of Morrow porosity on its Osudo 9 State Com. Well No. 1 (Osudo 9 well) located in the southeast quarter of the northeast quarter of Section 9, Township 21 South, Range 35 East, NMPM, being the quarter section immediately south of the southeast quarter of Section 4, Township 21 South, Range 35 East, NMPM. On March 8, 2005, Mewbourne placed that well on line and began selling natural gas. The Osudo 9 well is a prolific producer of natural gas from the Morrow formation and is owned by Mewbourne, Chesapeake, and Finley Resources. Stipulation, page 2.

13. On March 9, 2005, Chesapeake sent a letter to Samson (received on March 11, 2005) proposing the drilling of the KF 4 well "in the south half of Section 4" and requesting the recipient to elect whether or not to participate. The letter also invited Samson to enter into negotiations for sale of its interest to Chesapeake, but stated, "be advised that entering into negotiations to sell Samson's interest does not excuse or allow Samson to delay the required election under this well proposal". Chesapeake also sent a similar proposal letter to Kaiser-Francis. Chesapeake did not send a proposal letter to Mewbourne because Mewbourne had not yet obtained an interest in the proposed spacing unit. Stipulation, pages 2 and 3.

14. On March 10, 2005, Chesapeake Operating, Inc. filed an APD for the KF 4 well, designating a lay-down spacing unit consisting of the southeast and southwest quarters of Section 4, Township 21 South, Range 35 East, NMPM. Stipulation, page 2.

15. The Division approved Chesapeake's APD on March 11, 2005. Stipulation, page 2.

16. There was no operating agreement between Chesapeake and Samson or Kaiser-Francis that would require an election, and Chesapeake knew that there was no such agreement. Stipulation, page 3.

17. On March 22, 2005, Samson signed and returned Chesapeake's election letter and authorization for expenditures, indicating that it elected to participate in the proposed KF 4 well, but did not send its portion of the dry hole costs as requested in the letter. Stipulation, page 3.

18. On March 28, 2005, Mewbourne, as operator on behalf of Samson et al., filed an APD for its proposed Osudo 4 State Com. No. 1. The Mewbourne APD proposed a location in the southeast quarter and the east half of the middle third of Section 4, Township 21 South, Range 35 East, NMPM. The Division rejected Mewbourne's APD on March 30, 2005 because of its earlier approval of Chesapeake's APD. Stipulation, page 3.

19. On March 30, 2005, Samson sent a letter and fax to Chesapeake stating that "Samson hereby rescinds and revokes its invalid election to participate in [the KF 4 well]". Stipulation, page 3.

20. On April 15, 2005, Chesapeake began site construction for the KF 4 well. Stipulation, page 3.

21. On April 20, 2005, Mewbourne, as the last of the designated parties (Kaiser-Francis, Samson, and Mewbourne) signed a communitization agreement providing for a communitized unit in the Morrow consisting of the southeast quarter and the east half of the middle third of Section 4, Township 21 South, Range 35 East, NMPM. Stipulation, page 3.

22. On April 26, 2005, the applications in Case No. 13492 and Case No. 19493 were filed with the Division. Stipulation, page 3. In Case No. 13492 Samson et al sought cancellation of two drilling permits and approval of a drilling permit and in Case No. 193493 Chesapeake applied for compulsory pooling, Lea County, New Mexico.

23. On April 27, 2005, the New Mexico State Land Office approved the communitization agreement described above in paragraph 20, noting that, "[t]he effective date of this approval is April 1, 2005".

24. On April 27, 2005, Chesapeake spudded the KF 4 well. Stipulation, page 3.

25. Chesapeake completed the KF 4 well and placed it in production in January 2006. Stipulation, page 3.

26. As of April 2006, the KF 4 well had produced 270, 279 Mcf of gas and 2, 286 barrels of oil. Stipulation, page 3.

CONCLUSIONS REGARDING LEGAL ISSUES

27. It is undisputed that Chesapeake did not own, and does not own, title to the minerals or surface of the southeast quarter of Section 4, Township 21 South, Range 35 East, NMPM where it drilled the KF 4 well.

28. If Chesapeake had any contractual right in the southeast quarter of Section 4, Township 21 South, Range 35 East, NMPM, it arose by virtue of Samson's election letter and authorization for expenditures approval. Samson rescinded those prior to Chesapeake drilling the KF 4 well.

29. The facts existing at the time of the Division's approval of Chesapeake's SPD were materially distinguishable from the facts in Case No. 13153, *Application of Pride Energy Company, etc.*

30. In *Application of Pride Energy Company, etc.* the Commission found that an operator could file an application for permit to drill before it filed a pooling application. It did not find that an operator could actually drill a well on acreage in which it had no interest before the Division or Commission decided a pooling application.

31. In this matter Chesapeake drilled a well on acreage it did not have an interest in before the Division or Commission decided on the pooling application.

32. As such, since it is within the Commission's discretion whether to allow a risk charge for drilling the well, the Commission finds that Chesapeake should not be allowed a risk charge for drilling the KF 4 well on acreage it did not have an interest in prior to the Division or Commission deciding on the pooling application.

33. To prevent further misunderstandings in the interpretation of the Commission's orders, particularly in Case No. 13153, *Application of Pride Energy Company, etc.*, Order No. R-12108-C and *Application of TMBR/Sharp,Inc.*, Order R-11700-B, the Commission approves of the language on Division Form C-102, field 17, concerning the operator's certification and asks the Division to continue its use and to notify the Commission if it plans to discontinue its use. That certification states "I hereby certify that the information contained herein is true and correct to the best of my knowledge and belief and that the organization either owns a working interest or unleased mineral interest in the land, including the proposed bottomhole location, or 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".

34. Chesapeake indicated that it no longer intends to drill a well at the location of its proposed Cattlemen 4 State Com Well No. 1. See Order No. R-12343-B, page 20.

35. Accordingly, the application of Samson et al, in Case No. 13492, for cancellation of the permit to drill for the Cattleman 4 State Com Well No. 1 should be approved.

CONCLUSIONS REGARDING TECHNICAL ISSUES

36. The isopach maps (maps of the oil and gas producing layers that estimate the location and depth of those layers) created by the geologists of each party support their respective positions on what should be the correct orientation of the spacing unit. Each was bound by his interpretation of the existing well control (other existing wells in the vicinity that are drilled in the same formation that have production from that formation or did not have production) and was free to project contours into areas void of data based on an overall interpretation of general trends,

37. Both Chesapeake and Samson et al presented logical interpretations of the data in these cases. No effective well control exists either to the north or to the west that could preclude projection of the Osudo 9/KF 4 reservoir in either of those directions.

38. The parties interpreted the thickness of the Morrow sands (oil and gas producing layers) of several wells differently. Some of the older wells have only sonic logs, which are sometimes difficult to relate to neutron-density logs. In addition, a lime matrix was used to scale the neutron-density logs. These differences significantly affected the way the geologists drew the contours for the Morrow. The interpretations seemed to agree on the western edge of the maps (three to four miles west of the subject area) but disagreed locally over the area in question.

39. Both parties agree that the Central Basin Platform (CBP) exists to the east. Chesapeake's geologist testified that the CBP was a local source of Morrow sediments and influenced the local flow direction of the Morrow channels. Samson et al's geologist testified the Morrow sands originated from the Pedernal highlands to the north, and the CBP was too low and swampy in Morrowan times to contribute to the Morrow sands.

40. The Chesapeake geologist attempted to separate the Middle Morrow sands into layers and mapped each of these lenses using existing well control. Chesapeake did not relate the direction of the Morrow sand channels with the mapped top-of-Morrow structure or the north-south faulting and pointed out that one of the best Morrow wells, a well in Section 5, exists on a structural high (an elevated area within the geologic layer).

41. The Delaware Basin began forming in the late Mississippian period into the early Pennsylvanian period. Samson Exhibit 12, page 38.

42. The Delaware Basin's axis lies west of the KF 4 well area and trends in a north/northwest-south/southeast lineation. Samson Exhibit 12, pages 39 and 42.

43. Pennsylvanian age Morrowan sediments are fine-grained sandstone and shale that eroded from areas north, east and northwest of the Delaware Basin. See Chesapeake Rebuttal Exhibit 9.

44. The Pedernal highlands located northwest of the KF 4 well area were the primary source for Morrowan sediments. See Samson Exhibit 12, page 39.

45. The erosion of the Mississippian section off the exposed CBP provided additional sediments. See Samson Exhibit 12, page 39; Transcript, pages 761 through 767 and 788.

46. The Barnett shale, which consists of partly silty, brown shale and contains very fine-grained sandstone and siltstone, overlies the Mississippian limestone. See Sampson Exhibit 12, page 38 and Samson Exhibit 10, page 414.

47. The Midland Basin had not yet formed during the Morrowan period and was therefore an area of non-deposition. Transcript, page 724.

48. In addition, the CBP's western boundary contained greater structural relief and vertical separation than the eastern boundary so erosion would be to the west. See Samson Exhibit 16, page 163.

49. During lowstands during the Pennsylvanian period fluvial systems would have trended in an east-west direction with a possible southwesterly component. Transcript, page 785. Samson Exhibit 18, page 149.

50. In addition, fluvial systems from the Pedernal highlands would have been in a northwest to southeast direction and the two would have converged. Transcript, page 785; Samson Exhibit 18, page 149.

51. Both the Pedernal highlands and the CBP provided sediments to the subject area, and as a result the sands in the reservoir area are a coalescence of sands that are oriented both north-south/northwest-southeast and east-west. As a result the Commission should create a 640-acre proration unit consisting of the south two-thirds of Section 4, Township 21 South, Range 35 East, NMPM, in order to prevent waste and protect correlative rights.

52. The Commission also takes administrative notice that the special rules and regulations for the North Osudo-Morrow Gas Pool provide for a standard unit containing 640 acres.

IT IS THEREFORE ORDERED THAT:

1. All uncommitted mineral interests, whatever they may be, in the oil and gas from the top of the Wolfcamp formation to the base of the Morrow formation underlying the south two-thirds of irregular Section 4, Township 21 South, Range 35 East, NMPM, Lea County, New Mexico are hereby pooled forming a 640-acre, more or less, spacing unit in all pools or formations within that vertical extent, including but not limited to the South Osudo-Morrow Gas Pool (82200) (the Unit).

2. There may be up to four total wells drilled in the Unit including the KF 4 well. Future wells shall be located at standard locations.

3. While the Commission will not cancel the APD for the KF 4 well, effective on the date of this order, Samson is hereby designated the operator of the Unit, the KF 4 well and any subsequent wells in the Unit.

4. After pooling, uncommitted working interest owners are referred to as pooled working interest owners. ("Pooled working interest owners" are owners of working interests in the unit, including un-leased mineral interests, who are not parties to an operating agreement governing the unit as established by this order)

5. Chesapeake shall furnish the Commission and each known pooled working interest owner (including non-consenting working interest owners) an itemized

schedule of actual well costs for the KF 4 well, including invoices and other documentation, as well as sales documents within 30 days following this order. Pooled working interest owners shall file any objections to the documentation or well costs with the Commission within 30 days following receipt of the documentation. If there is an objection to actual well costs, the Commission will determine reasonable well costs at a regularly scheduled meeting after public notice and hearing.

6. Pursuant to NMSA 1978, Section 70-2-17, the well costs for the KF 4 well shall be divided according to the pooled working interest owners in the Unit, with all pooled working interest owners paying their pro rata share of the reasonable, actual well costs. Such costs shall not include a risk charge, but shall include reasonable, actually incurred charges for supervision. Pooled working interest owners shall offset costs and proceeds from production shall be credited to the parties from the date of first production of the KF 4 well.

7. Reasonable charges for supervision for the KF 4 well (combined fixed rates) shall not exceed $7,000 per month while drilling and $750 per month while producing, provided that these rates shall be adjusted annually pursuant to Section III. LA. of the COPAS form titled "*Accounting Procedure-Joint Operations*".

8. Except as provided above, all proceeds from the production from the KF 4 well that are not disbursed for any reason shall be placed in escrow in Lea County, New Mexico, to be paid to the true owner upon demand and proof of ownership. The operator shall notify the Commission of the name and address of the escrow agent within 30 days from the date of first deposit with the escrow agent.

9. For any additional wells that the operator may drill in the Unit (wells other than the KF 4 well), the operator shall furnish the Division and each known pooled working interest owner in the Unit an itemized schedule of estimated costs of drilling, completing and equipping the well ("well costs").

10. For additional wells, within 30 days from the date the operator furnishes the schedule of estimated well costs, a pooled working interest owner may pay its share of estimated well costs to the operator in lieu of paying its share of reasonable well costs out of production. Pooled working interest owners who elect to pay their share of estimated well costs shall remain liable for operating costs but shall not be liable for risk charges. Pooled working interest owners who elect not to pay their share of estimated well costs as provided in this paragraph shall thereafter be referred to as "non-consenting working interest owners".

11. For additional wells, the operator shall furnish the Division and each known pooled working interest owner (including non-consenting working interest owners) an itemized schedule of actual wells costs within 90 days following completion of the well. If the Division does not receive an objection within 45 days following receipt of the schedule, the actual well costs shall be deemed to be the reasonable well

costs. If there is an objection to actual well costs within the 45-day period, the Division will determine reasonable well costs after public notice and hearing.

12. For additional wells, within 60 days following determination of reasonable well costs, any pooled working interest owner who has paid its share of estimated costs in advance shall pay to the operator its share of the amount that reasonable well costs exceed estimated well costs and shall receive from the operator the amount, if any, that the estimated well costs it has paid exceed its share of reasonable well costs.

13. For additional wells, the operator is hereby authorized to withhold the following costs from production:

(a) the proportionate share of reasonable well costs attributable to each non-consenting working interest owners; and

(b) as a charge for the risk involved in drilling the well, 200% of the above costs.

14. For additional wells, the operator shall distribute the costs and charges withheld from production, proportionately, to the parties who advanced the well costs.

15. For additional wells, reasonable charges for supervision (combined fixed rates) are hereby fixed at $7,000 per month while drilling and $750 per month while producing, provided that these rates shall be adjusted annually pursuant to Section III.A.3 of the COPAS form titled "*Accounting Procedure-Joint Operations*". The operator is authorized to withhold from production the proportionate share of both the supervision charges and the actual expenditures required for operating the well, not in excess of what are reasonable, attributable to pooled working interest owners.

16. Except as provided in Ordering Paragraphs 13 and 15 above, all proceeds from production of additional wells that are not disbursed for any reason shall be placed in escrow in Lea County, New Mexico, to be paid to the true owner upon demand and proof of ownership. The operator shall notify the Division of the name and address of the escrow agent within 30 days from the date of first deposit with the escrow agent,

17. Upon final plugging and abandonment of the KF 4 well and other wells drilled on the unit pursuant to Division rules, the Unit created by this order shall terminate, unless this order has been amended to authorize further operations.

18. The permit to drill issued to Chesapeake for the Cattleman 4 State Com Well No. 1 is cancelled.

19. An operator shall not file an application for permit to drill or drill a well unless it owns an interest in the proposed well location or has a right to drill the well as stated in Division Form C-102.

20. The Commission retains jurisdiction of this matter for entry of such further orders as may be necessary.

DONE at Santa Fe, New Mexico on the 16th day of March 2007.

STATE OF NEW MEXICO
OIL CONSERVATION COMMISSION

JAMI BAILEY, C.P.G., MEMBER

WILLIAM OLSON, MEMBER

MARK E. FESMIRE, P.E., CHAIR

SEAL

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

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

CASE NO. 14323
ORDER NO. R-13154-A

APPLICATION OF CHESAPEAKE ENERGY CORPORATION FOR CANCELLATION OF A PERMIT TO DRILL (APD) ISSUED TO COG OPERATING, LLC, EDDY COUNTY, NEW MEXICO.

ORDER OF THE DIVISION

BY THE DIVISION:

This case came on for hearing at 8:15 a.m. on August 20, 2009, at Santa Fe, New Mexico, before Examiner David K. Brooks.

NOW, on this 21st day of September, 2009, the Division Director, having considered the testimony, the record and the recommendations of the Examiner,

FINDS THAT:

(1) Due notice has been given, and the Division has jurisdiction of the subject matter of this case.

(2) Chesapeake Energy Corporation ("Applicant" or "Chesapeake") asks the Division to cancel its approval of an Application for Permit to Drill (APD) filed by COG Operating, LLC ("COG") for its proposed Blackhawk 11 Federal Com. Well No. 1 (API No. 30-015-36541) (the proposed well). The proposed well is to be a horizontal well in the Wolfcamp formation, with a surface location 430 feet from the South and West lines (Unit M) of Section 11, Township 16 South, Range 28 East, NMPM, in Eddy County, a point of penetration 426 feet from the South line and 621 feet from the West line (Unit M) of the same section, and a terminus 330 feet from the South and East lines (Unit P) of the same section.

(3) COG plans to dedicate the proposed well to a 160-acre project area consisting of the S/2 S/2 of Section 11, and comprising four adjacent, standard 40-acre spacing and proration units.

(4) Both Chesapeake and COG appeared at the hearing through counsel and presented testimony. The following facts are undisputed:

(a) COG owns working interests in the S/2 of the SE/4 of Section 11, but does not own any working interest in the S/2 SW/4 of Section 11. The only ownership interest that COG holds in the S/2 of the SW/4 of Section 11 is a contractual easement or license to use the surface of the SW/4 SW/4 for a well site and access.

(b) COG intends to complete the proposed well in the Wolfcamp formation in all four quarter-quarter sections of the project area, including the SW/4 SW/4 and SE/4 SW/4 of Section 11.

(c) Oil and gas ownership within the project area has not been consolidated, either by voluntary agreement or by order of the Division.

(5) Chesapeake contends, and the Division concludes, that the Division's approval of the APD should be cancelled by reason of the undisputed facts set forth in Finding Paragraph (4).

(6) Although the Division has no jurisdiction to determine ownership, this case requires no such determination, since ownership in undisputed. The sole question is whether the Division properly approved the APD in view of the undisputed fact that COG owns no oil and gas interest in portions of the area that the drill bit will penetrate.

(7) This case is controlled by the decision of the Oil Conservation Commission ("the Commission") in Order No. R-12343-E, issued in consolidated Cases Nos. 13492 and 13493. In those cases, Chesapeake Operating Inc. obtained approval of an APD for, and proceeded to drill, a vertical Morrow well at a location where it owned no interest. Although it owned an interest in a portion of the 320-acre unit it sought to dedicate to the well, it had not, as COG has not in this case, obtained a voluntary agreement, or compulsory pooling order, consolidating ownership in the 320-acre unit.

(8) In Order No. R-12343-E, the Commission, construing a previous order, stated:

> "In *Application of Pride Energy Company, etc.* [Order No. R-12108-C], the Commission found that an operator ***could file*** an application for permit to drill before it filed a pooling application. It did not find that an operator could actually drill a well on acreage in which it had no interest before the Division or Commission decided a pooling application. [Order No. R-12343-E, Finding Paragraph 30, page 6. Emphasis added.]

(9) In Finding Paragraph 33 of the same Order, the Commission admonished the Division to continue requiring that operators filing APDs certify that they have an ownership interest at the proposed location. The certification of ownership language counseled by the Commission in Order No. R-12343-E is the same language that appears on the form C-102 filed by COG with their APD in this case.

(10) Although Order No. R-12343-E concerned, and the certification language it approved for APDs was drafted with reference to, a vertical well, the same concerns that evidently prompted the Commission's approval of this certification language apply equally to horizontal wells.

(11) COG now has an approved APD which, under applicable Division rules, authorizes it to proceed at any time to drill the proposed well and complete it in all four of the units included in the proposed project area, even though it owns no interest in the oil and gas in two of those units. If COG were to do this prior to obtaining voluntary or compulsory pooling, it would undoubtedly constitute a trespass under applicable property law, and it would pre-empt the Division's authority to determine the configuration of any compulsory pooled unit by confronting the Division with a *fait accompli*.

(12) COG's ownership of an easement or license authorizing its use of the surface location of the proposed well does not distinguish this case from the case decided in Order No. R-12343-E because a surface easement or license does not, and cannot, authorize the drilling and completion of a horizontal well in the subsurface without the approval (actual or compelled) of at least one owner of oil and gas rights in each tract to be included in the project area.

(13) For the foregoing findings the Division's approval of the APD for the proposed well should be cancelled.

(14) This APD was filed with, and approved by, the United States Bureau of Land Management (BLM). The Division has no jurisdiction with respect to the BLM's approval of the APD. However, the Division's action cancelling its approval of the BLM-approved APD does not affect BLM's approval. The proposed well cannot be drilled without the approval of both agencies. The Division's approval could be reinstated in the event that a voluntary or compulsory pooling consolidates ownership in the project area. Presumably BLM's approval remains viable until it expires or BLM takes action to rescind its approval. If the Division were to reinstate its approval while BLM's approval remains in force, the well could be drilled without re-application, unless BLM were to determine otherwise. Accordingly, the Division's lack of jurisdiction over BLM's approval is not an obstacle to the Division's cancellation of its own approval.

IT IS THEREFORE ORDERED THAT:

(1) The Division's approval of the APD filed by COG Operating, LLC for its proposed Blackhawk 11 Federal Com. Well No. 1 (API No. 30-015-36541) is hereby

cancelled, without prejudice to its reinstatement in the event of a voluntary or compulsory pooling of the oil and gas interest within the proposed project area.

(2) Jurisdiction of this case is retained for the entry of such further orders as the Division may deem necessary.

DONE at Santa Fe, New Mexico, on the day and year hereinabove designated.

SEAL

STATE OF NEW MEXICO
OIL CONSERVATION DIVISION

MARK E. FESMIRE, P.E.
Director