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:

APPLICATION OF THE NEW MEXICO OIL CONSERVATION DIVISION THROUGH THE ENGINEERING BUREAU CHIEF FOR ADOPTION OF A NEW RULE RELATING TO COMPULSORY POOLING AND PRESCRIBING RISK CHARGES

CASE NO. 13069
ORDER NO. R-11992

ORDER OF THE OIL CONSERVATION COMMISSION

BY THE COMMISSION:

THIS MATTER came before the Oil Conservation Commission (hereinafter referred to as "the Commission") for evidentiary hearing on May 15 and June 12, 2003 at Santa Fe, New Mexico on application of the Oil Conservation Division (hereinafter referred to as "the Division"), *de novo,* and the Commission, having carefully considered the evidence, the pleadings and other materials submitted by the parties hereto, now, on this 17th day of July, 2003,

FINDS,

1. Notice has been given of the application and the hearing of this matter, and the Commission has jurisdiction of the parties and the subject matter herein. In this rule making proceeding, the Division has applied for adoption of a new rule concerning compulsory pooling pursuant to NMSA 1978 Sections 70-2-17 and 70-2-18, as amended, prescribing the risk charges to be applied by the Division in such cases, and defining the "costs of drilling and completing" to which such charges apply.

2. To assist in formulating the proposed rule, the Division formed a work group composed of industry representatives, including representatives of the New Mexico Oil and Gas Association and the Independent Petroleum Association of New Mexico, which produced a draft that represents the consensus of its members on most issues. Those points on which consensus was not achieved were presented to the Commission.

3. NMSA 1978 Section 70-2-17, as amended, confers on the Division the power to order pooling of the lands constituting a spacing or proration unit for oil and gas

development where the 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.

4. The same statute further provides that the Division may provide in orders for compulsory pooling that the party or parties drilling a well may recover out of the share of production that would otherwise accrue to owners who do not join in the drilling certain costs, which:

> may include a charge for the risk involved in the drilling of such well, which charge for risk shall not exceed two hundred percent of the nonconsenting working interest owner's or owners' prorata share of the cost of drilling and completing the well.

5. Heretofore, the Division has determined the amount of the charge for risk authorized by Section 70-2-17 ("risk charge") on a case-by-case basis, separately in each compulsory pooling case.

6. The Division now proposes the adoption of a new Rule 35 to make general provision for the amount (not to exceed 200%) of the risk charge to be assessed, to define more precisely the "cost of drilling and completing the well" by which the risk charge percentage is multiplied to determine the actual amount of risk charge that may be recovered in a particular case, and to provide a procedure for assessing the risk charge by order in exceptional cases where the risk charge provided in the rule may not be appropriate.

7. At the hearing, the Division appeared by attorney and presented evidence. Burlington Resources Oil and Gas Company, LP, appeared by attorney and corporate representatives and presented evidence. BP America Production Company, Yates Petroleum Corporation, the New Mexico Oil and Gas Association, XTO Energy, Inc., Texakoma Oil and Gas Corporation, Pogo Producing Company and Mewbourne Oil Company appeared by attorney and presented statements that were made part of the record.

8. The Division presented the testimony of Michael E. Stogner, a petroleum engineer and hearing officer employed by the Division.

9. Mr. Stogner testified that compulsory pooling hearings constitute a large part of the Division's hearing docket and that eliminating the portion of each hearing dealing with the factors to be considered in assessing the risk charge would significantly reduce the length of compulsory pooling hearings, would obviate the necessity, in most cases, of the operators bringing expert geologic or engineering witnesses to the hearings, and would significantly reduce the costs associated with such hearings both for the Division and the parties.

10. Mr. Stogner pointed out that the New Mexico Oil and Gas Act (NMSA 1978 Section 70-2-17, as amended) provides that the risk charge shall not exceed 200 percent, but may be less, and indeed could be zero.

11. Mr. Stogner testified that the Division, over years of hearing such cases, has developed guidelines for determining the amount of risk charges to be assessed in particular classes of cases. Specifically, he testified that in the **Basin-Fruitland** Coal Gas Pool in the San Juan Basin, the Division ordinarily fixes the risk charge at 156%. In cases, wherever arising, where there is an existing well bore to the primary zone of interest, whether it is a plugged well proposed for reentry, an existing well proposed for recompletion in the primary zone of interest, or a new well that the applicant has drilled prior to seeking compulsory pooling, the Division ordinarily fixes the risk charge at 100%. In all other cases, the Division ordinarily fixes the risk charge at the statutory maximum of 200%.

12. Mr. Stogner testified that for at least the last fifteen years, the Division has followed these guidelines with substantial consistency.

13. Mr. Stogner testified that the "156% rule" applied in cases involving the Basin-Fruitland Coal Gas Pool was first applied in Order No. R-8818, entered in Case No. 9537, a case wherein he was the hearing examiner, and was based on his recommendation. He discounted the risk from the statutory maximum of 200% by allocating the maximum risk charge of 200% in equal parts to geologic risk, reservoir risk and operations risk and assigning a 66% factor to each type of risk. He then relied upon testimony presented in that case and in Case No. 9420, wherein the Basin-Fruitland Coal Gas Pool was designated, to the effect that the Fruitland Coal formation was present throughout the Basin-Fruitland Coal Gas Pool to conclude that the 66% factor assessed for geologic risk should be discounted by at least two-thirds. Subtracting two-thirds of 66% (or 44%) from the statutory maximum of 200%, Mr. Stogner concluded that the applicable risk charge should be 156%. He recommended that percentage, which was accepted by the Director of the Division in that case and in numerous subsequent cases involving the Fruitland Coal.

14. Mr. Stogner pointed out that the Commission, in Order No. R-11301-B, entered in Case No. 12299 on July 21, 2000 found that because of reduced risk typical of drilling in the Fruitland Coal, the 156% risk penalty in such cases was appropriate.

15. Mr. Stogner testified that the "100% rule" applied by the Division in cases where there was an existing well bore was formulated by the examiners and former Division Director, William Lemay, in about 1988, and reflected the fact that, if a well bore existed, the operator knew that the well bore intersected the formation of interest and, in most cases, knew something about the characteristics exhibited by the formation in that well bore, and accordingly its risk would be much less than the risk in drilling a new well. He further explained that if the operator has already drilled a new well prior to seeking a compulsory pooling order, that fact evidences that it was willing to assume that risk regardless of whether the pooled owners participated or not.

16. Mr. Stogner testified regarding the difference between "costs of operation," which, under NMSA 1978 Section 70-2-17, as amended, the drilling parties are to recover on a dollar-for-dollar basis, and "cost of drilling and completing," to which the Division may apply a risk charge. He testified that these concepts are generally well understood in the industry, but that there may be questions about the appropriate categorization of specific expenses. He testified that all of the expenses defined as well costs in proposed Rule 35, except some types of "work over" costs, were properly classified as "costs of drilling and completing." He testified that some work over costs, such as cleaning out a well, might be more properly treated as costs of operation, as to which the statute does not authorize a risk charge.

17. Mr. Stogner testified that the proposed rule generally would not allow a drilling party who re-entered an existing well to recover from the non-participating parties the historical cost of drilling that well, or a risk charge based thereon, and that, in that respect the proposed rule would codify existing Division practice.

18. Mr. Stogner testified that the provision of the rule allowing recovery of a risk penalty based on costs of reworking, diverting, deepening, plugging back or recompleting a well subsequent to initial completion addressed a situation not heretofore addressed by the Division in compulsory pooling orders, but that the costs described in that provision of the proposed rule, with the exception of some types of work over expense, would properly be classified as "costs of drilling and completing the well," upon which a risk charge is authorized by statute.

19. Mr. Stogner explained the provision of the proposed rule defining well costs as including the cost of a substitute well in the event of the operator's inability to drill the initial well to the proposed depth, and testified that the proposed provision addressed a problem occasionally encountered in the industry. He further testified that the provision of the proposed rule allowing recovery of such costs, and of a risk penalty thereon, as a consequence of the original order would prevent economic waste by allowing the operator in that situation to proceed with the drilling of the substitute well with the same rig, which would not be practicable if a supplemental application to the Division were necessary.

20. Finally, Mr. Stogner testified that the provision of subsection B of the proposed Rule 35 for exceptions to the risk charge provisions of the rule in particular cases would afford the Division necessary flexibility in addressing unusual circumstances that might render the risk charges provided in the rule inappropriate, while still preserving the efficiency and cost-saving advantages associated with establishment of such charges by rule.

21. The Division also presented the testimony of Randy G. Patterson, a petroleum landman and Land Manager for Yates Petroleum Corporation.

22. Mr. Patterson testified that he was a member of the industry workgroup that was instrumental in developing proposed Rule 35, and he described the membership and activities of the workgroup. Mr. Patterson testified that the workgroup reached a consensus of agreement with the basic concept of the proposed rule - prescribing risk charges by rule, rather than case-by-case, and with all of the provisions of the proposed rule except the provisions that would incorporate the "156% rule" for assessing risk charges in the Basin-Fruitland Coal and the "100% rule" for assessing risk charges in cases of an existing well bore. He testified specifically that all members of the workgroup except the Division representative concurred that the "100% rule" should not be included in the proposed rule, and that provision should be made for a maximum, 200% risk charge in such cases.

23. Mr. Patterson testified that the workgroup unanimously agreed that, as provided in the proposed rule, but in contra-distinction to existing Division practice, a 200% risk charge should be applied in cases involving re-entry of a plugged and abandoned well. He identified risk factors, such as junk in the hole, deteriorated casing and reliance on information derived from out-dated technology that could make re-entry of a plugged well more risky than other recompletion operations.

24. In support of application of a 200% risk charge in all re-entry situations, Mr. Patterson explained that the costs associated with a re-entry operation would be substantially less than those associated with drilling a new well so that the actual dollar amount of the risk charge in such cases would be much less even if the same 200% factor were applied.

25. In support of the application of a 200% risk charge in all existing well bore situations, Mr. Patterson testified that:

a. the fact that a well exists, or that the applicant has drilled to the objective formation before the hearing, actually benefits the pooled party, in that the pooled party gets to make its election at a time when it possesses substantially more information to assess risk than it would have had if the well had not already been drilled;

b. the necessity for the applicant to bring its application to hearing prior to drilling increases the cost of hearings to the applicant, since otherwise it could achieve efficiency in use of its resources by deferring the hearing to a time when it was presenting other cases;

c. 200% is not a high-risk allowance in light of current industry conditions and current industry practice;

d. reduction of the risk charge when a well has been drilled prior to the hearing encourages delaying tactics on the part of responding parties; and

e. the industry and workgroup consensus supports a 200% risk charge in such situations.

26. Mr. Patterson testified that the general definition of "well costs" set forth in the first sentence of the definition in the proposed rule is essentially identical to the definition found in forms of operating agreements generally used in the industry.

27. Mr. Patterson explained the sentence of the proposed rule dealing with costs of reworking, diverting, deepening, plugging back or recompleting a well subsequent to completion but prior to payout of the original drilling and completion costs and risk charge. Mr. Patterson testified that the rule treats those costs as additional drilling and completion costs that can be recovered out of a non-participating party's share of production, and to which the risk charge applies. Mr. Patterson testified that the proposed rule treats such costs, as to a non-participating party, in the same manner as they are treated in agreements customary in the industry. Mr. Patterson further explained that any of the subsequent operations to which this sentence of the proposed rule would apply a risk charge involve elements of risk to the operator, such as mechanical risk (possible damage to the hole during the operation) and geologic risks, such as reliance on a log misinterpretation.

28. Mr. Patterson testified, in contra-distinction to the testimony of Mr. Stogner, that all expenses properly classified as "work over" expenses involve risks similar to risks associated with "drilling and completion," and could properly be deemed to be "costs of drilling and completion," in accordance with industry understanding of those terms.

29. Finally, Mr. Patterson testified that the provision for inclusion in "well costs" of the cost of a substitute well in the circumstances provided in the proposed rule was analogous to provisions frequently encountered in agreements negotiated in the industry.

30. Burlington Resources Oil and Gas Company, LP ("Burlington") presented the testimony of Jim Schlabaugh, a reservoir engineer and Steven M. Thibodeaux, a geologist, both of whom described their extensive experience working with the Basin-Fruitland Coal Gas Pool.

31. Mr. Schlabaugh testified that:

(a) the actual experience of Burlington and other operators with operations in the **Fruitland** Coal formation and in other formations in the San Juan Basin indicated that drilling in the Fruitland Coal formation is not significantly less risky, in that the overall probability of drilling a non-economic well is similar to, or perhaps greater than, the probability of drilling a non-economic well in other formations in the Basin;

(b) even if the Fruitland Coal formation is encountered in a well, there is a significant risk that low permeability will make effective production impossible, thereby causing the well to be a dry hole; and

(c) in 1989 when the Division developed the "156% rule", most of the Fruitland Coal development was in the "high productivity area" where rewards are greater and risks lower, whereas now experience in the low productivity area has established that risks, pool-wide, are not lower than in other formations.

32. Mr. Thibodeaux testified that:

(a) he has worked all of the principal producing formations in the San Juan Basin and believes that the Fruitland Coal is the most complex;

(b) finding the coal in a particular well does not constitute finding a reservoir because without permeability, cleating or fracturing, you have no reservoir and no producible resource; hence the risk charge should not be discounted because of the probability of finding the coal;

(c) there is no effective means, prior to drilling a well, to forecast the degree of cleating and fracturing that will exist in the coal at any given location, and the productive potential of a well is dependent on the existence of cleating and fracturing;

(d) due to differences in depositional environment over time, the Fruitland Coal exhibits an extreme degree of discontinuity and heterogeneity, both within each of the nine coal packages that can be identified across the Basin, and among individual coal seams within those packages; and

(e) these discontinuities and lateral heterogeneity events are difficult to map, or see on logs, making it difficult to predict the performance of a new well based on offset well behavior.

33. Both Mr. Schlabaugh and Mr. Thibodeaux testified that, in their opinion, drilling in the Fruitland Coal is not significantly less risky than in other formations in the San Juan Basin, and that accordingly the Division should apply the maximum 200% risk charge in the Basin-Fruitland Coal Gas Pool as it does in other formations.

34. Mr. James Bruce, attorney, stated, on behalf of XTO Energy, Inc. and Texakmoa Oil and Gas Corporation, operators active in the San Juan Basin, that those companies support application of a 200% risk charge in the Basin-Fruitland Coal Gas Pool.

35. Mr. Bruce also stated, on behalf of Pogo Producing Company and Mewbourne Oil Company, that those companies support application of a 200% risk charge for recompletions and re-entries.

36. Mr. William Carr, attorney, on behalf of the New Mexico Oil and Gas Association ("NMOGA"), stated that NMOGA supports the effort of the Commission to adopt compulsory pooling rules, and agrees that the presentation of technical evidence in support of the risk charge in each and every case is unnecessary. However, the NMOGA advocates the adoption of a 200% risk charge across-the-board in lieu of the schedule of risk charges in the Division's proposed rule.

37. The evidence demonstrates that decisions regarding the risk charge to be assessed are appropriately made in accordance with more or less uniform guidelines that apply to broad categories of cases, and that the specific technical testimony in particular cases has played a relatively limited role in the decision-making process. Accordingly, the adoption of risk charges by rule, with provision for exceptions in particular cases where a party seeks an exception and offers sufficient supporting evidence, is an appropriate approach, and such a rule should be adopted.

38. The evidence demonstrates that the maximum 200% risk charge is appropriate in the vast majority of cases, is actually being assessed by the Division in the vast majority of cases, and is equal to or less than the risk charge factors customarily provided in voluntary agreements negotiated between active industry participants. Accordingly the maximum 200% risk charge should be provided by rule except in cases where a specific reason exists to provide a lesser charge.

39. The evidence presented by Burlington in this case demonstrates that exploration in the Basin-Fruitland Coal Gas Pool is not significantly less risky on an overall basis than is exploration in other pools in the San Juan Basin to which the Division is now applying a 200% risk charge. Accordingly, the rule to be adopted should not provide for a distinction for the Basin-Fruitland Coal Gas Pool, but should provide for the application of the maximum 200% risk charge to wells in that pool, absent a basis for an exception, in the same manner as in other pools.

40. Because re-entry and recompletion operations do involve risk, and there is insufficient evidence that such operations are inherently less risky than drilling, the maximum 200% risk charge should ordinarily be applied to such operations.

41. An applicant who has drilled a new well prior to applying for compulsory pooling has assumed a risk no less than would have been the case had drilling been deferred until after entry of a pooling order, but instead has incurred, in addition to the economic risks otherwise associated with the operation, the legal risk that the Division may deny or limit its risk charge recovery.

42. In such cases, it is not the applicant but the pooled party whose risk is reduced due to the opportunity afforded to the pooled party by statute to participate on a heads up basis, without any risk charge, by electing to advance its costs of drilling after the pooling order is entered, based on information developed by the drilling and not

known to the applicant at the time the decision to drill is made. Accordingly, the maximum 200% risk charge should ordinarily be applied in such cases.

43. Although cases may occur in which the applicant has drilled prior to presenting a compulsory pooling case to the Division in order to preempt a potential rival applicant's development plans, or has otherwise delayed filing of an application in a manner that operates to the prejudice of the pooled parties, such cases will depend on their particular facts, and will be most appropriately handled by the exception process provided in the proposed rule.

44. The definition of "well costs" set forth in the proposed rule is in accordance with accepted industry understanding, is very similar to the definitions provided in operating agreements in general use in the industry where there is voluntary agreement between parties, and should be adopted.

45. Specifically, though the term "work over" is a very general term that applies to a variety of very different operations, there is a general understanding in the industry that costs associated with a work over are capital costs more closely related to "costs of drilling and completion" than to "costs of operation," as reflected by the inclusion of work over costs in the general listing of drilling and completion costs in forms of operating agreements in general use in the industry.

45. The concept of a "well bore election," whereby a party who elects not to participate in the drilling of a well does not have an opportunity to participate in subsequent development operations, such as recompletions, of that well, and the cost of such subsequent operations, together with a risk charge, is added to the amount to be recovered by the participating parties out of the non-participating parties' share of revenues, is well understood in the industry, is similar to provisions in operating agreements in general use in the industry where there is voluntary agreement between parties, and should be adopted.

46. Because the Commission cannot foresee all of the factors that might influence the appropriate level of risk charge for every compulsory pooling case that might arise, provision should be made for the Division to assess different risk charges in particular cases after notice and hearing.

47. Rule 35 as set forth in Exhibit A hereto (which Exhibit is incorporated herein by this reference for all purposes) contains the provisions specified above, together with necessary and suitable ancillary provisions, and should be adopted.

IT IS THEREFORE ORDERED THAT:

1. A new rule of the Oil Conservation Commission, to be codified at 19.15.1.35 NMAC (or elsewhere if necessary to meet requirements of the Commission of Public Records), copy attached as Exhibit A, is hereby adopted, effective as of the date of

its publication in the New Mexico Register. Staff is instructed to forthwith seek publication of the new rule in its entirety in the Register.

2. Jurisdiction of this matter is retained for entry of such further orders as may be 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

SEAL

Case No. 13069

Exhibit A to Order No. R-11992

Rule 35. COMPULSORY POOLING. CHARGE FOR RISK

A. General Rule. Compulsory pooling orders entered by the Division pursuant to NMSA 1978 Section 70-2-17, as amended, may provide for the recovery, out of the share of production allocable to the working interest of any party that elects not to pay its proportionate share of well costs in advance, in addition to reasonable well costs and costs of supervision and management, of a charge for risk associated with the drilling, completion, or working over and recompletion of each unit well for which provision is made in the order. Unless otherwise ordered pursuant to subsection B of this section, the charge for risk shall be 200% of well costs.

"Well costs" shall mean all reasonable costs of drilling, reworking, diverting, deepening, plugging back and testing the well; completing the well in any formation pooled by the order; and equipping the well for production. If, however, any well was previously completed in another formation or bottom-hole location, or was previously abandoned without completion, well costs as to such well shall mean only the reasonable costs of re-entering, reworking, diverting, deepening, plugging back or testing the well; completion in the pooled formation or formations and; if necessary, reequipping the well for production, unless the Division determines that allowance of all or some portion of historical costs of drilling is just and reasonable due to particular circumstances. If a well is completed in two or more formations having diverse ownership or a different risk charge percentage, the order shall provide for allocation of well costs between the formations. As to any interest owner who elects not to pay its share of well costs associated with a specific well in advance, as provided in the applicable order, "well costs" shall include costs of any subsequent operation undertaken to secure or enhance production from any formation pooled by the order prior to the time that the entire amount of such non-consenting owner's share of well costs and applicable risk charge have been recovered from such non-consenting owner's share of production from such well. Such costs shall include expenses for reworking, diverting, deepening, plugging back, testing, completion or recompletion and equipping for production, but not ordinary operating expenses

Well costs shall also include reasonable costs of drilling, testing, completing, and equipping a substitute well if, in the drilling of a well pursuant to a compulsory pooling order, the operator loses the hole or encounters mechanical difficulties rendering it impracticable to drill to the objective depth, and the substitute well is located within 330 feet of the original well and drilling thereof is commenced within ten (10) days of the abandonment of the original well.

An applicant for compulsory pooling shall not be required to present technical evidence justifying the risk charge provided in this subsection.

B. Exceptions.

Any person responding to a compulsory pooling application who seeks a different risk charge than that provided in subsection A shall so state in a timely pre-hearing statement filed with the division and served on the applicant in accordance with 19.15.N.1208.B NMAC, and shall have the burden to prove the justification for the risk charge sought by relevant geologic or technical evidence. The hearing officer shall have discretion to allow a responding party who has not filed a pre-hearing statement, but who appears in person or by attorney at the hearing, to offer evidence in support of a different risk charge than that provided in subsection A, but in such cases a continuance of the hearing shall be allowed, if requested, to enable the applicant to present rebuttal evidence.