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

APPLICATION OF DEVON ENERGY PRODUCTION COMPANY LP FOR A HORIZONTAL SPACING UNIT AND COMPULSORY POOLING, LEA COUNTY, NEW MEXICO

Case Nos. 20962 and 20963

APPLICANT'S BRIEF REGARDING NOTICE TO ORRI OWNERS

As authorized by the Hearing Examiners at the hearing on Case Nos. 20962 and 20963 on December 12, 2019, Devon Energy Production Company, L.P. ("Devon") submits this brief setting forth its legal analysis regarding the requirement of notice to overriding royalty interest ("ORRI") owners in compulsory pooling cases. The New Mexico Oil Conservation Division's rules unambiguously state that an "applicant shall give notice to each owner of an interest… ***(other than a royalty interest subject to a pooling or unitization clause)***." 19.15.4.12A(1)(a) NMAC (emphasis added). This provision is the basis for the Division's exclusion of leasehold royalty interest owners from notice requirements; the same reasoning should apply to exclude ORRI owners from notice, particularly owners of federally-derived ORRIs, such as those at issue in these cases. Devon understands that the Division is in the process of reviewing its current practices; accordingly, the above-referenced cases may provide an opportunity to review a current practice that appears to raise a number of legal and policy considerations.

I. ORRI Properly Defined as a Royalty Interest Under New Mexico Law

Under New Mexico law, "[a]n overriding royalty is, first and foremost, a royalty interest." *Christy v. Petrol Resources Corp.,* 1984-NMCA-108, ¶ 21, 102 N.M. 58, 691 P.2d 59 (*quoting* 2 H. Williams & C. Meyers, Oil and Gas Law § 418.1 (1983)). According to *Williams & Meyers,* an

interest is deemed a royalty interest when it falls into one of three types: (1) a royalty interest can arise between lessor and lessee that is "a normal incident of a lease" where "the lessor reserves such interest in production by the lessee;" (2) a royalty interest can be "created apart from a lease," such as reserving a nonparticipating royalty interest in a transfer by mineral deed; and (3) a royalty interest can arise as an ORRI, which is "a royalty created from a lease that is in favor of a person other than the lessor of the lease." *See* 1-2 Williams & Meyers, Oil and Gas Law § 202, 202.3 ¶¶ 1-4.

The fact that an ORRI is carved out of the working interest of the lease, as opposed to lessor's royalty, is irrelevant to the question whether an ORRI qualifies as a royalty interest under 19.15.4.12A(1)(a) NMAC. Unleased landowners own 100% of the working interest in their lands and have the right to drill, but because landowners do not want to assume the obligations, responsibilities and liabilities of drilling a well, they will lease their working interest to the lessee, who assumes the weight of such responsibilities in exchange for a royalty interest free of such responsibilities and liabilities; in effect, they receive a passive, nonoperating interest free from the costs of production. *See* 1 Kuntz: The Law of Oil and Gas, § 16.2, ¶ 3.

Similarly, a working interest owner, such as a lessee, will often exchange its working interest for an ORRI in the same way and for the same reasons. In the oil and gas industry, it is common practice for parties to acquire leases with no intent to develop the resources themselves, but rather to sell the leases to another party who is willing to assume the costs and responsibilities of development, and in exchange receive an ORRI, a passive nonoperating royalty interest with no executive rights or right to drill and free of costs of production, as part of the transaction. *See Continental Potash, Inc., v. Freeport-McMoran, Inc.*, 1993-NMSC-039, ¶ 3, note 2, 115 N.M. 690, 858 P.2d 66 (describing the reservation of an ORRI as involving the transfer of a lease in which the

assignor retains a nonpossessory interest free of the expenses of production). Thus, a leasehold royalty and an overriding royalty are both royalty interests received in exchange for the transfer of working interest and the right to drill, which absolve such royalty owners of all responsibilities, obligations and liabilities for actually drilling and operating a well.

The Division exercises its proper statutory authority when it directs, under 19.15.4.12A(1)(a) NMAC, that owners of royalty interests subject to a pooling or unitization clause do not receive notice. *See* NMSA 1978, § 70-2-7. Such royalty interests (which should also include ORRIs) are truncated, derivative interests that carry no working interest, executive rights or right to drill. Thus, ORRI owners should not be allowed to burden the limited resources of the Division as it endeavors to arrive at the best decisions for conservation and prevention of waste, which comprise the Division's primary focus. *See* NMSA 1978, § 70-2-6 (the Division shall have authority over all matters relating to conservation and waste). In its examination of waste, the Division does have the authority to consider and protect correlative rights. *See* NMSA 1978, § 70-2-11. However, correlative rights must be considered only in their relation to the Division's focus on the prevention of waste. *See* NMSA 1978, § 70-2-33(H) ("correlative rights" means the opportunity afforded the owner of each property in a pool "***to produce without waste***….") (emphasis added). Only a working interest owner has the right to produce under the Oil and Gas Act. NMSA 1978, § 70-2-33(E) ("'owner' means the person who has the right to drill into and produce from any pool…."). Therefore, the Division should evaluate correlative rights in a unit by giving primacy to the interests of owners who have a right to produce and extract oil and gas, not the assertions of ORRI owners. *See* also 1 Kuntz: The Law of Oil and Gas Sec. § 16.2, ¶ 3 (noting that the owner of the royalty interest looks to enjoyment of its rights only after extraction of oil and gas by another, that other being the working interest owner or the lessee).

New Mexico case law upholds and clarifies this interpretation, stating "[t]he prevention of waste is of paramount interest, and protection of correlative rights is interrelated and inseparable from it," as the "very definition of 'correlative rights' emphasizes the term 'without waste'." *Continental Oil v. Oil Conservation Commission,* 1962-NMSC-062, ¶ 27, 70 N.M. 310 (noting that because correlative rights are subservient to the prevention of waste and to the practicalities of the situation, the protection of correlative rights depend on the Commission's findings as to the extent and limitation of the right). In its Order No. R-13124, the Division used the *Continental* court's analysis to limit and subrogate the correlative rights of the wellbore owners, who owned only a truncated interest in production, to the owners within the larger unit with what the Division held were superior rights outside the wellbore. In the same way, the correlative rights of ORRI owners, who own only a passive interest in production of hydrocarbons after their extraction at the wellbore, should be limited in relation, and made subservient, to the superior rights and responsibilities of the working interest owners and lessees within the unit.

II. Current Practice Undermines Conservation and Prevention of Waste

A policy of notifying ORRI owners, whose interests have already been accounted for within pooling and unitization provisions of the underlying leases whether through a pooling clause or a communitization agreement, could serve to undermine the Divisions efforts to conserve vital resources and prevent waste. Because ORRI owners have no responsibilities or accountability for the proper stewardship of the land and its resources, such owners "are understandably concerned with their own interests and cannot be expected to litigate anything except that which concerns them." *Continental Oil*, 1962-NMSC-062 at ¶ 28. Furthermore, ORRI owners are often sophisticated players in the industry with substantial resources to burden and consume the Division's limited resources when their singular self-interests are encroached upon. Excluding

ORRI owners from notice, as provided by 19.15.4.12A(a)(1) NMAC, would optimize the Division's flexibility and ability to conserve natural resources and prevent waste by limiting the impact of such singular interests that run counter to the OCD's mission; additionally, this would allow the Division to focus on collaborating with those parties who have chosen to bear the costs, responsibilities and liabilities of development and who hold the actual rights, and have the ability, to control operations and externalities that impact the land. Such reasoning is acknowledged by Colorado and Oklahoma, states with statutory pooling comparable to New Mexico, as both have adopted the policy of excluding ORRI owners from notice.[1]

III. ORRI Owners Subject to Communitization Agreements Are Unnecessary Parties

Another important consideration involving notice in these cases involves the principles of Federalism. The ORRIs in Devon's cases are derived solely from federal leases, and are therefore subject to the pooling and unitization provisions of the federal communitization agreement and relevant federal statutes. The Division plays an important and necessary role in the management of federal lands residing within New Mexico for purposes of conservation and prevention of waste. *See, e.g.,* 30 U.S.C. § 184a (providing that state lands may be joined with federal lands under agreements approved by the Secretary of the Interior for the purpose of more properly conserving the oil and gas resources within such state). However, the State's role expands or contracts under principles of Federalism depending on the nature and amounts of fee or State lands involved. *See id.* (noting that nothing in such agreements with the states shall be construed as in any respect waiving, determining or affecting any right, title or interest, which otherwise may exist in the United States or affect title of ownership).

[1] For Colorado, *see* COGCC Rule 507(b)(2); *Garman v. Conoco, Inc.,* 886 P.2d 652 (Colo. 1994). For Oklahoma, *see* OCC Rule 165:5-7012(d)(3); *O'Neill v. American Quasar Petroleum Co.,* 617 P.2d 181 (Okla. 1980).

Consequently, federal regulatory schemes maintain priority over state regulations when federal interests are involved, as is observed for example when the Division recognizes that a party owns 100% of all the federal interests in a spacing unit comprised solely of federal land, and therefore is willing to rely on the federal communitization agreement for pooling the interests without state participation. On the other hand, the role of the Division properly expands when fee lands and state lands are included in a spacing unit along with federal lands. *See, e.g.*, 43 CFR § 3105.2-2 (stating that when federal land cannot be developed independently within a spacing unit, the authorized officer may approve communitization or drilling agreements for such lands with other lands, whether or not owned by the U.S.).

CONCLUSION

In the subject Cases, Devon fully satisfied the notice requirements for all necessary parties subject to a Federal Communitization Agreement for the pooling of federal interests, which are limited to Working Interest owners and Lessees of record. *See* 43 CFR Sec. 3105.2-3; *see also* Angela L. Franklin, *Communization Agreements in the 21st Century*, Federal Onshore Oil and Gas Pooling and Communitization, 3-4 (Rocky Mt. Min. L. Fdn. 2006). Further, the BLM will approve the Communitization Agreement without joinder by royalty and ORRI owners, which are both considered unnecessary. *See id.*

Therefore, given the specific facts of the subject cases and the legal analysis provided herein, Devon respectfully asks the Division to consider that Devon successfully fulfilled the notice requirements pursuant to the federal statutes for the necessary parties involved, and fulfilled the notice requirements specified at the state level under 19.15.4.12A(a)(1) NMAC. Accordingly, Devon respectfully requests that the Division not dismiss Case Nos. 20962 and 20963 for lack of

timely notice, but allow the cases to move forward procedurally toward full consideration of the Applicant's request for the proper pooling and spacing of the proposed units.

Devon recognizes that the Division may be reluctant to alter current customs of practice without time for public input and comment. If this is the case, then Devon alternatively requests that the Division allow Devon to continue Case Nos. 20962 and 20963 to the January 23, 2020, docket in order to satisfy any concerns regarding publication. Devon appreciates the opportunity to provide this legal analysis on what it considers to be important matters in the conservation of a valuable resource.

Respectfully submitted,

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CERTIFICATE OF SERVICE

I hereby certify that a true and correct copy of the foregoing was filed with the New Mexico Oil Conservation Division and was served on counsel of record via electronic mail on December 16, 2019:

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