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January 17, 2018

HAND-DELIVERY

Florene Davidson
New Mexico Oil Conservation Division
1220 South St. Francis Drive
Santa Fe, NM 87505

Re: Application of Southland Royalty Company LLC for Designation of a Non-Standard Spacing and Proration Unit and Project Area, and for Exception to the Well Location Provisions of the Special Rules and Regulations for the Basin-Mancos Gas Pool and the Basin-Dakota Pool, Rio Arriba County, New Mexico

Dear Ms. Davidson:

Enclosed please find for filing the original and one copy of a Memorandum on Notice Requirements for Overriding Royalty Interests regarding the above matter.

Thank you.

Very truly yours,

J. Scott Hall

J. Scott Hall

Enclosure
cc (via email, w/enc.): David Brooks, NM Oil Conservation Division

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

IN THE MATTER OF THE APPLICATION OF SOUTHLAND ROYALTY COMPANY LLC FOR DESIGNATION OF A NON-STANDARD SPACING AND PRORATION UNIT AND PROJECT AREA, AND FOR EXCEPTION TO THE WELL LOCATION PROVISIONS OF THE SPECIAL RULES AND REGULATIONS FOR THE BASIN-MANCOS GAS POOL AND THE BASIN-DAKOTA POOL, RIO ARRIBA COUNTY, NEW MEXICO **CASE NO. 15919**

MEMORANDUM ON NOTICE REQUIREMENTS FOR OVERRIDING ROYALTY INTERESTS

SOUTHLAND ROYALTY COMPANY LLC, ("Southland"), by its undersigned attorneys, Montgomery and Andrews, P.A. (J. Scott Hall), provides this memorandum regarding the New Mexico Oil and Gas Act ("OGA"), NMSA 1978, §§ 70–2–1 to –38, and its implementing regulations' notice requirements related to overriding royalty interests for non-standard units.

I. Regulatory and Rule Interpretation

Understanding the recognized principles of statutory and regulatory construction are necessary to analyze the notice requirements in light of the regulatory definitions related to the mineral estate. *Wineman v. Kelly's Restaurant,* 1991-NMCA-128, 113 N.M. 184, 185. The first rule of interpretation is that the "plain language of a statute [or regulation] is the primary indicator of legislative [or agency] intent." *General Motors Acceptance Corp. v. Anaya,* 1985-NMSC-066, ¶ 15, 103 N.M. 72, 76. Courts and agencies are to "give the words used in the statute their ordinary meaning unless the legislature [or agency] indicates a different intent." *State ex rel. Klineline v. Blackhurst,* 1988-NMSC-015, ¶ 12, 106 N.M. 732, 735. This means that a tribunal "will not read into a statute or ordinance language which is not there, particularly if it makes sense as written." *Burroughs v. Board of County Comm'rs,* 1975-NMSC-051, ¶ 14, 88 N.M. 303, 306.

II. Overriding Royalty Interests

The New Mexico Oil Conservation Division ("Division") rules found in Parts 1 thru 39 of Title 19, Chapter 15 of the New Mexico Administrative Code do not define an "overriding royalty interest." Instead, the code includes "overriding royalty interest owners" within the definition of a "royalty interest owner" which "means the owner of an interest in the *non-executive* rights . . . [that] are non-cost bearing." 19.15.2.7(R)(7) NMAC (emphasis added). Oil and gas precedent has universally recognized an "overriding royalty" as a "nonoperating interest that is carved out of (the) working interest of an oil and gas lease." EUGENE KUNTZ, LAW OF OIL & GAS, §63.2, 217 (2009); *see also Sw. Energy Prod. Co. v. Berry-Helfand,* 491 S.W.3d 699, 182 O.G.R. 832 (Tex. 2016) (defining an "overriding royalty interest" as a fraction of gross production that does not affect mineral owners because it is carved out of the working interest under the oil and gas lease).

III. Non-Standard Unit Notice Requirements

As a general matter, the OGA imposes a "reasonable notice" requirement for all oil and gas hearings. § 70–2–23. In drafting the relevant Code provisions, the Division clearly delineated the parties entitled to notice prior to an adjudication. 19.15.4.12 NMAC. Applicants seeking approval of "unorthodox well locations" must notify "affected persons." 19.15.4.12.A(2)(a) NMAC; *see also* 19.15.26.7 (defining "affected persons"). Affected persons are the following: the operator; the lessee, only if there is no operator; and the "mineral interest owner," only if there is no operator or lessee. 19.15.4.12.A(2)(a) NMAC. "Mineral interest owners means owners of an interest in the executive rights, which are the rights to explore and develop, including oil and gas lessees (i.e., "working interest owners") and mineral interest owners who have not signed an oil and gas lease." 19.15.2.7(M)(9) NMAC; *see also Johnson v. New Mexico Oil Conservation Comm'n,* 1999-NMSC-021, ¶ 3, 127 N.M. 120, 121 (finding the Commission's order increasing

the spacing requirements for deep wildcat gas wells, without first providing the working interest owners reasonable notice of the proceedings was invalid). While these notice requirements are more stringent than in other instances, none of these unambiguous provisions related to non-standard units require notice to royalty interest owners.

IV. Compulsory Pooling Notice Requirements Compared

It is important to recognize the Code's distinguishable notice requirements for compulsory pooling applications. 19.15.4.12 NMAC; 19.15.12 NMAC. Applicants seeking compulsory pooling or statutory unitization must give notice to the mineral interest owners, but only if their interest has not been voluntarily pooled in the lease agreement. 19.15.4.12.A(1)(a) NMAC; 19.15.12.10.C(4)(c) NMAC (requiring notice to interest owners of applications for surface commingling as provided in 19.15.4.12 NMAC, but only where ownership is not common in zones to be commingled). This notice requirement to all owners of the mineral estate does not include overriding royalty interests because, by definition, mineral interest owners are defined as only the owners of an interest in the executive rights. 19.15.2.7(M)(9) NMAC.

Historically, the Division has interpreted this rule as not requiring notice to overriding royalty interest owners who may be subject to compulsory pooling. Generally, an agency's interpretation of its own regulations is entitled to substantial deference, except in those instances where such interpretation is unreasonable, plainly erroneous, or inconsistent with the regulation's plain meaning. *Compare Via Christi Reg'l Med. Ctr., Inc. v. Leavitt*, 509 F.3d 1259, 1272–73 (10th Cir. 2007), *with Perez v. Mortgage Bankers Ass'n*, 135 S. Ct. 1199, 1203–04, 191 L. Ed. 2d 186 (2015) (recognizing that the notice-and-comment requirement of the APA does not apply to interpretive rules or rules of agency procedure or practice). Accordingly, this historic interpretation

and established practice of the requisite notice should be given deference because requiring notice in these instances would be inconsistent with the regulation's plain meaning.

For example, a reason that owners of interests to a proposed pool are entitled to notice is that those executive rights may be affected by expanding or restricting their production-cost liability. *See Johnson*, 1999-NMSC-021, ¶¶ 3-4. Unlike in the case of a non-executive royalty interest, the mineral interest owners subject to a compulsory pooling proceeding may be compelled to contribute to the drilling costs associated with the pool in addition to enjoying the privileges of development. *Id.* The Code entitles these parties to notice so that they have the opportunity to protest the proceedings on an application for pooling. *Id.* at ¶ 4. There is no such justification for the non-executive rights such as overriding royalty interests.

V. The Code Does Not Require Notice to Overriding Royalty Interests for a Non-Standard Unit Application

To obtain approval of a non-standard spacing unit, an operator is required to comply with the notice requirements of 19.15.4.12.A(2)(a) described in Section III. 19.15.15.11.B(4) NMAC. Similarly, the rules for horizontal wells require notice in the same manner. 19.15.16.15.E NMAC. This means that operators seeking to drill a horizontal well within a non-standard project area must notify the "affected persons," as defined in 19.15.4.12 NMAC. *Id.* The plain language of the code does not require notice to overriding royalty interests. Moreover, historical agency interpretation of this rule has not been to read a requirement of notice to overriding royalty interests, which is absent from the plain language of the rule.

This case involves horizontal gas wells that are proposed to be drilled within a non-standard unit. As explained above, a royalty interest in New Mexico is a non-cost bearing, nonoperating interest that is carved out of the working interest of an oil and gas lease. As non-executive rights, the holders of an overriding royalty have no rights during drilling until revenues are produced by

the working interest owners. These interests are non-possessory and owners are not entitled to possessory remedies, such as a right to partition.

Simply put, overriding royalty interests are a revenue right at most, and imposing a new requirement upon these interest owners is a departure from long-standing practice and agency interpretation. In drafting the regulations, the Division made a clear distinction after giving due regard to the rights of the working interest owners that may be affected by an application for a non-standard spacing unit. Requiring notice to all interests in the mineral estate is unreasonable and contrary to canons of statutory and regulatory construction because it would read language into the regulation that is plainly not there. This complete distortion of the rule would open the door to an interpretation requiring notice to all property interests in the mineral estate cognizable under New Mexico law (*e.g.*, mortgage holders, net profits interests, carried interests, reversionary interests, liens, etc.). For these reasons, Southland requests the Division to maintain the integrity of the notice requirements and refrain from imposing new or contrary obligations.

Respectfully submitted,

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