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

APPLICATION OF MATADOR PRODUCTION COMPANY FOR A NON-STANDARD SPACING AND PRORATION UNIT AND COMPULSORY POOLING, LEA COUNTY, NEW MEXICO.

Case No. 15363
Order No. R-14053
Order No. R-14053-B

MOTION TO DISMISS AND DECLARE THE RIGHTS AND OBLIGATIONS OF PARTIES IN A POOLING APPLICATION UNDER NMSA 1978 § 70-2-17

Jalapeno Corporation ("Jalapeno") by and through counsel the Gallegos Law Firm, P.C., requests that the New Mexico Oil Conservation Commission enter its order dismissing this proceeding on the grounds that the Commission has no authority under statute or rule to enter a compulsory pooling order on Matador's application. The application seeks approval of a non-standard oil spacing unit comprised of four separate forty acre oil spacing units for a horizontal oil well testing the Wolfcamp formation. The Commission's pooling authority under NMSA 1978 § 70-2-17 is limited to circumstances involving a single spacing unit.

Jalapeno also requests that the Commission declare the rights and obligations of parties to compulsory pooling proceedings concerning the assessment of a statutory risk penalty where owners go non-consent. First, the Commission should hold that Rule 19.15.13.8(A), (C) and (D) NMAC is invalid and contrary to § 70-2-17 to the extent it (a) authorizes the assessment of a 200% risk penalty without the need for the applicant to provide evidence supporting the penalty and (b) puts the burden on the party opposing the application to justify a lower risk penalty. Second, the Commission should hold that

pursuant to § 70-2-17 any risk penalty assessed can only be charged on the costs of drilling and completing the well, and that Rule 19.15.13.8(A) and (B) is invalid to the extent it authorizes a risk penalty to be charged on costs in excess of those provided by statute.

As grounds for this Motion, Jalapeno states as follows:

A. Introduction and Summary of Facts Material to this Motion.

1. This case was filed by applicant Matador Production Company on July 21, 2015. Matador seeks approval of a non-standard oil spacing unit in the Wolfcamp formation comprised of four separate 40 acre oil spacing units comprising the W/2 W/2 of Section 31, T-18-S, R-35-E, Lea County, New Mexico. Matador seeks to pool all mineral interest owners in order to drill the Airstrip 31 18 35 RN State Com. Well No. 201H to "a depth sufficient to test the Wolfcamp formation."

2. Jalapeno owns working interests affected by the compulsory pooling application and opposes this application.

B. Proceedings Before the Division.

3. Jalapeno raised its jurisdictional challenge to the Division's authority to pool across four separate 40 acre oil spacing units by motion. Following briefing and argument, the Division entered its Order R-14053 denying Jalapeno's Motion based upon Commission Order No. R-13708-A in Case No. 14966. The Division held that the issues in Case No. 14966 were identical to those presented in this case. The Division cited language in Order No. R-13708-A wherein the Commission stated that "The amended horizontal well rules do not restrict the lateral length of a horizontal well that may be drilled, or the size of a non-standard spacing unit for a horizontal well which may be compulsory pooled."

4. Jalapeno filed an application for de novo hearing from the Order on Pre-Hearing Motion. Consideration of that de novo application was stayed pending hearing and an order on Matador's compulsory pooling application.

5. The Matador application was heard on the merits by the Division on September 29, 2015. The Division entered its Order R-14053-B on April 25, 2016. The Division approved Matador's compulsory pooling application. The Division considered Matador's request for a risk penalty under Rule 19.15.13.8 NMAC, which creates a presumption of a 200% risk penalty unless a person responding to the application meets its burden to justify a lesser penalty based on relevant geologic or technical evidence. Jalapeno introduced evidence in opposition to the risk penalty. The Division approved a risk penalty of 133% of the "well costs" in the event any pooled working interest owner chooses not to pay its share of the estimated well costs. Well costs are defined in the Order as the costs of drilling, completing and equipping the proposed well.

6. Both Jalapeno and Matador filed applications for de novo hearing. All applications have been consolidated for decision by the Commission.

C. The Commission Lacks Jurisdiction to Compulsory Pool here.

7. As creatures of statute the Division and the Commission are established by and their authority is limited to the enabling legislation as set forth in the New Mexico Oil and Gas Act, NMSA 1978 §70-2-1 et seq.; *Continental Oil Co. v. Oil Conservation Comm'n,* 1962-NMSC-062, ¶ 11, 70 N.M. 310, 373 P.2d 809. As the Supreme Court stated in *Marbob Energy Corp. v. N.M. Oil Conservation Comm'n,* 2009-NMSC-013, ¶ 23, 146 N.M. 24, 206 P.3d 135: "[A]ny enhancement to the Commission's authority must come from the same legislative body that created the Commission in the first place.")

8. While the New Mexico Legislature in NMSA 1978 § 70-2-17 has authorized compulsory pooling *within spacing or proration units*, it has not authorized compulsory pooling of project areas linking and crossing multiple, standard spacing units. The Division authority to allow compulsory pooling reads as follows:

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

9. The enabling legislation in the Oil and Gas Act was adopted in a vertical well environment. It has not been amended to address issues raised by the drilling of horizontal wells. The Legislature has never authorized the Commission to compulsory pool interests across multiple, contiguous spacing units. It has never authorized the Commission to compulsory pool multiple spacing units as "project areas" in connection with horizontal oil wells.

10. The lawful authority of the Commission is related to pooling of interests within an existing spacing unit, be it a 320 acre gas unit or a 40 acre oil unit. An order combining multiple, contiguous units essentially accomplishes statutory unitization. However, the Legislature has not authorized the Division and Commission to unitize under these circumstances. Unitization authority is limited to units for secondary and tertiary recovery, neither of which applies here. NMSA 1978 § 70-7-1. *Santa Fe Exploration Co. v. Oil Conservation Comm'n*, 1992-NMSC-044, ¶ 31, 114 N.M. 103, 835

P.2d 819 ("Statutory Unitization Act is not applicable to fields in their primary production phase"). Moreover, 75% of the owners must agree to unitization, and the agency must determine whether the participation formula is fair and reasonable. NMSA 1978 §§ 70-7-6(B), 70-7-8.

11. The Division and Commission have authority to create non-standard spacing units and to compulsory pool separately owned tracts "**within an oversize non-standard spacing unit.**" *Rutter & Wilbanks Corp. v. Oil Conservation Comm'n,* 1975-NMSC-006, ¶ 15, 87 N.M. 286, 532 P.2d 582 (emphasis added); NMSA 1978 § 70-2-18(C). This authority allows an alteration of the acreage of a single spacing unit to be larger or smaller than a standard spacing unit which does not fit neatly into the standard acreage allocation, typically because of irregular survey subdivisions. The relevant spacing for oil wells is 40 acres.

12. Here, Matador requests that the Commission approve a 154 acre non-standard spacing unit in a pool comprising four separate oil well spacing units, and to pool all interests within those units.

13. *Rutter* does not support Matador's application in this case. The non-standard spacing units in *Rutter* were created pursuant to what was then Commission Rule 104, the well spacing rule. The Court in *Rutter* recognized that the units at issue satisfied the requirements of Rule 104. 1975-NMSC-006, ¶ 9. *Rutter* did not involve multiple, existing spacing units but rather an oversized unit slightly larger than the standard 320 acre spacing unit that was necessitated by the irregular configuration of the section at issue.

14. The Commission's authority to create non-standard units or fix different spacing requirements recognized in *Rutter,* standing alone, does not support approval

of Matador's application. The Court in *Rutter* cited then Rule 104(L) on the Commission's authority to fix different spacing requirements, ¶ 13, but only in the context of approving the Commission's authority to compulsory pool tracts within an existing spacing unit.

15. The wells at issue in *Rutter* were vertical gas wells, not horizontal oil wells. The units were approved, non-standard spacing units. *Rutter* did not involve compulsory pooling across existing spacing units. That decision is not authority for the proposition that the Division and Commission can establish a non-standard spacing unit which combines multiple, contiguous spacing units.

D. The Commission's Rules do Not Authorize Matador's Requested Unit.

16. The Commission has adopted rules with respect to its ability to approve and the circumstances justifying non-standard spacing units. Rule 19.15.15.11(B)(2) recognizes two circumstances which justify approval of a non-standard oil spacing unit. The first, "when the unorthodox size or shape is necessitated by a variation in the legal subdivision of the United States public land surveys," does not apply here.

17. The rule also authorizes a non-standard spacing unit if (a) "the non-standard spacing unit consists of a single quarter-quarter section or lot or quarter-quarter sections or lots joined by a common side," and (b) "the non-standard spacing unit lies wholly within a single quarter section if the well is completed in a pool or formation for which 40, 80 or 160 acres is the standard spacing unit size". These circumstances do not apply here.

18. Thus, Matador's application requests, and the Division decision authorized, creation of a non-standard spacing unit which is not authorized by the Commission rules.

19. The Division and Commission have ignored the statutes and their own rules in an attempt to support shale formation development with respect to the technological changes resulting from the development of horizontal well drilling. Jalapeno does not oppose horizontal well drilling, and recognizes such drilling as a benefit to operators, lessors and the state economy. Jalapeno does contend that such drilling should proceed lawfully and in accordance with the statutes and rules. In order to properly address horizontal wells, the Legislature should amend the compulsory pooling statute and the Commission should adopt by rulemaking rules which govern the spacing of such wells.

20. New Mexico operators have adopted a practice, supported by the Division, to file compulsory pooling applications seeking to combine multiple 40 acre oil spacing units into a larger "project area," which applications include a request to approve a non-standard proration unit. This practice has been entertained by the Division under the Special Rules for Horizontal Wells. Rule 19.15.16.15 NMAC. The Commission has fastened on the "project area" label as a means to circumvent the limitations in the existing spacing rules.

21. The Oil and Gas Act makes no mention of or allowance for what the Division has titled a "project area." There is no legislative grant of authority to create project areas for a horizontal well comprised of a combination of complete, contiguous spacing units. There is no legislative grant of authority to compulsory pool horizontal well project areas. The Commission has previously ruled that combining complete, contiguous spacing units is in the nature of unitization and is not properly considered in the creation of a non-standard spacing unit. *See Order* No. R-13228-F (November 4, 2010).

22. The Commission entertained a rulemaking application by the Division in Case No. 14744 to amend Rule 19.15.14.8 NMAC and Rule 19.15.16 NMAC to address spacing and well restrictions for horizontal wells. The Commission declined to grant the application insofar as it attempted to address compulsory pooling and spacing for horizontal wells because its authority "has not been clearly delineated by either judicial or Commission precedent." See Order No. R-13499 (January 23, 2012). The Commission's ruling, made some thirty-seven years after the Supreme Court's decision in *Rutter,* is an express recognition that *Rutter* does not support compulsory pooling of multiple, contiguous spacing units.

23. The Commission went even further in its Order and entered a conclusion of law that the proposed rule should not be adopted "to forestall any possibility that the rule amendments being adopted would be construed to authorize compulsory pooling of horizontal well 'project areas' without regard to applicable statutory and regulatory limitations." In short, the Commission in that rulemaking case recognized the absence of lawful authority for the compulsory pooling of horizontal well project areas.

E. An Adjudicatory Commission Decision is Not Rule Making.

24. Notwithstanding the Commission's refusal in the rulemaking case to adopt specific rules for spacing for horizontal wells and its refusal to recognize any authority to compulsory pool horizontal well project areas, the Division and the Commission have addressed and approved applications for non-standard spacing units in compulsory pooling proceedings on an ad hoc basis. The Division in this case relied on one of those ad hoc adjudicatory decisions to approve Matador's application.

25. Commission Order No. R-13708-A was entered in Case No. 14966, an application for compulsory pooling filed by Cimarex Energy, Inc. Cimarex sought

approval of a 240-acre non-standard unit for a horizontal oil well. The Division denied the compulsory pooling application even though no party had intervened to oppose. The Division based its decision on a finding that the inclusion of some acreage in the 240-acre well unit would impair the correlative rights of other owners. The Division also held that non-standard units exceeding 160 acres should only be granted in unusual cases.

26. The Commission on de novo review approved the unopposed Cimarex application. It cited to Order No. R-13499, where the Commission declined to adopt a rule regarding non-standard spacing or proration units for horizontal wells. The Commission then relied on the absence of applicable special rules as authority for approving the application for a 240 acre non-standard spacing unit: "The amended horizontal well rules do not restrict the lateral length of a horizontal well that may be drilled, or the size of a non-standard spacing unit for a horizontal well which may be compulsory pooled." Order No. R-13708-A, p. 4.

27. In other words, the Commission reasoned that the Cimarex application could be approved because of the absence of rulemaking authority.

28. The Division in this case relied on Commission Order No. R-13708-A to justify its authority to consider Matador's compulsory pooling application. It did so, at least in part, because the Commission has not adopted spacing rules for horizontal wells.

29. The action of the Division in its decision in this case is wrong because it ignores the distinction between rulemaking and adjudication. While rulemaking creates generally applied standards to which an agency and individuals are held, adjudication is the resolution of particular disputes involving specific parties and specific problems by

applying the rules. *Uhden v. N.M. Oil Conservation Commission,* 1991-NMSC-089, ¶ 7, 112 N.M. 528, 817 P.2d 721.

30. Order R-13708-A is not competent authority for the proposition that the Division or the Commission can compulsory pool across contiguous spacing units. That would require a legislative authorization and adoption of rules through the standard process of notice and a hearing. Order No. R-13078-A is not competent authority for the proposition that the Division or Commission can approve a non-standard spacing unit which does not comply with Rule 19.15.15.11(B).

31. Even if the Commission had the authority to make such an order absent legislative authority, which is denied, Case No. 14966 has no precedential value here. That case did not involve any challenge to the authority of the Commission to compulsory pool across contiguous spacing units. Cimarex's original application, and its de novo application, were unopposed. COG Operating LLC intervened in support of the application. No party to that proceeding presented any argument against such compulsory pooling orders. Adjudicatory proceedings do not substitute for proper rulemaking, particularly where they are unopposed.

32. The stacking of 40 acre oil spacing units implicates multiple complex issues which impact correlative rights and the avoidance of waste. The issues include ownership, drainage, reservoir inconsistencies, royalty responsibilities, conflicts in the owner or owner who has the right to drill, and other factors that must be systematically and thoroughly analyzed in order for the legislature to consider the industry and public interest in determining whether authorizing legislation should be enacted and, if enacted, after rules governing such compulsory pooling proceedings are properly adopted. The Division and the Commission have been exceeding their statutory

authority by its *ad hoc* approach to this subject of significant public and industry consequence.

F. Rule 19.15.13.8 is Invalid to the extent it creates a presumption of a 200% risk penalty without the need for supporting evidence.

33. The Legislature in Section 70-2-17(C) addressed pooling orders. The Legislature provided that such orders "shall make definite provision" for any owner who elects to go non-consent so that the parties advancing the costs of the development and operation are reimbursed out of production. Reimbursement is limited to "the actual expenditures required for such purposes not in excess of what are reasonable." Such orders "shall include a reasonable charge for supervision." Finally, pooling orders "may include a charge for the risk involved in drilling of such well, which charge for risk shall not exceed two hundred percent of the nonconsenting working interest owner's or owners' pro rata share of the cost of drilling and completing the well."

34. Thus, the Legislature provided that risk penalties are discretionary, not mandatory. *State v. Guerra,* 2001-NMCA-031, ¶ 14, 130 N.M. 302, 24 P.3d 334 (word "shall" in statute construed as mandatory, and where shall and may have been juxtaposed in same statute, it must be concluded that the legislature was aware of and intended different meanings). The "may include a charge" language anticipates that there will be no risk penalty where there is no risk.

35. The Legislature intended, and the New Mexico Supreme Court has confirmed, that a party requesting imposition of a risk penalty is required to appear before the Division or the Commission and support the request with competent evidence. *Viking Petroleum, Inc. v. Oil Conservation Com'n of New Mexico,,* 1983-

NMSC-091, ¶ 20, 100 N.M. 451, 672 P.2d 280 (substantial evidence must be presented to support a risk determination).

36. Rule 19.15.13.8(A) provides that unless otherwise ordered under subsection D, the charge for risk is 200% of well costs. Subsection C provides that an applicant for compulsory pooling is not required to present technical evidence justifying the 200% risk charge. Thus, under the rule, a compulsory pooling applicant can achieve, and the Division or Commission can award, a 200% risk penalty without the presentation of any evidence, much less substantial evidence supporting the penalty. The rule, as adopted and applied by the Division and the Commission, is invalid because it alleviates the substantial evidence requirement imposed by § 70-2-17 and the New Mexico Supreme Court in *Viking Petroleum.*

37. In addition, the rule reverses the burden of proof rule that applies in New Mexico by creating a presumption in favor of awarding a risk penalty to an applicant unless a party opposing presents evidence supporting a lesser risk charge. New Mexico has long recognized a fundamental rule underlying all procedure that the party alleging and seeking affirmative relief has the burden of proof. *Allsup v. Space,* 1961-NMSC-175, ¶ 23, 69 N.M. 353, 367 P.2d 531.

38. Jalapeno requests that the Commission hold that Matador will bear the burden of establishing by substantial evidence a record supporting any risk penalty it seeks in this de novo proceeding.

G. The Commission lacks authority to impose a risk penalty on well costs.

39. Section 70-2-17 expressly provides that the risk penalty is to be assessed only "on the cost of drilling and completing the well."

40. The Commission by Rule 19.15.13.8 has modified the statute to allow a risk penalty to be charged on "well costs," which include the statutory approved costs for drilling and completing, but adds "the reasonable costs of . . . equipping the well for production." A well is equipped only after it has been proven to be productive, thereby negating the need for any risk penalty on such costs.

41. By authorizing a risk penalty on the costs of equipping the well for production, the Commission exceeded the authority granted by the Legislature in § 70-2-17. *Continental Oil, supra; Marbob, supra.*

42. Based on the definition of well costs, the Division has routinely authorized a charge for risk on the costs of equipping a well for production even though such an authorization is beyond the scope of the Division's authority. The Division approved in this case a risk penalty on well costs, including the cost of equipping the well for production. Order No. R-14053-B, ¶ (13) p. 10.

43. Jalapeno requests that the Commission hold that any risk penalty is limited to being assessed on the costs of drilling and completing a well, and cannot be charged against the reasonable costs of equipping a well.

WHEREFORE, Jalapeno requests that the Commission dismiss Matador's Application in this proceeding. If the matter proceeds to hearing on the application, Jalapeno requests that the Commission impose on Matador the burden to justify any requested risk penalty, and limit the application of any risk penalty awarded to the costs of drilling and completing the well.

Respectfully submitted,

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CERTIFICATE OF SERVICE

I hereby certify that a true and correct copy of the foregoing was served on the following counsel of record by electronic mail this 1st day of August, 2016.

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