

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:

ORIGINAL

APPLICATION OF MATADOR PRODUCTION
COMPANY FOR A NONSTANDARD OIL SPACING
AND PRORATION UNIT AND COMPULSORY
POOLING, LEA COUNTY, NEW MEXICO.

CASE NO. 15363
(De Novo)

REPORTER'S TRANSCRIPT OF PROCEEDINGS

COMMISSION HEARING

October 17, 2016

Santa Fe, New Mexico

BEFORE: DAVID R. CATANACH, CHAIRMAN
PATRICK PADILLA, COMMISSIONER
DR. ROBERT S. BALCH, COMMISSIONER
BILL BRANCARD, ESQ.
CHERYL BADA, ESQ.

This matter came on for hearing before the
New Mexico Oil Conservation Commission on Monday,
October 17, 2016, at the New Mexico Energy, Minerals and
Natural Resources Department, Wendell Chino Building,
1220 South St. Francis Drive, Porter Hall, Room 102,
Santa Fe, New Mexico.

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1 (10:03 a.m.)

2 CHAIRMAN CATANACH: Also on today's agenda
3 is Case Number 15363. We heard the first part of this
4 case, I believe, on September 6th, 2016, and we
5 continued the hearing to this date because we have not
6 gotten through all the witnesses in that case. So at
7 this time hopefully we can conclude with the proceedings
8 in this case.

9 At this time I'll call for appearances.

10 MR. BRUCE: Mr. Examiner, Jim Bruce of
11 Santa Fe appearing for Applicant, and in association
12 with Dana Arnold, in-house attorney for Matador.

13 MR. GALLEGOS: Mr. Chairman, Members of the
14 Commission, Gene Gallegos appearing for Intervenor,
15 Jalapeno Corporation.

16 MR. BROOKS: Mr. Chairman, Honorable
17 Commissioners, David Brooks representing the Energy,
18 Minerals and Natural Resources -- I'm sorry -- assistant
19 general counsel for the Energy, Minerals and Natural
20 Resources, here representing the New Mexico Oil
21 Conservation Division.

22 CHAIRMAN CATANACH: Do I have any other
23 appearances?

24 And I believe we have two more witnesses on
25 your behalf?

1 MR. GALLEGOS: We do, Mr. Chairman, yes.

2 CHAIRMAN CATANACH: Okay. And, Mr. Bruce,
3 do you have any witnesses today?

4 MR. BRUCE: We may present some rebuttal
5 witness or witnesses.

6 CHAIRMAN CATANACH: Let's go ahead and
7 swear the witnesses in at this time, if you would,
8 please.

9 (Witnesses sworn.)

10 CHAIRMAN CATANACH: So before we start, we
11 have one issue to -- one order of business to take care
12 of before we start the actual case. This involves the
13 submission of some exhibits by Jalapeno on October 13th,
14 and I believe we also have an objection to that
15 submittal.

16 MR. BRUCE: That's correct, sir.

17 CHAIRMAN CATANACH: Can we hear very brief
18 arguments on this matter?

19 MR. BRUCE: I will be very brief. My
20 motion's only one page long.

21 It is Matador's point that the Division --
22 or Commission procedure requires filing of exhibits a
23 week ahead of time. We didn't get them but one day
24 before the hearing. So it's not only procedurally
25 incorrect, but it's unfair. I mention in my motion that

1 they had 33 days from the last hearing to timely file --
2 that Jalapeno had 33 days from the last hearing to
3 timely file them. And, frankly, they've had one-plus
4 years to prepare these exhibits, and they dropped them
5 on us one day before the hearing. And I think that's
6 patently unfair, and they should be excluded.

7 MR. GALLEGOS: Mr. Chairman, I think we all
8 know the importance of this proceeding beyond just this
9 case, so I think as complete and informative a record as
10 possible is important to have here. So I think this is
11 a matter of discretion, and the Chair can exclude
12 exhibits, and can allow Matador, I suppose, a
13 continuance, if they seek one.

14 But let me point out what we have here
15 because we're really talking about four exhibits. And
16 we had an Exhibit 5 originally, which was a sample of
17 nine wells. And what we've done in the interim -- and I
18 can't hurry up engineers, unfortunately, trying to get
19 them to get something done. I apologize about that.
20 But basically what we've done is had the engineers --
21 instead of just taking a sample of nine wells, really
22 let's have the whole picture.

23 So what 5A and 5B do is say, Here are all
24 the wells. Here's all this four township. Here are all
25 the Bone Spring wells. Here are all the Wolfcamp wells.

1 Instead of saying, Here's a sample and take from a
2 sample, we think it's more important that you have the
3 full picture. I thought that was important. And the
4 engineer, with his Exhibit 7, takes that information
5 and, from it, constructs what's called a probability
6 curve. It says, If you take the Bone Spring wells,
7 here's your probability, and you take your Wolfcamp
8 wells, here's the probability.

9 I don't think there is anything in there
10 that'll be any mystery to Mr. Bruce as far as being able
11 to cross-examine or his witnesses being able to address,
12 but I think it makes a much more complete record, as I
13 say, because of the importance of this proceeding.

14 We had additional -- you know, basically
15 that's -- that's three -- two more exhibits. We had an
16 Exhibit 6 that was economic cases. It really was sort
17 of confusing, and we think 6A is a better, more
18 understandable presentation of that information. So
19 that's the additional exhibit.

20 And none of this is anything different,
21 anything, in the sense, new. It's taking the same
22 information we're all dealing with and trying to present
23 it in a more complete and better way.

24 I do have an Exhibit 22, which will not be
25 through a witness. I'm going to ask the Commission just

1 to take administrative notice of some cases, which I
2 think it is discretion. You can do that at any time.

3 So we would ask that we be permitted to
4 introduce these exhibits, and they be presented with our
5 engineer witness.

6 CHAIRMAN CATANACH: So as I understand it,
7 Mr. Gallegos, this is not anything new? This was
8 previously presented as evidence, just recompiled or
9 re- --

10 MR. GALLEGOS: Well, we've added -- for
11 example, under Exhibit 5, what the engineer has done is
12 taken three high wells, three intermediate wells and
13 three low wells as a sample and said, you know, Instead
14 of a sample, let's give the Commission -- let's give the
15 record all of the wells, all of the Bone Spring wells,
16 all of the -- all of the Wolfcamp wells. Let's don't do
17 a sample thing. So we've got -- presented all of that
18 in Exhibit 6A and 6B. And then he just takes that
19 information and he just says, When you lay that out on a
20 curve theory, here's where the wells fall on a
21 probability curve. So it's -- it's not complicated, but
22 I think it's helpful if we're going to have a complete
23 record, particularly with so much overall policy that's
24 involved and at stake in this case.

25 (Jalapeno Corporation Exhibit Numbers 5A,

1 5B, 6A, 6B, 7 and 22 are offered into
2 evidence.)

3 MR. BRUCE: Mr. Chairman, if I may, you
4 know, just looking at Exhibit 5A, I think in the prior
5 testimony on September 7th, Mr. Yates testified that the
6 study had about 80 wells in it. Looking at Exhibit --
7 if you combine Exhibits 5A and 5B, now we're up to 110
8 wells. We've never seen this data before. He gives us
9 one business day, when I have to travel, to counter
10 this.

11 Exhibit 6B, that's an entirely new concept
12 that we've never seen before. This data is a completely
13 new presentation than the original opening arguments.
14 Mr. Gallegos said that we had completely changed our
15 story from the original Division hearing. Story -- we
16 presented the same story twice, maybe a little more
17 detail the second time, but they had the chance to
18 properly review the exhibits. This is substantially new
19 data that we have not had time to look at. We do not
20 want a continuance, and we ask that it be excluded.

21 MR. BRANCARD: I could read you the
22 regulation that applies to this. Okay? This is under
23 the Commission's rules for adjudicatory proceedings,
24 19.15.4.13(B)(2), relating to prehearing statements.
25 "In cases to be heard by the Commission, each party

1 shall include copies of exhibits that it proposes to
2 offer into evidence at the hearing with the prehearing
3 statement. The Commission may exclude witnesses the
4 party did not identify in the prehearing statement or
5 exhibits the party did not file and serve with the
6 prehearing statement unless the party offers such
7 evidence solely for rebuttal or makes a satisfactory
8 showing of good cause for failure to disclose the
9 witness or the exhibit."

10 So now the standard of good cause can be
11 met to have a late filing of an exhibit. And this was
12 filed late. Sometimes people show up at hearings with
13 exhibits.

14 CHAIRMAN CATANACH: What is the pleasure of
15 the Commission? Do you want to go into executive
16 session to talk about this?

17 COMMISSIONER BALCH: I would move to go
18 into executive session.

19 COMMISSIONER PADILLA: Second.

20 CHAIRMAN CATANACH: All in favor?

21 (Ayes are unanimous.)

22 (Recess, Executive Session, 10:14 a.m. to
23 10:30 a.m.)

24 CHAIRMAN CATANACH: Back in regular
25 session. All in favor?

1 (Ayes are unanimous.)

2 CHAIRMAN CATANACH: During the executive
3 session, we discussed the request to include the
4 exhibits as part of the record and the argument to
5 exclude the exhibits.

6 We've decided that the exhibits were not
7 filed in a timely manner and that there wasn't
8 sufficient cause to demonstrate why they should be
9 allowed in the hearing, so the exhibits will not be
10 allowed at this hearing.

11 MR. GALLEGOS: So, Mr. Chairman, we're
12 going to call Maurice Gaddis to the stand. I do want to
13 point out we will make presentations, but at the tail
14 end, then, of his testimony, what I'm going to ask is to
15 do an offer of proof because I want the record to be
16 able to reflect the exhibits and the testimony that
17 would have been with this, so we have that as a record.

18 CHAIRMAN CATANACH: I'm sorry? So I guess
19 I don't understand. What are you going to be asking?

20 MR. GALLEGOS: We're going to have what is
21 called an offer of proof, in other words, testimony
22 ruled by the presiding judge or Commission or whatever
23 on something that is excluded. We're entitled to be
24 able to present it in the record so we can preserve that
25 in the record. So what I'm saying is we'll go through

1 our testimony with the exhibits that were previously
2 filed, but I do want, then, at the end to be able to
3 make this offer of proof so our record reflects what the
4 testimony would be and what the exhibits consist of.

5 MR. BRUCE: I will object to that.

6 CHAIRMAN CATANACH: We'll deal with that
7 down the road.

8 MR. BRANCARD: Yup.

9 MR. GALLEGOS: So we call Maurice Gaddis.

10 Mr. Bruce, can we have copy of the Matador
11 exhibits? I'm going to ask him to refer to a few of
12 those if we could have your exhibit book.

13 MR. BRUCE: Well, if you don't have any
14 handwritten notes on them --

15 MR. BRANCARD: Here you are (indicating).

16 MR. GALLEGOS: I think we have one on the
17 witness stand. Thank you.

18 MR. BRUCE: Okay.

19 CHAIRMAN CATANACH: Go ahead.

20 MAURICE P. GADDIS, JR.,
21 after having been previously sworn under oath, was
22 questioned and testified as follows:

23 DIRECT EXAMINATION

24 BY MR. GALLEGOS:

25 Q. State your name, please.

1 A. My name is Maurice P. Gaddis, Jr.

2 Q. Where do you live, Mr. Gaddis?

3 A. Midland, Texas.

4 Q. What is your occupation?

5 A. I'm a reservoir engineer, and I'm a registered
6 professional engineer in Texas.

7 Q. Would you tell the Commission about your
8 education to prepare you for your profession?

9 A. I graduated from the University of Texas at
10 Austin with a bachelor's and master's degrees in
11 petroleum engineering in 1976 and '77, respectively.

12 Q. Are you member of the SPE?

13 A. I am. I've been a member for approximately 40
14 years. I've served in numerous capacities, including
15 the chairman of the Permian Basin section in 2001 and
16 '2.

17 Q. And what is the SPE? Maybe I should ask that.

18 A. The SPE is the Society of Petroleum Engineers.
19 It's our recognized international society.

20 Q. Are you a member of an engineering firm?

21 A. I'm a member of the Hickman McClaine &
22 Associates firm in Midland, and we provide reservoir
23 engineering services.

24 Q. And what is the various geographic scope of
25 Hickman McClaine's practice?

1 A. Our services include but they're not limited to
2 reservoir evaluation, reservoir characterization,
3 acquisition and vestiture evaluation, waterflood and CO2
4 flood evaluation, optimization of floods, as well as
5 feasibility studies, planning and implementation. And
6 one of the others is expert witness testimony.

7 Q. Okay. Is there a particular area of services
8 that the Hickman firm performs in which you spend more
9 of your time?

10 A. We do spent a fair amount of time evaluating
11 horizontal plays, horizontal wells, as well as
12 waterfloods and CO2 floods.

13 Q. Has some of your practice and your evaluation
14 been directed at production in the Permian Basin of New
15 Mexico and West Texas?

16 A. Yes, a very large amount of our work.

17 Q. And there's been mention here of two particular
18 formations, the Bone Spring and the Wolfcamp. What is
19 your familiarity with those formations?

20 A. Not only in a previous job, having worked with
21 some Bone Spring, but also having looked at, evaluated
22 and numerous times Bone Spring wells, as well as
23 Wolfcamp, horizontal and vertical.

24 Q. Have you previously given petroleum engineering
25 expert testimony before the New Mexico Oil Conservation

1 Division?

2 A. Yes.

3 Q. And do you recall about on how many occasions?

4 A. I think I lost count around 12, 13 times, at
5 least. I've been here quite a few times over the years.

6 Q. Okay. Have there been other oil and gas
7 regulatory agencies in which you've given testimony as
8 an expert petroleum engineer, Mr. Gaddis?

9 A. Yes, sir, in Texas, Wyoming and Montana.

10 Q. I'm going to ask you about certain exhibits.
11 I'm going to start with Exhibit 5, but as a general
12 proposition, as far as any exhibit that I direct you to
13 that is a Jalapeno exhibit, can you tell the Commission
14 whether you prepared that yourself, individually?

15 A. Before -- let me say. I have my cell phone
16 here because I can turn up my hearing aids if I can't
17 hear. I'm not recording, and I'm not checking texts. I
18 just have to do it sometimes. I'm getting old.

19 Q. Okay. The question was just if I direct you an
20 exhibit, can we assume, if it's a Jalapeno exhibit, not
21 in the Matador book --

22 A. Yes.

23 Q. -- Jalapeno exhibit, that this is an exhibit
24 you personally prepared?

25 A. Exhibit 5 was prepared by me. It consists of

1 nine wells within the -- a four-township study area.

2 Q. I just didn't ask you what the content was.

3 I'm just asking if you prepared the exhibits.

4 A. Yes.

5 Q. Okay. Stop there.

6 Because I want to offer you as an expert
7 witness. I'm asking the Commission to accept that you
8 may testify and give opinion testimony as a petroleum
9 engineering expert.

10 MR. GALLEGOS: I'm asking -- I'm
11 offering --

12 CHAIRMAN CATANACH: Any objections?

13 MR. BRUCE: No objection.

14 CHAIRMAN CATANACH: The witness is so
15 qualified.

16 I seem to be missing some exhibits. I'm
17 going to check my office. I'll be right back.

18 (Pause in proceedings, 10:38 a.m. to 10:43
19 a.m.)

20 Q. (BY MR. GALLEGOS) All right. In the exhibit
21 book, would you turn to Exhibit 5? Do you have that?

22 A. Right here. This book here, Exhibit 5.

23 Q. Exhibit 5. Okay. And is it a series of plots?

24 A. Yes.

25 Q. Okay. Explain how these plots were prepared,

1 Mr. Gaddis.

2 A. Okay. We did a cursory review of a
3 four-township area of the Bone Spring wells, and we
4 chose nine wells of what appeared to give a reasonably
5 good description of what a high well would look like, a
6 medium and a low, and we chose three sets of three wells
7 each. One of these does happen to be a Wolfcamp well,
8 the only horizontal Wolfcamp well in that four-township
9 area. The other eight are Bone Spring wells. And this
10 was -- we used these to estimate ultimate recoveries and
11 come up with our cases for a type curve.

12 Q. How many wells was it necessary for you to
13 examine in order to present some examples of the wells?

14 A. There are well over 100 Bone Spring wells in
15 there. At the time we reviewed, probably -- I would say
16 we probably looked at all of them. We picked the ones
17 that had the best data that had fit those ranges, high,
18 medium and low.

19 Q. Likewise, did you examine all the Wolfcamp
20 wells that were available?

21 A. Yes, I did.

22 Q. Can you tell the Commission how many that
23 amounted to?

24 A. Mostly in Lea County, a few in -- I'm sorry.
25 Mostly in Eddy County, a few in Lea County. I was able

1 to pull 64 wells in the Wolfcamp and apply the decline
2 curve analysis to those wells and come up with the
3 ultimate recovery on the 64 wells.

4 Q. How many Bone Spring wells did you look at to
5 select the example?

6 A. Around -- about 102 were actually able to apply
7 decline curves to.

8 Q. All right. Now, let's take the Commission
9 through -- I think your first -- your first example well
10 is a Mallon Federal; is that correct?

11 A. Yes.

12 Q. And what does that show?

13 A. The well is actually very much on the low end
14 of an ultimate recovery. As far as the oil concerning
15 the Mallon Federal 4H, it looks to have an ultimate oil
16 recovery of around 147 MBOEs.

17 Q. So that would be an example of one of your low
18 recovery --

19 A. Yes.

20 Q. -- in the examples?

21 And how many of those were there, you said,
22 that you put in that category of low EURs?

23 A. Three. I picked three wells to show the
24 low-end recovery.

25 Q. And what are the other wells in that category?

1 A. As we thumb through, we can see fairly low end.
2 The next one is Albatross State Com 2H, showing an
3 ultimate recovery of oil of 237 MBOEs, and I believe we
4 progressively get higher. There is a lower well.
5 It's -- there is -- next to last, there is the Pickard
6 State 2H. That's a Wolfcamp well. It is 277 MBOs. And
7 the rest -- that's more or less starting in your
8 midrange. The lowest well out there is the Buttercup
9 State Com 1H, and I believe that's the third -- yeah,
10 third one from the end. And you can see that it will
11 just make 100,000 MBOEs.

12 Q. And your medium-range wells, the examples of --
13 what do you call the medium-range recoveries?

14 A. The King Cobra 2 State 2H -- that's your third
15 well in the package -- shows an ultimate recovery of
16 around 365 MBOEs. And in the range of 365, even 383,
17 there is the Cordoniz 2 Federal Com 4H. It is one that
18 will recover 384 MBOEs. That would be a low-medium.
19 And the others -- usually when you get up close to over
20 400 MBOEs, 500, 600, those are your higher-end oils.

21 Q. Look at the Cimarex 16, Quail Ridge Bone
22 Spring. What does that tell you as far as thousands of
23 barrel of oil equivalent?

24 A. This particular Quail Ridge Bone Spring well,
25 it has enough data to project. That's the good point.

1 And it shows a very typical decline. It's definitely a
2 very good well. It has ultimate recovery of 524-plus
3 MBOEs.

4 Q. Let me -- let me ask you about the Pickard
5 State because we've heard testimony. Is the Pickard
6 State 2H a Matador well?

7 A. Yes, it is.

8 Q. All right. And did you hear the testimony that
9 Matador gave regarding this as a wildcat well?

10 A. Yes.

11 Q. What do you -- what information can you provide
12 the Commission about the -- when you combine the oil and
13 the gas production for this well, about what is the
14 thousand barrels of oil equivalent this well has made?

15 A. This well, with the gas equivalent, would be
16 approximately 350 MBOEs.

17 Q. Now, if you take -- if you took the 102 Bone
18 Spring wells and just said to yourself, All right, I
19 want to tell the Commission what that showed me in terms
20 of what I think are the probabilities of what kind of
21 recovery you're going to have, what would your testimony
22 be?

23 A. The range of recoveries on just the probability
24 would show on a low end of acceptable, around 100 MBOEs,
25 your high end of the well into the 600 range, with a

1 median probably in the 300s. And what this tells you is
2 this well is probably going to be just a medium-range
3 well, maybe below. This particular Wolfcamp well, it's
4 hidden pretty close to the middle of -- if you look at
5 either a Bone Spring or a Wolfcamp plot, this is where
6 it'll end up.

7 Q. And if you take the Wolfcamp -- 64 Wolfcamp
8 wells -- and this, in particular, happens to be a
9 Wolfcamp well -- what can you tell the Commission when
10 you look at the wells overall what you see as the
11 probabilities of recovery in a typical well?

12 A. A typical well -- and if I may say, the
13 probability of a 50 percent plot -- 50 percent of your
14 wells is around 500 MBOEs on the Wolfcamp. That's your
15 midrange. And your upper end is, of course, approaching
16 million barrels, and the lower end is less than 200. So
17 midrange is what we'd love to look at, and we're seeing
18 500 MBOEs in the Wolfcamp, of the 62 wells that I -- 64
19 are wells what I evaluated.

20 Q. Are you familiar with the terminology of a
21 resource play?

22 A. Yes.

23 Q. What does that mean?

24 A. If I summarize it in one sentence, it would be:
25 A resource play would be one where you have very little

1 chance of drilling a dry hole. There are, I would say,
2 definitions that the SPEE and SPE have put out, but the
3 one thing -- once it's established as a resource play,
4 one of the top of the list of all of them is repeatable
5 statistical distribution of estimated ultimate
6 recoveries. And that's definitely what we see in the
7 Bone Spring play.

8 And let me state that when you have 100
9 wells, most of the experts will say, yes, 100 wells is
10 what you need to establish, minimum, as a resource play.
11 And I said I have Wolfcamp wells, evaluated 64, and it's
12 shaping up very much to look like a resource play by all
13 definitions.

14 Q. And as a resource play, aside from the fact
15 that there is very little risk of a dry hole, does it
16 also tend to indicate what the expectation or the
17 probability will be of a well drilled in that formation,
18 in that play?

19 A. In the Wolfcamp, what I saw -- and 50 percent
20 of your wells are greater and 50 percent less, but
21 around 50 MBOs in the Wolfcamp play so far.

22 Q. So from -- from a risk standpoint, what can the
23 Commission conclude from the range of the results you've
24 seen on horizontal wells in the Delaware Basin?

25 A. As we -- the range that you will see, the

1 Wolfcamp is definitely indicative of being a much higher
2 recovery so far. It's in the Bone Spring. It's very
3 acceptable. There is much more established decline --
4 much more established data, as well as the number of
5 wells, and your range there, as I stated earlier, from
6 your P90, is around 100 MBOEs and up to a P10, which is
7 well over -- it's probably closer to 700 MBOEs.

8 Q. From your examination of all those available
9 wells, what do you conclude regarding the -- regarding
10 whether or not this productive Wolfcamp Formation exists
11 over a large geographical area in the Delaware Basin?

12 A. Well, that is one of the definitions of a
13 resource play, that it is -- it's regional. And I would
14 have to say that from what we've seen in Eddy and
15 southern Lea County, as well as what we see from the
16 vertical Wolfcamp wells that are penetrated in the
17 four-township study area, the Wolfcamp is there, not
18 only the Upper but the Lower as well. We have a Lower
19 Wolfcamp well that has been completed by Matador. And I
20 would have to say riskwise, it's already proven that
21 there is a geopressure environment in that area. I
22 would have to say that the risk involved is very minor
23 to say that this regional resource play does not exist.
24 It looks very much to me like it does exist.

25 Q. From a -- from a -- from just a payout approach

1 to the evaluation of these wells, can you give the
2 Commission some idea of what you would say would be the
3 probability that if you drill a well, Wolfcamp, in this
4 resource play, you're likely to achieve X amount of
5 payout? What is your opinion?

6 A. From our evaluation of the Wolfcamp wells and
7 applying that to a type curve with consistent economics,
8 all the parameters, what you have -- a Wolfcamp well of
9 the type that we're looking at, Eddy County, Lea County,
10 you could expect payout possibly as low as -- this is
11 payout of the original capital investment of 250,
12 upwards to 275 MBOEs. You would break even. You would
13 get one more dollar than what you put into it.

14 Q. Now, Matador's witness geologist, Dr. Ed Frost,
15 testified that he believed that probability of payout is
16 75 percent of the wells. Would you take issue with
17 that?

18 MR. BRUCE: I would object to that
19 characterization. That's not what Dr. Frost said.

20 MR. GALLEGOS: Dr. Frost said directly that
21 75 percent would break even.

22 THE WITNESS: Well, regardless of
23 Dr. Frost's -- what he said, my evaluation is that you
24 will -- you can -- from the wells I evaluated,
25 87-and-a-half percent of them will achieve payout. The

1 economics that I utilized and staying consistent, you
2 could -- you could see as little as 75 percent payout,
3 as much as 87-and-a-half paying out.

4 Q. (BY MR. GALLEGOS) 87.5 percent?

5 A. 87.5 percent.

6 Q. Do you find a different probability of the
7 payout in the Bone Spring as contrasted with the
8 Wolfcamp?

9 A. Yes, I do. The Bone Spring, we -- running,
10 like I say, a plethora of economics, but the range we
11 feel most comfortable with, that I feel best about is
12 under -- if a well costs \$5.25 million and we apply a
13 reasonable economic profile, what you come up with is
14 about a 210 MBOE well will payout. And that represents
15 about 60 -- a little over 60 percent of the wells. Your
16 P60 environment and above will pay out. So what I'm
17 finding is it can be as low as -- you know, as good as
18 saying 66 percent of the wells will pay and as low as 61
19 percent of the wells. That's my range in there. But I
20 would say at least 60-plus percent of those wells in the
21 Bone Spring will pay out.

22 Q. When you opine that in the Wolfcamp 87.5
23 percent would pay out, what are you considering to be
24 the well cost?

25 A. I used \$6.5 million. I believe that was a cost

1 on one of the latest cost estimates, as well as I
2 believe it was included in some of the public
3 information by Matador. But whatever it may be, 6.5 was
4 the number I used for a Wolfcamp well.

5 Q. And what assumptions do you make economics --
6 economically other than the --

7 A. Once we established our type curve, the -- we
8 did make runs on a variety of these using just the NYMEX
9 curve, and it can be very punishing. But what we did
10 was we backed up everything to a day one. Every well
11 was normalized to a day one, and we assumed every well
12 on the cost of 6.5 million. This was no lost hole,
13 redrill or anything. Everything was just given its own
14 fair shake.

15 Then we applied product process that had
16 been -- that were put out by a reputable financial
17 institution, Bank of Oklahoma, their September prospect.
18 We applied this to each and every well, put our decline
19 curve and proceeded on forward with it and came up with
20 the economics on each well. And, again, of the 62
21 wells, 87-and-a-half of them did obtain that level --

22 Q. You said 62, and you said 64. How many
23 Wolfcamp wells?

24 A. I'm sorry. It is 64 Wolfcamp wells, 64
25 Wolfcamp wells. And of those, 87-and-a-half paid out.

1 Under that scenario.

2 Q. I want you to take a look at Jalapeno
3 Exhibit -- let's see -- 13. It's actually taken from
4 the Matador presentation. But can you find that in the
5 exhibit book up there on the stand, Mr. Gaddis?

6 A. Number 13?

7 Q. Yes.

8 A. That was a Matador exhibit, and it's -- yes.
9 I've got it in front of me.

10 Q. What does that tell you -- those are cross
11 sections, right?

12 A. Yes. This is a -- it's in the Airstrip area.
13 It's a Wolfcamp pool cross section. It's labeled
14 "stratigraphic cross section A to A prime."

15 Q. Okay. And what does that tell the Commission
16 about the presence of the -- of the Upper Wolfcamp?

17 A. I believe their cross section, the logs --
18 electric logs definitely indicate the presence of the
19 Upper Wolfcamp, especially due to the fact that they do
20 plan to drill their lateral through the Upper Wolfcamp.

21 Q. Flip to Exhibit 14, which is another Matador
22 well, but it's Jalapeno Exhibit 14. It has a heading
23 "Rustler Breaks - Focus on Wolfcamp Development in
24 2016."

25 A. Yes.

1 Q. What information do you take from that that you
2 believe is significant to the Commission?

3 A. This is data that Matador presented that -- it
4 shows some -- well, some very good initial production
5 data for the seven Wolfcamp producers in the Rustler
6 Breaks area.

7 Q. How does this information that's shown here
8 correlate with your description of the -- of these
9 Wolf-Bone Spring and Wolfcamp as being resource
10 play-type reservoirs?

11 A. Well, this covers, definitely, a significant
12 area, and it fits within the overall -- of the 64
13 Wolfcamp wells I combined with these, it has, I would
14 say, a very strong indication that this too is part of a
15 resource play, the Wolfcamp.

16 Q. And Exhibit 15, would you turn to that? What
17 is that exhibit?

18 A. This is titled "Rustler Breaks Wolfcamp A-XY
19 Wells Performing Above Expectations." What we see there
20 is -- it's a composite historical production plot of the
21 same seven wells we talked about on the previous
22 exhibit. And what we see are two projections in there,
23 one of them of a 500 MBO type curve -- MBOE type curve
24 and then the 800 MBOE type curve. They're -- they're
25 saying that they're definitely performing above

1 expectations. There are some very good wells there.

2 Q. Does this support or conflict with your
3 analysis of the Wolfcamp wells and the probability of
4 success?

5 A. It definitely fits my regression analysis.

6 Q. Let's see. Now what I'd like for you to do is
7 take a look at the Matador exhibit book. It should be
8 right there. Let me refer you to that. Do you have
9 that --

10 A. I have the book.

11 Q. -- handy?

12 A. I have the book handy.

13 Q. Okay. Okay. All right. Flip over to Exhibit
14 20 in that book, and do you find an exhibit with the
15 title "Airstrip Wolfcamp Pool (Pool Code 970)
16 Operational Risk"?

17 A. Yes.

18 Q. What do you understand this exhibit by Matador
19 to be attempting to illustrate?

20 A. The bottom line is -- what Matador is saying
21 there is their chance of operational success for a well,
22 group of wells or however many hundreds they want to
23 drill appears to be -- what they're saying is about 75
24 percent.

25 Q. Would this mean to you that they think that one

1 out of four of their wells is going to be a failure --
2 operational failure?

3 A. That's what it appears to be to me, an
4 operations failure, what definition could be. They'd
5 either lose the well completely and have to redrill or
6 maybe lose the lateral. But that seems -- losing one
7 out of four wells is tough.

8 Q. All right. And from your analysis of the wells
9 that actually have been drilled, that you've watched and
10 analyzed 64 Wolfcamp wells, what is your opinion of what
11 would be the appropriate percentage for operational
12 risk?

13 A. I would think that as many wells as Matador has
14 drilled or other people, if you're not above 95 percent,
15 it would surprise me. I think we could see well above
16 95. In fact, we should be looking at -- 98 to 99
17 percent is as good as these folks are getting. Matador
18 is not dummies. They know what they're doing. They can
19 do better. They've drilled a lot of wells.

20 Q. Let's see. Flip over to Matador's Exhibit 13.
21 It's "Wolfcamp Core- to Pore-Scale Heterogeneity." Does
22 this tell you anything about the geology and geologic
23 risk?

24 MR. BRUCE: I would object. He's not
25 qualified as an expert petroleum geologist.

1 MR. GALLEGOS: I think a petroleum engineer
2 is an expert.

3 CHAIRMAN CATANACH: Mr. Gaddis, what is
4 your experience with this type of evaluation?

5 THE WITNESS: I've looked at a lot of
6 cores. I have worked in teams with geologists. In
7 fact, I've even worked on one where the DOE was
8 involved. And I would say that while I may not be the
9 guy that gets down into the minutia of the cores, I
10 know -- when I look at a core and I look at a core
11 analysis, I believe I can interpret that.

12 CHAIRMAN CATANACH: We'll let him answer
13 the question.

14 Q. (BY MR. GALLEGOS) So the question is: Does
15 this tell you anything about the significance or lack of
16 significance of geologic risk for the proposed well?

17 A. As far as geologic risk is concerned, the very
18 fact that we looked on a previous exhibit and we saw the
19 presence of the Upper Wolfcamp, we saw the idea of
20 putting a horizontal well through the Upper Wolfcamp, we
21 know the existence of the Lower Wolfcamp, and when I
22 look at a core that appears to have, in the Airstrip,
23 talk about -- it appears to me that what you have here
24 is -- if this is -- indeed if it's a Wolfcamp core,
25 which it says it is, then I would think that your

1 geologic risk of finding the Wolfcamp in this area is
2 zero. The Wolfcamp is there. It's all around you. The
3 vertical wells themselves have shown that. Geologic
4 risk, I would have to say, is zero that you won't find
5 the Wolfcamp -- Upper Wolfcamp.

6 Q. Their Exhibit 21, I refer you to. It's
7 entitled "Airstrip Wolfcamp Pool (Pool Code 970)
8 Reservoir Risk." Do you have that in front of you?

9 A. Yes, I do.

10 Q. Do you understand what Matador is attempting to
11 present --

12 A. Yes.

13 Q. -- by this exhibit?

14 A. Yes, I do.

15 Q. Okay. And it appears to say that the chance of
16 reservoir success is 50 percent. Based on your
17 observation of the many wells that you've looked at,
18 what is your opinion in that regard?

19 A. My opinion, after looking at all of the data
20 that's there, that -- I would have to say my first pick
21 on it would be the permeability of being greater than
22 100 nano-darcies, I think, would be not near as high as
23 what they're saying. I say that because there have been
24 numerous penetrations in the Wolfcamp in this area.
25 There have been reports of the wells actually either

1 having formation sluffed off, having fluid come into the
2 hole.

3 I think the chances are you've got
4 permeability. I can't say for every well you'll have
5 it, but in this area, the chances are better than --
6 it's not high that you'll have permeability.

7 We know the net thickness is extremely low.
8 The thickness itself showing up on the logs on the cross
9 section is probably 1,000 feet or more. The water
10 saturation, less than 45 percent. That's one of the
11 criteria. I believe that maybe that one might be pretty
12 close. But the one that I don't quite -- the formation
13 pressure gradient has to be greater than 0.6. We know
14 that in this area we don't see geopressure in the Bone
15 Spring. We do see it in the Lower Wolfcamp, as
16 indicated by the drilling engineer who testified earlier
17 that they had to weight their mud considerably. And it
18 should be noted that in this area, there are a lot of
19 cases where the -- when you get below the Bone Spring,
20 you better have pipe set to the Bone Spring because
21 you're going to have to weight up in the Wolfcamp.

22 My opinion is that continuity is not even
23 that much of -- it would just -- I would have to say
24 it's everywhere. And as we've contended, it appears to
25 be shaping up to be a resource play. So you've got --

1 you've got the continuity and criteria. So the chance
2 of reservoir success, I'd have to say is somewhat higher
3 than 50 percent as noted on their exhibit.

4 Q. Have you taken count of the evidence that
5 Matador presented about how they were going to drill
6 this well -- drill and complete this well --

7 A. From --

8 Q. -- from their testimony, particularly?

9 A. From their testimony, I think that they will
10 have -- they will have mud weights up where they need to
11 be and maintain well -- wellbore integrity.

12 Q. My question is: Did you see anything that
13 indicated they were going to drill and complete this
14 well any differently than any other Wolfcamp wells that
15 they've successfully completed?

16 A. I see no indication that there is any
17 difference and using very good technology.

18 Q. If you go over to Matador's Exhibit 24, it's
19 entitled "Airstrip; Wolfcamp Pool...Applicability
20 Probability of Success." And I suppose you've not only
21 seen this exhibit, but you heard their testimony that
22 they think the probability of success is less than 10
23 percent for this Airstrip well? Do you understand
24 that --

25 A. Yes.

1 Q. -- to be their position?

2 A. This is their position, that they're drilling a
3 rank wildcat, less than 10 percent chance of success.

4 Q. Mr. Gaddis, if a producer client of yours comes
5 to your -- comes to your firm and tells you they're
6 going to spend \$6-and-a-half million to drill a Wolfcamp
7 well, but they think their chance of success is less
8 than 10 percent, what would your advice be to them?

9 A. I would say don't do it unless you can mitigate
10 the risk through other methods.

11 Q. And is there a way that a company can do that
12 so that they're not spending \$6-and-a-half million on a
13 less than -- one out of ten chance of success?

14 A. If they really, truly believe it's a one and
15 ten chance of hitting that well, I would do everything
16 that I would -- I would drill a pilot. I'd get a core.
17 I'd get the necessary appropriate logs, just anything to
18 help ascertain that you've got the necessary and
19 essential components that tells us this rock has great
20 potential of being a reservoir.

21 Q. And if -- and if that showed that the chance
22 was less than 10 percent, what would your advice be to
23 your producer client?

24 A. Save your stockholders some money and go use
25 the rest of the money somewhere else where your chance

1 of success is better than 10 percent.

2 Q. Now I want to go back to the Jalapeno exhibits,
3 and let's go to tab six. Explain why -- in the first
4 instance, why you prepared this exhibit that has six
5 cases scenarios.

6 A. Okay. This was a set of cases that I ran where
7 I wanted to show just how difficult, I'd say, it is for
8 a well to achieve not only the payout of its original
9 capital investment but also the capital equivalent of a
10 200 percent penalty. Now, I ran this case quickly on
11 100 percent working interest and 75 percent working
12 interest.

13 Q. Okay. Let me take you -- let me take it a step
14 at a time, please --

15 A. Okay.

16 Q. -- of what you were doing here.

17 Did you have to make some assumptions about
18 prices, expenses, volume of oil and gas production?

19 A. Okay. Yes. We built type curves for sure to
20 represent a 700 MBOE well and around 440 MBOE well,
21 cases one, two and three.

22 Q. Okay. So the top one, two and three are the
23 more than 700,000 --

24 A. Yes.

25 Q. -- MBOE well?

1 A. That's correct.

2 Q. Any reason why you picked that level of -- that
3 high level of production?

4 A. That high level of production was also one of
5 the high-level producing wells in the -- in the
6 probability of achieving that result. We wanted to get
7 a well on the upper end of the probability curve, and
8 700 was one of them. This is also in the range of what
9 we're seeing for Wolfcamp, what we're seeing in some of
10 Matador's exhibits. So it appeared to be a good
11 starting point.

12 Q. Does this exercise give the Commission some
13 idea of the economic impact on your nonconsent owners
14 who are force pooled and subject to a 200 percent risk
15 penalty?

16 A. Yes.

17 Q. And is that one of the purposes of this exhibit
18 so that you have that information as to giving different
19 well volumes, production revenue, what happens to that
20 nonconsent interest subjected to the 200 percent risk
21 penalty?

22 A. That was the purpose of this exhibit, yes.

23 Q. Okay. So let's take scenario one. Let's go
24 through it because there is a pattern here, so you can
25 explain the situation, because you're assuming various

1 things as far as working interest, net revenue interest
2 and so forth.

3 A. Yes. We're assuming, under case one, 100
4 percent working interest with a 75 percent net revenue.
5 All the cases will have the equivalent of a 75 percent
6 net revenue or net lease ratio. We also -- pricing
7 assumptions, we used the NYMEX strip available at the
8 time of a starting oil price 44.86 up to 50.10 by 2020
9 and then held flat thereafter. Expense -- I believe the
10 expense from our knowledge of previous work in Wolfcamp
11 and Bone Spring and other horizontal wells, the
12 operating expenses that we utilized.

13 And in case one --

14 Q. And did you use -- did you have a well cost? I
15 think it's shown here.

16 A. It is, yeah. We used a \$6 million well cost.
17 This was one that -- more than average type number. We
18 didn't think it would be up in the 7 million range, but
19 we weren't sure a Wolfcamp well, we could get it down to
20 5.25. Cost of goods and services were definitely
21 getting to a point where perhaps the cost could be at \$6
22 million. We could have run more at 6.5, but this one,
23 because we were using the NYMEX and did not have that --
24 the NYMEX doesn't show much optimism in oil pricing, so
25 we're thinking \$6 million to be a good price. And a

1 result of that, the net cash flow to the 100 percent is
2 around \$17.4 million.

3 Q. Now, at the bottom here, we'll get to this, but
4 there is revenue to other working interest owners,
5 nonconsent. Were you assuming a 200 percent penalty?

6 A. On case one, it's just a straight run, nothing
7 else. But in cases two or three, I did assume a 200
8 percent penalty.

9 Q. All right. Go ahead. I interrupted you.

10 A. Okay. In case two, I assumed that there would
11 be a 30 percent working interest forced pool. The gross
12 oil, gross gas, everything stays the same there, barrels
13 of oil equivalent; of course, net costs stay the same.
14 What I wanted to show with this is that the net cash
15 flow, when you take into account the 200 percent
16 penalty, it looks like it's only 12.2 million, but there
17 is a cost recovery element, and the penalty portion,
18 which says yes, our net -- the net back to the operator
19 is \$17.4 million. All that's really saying is under a
20 200 percent penalty, there is no value ever taken away
21 from that. This goes back to the people who are force
22 pooled, even a 700 MBOE well.

23 Case three --

24 Q. Just to -- let me --

25 A. Sorry.

1 Q. Just for interpretation, net cash flow, is that
2 over the -- is that after payout?

3 A. After payout of the original capital investment
4 of \$6 million.

5 Q. Still -- still 12 -- in case number two, still
6 a recovery, then, of \$12.2 million?

7 A. But you'd have to also put in there the cost
8 recovery and then the penalty value. I wanted to break
9 those out to show. But it still comes out the cash flow
10 after payout of that \$6 million is still the same as it
11 was under 100 percent. In other words, when you look at
12 a maximum penalty of 200 percent, they only achieve
13 getting a 191 percent of that with this well. So their
14 net to the operator is still going to be \$17.4 million.
15 It doesn't change.

16 Q. And does this mean that the penalty after --
17 over and above costs, the penalty yields \$3.4 million to
18 the force pooling party?

19 A. The force-pooled interest, that penalty amount
20 does go to the operator. The people who force pooled
21 the interest, yes.

22 Q. Okay. And the force pooled party receives
23 zero?

24 A. Zero.

25 Q. Okay. In case number three, then?

1 A. This is one just to show kind of an extreme
2 case, whether somebody had 50 percent or whether they
3 had 10 percent, and they went and force pooled the other
4 interest. When a 200 percent penalty is applied, it
5 doesn't matter. You're still achieving -- you're
6 getting all your money back, plus nearly all of your
7 penalty dollars. The well didn't last long enough to
8 get 200 percent. It only got to 191 before an economic
9 limit was attained. So it's showing essentially the
10 same as case two.

11 Q. So to put it in other terms, even if the force
12 pooling party only got a 50 percent working interest,
13 37.5 net revenue interest, that 200 percent penalty
14 still achieves the net to the force pooler?

15 A. Yes.

16 Q. You have net to Matador 17 million-plus?

17 A. That's correct.

18 Q. And, of course, the nonconsenting parties
19 receive zero?

20 A. The nonconsent parties, yeah, they never
21 receive any value at all.

22 Q. Okay. Now let's take cases four, five and six.
23 The assumption, differences besides, obviously, the
24 barrel of oil equivalent?

25 A. The only assumption that changes there is the

1 gross oil and gas or your barrel of oil equivalents. It
2 drops from around 700 MBOEs down to -- I used 441, plus
3 some change, MBOEs.

4 Q. Walk us through case number four there.

5 A. Case number four is just assuming that if
6 someone drills, they'd have 100 percent working, 75
7 percent net. There is no forced pooling, and their
8 operator total -- their cash flow is \$10 million.

9 Case five, again it's the same assumptions
10 as case two except for the change in volumes recovered.
11 And, again, what you say, because the 200 percent
12 penalty is never fully achieved, they still manage to
13 get \$10 million in case five, as well as case six. But
14 the 200 percent penalty, the force pooled interest never
15 sees any value.

16 Q. No return.

17 Now, with your analysis of all this,
18 Mr. Gaddis, can you tell us, if you're able to, if you
19 took a well of this kind of production level, 441,000
20 BOEs and you reduced the penalties? Let's say kept
21 reducing the risk penalty down, can you tell the
22 Commission at what level the nonconsent owners would
23 finally receive some revenue?

24 A. I ran cases with a 200 percent penalty. Of
25 course, it was zero. And 133 percent penalty, it was

1 still zero. When I got below 100 percent, finally
2 around the 66 percent level, we started seeing
3 recoveries values going back to the forced pooled
4 interest for a well of this magnitude, in the 450 to 500
5 MBOE range.

6 Q. Would the -- the operator or the force pooler
7 would still be making more money on the force pooled
8 interest than the -- than the nonconsent owner, but the
9 nonconsent owner would have some?

10 A. They would have some, maybe 20 percent of what
11 the -- at best, 25 percent of what the operator would
12 get from that interest that's force pooled.

13 Q. At a 66 percent penalty -- risk penalty?

14 A. Yes.

15 Q. And I guess we could assume -- I don't know if
16 you ran this, but if you're under 441 -- let's say
17 you're down to 300 -- let's say you're down to 300,000
18 barrels of oil equivalent. Is there a penalty risk
19 level that nonconsent owners would ever receive --

20 A. I ran a -- I ran a 350 MBOE case, as well as
21 300 and on down, but at the 350 MBOE case, type curves
22 hits the curve point. What you see is -- at a 33
23 percent penalty, you can finally start to see some value
24 coming back to the force-pooled interest. Below that,
25 it's very doubtful that you'll get much ever.

1 Q. That would be at 350 --

2 A. At a 350 level, yes.

3 Q. And a 33 percent penalty?

4 A. Yes, sir.

5 Q. Nonconsent parties might receive some return?

6 A. They might, yes.

7 MR. GALLEGOS: That completes my direct
8 examination, and we would move the exhibits -- move
9 admission of Exhibit 5 and Exhibit 6. These were prior
10 exhibits. And I think all the Matador exhibits that
11 were referred to, I believe, were already admitted in
12 Matador's testimony. So I think our only two that we're
13 asking admission are -- let me just check -- are 5 and
14 6?

15 CHAIRMAN CATANACH: Any objection?

16 MR. BRUCE: No objection.

17 CHAIRMAN CATANACH: Exhibits 5 and 6 will
18 be admitted.

19 (Jalapeno Corporation Exhibit Numbers 5 and
20 6 are offered and admitted into evidence.)

21 CHAIRMAN CATANACH: Mr. Bruce.

22 CROSS-EXAMINATION

23 BY MR. BRUCE:

24 Q. Mr. Gaddis, could you turn to your Exhibit 5,
25 first page? And the type curves you've given us here,

1 the first well, the Mallon 4H, is a Bone Spring well,
2 correct?

3 A. That's correct.

4 Q. And the second one, the Albatross, is a Bone
5 Spring well?

6 A. Correct.

7 Q. And the third one, the King Cobra, is a Bone
8 Spring well?

9 A. Yes, it is.

10 Q. And the fourth one, Aircobra, is a Bone Spring
11 well?

12 A. Yes. Yes, it is.

13 Q. And the fifth well, the Cimarron, is a Bone
14 Spring well?

15 A. Yes, it is.

16 Q. The next one, the Buttercup, is a Bone Spring
17 well, correct?

18 A. Yes, it is.

19 Q. The next well, the Cordoniz, is a Bone Spring
20 well?

21 A. Yes, it is.

22 Q. The next one, the Pickard 2H, that is the only
23 Wolfcamp well in your presentation, isn't it?

24 A. The only Wolfcamp well in this presentation,
25 yes.

1 Q. And what zone did that well --

2 A. That is in the Wolfcamp.

3 Q. And we're not drilling a Lower Wolfcamp well
4 here today?

5 A. That's correct.

6 Q. So this is inapplicable?

7 A. I would disagree with you, but I will wait.

8 Q. And then the final well you have, Chaparral
9 well, is a Bone Spring well?

10 A. That's correct.

11 Q. Let me ask you about -- you mentioned some
12 numbers here that you looked at, 102 Bone Spring wells.
13 Were those in that four-township area?

14 A. Yes.

15 Q. Okay. And you mentioned -- even though you
16 only had the one Wolfcamp well here, you mentioned 64
17 Wolfcamp wells. What is the geographic extent which
18 includes those 64 Wolfcamp wells east to west and north
19 to south?

20 A. You're dealing with wells that are probably, on
21 average, 15 to 20 miles away from the Airstrip Wolfcamp
22 well and the Airstrip proposed Upper Wolfcamp well. You
23 are dealing with southeastern Eddy County and
24 southwestern Lea County where these wells have been
25 drilled. It appears to be a large, widespread Wolfcamp

1 area. Milewise, it hasn't been fully defined yet, but
2 you're talking about -- you can look from the exhibit
3 that the border of the Rustler Breaks itself covers a
4 lot of territory, and then the other wells in my
5 analysis from the Texas border -- Texas-New Mexico
6 border all the way up to the Rustler Breaks.

7 Q. So for your Wolfcamp, you're looking at a
8 12-mile-by-12-mile area?

9 A. For the Rustler Breaks, that area, yes,
10 possibly --

11 Q. No, no, no, no, no. No, no. For your Bone
12 Spring analysis, you're looking at an area that's two
13 townships by two townships?

14 A. Yes.

15 Q. 12 miles by 12 miles?

16 A. Yes.

17 Q. But when you look at Jalapeno Exhibit 14, you
18 are looking at -- you're looking at a larger area just
19 for the one pool, the Rustler Breaks area?

20 A. That's correct.

21 Q. You're looking at a fairly substantially larger
22 area.

23 And you were here for the testimony of
24 Matador's witnesses; were you not?

25 A. Yes.

1 Q. And didn't they state that the nearest
2 equivalent -- and it's not even equivalent because they
3 get -- the same zone in Rustler Breaks does not exist in
4 the Airstrip area, but that's about 45 miles away.

5 A. I believe what you're talking about is an Upper
6 Wolfcamp, and they say that -- I believe it's A-XY.
7 They don't know if it exists down in the Airstrip area,
8 but the nearest Wolfcamp production that you can call --
9 whether it's equivalent or not, it is called Wolfcamp,
10 and I believe it's 20-some-odd miles of the Airstrip
11 location.

12 Q. Do you recall Dr. Frost saying that the -- he
13 mentioned that A-XY does not exist in the Airstrip area?

14 A. I would have to say I don't recall exactly, but
15 I think -- I thought he did say he wasn't sure the x-y
16 existed. I believe those were his words.

17 Q. And you just take your Lea County area, how
18 many of the 64 wells were Upper Wolfcamp?

19 A. I will have to tell you I didn't delve into
20 that piece of it. I was looking at Wolfcamp. If it
21 said "Wolfcamp" and it was horizontal and it was
22 productive and I could project it, that's what I did. I
23 would say most of the Wolfcamp, if it is -- in that
24 area, the portion of Eddy County and Lea County, as well
25 as when you walk into Loving County to the south, you're

1 dealing with a lot of the Upper Wolfcamp information.

2 Q. And the prior testimony was that any Upper
3 Wolfcamp is 45 to 65 miles away from the proposed
4 Airstrip well?

5 A. I will stand corrected then.

6 Q. And the Wolfcamp wells are deeper, correct,
7 than the Bone Spring?

8 A. Yes.

9 Q. And they have extra casing string on them?

10 A. It appears that -- yes. You might have to have
11 a little extra casing for that. That's probably why
12 your costs are more. You're drilling deeper. You're
13 having -- you're having to worry about your geopressure
14 zone. You're having to mud up, but also having
15 additional casing to protect your shallow zones.

16 Q. Now, in your study, if I understand what you're
17 saying is that -- and let's just look at the Bone
18 Spring. You assumed an AFE cost?

19 A. About \$5.25 million for an AFE cost for the
20 Bone Spring is a middle-of-the-road number between what
21 would Matador present. And what they expect to be
22 drilling Bone Spring wells for, I believe that's a
23 little lower than that, but also some of them were
24 higher. I attempted to take a number that I felt like
25 was representative of the \$5.25 million.

1 Q. But that is an assumed cost? You assume that
2 each Bone Spring well met that cost?

3 A. Try me again on what you just said.

4 Q. You said -- you assumed an AFE 5.25 million?

5 A. Yes.

6 Q. For a Bone Spring?

7 A. Yes.

8 Q. And you assumed every Bone Spring well in your
9 study area met that AFE cost?

10 A. No. No, I didn't. That's not -- what I did
11 was I normalized every well and its production to call
12 it times zero, day one, however you want to present
13 yourself on that. You take it this point. Every well
14 is moved back to this point. It's actual production.
15 I'm giving all production -- at this point forward,
16 everything got the same oil price. Everything got the
17 same operating expense, same taxes for ad valorem,
18 severance, got the same exact cost. I wanted to see
19 what each well, standing on its own merit, would do.

20 Yeah. Some of those wells probably cost
21 12-, \$15 million, but I'm trying to show that all these
22 wells, if you started drilling them and producing them
23 right now at the same time, that's how your breakout
24 would happen. You would have wells -- and I'm not
25 saying that -- we know that the Pickard well was an

1 extremely expensive well due to drilling circumstances,
2 but that was not the -- my analysis was to find out,
3 given all things equal, what well would pay out -- what
4 percentage of them would pay out today.

5 Q. And so you didn't check on the actual time it
6 took to drill the wells? And, of course, drilling is a
7 large cost in the well.

8 A. No, I did not. All I applied was a simple,
9 straightforward cost as we know it today.

10 Q. Did you know the royalty interest plus
11 overriding royalty burdens on each well?

12 A. No, I did not. I assumed a straight 100
13 percent working interest, 80 percent net revenue.

14 Q. And of the Bone Spring wells, how many were
15 subsequent infill wells or were right next to wells that
16 had proven up in the area?

17 A. Let me handle that with a two-part answer. One
18 of the definitions of a resource play, of which I think
19 I can clearly establish that the Bone Spring is a
20 resource play, that an offset location does not
21 necessarily dictate or tell you in a range of what your
22 offset well would be. That is, you have a range. You
23 do not have a deterministic values. And -- I mean, I
24 can quote you all that from the SPEE monograph number
25 three.

1 But the case is most of these wells are
2 still early enough in life that we're not seeing
3 interference yet. At least there may be some, but in
4 our evaluation -- and we went through, looking at the
5 decline curves -- we saw where probably there was some
6 downtime due to either offset fracking. There was some
7 downtime due to possibly having to change out a pump,
8 ESP, lifting progress, whatever. But we attempted to
9 account for that as best we could.

10 So of the 102 wells, we're letting them
11 stand on their own to say this is what this well appears
12 that it will make, and it's not robbing any of the other
13 wells.

14 Q. Oh, I'm not asking about interference. But if
15 you have a well in an area that might prove up -- if you
16 drill a first well in an area and it's successful, it's
17 one of your 350,000 barrel Bone Spring wells -- assume
18 that.

19 A. Okay.

20 Q. -- doesn't it help you decide where to drill
21 the additional wells? In other words, let's say you're
22 just drilling infill wells and, of course, you have a
23 higher chance.

24 A. Once you have established that you are in a
25 resource play, and vertical wells were, as this play was

1 being -- yes, a single well may be drilled. What do we
2 learn from that area? What do we learn from that?
3 Where do we go to the next one? Of course you use that
4 data.

5 But once you have 100 wells in that area --
6 and that's the minimum that all experts write about.
7 When you have a 100 wells, you start looking at your cum
8 probability, and then even worse, I'd say keep going to
9 the Monte Carlo simulation, and then you can start
10 telling what your next steps on the wells will be,
11 infill, step-out, whatever you wish. But in answer to
12 your question, every well tells you something.

13 Now, do you use that data to mitigate any
14 risk of getting a lower well? Sure, you do. You try,
15 anyhow. You try to find that information that would
16 lead you to a better well area, especially in this type
17 of economic environment. You definitely to want find
18 your sweet spots.

19 Q. So is the Wolfcamp present in other areas of
20 the Basin, say parts of Chaves County?

21 A. I did not look at Chaves County, but if you
22 head north, it is definitely present in the northern
23 part Eddy County.

24 Q. Is present in Pecos County, Texas?

25 A. I know it's present in Loving. That's as far

1 down as I went.

2 Q. Do the distributes of data that you see from
3 southern Eddy County apply to Chaves and Pecos Counties?
4 Would they?

5 A. Huh. What you see in Eddy County, combined
6 with the few in Lea County, is probably unique as far as
7 the distributions are concerned. I have not delved into
8 distributions or the analysis of all the Wolfcamp wells
9 in Lea County.

10 Q. Getting back to your study -- first of all, the
11 only well you're talking about in your exhibits is a
12 Lower Wolfcamp well. What do the Bone Spring wells have
13 to do with drilling Wolfcamp wells?

14 A. In the area, what we were looking at -- well,
15 what we were trying to find -- we saw one Lower -- the
16 one Lower Wolfcamp well, and it -- it did look
17 different -- a bit different than some of the Bone
18 Spring wells. What we were trying to come up with is
19 okay, these are Bone Spring wells. They're not as good
20 as what we see in the Wolfcamp, but we don't -- we
21 looked at all the Bone Spring just because I wanted to
22 establish not only that it was a resource play, but also
23 the fact is running economics on the Bone Spring also
24 shows, in my opinion, some very large, egregious
25 problems, that when you apply a 200 percent penalty to a

1 Bone Spring well, the working interest that's force
2 pooled, probably 85 to 90 percent of the time, will
3 never see any value. That's just the Bone Spring. It
4 does get a little bit better in the Wolfcamp because the
5 volumes are so much higher, it appears, at least the
6 area that I studied.

7 So I had to take an analog, which is the
8 only Wolfcamp I've got in Eddy and Lea County, and say,
9 Okay, I feel like the Upper Wolfcamp here is going to be
10 your big zone, and said, This is an analog. And the
11 whole purpose of that was to say if I can get a Wolfcamp
12 well that makes 700 MBOE and I apply this type of
13 pricing to it, it doesn't matter. The guys that are
14 force pooled still aren't not going to see any money out
15 of it at 200 percent penalty.

16 Q. But they will have their acreage proven up if
17 it's a successful well?

18 A. And will -- successful? I don't know. And
19 sometimes those pooling agreements are -- carry a
20 whole -- cover a whole section. I don't know. But if
21 they are in the well --

22 Q. But since this is a forced pooling, Mr. Gaddis,
23 do you know there is no JOA with Jalapeno?

24 A. If they're not forced to signed a JOA, I would
25 have to say they have that privilege, then, being in the

1 remaining wells, if they have the interest.

2 Q. You realize a forced pooling order only affects
3 one well unit?

4 A. That's what I understand.

5 Q. And Mr. Yates testified that he has acreage
6 throughout this section.

7 A. Yes.

8 Q. I didn't ask him if he had it outside of this
9 section, but he owns an extensive interest.

10 A. Yes.

11 Q. When you talked about a resource play, 100
12 wells, how many of the Wolfcamp wells are there within
13 40 miles of the proposed Airstrip well?

14 A. Vertical? There are a lot vertical
15 penetrations.

16 Q. No, horizontal -- horizontal Upper Wolfcamp
17 wells.

18 A. Upper Wolfcamp wells, there -- there -- if your
19 information is saying 40 miles away, then I'll go with
20 your information. If there is an Upper Wolfcamp well or
21 it's similar to others within 20-some-odd miles, if
22 that's where it is, a distance away, there's no doubt.

23 Q. Well, is the Northern Delaware Basin, then, a
24 resource play in the Wolfcamp?

25 A. I think it has all of the possibilities of

1 being one.

2 Q. Except it has zero wells versus 100?

3 A. Absolutely.

4 Q. Just some information. You said you used the
5 prices from the Bank of Oklahoma price deck?

6 A. September price deck, yes.

7 Q. What are those?

8 A. And I can quote them. I may have it right
9 here. Let me help you out just a little bit.

10 Q. Go ahead.

11 A. I can either quote them for you, or I can --

12 Q. Just quote them, please.

13 A. Okay. In 2016, the base for oil is 47.77. The
14 next year is 48.55. 2018 is 50.22. And I'm going to
15 read -- these are sequential years: 51.44, 52.98,
16 54.57, 56.20, 57.89, 59.63, 61.42. And what's happening
17 is we're just escalating 3 percent per annum, with a
18 maximum of \$85, which occurs around 2035 or so.

19 Q. Do these represent the actual historical prices
20 or just estimates?

21 A. No. These are estimates made by a financial
22 institution.

23 Q. You didn't use the actual prices over the past
24 two years to calculate the average profit or loss?

25 A. When -- when I did some scenarios where we

1 used -- again, scooting all production up to a times
2 zero element with the appropriate capital costs, as we
3 said before, we did apply in actual costs, and some of
4 those costs were seen back in 2010. '11 and '12 looked
5 good, and it hit the average in 2015. It got ugly for
6 that month and -- or that year. And then after that,
7 for 2015, we used 47. We started at the Bank of
8 Oklahoma price on that. And, I mean, it was -- it can
9 be skewed. It just shows some really, really high
10 numbers on a lot of the wells.

11 Q. Okay. Now, that brings up something when you
12 said 2011 or 2012. Oil prices were pretty good?

13 A. Yeah, averaging probably \$96 a barrel, maybe
14 98.

15 Q. And drilling costs were substantially higher,
16 too?

17 A. That's right. Kind of a mixing of apples and
18 oranges thing right there, but we wanted to run them
19 anyhow to see what it looks like.

20 Q. Did you discount revenue to account for the
21 future value of the dollar?

22 A. I, of course, ran before tax, discounted future
23 net worth. I did not take that -- I didn't show any of
24 this, no.

25 Q. So undiscounted numbers are higher than

1 discounted numbers?

2 A. Yes, absolutely. We do not account for time,
3 money -- discussion.

4 Q. And a dollar is substantially less than 20
5 years ago.

6 MR. BRUCE: Just give me a minute,
7 Mr. Chairman.

8 Q. (BY MR. BRUCE) Going to your Exhibit 6, your
9 case studies, and just in general, for Bone Spring, what
10 oil pad did you use?

11 A. Oil cut versus water or oil cut --

12 Q. Yeah.

13 A. A lot of these wells, you will see there is a
14 range of them. That's why we -- we saw some of the oil
15 cuts rather -- rather low compared to the water. So,
16 you know, I would have to say that a range could have
17 been as high as -- we saw 75 percent, first, of water to
18 as low as -- some of those were actually in the 40
19 percent range, I believe. The water fell -- of course,
20 most of the time, the water fell with the oil. And I'm
21 not saying -- that is not an exact set of ranges, but it
22 fit our purpose. It's also part of the reason why we
23 used the operating expense scenario that we did.

24 Q. Isn't the average oil cut in a Wolfcamp well
25 lower than a Bone Spring well?

1 A. I've seen some Wolfcamp wells that did have a
2 significant water cut, but from the wells that you're
3 talking about, equal or less.

4 Q. In looking at your Exhibit 6, what case number
5 would you apply to the Airstrip well here?

6 A. If I was a betting man, I would say case four
7 is -- cases four, five and six would be your Airstrip
8 Wolfcamp well. And that is really based upon Matador's
9 testimony, that they feel like that it'll be around a
10 400 MBOE well.

11 Q. So if it's 440,000 barrels, that's -- I think
12 you said your estimate of payout would be about a
13 quarter million barrels; is that correct?

14 A. In a Wolfcamp well, where you achieve your
15 payout of your original capital investment could be as
16 low as 250 and upwards -- and I'm saying this is if
17 everything goes good with your operations and frac and
18 everything else. You could look at 275 MBOEs.

19 Q. Do you recommend Jalapeno that they join in
20 this well?

21 A. That is not in my -- I would say, my bailiwick
22 of expertise.

23 Q. Okay. Now, regardless of what happens to the
24 working interest owner, whether you're an operator,
25 consenting working interest owner or a nonconsenting

1 working interest owner, the royalty owners and the
2 overriding royalty owners always get paid?

3 A. The people who originally own the minerals,
4 whether it's state, fee or federal, of course.

5 Q. That's right.

6 And if the well doesn't pay out, Jalapeno
7 isn't out, if it goes nonconsent, one penny?

8 A. Try me again, please. What did you just say?

9 Q. If a forced pooling order is entered in this
10 case, whatever the risk penalty --

11 A. Yeah. If the well doesn't pay out --

12 Q. -- and Jalapeno doesn't join in the well, it's
13 not out one dime?

14 A. They're not out -- Jalapeno would not have to
15 pay any money, and they wouldn't see any.

16 Q. And Matador certainly wouldn't see any money?

17 A. They would see money coming back to them even
18 if the well didn't pay out.

19 Q. But they would operate at a loss?

20 A. You're operating on the overall lifetime of the
21 project. It will be negative -- considered to be
22 negative cash flow, but they are going to be making
23 money off of it. If it comes in at, you know, 500
24 barrels a day and you know where your hyperbolic decline
25 and curves are, it's never going to pay out, but they've

1 still going to keep pumping it and make money on what
2 they can off of it.

3 Q. That all is common sense?

4 A. Absolutely.

5 Q. But if the well costs 6-and-a-half million and
6 you only make 5-and-a-half million, we're loosing money?

7 A. Absolutely. I mean, you're going to be losing
8 money. If you can mitigate the risk, try to keep from
9 losing money.

10 Q. Let's talk about that very briefly. If you
11 could turn to Matador Exhibit 23, Mr. Gaddis -- 23 and
12 24 together, what, in your analysis, is the risk
13 involved in drilling this well -- in drilling and
14 completing it?

15 A. As I stated earlier, as far as risk, it's call
16 operational risk. Matador's drilled a lot of wells.
17 Maybe that first well in an area might have some
18 operational risk, but in this particular area, they have
19 already discovered that with their Pickard well. They
20 already know they've got a problem in the Wolfcamp.
21 It's called geopressure. And it's also what caused that
22 wellbore to collapse or sluff off and what -- what they
23 finally had to go to some really heavy mud to maintain
24 the wellbore integrity.

25 And I will state again that these guys are

1 drilling a lot of wells. In fact, I know the school he
2 went to. He's brilliant. So anyhow --

3 Q. I sense a little favoritism in schools here.

4 A. Very much so, yes (laughter). I will say they
5 don't turn out dummies from that school. I'm one of
6 them, so I'm patting myself on the back.

7 But these guys know what they're doing, and
8 they've already had their first well in there. We'll
9 see if their AFEs are higher on the first well. Most
10 people do that. But to call it an operational risk of
11 75 percent, I find that stretching it kind of -- I don't
12 believe it. Let me put it that way. I would have to
13 say that they've got a real good chance of getting all
14 of their wells down at the AFE cost here on out out
15 there. They know what the Wolfcamp is like. So I would
16 say bare, bare minimum, 95 percent operational success.

17 Now, when I say operational success,
18 they've got casing set. They've got cement, and the
19 rest of it on the frac job, they've done tons of those,
20 too. And they -- from what I can tell, they use some of
21 the latest technology. They know where to perf. They
22 know how to perf it. They know how to -- whatever
23 they're using for -- or if it's packers or whether
24 they're using brines [sic] and baffle, I don't know.
25 I'm a reservoir engineer. But judging from some of

1 their other Wolfcamp wells, they've been extremely
2 successful.

3 Q. Well, looking at what Matador said regarding
4 risk involved in drilling this well, what risk would you
5 give?

6 A. Operational or reservoir?

7 Q. Overall.

8 A. Overall. If I multiplied it up in my head, I'm
9 going to say -- the drilling engineers are not 100
10 percent, but he's going to get that well down to AFE
11 cost, plus or minus a little, maybe slow. But geologic
12 risk to me -- we already tend to show that there is --
13 and to me the geologist has already said that they
14 believe there is more total organic carbon in the
15 Wolfcamp than there is in the Bone Spring. So I'm going
16 to take him at his word. That's not going to be part of
17 it.

18 The thermal maturity in the Wolfcamp is --
19 I would have to say there is a good chance that if it's
20 already in the Lower Wolfcamp, all the chance -- I think
21 you're looking overall, completionwise, geologic and
22 reservoir risk -- when I start looking at reservoir
23 risk, yeah, you've got a little bit. But I think you're
24 dealing with 70, 80 percent chance of success on this
25 well. Otherwise, I don't think they'd be drilling it.

1 You can call it a 10 percent wildcat, but
2 if it's 10 percent, I don't want to be a stockholder if
3 somebody goes and spends 6-and-a-half million bucks to
4 prove a point, when you can spend a million and a half
5 or 2 million and get yourself a core, samples and find
6 out.

7 Q. And an added cost to the well?

8 A. Sir?

9 Q. And add substantial cost to the well?

10 A. It's better than drilling a \$6.5 million
11 duster, if you add, what, 250-, \$500,000.

12 Q. I think the estimates were substantially more
13 than that but whatever.

14 A. Whatever. Say a million. I'd rather have
15 \$7-and-a-half million on a great Wolfcamp well than
16 6-and-a-half million on a beer can disposal.

17 Q. When you drill a well, is there any guarantee
18 it'll pay out and you'll make money on it?

19 A. May I qualify that? If you are in a resource
20 play, you have a better chance of making oil than any
21 conventional series I know. So in a resource play,
22 chances are you're going to make a well that'll give you
23 some money back. You have a 66 percent chance that you
24 will -- in the Bone Spring, that you'll actually pay for
25 that well. You'll get your money back plus \$1.00.

1 Q. But we're not dealing with the Bone Spring
2 here.

3 A. In a Wolfcamp, it looks -- and, again, let me
4 reiterate. I only had 64 wells to deal with. That does
5 not really fit the criteria, but when I put my
6 regression analysis through it, it looks very good. And
7 let me tell you that there you've got well over 80
8 percent. I said 87-and-a-half. Of the wells I
9 analyzed, 87-and-a-half of them, when I normalize
10 everything, they're going to pay out. Now, if somebody
11 spent \$15 million for a Wolfcamp well and immediately
12 oil prices dropped down to 30, no, you're not going to
13 get it. But when you normalize it, it pays. So
14 Wolfcamp is a good bet. It's a real good bet.

15 Q. Which Jalapeno isn't willing to spend any money
16 on?

17 A. They're willing to spend their money -- I think
18 if they spent a little more, they could make my bets a
19 little better. Let's go get a core, go get some logs
20 through that zone before you do the rest of it.

21 Q. Isn't that contrary to what you commented on
22 Matador's geologic presentation? Why should they get
23 more geologic data if you're assigning no risk to the
24 geology?

25 A. Well, let's take a look at that just a second.

1 Do we believe that the profit is greater than 8 percent?
2 They themselves say that's a pretty low risk. They've
3 seen the same vertical wells that have been drilled
4 through there, and they've drill through it themselves.
5 Total organic carbon -- their testimony is that there is
6 more total organic carbon there than there is in the
7 Bone Spring, which kind of sets it up to say that medium
8 might be just a little bit high on the guesstimation
9 process.

10 Then you look at thermal maturity. If that
11 one is the high one -- we have thermal maturity in the
12 shales above in the Bone Spring. We have thermal
13 maturity in the Lower Wolfcamp in this area. And I
14 think it would be most unique f we didn't have thermal
15 maturity in the -- in the space in between. But then,
16 again, that's -- that's just a little thought process,
17 to have it both places.

18 Does it have the brittleness to make it
19 where it'll be fractured? That's a little risk. But
20 I've got Wolfcamp in Eddy and Lea and Wolfcamp to the
21 north that says yeah, it can be fractured.

22 What I'm saying is the chance of a geologic
23 success -- and you're mixing up reservoir with that as
24 well, reservoir, saying 25 percent. I'm -- I'm thinking
25 that's playing the lower end that it's not there. I

1 believe your geologic success is much higher than that
2 because the Wolfcamp is there.

3 Q. Earlier you testified on direct examination
4 that -- you said geologic risk was zero. In other
5 words, it's 100 percent sure?

6 A. Yes. And I'm saying the geologic risk is zero
7 because the formation is there. Again, I'm referring to
8 the technique that was known as, I believe, Stogner's
9 method. Is the Upper Wolfcamp present? Is the zone
10 present? And the OCD ruling said, Yes, it is.
11 Therefore, that risk is zero. And I was just
12 mirroring -- mirroring that opinion.

13 Porosity is a reservoir concept. And the
14 others, as far as geologic risk factors, I think that's
15 more of a reservoir aspect you have to look at. But
16 under the definition, as I was led to believe and have
17 seen, the geologic risk factor is -- there is nothing
18 there because the Upper Wolfcamp is present.

19 Q. So you're saying -- again, this is your
20 comment -- there is like an 80 percent chance of success
21 in this well?

22 A. I believe that yes, I think the upper end of
23 success of this is 80 percent, and I also said I believe
24 it could be as low as 70. I think there is a very good
25 chance that there is going to be a Wolfcamp well -- a

1 good Upper Wolfcamp well made here.

2 Q. Thank you, Mr. Gaddis.

3 A. Thank you.

4 CHAIRMAN CATANACH: Any redirect?

5 MR. GALLEGOS: Do you want redirect after
6 lunch or now?

7 CHAIRMAN CATANACH: How long?

8 MR. GALLEGOS: Not that long.

9 CHAIRMAN CATANACH: Go ahead.

10 REDIRECT EXAMINATION

11 BY MR. GALLEGOS:

12 Q. There was some question that I think you
13 probably have answered it now. But as far as knowledge
14 concerning the geology in the four-township area, did
15 you make yourself aware of the vertical wells in that
16 area?

17 A. Did I make myself a list?

18 Q. Did you study what information was available on
19 vertical wells in that area?

20 A. There are a lot of vertical Wolfcamp wells in
21 that area. And all we did was take a real quick cursory
22 look to say, Yes, the Upper Wolfcamp is there. The
23 Lower Wolfcamp where penetrated is there. And I would
24 say I was unable to find a whole lot of data, and I
25 think it's tough to find it, as Matador has said. But

1 the fact that the Upper Wolfcamp seems to be quite
2 ubiquitous in that four-township area, it's definitely
3 there.

4 Q. Now, on the 64 wells -- Wolfcamp wells that you
5 did look at, would you tell the Commission whether some
6 of those were what you might call step-out wells?

7 A. Yeah. They were -- definitely, of all those
8 wells -- you might have had one well originally in the
9 area, and then somebody would say, Okay, this is
10 productive; let's -- we have acreage in between, but
11 let's step out; and they might step out a mile or two or
12 five from what we've seen. Time-lapsewise, there were
13 wells stepped out a considerable distance away.

14 But we attempted to locate the first
15 horizontal Wolfcamp well in an area, and then over the
16 next -- you know, the subsequent years, how many
17 wells -- and lot of the wells were step-outs. Not so
18 many of them, I would say, were infill wells either.
19 They were step-outs and pretty much on their own. So it
20 could be five miles. It could have been as much 10 to
21 12.

22 Q. I'd just like a little clarification because
23 we've heard some numbers that are slightly different.
24 If I understand your testimony, the Wolfcamp is a
25 resource play, and from you observed in those wells,

1 there's been 87.5 percent of those wells that are payout
2 or better?

3 A. Yes. When -- let me clarify. When I
4 normalized it, we used the same pricing deck against all
5 wells, actual production data, cost of 6.5 million
6 capital, times zero, normalized forward. Yes,
7 87-and-a-half percent that actually reached payout of
8 the original capital investment that I used -- the
9 capital investment that I used.

10 Q. Okay. Now, how does that compare to your
11 recent testimony that you're saying that you think that
12 the probable success on this Airstrip well, that Matador
13 would be an 80 percent factor? Is that based on payout,
14 based on -- how do we correlate that with the 87.5
15 percent?

16 A. The way I would correlate that is not on -- I
17 can say that when I look at my probability plot and I
18 plug in the numbers that Matador themselves have said a
19 400 MBOE well -- and let's assume that doesn't mean 400
20 MBOE, but on an average Wolfcamp well, a 400 MBOE, plus
21 subsequent gas producing with it, you're talking
22 something in excess of maybe 500 to 550 MBOEs. The
23 midpoint that we see -- the P50 point on a probability
24 plot is 492, so I think we're right there in the
25 midrange range, and it would definitely pay out under

1 these economic situations as we have right now.

2 Q. Do you have an opinion for guidance for the
3 Commission, that the Commission is thinking are we
4 better off to think about a measure of success is well
5 payout or a measure of success is what we might call the
6 Stogner factors? Which, from a reservoir engineering
7 standpoint, do you think is the more rationale?

8 A. I think that once you establish production in
9 that area and the other criteria I've talked about, that
10 when you concede that, one, you have a definite producer
11 and you can say, I have this production, I think the
12 better method is let's talk about the percentage of
13 wells that pay out to start establishing risk, not --
14 nothing against Mr. Stogner. I just -- from a reservoir
15 engineering standpoint, that's a little -- it's not
16 something I've normally seen. Let me say that.

17 Q. But if you -- from your testimony on cross, I
18 would understand that if you're -- if you're using the
19 Stogner approach, you'd have first percent operational
20 risk, zero geologic risk and what reservoir risk?

21 A. Well, between -- let's just call it -- let's
22 call it 80. You know, let's take it down. 75 percent.
23 Let's call it 75 percent. 25 percent chance of failure
24 of a dry hole or something less than a payout well.

25 Q. So 5 percent, zero percent and 25 percent --

1 A. Yeah.

2 Q. -- if you use those factors?

3 Although, in your opinion, the rationale
4 way to approach it is what's the risk of the operator
5 returning his money by the well paying out and making
6 some money in addition?

7 A. Yes.

8 MR. GALLEGOS: That's all the questions I
9 have on redirect. Thank you.

10 CHAIRMAN CATANACH: Thank you.

11 Okay. We'll go ahead and break for lunch
12 at this point. 1:30?

13 COMMISSIONER PADILLA: Sure.

14 (Recess 12:15 p.m. to 1:33 p.m.)

15 CHAIRMAN CATANACH: All right. We'll call
16 the hearing back to order, and I think Mr. Gaddis was
17 probably still on the stand.

18 THE WITNESS: Do I have to put my coat back
19 on?

20 COMMISSIONER BALCH: No.

21 CHAIRMAN CATANACH: That's all right.

22 COMMISSIONER BALCH: Two out of three
23 Commissioners voted for no coats.

24 THE WITNESS: Sounds like a good decision.

25 CROSS-EXAMINATION

1 BY COMMISSIONER BALCH:

2 Q. Good afternoon, Mr. Gaddis.

3 There's been a lot of discussion in your
4 testimony about the Wolfcamp being a resource play, and
5 I think that even when you're short by 100 wells, that
6 you would need to make that definition. The wells that
7 do exist in the south part of the Delaware Basin
8 probably would meet that definition, even though there
9 is probably less than 100 or around 100.

10 A. Yes.

11 Q. But the wells that are being -- the well that
12 is being proposed is well north of that.

13 A. Yes.

14 Q. In fact, they're almost out of the Delaware
15 Basin or maybe in that channel between the Delaware
16 Basin and the Midland Basin, and they're almost up on
17 the shelf. That's a pretty different place, I would
18 think, to be at.

19 A. I think that's a good observation, but the fact
20 is, there is a Wolfcamp well there already. It is a
21 horizontal Wolfcamp.

22 Q. Lower Wolfcamp well?

23 A. Yes, Lower Wolfcamp. And, of course, that in
24 itself doesn't, I would say, prove that there is a
25 resource play going on right there. Of course, that's

1 what Matador would like to verify and prove up. I would
2 say that when you look at the statistics from the
3 Wolfcamp in the south part, either in Loving County,
4 Texas or what's proving up in Eddy and Lea, that the
5 Wolfcamp -- the Upper Wolfcamp is starting to show in
6 that area very close to having that 100 wells in
7 New Mexico. When you add in Lea -- Loving County, it's
8 there.

9 Q. Stratigraphically, that's got to be 3- or 4,000
10 feet deeper at least.

11 A. I am sorry?

12 Q. Stratigraphically, that's got to be several
13 thousand feet deeper.

14 A. But when we start looking at the components
15 that tell you you have a shale that is a Wolfcamp Shale
16 that's going to be a pay zone, I guess my contention is
17 that's not a rank wildcat area, even for Upper Wolfcamp,
18 because you've got the thermal maturity. You have
19 production in the Bone Spring. Somewhere in there
20 you've got the Lower Wolfcamp that's showing the same
21 thermal maturity, total carbon organic content. You've
22 got brittleness in the bottom part. You've got
23 brittleness above you.

24 And I'm not saying that that absolutely,
25 positively verifies it. But when you have it above you

1 and below you and you have a geopressured zone that you
2 know exists in that Wolfcamp, you've got a lot of the
3 components already to say, You don't have a rank
4 wildcat. But if you do, why not go get the additional
5 data? That's what I'm saying.

6 Q. So, I mean, even a resource play, they have
7 boundaries. There are edges to it. There are fairways
8 and sweet spots in there.

9 A. We even see that in the -- I guess you'd call
10 it the coalbed methane --

11 Q. Uh-huh.

12 A. -- that, I guess, 20 years ago or more, we used
13 to think that, okay, everywhere you drill, you're going
14 to get something good. Well, we found out not. There
15 are fairways. And that's what drilling a well does for
16 you. Hopefully, that first well really helps you a lot,
17 and the next wells help you more.

18 Q. I think I agree with you on that. My concern
19 here is that you're 29 miles away from the nearest Upper
20 Wolfcamp well, and then the next two closest are 45 and
21 49 miles away. I mean, that's a substantial distance
22 even in a resource play; wouldn't you think?

23 A. I would say yes. But it is -- do you feel like
24 the Upper Wolfcamp is a regional thing? That's -- we
25 see the Upper Wolfcamp in existence there. So is it too

1 different -- is it two different systems? I can't
2 answer that either. But to say that there is a less
3 than 10 percent chance of hitting a Wolfcamp well that
4 will produce oil, I find that to be -- again, this is my
5 opinion based upon the information that I've come up
6 with. To say that that is a 10 percent chance of
7 success seems remarkably low.

8 Q. I'm not sure I agree with that risk assessment
9 method myself, but it's probably somewhere between 10
10 and 100, right?

11 A. I wouldn't give it 100 percent chance success.
12 I'm not that optimistic.

13 Q. It sounds like the numbers you were tossing out
14 would put it between 15 and 70 percent chance.

15 A. Yeah. I would say 75 to 80 percent. Call it
16 70 to 80, my range, that I think is their chance of
17 making a payable Wolfcamp well above a P90.

18 Q. Well, what would you call a wildcat out there
19 in a resource play like the Wolfcamp?

20 A. If it was a total wildcat, there would be no
21 penetrations in the Wolfcamp of any kind, vertical or
22 horizontal. There would be nothing out there to say --
23 other than maybe 3D seismic possibly or maybe you've got
24 a well 40 miles away that penetrated in the vertical
25 position that says, Yeah, the Wolfcamp's sort of over

1 here. But my goodness, we've got hundreds of
2 penetrations that say the Wolfcamp is there. I'm not
3 saying --

4 Q. I agree that you know the Wolfcamp is there.

5 A. Okay.

6 Q. I'm going to probably also think that not a lot
7 of it has been extensively logged, because people were
8 going to deeper targets and shallower tar- -- or deeper
9 targets, so they're going to log in what they're
10 interested in. There are two parts to that: Probably
11 not a lot of core. They're showing one piece of core
12 that was --

13 A. Yeah. Yup.

14 Q. -- perhaps analog. New Mexico Tech did a
15 resource evaluation for the southeast -- for the Pecos
16 District for the BLM a few years ago. Granted, there is
17 a lot more data now than there was even three years ago.

18 A. Yes.

19 Q. We put the fairway for the Wolfcamp as probably
20 about halfway through the potash area and then further
21 south. So, I mean -- I bet that information has changed
22 a little bit, but I think this is still a little bit
23 frontier, to go 30 miles away from the nearest Upper
24 Wolfcamp.

25 A. I can't disagree with you. The fact is a

1 horizontal Wolfcamp well, the closest one, 20 to 40
2 miles away, whatever that may be, it's a considerable
3 distance, and I can't argue -- I can't argue the
4 geography of where those wells are located.

5 Q. So you drill the first one there, this first
6 one that's being proposed. You'll have a lot more
7 information for sure.

8 A. I would tend to think if you establish
9 production -- if what they say, a 400 MBO well, I would
10 have to say, you know, it goes against everything --
11 what everybody says of how many wells it takes to say
12 you've established a resource play. But with the --
13 with the knowledge of what you have, one well, if it's
14 really fantastic and there's nothing exceptional about
15 it to say as to why this well is or isn't a 400 or 800
16 MBOE well, it would lead you to indicate there's going
17 to be a lot more drilling up there because it just came
18 in the minds of whoever is drilling that it's a
19 resource.

20 Q. Sure, if you prove it up.

21 A. You bet.

22 Q. Or at least it's targeted, and you're going to
23 need a lot more wells before you finally prove it up.

24 Well, I think the next thing I'd like to
25 talk a little bit about with you is just the -- the

1 payback part of it --

2 A. Okay.

3 Q. -- 66 percent chance that you would break even
4 on it. As you know -- well, Helge Haldorsen, the
5 previous SPE president --

6 A. Try me again. I'm sorry.

7 Q. Helga -- Helge Haldorsen, he was last year's
8 SPE president.

9 A. Okay. Yes.

10 Q. And he likes to remind students, particularly
11 when looking at senior design and things like that, that
12 energy companies aren't in the business of making oil.
13 They're in the business of making money.

14 A. Yes.

15 Q. So breaking even on 66 percent is not really
16 that great. You'd have to have a good, substantial
17 portion of them where you do way better than you do
18 breaking even to make up for the ones you don't break
19 even on.

20 A. I agree with you.

21 Q. Those three wells in a resource play, you have
22 that advantage that they're probably going to make
23 something or recoup some of that loss. They're got
24 going to be 100 percent dry hole in most cases, but the
25 economics say you have to have, over the portfolio wells

1 that you drill in that play, enough money for mutual
2 funds, or the investors are going to go somewhere else.

3 A. Yes.

4 Q. So that's something we have to wrestle with on
5 resource plays versus, you know, more traditional type
6 of plays, especially when it comes to risk assessment.
7 And the wells are more expensive, horizontal or long,
8 and, in this case, they're pretty deep as well.

9 There is not 100 Upper Wolfcamp wells at
10 all, much less in the area.

11 A. Agreed.

12 Q. I want you to convince me this is not a
13 wildcat, at least at some level. It seems to me there
14 is some risk associated with this.

15 A. I agree that there is some risk. And when I
16 sit there and I -- let's just put it into a --
17 operational risk, I've already talked about. Not that
18 risk. I'm not going to worry about operational risk.
19 I'm going to talk to you -- if I'm on an exploration
20 team, which I've been on a variety of them in my career,
21 when you look at something like this, that -- the first
22 thing that comes in is: Is this reservoir present?
23 That's a big piece of it. The horizon is present.
24 Okay? The Wolfcamp is there. Since this stuff isn't --
25 or doesn't appear to be -- let me -- let me read just a

1 minor part here, but the -- "a continuous hydrocarbon
2 system that is regional in extent." That's number two
3 on the SPE's list of how you quantify a resource play.
4 Of course, the first one is it's got to be repeatable
5 statistical distribution of the EURs. We don't have
6 that here.

7 Q. You don't have 100 wells.

8 A. You don't have 100 wells. You have -- down in
9 Loving County, you do, but in Eddy County and Lea,
10 combined, I was able to mess with 64.

11 Now, in answer to your question, is this
12 continuous hydrocarbon system -- this is what one well
13 will prove, I think, is that it is. Pre-hydrocarbons
14 are not held in place by hydrodynamics. So we're
15 dealing -- I was always used to saying, Okay, what does
16 our structure look like? What does our 3D seismic look
17 like? It's a different set of items, whatever it is
18 that we look at, but the tier one items are those. And
19 we are -- what do we take from something like this? The
20 Wolfcamp is present. Do we know that there is porosity
21 greater than 8 percent in the immediate area? You can
22 always say in the immediate area, we don't know anything
23 where that location is located. But it's pretty obvious
24 that Matador knows a lot about what is there and what
25 they feel like is there or what they hope is there, and

1 when they can -- when they can unequivocally state that
2 yes, there is more total, more organic carbon there than
3 in the Bone Spring, that's a good point.

4 The other one is -- I believe it was what
5 reserves are you expecting? And they said, Probably a
6 400 MBO well. And what I inferred beyond that is
7 they've already established the first well in the area.
8 They know it's geopressured at least in the Lower, and
9 everybody knows it's not geopressured in the Bone
10 Spring. Where is the barrier? Does any of the Upper
11 Wolfcamp or the other Lower Wolfcamp in the other
12 areas -- everybody knows -- it seems that everybody
13 knows it. Yes, the Wolfcamp, the reason you go after it
14 is geopressure. So has something occurred between the
15 Lower Wolfcamp and Upper Wolfcamp that has cut off the
16 geopressure in the Upper Wolfcamp? It doesn't happen,
17 as far as I know, anywhere else. Maybe this is unique,
18 but I don't think so.

19 A lot folks through my last 15, 20 years of
20 just being involved in New Mexico drilling and other
21 drilling -- in this part of the country, when you go to
22 drilling vertical wells and, you know, horizontal, but
23 when you go vertical wells, you've got to be careful to
24 know that the Wolfcamp is probably going to be
25 geopressured. So that takes away one of the big risks

1 that I see that says this is not a rank wildcat.

2 And reservoir qualitywise, I think you
3 have -- I just tend to think you've got a
4 reservoir-quality rock up there. But --

5 Q. It sounds like you've boiled it down to the two
6 big risks being mechanical, you can't fracture the rock,
7 or there is not enough porosity.

8 A. That would be, I think, your reservoir
9 situation. And most of your Wolfcamp appears to have --
10 now, again, I say appears because nobody has gathered up
11 any samples in the vertical wells and been able to take
12 a look at them and analyze them to say, Yes, these do
13 have a fracturing capability; they've got enough
14 brittleness in them. So if that's the Lower Wolfcamp --
15 right there, six, seven miles away, it fracked. It had
16 the brittleness you needed. The Bone Spring above it,
17 it has the brittleness you need. And it's hard -- why
18 would the Upper Wolfcamp not have it?

19 Q. I think it would be more dependent upon
20 deposition, and you're talking millions of years' time
21 span. Things can be different.

22 A. Quite possibly. Quite possibly.

23 So like I said, to me it boils down to is
24 the porosity there, or is there any -- and if there is
25 no data to say there is no porosity, then that is part

1 of your risk.

2 I -- I tend to think that most of the
3 Wolfcamp, it's not all perfect, but it does have the
4 ability to be fractured, and it does have the
5 brittleness necessary. So mine has become a
6 reservoir-quality issue, and that's at 8 percent. And I
7 think you've got a good chance it's there.

8 Q. But if Jalapeno had the majority interest
9 there, would you encourage them to drill this well?

10 A. They wouldn't have hired me. But, again, to
11 say would I recommend -- I'm a consultant. I don't get
12 brought in on those decisions. But if they had the
13 majority of it, I would -- I would think that they'd be
14 the kind of folks that would go in and get a pilot hole
15 and find out what are they actually spending their money
16 on.

17 Q. Thank you very much.

18 A. Thank you, sir.

19 CROSS-EXAMINATION

20 BY CHAIRMAN CATANACH:

21 Q. Mr. Gaddis, you can't really separate a
22 geologic -- a geologic factor and a reservoir factor.
23 Don't those have to be considered in combination with
24 each other? I mean, you can't -- just because the
25 Wolfcamp is there doesn't mean it's going to be

1 productive?

2 A. That's right. I agree with you on that,
3 Mr. Catanach, Commissioner. I -- one of the biggest
4 risk factors that we used to talk about was -- is --
5 well, when you would go after a zone that maybe was a
6 river channel, the biggest problem people had was how
7 can we see that? Well, 3D seismic enables it. Yes, the
8 river channel was there. And I can tell you I drilled a
9 number of those and found out one well wasn't connected
10 to the next. But the river channel we were able to see
11 and dense enough drilling we could connect them up.

12 But in answer to your question, absolutely.
13 Just because the Wolfcamp is there doesn't mean it's
14 productive. But the fact that it is there and it's
15 proven to be productive in a rather large region and
16 been penetrated many times all around with vertical
17 wells, I tend to lean more towards the fact that I think
18 Matador really truly believes that it is a productive
19 horizon or they would be hesitant to spend 6-and-a-half
20 million bucks.

21 Q. So given the fact that you've agreed that there
22 are fairways in this Wolfcamp interval and there could
23 be sweet spots and such, isn't it possible that you
24 could, at this location, drill a well where you're not
25 going to hit all the permeability that you need or have

1 all the geologic characteristics that you need to make a
2 good well?

3 A. Let me divide that up just a little bit. There
4 are -- even within the zone like the Wolfcamp out here,
5 you're going to have portions of those rocks -- the Bone
6 Spring, the same way -- that some of them will be
7 softer. They'll be able to be -- some of them will be
8 harder. I mean, there is a difference in them. It's
9 like saying they don't both possess oil. Maybe one of
10 them has got maybe a little bit more perm and one of
11 them doesn't. But right now what I am seeing and what
12 I've been familiar with and what I've been involved with
13 is that people are starting to take that information
14 while they're drilling, whether it's gamma ray while
15 drilling, add to it penetration rate, weight on bits,
16 rotation, all those factors, you send all those into a
17 super high-tech company that can crank on those, and
18 they can actually show you where all your different
19 types of rocks tend to accumulate so that you don't end
20 up trying to frac one that's harder than the other one.

21 So there is nothing -- everything in
22 nature, like the rocks we deal with, is heterogeneous.
23 I've never found a homogeneous reservoir. But to say
24 that these are homogeneous would be -- I mean, you just
25 can't. But the heterogeneity of it is also a tool you

1 can use to make sure you get your frac placed right.

2 Q. So I just want to understand. The area that
3 you examined as far as the Wolfcamp area, you examined
4 64 wells, and it's a rather large area. I don't think
5 it was actually defined as far as miles.

6 A. No. It's just a big -- it was really from the
7 New Mexico-Texas border up to, I guess, the farthest
8 extent in Eddy County and Lea County where we saw some
9 Wolfcamp wells producing.

10 Q. And in that area that you looked at, you
11 just -- you didn't differentiate between Lower and Upper
12 Wolfcamp?

13 A. No, I didn't. If it said "Wolfcamp," I grabbed
14 it.

15 Q. And in that area that you examined, those were
16 all horizontal wells?

17 A. Yes.

18 Q. Were there any dry holes?

19 A. Let's see. If there was a horizontal well that
20 had been drilled in the Wolfcamp that showed up with
21 zero production on it, and I did not know whether it was
22 a dry hole or not, or was it a failure of some type, I
23 didn't know that either. The only thing I looked at was
24 the wells that actually had enough production on it for
25 me to be able to put a decline curve on it. And I

1 believe -- I would have to think that there may be at
2 least a failure or two, and there might possibly be a
3 true dry hole, but it would be a step out so far out of
4 the region, I think that -- or something beyond the
5 scope of what I was looking at to say what that well
6 was, why it was a dry hole.

7 Q. So then the next step, you took all those 64
8 wells and you got a decline on them, you got an ultimate
9 recovery from them and then you normalized all that
10 production --

11 A. Yes.

12 Q. -- to determine that. And I think the number
13 you came up with is 87.5 percent were capable of paying
14 out?

15 A. Yes, sir. Let me explain. When you take all
16 of the wells, normalize them to day one with their
17 production, I take the actual production data and apply
18 an annualized cost of -- I mean an annualized price of
19 oil and gas that we use for those, and we use the same
20 capital cost for each well. And all that's saying is
21 that if we took every well like that right now, drilled
22 them at this point in time with the capital cost of 6.5
23 million and applied today's pricing depth to it, that's
24 how many of those wells would have paid out,
25 87-and-a-half percent of them. That's a bunch. But

1 that's how good some of the Wolfcamp wells have been
2 down there.

3 But, again, we know some of those wells may
4 have cost 15 million bucks, and they were a couple of
5 years ago. And if you don't get your payout on some of
6 these wells within 18 to 24 months, you're never going
7 to get one, or it's going to be a long time of an oil
8 price.

9 What I did was I wanted to take a
10 normalization route and say, Yes, these wells would have
11 paid out at today's circumstances. That's all -- that's
12 what that was.

13 Q. But in reality -- I know what you were trying
14 to do, but in reality, each of these wells is going to
15 have different well costs, and there are going to be
16 different things that affect --

17 A. Of course.

18 Q. -- when they pay out. So, you know -- so this
19 is kind of like -- to you, it's like an average or
20 something?

21 A. That's one way to put it. If you plot up all
22 of the EURs on cum prob paper, cumulative prob versus
23 the log of the EUR, you tend to get straight lines out
24 of the data. Now, I did that; then I did type curve
25 analysis to come up with where does the real payout

1 occur with a type curve? And I came up with those
2 ranges, 250 to 275 MBOEs. And when I put that on my
3 regression line, it says about 66 percent of those wells
4 were going to pay out, or more. It depends on where --
5 where you really feel.

6 And when you take a well and normalize and
7 put in today's data with it, yeah, that many
8 percentage -- of the wells I looked at, that percentage
9 paid out 87-and-a-half. And, again, that's based on my
10 economics, the -- as I said, 6.5 million per well,
11 applying a cost of the Bank of Oklahoma's pricing deck
12 and everything's normalized, everything consistent
13 between each well, operating expenses and everything.

14 Q. I don't recall the last -- last hearing. Is
15 that what Jalapeno was proposing the risk penalty to be,
16 66 percent on this compulsory pooling?

17 A. I do not recall. Try me again, your question
18 again. I'm so sorry.

19 Q. The risk penalty for the compulsory pooling
20 order, is that what they're proposing? Rather than the
21 200 percent, are they actually proposing 66 percent?

22 A. I believe the Division recommended 133 percent
23 penalty, if that's --

24 THE WITNESS: Is that right, Gene?

25 MR. GALLEGOS: That's not the question.

1 THE WITNESS: But I believe it was --

2 CHAIRMAN CATANACH: It may be 50 percent,
3 according to Commissioner Padilla.

4 COMMISSIONER PADILLA: If I remember
5 correctly.

6 CHAIRMAN CATANACH: I don't have anything
7 else.

8 COMMISSIONER BALCH: Can I follow up, at
9 the risk of the stepping on Patrick?

10 THE WITNESS: Let me -- let me -- I think I
11 understand a little bit better. What you're saying is
12 that -- were you referring to the Railroad Commission
13 data, the way they have assessed risk penalty, that they
14 look at all the wells in a five-mile area and say, Okay,
15 half of them payout, okay, that's a 50 percent risk. Is
16 that what you're referring to?

17 Q. (BY CHAIRMAN CATANACH) I'm referring to -- I
18 mean the risk penalty that we award in this case, I just
19 want to know what Jalapeno was recommending as far as
20 the risk penalty, and I think it was presented at the
21 last hearing.

22 A. At 66? I don't recall, but from my numbers
23 that I'm seeing, on a P50 well, at a 66 percent penalty
24 where you're force pooled, the interest would begin to
25 get some value for their interest.

1 Q. All right.

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1 RECROSS EXAMINATION

2 BY COMMISSIONER BALCH:

3 Q. Just to follow up on the payout a little bit
4 more, what's the timing of that payout? That's kind of
5 critical. If it's 30 years away, that well is much less
6 desirable than one that's three years away from payout.

7 A. We -- again, it really depends on the type of
8 well. But we see payouts occurring for not the original
9 capital investment, but the penalty payout, of course,
10 from nothing all the way up to 35 years from now.

11 Q. In those wells that you looked at --

12 A. Yes.

13 Q. -- so everything?

14 A. So if I was going to say, Let's take a
15 middle-of-the-road well, give it a 66 percent -- a 500
16 MBOE well. Let's put a 66 percent penalty on it.
17 Somewhere around -- I believe it was around 2033, is
18 when -- I'm going to back up. Between 2029 and 2033 is
19 a range where you will start to see some value come back
20 to you, the working interest owners that were pooled.

21 Q. Not to the primary operator? You're talking
22 about the force pooled --

23 A. Yeah. The primary operator is going to have --
24 he's going to be making money off that interest for
25 quite a while.

1 Q. So I'm going to use this conventional well. If
2 I go down to Roswell and I asked the small producers
3 what they want to see in a project, they tell me they
4 need to see a 3-to-1 payout in the first three to four
5 years, or they can't beat mutual funds portfolio-wide.
6 Now, that's conventional wells.

7 A. Yeah.

8 Q. And I'm going to agree with you, I think, that
9 horizontal wells are less risky than that. The question
10 is how much less risky?

11 A. When you drill the number of wells you need to
12 mitigate that risk of hitting all your wells at the P90
13 range, but you're not going to hit all of them at the
14 P10, your average is going to be in that P50 range,
15 you're going to have to drill a portfolio of 30 wells,
16 and you're going to have to -- in order to hit, I would
17 say 30 wells minimum. What that means is you're when
18 hitting that P50 -- I don't want to get into the booking
19 reserves and aggregation type stuff. But what it means
20 is that you get better and better and faster at drilling
21 them and cheaper, and you also get better at bringing
22 them on and keeping them on. So what it really comes
23 down to is you can beat the mutual fund once you're in
24 that resource play, but you've got to be good at it.
25 And I think a lot of folks are getting very good at it.

1 I think Matador's good at it.

2 CHAIRMAN CATANACH: Thank you.

3 CROSS-EXAMINATION

4 BY COMMISSIONER PADILLA:

5 Q. Mr. Gaddis, just a few questions. The \$6.5
6 million cost estimate per well, is that based entirely
7 on the AFE, or is there some other cost data from the
8 producers?

9 A. That cost data, I believe, was the value that
10 Matador put on some of their public data, if I'm
11 correct.

12 Gene, you may correct me.

13 But that was information from them that we
14 saw in their public, I guess -- not their exhibits --
15 their annual report, the 6.5 million.

16 Q. I think I just heard -- I can't remember if it
17 was the Chairman or you when you were talking about it.
18 It's not an average price. It would be safe to say
19 that's about the minimum cost you're going to get a well
20 drilled and completed for. So we're really talking
21 minimums for a Wolfcamp horizontal?

22 A. For a Wolfcamp well? I know that there are
23 people drilling Wolfcamp wells with merely a
24 mile-and-a-quarter lateral, and they have got the
25 drilling time down from over 40 days to around 15 days

1 now. And they've actually gotten their entire cost to
2 around \$5 million. These are Wolfcamp wells but next to
3 the New Mexico State line. And 6.5 I think is a -- I
4 think is a pretty good number. It's not too high. It's
5 a good middle-of-the-road number that you'll see
6 Wolfcamp wells being drilled at completed at out here.

7 Q. But that would be in -- you know, disregarding
8 your normalization, that would be in the future?

9 A. Yeah.

10 Q. So all the wells that we're talking about, the
11 64 Wolfcamps that are in your study, would have
12 historically cost probably significantly more than that?

13 A. Absolutely. Yes. We've seen wells that
14 were -- like, they're now 5.25 million or 6.5 million
15 that were in excess of 8, 10, 12. Yes.

16 Q. So when you say that the P50 -- I think it's
17 492 MBOEs -- 492, that's based on a 6.5 million cost,
18 right? So that would shift?

19 A. No. Those values of MBOEs, there are no costs
20 involved in that. That is strictly an evaluation of the
21 estimated ultimate recovery of each well and plotted up
22 on prob paper.

23 Q. Okay. Moving on to the pricing, you mentioned
24 two figures early on in your testimony, 44.86 and \$50.10
25 a barrel after 2020.

1 A. Yes.

2 Q. Where do those numbers come from?

3 A. Those -- that was the NYMEX strip for that back
4 in September. That is rough pricing for these. That
5 really drives -- that's a hard pricing deck, but that's
6 what -- that's NYMEX's, kind of basis that you start
7 with.

8 Q. So Jalapeno's Exhibit 6, with the scenarios,
9 cases 1 through 6, is based on those or based on the
10 Bank of Oklahoma?

11 A. Those are based on the NYMEX pricing.

12 Q. Okay. So what's based on the Oklahoma
13 numbers -- Bank of Oklahoma numbers?

14 A. I am so sorry. I'm having trouble hearing.
15 Try me again.

16 Q. The Bank of Oklahoma numbers, the yearly
17 cost -- the yearly price projections that you listed off
18 earlier?

19 A. Yes.

20 Q. -- what are those the basis for --

21 A. Those numbers --

22 Q. -- as it relates to this case?

23 A. Yeah. We use the NYMEX first. And realizing
24 it is -- NYMEX is pretty much everybody would use in an
25 evaluation if you were going across the board. What we

1 were attempting to show really is what we feel like is
2 an acceptable pricing scenario for the next few years
3 and then a slow escalation of 3 percent. It's going to
4 be quite a while until you ever get to that \$85 a
5 barrel, which is the peak price.

6 But this pricing deck, it does show that
7 you can get -- when you normalize it, like I did, and
8 used that pricing deck for that scenario, that was where
9 I was showing that a payout, a well in the Bone Spring
10 that makes about 210 MBOEs, that's what you get your
11 money back. I want to say one dollar more. And on a
12 Wolfcamp well, from the -- and, again, it's 64 wells.
13 It was -- the regression line that I was able to get
14 from it and the type curve analysis shows that probably
15 around 275 MBOEs for a \$6-and-a-half million Wolfcamp
16 well. I can get it lower or I can get it higher, but
17 that's a pretty good number, I think, for the values.

18 Now, what does that mean? It means that by
19 just strictly type curve analysis, plugging in values,
20 then I can -- I can show easily that 75 percent of the
21 wells, again, in the Wolfcamp, the Wolfcamp
22 normalization -- I can show 75 percent of them at least
23 to pay out. That's with -- again, that's using a type
24 curve based on regression analysis.

25 Now, when I go through and normalize

1 everything and run it from day one, with that pricing
2 deck and a capital cost of 6.5, I get 87-and-a-half
3 percent of those 64 wells paying out.

4 COMMISSIONER BALCH: With a minimum of 13
5 to 17 years?

6 MR. GALLEGOS: I think Mr. Gaddis has a
7 hearing problem. I don't think he heard your question,
8 because you were asking what's the pricing source.

9 COMMISSIONER PADILLA: I think he did
10 answer it.

11 MR. GALLEGOS: Did he answer it?

12 Q. (BY COMMISSIONER PADILLA) NYMEX is the pricing
13 source for the exhibit --

14 A. Yes.

15 Q. -- for the exhibit with the case studies?

16 A. Yeah. For that exhibit, that five or six --
17 yes. The one where it shows the six cases, that's the
18 one we used NYMEX prices.

19 Q. So I guess the follow-up may be the one that
20 you're referring to, Mr. Gallegos.

21 What were the Bank of Oklahoma numbers used
22 for as it relates to the exhibits?

23 A. The -- the -- I don't believe I --

24 Q. I'm just wondering which numbers got used
25 where, essentially.

1 A. Okay. In the exhibit, I used NYMEX. And it
2 showed that there was -- using NYMEX pricing, there
3 would -- there would never be any type of payout or any
4 type of value given back to 200 -- with a 200 percent
5 penalty imposed, the NYMEX pricing shows that even in a
6 700 MBOE well, there is no value that ever came back to
7 the pool interests.

8 If I use this type of pricing here, it
9 shows that --

10 Q. Just to be clear, you're talking about the
11 NYMEX pricing?

12 A. The NYMEX.

13 If I use Bank of Oklahoma pricing, it's
14 really -- it helps show that yeah, there is some payout
15 occurring on a 700 MBOE well. There is some -- and
16 you're going to get -- the value will be better for your
17 pooled interest owner. But in a 350 MBOE well, even
18 using this -- I want to call it a more optimistic
19 pricing deck -- there's still no value ever given to the
20 working -- pooled interest.

21 A 500 MBOE well -- and, again, a \$6.5
22 million well is all and a Wolfcamp well drilled like
23 a -- standard operating, when you put this more
24 optimistic pricing, they're going -- they only start to
25 see money when you get less than 100 percent penalty,

1 and they start to see some value. And it's not
2 meaningful, but there is some value at the 66 percent
3 penalty.

4 Q. So is that the max percentage that they get,
5 like you said, one dollar back?

6 A. That is from -- from the scenarios I ran, in
7 that 66 percent penalty range is where finally the
8 pooled interest gets some value for their interest.
9 They get some value back.

10 Q. In any value whatsoever? It just goes from a
11 negative to a positive. That 191 percent actual flips
12 over. The 200 percent is met, and they get their
13 dollar?

14 A. They get some dollars back. It can be -- it
15 can be as low as 50, on up to maybe \$130,000, but it's
16 way on out there. Time, value and moneywise, it's not
17 much. But I didn't bring time and value into this.

18 Q. But for the purposes of that exhibit, you're
19 using the \$44.86 per barrel?

20 A. I see -- for the NYMEX, I started out --

21 Q. For 2020?

22 A. Yeah.

23 And for the starting point for the Bank of
24 Oklahoma, for 2016, was 47.77 a barrel. That was at
25 starting.

1 Q. So it's significantly better?

2 A. A bit better, yeah. But it does show if I
3 stayed with NYMEX, I could drive those into the ground
4 all over the place. But I wanted to show a little
5 bit of a -- I'm a reservoir engineer. I've got to
6 believe that their stuff is going to make money.

7 Q. Mr. Bruce asked about royalty rates and taxes
8 and all the deductions that would come off of -- you
9 know, before NRI. As far as that model you built --

10 A. Yeah.

11 Q. -- what were the -- is that all-inclusive? Let
12 me put it that way. And if it is, what were the LOE
13 costs, and where do those come from?

14 A. The answer to your question is a cash flow
15 naturally takes out your operating expense and your ad
16 valorem taxes. But this is a B tax. This is before
17 federal taxes. And this an undiscounted cash flow.
18 It's not discounted. I'm not sure what discount rate
19 I'd want to use. But yes, you take your net -- you take
20 your yearly net income, subtract from it your operating
21 expenses and your taxes, and that's your cash flow. And
22 what we see, of course, in all these percentages we've
23 been talking about, when does that initial capital
24 investment pay out? When does it occur? How much do
25 they make after that? That is what your cash flow is

1 telling you.

2 I will say it does look better with the
3 Bank of Oklahoma. They're a reputable financial
4 institution. This is more or less what they're loaning
5 money on. And I think -- they've been in business a
6 while, so I think they're feeling -- NYMEX can be very
7 punishing, and this may be more -- we are hoping it's
8 more realistic. I think everybody does. We'd love to
9 see it at \$80 again, but it may not happen for a while.

10 Q. And the NRI has calculated at 75 percent or 80
11 percent?

12 A. On the -- on the -- on the ones I did for the
13 exhibit -- because I went back to the 75 percent NRI.
14 Everything else I did, doing everything I could to get a
15 payout to occur, I used 100 percent and 80 percent and
16 stayed consistent with that when I was running the Bank
17 of Oklahoma, or if I made a run using NYMEX, I went
18 ahead and moved to the 100 percent, 80 percent type
19 interest working revenue, respectively.

20 Q. When you say everything else you did, are you
21 referring to the EUR estimates that were not part of
22 Exhibit 6 or --

23 A. No. Since -- since none of -- let me say that
24 the probability plots do not include anything other than
25 estimated ultimate recovery of each well.

1 Now, when I started running cash flows on
2 any of those streams on any of those wells --

3 Q. Which are based on those EURs?

4 A. Yes, based on that.

5 -- and I normalized the actual production
6 back to day one, I ran the Bank of Oklahoma pricing
7 nearly consistently to come up with wells, where would
8 they pay out and how many of them would pay out.

9 And, again, this is one that is strictly
10 trying to find out, in today's dollars -- if we go -- if
11 somebody goes on and drills another 102 wells in the
12 Bone Spring or maybe they go drill 2- or 300 Wolfcamp
13 wells, what is -- you look at the value. This is the
14 value right now of what we're looking at, a
15 \$6-and-a-half million Wolfcamp well. And this is based
16 on -- when I start looking at my probability plot in an
17 area, this is what I'm expecting.

18 Now, then, when I have done that -- but the
19 only way to really come up to say if I drill another 64
20 wells in the Wolfcamp like this, what are they worth?
21 Well, normalize your old data and run your economics
22 over the actual production and the decline and get
23 your -- and just take a look at all your wells. And
24 that way we came up with one -- that's how we came up
25 saying, My goodness, 87-and-a-half of these things are

1 going to pay out based on today's scenario -- economic
2 scenario.

3 Q. Okay. Just to summarize -- I think you just
4 answered my question -- the only thing you used from
5 NYMEX is the exhibit with the case studies?

6 A. Yes.

7 Q. Everything else you were using the more
8 favorable Bank of Oklahoma economic?

9 A. Yes, I did.

10 Q. Okay. Thank you.

11 A. Thank you.

12 RE CROSS EXAMINATION

13 BY CHAIRMAN CATANACH:

14 Q. Mr. Gaddis, there has been some testimony from
15 Matador that drilling costs are coming down. That's
16 going to affect your payout, as well as a change in oil
17 prices will affect your payout?

18 A. Yes, it will. Absolutely.

19 Q. I mean, it's -- you can't predict what those
20 are going to be?

21 A. Prediction is one thing, but if you notice on
22 our exhibit, the six cases, we ran that at the
23 \$6 million instead of the 6.5, and they still would
24 not -- with a pricing deck and the \$6 million DNC
25 [phonetic] cost, we still couldn't get any value being

1 returned at a 200 percent penalty.

2 Costs are coming down all over.

3 Absolutely. And if somebody came up and said, Mo, we
4 just drilled 15 wells at 4 million each. Can you
5 normalize those again? I go, You bet. Now let's see
6 what they look like. But yes, sir, I have to agree with
7 you. We are getting much better. And that may be a
8 curse if we get that good. We're going to have another
9 oil glut.

10 MR. BRUCE: I have a follow-up on something
11 from the Commissioners.

12 CHAIRMAN CATANACH: Sure.

13 RE CROSS EXAMINATION

14 BY MR. BRUCE:

15 Q. Mr. Gaddis, the testimony is that when you
16 calculated payout, you used a more optimistic price deck
17 and a higher NRI than you did in Exhibit 6.

18 A. (Indicating.)

19 Q. So does that inflate your payout percentage?

20 A. It -- when you drop in Bone -- of course, I did
21 and Bone Spring and Wolfcamp. Let's talk Wolfcamp. I
22 ran it at \$6.5 million that Matador feels like they
23 could drill them for, and probably get better than that
24 even. If I run that value at NYMEX pricing, it will
25 show that there will be no value ever returned to a -- I

1 mean, it would have to be phenomenal Wolfcamp well,
2 approaching 900 to a million MBOEs before any value was
3 ever returned, on a 200 percent penalty return, to a
4 force-pooled interest.

5 When I went to the more optimistic pricing,
6 yes, it improves your payout. It also -- but it shows
7 that yes, there would be some value returned at a 7 --
8 you know, at the -- on a 66 percent penalty on a 500
9 MBOE well, the interest owner that is force pooled would
10 get some value.

11 Q. Okay. So what you're saying is that you're
12 looking for a guarantee for the force pooled interest
13 owner?

14 A. I don't know that I'm saying that, but I
15 would -- I would like to see something that -- in the
16 world of statistics, I would like to see that
17 opportunity occur.

18 Q. And the forced-pooled working interest owner,
19 if they don't pay their proportionate share, they're
20 incurring no cost whatsoever?

21 A. The people who drill the well and who get the
22 interest, they benefit tremendously from it.

23 Q. If the well pays up.

24 A. If the well -- well, if you help them reach
25 their payout, it would be easier.

1 Q. In a reasonable time? You're looking at a rate
2 of return. That's what you want. You don't want to
3 reach payout. You want to make money.

4 A. You know, I'm in the business of making money
5 when I was with -- you know, with an exploration
6 production company, I'm in the business of making money,
7 and I have to meet the hurdle rates that beat out the
8 other guys' projects. Mine are always better, of
9 course. So what you're saying is how much effect does
10 it have on a rate of return. Let me -- I didn't bring
11 any of those in, but I ran --

12 Q. Actually, I'm just getting at one point, which
13 is if Jalapeno doesn't join in the well, it doesn't bear
14 any cost?

15 A. True.

16 Q. And if Matador pays Jalapeno's share of well
17 costs plus its own and it doesn't pay out, it loses
18 money?

19 A. That's the game, yes.

20 Q. Thank you.

21 REDIRECT EXAMINATION

22 BY MR. GALLEGOS:

23 Q. One question, just to clarify what you said.
24 If the operator of the well has reached that point that
25 we're calling payout, recovered expense, does that

1 equate to having reached the point where there is no
2 longer a risk in the drilling and completion of that
3 well?

4 A. If I interpret your question, when a payout of
5 the capital investment is made, at that point in time
6 when that's achieved by the operator -- the working
7 interest owner, what we talk about, the next payout of
8 the penalty is where it takes so long to usually get
9 that, and sometimes that's not achieved. But as far as
10 any risk beyond that -- if I understand your question
11 right, the risk of that is then just based upon what is
12 your product price going to be? How efficiently do
13 operate the well? But the risk of the oil, gas, it's
14 there.

15 Q. But what I'm talking about is the risk of the
16 cost of drilling and completion. Upon payout, does that
17 mark the point where that risk has been eliminated?

18 A. Yes. I understand. Yes.

19 COMMISSIONER CATANACH: Okay. Anything
20 further?

21 If not, this witness may be excused.

22 MR. GALLEGOS: Jalapeno calls Emmons Yates.

23 HARVEY EMMONS YATES III,

24 after having been previously sworn under oath, was
25 questioned and testified as follows:

DIRECT EXAMINATION

1
2 BY MR. GALLEGOS:

3 Q. State your name, please.

4 A. Harvey -- sorry -- Harvey Emmons Yates III, but
5 I go by Emmons because my dad has the same name as me.

6 Q. Where do you live, Mr. Yates?

7 A. I live in Albuquerque.

8 Q. What is your occupation?

9 A. I work for Jalapeno Corporation. I'm the vice
10 president.

11 Q. Would you describe for the Commission your
12 employment experience in the oil and gas business?

13 A. Well, we're a lot smaller than Matador, so we
14 tend to -- working for Jalapeno, we tend to carry --
15 wear a lot hats, I guess, is how you put it.

16 Experience has been working with my dad in
17 terms of operated wells. We operate a small field in
18 Chaves County, where we drill and operate San Andres
19 wells. It's also about dealing with the banks and
20 running economics and looking at horizontal
21 opportunities that have started to become a larger and
22 larger piece of our business as companies like Matador,
23 got better at their jobs.

24 So, in general, what I do is I'm in charge
25 of our field operations. I am what's called a company

1 man, which is we drill and operate our own San Andres
2 wells. I'm the one out there making sure things are
3 going well, dealing with subcontractors. When we get
4 new AFEs or new opportunities for horizontal wells, I'm
5 the one that gives a recommendation of whether or not we
6 should participate or not participate, things of that
7 nature.

8 Q. How many years have you been doing this?

9 A. I think February will make seven.

10 Q. And are there occasions when Jalapeno receives
11 proposals -- well proposals and you evaluate those and
12 recommend to the company that it participate?

13 A. All the time. I mean, when oil was at \$100 a
14 barrel or \$90 a barrel, we had a lot more AFEs. When it
15 dropped to 30, we tended to get a lot less. But the
16 economics have gotten better. We've received a lot of
17 AFEs for horizontal wells. So yes, it's a normal part
18 of our business.

19 Q. And could you tell the Commission just roughly
20 how many instances in which you received AFEs that you
21 evaluated the situation and negotiated and came to terms
22 so that you were a consent to participant -- Jalapeno
23 was a consent to participant?

24 A. Well, before -- before 2012 or 2011 -- that
25 might have been the first horizontal -- we really didn't

1 see any horizontals. Mostly it was all vertical.

2 But since then, I think with our latest
3 batch of AFEs from EOG in the Eagle Ford, we're
4 approaching 100 horizontal wells. I've evaluated and
5 looked at and decided whether we're going to participate
6 or not.

7 Q. Have the circumstances been such at some point
8 you became involved with this Matador application to
9 drill this Airstrip well?

10 A. Sure. You know, we have a lot of the same
11 acreage as HEYCO, and I know there is some confusion to
12 our -- Jalapeno spun off from HEYCO a long time ago.
13 Matador bought HEYCO out of their acreage. I don't
14 know. It was a year and a half ago or something like
15 that. HEYCO had originally proposed a Bone Spring
16 horizontal, which I believe we consented to. After
17 HEYCO was bought out by Matador, we saw another AFE come
18 in for the same spacing unit, but this one was a
19 Wolfcamp well. And I became involved because I
20 represented the company in going down to meet Matador in
21 Dallas because -- just because --

22 Q. What was the purpose of that meeting?

23 A. Well, it was to get to know Matador. I mean,
24 they had just -- they had just bought out HEYCO out of a
25 lot acreage. We happen to have a lot of the same

1 acreage, so the idea was getting to know Matador since
2 we're going to be doing business with them probably for
3 the next 40 years of my life. Because we have so much
4 in-common acreage, it was a get-to-know-you meeting.
5 And I think that Fred had actually proposed -- based on
6 -- based on the first AFE, you know, it was -- we'd sent
7 a few letters back. There didn't seem to be any
8 transaction. Somehow it was kind of get to know each
9 other and work something out in regards to this Wolfcamp
10 well.

11 Q. Okay. Mr. Yates, if you'll take the exhibit
12 book that's the Jalapeno exhibits and flip through to
13 Exhibit 3, please. Let us know when you have that in
14 front of you.

15 A. I have it in front of me.

16 Q. What is this?

17 A. It's a picture I took of the whiteboard in our
18 meeting with Matador at their Dallas office.

19 Q. About when did this meeting take place?

20 A. Geez. You know, I have it on my phone, time
21 and dated. I want to say about a year and a half ago,
22 something along those lines. I can get the exact date
23 if you need it.

24 Q. No. That's good enough.

25 Set the scene for us, would you? Who was

1 present?

2 A. I was there representing Jalapeno Corporation.
3 Fred and Becky Yates were there representing Yates
4 Energy, who happen to have spun off of HEYCO so have a
5 lot of same acreage, and I believe there were a lot of
6 people from Matador. It was their office, so I think
7 the CEO, Joe Foran, was there and a lot of the people
8 you see in this room. I think about 15 or 20 people, if
9 I had to guess, in the room for Matador and about three
10 or four people non-Matador that were there, myself
11 included.

12 Q. Was there somebody who, say, conducted the
13 meeting, was in charge of --

14 A. Sure. I mean, we were at Joe Foran's building.
15 He was the one who mostly conducted it. He let everyone
16 introduce themselves, and then he kind of -- after the
17 get-to-know-you period, he was the one conducting the
18 meeting, with questions from myself and from Fred and
19 Becky.

20 Q. Is Joe Foran the president of Matador?

21 A. I believe he's the CEO.

22 Q. In regard to the discussions -- and we'll get
23 into more specifics as shown here -- was there any
24 discussion about a farm-out option to be afforded for
25 Jalapeno as opposed to having to participate?

1 A. No. No, there wasn't. And we were somewhat
2 surprised by that.

3 I mean, to give you a little bit of context
4 in terms of how we've been doing business in my seven
5 years and my dad long before me, whenever you're --
6 someone's drilling on your acreage and you're trying to
7 make a deal with them, you know, you'll talk about
8 buying someone out being -- you know, there are all
9 types of different possibilities, but a farm-out is
10 standard operating procedure how we deal with Yates and
11 how we deal with other companies. But it wasn't on
12 here.

13 It became pretty clear to me, while
14 everyone that we met was very nice, the real sticking
15 point was our not willing to have this nonconsent be so
16 high. I think Mr. Foran's explanation was, This is what
17 we do. This is standard procedure. We're not going to
18 go less, and it wouldn't be fair for us to do a
19 nonconsent penalty less than, you know, the 200 percent
20 or, I guess, in the JOA, at 300 percent, because (A)
21 it's not what they've been doing to other people, and
22 (B) it would look weird if family members from George,
23 who had just become, I think, part of the board.

24 And so what was offered in front of us here
25 was either to sell our acreage at \$5,000 an acre, which

1 we knew we wouldn't do because we thought --

2 Q. Why wouldn't you do that?

3 A. Well, we think there is a lot of value to this
4 acreage. First and foremost, we were very aware that
5 Matador had just bought HEYCO's acreage for \$8,000 an
6 acre, and I thought it was a good investment. I still
7 do, because there is, as you guys talked about, you
8 know, Upper and Lower Wolfcamp, 1st, 2nd and 3rd Bone
9 Spring. I mean, we felt that the Delaware Basin -- that
10 we were lucky to have acreage in there, and we thought
11 this was (A), \$3,000 less per acre than what they had
12 just paid George, and (B), there wasn't a lot of value
13 in us disposing of all of our acreage there at \$5,000 an
14 acre.

15 Q. Were you given any other options other than to
16 sell your acreage for \$5,000?

17 A. Well, sure, I believe. That's a year and a
18 half ago so my memory is a little hazy. I believe that
19 the other thing that was talked about -- and we actually
20 skipped over three -- was number four. Matador and
21 Spiral had done a joint venture. But it's basically the
22 same thing. We would sell out our interest to this
23 joint venture company, and it would be paid at \$5,000 an
24 acre, and we would kind of participate going forward
25 from there. We didn't see a lot of value in that just

1 because -- I mean, it was great that, you know, a joint
2 venture was offered as another alternative, but, I
3 think, once again, HEYCO -- or Spiral, which was -- it
4 gets confusing with all the companies. But Spiral was
5 paid \$8,000 an acre there. So we thought that was less
6 than market value.

7 But what it really came back to, quite
8 honestly, was the nonconsent provisions over and over
9 again. It became clear that if we weren't willing to do
10 the nonconsent provisions at 300 percent in the JOA that
11 we would end up exactly where we are right now, the
12 forced pooling.

13 And it was our feeling, based on the
14 results that we'd seen in all the horizontals we had
15 participated in, that basically if you're signing a 300
16 percent nonconsent penalty, you're giving away your
17 acreage because you need such a high rate of return to
18 achieve -- at the time I believe it was a \$9-and-a-half
19 million AFE, you know. So you're talking closer to.
20 \$27 million this well needs to produce before we would
21 ever back in. So 300 percent just seemed absurd in
22 terms of losing value of our acreage.

23 Q. So, Mr. Yates, did it basically boil down to
24 sell for \$5,000 an acre or be force pooled?

25 A. That's really where it became pretty clear. If

1 we weren't willing to part with our acreage at 5,000 an
2 acre, that we would end up being exactly where we are
3 right now.

4 Q. Now, I'm going to ask you about some exhibits
5 that illustrate some data, and those are Exhibits 9, 10,
6 11 and 12. And as a preliminary, did you prepare these
7 exhibits, is my question?

8 A. I prepared 9. Matador prepared 10.

9 Q. Did you prepare 11 and 12?

10 A. 11, yes. And 12, yes, I did.

11 Q. And how did you prepare this document? Where
12 did the data come from?

13 A. Well, all of this came from the OCD Web site.
14 Do you want me to expand here? It all came from the OCD
15 Web site. It's basically Jalapeno -- we're trying to
16 get a grasp of the area around the well that was being
17 force pooled. And the reason we looked at four
18 townships was that if you look at that red on Exhibit 9,
19 it's right in the middle. So I didn't think it was fair
20 to just look at, you know, 18-35 or 18-34 when it's just
21 as close to 19-34 and 19-35.

22 Q. So the four townships that are illustrated here
23 are what? State for the record. What are the townships
24 and ranges?

25 A. 18 South, 34 East; 18 South, 35 East; 19 South,

1 34 East; and 19 South, 35 East.

2 Q. And might we just say that you simply were
3 plotting data that you obtained from the Division?

4 A. Yeah. All this was was -- at this time I think
5 that Jalapeno's approach was just using the only
6 information we had in terms of how the OCD justified the
7 risk penalty they applied. And I think we all talked
8 about this earlier. It was Stogner's method.

9 And so we wanted to see how many times the
10 Wolfcamp had been penetrated by vertical wells in the
11 area. Obviously, this is a well-established vertical
12 area. You know, a lot of people used to think the
13 Permian was played out. So going through here, if you
14 look at the OCD Web site and you simply type in "wells,"
15 you know, "section," "township," you'll get all the
16 wells drilled in that. So I was just attempting to show
17 how many wells, according to the C-105 and things of
18 that nature, on the OCD Web site, how it showed the
19 Wolfcamp had been penetrated.

20 Q. So just the fact that each of these little blue
21 crosses is a -- is a vertical Wolfcamp?

22 A. Yeah. They're all vertical.

23 And, you know, I think a lot them --
24 sometimes when you're looking at information from the
25 1950s or '60s, you know, you tend to -- and I don't want

1 to say companies do it on purpose, but some folks tend
2 to leave out some data and some of them put it in there.
3 And so I tried, to the best of my ability, to figure out
4 which ones penetrated the Wolfcamp. And that's why we
5 included Exhibit 10, which was Matador's own work, just
6 to show that I hadn't thrown anything out there, that,
7 in fact, this Wolfcamp had been penetrated many times.

8 Q. Let me back up. As far as -- as far as
9 penetration of the Upper Wolfcamp, can you tell us what
10 the circumstances are and what the facts are
11 regarding --

12 A. Yeah. I believe it was upwards of -- I think
13 it was pretty close to about 300 penetrations within the
14 four townships in terms of how many times the Wolfcamp
15 has been penetrated there, give or take. But needless
16 to say, the Wolfcamp has been drilled several times.
17 Some of those were on the way down to the Morrow. Some
18 of them were Bone Spring wells that, you know, tailed in
19 to the top of the Wolfcamp, things of that nature. But
20 generally speaking, it was close to 300, my
21 recollection.

22 Q. And, again, I just want to make it clear
23 because -- I believe you said this, but the little red
24 line which is just off to the center of the --

25 A. Yeah. The little red line in the southwest

1 corner of 18 South, 35 East represents the spacing unit
2 for where this Airstrip well that we're all in here for
3 is going to be drilled.

4 Q. Okay. And let's flip over to Exhibit 10. This
5 is -- this is the exhibit, as you told the Commission,
6 you did not prepare but used it as a source.

7 A. Yeah. We just thought this was important just
8 to -- I mean, one of the things that we've always been
9 concerned with was the appearance that we were trying to
10 skew facts in our favor. That's why we brought an
11 outside engineer in, to run his analysis, and that's why
12 we're including Matador's own figures, just to show that
13 we're trying to do our best to give an actual
14 representation of what we're looking at here. And so we
15 just wanted to include that well to show that Matador
16 agrees the Wolfcamp has been penetrated several times.

17 Q. What does that tell us about the Wolfcamp?

18 A. The formation's there. I mean, they're running
19 a structure map off of it. They feel strong enough
20 about it to drill a \$6-and-a-half million well, at the
21 time they had been negotiating with us, a \$9-and-a-half
22 million well. So, once again, it's just us proving a
23 point that the Wolfcamp is there. I'm not trying to get
24 into whether or not, you know, the right porosity is
25 there or anything like that. I'm just simply using

1 their work to say, you know, the Wolfcamp's been
2 penetrated.

3 Q. All right. Mr. Yates, turn to Exhibit 11 and
4 describe what this shows.

5 A. This is real simple, very similar to what I
6 did. All I did was go to the OCD Web site. I looked at
7 actual reported data in terms of the production figures
8 that companies report to the OCD. It's just kind of
9 a -- there's no analysis in this. All it is --

10 Q. These don't show any horizontal wells?

11 A. It's all showing horizontal wells, and it's
12 just showing what their production is as of that moment.
13 So if you look -- and I believe it was in September, so
14 that had, you know, June production figures on it, I
15 think is what it was. And so you saw what the wells had
16 produced in that four-township area as of that time.

17 Q. And are these wells that are operated by
18 numerous different operators?

19 A. Absolutely. Matador's -- Matador's in here,
20 COG, Mewbourne. I think XTO's in here and probably
21 Devon as well.

22 Q. And where you have a legend up here, "Current
23 VOE," and it's color-coded, what was the source of that
24 information?

25 A. Just the OCD Web site, and just going on --

1 nothing that I put in there. It's just simply
2 converting the OCD Web site to this.

3 Q. Okay. And I direct your attention to the
4 crosshatched section. Is that Section 31?

5 A. Yes. That's the -- I believe that's our
6 acreage position within Section 31, and if you look in
7 the west half-west half of Section 31, 18 South, 35
8 East, that's going to be the spacing unit. And I think
9 that's why there was some confusion of where our working
10 interest actually was in this. But yeah, it shows that
11 we will have an interest in the Airstrip #1. That's
12 what that crosshatch section is, our position.

13 Q. All right. And now let's flip to Exhibit 12
14 and describe to the Commission what that shows.

15 A. Well, one of the things, like I said, we are
16 looking at is Stogner's method, and one of it was
17 operational. This is just showing basically the same
18 thing that we've said countless times again. There were
19 104 wells -- horizontal wells drilled in this area.

20 Q. Okay. Now, back on Exhibit 11, there would be
21 104 --

22 A. Sure.

23 Q. -- horizontal wells?

24 A. Yeah.

25 And when you look at this, it just shows

1 the one well that I could find, according to OCD data,
2 where a well was actually plugged. Now, some of these
3 wells could have been sidetracked and completed, but
4 this is the only one I found that didn't reach its
5 destination in terms of getting casing in the hole,
6 cemented and start production.

7 Q. So out of 104 wells, one well would reflect a
8 circumstance of operational failure?

9 A. That's correct.

10 Q. I just want you to refer to -- for the
11 Commission, because there's been some question about
12 it -- Exhibit 18. Do you recognize what this is?

13 A. If it's what I think I'm doing -- yeah. It's
14 the Investor Presentation that Matador, I think, has to
15 give quarterly or semiannually to its investors. And
16 it's their own data that they give out to shareholders
17 or investors.

18 Q. Turn to page 31.

19 MR. GALLEGOS: And I'd direct the
20 Commission's attention to what is shown there, since
21 there's been some very recent discussion about well
22 costs and EURs.

23 THE WITNESS: Sure. We kind of picked up
24 on this because -- you know, once again, what I said
25 earlier was we never wanted to appear that we were

1 trying to skew data to our benefit. So what we try to
2 do is find things that Matador has put out there that
3 show their own internal rates of returns are, you know,
4 what their own engineers are saying.

5 And if you look in here and you look at --
6 this is not. It's the Wolf. So they're going to say
7 this is a different area than what we're talking about.
8 But if you look at the range that they see here for
9 Wolfcamp, A-XY wells, which is what we're drilling, a
10 Wolfcamp A well, it ranges from 5.5 to 6.5. So that
11 would be another way of us showing that, you know, 6.5
12 isn't the low-end figure. It's very middle-of-the-road,
13 based on current scenarios that you're seeing here.

14 Q. (BY MR. GALLEGOS) Is that the figure that
15 Mr. Gaddis used?

16 A. Yeah, the figure that Mr. Gaddis used. I mean,
17 not only was it based on the AFE that we received, most
18 of this is from Matador as well. If you look at this
19 Investor Presentation or even if you go into their
20 August presentation, 6.5 is a middle-of-the-road figure
21 for what they're saying Wolfcamp wells will cost in New
22 Mexico, Eddy, Lea, Rustler Breaks, Wolf and all those
23 things.

24 But the whole point here was just showing
25 that -- and forgive me if I'm expanding here -- is just

1 that the 200 percent nonconsent penalty really imposed a
2 hard burden to meet from us, of us ever seeing value for
3 wells that we didn't participate in.

4 You have their own internal rate-of-return
5 figures here at \$50 oil that's held constant, and they
6 get a million dollar well that costs them \$6.5 million?
7 They're going to get somewhere like 125 percent rate of
8 return. Now, that's according to their own figures.

9 So, you know, I don't -- and that's them
10 assuming -- what is this? \$2.50 mcf flat natural gas
11 price. It includes drilling, completion and production
12 and facility costs. And so -- I mean, anytime you go
13 out here and you're guessing what the price of oil is
14 going to be or what it costs to operate a well, well,
15 that's what every company does. You assume what are the
16 costs to produce a well this month and next month. And
17 so they put all that guessing together and their own
18 internal statement to get a rate of return -- for a
19 million MBOE well at \$6.5 million, their internal rate
20 of return will only be 120 percent.

21 So I had a hard time saying if it took a
22 million dollars to get that internal rate of return, how
23 we would ever see anything at a 200 percent nonconsent
24 penalty.

25 Q. How do you interpret this last column at the

1 top where it says "Percent Oil"?

2 A. Oh, that's just oil-to-gas cut, is how I
3 interpret it. And I agree with what they were saying
4 earlier. I think the oil-to-gas cut in the Bone Spring
5 we were seeing is like 80 to 70-and-a-half
6 percent oil-to-gas cut in that four-township area.

7 If you look at their oil-to-gas cut in the
8 Wolf or go over to the Rustler Breaks, I think the
9 average in the Rustler Breaks was 74, 75 percent
10 oil-to-gas cut, but clearly their EURs are much higher
11 over there. That's how I interpret that.

12 It's just -- it's just them saying -- you
13 know, when you're putting together -- it can be somewhat
14 misleading when you're running, you know, EURs. If 90
15 percent of the well is a gas well and you're doing a
16 \$3.00 or whatever, maybe, or 7 to 1 mcf, it can be
17 misleading in terms of the ultimate recoveries for that.
18 It's better to look at the oil. The oil is much more
19 telling in terms of what a well will pay out.

20 Q. Thank you.

21 MR. GALLEGOS: That concludes my questions,
22 Mr. Chairman.

23 I do move the admission of Exhibits 9, 10,
24 11, 12 and page 31 of Exhibit 18.

25 CHAIRMAN CATANACH: Exhibits 9, 10, 11 and

1 12 and page 31 of Exhibit 18 will be admitted.

2 (Jalapeno Corporation Exhibit Numbers 9
3 through 12 and page 31 of Exhibit 18 are
4 offered and admitted into evidence.)

5 MR. BRUCE: The first question is for
6 Mr. Gallegos. Just curious. Out of curiosity,
7 Mr. Yates is not being tendered as an expert?

8 MR. GALLEGOS: No, just a fact witness.

9 MR. BRUCE: Thank you.

10 CROSS-EXAMINATION

11 BY MR. BRUCE:

12 Q. You alluded to this, but on your Exhibit 18,
13 page 31, this is Texas, right?

14 A. The Wolf? This can be -- yeah. I could also
15 show one from the August one, where it has very
16 similar -- I think it's 750, and it shows higher. But
17 if you look at their internal rate of return with the
18 700, it still never approaches the 200 percent. But I
19 think this is their Wolf --

20 Q. Wolf area in Texas?

21 A. Uh-huh.

22 Q. And I think there was prior testimony this is
23 50 to 60 miles away from the Airstrip?

24 A. Well, sure. But the whole point is what type
25 of estimated EUR you get. It doesn't matter if it's in

1 Wolf, and it doesn't matter if it's in Eddy. If it's
2 still producing a million barrel of oil equivalent and
3 it doesn't pay out \$6.5 million, then I don't see what
4 the difference is.

5 Q. So you're not interested in joining in a well
6 with a million barrel of oil equivalent?

7 A. Oh, sure, I am, I mean, if I know it's going to
8 produce a million barrel oil of equivalent.

9 But the whole point here, the whole reason
10 that we're here is so that the OCC can come up with what
11 is a reasonable risk that the operator's taking by
12 carrying a nonconsenting party, you know. And so if I
13 knew that a well was going to make a million barrels,
14 then sure, I'd love to participate if I had the money to
15 do so. But if I know that a million barrels is a high
16 end of what a Wolfcamp well can possibly ever produce
17 and I still would never get 100 percent drilling
18 operational, a 200 percent risk factor, I'd probably
19 seem very inclined to be here in front of the OCC asking
20 for a lower risk penalty.

21 Q. If you'd turn to your Exhibit 3 --

22 A. Okay.

23 Q. -- and as you stated, there are four options
24 listed here, correct?

25 A. Yes.

1 Q. And wasn't there a fifth option that came
2 later, a couple of months later, from Mr. Singleton to
3 Jalapeno to sell down and participate with a lesser
4 percentage?

5 A. Well, I think there were several things on this
6 board. By several, I mean maybe one or two that were
7 not included on this board.

8 For example, we had offered to trade
9 acreage that Matador didn't even know they had in Chaves
10 County for our spacing unit there, and they declined to
11 do that. That was Chaves County acreage selling at \$250
12 an acre. We offered to just flat out trade them their
13 interest in Chaves County acreage for the spacing unit
14 so we could avoid this whole thing. They declined to do
15 that unless we were willing to sign a JOA with a 300
16 percent nonconsent penalty.

17 Q. That's the real sticking point, isn't it?

18 A. Sure. If you think that an oil company -- if
19 you don't have a JOA in place and you're interested in
20 not just giving away value -- which Matador is doing the
21 right thing here; they're trying to have the most value
22 for their shareholders -- we're not interested in
23 signing a 300 percent nonconsent penalty. That's just a
24 fancy way of saying, Here's our acreage.

25 Q. And the pooling in this case is listed -- is

1 limited to just this well unit, approximately 154 acres,
2 correct?

3 A. Well, it is, but then, again, it's not. I
4 mean, I think you guys kept bringing up the fact that --
5 I believe what you're asking me for is that the force
6 pooled here -- now, correct me if I'm wrong. I think
7 the 200 percent risk penalty or whatever the risk
8 penalty is would be applied to all the Wolfcamp
9 Formation. And so you said you'd de-risk the D
10 formations, but whatever they say here to the A-XY or
11 the A would be applied to the Wolfcamp. So that's a lot
12 value in, I think, eight different stacked horizons
13 where you guys have had an automatic 200 percent
14 nonconsent.

15 Q. Are you aware that under OCD regulations an
16 operator can drill a well under the forced pooling
17 order?

18 A. Uh-huh.

19 Q. You're aware of that?

20 A. Sure. That's why we're here.

21 Q. And that is to each additional well drilled on
22 that well unit, the working interest owners have a new
23 election?

24 A. To participate or automatically be force pooled
25 with 200 percent.

1 Q. Whatever the percentage is --

2 A. Well, sure. That's my whole point, though.

3 Q. But then you would have to -- you would have
4 the right to elect to participate --

5 A. Sure. Well, they -- they get this acreage,
6 right, this interest.

7 But our whole point is you have eight
8 different horizons that you guys have so eloquently
9 argued have different risks, right? You're saying that
10 the D is present above. I'm saying -- and yet that's
11 still the same 200 percent risk penalty or whatever they
12 come up with. It's going to be applied to all those
13 different horizons within there, and we don't have a
14 chance to say, Well, there's been ten D Wolf wells
15 drilled here. The risk is clearly less than the 200
16 percent than you guys said it was in the A.

17 So by being here, I mean, we're losing a
18 lot. We're losing a lot by being force pooled with the
19 200 percent risk penalty.

20 Q. But you're not planning on joining in in the
21 Wolfcamp wells out here?

22 A. I didn't say that. I think that the reason
23 we're here is that regardless -- now, we're here because
24 originally it was a \$9.5 million AFE. We think Matador
25 is a good company. We think that -- we've had the

1 pleasure of meeting them and doing business with them.
2 But when you're presented with a \$9-and-a-half million
3 AFE and it's either participate or lose all your other
4 horizons, and then now it's a \$6.5 million AFE -- sure,
5 there are certain situations where we would participate
6 depending on our what own economic situation is,
7 depending on several factors.

8 But the reason we're here, we're fighting
9 as hard as we are, is that we felt this was -- this was
10 an issue that needed to be addressed. Because if you
11 have people coming to the OCC and getting an automatic
12 200 percent risk penalty, that they're getting 200
13 percent in the Bone Spring, they're getting a 200
14 percent risk penalty -- Matador had a 200 percent risk
15 penalty for five other companies when they had
16 offsetting wells, hellaciously good wells, and still a
17 200 percent risk penalty is being applied. We felt that
18 this was the time to address what we felt like was a
19 taking because we were losing our minerals.

20 I understand that Matador needs to be
21 awarded a risk penalty for taking the risk in terms of
22 drilling the well, but when you make it so one-sided
23 that it's 200 percent, when you can't reach a fair
24 negotiation otherwise, then it needs to be addressed,
25 because it's very hard to ever have a situation where

1 you get 100-200.

2 Q. And you are aware that the pooling application
3 does not cover the Bone Spring Formation?

4 A. Sure. But it's the automatic 200 percent that
5 the OCC was applying to people and in the four-township
6 area and that Matador's own geologist said, We feel like
7 the Wolfcamp is a better target zone than the Bone
8 Spring -- you said guys said that, that the Wolfcamp is
9 a better target than the Bone Spring -- that if they're
10 automatically applying a 200 percent risk penalty
11 without concern what the actual risk was, then the
12 situation needed to be brought up to the OCC so they
13 could start looking at what actual risk was.

14 Q. That would be what Matador geologists say, that
15 the Wolfcamp looked better than the Bone Spring zone
16 proposed by HEYCO originally?

17 A. Okay. So are we mincing words in terms of Bone
18 Spring 1, 2 or 3 or Wolfcamp A-XY or Wolfcamp D? I
19 mean, the whole point here is --

20 Q. There are multiple --

21 A. Sure. If you have a horizon that you're saying
22 is better than this horizon, what's the harm in looking
23 at to what the economics are with the horizon above it
24 saying it's better?

25 Q. And what return on investment does Jalapeno

1 require and in what time frame to participate in the
2 well?

3 A. Well, I think it varies. You know, we don't
4 have access to the cash that a larger company like
5 Matador would, so we have to look at the best drilling
6 opportunities that we have put in front of us. And so
7 generally speaking, I think we're looking for payout in
8 less than two years just because of the cash-flow
9 situations.

10 When a nonoperator participates in a well
11 with an operator, once that production is produced, we
12 usually get our -- we pay up front, and we usually get
13 our money six months later. So cash flow can become an
14 issue.

15 Sometimes I think a lot of companies are
16 seeing too much of a good thing can be a bad thing so
17 that if we invest in a lot of wells that will ultimately
18 make money, but by participating in those wells, we miss
19 other opportunities, I mean that's a long-winded answer
20 of saying it really depends on a case-by-case basis.

21 Q. When you say payout of less than two years,
22 what would you require for this particular well?

23 A. Well, let's see here. This is a \$6.5 million
24 well. We're going to assume that it's normal operating
25 costs, because I think there is water disposal in the

1 area. I would say that -- I would agree that if oil
2 prices stay where they're at right now, about 50 and
3 work their way up, like the Bank of Oklahoma or, you
4 know, things like that but stays within that range, I
5 would think that you would need -- I don't know --
6 probably closer to the 240 to 250 range. And the reason
7 that it's less is because if it comes out quicker, then
8 you're not paying the same operating costs. You know,
9 you're lucky if you get to 270. The EUR didn't pay out
10 the operating costs.

11 Q. Are you saying you're -- well, looking for
12 250,000 barrels of oil equivalent to be produced in less
13 than two years?

14 A. Well, that's what we consider prime targets in
15 terms of our cash flow. I mean, we have other horizons
16 in other areas where, as a smaller company with limited
17 assets, we have to put our money in the best location
18 possible. And that's out of a \$6.5 million well.

19 I mean, in this area, you're also getting
20 AFEs of, you know, \$4.7 million, \$5.2 million. That
21 might make more sense for us in terms of hey, we think
22 this is going to be great, it's going to have a longer
23 longevity longer, but it's going to take longer to get
24 our money back because the difference from 6.5 to 5.2,
25 you know, even if it's a better well over the long term,

1 in terms of cash flow, it might be worse in the short
2 term.

3 Q. And there are operating costs to take into
4 account?

5 A. Oh, sure, with any well, you know. But they're
6 held flat, you know. I mean, everybody knows that the
7 first few months of a horizontal well, you have a
8 hellacious decline in terms of production, and you have
9 a heck of a high operating cost during the fracing, flow
10 back that water. So --

11 Q. So is it your recommendation that Jalapeno not
12 participate in this well?

13 A. At the \$9.5 million, it certainly wasn't. I
14 did not think we should participate in the well at
15 \$9.5 million. And I think at the time it was 37 or \$40
16 oil.

17 At \$6.5 million, I think that that would be
18 something we would have to take a long, hard look at in
19 terms of participating.

20 But the thing that we're really fighting
21 for here is -- well, one, we think it's going to be a
22 good well. Two, Matador thinks it's going to be a good
23 well. But if our economic situation is to the point
24 where it would be inadvisable for me to recommend
25 participating in this well when we have other wells

1 coming at us, whatever our situation may be, you know,
2 we need to know that the OCC is going to be presenting a
3 fair opportunity what risk actually is so we don't lose
4 acreage. And we feel that's where we're at right now.

5 Q. Now, Mr. Gaddis -- you listened to Mr. Gaddis
6 testify; did you not?

7 A. Yes.

8 Q. And he was coming up with numbers that I
9 interpreted as him saying, Well, there is only maybe a
10 20, 25 percent risk in drilling this well. Is that too
11 high a risk for Jalapeno?

12 A. On a well-by-well basis -- I mean, if we had
13 unlimited money, no. But if I have to look at I have to
14 invest in the best opportunities we have in front of us,
15 then absolutely it might be. In a certain cash-flow
16 situation, 10 percent risk might be too high, depending
17 on how much cash you're asking from us up front.

18 But what Mo Gaddis was attempting to do and
19 what we believed in was looking at, based on historical
20 data that we have access to, what are your chances that
21 this well won't pay out? And that's where he came up
22 with the risk of 20, 25 percent based on the Wolfcamp.
23 And I think he was trying to be fair, because I think
24 his studies showed 87-and-a-half percent, and he was
25 trying to say -- just like my dad was earlier. We were

1 saying 33 percent risk. And he said, Well, I agree with
2 you, proximity is a big deal. That's where he came up
3 with the 66 percent of what we were talking about
4 earlier, say double it to what's fair.

5 But our whole point of being here is --
6 yeah, 6. -- if we had just now received an AFE for
7 \$6.5 million in the Wolfcamp, we would take a long, hard
8 look at participating. But, you know, if -- we need to
9 know that if we don't participate, we're not going to
10 lose our minerals.

11 Q. You mention you've gotten proposals from EOG on
12 Eagle Ford shale wells?

13 A. Uh-huh.

14 Q. And what risk charge does EOG put in its JOAs
15 there?

16 A. You know, I'm not completely familiar with that
17 JOA. We've actually never nonconsented on an EOG well
18 in the Eagle Ford. It was recently put together. I'd
19 have to go back and take a look at it. All I know is we
20 certainly haven't signed any new JOAs with the 100-300.
21 So if there is a JOA in place, it had to do with a long
22 time ago in a vertical-era world, where the nonconsent
23 provisions make sense like anything else does. So to my
24 knowledge, we have not signed a JOA with anything
25 approaching nonconsent.

1 Q. When do you receive -- do you recall when
2 Jalapeno received the Matador revised AFE for
3 \$6.5 million?

4 A. I think it was before this testimony. I
5 couldn't say exactly the month. I think I remember the
6 first time seeing it is when we all got -- we were
7 waiting on the OCD's decision. I think it was for about
8 six or seven months or something like that. And once we
9 got that, I think we got a revised one. But it was
10 certainly after the OCD hearing had taken place, and
11 then, I think, prior to the OCC hearing.

12 Q. At this point would it be fair to say, it's
13 probably a half a year old?

14 A. Probably. I mean, I couldn't say exactly when
15 it is. I mean, I think that was one of our arguments at
16 the time, that the 9.5 was too high, that it didn't
17 reflect adequate costs. And I would also argue that 6.5
18 is probably a little bit high versus where the industry
19 is going to right now as well.

20 Q. Looking at your Exhibit 9, in your opinion, are
21 there any limitations on a study with wells that only
22 penetrate a particular formation?

23 A. Well, sure. I mean, whenever you're drilling a
24 well -- and mind you, I've never claimed to be a
25 reservoir engineer or anything like that.

1 Q. Understood.

2 A. I think it's one of the things that everyone's,
3 you know, flip-flopping on in terms of trying to figure
4 out what it means.

5 I think anytime you drill a well, anyone
6 would obviously agree the more data you can have, the
7 better. And so going through the entire Wolfcamp
8 horizon versus penetrating just the top of it would give
9 you more data for the eight horizons, but sometimes just
10 penetrating the top of it will give you enough or
11 getting a sidewall core from a deeper well, you know.
12 My argument would be that the more data you have, the
13 further -- the deeper you go, the more data you get,
14 and, obviously, the more data you have, the better the
15 result is.

16 Q. And on Exhibit 9, which of these wells
17 penetrate the Upper Wolfcamp, or if you don't know which
18 ones, how many of them?

19 A. The Upper Wolfcamp? I would say probably -- I
20 mean, all of them, if I had to guess. I mean, it
21 depends what you consider the Upper Wolfcamp. Is the
22 Upper Wolfcamp 100 feet in? Is it 200 feet in? Is it
23 500 feet in? I mean, I couldn't give you -- all I can
24 tell you is looking at this data was looking at this is
25 where the Wolfcamp is. They're saying this is how deep

1 it went. And so all of these penetrate -- to the best
2 of my ability, based on the data that's provided in the
3 OCD Web site, all of these points penetrate the
4 Wolfcamp. I can't tell you how deep they go. I didn't
5 write that down.

6 Q. And how many are horizontal wells -- existing
7 horizontal Wolfcamp wells?

8 A. Oh, these? None. These are all vertical.

9 Q. In Exhibit 10, other than the proposed Airstrip
10 201H well, all of the horizontal wells are Bone Spring
11 wells, are they not, on this map?

12 A. In Exhibit 10?

13 Q. Yes.

14 A. Oh, you mean the laterals that you see there?

15 Q. Yeah.

16 A. Yeah. All of those are -- there aren't any --
17 as you said, there aren't any Wolfcamp horizontal wells
18 in the area. The closest one is the Pickard #2H, which
19 went down to the E section. But they still found it
20 useful in developing a structure map for this well.

21 Q. And if you turn to your Exhibit 11, please,
22 first of all, in Section 31, the crosshatched area, that
23 indicates that Jalapeno has acreage in, looks like, 440
24 acres of land within this section, roughly?

25 A. I'll have to take your word for it. I can just

1 tell you that those are 40-acre blocks in the hatch
2 mark.

3 Q. They might be a little less than that.

4 A. Give or take.

5 Q. Quarter-quarter sections are lots, so that's
6 understandable.

7 But looking at this, at least at this
8 point, when you're looking -- I'm just eyeballing this,
9 and you can comment appropriately. But it looks like
10 most of these are either blue or black, so they've cumed
11 less than 45,000 barrels of oil equivalent?

12 A. Sure. But that's not very telling because --
13 actually, I found it a pretty optimistic figure, cums
14 like that, because that means that a lot of the wells
15 that were drilled were drilled recently and that they --
16 companies that drilled them felt so strongly about them
17 that they were willingly to drill them at 30 to \$45
18 range oil. So all this tells you is a snapshot of where
19 it's at at the time. So you have a lot of blue and
20 black wells there that Mo's EURs and our internal
21 figures are just, you know, 500,000-barrel wells.

22 Q. This does not give the time frame in which,
23 say, 75,000 barrels of oil will be used for each well?

24 A. No. It's just a simple snapshot to prove that
25 in this area and what you're -- and the real point of

1 this, if you look at it -- and I don't mean to go on a
2 tangent, but I'm going to.

3 If you look at it over here in the
4 southeast corner, Section 103, that was -- the whole
5 point of this was to show that all these wells have been
6 drilled, 104 of them have been drilled, and that all of
7 them encountered hydro -- hydrocarbons started flowing
8 back oil or flowing oil or producing oil, and only one
9 of them out of 104 was a dry hole. And that was a
10 horizontal Delaware well in the southeast corner of 19
11 South, 35 East. So the whole point here was to prove
12 the notion that based on what we've seen, you have
13 higher than a 99 percent chance of always getting oil
14 back, getting some type of return on your investment.

15 Now, you can have negative cash flow, like
16 you said, but you will always get oil in your tanks.
17 That's why Matador and the drilling engineer said that,
18 you know, unlike verticals, you already have those
19 horizontal wells. You already have those tanks in
20 place, even though you're getting oil back. And that
21 was the whole point of that.

22 Q. But you can't tell from this which wells are
23 going to pay out?

24 A. No. We put together a plot like that, but we
25 decided that you guys might pick apart our internals.

1 So that's why we had an outside engineer put together
2 the probabilities for a map like this, to show which
3 wells are going to pay out and which ones won't.

4 I can tell you now that all those yellow
5 wells you see there in the Bone Spring, in 19 South, 34
6 East, and right up to the corner there of 18 South, 35
7 East, those are all very good wells. So the Bone Spring
8 is a very good producer in this area.

9 MR. BRUCE: That's all I have,
10 Mr. Chairman.

11 REDIRECT EXAMINATION

12 BY MR. GALLEGOS:

13 Q. Mr. Yates, are you aware that the Matador
14 application here is to force pool the Wolfcamp Formation
15 under the specified acreage, not just to force pool the
16 Upper Wolfcamp or simply the A section of the Wolfcamp?

17 A. Yeah. And that was -- that was the point I
18 was -- I'm sorry if I didn't make it clear. And that
19 was one of my main problems of what was going on here,
20 is that by coming in and getting a force-pooled section
21 to the top of the Wolfcamp, they will have an automatic
22 200 percent risk penalty applied to any horizon within
23 the Wolfcamp. Now, that's eight different horizons.

24 Even in the interim, wells have been
25 drilled all around here. And, say, the D section or

1 something like that, that's proven not to have risk,
2 when they come in and if we're in a situation where we
3 can't participate, there's going to be a 200 percent
4 risk penalty applied, and we're going to effectively
5 lose our minerals, unless we happen to hit that jackpot
6 scenario where they happen to produce over 750 million
7 barrels of oil, and we'll come back in and tail in in 15
8 years from now. I mean, it's just a really high
9 threshold to meet, and that was one of the things I had
10 an issue with, us losing all the horizons of the
11 Wolfcamp based on this initial well.

12 CHAIRMAN CATANACH: Let's go ahead and take
13 a break at this point.

14 (Recess 3:08 p.m. to 3:25 p.m.)

15 CHAIRMAN CATANACH: Call the hearing back
16 to order.

17 I just have a question.

18 CROSS-EXAMINATION

19 BY CHAIRMAN CATANACH:

20 Q. Mr. Yates, are you basically in charge of
21 negotiating the participation in some of these
22 horizontal wells?

23 A. I guess my answer to that would be anytime you
24 do business with your family, your title might say one
25 thing, but what happens is different. Ultimately, my

1 father makes all the decisions. I just do my best to
2 give what my recommendation would be. But it's part of
3 my job to analyze horizontal wells drilled around a
4 certain area, look at what their rates of returns have
5 been and then try to decide if it makes sense, with our
6 cash flow, whether to participate or not participate.
7 But ultimately, everything comes -- it's my father's
8 decision.

9 Q. So did I hear you correct in saying that
10 generally you do participate in horizontal wells?

11 A. Generally, we do.

12 Like anyone else, I think a lot of the
13 industry kind of -- kind of -- kind of free-falled into
14 the participation of the horizontal era. It was
15 almost -- like, it was too good to be true. You had
16 \$100 oil. You knew you had access to oil there. You
17 were seeing great initial production figures, and so you
18 had a lot of people participating right away. And we
19 were participating probably more than we should have,
20 but we did.

21 But then you became more and more familiar
22 with the industry in terms of how high your operating
23 costs were going toward your LOE or just how -- after
24 the frac matrix, just how rapid the decline is and what
25 you get into afterwards.

1 But generally speaking, we did participate
2 in a lot of AFEs that came our way. We declined on a
3 lot of AFEs that came our way when we didn't think there
4 was the same value there, say. We were getting a lot of
5 1st Bone Spring wells that we didn't think there was a
6 lot value with that we nonconsented on. We've
7 nonconsented on a few 2nd Bone Spring wells that we're
8 happy we nonconsented on. And we've nonconsented on a
9 few Bone Spring wells that we're not happy we did a
10 nonconsent on. But generally speaking, I think it's
11 probably maybe 80 percent of the AFEs -- maybe 70 to 80
12 percent of the AFEs we've received we've participated
13 on.

14 Q. And so, generally, do you sign the JOAs?

15 A. No. We've -- as we've said, we really
16 haven't -- since the horizontal world has come about, we
17 really haven't signed any JOAs because the sticking
18 point has always been this nonconsent penalty.

19 In the vertical world, it's always that 300
20 percent.

21 And so while some of the wells that we've
22 participated in already had a JOA signed because it was
23 signed in 1980, before horizontal drilling was ever
24 thought, in wells where we've gotten new AFEs on that
25 we've participated in, what we've done is we've signed,

1 I think -- I really don't mean to misspeak here. I
2 think what we've done in some cases is said, Look, we're
3 going to participate, so there's nothing to force pool
4 us on. We're not going to sign this AFE, but we're
5 participating so there's nothing to get into there, or
6 saying, Look, we're going to participate, and we'll sign
7 the JOA to this area only or to this wellbore only, but
8 we're participating, so it doesn't matter.

9 But generally speaking, no, we don't sign
10 any new AFEs. And if -- I do sign documents sometimes
11 in regards to stuff, but generally speaking, it would be
12 my father, and I don't think he's done that.

13 Q. So have you been in a situation where you've
14 tried to negotiate a lower risk penalty in a JOA?

15 A. Absolutely. I mean, besides Matador, you mean?

16 Q. Yeah.

17 A. I believe we did one with Yates Petroleum or
18 Yates -- my father might have a better recollection of
19 this than I do. I think that we had a lot of the same
20 argument with them that we're having with Matador,
21 saying, We thought -- you know, what a lot of companies
22 like to do, and it makes sense from their standpoint, is
23 they put a JOA out there and it covers -- you know,
24 let's just exaggerate -- 10,000 acres. And what that
25 enables them to do is very quickly drill wells. If they

1 have to go through and negotiate with you on each
2 individual well because there is not a JOA in place, it
3 slows up their process.

4 So I think Yates and Mewbourne both sent
5 us, you know, JOA offers, which we declined to do, but
6 we did negotiate down on Yates with one. And I think
7 that they countered. They would do a 250 percent
8 nonconsent or something like that. I don't believe we
9 signed that. I think we just participated in the
10 wellbore, so there is nothing to fight about really.
11 But --

12 Q. So I guess I'm just -- I'm just curious what
13 the industry perspective is on that. It doesn't seem
14 like the industry would like that penalty reduced in the
15 JOAs.

16 A. Well, let's put it this way, I don't think the
17 operators would, because, you know, they're the ones
18 drilling the well. And initially -- just being honest.
19 Right? We all admit that they're taking a risk.
20 Nothing in this world is guaranteed. I think we all
21 know that. And so they're taking a risk out there by
22 drilling the well and saying we're -- this is enough of
23 a risk they think they're going to make money on it.

24 But our point has always been that the
25 nonoperators, the people that don't have to pick and

1 choose the wells they participate in, they're put into a
2 circumstance where -- we referenced it earlier -- where
3 maybe in the vertical world, operators would have the
4 incentive to negotiate, say, a farm-out, where we
5 participated, they would drill for our acreage, and we
6 back in after payout for, say, 20 percent or 25 percent,
7 whatever it may be. And those were standard in the
8 industry.

9 We had stuff like that happen because there
10 was an incentive for the operators to negotiate with you
11 because if they hit a well, then that 200 percent
12 nonconsent penalty, if you're only spending \$700,000 or
13 a million dollars, you could really reach that 200
14 percent nonconsent penalty quickly, and there would be a
15 lot on the back end, which is really why they'd be
16 negotiating it, right?

17 But here, because the nonconsent penalty is
18 so much higher proportionately, because you're not
19 drilling a \$750,000, you're drilling a \$9.5 million well
20 or something like that, if you look at the percentages,
21 what that means is the well has to produce \$19 million
22 of oil or 27-and-a-half-, \$28 million, if it was
23 \$9-and-a-half million, and there is no value for them to
24 negotiate a farm-out there because there is no value on
25 the back end after the nonconsent.

1 And so it's reached that point where
2 operators can come in and really push around the smaller
3 company if they're going to nonconsent because they're,
4 really, you know, eight out of ten, nine out of ten
5 times taking their minerals without us ever seeing a
6 dollar in value. Now, I agree that they need to be
7 compensated for the risk they're taking, but the dollars
8 for the wells are so high that percentages have skewed
9 this thing so that nonoperators of course want to stay
10 in the vertical -- of course want to stay -- the
11 operators of course want to stay in that 200, 300
12 percent nonconsent penalty, because what it means is if
13 you don't participate, we get everything. So they're
14 not going to want to be the ones that initially say,
15 Okay, we're going to lower that JOA nonconsent penalty.
16 But I think a nonoperator, it would leave them some
17 flexibility in terms of being able to negotiate for
18 minerals if they can't participate in every single well.

19 I know that's maybe a broad answer, but
20 that's kind of where we're coming from.

21 Q. Let me ask your opinion. Given what you know
22 about the Wolfcamp in southeast New Mexico, do you think
23 that that reduced mineral -- reduced penalty should
24 apply to all horizontal Wolfcamp wells?

25 A. Let me preface it by saying this, I think the

1 Wolfcamp -- and while I agree Matador's stepping out
2 here on this Wolfcamp. But I think the Wolfcamp horizon
3 in itself is creating opportunities that New Mexico has
4 not seen, even including the Bone Spring, at \$100 oil.
5 The reason I say this -- and you guys are well familiar
6 with it -- the most recent lease sales, you go through
7 and you see what are people willing to pay on acreage,
8 20-, 30-, \$40,000 an acre, right, in southern Lea
9 County -- most of that is Wolfcamp, too. And the reason
10 they're doing that is because they think the value of
11 these Wolfcamp horizontals is so great that they can
12 afford to pay 20-, 30-, \$40,000 an acre before they even
13 drill a well and they're still going to get great
14 returns.

15 I mean, we were talking earlier about
16 mutual funds and all of that. You're seeing private
17 equity money flowing into the Basin. If you were at
18 NMOGA this last -- this last few weeks, you would have
19 seen a lot more private equity money in that building,
20 where people are trying to get in and acquire acreage at
21 high, high costs per acre, and the reason they're doing
22 that is because they think there is a lot of value in
23 this Delaware Basin.

24 You read articles. This is where the
25 industry's money is flowing, and it's flowing here for a

1 reason, and it's not because the Wolfcamp has a 10
2 percent chance of likelihood. It's flowing in here
3 because this is a safe and a really smart way to park
4 your money, and a lot people think there is a lot of
5 future value.

6 And that's why we're here fighting for
7 every acre that we have because we think every acre that
8 we have is very valuable. And when you take away and
9 you put a 200 percent nonconsent penalty on that, it
10 does a substantial amount of damage to a company our
11 size.

12 Q. So why not participate?

13 A. Well, because we think we're at that point
14 right now, right, where you need to have this battle
15 sometime. If we truly believe what we believe, that a
16 200 percent nonconsent penalty is too onerous on a
17 company our size and that we have very little chance of
18 us ever having -- and you do believe a 200 percent
19 nonconsent penalty is essentially taking your minerals,
20 you need to have that fight sooner rather than later.

21 Now, as I said, we were here originally
22 because an AFE was \$9.5 million, and we did not think
23 that that was a good investment for a company our size,
24 to invest that type of money, a \$9.5 million AFE, when
25 we have other opportunities that have allowed us to do

1 better than, I think, a lot of other companies have at
2 lower, depressed prices.

3 So it's just a question of might -- if we
4 had received the \$6.5 million current scenario, might we
5 have decided to participate? Sure. But we're at that
6 circumstance where this 200 percent nonconsent penalty
7 needs to be addressed. I think it would probably have
8 been easier to address this situation if it was, say, a
9 Bone Spring well offset by a bunch of other Bone Spring
10 wells where the OCC has applied an automatic 200 percent
11 penalty next to offsetting acreage regardless.

12 But even in this situation, if you look at
13 producing \$19 million of what it would take to pay out
14 the 100-200, I think it's just -- based on our
15 engineer's work and based on the work we've done, we
16 still think we have a very viable case of showing that a
17 200 percent or 133 percent nonconsent penalty is so
18 onerous that we don't receive anything, and it's above
19 and beyond the risk that they're taking.

20 CHAIRMAN CATANACH: I have nothing further.

21 CROSS-EXAMINATION

22 BY COMMISSIONER PADILLA:

23 Q. So what's the risk penalty that you'd like to
24 see globally, and not just in this case?

25 A. Well, I think that --

1 Q. For horizontals.

2 A. For horizontals.

3 Let me start by saying it this way. I
4 think that a risk penalty should never be applied
5 globally. I think what you should do is have a process
6 of how it's applied.

7 I think one of the things that we were
8 contentious about at the beginning was we felt like the
9 burden of proof was on us, where you guys automatically
10 start off with a 200 percent penalty and we have to try
11 to chip away at that. So you start off in a situation
12 saying, Well, you're going to get a 200 percent. So
13 even if we get 70 percent of that taken off, like we did
14 at the OCD, it goes down to 133 percent, what's that
15 really saying? We still don't get any of our -- any
16 reasonable rate of return on any -- or not rate of
17 return, but we don't get any money back for our
18 minerals.

19 I think, generally speaking, when you say
20 33 percent for a known play like the Bone Spring, what
21 you're saying is you can -- you make your money back,
22 and then you make \$2 million, right? I don't think
23 that's asking too much at 33 percent. But we're trying
24 to be fair, and we're agreeing to -- we're agreeing with
25 you guys that because there aren't horizontal wells,

1 Bone Spring, A-XY wells in this immediate area, let's
2 just go ahead and double that to 66 percent.

3 So what we're saying is this well cost,
4 what, \$5 million, right? So it's 66 percent. You guys
5 go ahead and make \$3-and-a-half million before we ever
6 have an opportunity to receive any, and it'll be on the
7 tail end if we do, because the well has to produce
8 \$19 million. We think that's pretty fair. I'm sorry I
9 misspoke on the 66 percent. But we think that's
10 generally pretty fair, about a 66 percent range.

11 But when you're getting into the 100-200
12 percent range, I think it really gets to that point
13 where it just really marginalizes what a nonoperator can
14 do in this business. It's forcing it to where it's just
15 a big boy game, which the oil industry has always been.
16 But it really leaves almost no room for a company like
17 Matador to negotiate in an area with a nonoperator
18 because why would you? You can just force pool them and
19 take their acreage.

20 So I guess that's a long, roundabout way of
21 saying I would think that the argument should start at
22 the 30 percent range, and then you move it up from there
23 depending on how risky you think it is. But in my
24 opinion, starting at 200 percent is crazy when you're
25 talking about the prices of these horizontals and you're

1 talking about the success ratio that they have.

2 Q. At some point you have to balance being able to
3 economically develop these assets against bureaucratic
4 entanglement --

5 A. Absolutely.

6 Q. -- having companies come here for every single
7 case-by-case analysis of what the risk is.

8 A. Sure.

9 Q. So I think there's going to have to be some
10 kind of over -- if there is a solution, it's going to
11 have to be somewhat universal --

12 A. Oh, sure.

13 Q. -- slash, global.

14 A. Sure. I agree.

15 I think what we're trying to get across
16 right now is that hopefully, clearly by the end of this,
17 you guys will do the math, you know, yourselves. Plug
18 in whatever numbers you want, and you'll say, Wow, that
19 200 percent really is just a crazy starting-off point.
20 Maybe we should start at 50 percent or something like
21 that that you feel -- you know, at 50 percent, these
22 companies make \$3 million, right, or \$3-and-a-half
23 million. After they get their money back, they're in a
24 situation where they're making \$3-and-a-half million,
25 and then we would back in for our interest or have the

1 opportunity to receive any money from our minerals.

2 And that's all going to be your guys'
3 discretion. I think that range is in that 30 to 60
4 range. And that's my honest opinion. I think it's in
5 the 30 to 60 when you're looking at what their actual
6 risk is, what they're having there, when you look at the
7 money flowing into this play and why the industry's
8 willing to put their money into this play.

9 And I think what you guys need to balance
10 is just that situation where you're not putting it too
11 far in our favor, where you nonconsent on wells because
12 somebody is going to carry your interest and then you're
13 not going to have any drilling. But you also can't go
14 too far on the other one, where a company doesn't need
15 to negotiate with somebody who actually owns the
16 minerals -- or owns their share of the minerals because
17 they can just take them. So that's -- I mean, that's
18 ultimately up to you guys.

19 Based on the information that I've seen, I
20 think the 30 to 60 percent range is where I would start
21 just based on the high numbers that you're seeing.

22 Q. So you said you've participated in roughly 80
23 percent of horizontals?

24 A. Uh-huh. Uh-huh.

25 Q. Was that out of -- you mentioned 100

1 horizontals early on.

2 A. No. I think we have participation in about 100
3 horizontals.

4 Q. Okay.

5 A. We are in a very fast and aggressive drilling
6 program with EOG where next month or the next two
7 months, that could be 10, 15 wells different. And then
8 once EOG buys -- once Matador gets going here with the
9 bunch of rigs that I know they want to do and all that,
10 it can -- it changes very quickly. But we've been very
11 blessed, through good fortune, to be in the right
12 locations in terms of the Eagle Ford and in terms of the
13 Permian Basin, right in the same window that Matador
14 paid \$8,000 an acre for a couple of years ago for HEYCO.
15 The reason they did that is because it's good minerals.
16 And so we've fortunately been in a position where it
17 makes more sense to participate than not to.

18 Q. So what's your primary consideration for the
19 nonparticipating wells?

20 A. My primary consideration is how much money does
21 it tie up in terms of us not being able to participate
22 in things that we have a known quantity on? And, you
23 know, how risk -- I would like to say first and foremost
24 that our company is very, very conservative compared to
25 a lot of companies. The reason is that my dad's gone

1 through a couple of busts in his lifetime, and he's seen
2 people make a lot of money and then lose a lot money and
3 be out of business. He's seen companies come and go.

4 And so my father and I have had battles in
5 terms of I think this well, if you look at it on its own
6 individual basis, it makes a lot of sense to
7 participate. But you know what, sometimes you have to
8 say, Don't participate in that well; let's just squirrel
9 money away so if a rainy day comes, you can survive that
10 \$20, \$25 oil period. I can guarantee you a lot of
11 companies in here that participated in wells, that
12 because there is a brief flip down, they were checking
13 their hold card, saying, Wow, I really shouldn't have
14 invested in that well, wished we had saved some money,
15 you know, because, you know, your hold card changes at
16 \$25 oil. So we're very conservative. I mean, but --

17 Q. So would it be safe to say that because this is
18 somewhat of a step out, that you --

19 A. I think originally, if you want my --

20 Q. -- that goes into risk --

21 A. -- the absolute, honest truth, the reason we
22 didn't participate in this initial well initially and
23 the reason that we hadn't signed the original AFE from
24 HEYCO was the \$9.5 million drilling cost really, really,
25 really jumped out at us. It jumped out at us. I think

1 we were complaining that we thought it was a little bit
2 high for the times in terms of the wells that we were
3 seeing, even though we knew they had to run an extra
4 casing design, you know.

5 We really thought that \$9.5 million, at \$40
6 oil -- if we ran those situations, \$9.5 million, \$40
7 oil, if Mo plugged in those figures with the -- you
8 would have had, what, 10 percent, 20 percent of the
9 wells pay out. I mean, it would have been drastically
10 less than, say, 66 or 87 percent, depending on which
11 horizon you're talking about.

12 And so the real reason we didn't
13 participate in the beginning was we had originally saw
14 that \$9.5 million AFE, and we didn't think it was a wise
15 investment at that time.

16 Now, we haven't had internal discussions
17 about \$6.5 million for the AFEs for the current
18 Wolfcamp. But certainly we do think there is added risk
19 in terms of drilling this Wolfcamp well versus the Bone
20 Spring and that, which is why my dad said, Instead of
21 going 33, let's just double it to 66. Right? I mean,
22 we're trying to be fair in terms of compensating for
23 Matador drilling the well, but not to the point where if
24 they hit a million-barrel well or a 750,000-barrel well,
25 we don't receive any rate of -- we don't receive any

1 money back for our minerals.

2 Q. So there is a good chance that if you had seen
3 a \$6.5 million AFE back then, we wouldn't be here?

4 A. I would say there's a good chance. I mean, if
5 you look at the wells that we did participate in that
6 time area, Bone Spring wells, about \$6.7 million, and
7 we've participated in several ones since then, several
8 wells with COG, a couple with Mewbourne.

9 CROSS-EXAMINATION

10 BY COMMISSIONER BALCH:

11 Q. I have had the dubious distinction, Mr. Yates,
12 of having been on the Commission during horizontal well
13 ruling, and through those days, there wasn't a lot of
14 conflict. But one of the things that did come up was
15 the risk penalty, and I believe I'm on the record as
16 having some discomfort with assigning the same risk to
17 horizontal wells. However, at that time there wasn't
18 notice on that particular issue and the parties weren't
19 ready to argue it, so it was punted on.

20 There's not a lot to debate about whether
21 this well is a wildcat or whatever you want to call it.
22 It's something different than what's been done before.

23 A. Uh-huh.

24 Q. It does increase the risk. By how much, I
25 don't know for sure.

1 A. Uh-huh.

2 Q. People can do calculations. We won't know
3 until the well is drilled, to be honest.

4 And I think that if you're asking us to set
5 a precedent, that a single well that is a wildcat may
6 not be the best -- this is only my opinion -- may not be
7 the best scenario for that, rather than coming back and
8 addressing the issue directly and letting a number of
9 different parties come in and show their results for a
10 number of different horizontal plays might give a better
11 overall sense of what an official number might be where
12 you would start. So that's kind of my concern.

13 It does seem to me, though, that in this
14 particular case if you were able to limit your
15 involvement, forced or otherwise, to just the Airstrip 1
16 and just the Upper Wolfcamp, that that would increase
17 your comfort level. Did I gather that?

18 A. Certainly.

19 I mean, I think that's one thing that -- if
20 you're a company that has limited acreage, right, every
21 single horizon is important to you, let alone if you're
22 being force pooled on one horizon, that somehow
23 constitutes an automatic forced pooling 200 percent
24 where seven different ones own it even though, it's been
25 argued by both sides, that the risks are different,

1 depending on which horizon you drill within that
2 formation. I would certainly think that would ease the
3 comfort level in what we have.

4 That's not to say that I would think that a
5 200 percent nonconsent penalty on a horizontal well in
6 that case would be justified, but certainly it would
7 be -- I mean, anytime you limit it to what the actual
8 risk is -- they're not risking anything in the D section
9 or anything. They're not even planning on drilling into
10 it, so I don't see why that -- I mean, that's one thing
11 I've always had a problem with. But yes, it would ease
12 my comfort, if that's what you're asking.

13 Q. I was curious about that.

14 I think I understand what Matador wants to
15 do. They want to maximize their upside.

16 A. Sure, as any company should.

17 Q. Sure. No fault in that at all.

18 A. No. No.

19 Q. But this is something that is something
20 different.

21 That's all I have. Sorry. Not much in the
22 way of questions.

23 A. Works for me.

24

25

CROSS-EXAMINATION

1
2 BY MR. BRANCARD:

3 Q. Just a couple of quick questions. Your Exhibit
4 11 --

5 A. Yes.

6 Q. -- which I think would be a great test for
7 color-blindness --

8 A. I don't think I'm color blind.

9 Q. Well, good, because I'm looking for the black
10 lines here, and I think I see just two, but I could be
11 wrong.

12 A. Let me go -- sorry.

13 Q. The black lines, you indicate, are dry hole or
14 plugged?

15 A. Absolutely. You're right.

16 Q. And the next exhibit, Exhibit 12, has 104 on
17 it, which you said was an operational --

18 A. Absolutely. We had -- so 104 was, I think, the
19 well that we've talked about several times. Matador
20 drilled it. I think they had a collapsed casing on it,
21 was their issue. And so that was a well that they had
22 to plug and abandon without ever, I think, penetrating
23 or completing in the target zone because of operational
24 failure. So that was -- but I was trying to
25 differentiate that, the 104 in 18 South, 34 East --

1 Q. 103.

2 A. -- versus 103 in 19 South, 35 East, in the
3 southeast quarter there.

4 Q. Right.

5 A. Because that was the only well that I saw had
6 been actually been -- first of all, I thought it was a
7 new water disposal well or something like that. I
8 couldn't figure out what it was. And the reason was
9 that I saw that it had been drilled and completed down
10 into what I assume was the target formation, but it
11 had -- the first thing that had come back was zero
12 hydrocarbons back. So that was the first well that I
13 saw that I would consider -- what you would consider in
14 a vertical well a dry hole. You know, I just hadn't
15 seen anything -- like an actual dry hole. And Mo
16 stipulated to, I think, some of your lower-range wells
17 were, like, you know, 10- or 20,000 EURs, something like
18 that, were really bad wells for horizontal, but you're
19 still getting 10- or 20,000 back. This was the first
20 one I saw that was absolutely dry.

21 Q. So just to be clear, then, 104 relates to the
22 operational-risk issue.

23 A. Right.

24 Q. 103 relates to the geology/reservoir --

25 A. Geology/reservoir, however you guys want to

1 characterize it.

2 Q. I'm a lawyer so I don't know the difference.

3 A. Yeah.

4 Q. And so -- and then as you were just talking
5 here about this range you were looking at of 30 to 60
6 percent --

7 A. Uh-huh.

8 Q. -- if I understand the way you're testifying,
9 what your focus is is entirely on horizontal wells?

10 A. Exactly.

11 I think the vertical versus horizontal,
12 it's two different things. I'd be the first to tell you
13 and I think my dad said this before, that when we drill
14 a vertical well, we drill two dry holes. You know, the
15 risk is just a lot greater, because you're just
16 narrowing that window where you can penetrate into a
17 reservoir and get hydrocarbons back. Your chances of
18 failure are great, but if you do happen to hit, your
19 costs are so low that you can have the percentage of 200
20 percent rate of return -- your percentages are just
21 vastly -- they make up for it.

22 But in the horizontal world, percentages
23 are just greatly skewed because the cost of drilling the
24 well is so great. Where if you hit a gangbuster well,
25 like I said, at a million dollars and you're talking

1 \$3 million to ever make that back, but you have wells
2 that'll make 12 million. So there is a lot of back-end
3 value to that after the nonconsent penalty.

4 But here, where it takes the 18- to
5 \$19 million, there's none of that back-end value, so
6 there is no reason for an operator to ever negotiate a
7 farm-out or anything like that. I just think the
8 percentages are skewed just because of the differential
9 costs.

10 Q. And I think you testified that your first
11 experience with horizontal wells was 2011?

12 A. Yes.

13 Q. Okay.

14 A. 2011, early 2012. I don't mean to mislead you,
15 but yes.

16 Q. Sure.

17 And this order that the Division order
18 focuses on, which is the rulemaking that adopted the 200
19 percent penalty default --

20 A. Was in '03 or something for verticals.

21 Q. Exactly.

22 -- was adopted in 2003. Right? And that
23 order was where these Stogner factors are discussed,
24 which are clearly applied to vertical wells.

25 A. Yeah. You know what, I don't even try to act

1 like I'm an expert on the Stogner method. My dad and
2 our in-house attorney are the ones that did a lot of
3 research on that. I wasn't around in '03. I was in
4 college, not worried about horizontal drilling rules or
5 anything like that. And so I don't pretend to be an
6 expert here.

7 But I do know that when you apply that 200
8 percent penalty versus what all my experience has been,
9 in the horizontal, which is the vast majority of my
10 experience since I've been in the industry, has been
11 horizontal, that the percentages just seem very, very
12 favored and skewed to the operator.

13 Q. That's it.

14 CHAIRMAN CATANACH: Okay. This witness may
15 be excused.

16 MR. GALLEGOS: Mr. Chairman, Members of the
17 Commission, I want to direct your attention to what I
18 put in the book as Exhibit 22. I just wanted to have
19 something in front of you. If I had included the
20 transcript, it would have just bulked this book up.

21 But what I'm asking is administrative
22 notice be taken just of these sample cases. And it
23 would be Case 15302, with Order R-13997, Case 15372,
24 Order R-14083, and Case Number 15444, Order R-14139.

25 The purpose here is just so that there is

1 an understanding of the -- what I would call the
2 context. This is probably not the ideal case to test
3 the 200 percent nonconsent penalty, but it is unique, as
4 it shows what happens once that test is really raised
5 and what Matador has come forward with to try to support
6 the penalty. The purpose of this is just to give a
7 sample, and there are many, many more of these. But if
8 you go to these cases, what you find is there is
9 absolutely no scientific proof. They have nothing to
10 support the 200 percent penalty over and over again.
11 The landman is simply asked a question, as I give a
12 sample here, Are you asking the Division for a 200
13 percent penalty, and the answer is yes, and then the
14 order comes forward with a 200 percent penalty.

15 So I think if administrative notice be
16 taken of these cases, more and more could actually be
17 submitted. But that context is necessary because this
18 is very unusual, for the Division or the Commission to
19 have this kind of presentation to try and support the
20 risk penalty at any rate.

21 MR. BRUCE: And I object to Exhibit 22 not
22 only for the reasons stated before but because there has
23 been a full geologic presentation and engineering
24 presentation and operational presentation on risk by
25 Matador in this case, so these other cases are

1 inapplicable. You've already ruled these exhibits
2 should not be admitted because of late filing. And,
3 frankly, you know, NMOGA filed a notice of intervention,
4 and that was one of the reasons that you ruled against
5 NMOGA, because it wasn't timely filed. So we would ask
6 that Exhibit 22 be rejected as well.

7 MR. GALLEGOS: Well, let me say I think
8 it's appropriate at any time during the proceedings to
9 request administrative notice be taken as part of the
10 records of this Commission and of the Division. It
11 doesn't necessarily have to be an exhibit. This was a
12 handy way to present it. But I ask that administrative
13 notice be taken of those cases, and it'll be up to the
14 Commission to evaluate what Mr. Bruce says about the
15 scientific evidence presented. I think you'll see on
16 your own, when the transcripts are examined, as to what
17 has been happening as far as granting of this penalty.

18 MR. BROOKS: Mr. Chairman, the Division
19 joins in Mr. Bruce's objection.

20 CHAIRMAN CATANACH: Mr. Gallegos, the cases
21 that you are referencing, are those just standard
22 horizontal pooling cases?

23 MR. GALLEGOS: Those are -- yes. They just
24 happen to be Matador compulsory pooling cases in the
25 Wolfcamp Formation. I mean, I could have had 20 of

1 them, but I just thought, you know, here's three good
2 examples. It all shows the same, what I call, just a
3 single question and answer.

4 COMMISSIONER CATANACH: Well, I think the
5 Commission is all -- is pretty aware of the procedure
6 that's gone forth prior to this case, where the
7 applicants don't have to present any geologic evidence
8 to establish the 200 percent penalty. I don't know that
9 it's adding to the proceeding to add those in. I think
10 we are aware of it.

11 MR. BRANCARD: The Commission can take
12 notice of whatever decisions have been made by the
13 Commission or the Division in the past in exacting its
14 orders. So whatever you want to use in your order is
15 irrelevant or relevant. If not, it goes to the matter.
16 I don't think it has to be an exhibit, in other words.
17 The Commission can take notice of --

18 MR. GALLEGOS: Well, it doesn't have to be
19 an exhibit, and I read into the record what the cases
20 are, what the orders are. So if we just understand that
21 administrative notice is taken of those cases and those
22 orders, that'll -- it doesn't necessarily require
23 admission of an exhibit.

24 CHAIRMAN CATANACH: Well, I think to the
25 extent that the Commission might want to reference these

1 cases, we can take administrative notice. I'm not
2 saying it's necessary or that we will actually take
3 these -- read the case files or anything like that, but
4 we'll go ahead and take administrative notice to the
5 extent we need to look at them to write an order.

6 MR. GALLEGOS: Okay. Thank you.

7 That concludes the evidence for Jalapeno.

8 MR. BRANCARD: Mr. Chairman, you've got 21
9 exhibits. Only a few have been admitted, as far as I
10 can tell. So I just want to sort of go through -- I
11 think all of Matador's exhibits were admitted.

12 MR. BRUCE: Correct. I was going to bring
13 up the same thing.

14 MR. BRANCARD: And I just want to clarify,
15 so we have it clear for the record and for the court
16 reporter, which of these 21 exhibits have actually been
17 admitted. I think I have 5, 6, 9, 10, 11, 12 and 18, in
18 my notes, as having been formally admitted.

19 COMMISSIONER BALCH: Page 31 of 18.

20 MR. BRANCARD: Page 31 of 18; 5, 6, 9, 10,
21 11, 12, 18.

22 MR. GALLEGOS: 9, 10, 11, 12 and 18, I
23 moved -- with Mr. Emmons Yates' testimony, I failed to
24 move the admission of 3, which is the photo of the
25 notes. I move that.

1 And I thought -- and the record will show,
2 but I thought Exhibits 1 and 2 were admitted with
3 Mr. Harvey Yates' testimony.

4 MR. BRANCARD: That may be true. I'm just
5 looking at my notes and going back in the hearing.
6 During Mr. Harvey Yates' testimony, a lot of what he
7 testified to were actually Matador's exhibits.

8 MR. GALLEGOS: Right. Right. A number of
9 them were, yeah.

10 MR. BRANCARD: But if you want -- if you
11 want -- now's your chance to make sure we have them in
12 the record.

13 MR. GALLEGOS: Right. Right. Let's do
14 that. So 1, 2 and 3, I'm moving their admission.

15 Let me check 4, because I think that was --
16 yeah, Number 4. We'd move the admission of that.
17 That's the AFE.

18 Number 5 is in, correct --

19 MR. BRANCARD: Yes.

20 MR. GALLEGOS: -- for the record? 5 and 6?

21 MR. BRANCARD: Yes.

22 MR. GALLEGOS: 5 and 6.

23 9, 10, 11, 12, 13 was referred to with
24 Mr. Gaddis' testimony. I'd move the admission of those.

25 And let's see. 14 was referred to by

1 Mr. Gaddis. 15 was referred to by Mr. Gaddis. So we
2 would move the admission of those exhibits, 14 and 15,
3 and 18 page 31, which I believe was admitted.

4 MR. BRANCARD: Yes.

5 MR. GALLEGOS: And previously, Mr. Bruce
6 moved admission and we actually joined in it, the
7 transcript of the hearing before the Division. That
8 was --

9 MR. BRANCARD: That's your Number 19.

10 MR. GALLEGOS: -- from the September 6th
11 session.

12 MR. BRANCARD: That's your 19.

13 MR. GALLEGOS: That's 19. Yes, sir.

14 I think that's -- let me just check what 21
15 might be.

16 COMMISSIONER BALCH: Mr. Gaddis testified
17 to that.

18 MR. GALLEGOS: Yes. Mr. Gaddis testified
19 to that, 21. So we'd move admission of 21.

20 And we just discussed 22, which I think the
21 Chair ruled on.

22 So just to be clear, because of the
23 exclusion that was announced earlier today, 5A and 5B
24 are not admitted. 6A and 6B and 7 are not admitted.
25 And we didn't offer 8.

1 COMMISSIONER CATANACH: What does that
2 leave us with? 1 through 4, 14 and 15 and 21?

3 MR. GALLEGOS: That leaves us with 1
4 through 4, 5, 6, 9, 10, 11, 12, 13, 14, 15, 18, 19, 21.
5 I believe that's where we stand. Let me just
6 double-check.

7 Yeah. I believe that's what we asked be
8 admitted from the Jalapeno exhibits.

9 CHAIRMAN CATANACH: Okay. So just to make
10 sure we have everything, we'll admit 1 through 6, 9
11 through 15, and 18, 19 and 21.

12 MR. GALLEGOS: That's correct.

13 CHAIRMAN CATANACH: Okay.

14 MR. BRUCE: No objection.

15 CHAIRMAN CATANACH: Any objection?

16 Okay. No objection.

17 Those exhibits will be admitted into
18 evidence.

19 (Jalapeno Corporation Exhibit Numbers 1
20 through 6, 9 through 15, and 18, 19 and 21
21 are offered and admitted into evidence.)

22 CHAIRMAN CATANACH: Mr. Bruce.

23 MR. BRUCE: I'm going to put, I think, just
24 a couple of witnesses up, with orders to be brief.

25 Mr. Singleton.

1 VAN H. SINGLETON II,
2 after having been previously sworn under oath, was
3 questioned and testified as follows:

4 DIRECT EXAMINATION

5 BY MR. BRUCE:

6 Q. Can you please state your name for the record?

7 A. Van Singleton.

8 Q. For whom do you work and in what capacity?

9 A. Matador Resources Company. I'm the executive
10 vice president of land.

11 Q. And in the original evidentiary hearing in this
12 matter in September, were you qualified as an expert
13 petroleum landman?

14 A. Yes.

15 MR. BRUCE: Mr. Chairman, I tender
16 Mr. Singleton as an expert petroleum landman.

17 MR. GALLEGOS: No objection.

18 CHAIRMAN CATANACH: He is so qualified.

19 Q. (BY MR. BRUCE) Mr. Singleton, just a few brief
20 questions. There's been talk today how Jalapeno was
21 offered 5,000 an acre. Whereas, HEYCO, which was
22 acquired as a Matador entity --

23 A. Merged into Matador.

24 Q. -- merged into Matador, got 8,000 an acre. Is
25 there a difference -- is there a reason for the

1 difference in price between the two offers?

2 A. Absolutely. Yes.

3 Q. What is that?

4 A. The HEYCO merger was for acreage over a broad
5 area, right? So the number, 8,000 an acre, was an
6 average across a broad area. Some of those tracts may
7 have been valued at 12,000 an acre. Some may have been
8 valued at one or less. There were some tracts that were
9 100, and you came out with an average of eight. Big
10 difference.

11 Here we're talking about one section. And
12 not only did we think 5,000 an acre was fair, it was
13 actually generous for what our economic runs came out
14 with because it was a smaller interest. We were hoping
15 to keep, you know -- we're going to work with Harvey and
16 Emmons on a lot of wells on a lot of different acreage,
17 and so we want a good working relationship.

18 Q. You want them to join in the well?

19 A. Absolutely.

20 That was one of the things, when you look
21 at the -- I don't remember what exhibit it was, but the
22 picture of the whiteboard from the May 2015, I think it
23 was, meeting. The number one thing on there was
24 "participate." We want them to participate. We want
25 them to share in everything the well's going to make,

1 but to take an equal risk.

2 And Emmons talked about rate of return and
3 return on investment. Well, rate of return really only
4 applies to up till payout. Return on investments is the
5 whole deal. And when you have a situation where you
6 have a nonconsenting party, we're still putting up 100
7 percent of the cost. Whenever that party backs in,
8 whether it's at 100 percent, 200 percent, 300 percent,
9 the remaining barrels of EUR that's going to go to the
10 nonconsenting party reduces whatever return on
11 investment the returning parties get, not just the
12 operator, but the nonoperators, too.

13 So you have to look at both, return on
14 investment and rate of return.

15 Q. And when Matador agreed or starting talking
16 with HEYCO about the merger, et cetera, were oil prices
17 substantially higher than when you were dealing with
18 Jalapeno?

19 A. Yes. I don't remember exactly what it was, but
20 above 90.

21 Q. One thing -- one thing, up-front money that you
22 spend, is there a cost to acquire acreage so there is a
23 high-acreage cost on top of the drilling cost?

24 A. Yes. But it all factors into the project. And
25 we did offer 5,000 an acre, which we thought was a fair

1 and generous price. But that would even add to our cost
2 of the overall project.

3 Q. These are up-front costs?

4 A. Yes. Once you spend that, whether it works or
5 not, that money's gone.

6 Q. That's not accounted for in an AFE?

7 A. No.

8 Q. And I think you discussed it in your original
9 testimony, about the amount of acreage you have in the
10 Northern Delaware Basin, correct?

11 A. I believe so, yes.

12 Q. Yeah. Something like 30- --

13 A. If you say I did, I'm sure I did.

14 Q. Something like 30,000 acres?

15 A. Right.

16 Q. That's a lot of up-front money, at least to
17 Matador. It increases the risk of a prospect.

18 A. Absolutely.

19 Q. Do you recall the date of the \$6.5 million AFE,
20 approximately?

21 A. I don't recall the exact date. I would say it
22 was sometime in the spring of this year, maybe April.

23 Q. For Matador, would, say, five months be an
24 adequate time to determine to participate in a well?

25 A. Yes. In fact, most of the time, these things

1 are sent out around a 30-day clock.

2 If I could point out, too, that we are
3 under a number of operating agreements where we're the
4 non-op position, where we've participated in some wells
5 and we have not participated in some wells. We
6 understand that's part of the business, and it is what
7 it is.

8 Q. And part of those up-front costs are production
9 equipment, too?

10 A. Yes.

11 Q. So there are a lot of up-front costs that
12 Matador invests before seeing a dime's worth of return
13 on oil?

14 A. Yes.

15 Q. One final thing, Mr. -- Mr. Harvey Yates
16 testified about some Texas Railroad Commission
17 proceedings. Is Texas -- is the Texas Pooling Act
18 different than the New Mexico act? You conduct business
19 Texas?

20 A. We do. And we have never -- it's the Mineral
21 Interest Pooling or Mineral Interest Protection Act or
22 Pooling Act. I'm no expert on MIPA, as we call it,
23 because we've never used it. It is very infrequently
24 used. And if I remember, the case that Harvey cited was
25 in the middle of Fort Worth. It was in the middle of

1 the Barnett Shale play, in a place where I think there
2 were over 400 wells within five miles of that well, that
3 they had something to base a decision on.

4 Now, MIPA is normally not used in Texas.
5 But I think it's a totally different animal. It's meant
6 to protect these small, separate tracts from being
7 drained, because in Texas, you don't have to -- I
8 apologize for being remedial. But in Texas, you don't
9 have to drill in the west half of the west half of a
10 section because in many cases, there are no sections.
11 You know, the tracts are very oddly shaped. And so
12 there have been instances in the past where if a --
13 let's say, you have a 200-acre tract and you have a
14 10-acre tract just next to it. And the 10-acre tract is
15 an unleased tract. And that's a very important
16 distinction because MIPA is normally used in unleased
17 mineral tracts.

18 The operator can gerrymander the boundary
19 of their unit around that tract if it will not agree to
20 participate or to lease, and in some cases, that could
21 result in drainage. And so one reason it was designed
22 is to let that 10-acre tract force their way into the
23 area, to say, Hey, we don't want you drilling over there
24 without us; we want to be in. So it's a very different
25 animal.

1 Q. Kind of the flip side of what we're talking
2 about here?

3 A. It's very much the flip side.

4 Q. Thank you, Mr. Singleton.

5 MR. BRUCE: I pass the witness.

6 CROSS-EXAMINATION

7 BY MR. GALLEGOS:

8 Q. Mr. Singleton, have you put a pencil to a
9 situation where you say you have a Wolfcamp well, let's
10 say, one you propose here, that's going to make 400,000
11 BOEs and it's subject to a 200 percent penalty. Have
12 you calculated at what point the nonconsent owner
13 subject to a 200 percent penalty will receive any money?

14 A. That is not a calculation that I would make.
15 One of our engineers may have made that calculation.

16 Q. Would you accept my representation that the
17 nonconsent owner will not receive a dollar?

18 A. I don't know. I don't know that I accept that.
19 I haven't looked. I don't know that I'm the right
20 person to discuss that.

21 Q. Would it be the same if it was 66 percent
22 nonconsent penalty?

23 A. Oh, you mean the nonconsent party that was
24 putting their money into the well?

25 Q. I'm talking about a nonconsent party who is

1 subject to a 200 percent penalty.

2 A. Right. That pays no money; they take no risk.

3 Q. Yeah? I'm saying if they get -- if they get no
4 money at all, they're subject to a 66 -- even a 66
5 percent penalty, do you have any evidence to indicate
6 that's not the fact?

7 A. I think you're asking completely the wrong
8 person. I'm a landman. You can ask one of our
9 engineers. They would be able to tell you.

10 Q. Well, as a landman -- let's put it in landman
11 terms.

12 A. Okay.

13 Q. If you assume with me that that's the fact,
14 then Matador has acquired Jalapeno's acreage not for
15 5,000 or 8,000, but they've acquired it for nothing;
16 isn't that true?

17 A. That's absolutely not true.

18 Q. Jalapeno has lost its acreage?

19 A. Jalapeno has --

20 Q. It gets nothing. It gets not one dollar.

21 A. Jalapeno has every right and opportunity to
22 participate in that well and get the exact same thing --

23 Q. I'm not talking about that.

24 As a nonconsenting -- I'll say it again.

25 As a nonconsenting party, subject to even a 66 percent

1 risk penalty on a 350,000 BOE well, they get not one
2 dollar. So the acreage has been taken by Matador.

3 A. I disagree with that. Jalapeno's taken no
4 risk. And I'm sorry. We're using Jalapeno. Let's just
5 say the nonconsenting party has taken no risk. They've
6 paid nothing for it. The return on investment on one
7 dollar is --

8 Q. Are you saying that in their acreage -- their
9 middle acreage, whether it's one acre or five acres or
10 ten acres, it's -- it's lost and they haven't -- they
11 haven't spent a penny? They've lost their -- they've
12 lost their value. They've lost their asset.

13 A. Mr. Gallegos, who makes that decision? It's
14 the party who decides to nonconsent.

15 Q. And who makes the decision -- and in cases
16 you've testified before, every instance, you demand a
17 200 percent penalty, and you have never negotiated even
18 1 percent off of that penalty. It's what you testified
19 to in this room at the earlier hearing, didn't you?

20 A. Well, to be clear --

21 Q. Can you answer the question? That was your
22 testimony? You have never negotiated --

23 MR. BRUCE: I'd ask that he be allowed to
24 answer the question.

25 Q. (BY MR. GALLEGOS) You've never negotiated 1

1 percent off of requiring the 200 percent penalty?

2 A. That is correct. And we've gotten voluntary
3 joinder in most of the instances. Very few have not
4 joined.

5 Q. Okay.

6 A. But to clarify your point, when I --

7 Q. Well, there is no question pending.

8 A. -- testified in September --

9 Q. You've made [sic] enough.

10 A. Well, you've misstated something I'd like to
11 clarify.

12 May I?

13 CHAIRMAN CATANACH: Sure.

14 THE WITNESS: When I testified in
15 September, it was the first time I had testified. You
16 said that I had testified in previous hearings, which is
17 not correct, only in September.

18 Q. (BY MR. GALLEGOS) I didn't mean to say that. I
19 meant to say you testified --

20 A. You probably didn't. I just wanted to clarify
21 that point.

22 Q. Yeah. You testified at the September
23 session --

24 A. Yes.

25 Q. -- for this hearing?

1 A. Correct.

2 CHAIRMAN CATANACH: Mr. Bruce?

3 REDIRECT EXAMINATION

4 BY MR. BRUCE:

5 Q. Just one clarification to get to one of
6 Mr. Gallegos's points, that you're getting Jalapeno's
7 interest in this specific well for free. Now, if the
8 well was going to cost, say, \$5 million and Jalapeno's
9 working interest in the well was 20 percent, their cost
10 would be a million dollars?

11 A. Right.

12 Q. You'd have to pay that cost?

13 A. Yes.

14 Q. Up front?

15 A. Yes. That was my point.

16 Q. Nothing -- there is nothing for free?

17 A. That's correct.

18 CHAIRMAN CATANACH: Thank you.

19 RECROSS EXAMINATION

20 BY MR. GALLEGOS:

21 Q. And you would get their revenue to pay the
22 million dollars and to pay \$2 million and to pay
23 \$3 million, with their revenue from their share? That's
24 the way it works with penalty.

25 A. Yes. That is the way the risk charge works.

1 Q. Thank you.

2 CHAIRMAN CATANACH: This witness may be
3 excused.

4 THE WITNESS: Thank you.

5 MR. BRUCE: Call Dr. Frost to the stand.

6 EDMUND "NED" LOCKE FROST, Ph.D.,
7 after having been previously sworn under oath, was
8 questioned and testified as follows:

9 DIRECT EXAMINATION

10 BY MR. BRUCE:

11 Q. Would you please state your name for the
12 record, please?

13 A. Dr. Edmund Frost.

14 Q. And who do you work for and in what capacity?

15 A. Matador Resources. I'm the chief geologist.

16 Q. And at the prior evidentiary hearing, were you
17 qualified as an expert petroleum geologist?

18 A. Yes.

19 MR. BRUCE: Tender Mr. Frost as a qualified
20 petroleum geologist.

21 CHAIRMAN CATANACH: He is so qualified.

22 Q. (BY MR. BRUCE) Mr. Frost, at the first hearing,
23 I believe you got into a colloquy with Commissioner
24 Balch about -- about geologic issues regarding what was
25 the chance of making oil in a well, more or less. And

1 I'm simplifying it. I don't want to ask specific
2 questions. When Mr. Harvey Yates got up and testified,
3 he said that -- and it's in the transcript -- that you
4 were saying that there is a 75 percent chance of getting
5 payout in a well such this one. Do you agree with that
6 characterization?

7 A. Well, that's what happened, but that's
8 certainly not what was said. I never said that there
9 was a 75 percent chance to get payout in this well.

10 Q. Based on the risk factors -- the geologic risk
11 factors outlined in your testimony, do you feel that
12 there is a 25 percent chance of geologic success in the
13 Airstrip well?

14 A. As we defined geologic success, and that is
15 basically a 400 MBOE well. But that doesn't mean that
16 there is a 25 percent chance of success for the whole
17 project. The other risk factors also have to be
18 included, and I think that's what was missing from the
19 characterization of my testimony at the September
20 hearing.

21 Q. So this 25 percent chance of success applies
22 only to geologic risk?

23 A. That's correct.

24 Q. And it doesn't apply to overall success for the
25 project?

1 A. No. When you consider the other risk factors,
2 as we've said, it goes down to about 9 percent for the
3 total risk of this -- this prospect.

4 Q. So what you're saying is there -- there is a 75
5 percent chance that the well is not an economic success?

6 A. Well, I think there is probably even a greater
7 chance than that based on total risk. And to be clear,
8 again, economic, as we defined it, where we're defining
9 it as the 400 MBOE well. We're not talking about payout
10 here, and I think that's also what's been misconstrued.

11 Q. One final point, there's been talk about eight
12 productive zones. Are you talking just about the
13 Wolfcamp, or are you looking at other zones, say, the
14 Delaware, Bone Spring?

15 A. Right. I would love to find the heart of the
16 Basin where there are eight prospective zones in the
17 Wolfcamp that could be completed independently, but it's
18 certainly not in this prospect. In our Rustler Breaks
19 asset, there is probably about, I'd say, four in the
20 Wolfcamp that can operate as independent. So --

21 Q. Several possible in the Bone Spring?

22 A. Yeah. Uphole, there are several possible. If
23 you include Avalon, there is a possibility there, and
24 that's pretty clearly outlined on our investor deck. I
25 think it's one of the first lines.

1 MR. BRUCE: That's all I have of this
2 witness.

3 CROSS-EXAMINATION

4 BY MR. GALLEGOS:

5 Q. Mr. Frost -- or Dr. Frost, I'm going to refer
6 to page 168 of the transcript of the prior hearing.

7 A. I'm not actually sure that I have the
8 transcript here.

9 Q. I wanted your counsel to be able to have that.
10 Are you there?

11 A. I'm there. What line, specifically?

12 Q. We're going to be at line 17. The questioning
13 was by Commissioner Balch. And the question asked --
14 or, actually, line 21. The question was asked: "And a
15 75 percent chance you'll maybe break even, and nobody
16 gets money, period?"

17 Your answer was: "Yeah. I think in the
18 most black-and-white sense, that's a fair appraisal.
19 But we would hope that, you know, we see something in
20 this first well that says, Okay, well, we learned
21 something, and we can hopefully do better on the next
22 one. And you know, we -- as a [sic] CEO always likes to
23 say, We try to get a little better every day."

24 Is that your testimony?

25 A. That is my testimony. It's "our CEO," though.

1 Q. What?

2 A. I think you misquoted it to say "a CEO." It's
3 "our CEO."

4 Q. You're correct, your CEO.

5 So breaking even -- you [sic] asked the
6 question: Breaking even, and you say, That's fair.
7 What does breaking even mean?

8 A. Hold on. I think we're missing a word here
9 that's pretty important. In the question on line 21,
10 there is a statement of "maybe the well will break
11 even."

12 Q. Right.

13 A. And there is no guarantee there. And I think
14 what you guys are construing is that by that statement,
15 we're saying there is a 75 percent chance the well will
16 break even versus a 75 percent chance maybe the well
17 will break even. So breaking even for us basically
18 means that --

19 Q. Let me just confirm with you what your
20 testimony was. Then we'll -- I'll give you a chance.

21 A. Yeah.

22 Q. Obviously, you're primed up for that. But your
23 answer was -- the question was: "And a 75 percent
24 chance you'll maybe break even, and nobody gets money,
25 period?"

1 You say: "Yeah. I think in the most
2 black-and-white sense, that's a fair appraisal."

3 Okay. Now, doesn't break even mean that
4 you spent X dollars and you got back only X dollars, and
5 so that's breaking even?

6 A. That's correct. That's how we define it.

7 Q. Okay. And you thought that that was a fair
8 appraisal, that maybe --

9 A. Yes, maybe.

10 Q. I'll put the word in, "maybe 75 percent." And
11 that was the question. And that was your answer?

12 A. Right. And within that "maybe," though,
13 becomes the gray area. We don't know what the
14 probability of breaking even here is, and I think that's
15 where the testimony's gotten a little bit misconstrued.
16 And, again, we're talking about geologic risk factors
17 only. So if all things went perfectly and reservoir
18 risk was none or there is a 100 percent chance of
19 success, and operational risk was none and there was a
20 100 percent chance of success, that 75 percent with the
21 "maybe" would be -- would be fair.

22 Q. Thank you.

23 COMMISSIONER BALCH: Dr. Frost, I'd just
24 like to say I think understood your answer the first
25 time in September.

1 THE WITNESS: Yeah. Okay. Thank you
2 (laughter).

3 MR. BRUCE: One more, but I've only got two
4 questions of him, Mr. Examiner -- Mr. Chairman. Sorry.
5 Old habits die hard.

6 BRADLEY M. ROBINSON,
7 after having been previously sworn under oath, was
8 questioned and testified as follows:

9 DIRECT EXAMINATION

10 BY MR. BRUCE:

11 Q. Would you please state your name for the
12 record?

13 A. Bradley Robinson.

14 Q. And who do you work for and in what capacity?

15 A. I work for Matador Resources Company as a
16 senior vice president of reservoir engineering.

17 Q. And in the prior evidentiary hearing, were you
18 qualified as an expert reservoir engineer?

19 A. Yes.

20 MR. BRUCE: Mr. Chairman, I tender
21 Mr. Robinson as an expert reservoir engineer.

22 CHAIRMAN CATANACH: He is so qualified.

23 Q. (BY MR. BRUCE) There has been testimony today,
24 Mr. Robinson, and I believe I'm accurately quoting this
25 from the two Jalapeno witnesses that testified today

1 that, quote, unquote, "Matador expects a 400,000-barrel
2 well." Is that -- is that what your opinion was?

3 A. No, not at all. I mean, my testimony -- and I
4 went back and re-read it several times -- is that we
5 believe it has the potential to produce up to 400,000
6 barrels. Based on our engineering and geologic
7 analysis, it has that potential.

8 We don't expect it to produce 400,000. If
9 we expected it to produce 400,000, we would have had a
10 rig out there, you know, a long time ago. So no. We
11 believe the potential for a well with 400,000 barrels --
12 I said it two or three times in my testimony. That's
13 the 400,000 barrels.

14 Q. And is it what Matador hopes to get in order to
15 achieve payout of the well?

16 A. Yes.

17 Q. Thank you.

18 CROSS-EXAMINATION

19 BY MR. GALLEGOS:

20 Q. This is going to be -- for some reason, we have
21 a short transcript here, but it's pages 42 and 43 of
22 Mr. Robinson's testimony.

23 MR. BRUCE: Mr. Gallegos, just so I make
24 sure if I give him the transcript, what you're referring
25 to.

1 MR. GALLEGOS: It begins on page 42, and
2 I'm going to read -- one line goes into page 43.

3 COMMISSIONER CATANACH: What transcript is
4 this, Mr. --

5 MR. GALLEGOS: This is the transcript --
6 for some reason, this one begins on page -- begins on
7 page 2, and then we have a larger transcript with the
8 other witnesses' testimony. I don't know why it was
9 assembled this way, but Mr. Robinson's appears over in
10 this.

11 CHAIRMAN CATANACH: And that's from the
12 hearing in September?

13 MR. GALLEGOS: Yes, it is, from the
14 September 6th hearing.

15 MR. BRANCARD: I just want to be sure this
16 is the final transcript. This is not a draft like we
17 had a problem with before.

18 MR. GALLEGOS: No. It's the one that was
19 provided to us. It's fine.

20 Q. (BY MR. GALLEGOS) Yeah. I just wanted to call
21 your attention to page 42, the lower part of the page,
22 Mr. Robinson --

23 A. Okay.

24 Q. -- line 14. The question I asked: "And so the
25 definition of commercially successful is what,

1 Mr. Robinson?"

2 Your answer was: "That the well will
3 generate a greater return of at least 10 percent for
4 nonoperating wells and that the well will generate a
5 positive rate of return for operating wells. It can be
6 .1 percent rate of return. As long as it makes one
7 dollar more than it costs, then it's a commercially"
8 [sic] -- "commercial success for operated wells."

9 Was that the question asked of you, and was
10 that your answer?

11 A. Yes.

12 Q. And was the question following: "And the
13 assumption that you're presently using for the price in
14 the \$6.4 million AFE, if the expectation of this well of
15 EUR of 400,000 barrels is realized, is it a commercially
16 successful well?"

17 Answer: "We would expect it to be, yes."

18 Was that the question, and that's your
19 answer?

20 A. Yes.

21 Q. So if the operated well makes one dollar more
22 than its cost, then that would be basically -- it has
23 reached payout plus one dollar, correct?

24 A. Yes.

25 Q. Let me then ask you about -- if we go over --

1 A. For an operated well?

2 Q. For an operated well, yes.

3 -- to page 47.

4 A. Okay.

5 Q. And I asked you this question: "Well, I
6 thought you suspected there was some cuttings available.
7 Maybe I misunderstood. But if that's the situation,
8 then why would you have any opposition to drilling a
9 pilot hole? Since this is a wildcat prospect, yet so
10 important for tens of thousands of Matador acreage, why
11 not drill the pilot hole and get the information you
12 need?"

13 And was your answer: "I did not have
14 opposition to that idea. I was part of the team that
15 discussed, evaluated and weighed the benefits of
16 drilling a pilot hole. We had drilled two pilot holes
17 in the area and had gathered a substantial amount of
18 information on the Lower Wolfcamp. As a management
19 team, we had the decision to make. We could just drill
20 the well and complete it, as we had done in many other
21 areas. Rustler Breaks being one where we successfully
22 drilled. We still don't have a pilot hole in Rustler
23 Breaks, and we have 15-plus wells there that are going
24 to be very good wells for us. So you don't have to
25 drill a pilot hole to have a success test.

1 "We made the decision, as a management
2 team, to go ahead and drill the well instead of drilling
3 the pilot hole and spending the money for the data, and
4 I was part of that decision and agreed with it.
5 Although I would have liked to have seen a pilot hole, I
6 don't [sic] think it was absolutely necessary."

7 Did I correctly read the question and your
8 answer?

9 A. You were close.

10 Q. Well, I don't read very well.

11 A. I think you got --

12 Q. I went to high school --

13 A. You got the general idea. You missed a few
14 words.

15 Q. I went to high school in New Mexico.

16 (Laughter.)

17 A. I'll accept your rendition.

18 Q. Okay. Well, if I went wrong somewhere, I think
19 I got the essence of it.

20 A. You got the essence of it.

21 Q. All right. Thank you.

22 REDIRECT EXAMINATION

23 BY MR. BRUCE:

24 Q. One thing. Turn back to your testimony on page
25 23, I believe it is.

1 A. 23.

2 Q. 22 or 23?

3 A. Okay.

4 Q. That's my copy. Do you see some underlines?

5 A. Yes, on 22.

6 Q. 22.

7 A. Yeah.

8 MR. GALLEGOS: You're on what page?

9 THE WITNESS: 22.

10 MR. BRUCE: Page 2, Mr. Gallegos.

11 MR. GALLEGOS: Okay.

12 Q. (BY MR. BRUCE) And I asked you a question.

13 Again, what did you say about the 400,000 barrels of
14 oil?

15 A. That "we need to have an EUR of at least
16 400,000 barrels to make this well economic."

17 Q. Not that you expect 400,000?

18 A. Not that we expected it, but we hoped --

19 Q. Hoped.

20 A. -- that it would make that.

21 RECROSS EXAMINATION

22 BY MR. GALLEGOS:

23 Q. Why don't you read the rest of that answer,
24 then? Because then you went on to say, "We hope to get
25 to that level."

1 A. "Hope to get to that level."

2 Q. "Based on our analysis, we think we can get
3 there. We think it can be more than that."

4 Did I read that correctly?

5 A. Yes. Emphasis on the "think," not "expect."

6 MR. BRUCE: That's all I have.

7 Q. (BY MR. GALLEGOS) Emphasis on -- based on our
8 analysis? How about emphasizing that?

9 A. Well -- and I've said that --

10 Q. Never mind. It's okay. Thank you,
11 Mr. Robinson.

12 CROSS-EXAMINATION

13 BY MR. BRANCARD:

14 Q. If I may -- and this relates to Dr. Frost, and
15 he can jump in if he wants. Matador has Exhibits 15, 20
16 and 21 where you lay out geologic risk, operational
17 risk, reservoir risk. You did reservoir risk?

18 A. Yes.

19 Q. And those are Matador's exhibits?

20 A. Yes.

21 Q. Okay. Those three ideas come out of the
22 Division order which reflected a hearing from 2003 where
23 it was said that the Division had used geologic risks,
24 reservoir risks and operational risks in determining the
25 risk charge; is that correct?

1 A. No. It's probably more coincidence. Those are
2 the three primary factors that Matador uses. There are
3 other factors.

4 Q. Right. Okay. Great. So --

5 A. But those are the three primary ones that we
6 used. It did not necessarily come from the 2003
7 hearing.

8 Q. Right.

9 So your list of factors for reservoir risk,
10 the list of factors that Matador has for geologic risk,
11 operational risk, those are Matador's factors for each
12 of those risk categories, correct?

13 A. Yes.

14 Q. Those are not factors that the Division or the
15 Commission has used in the past, correct?

16 A. Well, it sounds like you just stated that
17 they -- they used three factors that are -- that are
18 identical.

19 Q. The Commission used those three categories.

20 A. Yeah.

21 Q. Sorry. The Commission has never used those
22 three categories.

23 A. Okay.

24 Q. They've been referenced in a Commission
25 decision.

1 But all these subfactors that you have in
2 here -- like for reservoir, you have permeability,
3 thickness, saturation, gradient, et cetera -- those are
4 Matador's factors?

5 A. Yes, they are.

6 Q. Okay.

7 DR. FROST: I think it might be worth
8 pointing out those are also industry-standard factors as
9 well, the subcategories. We aren't alone in applying
10 those.

11 COMMISSIONER CATANACH: Thank you.

12 This witness may be excused.

13 MR. BRUCE: That's all I have.

14 CHAIRMAN CATANACH: Hmm.

15 MR. BRUCE: I swear.

16 Are you wanting or not wanting closing
17 argument?

18 COMMISSIONER CATANACH: Well, if you want
19 to make brief closing statements, that's fine. But what
20 I would also like is for you to go into for the
21 Commission -- summarize what you guys are asking for in
22 this order.

23 And also, Mr. Gallegos, I'd ask the same
24 thing. Summarize exactly what you're asking for.

25

CLOSING ARGUMENT

1
2 MR. BRUCE: Well, we're asking for a
3 nonstandard spacing and proration unit comprised of Lots
4 1 through 4 of Section 31 as to the Wolfcamp Formation
5 only. We are asking for the forced pooling of
6 Jalapeno -- and there are two other small interest
7 owners noted in Matador's exhibits -- into this well
8 unit. We are asking for a 200 percent risk charge
9 against anyone who nonconsents the well. And we ask
10 that that be applied to drilling -- drilling and
11 completion costs, which, by Division regulation,
12 includes equipping the well for production. And that's
13 what we're asking for.

14 As to a closing, I've got a fairly long one
15 here, but I will keep it short.

16 You know, as to the force pooling in the
17 nonstandard unit, we think the nonstandard unit has been
18 shown to be in the interest of conservation and the
19 prevention of waste. It's the only economic way to
20 drill this well as a horizontal well. Furthermore,
21 Matador negotiated in good faith to reach voluntary
22 joinder with the interest owners, not Jalapeno, but
23 other interest owners, and it was unable to come to
24 terms with three of them.

25 We believe, as to the 200 percent risk

1 charge, Jalapeno failed to meet its burden that the risk
2 charge should be less than 200 percent. We believe it
3 based its reasons on a flawed study involving basically
4 Bone Spring wells, wells in different counties, wells
5 drilled to different intervals in the Wolfcamp.

6 One thing I'd like to point out is that the
7 study area, four townships, 12-by-12, that's 144 square
8 miles. That's for the Bone Spring. But when you're
9 looking at the Wolfcamp, you're essentially looking at
10 most of Eddy and Lea Counties. I mean, it's a chunk of
11 land probably 35 miles north to south, 75 miles east to
12 west. You're looking at well over 2,000 square miles.
13 We don't think you can draw -- and very few of those
14 wells are Upper Wolfcamp, none are comparable to the one
15 that's being proposed here. So in short, this is a
16 wildcat well. We believe there are other flaws in the
17 study, assumed well costs, assumed oil prices,
18 undiscounted cash flow.

19 Matador has put on extensive expert
20 testimony as to geologic operational and reservoir risk.
21 Regardless of what the Division regulations say, we
22 think Jalapeno's distracting you from this specific well
23 with overgeneralizations about pooling or about the
24 Wolfcamp in general when you just have no comparable
25 testimony from Jalapeno.

1 We've gone through -- I won't go through --
2 again, we put on geology, operational. I won't go into
3 detail about it. But there is not enough of a sample
4 size to consider this anything other than a wildcat
5 well, Bone Spring wells. It's a nice study. They're
6 not comparable to the Wolfcamp.

7 Matador has shown that in calculating, you
8 have to multiply the risk factors, the various risk
9 components, and this results in a chance of success of
10 about 10 percent.

11 Operators drill wells to make a profit, not
12 just to recoup their capital outlays, and that profit
13 takes time. And during that time, royalties and
14 overriding royalties are paid, and everyone learns a
15 little more about the reservoir as you're drilling and
16 producing these wells. And compulsory pooling should be
17 used as an incentive to get operators such as Matador to
18 drill risky wells like this because of the potential
19 reward to interest owners, and not just Matador and not
20 just in this well unit. It's a lot more extensive than
21 this.

22 We think the process should also be a
23 deterrent to prevent -- to keep interest owners from
24 preventing a well being drilled, and that's what we feel
25 has happened here.

1 As I've indicated in questioning Jalapeno's
2 witnesses, if Jalapeno feels that there is so little
3 risk in this well, why don't they participate? And why
4 is it putting money in other projects, as both Mr. Yates
5 and his son testified? There is one word for that.
6 It's called risk.

7 And you heard, again, that Matador is
8 taking Jalapeno's property. Far from it. If Matador is
9 successful, it will prove up Jalapeno's acreage in this
10 section. I don't know what it owns outside this
11 section, but Jalapeno owns significant interests in
12 southeast New Mexico. Moreover, Jalapeno still owns its
13 working interest in the well unit and in this section.
14 They have not been taken. There is a risk charge
15 assessed against it, but that's what is provided for in
16 the pooling statute, plain and simple.

17 And under the pooling statute and under the
18 Division's regulations regarding infill drilling,
19 drilling extra wells in a well unit, it will have the
20 opportunity to join in well after well after well after
21 well. If it chooses not to join, well, then the
22 operator should be given some risk charge to take the
23 risk and put up all their money up front.

24 If you listen to his testimony, Jalapeno
25 wants a guaranteed return on a force-pooled well even

1 though it's putting up no money. To me that sounds like
2 something for nothing. That's not what the pooling
3 statute provides for. Nonetheless, again, if Matador is
4 successful, Jalapeno will get something for nothing. It
5 will have its acreage proven up at no cost to it.
6 Jalapeno wants the benefit of the project, if
7 successful, without any burden. Well, on the other
8 hand, Matador will have the risk associated with the
9 project if it fails.

10 For a year and a half, Jalapeno has
11 thwarted the drilling of this well. And we think it's
12 time to get the first well drilled in this area, and
13 Matador requests the Commission to approve its
14 application.

15 Thank you.

16 CHAIRMAN CATANACH: Thank you, Mr. Bruce.
17 Mr. Gallegos.

18 CLOSING ARGUMENT

19 MR. GALLEGOS: Yeah. Mr. Chairman, I
20 thought I heard the request was what do the parties
21 want? What are we asking for in the order? I didn't
22 hear that you were asking for closing arguments, so I'm
23 going to -- I'm going to address what I think what you
24 asked about.

25 I only want to say one thing briefly about

1 this idea of wanting something for nothing. The parties
2 got 5 percent in -- in the acreage, in the well, and the
3 well revenue is \$20 million. And 5 percent of that
4 \$20 million just goes in the operator's pocket and not a
5 dollar in the nonconsent's pocket. That's not
6 cost-free. That's not asking for nothing. Their
7 interest is being taken.

8 Now let me address what I think the
9 Commission wants to hear: What is it we're asking for,
10 and what do we think the ruling should be?

11 First of all, well cost is being
12 improperly, incorrectly applied by the Division.
13 Contrary to the statute, it is including not only
14 drilling and completion, but it is including surface
15 equipment. That should not be the case. There should
16 be only the 100 percent.

17 Mr. Singleton was a very honest witness.
18 If you'll remember his testimony, I referred him to the
19 JOA that they had in Section -- Article 5(B)(2)(A) of
20 the joint operating agreement that says, you know, there
21 is no penalty on surface equipment. And Mr. Singleton
22 was asked -- I asked him, So, you know, there is no
23 risk? "So you have no penalty?" Referring him to the
24 JOA, there is no penalty. "So you have no penalty?"

25 Mr. Singleton said, "Correct. Right."

1 "JOA provides no penalty?"

2 "Correct."

3 "And this is custom and practice in the
4 industry," and he said yes.

5 So that's a clear and obvious correction
6 that needs to be made in the Division order, and, in
7 fact, in Division practice.

8 So next let's talk about how this
9 Commission is going to rationalize a manner that is fair
10 in the horizontal well environment to arrive at
11 fashioning a risk penalty. I respectfully submit -- and
12 I don't think there is a lot of disagreement -- that the
13 so-called Stogner factors are not scientific, and
14 they're not logical. And to simply say, Well, I'm going
15 to start with 200 percent -- what if you start with 100
16 percent, and then say, I'm going to break it down, and
17 break it into all these factors. And you give them all
18 equal weight. Give operational equal weight with, say,
19 reservoir.

20 I think we've heard testimony here, and I
21 think Matador's testimony and Mr. Gaddis' testimony,
22 that there is a whole different thing between
23 operational. Matador is a good operator. They do
24 better than completing three out of four wells. They'll
25 probably -- they probably record -- complete 49 out of

1 50. So operational is to be an equal factor with
2 reservoir makes no sense.

3 But when is the risk terminated? The risk
4 is terminated when the forced-pooling party has a cheap
5 payout. In fact, as Mr. Robinson just testified, it's a
6 commercial well once you've recovered your cost and one
7 dollar. There's no risk. You've got -- you've made
8 your investment. You would like to have a big profit.
9 But you've made your investment. You've recovered that.
10 That payout stage is the true factor of how you can
11 calculate the risk factor. That's why, when you can
12 look at a group of wells -- and we talked about a
13 reservoir -- I mean a resource play. And Mr. Gaddis'
14 testimony is, you know, 87.5 percent of these wells pay
15 out. What's the risk? Very small. His testimony was,
16 you know, zero operational, 5 percent -- 5 percent
17 operational, zero geological, maybe 20 percent -- maybe
18 20 percent reservoir.

19 But at some time, the Commission has to say
20 there's got to be something more rational and something
21 more meaningful that we can -- in something as broad as
22 this, much like Fruitland Formation in the San Juan
23 Basin -- they call it a resource play -- where you have
24 to begin to say, you know, there is an area that's
25 proper for risk factor, penalty risk. And I say

1 that's -- that's studying what the payout circumstances
2 are realistically.

3 Having said that, we have testimony that
4 the risk factor here, based on our engineering witness,
5 would be 25 percent. But Mr. Yates has said he can live
6 with and say 33-and-a-third percent -- 33 percent is
7 probably right so 66 percent. So when you ask what
8 would we ask in an order, Mr. Yates has said that 66
9 percent, and if it's a good well, somewhere down the
10 line, the nonconsenting party will finally receive some
11 return on its asset.

12 The other thing that we ask is that in
13 issuing an order to force pool, the order should be
14 limited to the A section of the Wolfcamp Formation. It
15 is entirely inappropriate for this application to be
16 placed in terms of the Wolfcamp Formation and expect
17 that to be the case with the proof very much
18 concentrated on the A Formation.

19 So to summarize, well cost should be
20 confined to drilling and completion. We don't believe
21 these Stogner factors are a rational measure. We think
22 payout studies should be the measure, and we think
23 that -- we would ask that not more than a 66 percent
24 risk penalty be assessed Jalapeno and that the pooling
25 formation be limited to what the proof was.

1 CHAIRMAN CATANACH: Thank you,
2 Mr. Gallegos.

3 Do we want findings submitted by the
4 parties? Is that a good idea?

5 MR. BRANCARD: Well, the question now is
6 whether you want to deliberate now or put off
7 deliberation to November 10.

8 CHAIRMAN CATANACH: November 10th?

9 MR. BRANCARD: 10th.

10 CHAIRMAN CATANACH: We do have a case on
11 the docket for the 10th.

12 MR. BRUCE: Yeah, a lengthy case. But more
13 than that, Mr. Chairman, as Matador has testified, they
14 have expiring term assignments, et cetera, and they need
15 to -- now, I don't mind submitting findings if there
16 could just be a special meeting for the Commission to
17 deliberate or, you know, we need a decision.

18 COMMISSIONER BALCH: We can start
19 deliberations now.

20 CHAIRMAN CATANACH: We can try, and if we
21 can't reach a decision, we'll have to figure something
22 else out for some other time.

23 COMMISSIONER BALCH: Be there for
24 deliberations. It will be easier.

25 CHAIRMAN CATANACH: Right.

1 MR. BRUCE: If we could get a decision just
2 on the formation of the well unit, that would probably
3 tied us over and allow us to submit findings, pooling,
4 and not getting into the risk charge. Leave that for
5 future.

6 CHAIRMAN CATANACH: Why don't we take a
7 shot at deliberation now, and we'll see how it goes?
8 And then we'll advise you on the status.

9 COMMISSIONER BALCH: I'd make a motion to
10 go into closed session.

11 COMMISSIONER PADILLA: I'll second.

12 CHAIRMAN CATANACH: All in favor?

13 (Ayes are unanimous.)

14 (Executive Session, 4:56 p.m. to 5:55 p.m.)

15 COMMISSIONER BALCH: I move to go back into
16 open session.

17 COMMISSIONER PADILLA: I'll second that
18 motion.

19 CHAIRMAN CATANACH: All in favor?

20 (Ayes are unanimous.)

21 CHAIRMAN CATANACH: I must state for the
22 record, though, in executive session, we discussed the
23 matters in this case, and that was the only thing we
24 discussed. And we have reached a decision, and I will
25 let Mr. Brancard convey that decision.

1 MR. BRANCARD: Okay. The Commission, at
2 this point, proposes to approve the compulsory pooling
3 application of Matador for a nonstandard 154.28-acre,
4 more or less. That will be established for the Wolfcamp
5 Formation. The Commission finds that there was an issue
6 about whether this should be established for the entire
7 Wolfcamp Formation, but there is not sufficient geologic
8 evidence to support dividing the Wolfcamp Formation for
9 this particular application.

10 The primary issue in this case has been
11 what risk charge should be applied to this compulsory
12 pooling unit. The statute, 70-2-17C, allows for the
13 charge for the risk involved in drilling of a well that
14 will be applied to a nonconsenting working interest
15 owner's pro rata share of the cost for drilling and
16 completing the well.

17 The Commission regulations, 19.15.13.8D,
18 allow a person responding to a compulsory pooling
19 application to seek a different risk charge than 200
20 percent and has the burden to provide geologic relevance
21 or technical relevant evidence to support that different
22 charge. There has been a request in this hearing by
23 Jalapeno for a different risk charge than 200 percent,
24 and there has been evidence presented -- considerable
25 evidence presented by both parties, both pro and con,

1 for different risk charges in this case.

2 The Commission has reviewed the evidence.
3 The Commission at this point finds that there are risks
4 involved in drilling all wells, in particular this well,
5 risks that apply to both geologic issues and technical
6 issues. The Commission does find that the technology of
7 horizontal drilling is well developed and that risks are
8 reduced for the drilling of horizontal wells.

9 The Commission also finds that the
10 formation that is subject to this pooling application,
11 the Wolfcamp, does exist in this area. However, the
12 Commission finds that the lack of horizontal wells in
13 this area for the Wolfcamp Formation and the distance to
14 the nearest Upper Wolfcamp horizontal well shows that
15 this particular well is, in fact, a wildcat well.

16 Based on balancing all of these factors,
17 the Commission has determined that the appropriate risk
18 charge will be 150 percent.

19 The Commission has also heard concerns
20 during this hearing about including costs for equipping
21 the well for production, surface facilities, and it has
22 concerns about that, particularly for a wildcat well.
23 And in this case, well costs will not include equipping
24 the well for production for this well.

25 CHAIRMAN CATANACH: I'm sorry. The risk

1 penalty for the final well costs --

2 MR. BRANCARD: The risk charge.

3 CHAIRMAN CATANACH: The risk charge on the
4 well --

5 MR. BRANCARD: Right.

6 CHAIRMAN CATANACH: -- on the surface
7 facility.

8 COMMISSIONER BALCH: The pro rata of the
9 actual cost.

10 MR. BRANCARD: The additional 150 percent
11 will not be applied to equipping the well. It's part of
12 the cost. They have to be the first 100 percent, but
13 it's not part of what gets charged of well costs under
14 the rule for 150 percent.

15 Do you request an order to be drafted?

16 CHAIRMAN CATANACH: Yes.

17 May we get a draft order?

18 MR. BRUCE: I will prepare one. Can you
19 give me until next Monday?

20 COMMISSIONER BALCH: Next meeting is
21 November 10th, right?

22 MR. BRUCE: Yeah. Three weeks from now or
23 about three weeks from now.

24 COMMISSIONER BALCH: November 10th.

25 CHAIRMAN CATANACH: If you want to get --

1 if you want to take -- it might be longer than that.

2 Two weeks, maybe?

3 MR. BRUCE: Two weeks. Okay.

4 CHAIRMAN CATANACH: As long as we have time
5 to review it, Mr. Bruce.

6 MR. BRUCE: Yeah. Let's say -- let's say a
7 week from Friday.

8 MS. ARNOLD: The 28th.

9 MR. BRUCE: 28th.

10 CHAIRMAN CATANACH: Okay.

11 All right. Anything further?

12 MR. GALLEGOS: Nothing further.

13 CHAIRMAN CATANACH: Okay. Nothing further.

14 This Commission meeting is adjourned.

15 (The proceedings conclude, 6:00 p.m.)

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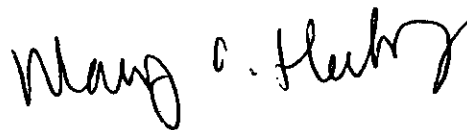
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