JALAPENO CORPORATION
P. O. BOX 1608
ALBUQUERQUE, NM 87103
PHONE (505)242-2050, FAX (505)242-8501

FACSIMILE TRANSMITTAL SHEET

TO: FLORENE DAVIDSON
FROM: HARVEY E. YATES, JR.
COMPANY: NM OCD
DATE: 10/6/2011
FAX NUMBER: (505) 476-3462
NUMBER OF PAGES INCLUDING COVER: 5
PHONE NUMBER: (505) 476-3458
SENDER'S REFERENCE NUMBER:
RE: NM OCC Case No. 14744
YOUR REFERENCE NUMBER:

☐ URGENT ☐ FOR REVIEW ☐ PLEASE COMMENT ☐ PLEASE REPLY ☐ PLEASE RECYCLE

NOTES/COMMENTS:

PLEASE FILE NOTICE OF RECOMMENDED MODIFICATIONS BY JALAPENO CORPORATION IN NM OCC Case No. 14744

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

APPLICATION OF THE NEW MEXICO OIL CONSERVATION DIVISION FOR THE AMENDMENTS OF 19.15.14.8 AND 19.15.16 NMAC.

CASE NO. 14744

NOTICE OF RECOMMENDED MODIFICATIONS by JALAPENO CORPORATION

In considering the rule changes requested by the Division for the purpose of facilitating horizontal drilling in the state, it is also necessary to consider both the initial purpose of the compulsory pooling rules in the state as well as the use made of those rules by some operators in recent years.

At the oil industry's origin in this country a person generally was allowed to drill and produce a well on his land regardless of the size of his land parcel. Thus, there developed fields where rigs and pump jacks sprouted out of the ground separated often by a mere acre of land.

After consideration it was decided that this circumstance was leading to a waste of resources because one well often could remove the oil which several wells had been drilled to produce.

Hence several states applied spacing rule requirements - for instance in New Mexico: 40 acres for a shallow oil well and 160 acres of land for a shallow gas well. (The spacing unit sizes usually increased by increments for deeper wells.) Consequently, states essentially denied a landowner's the right to drill a well on his land unless he was able to gain consent for the drilling from parties owning sufficient acreage to constitute the required spacing unit.

Some potential drillers complained that the spacing unit requirement, coupled with the fact that there existed recalcitrant adjoining land owners, were keeping them from developing possible reserves under their acreage. Some states resolved this problem - which had been created by state regulations requiring spacing units - by instituting compulsory pooling rules. Other states did not pass such rules and left such matters to be resolved by negotiations between the parties.

It is sometimes suggested that the capacity to adequately explore and produce in New Mexico is tied to the existence or expansion of the compulsory pooling rule. In that regard the Commission would do well to compare the exploration and production record of states such as Texas, which did not adopt compulsory pooling rules, with the exploration and production record of New Mexico, where such a rule was adopted. To

assist the Commission in comparing production trends of the two states, we attach a graph which compares the gas production trend in the State of Texas with gas production trend of the State of New Mexico for the years 2001 through the present. The State of Texas does not seem to have been comparatively hindered by the lack of a compulsory pooling rule.

The compulsory pooling rule was intended to resolve a problem created by an earlier, or simultaneously imposed, government rule. It was never intended to put the state in the position of being a facilitator of the taking of the property of one person by another person. Yet, over time the compulsory pooling rules of the State of New Mexico have verged on doing just that.

We fear that the application of the compulsory rules beyond spacing units into "project areas" does just that. The use of compulsory pooling rules should be limited to a spacing unit. If a horizontal driller wishes to extend his borehole beyond a spacing unit, he should be required to negotiate with, rather than force-pool, adjoining landowners. Hence as to the Division's suggested change at 19.15.16.15 A. (2) "***obtain a compulsory pooling order from the division,***" we request that the following be added: "***which shall not be available outside a single spacing unit which would be required for a vertical well drilled to the intended productive horizon at the same location.***"

We note that the compulsory pooling orders of the Division have allowed horizontal drilling into acreage covered by an existing Operating Agreement under which existing vertical wells are producing from the zone targeted by the horizontal well. We also note that compulsory pooling orders of the Division have allowed horizontal drilling into acreage covered by an existing Operating Agreement where the targeted horizontal zone contains "behind the pipe reserves" owned the parties to the Operating Agreement. We also note that the parties to the Operating Agreements specified above may have mortgaged to a bank both the producing reserves and the "behind the pipe" reserves. Such action by the Division ultimately will diminish the capacity of producers to gain financing in the State of New Mexico and thus inhibit, rather than promote, drilling. Further, such action by the Division essentially facilitates the taking by a horizontal driller of private property owned by another person or persons. This should be prohibited.

Hence, as to the Division's suggested change at 19.15.16.15 G. (4) we request that the following language be added, "***Nor may a project area be extended to include acreage dedicated to an existing Operating Agreement without the consent of that portion of parties to the Operating Agreement which is required under the Operating Agreement to change the terms of the Operating Agreement.***"

When compulsory pooling rules were instituted to remedy the problem caused by the spacing unit requirement, it was recognized that potentially the property of one party would be taken by another party. The rules sought to balance this by requiring a reversion of interest after the driller received his money back for the drilling plus compensation for taking the geologic risk. In New Mexico this compensation for taking

the risk originally was set at 100% for development wells, where there was thought to be less risk, and 200% for wildcat wells. An examination of the record of the Division in recent years indicates that the Division almost always has given a 200% compensation for risk. This is unfortunate. The extent to which the Division over-compensates the driller for risk, the Division takes from the person who is force pooled and gives to the driller what should not be his.

We note that horizontal wells usually are drilled into zones which have been penetrated by a number of wells. This has been the case because horizontal wells often target "source rock," such as shale. which often lies above earlier targeted porosity zones. The fact that numerous wells earlier have penetrated the zone targeted by the horizontal well means that the geologic risk being taken by the horizontal driller often is much less than the risk taken by a wildcat driller. Consequently, the reward for taking the risk should be adjusted downward where there have been a number of earlier holes which have penetrated the targeted zone.

Consequently, at 19.15.16.15 F. Compulsory pooling, we request that the following language be added: "***During a Compulsory pooling hearing involving a horizontal well the Division is instructed to examine closely the actual geologic risk being taken by the driller considering earlier penetrations of the zone being targeted by the driller in the area in which the driller proposes to drill and to reduce the compensation to the driller for risk taken to 50% where that more closely rewards the driller for the anticipated geologic risk of the endeavor.***"

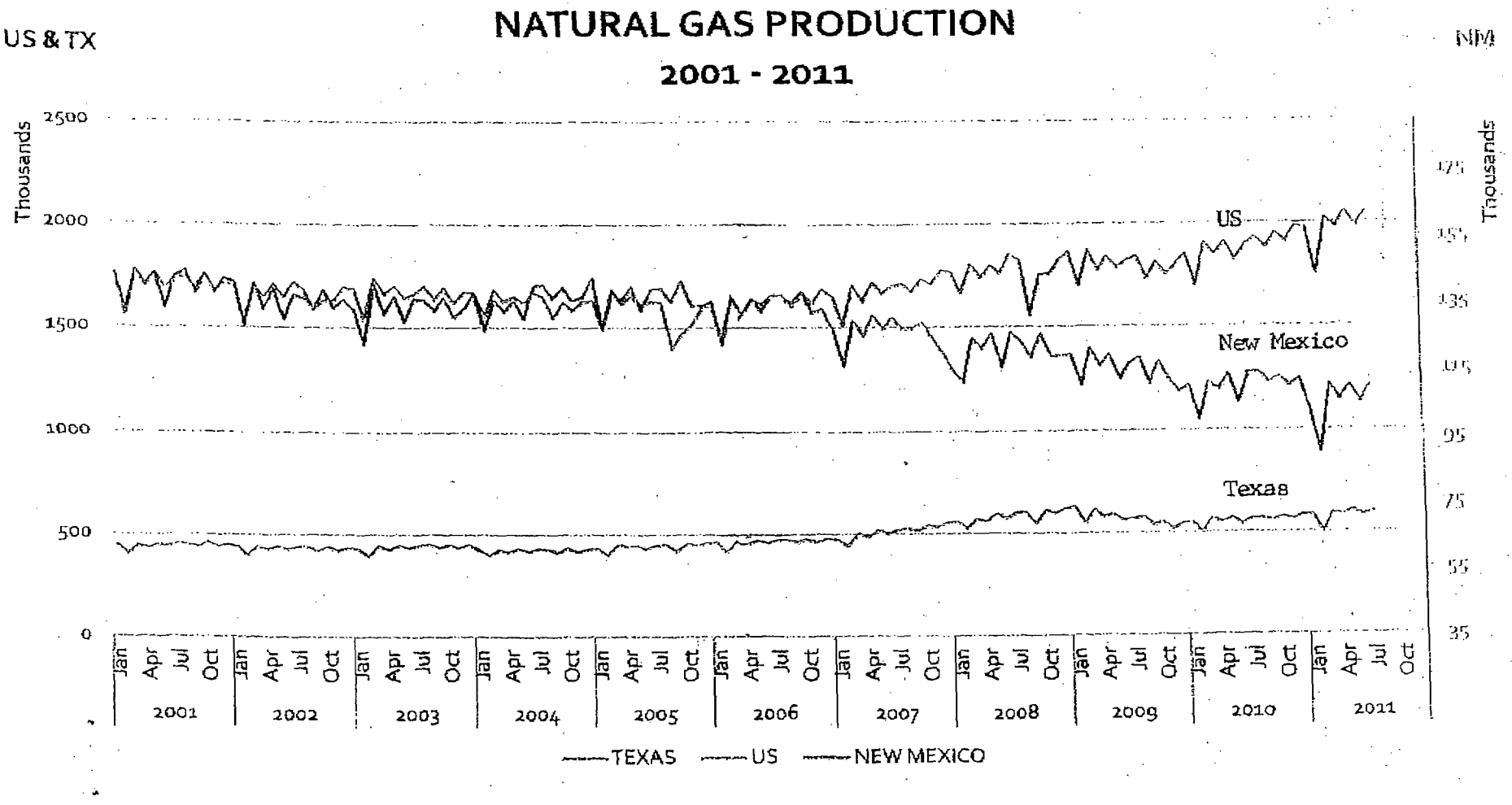
We request an opportunity to comment and present testimony at any hearing related to this matter.

Respectfully submitted,

Harvey E. Yates Jr.
For Jalapeno Corporation
P.O. Box 1608
Albuquerque, NM 87103
505-242-2050

Production

NATURAL GAS PRODUCTION
2001 - 2011



Source: US Energy Information Administration - Data as of July 2011.