R-11573
R-11573-A

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. 12601

THE APPLICATION OF BETTIS, BOYLE AND STOVALL TO RE-OPEN COMPULSORY POOLING ORDER NO. R-11573 TO ADDRESS THE APPROPRIATE ROYALTY BURDENS ON THE WELL FOR THE PURPOSES OF THE CHARGE FOR RISK INVOLVED IN DRILLING SAID WELL, LEA COUNTY, NEW MEXICO.

ORDER NO. R-11573-B

ORDER OF THE NEW MEXICO OIL CONSERVATION COMMISSION

BY THE COMMISSION:

This case came before the Oil Conservation Commission (hereinafter referred to as "the Commission") on December 4, 2001 at Santa Fe, New Mexico, and the Commission, having carefully considered the evidence, the pleadings and other materials submitted by the parties hereto, now, on this 15th day of February, 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. On October 23, 2001, Sun-West Oil and Gas Inc. (hereinafter referred to as "Sun-West") filed a timely application pursuant to NMSA 1978, § 70-2-13 for review *de novo* of Order No. R-11573-A of the Oil Conservation Division (hereinafter referred to as "the Division").

3. Order No. R-11573-A provided that the undivided interest owned by Sun-West was to be treated as an unleased mineral interest for the purpose of applying ordering Paragraphs (8), (11) and (12) of Division Order No. R-11573.

4. The Commission's review *de novo* is thus limited to whether Sun-West's interest should be treated as an unleased mineral interest for purposes of ordering paragraphs (8), (11) and (12) of Order No. R-11573 as the Division ordered.

5. The parties stipulated that the record of the Division proceedings would be treated as the Commission's factual record. During the hearing of December 4, 2001, the Commission took official notice of those proceedings but also requested that Sun-West produce additional evidence of its relationship with Gulf Coast. Sun-West accordingly submitted the Affidavit of Shane Spear, President of Sun-West Oil & Gas Inc. and Gulf Coast Oil and Gas Company. Mr. Spears' affidavit should also become a part of the record of this matter.

6. The facts, apparently largely undisputed,[1] are as follows:

a. the Division, in Order No. R-11573, ordered the compulsory pooling of uncommitted mineral interests from the surface to the base of the Undesignated South Flying "M" Bough Pool underlying Lots 3 and 4 (W/2 SW/4 equivalent) in Section 30, Township 9 South, Range 33 East, NMPM, Lea County, New Mexico;

b. Bettis, Boyle & Stovall, the applicant for compulsory pooling, proposed to dedicate the pooled acreage to its McGuffin "C" Well No. 1, which it proposed to drill at a standard location in Section 30;

c. at the time the application was filed, Sun-West owned an unleased and undivided 15% mineral interest in Section 30 and had not agreed to voluntary pooling;

d. Bettis, Boyle and Stovall attempted to reach an agreement with Sun-West prior to filing of the application, but Sun-West agreed to lease its interest to Bettis, Boyle & Stovall only for a 25% royalty and additional bonus;

e. when Sun-West failed to agree to voluntary pooling on acceptable terms, Bettis, Boyle and Stovall, on January 30, 2001, filed an application with the Oil Conservation Division for compulsory pooling;

f. notice of the filing of the application of Bettis, Boyle and Stovall and of the hearing thereon was sent by certified mail and received by Sun-West on February 6, 2001;

g. on February 15, 2001, Sun-West executed a lease of its interest in the lands that were the subject of the application in this case to Gulf Coast, reserving to itself a royalty of 27.5%;

[1] Sun-West disputed the finding of the Division that Sun-West and Gulf Coast are affiliates and the findings that the royalty interest reserved to Sun-West rendered the proposed well uneconomic.

h. only the lands within the unit at issue here were included in the lease to Gulf Coast;

i. Sun-West did not participate in the compulsory pooling hearing and appeared through counsel during the second hearing on the re-opened application, but presented no testimony;

j. Bettis, Boyle & Stovall's engineer, Bruce A. Stubbs, testified that Sun-West's 27.5% overriding royalty interest made drilling the McGuffin "C" Well No. 1 unfavorable and undesirable. He testified that while the proposed well would have marginal economics using a 3/16 royalty and yield a 28.13% rate of return before taxes and a 20% rate of return after taxes, a 1/4 royalty would yield a rate of return of 19.18% before taxes. He testified that a well will not be drilled when the rate of return is below 20%;

k. Order No. R-11573 provided for recovery out of production attributable to the interest of non-consenting working interest owners of reasonable well costs of the proposed McGuffin "C" Well No. 1, together with an additional 200% of these costs as a charge for the risk involved in drilling the well;

l. Order No. R-11573 further provided, in ordering paragraph (12), that "[a]ny well costs or charges that are to be paid out of production shall be withheld only from the working interests' share of production, and no costs or charges shall be withheld from production attributable to royalty interests";

m. on May 3, 2001, Bettis, Boyle and Stovall, apparently having learned of the Sun-West lease to Gulf Coast, filed an application to reopen the case "for the purpose of amending Division Order No. R-11573 to address the appropriate royalty burdens on the proposed well for purposes of the non-consent penalty";

n. during the hearing on the application to re-open, Bettis, Boyle and Stovall sought an order permitting it to recover the portion of well costs and of the 200% risk penalty attributable to the mineral interest of Sun-West out of 87.5% of production attributable to such interest as though Sun-West's interest were unleased;

o. Sun-West Oil & Gas Inc. is a Subchapter S corporation incorporated in the State of Texas on December 9, 1991 and its principal place of business is in Hobbs, New Mexico;

p. Gulf Coast is a subchapter C corporation incorporated in Delaware on November 6, 1980 and its principal place of business is in Midland, Texas. Gulf Coast has neither drilled nor operated wells in New Mexico;

q. Shane Spear is the President of both Sun-West and Gulf Coast but the two corporations have differing stock ownership;

r. Sun-West and Gulf Coast share a telephone number and address, and you speak to the same person when you discuss business matters with Sun-West or Gulf Coast;

s. when Bettis, Boyle and Stovall sought to contact Gulf Coast to negotiate terms of pooling, the individual who contacted Bettis, Boyle and Stovall to negotiate on behalf of Gulf Coast was the same individual with whom Applicant had previously discussed leasing of this interest from Sun-West; and

t. the interest of Sun-West in the proposed units was an unleased mineral interest on January 30, 2001, when an application for compulsory pooling of all interests therein was filed, and on February 6, 2001, when Sun-West received notice of the application. The interest of Sun-West was a leased interest as of the dates of the Division's orders.

7. On these facts, Bettis, Boyle & Stovall argued to the Commission that Sun-West's private contract with Gulf Coast improperly sought to avoid the jurisdiction of the Division and the Commission[2] to impose compulsory pooling in appropriate circumstances. Bettis, Boyle & Stovall argued that, but for the lease to Gulf Coast, the Oil and Gas Act would treat Sun-West's interest as an unleased mineral interest with a statutory 1/8 royalty interest and a 7/8 working interest, and the working interest would have been subject to the costs of drilling the McGuffin "C" Unit No. 1 plus a 200% risk penalty. Bettis, Boyle & Stovall claimed that the private contract with Gulf Coast was intended to avoid this result. Bettis, Boyle & Stovall further argued such private contracts could avoid the Division's jurisdiction by permitting a party to free a larger percentage of its interest from the costs of the drilling and create a smaller interest upon which the risk penalty would apply. The net effect of these actions, Bettis, Boyle & Stovall argued, is to reduce the Division's authority under the Oil and Gas Act, and to risk or impair the ability of the party pooling the acreage to produce a viable well because of the fundamental change in the economics wrought by the private contract.

8. Sun-West claimed that the Oil and Gas Act does not permit the Division to retroactively declare its royalty interest unleased. Sun-West claimed that such action would reduce the royalty interest, resulting in a partial taking of its interest and a complete taking of Gulf Coast's interest. Sun-West also claimed that the leasing of its interest was not taken to circumvent the jurisdiction of the Division and that substantial

[2] Further references to "the Division" are also to the Commission. See NMSA 1978, § 70-2-6(B).

evidence is lacking for a finding that Sun-West and Gulf Coast are affiliates. Sun-West also claimed that the Division's consideration of pooling applications is "standardless" and the Division's Order was therefore arbitrary; Sun-West's argument in this regard was based on its reading of Division cases cited as precedent by Bettis, Boyle & Stovall. Sun-West also claims that the Division's Order is not supported by substantial evidence because evidence is lacking to make a finding that the project was not economically viable. Finally, Sun-West claims that Order No. R-11573-A operated retroactively because it related back to the date of filing of the pooling application, not the time of the actual pooling (the entry of the pooling order).

9. It would circumvent the purposes of the Oil and Gas Act to permit a party owning an unleased mineral interest in a spacing unit at the time said party is served with an application for compulsory pooling to avoid the cost recovery and risk penalty provisions of the Act by leasing or otherwise burdening or reducing that interest after the application is filed with the Division and notice is served on the party.

10. Under certain circumstances, leasing, burdening or otherwise carving out a large non-cost-bearing interest may violate the correlative rights of interest owners and create waste if the non-cost-bearing interest is so large as to affect the economic viability of a prospect and prevent the drilling of a well.

11. The Division has repeatedly cautioned parties about carving out excessive non-cost-bearing interests. See R-7335 (interest owners created 50% overriding royalties in conveyances to their son and daughter, and the Division ordered either a voluntary reduction in the overriding royalties or that they be excluded from the proration unit); R-7998 (similar facts and result); R-12087 (a net profits interest carved out by an owner that would unnecessarily burden the project was found to be liable for its proportionate share of drilling and production costs and the risk penalty).

12. The record indicates that the lease to Gulf Coast was intended to circumvent the Division's pooling authority and that the 27.5% royalty interest reserved to Sun-West made the proposed McGuffin "C" Well No. 1 uneconomic and undesirable, threatened the correlative rights of other interest owners and threatens waste.

13. On the first point, uncontroverted evidence[3] indicates that the lease to Gulf Coast was intended to circumvent the Division's pooling authority. For example, counsel for Sun-West drafted and disseminated an article entitled "Compulsory Pooling in New Mexico." That article states that "... parties that anticipate compulsory pooling of their interests *may want to consider carving out or conveying a non-cost bearing burden prior to compulsory pooling. In this way parties being pooled can enhance their position.*" A copy of the relevant portions of the article were presented as a demonstrative aid by counsel for Bettis, Boyle & Stovall without objection during the hearing of December 4, 2001, and the Commission takes official notice of a copy of the article.

[3] Sun-West presented no evidence during the three hearings conducted in this matter.

14. The lease of Sun-West's interest to Gulf Coast for a 27.5% royalty strongly suggests implementation of the strategy outlined by Sun-West's attorney in the aforementioned article.

15. Further corroborating is the fact that the non-cost-bearing burden carved out by Sun-West was even greater than the burden demanded by Sun-West of Bettis, Boyle and Stovall during negotiations, and Sun-West carved out and conveyed to Gulf Coast only that portion of its property subject to the pooling application.

16. The timing of the lease (shortly after service of the application for compulsory pooling) is also highly suggestive, as is the fact that Gulf Coast has not drilled or operated wells in New Mexico heretofore, and the close relationship of the two corporations, evidenced by the service of Mr. Spear as President of both and the representation of both by the same individuals. While it is evident that the corporations are separate legal entities, the close relationship of the corporations provided Sun-West a convenient means to implement the strategy described.

17. On the second point, the transaction between Sun-West and Gulf Coast implicates correlative rights and threatens waste. The lease would protect 27.5% of Sun-West's interest from having to bear the costs of drilling and the 200% risk penalty. As the McGuffin "C" Well No. 1 was a marginal economic prospect to begin with, if Sun-West's reserved royalty interest means the well is not drilled and resources underlying Section 30 not recovered, interest owners would be deprived of their statutory opportunity to recover the oil and gas underlying Section 30.

18. Protection of correlative rights and prevention of waste are critical functions of the Division. See NMSA 1978, § 70-2-11. Its authority to regulate in matters relating to conservation of oil and gas production is very broad. NMSA 1978, § 70-2-6.

19. The Oil and Gas Act permits the Division to order compulsory pooling of interests when voluntary efforts are unsuccessful. NMSA 1978, § 70-2-17(C). Section 17 authorizes the Division to require that non-participating parties bear their proportionate share of the costs of development and operations, plus a risk penalty up to 200%. Id. Such orders must be on such terms as are "fair and reasonable," and must protect the opportunity of interest owners to recover or receive without unnecessary expense their fair share of the oil or gas or both. The Oil and Gas Act unambiguously provides that an unleased interest involved in compulsory pooling is treated as being a 1/8 royalty interest and a 7/8 working interest. Id.

20. It appears that a non-cost-bearing burden of 27.5% would render drilling of the McGuffin "C" Well No. 1 unlikely. As noted previously, Bettis, Boyle & Stovall's expert testified that while the proposed well would have marginal economics using a 3/16 royalty interest and yield a 28.13% rate of return after taxes and a 20% rate of return after taxes, a 25% royalty would yield a rate of return of 19.18% *before taxes*. Bettis, Boyle & Stovall's expert testified that a well will not be drilled when the rate of return is below

20% and that Sun-West's higher overriding royalty interest through the Gulf Coast lease made the well unfavorable and undesirable.

21. If the McGuffin "C" Well No. 1 is not drilled as a result of Sun-West's conduct, the correlative rights of the other interest owners would be violated and resources would be left in the earth and wasted.

22. The foregoing argues in favor of treating Sun-West's interest as unleased as ordered by the Division.

23. Sun-West's argument that the Division lacks authority to treat Sun-West's interest as unleased is incorrect for the reasons stated in paragraphs 18 and 19.

24. Sun-West's argument that Order No. R-11573-A creates a partial taking of Sun-West's interest and a complete taking of Gulf Coast's interest is misplaced. It is well established that private contracts in derogation of an oil and gas conservation statute are not enforceable, and that a regulatory body that refuses to recognize such a contract is not taking property in violation of a state constitution or the federal Constitution. Patterson v. Stanolind Oil and Gas Co., 182 Okla. 155, 77 P.2d 83 (Okla. 1938). Sun-West did not tender any evidence to this body tending to support its allegation of a taking; in most cases regulatory action becomes a "taking" only when a property owner is deprived of all or substantially all of the use of the property. Here, a reduced royalty would seem to have the opposite effect given the testimony of Bettis, Boyle & Stovall that the McGuffin "C" Well No. 1 would not be drilled. Reducing non-cost-bearing interests in appropriate circumstances is a well-recognized regulatory tool to ensure that waste is prevented and correlative rights are protected. See 5 Williams & Myers, Oil and Gas Law, § 944, page 680 (2000).

25. Sun-West's argument that the Division's review of compulsory pooling applications is "standardless" and therefore arbitrary is misplaced and based upon a misreading of prior Division cases. The Oil and Gas Act provides detailed standards for examination of applications for compulsory pooling, all of which were considered by the Hearing Examiner in this case and were addressed in detailed findings and conclusions in Order No. R-11573. The cases cited in paragraph 11, above, show that the Division has treated excessive non-cost-bearing interests consistently for many years.

26. Sun-West's argument that no evidence exists that the project was uneconomic also fails. Bruce A. Stubbs testified that a return of less than 20% after taxes results in "unacceptable economics" and "unfavorable economics" and that the higher royalty of the Sun-West lease created a rate of return of 19.18% percent *before taxes*. This more than establishes that the project is not economically viable. Sun-West presented no testimony on this or any other subject and Mr. Stubbs' testimony appears to support the proposition advanced.

27. Sun-West's argument that Order No. R-11573-A operates "retroactively" because it "relates back" to the date of filing of the pooling application, not the time of the actual pooling (the entry of the pooling order) is not valid because it assumes that the jurisdiction of the Division does not attach until issuance of an order. The jurisdiction of the Division attaches once an application for compulsory pooling is filed and the parties are properly served. If Sun-West's premise, that jurisdiction did not attach until the order was issued, is accepted, compulsory pooling could become a process without end and subject to severe abuse.

28. In order to effect pooling of the subject unit on terms that are just and reasonable under these circumstances, and to allow Bettis, Boyle & Stovall the opportunity to recover or receive without unnecessary expense its just and fair share of the oil or gas or both underlying the subject unit, the interest of Sun-West should be treated as an unleased mineral interest for the purpose of applying the cost recovery and risk charge provisions of Division Order No. R-11573.

29. Due to the delay occasioned by the *de novo* review of Order No. R-11573-A, the time for commencement of Applicant's McGuffin "C" Well No. 1, as provided in ordering paragraph (2) of Division Order No. R-11573, should be extended to May 15, 2002.

30. In all other respects, Division Orders No. R-11573 and R-11573-A should remain in full force and effect.

31. The Commission has not been asked to address, nor should it address, any issue regarding rights or duties as between Sun-West and Gulf Coast.

CONCLUSION OF LAW:

The Commission concludes that the authority expressly conferred on the Division and the Commission by the Oil and Gas Act is cumulative and not exclusive, and that the Commission and the Division have authority pursuant to NMSA 1978, §§ 70-2-11(A) and 70-2-17(C) to permit recovery of costs and risk charges out of production attributable to a non-expense-bearing interest where necessary to effect pooling upon terms that are fair and reasonable and to protect correlative rights and prevent waste, at least with respect to interests created subsequent to attachment of the Division's jurisdiction.

IT IS THEREFORE ORDERED:

1. The interest of Sun-West shall be treated as an unleased mineral interest for the purpose of applying ordering Paragraphs (8), (11) and (12) of Division Order No. R-11573.

2. The date for the commencement of Applicant's McGuffin "C" Well No. 1, as provided in Ordering Paragraph (2) of Division Order No. R-11573, is hereby extended to May 15, 2002.

3. In the event the operator does not commence drilling the well on or before May 15, 2002, Ordering Paragraph (2) of Order No. R-11573 shall be of no effect, unless the operator obtains a time extension from the Division Director for good cause.

4. To the extent not in conflict with this Order, Division Orders No. R-11573 and R-11573-A are hereby confirmed and shall be and remain in full force and effect.

5. 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

LORI WROTENBERY, CHAIR

JAMI BAILEY, MEMBER

ROBERT LEE, MEMBER

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