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NEW MEXICO OIL CONSERVATION DIVISION
 - Engineering Bureau -
 1220 South St. Francis Drive, Santa Fe, NM 87505



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JUN . 4 2003

Oil Conservation Division

ADMINISTRATIVE APPLICATION CHECKLIST

THIS CHECKLIST IS MANDATORY FOR ALL ADMINISTRATIVE APPLICATIONS FOR EXCEPTIONS TO DIVISION RULES AND REGULATIONS WHICH REQUIRE PROCESSING AT THE DIVISION LEVEL IN SANTA FE

Application Acronyms:

- [NSL-Non-Standard Location] [NSP-Non-Standard Proration Unit] [SD-Simultaneous Dedication]
- [DHC-Downhole Commingling] [CTB-Lease Commingling] [PLC-Pool/Lease Commingling]
- [PC-Pool Commingling] [OLS - Off-Lease Storage] [OLM-Off-Lease Measurement]
- [WFX-Waterflood Expansion] [PMX-Pressure Maintenance Expansion]
- [SWD-Salt Water Disposal] [IPI-Injection Pressure Increase]
- [EOR-Qualified Enhanced Oil Recovery Certification] [PPR-Positive Production Response]

[1] TYPE OF APPLICATION - Check Those Which Apply for [A]

[A] Location - Spacing Unit - Simultaneous Dedication

NSL NSP SD

Check One Only for [B] or [C]

[B] Commingling - Storage - Measurement

DHC CTB PLC PC OLS OLM

[C] Injection - Disposal - Pressure Increase - Enhanced Oil Recovery

WFX PMX SWD IPI EOR PPR

[D] Other: Specify _____

[2] NOTIFICATION REQUIRED TO: - Check Those Which Apply, or Does Not Apply

[A] Working, Royalty or Overriding Royalty Interest Owners

[B] Offset Operators, Leaseholders or Surface Owner

[C] Application is One Which Requires Published Legal Notice

[D] Notification and/or Concurrent Approval by BLM or SLO
U.S. Bureau of Land Management - Commissioner of Public Lands, State Land Office

[E] For all of the above, Proof of Notification or Publication is Attached, and/or,

[F] Waivers are Attached

[3] SUBMIT ACCURATE AND COMPLETE INFORMATION REQUIRED TO PROCESS THE TYPE OF APPLICATION INDICATED ABOVE.

[4] CERTIFICATION: I hereby certify that the information submitted with this application for administrative approval is accurate and complete to the best of my knowledge. I also understand that no action will be taken on this application until the required information and notifications are submitted to the Division.

Note: Statement must be completed by an individual with managerial and/or supervisory capacity.

James Bruce
 Print or Type Name

James Bruce
 Signature

Attorney for Applicant

Title
 jamesbruc@aol.com

e-mail Address

6/4/03
 Date

JAMES BRUCE
ATTORNEY AT LAW

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jamesbruc@aol.com

June 4, 2003

Hand Delivered

Michael E. Stogner
Oil Conservation Division
1220 South St. Francis Drive
Santa Fe, New Mexico 87505

See Note 104.c(2)(c)

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Oil Conservation Division

*Merit Energy
Corp.*

Re: **Revised** application of Chi Energy, Inc. for
administrative approval of an unorthodox gas well
location:

Well: Stephens A Com. Well No. 2
Location: 500 feet FSL & 1065 feet FEL
Well Unit: Lots 3, 4, E $\frac{1}{2}$ SW $\frac{1}{4}$, and SE $\frac{1}{4}$ (S $\frac{1}{2}$) of Section
7, Township 23 South, Range 27 East,
NMPM, Eddy County, New Mexico

Administrative application reference No. pKRV0-311952296

Dear Mr. Stogner:

Enclosed is the original application, previously submitted to the Division on April 29, 2003. We have received your letter of April 30, 2003, denying the application. Although you stated that the matter should be set for hearing, applicant respectfully requests that the matter be reconsidered for administrative approval.

As you correctly noted in your letter, the existing well on the well unit is operated by Merit Energy Company. Attached as Exhibit A is a portion of a farmout agreement between Merit Energy Company and Chi Energy, Inc.¹ As you can see, the agreement provides that, for acreage where there is an existing well, Merit Energy Company will be the operator of record, and Chi Energy, Inc. will be the contract operator. Thus, the parties to the farmout agreement will

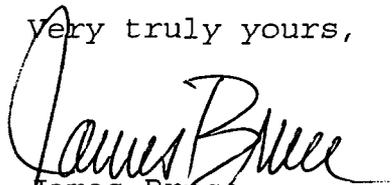
¹If you desire a complete copy of the farmout agreement, please let me know.

comply with the rules of the Division, regarding unit operatorship.

Based on the foregoing, applicant requests that the unorthodox location be approved without hearing. **Because Merit Energy Company will be operator of record, if necessary the order should be issued in the name of Merit Energy Company, or both parties.**

Thank you for your consideration of this matter.

Very truly yours,



James Bruce

Attorney for Chi Energy, Inc.

Master Farmout Agreement

This Master Farmout Agreement ("Agreement") is dated effective on the 1st day of August, 2002, and is by and between Merit Energy Company ("Merit") and Chi Energy, Inc. ("Chi"). Merit and Chi are sometimes referred to in the singular as a "Party" or collectively as the "Parties."

In consideration of \$25,000 paid by Chi to Merit contemporaneously with the execution of this Agreement and the payment of the sums described below, the mutual covenants and agreements of the Parties and the rights, duties and obligations to be borne by the Parties, the Parties have agreed to the following:

Article 1.

IDENTIFICATION OF LEASES AND LANDS

1.1 Drilling Units. The six areas which are to be subject to this Agreement are described in Exhibit "A" to this Agreement, which includes a description of the oil, gas and mineral leases (the "Leases"), together with any depth limitations or other limitations thereon, as well as the lands ("Lands") covered by the Leases. Each half section covered by the Leases is referred to as a "Drilling Unit," and all the Drilling Units described on Exhibit "A" are referred to collectively as the "Drilling Units."

Article 2.

INFORMATION TO BE DELIVERED TO CHI

2.0 Title Information. Merit will furnish Chi, with respect to each Drilling Unit, all title, lease and other like information (collectively, "title information") which it may have in its possession, or which it can obtain without additional expense from third persons. Chi understands and agrees that all title information supplied by Merit is without representation or warranty, express, implied or statutory, regarding the accuracy or completeness thereof, and Chi, to the extent it relies upon the title information, shall do so at its sole risk. Chi may, in the exercise of its commercial judgment, obtain additional title information, by requesting title opinions (whether original drilling opinions or supplements to existing opinions) or by a review of the public records or otherwise. To the extent that Chi, in its sole judgment, determines that there are matters of title which require curative work, Merit will cooperate with Chi in obtaining the curative matters, as may then be appropriate. There shall be no obligation on the part of Merit to purchase new supplemental abstracts, obtain any title opinions, nor to do any curative work in connection with title to the Leases or Lands.

- (1) Chi shall review the title information supplied by Merit, together with any curative work and additional title information obtained by Chi, if any, and, if, in the exercise of Chi's reasonable judgment, Chi determines that title to the Drilling Unit is unacceptable for drilling purposes, and title cannot be cured to Chi's reasonable satisfaction before the date upon which Chi is required to commence operations on the Drilling Unit, then that Drilling Unit shall not be considered a



Drilling Unit and the Drilling Unit shall no longer be deemed to be subject to the provisions of this Agreement.

- (2) If Chi determines that the title information supplied by Merit indicates that title to the Lease and Lands included in the Drilling Unit are reasonably satisfactory to Chi, then it shall have the election to proceed to commence operations on the Drilling Unit.
- (3) Chi will notify Merit that title to the Lease and Lands is acceptable for drilling purposes, or will reject title to the Lease and Lands included in the Drilling Unit within 30 days of the receipt of the title information supplied by Merit. The failure by Chi to notify Merit within 30 days of the receipt of the title information shall be deemed to be a determination by Chi that title to the Leases and Lands is acceptable for drilling purposes.
- (4) For the purposes of this Agreement, the Parties acknowledge and agree that title to the Leases and Lands comprising a Drilling Unit shall not be acceptable unless (1) a reasonably prudent operator under the same or similar circumstances would approve title and (2) all of Merit's co-working interest owners in the applicable Drilling Unit have supplied evidence, reasonably acceptable to Chi, that each of them have agreed to the provisions of this Agreement, insofar as their ownership rights in the Drilling Units are concerned, and that each of them will evidence that the agreement by and instrument reasonably acceptable to Chi and (3) Chi secures regulatory approval to drill and produce wells anticipated under this agreement through methods described in Article 3 below.

Article 3.

PERMITTING; REGULATORY MATTERS

The Parties acknowledge and agree that the New Mexico Oil Conservation Division ("NMOCD") and the Bureau of Land Management ("BLM") are the agencies or bureaus which regulate the drilling and spacing of wells upon the Lease and Lands comprising a Drilling Unit. The Parties also acknowledges and agree that the NMOCD and BLM may not be willing to permit an additional well on a Drilling Unit, and that the current regulation of the NMOCD will not allow the issuance of a permit for a second or additional well on a Drilling Unit, if that second or additional well is to be drilled to, and produced from, a formation or formations in which a currently existing well is producing and if the operator for the second well is different from the operator for the currently existing well. Accordingly, while Chi shall, as described below, conduct all operations on the second or additional well (the "Initial Well" as further described below in Section 4.1 or the "Subsequent Well", as further described below in Section 4.2), the permit to drill will be issued in the name of Chi, and the location thereof may be prescribed by the NMOCD or the BLM. Accordingly, until the current regulations of the NMOCD or the BLM, as appropriate, are modified, then, if necessary to secure a permit to drill and produce, Merit shall obtain all permits for the drilling of any well proposed by Chi under this agreement, in Merit's name, and Chi shall conduct all operations on the Drilling

Unit, to the extent the same apply to wells drilled by Chi under this agreement in the name, and on behalf, of Merit.

**Article 4.
INITIAL AND SUBSEQUENT WELLS**

4.1 **Operations on Initial Well.** On or before September 30, 2002 or within 30 days after a permit authorizing the drilling of a well is issued by the appropriate governmental agency, or within 30 days after title to the Lands in the first of the Drilling Units is approved (or deemed to be approved) by Chi, whichever should be the later date (but in no event later than November 30, 2002), Chi shall commence, or cause to be commenced, the actual drilling of the Initial Well (the "Initial Well") thereafter shall prosecute the drilling of the Initial Well with due diligence and in a workmanlike manner to a depth sufficient to test the Morrow formation (the "Contract Depth"). If after reaching Contract Depth, Chi determines that a completion attempt is not justified or an attempted completion fails to achieve a Commercial Well as such term is defined in Section Article 10, then the Initial Well shall be plugged and abandoned in accordance with Section 9.2 below.

- (1) If, in drilling the Initial Well, Chi encounters conditions which would render further drilling by ordinary means impractical, Chi shall have the option, but not the obligation, to commence drilling a substitute well, upon a site located at or near the original location for the Initial Well, within 30 days from the plugging and abandonment (or temporary abandonment) of the original Initial Well by Chi. The substitute well shall be drilled under the same terms and conditions as the Initial Well for which it is a substitute, except for the commencement date, and the substitute well shall be regarded for all purposes under the provisions of this Agreement as the Initial Well for which it is a substitute. As used in the following provisions of this Agreement, the term "Initial Well" shall include the substitute or substitutes therefore, as appropriate.
- (2) Chi shall notify Merit when the location for the Initial Well is staked, when the material for the drilling of the Initial Well is moved to the location and when actual drilling of the Initial Well is commenced. Merit's officers, employees and consultants (so long as they have been properly identified by Merit) shall access to the Initial Well, including access to the derrick floor, at all times.
- (3) Exhibit "B" sets forth the reports, data, notices and other information Chi shall provide to Merit in respect to the Initial Well and operations conducted thereon.
- (4) Chi shall test each prospective horizon if the same would be tested by a reasonably prudent operator and shall notify Merit when such a horizon is to be tested and allow Merit sufficient time to have a representative present

6.4 Existing Operating Agreements. Existing Operating Agreements (Existing OA) are described as follows and attached as Exhibit "D".

<u>Description</u>	<u>Date</u>	<u>EXISTING WELLS</u>
E/2 SEC 1 23/26	7/1/69	Collatt Estate Com #1
N/2 Sec 7 23/27	5/7/73	Stephens Com #1
S/2 Sec 7 23/27	11/1/72	Stephens A Com #1
S/2 Sec 22 22/27	3/11/85	Henry #2
Sec 34 22/26	6/12/72	Midwest Fed #1

6.5 Reporting Requirements. The Parties acknowledge that the COA, while identifying Chi as the Operator, is not sufficient to constitute Chi as the operator of record, insofar as the governmental agencies having jurisdiction over the Drilling Unit are concerned. Accordingly, the Parties agree that, to the extent feasible, they each shall cooperate with the other to request the appropriate governmental agencies to recognize Merit as the operator of record for the wells which are in fact operated by Merit in the Drilling Unit and Chi as the operator of record for the wells which are in fact operated by Chi in the Drilling Unit, which in the latter case are the Initial Well and Subsequent Wells and the Additional Wells, if any, in any Drilling Unit. However, if the appropriate governmental agencies are unwilling or unable to recognize the Parties as the operator of record for their respective wells, then Chi shall timely provide Merit with all information and other materials necessary or appropriate to permit Merit to make all required filings or reports or to supply all other information (including production, royalty payment and like information) then required by the appropriate governmental agency, until Chi can be recognized as operator of record by the appropriate governmental agency. Each Party will indemnify and hold the other Party harmless from and against all claims, demands or penalties (including interest, late charges or other monetary charges) asserted or levied by the appropriate governmental agency for late, inaccurate or improper reporting. The indemnity included in this Section 6.2 shall only be applicable to the extent that a Party has timely prepared, delivered and otherwise complied with the requirements of an appropriate governmental agency information and data and supplied the same to the reporting Party, and the claim, demand or penalty has been asserted against the reporting Party by the appropriate governmental agency for the failure to properly and timely report the information and data. Each Party will provide the other Party with copies of requests, demands, informational requests, notices of hearings and other written or oral communications from an appropriate governmental agency which affect a Drilling Unit and the other Party's operations thereon, and, to the extent permitted by the appropriate governmental agency, allow the other Party to respond to the requests, demands, informational requests, notices of hearings and other written or oral communications or to attend hearings held by or on behalf of the appropriate governmental agency.

Article 7.

ASSIGNMENT OF INTERESTS

7.1 Current Assignment. Subject to the terms and conditions of this Agreement and to

IN WITNESS WHEREOF, the Parties have executed this Agreement on the day and year first set forth above.

Chi Energy, Inc.

By: [Signature]
William R. Bergman - President

Merit Energy Company

By: [Signature]
Fred N. Diem, Vice President