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

IN THE MATTER OF THE HEARING CALLED BY THE OIL CONSERVATION DIVISION FOR THE PURPOSE OF CONSIDERING:

CASE NO. 13957
ORDER NO. R-1960-A

APPLICATION OF ENERGEN RESOURCES CORPORATION TO AMEND THE COST RECOVERY PROVISIONS OF COMPULSORY POOLING ORDER NO. R-1960, RIO ARRIBA COUNTY, NEW MEXICO.

ORDER OF THE DIVISION

BY THE DIVISION:

This case came on for hearing at 8:15 a.m. on November 29, 2007, at Santa Fe, New Mexico, before Examiner David K. Brooks.

NOW, on this 17th day of July, 2008, the Division Director, having considered the testimony, the record and the recommendations of the Examiner,

FINDS THAT:

(1) Due notice has been given, and the Division has jurisdiction of the subject matter of this case.

(2) By this application, Energen Resources Corporation ("Energen", "Applicant" or "Operator") seeks an order amending an existing compulsory pooling order to authorize Applicant as Operator to sell a non-consenting pooled party's working interest share of gas production from the compulsory pooled unit in order to enable Operator to recover the pooled party's share of operating expenses, and to otherwise prescribe and settle the rights and duties of the Operator and the pooled party with respect to the marketing of gas production from the pooled unit and the recovery by Operator of operating costs and overhead charges.

(3) The compulsory pooling order at issue in this proceeding (the Pooling Order) is Order No. R-1960, entered in Case No. 2249 on May 5, 1961. That order established a compulsory-pooled unit (the Unit) comprising the SW/4

of Section 2, Township 25 North, Range 3 West, NMPM, in Rio Arriba County, New Mexico, as to the Pictured Cliffs Gas Pool [Tapacito-Pictured Cliffs Gas Pool (85920)]. The Unit is dedicated to Applicant's Martinez Well No. 1 (API No. 30-039-06124), located 790 feet from the South line and 790 feet from the West line (Unit M) of said Section 2 (the subject well).

(4) Joseph A. Sommer (Sommer) was the owner of an unleased mineral interest in the S/2 SW/4 of Section 2. Sommer did not contractually commit his interest to the subject well and did not elect to participate therein under the Pooling Order. Accordingly he became a non-consenting party, under the terms of the Pooling Order, as to his deemed working interest (7/8ths of his total interest, pursuant to NMSA 1978, Section 70-2-17). Sommer's interest is now owned by JAS Oil and Gas Company, LLC (JAS).

(5) Applicant appeared at the hearing through counsel and presented the testimony of a landman, who testified as follows:

(a) The subject well was drilled in 1961 by Southern Union Production Company and completed as a producer of natural gas from the Pictured Cliffs formation. Union Texas Petroleum and Burlington Resources operated the well at various times. Applicant acquired the well and became Operator in 1997.

(b) Prior to 1992, the operators of the Unit sold gas produced from the subject well for the account of the working interest owners, including Sommer. However, in 1992, then operator Meridian Oil notified the working interest owners that it would no longer market their share of gas production from the subject well. For a time thereafter a Meridian affiliate purchased gas from some of the working interest owners, but, in 1995, that arrangement was also terminated.

(c) All of the working interest owners in the Unit except for Sommer/JAS, are parties to a joint operating agreement which includes a gas balancing agreement. The gas balancing agreement provides that, in the event that a working interest owner fails to arrange for the sale of its share of gas produced from the Unit, the operator is authorized to sell the corresponding percentage of gas produced for its (operator's) own account. The operator must account for the quantity of gas allocable to the non-selling working interest owner out of future production, if, as and when that owner arranges for the sale of its gas. If the non-selling working interest owner has not recouped all of the gas to which it is entitled under the terms of the gas balancing agreement when the well ceases to produce, then the operator is obligated to account to the non-selling owner in money on a basis provided in the gas balancing agreement.

(d) Neither JAS nor its predecessor, Sommer, never signed, ratified, or otherwise assented to, the joint operating agreement or the gas balancing agreement.

(e) Nevertheless, both Operator and previous operators have treated the Sommer/JAS interest as though it were governed by the gas balancing agreement, and have maintained a gas balancing account for that interest.

(f) When Applicant assumed operation of the Unit, the previous operator's gas balancing record showed the Sommer interest as "oversold," meaning that Sommer had been compensated for more gas than his share of the actual production from the Unit. Since assuming operations, however, Applicant has marketed the gas corresponding to Sommer/JAS working interest share of production from the unit for its own account, as it would have been entitled to do if Sommer/JAS had assented to the gas balancing agreement. Accordingly, Applicant's gas balancing accounts now show the JAS interest as "undersold," meaning that JAS has been compensated for less gas than its percentage share of the gas actually produced and sold from the Unit.

(g) Applicant has, at all times, paid Sommer/JAS the proceeds of sale of its deemed royalty interest (1/8th of its prorata share of production from the Unit, as provided in NMSA 1978, Section 70-2-17), and there is no controversy concerning the Sommer/JAS royalty interest.

(h) However, as to the Sommer/JAS deemed 7/8ths working interest, Applicant has invoiced Sommer, and subsequently JAS, for a proportionate share of the expenses of operating the subject well, including charges for overhead, as it would be entitled to do under the joint operating agreement if Sommer/JAS had assented to that agreement, but has not paid Sommer/JAS any portion of the proceeds Applicant has received from the sale of the corresponding share of gas produced from the Unit. Applicant has instead credited gas corresponding to this interest to a gas-balancing account as though Sommer/JAS were a party to the gas balancing agreement.

(i) Sommer and JAS has not paid invoices sent to it by Applicant for operating expenses or otherwise compensated Applicant for any part of the operating expenses pertaining to the subject well and the Unit.

(j) By various letters, Sommer made known to Applicant his position that he was not liable for operating expenses in the absence of revenue, and that Applicant should account to him for his working interest share of production from the Unit. Sommer's letters also asserted that

Applicant did not have authority to sell the share of gas production from the Unit corresponding to the Sommer/JAS working interest.

(k) Applicant made various offers of settlement of the resulting controversy. However none of its offers was accepted.

(l) It is the custom and practice in the oil and gas industry for working interest owners to enter into gas balancing agreements similar in terms to that to which the working interest owners (other than Sommer/JAS) agreed with respect to the Unit.

(m) The operating expenses invoiced to Sommer/JAS include "producing overhead" charges computed at the rate provided in the joint operating agreement agreed to by the other working interest owners, adjusted for inflation, as allowed by the 1984 joint operating agreement, in accordance with periodic bulletins issued by COPAS (Council of Petroleum Accountants' Societies).

(n) The producing overhead charges, including the COPAS adjustments, are fair and reasonable. It is usual and customary, though not universal, in the oil and gas industry to provide in joint operating agreement for escalation of overhead charges in accordance with the COPAS bulletins, and has been usual and customary, to the witness's knowledge, for at least 25 years. The witness expressly disclaimed knowledge as to what may or may not have been customary in 1961, when the Pooling Order was issued.

(o) Applicant seeks an order authorizing it to market JAS's working interest share of gas produced from the Unit for the account of JAS, and to reimburse itself out of amounts received from such sale for JAS's prorata share of operating costs, including producing overhead. Alternatively, Applicant seeks authority to market so much of JAS's working interest share of production from the Unit as is necessary to enable Applicant to recover JAS's prorata share of operating costs. Applicant also seeks an amendment to the Pooling Order authorizing it to charge producing overhead at the rates provided in its joint operating agreement with the other working interest owners, as adjusted in accordance with the COPAS bulletins.

(6) JAS appeared though counsel in opposition to the application, and presented the testimony of Kurt Sommer, the present beneficial owner of the Sommer/JAS interest, as a fact witness. Mr. Sommer testified, *inter alia*, that he believed that the operating expenses charged to this well, including the producing overhead charges, were not fair and reasonable, and that JAS opposed the Division granting Applicant any relief relating to past production or past operating expenses.

Recovery of Operating Costs

(7) Read literally, the Pooling Order does not contain any provision for recovery of operating costs incurred after payout from the share of production allocated to a non-consenting pooled party.

(8) Two provisions of the Pooling Order provide for recovery of costs. Since the provisions of the Pooling Order are not numbered, they will be referenced herein as the first proviso, being the paragraph of the order beginning, "provided however," and the second proviso, being the first of three paragraphs beginning, "provided further."

(9) The first proviso states that the "costs of development and operation of the pooled unit shall be borne by" the *consenting* working interests owners. The second proviso then provides for recovery of "the proportionate share of the costs of development, including a reasonable charge for supervision" out of a *non-consenting* working interest owner's share of production. However the phrase, "including a reasonable charge for supervision" is interpreted, the second proviso cannot the construed as expressly providing for recovery of operating expenses incurred after payout, because (a) operating costs incurred after payout are not *included* in "costs of development," and (b) the proviso states that the recovery allowed "shall be [not shall include] 110% of . . . the costs of drilling and completing the well . . . ." It is apparent that the second proviso expressly covers only to costs incurred prior to payout.

(10) If the second proviso is disregarded as literally addressing only costs incurred prior to payout, then the first proviso would seem to leave costs of operation to be borne solely by the consenting parties, unless the first proviso is also construed as referring only to operating costs incurred prior to payout, in which event the order is silent regarding responsibility for operating costs incurred after payout.

(11) It would, however, not be reasonable to construe the Pooling Order as either imposing the post-payout operating costs on the consenting parties, or as, by its silence regarding such costs, precluding recovery of the non-consenting pooled parties' share of such costs out of production. The compulsory pooling statute in force at the time of the entry of the Pooling Order, NMSA 1953, Sec. 65-3-147, as enacted by Laws 1953, Ch. 76, Section 1, did not contain the provision found in the present pooling statute to the effect that :

> Such pooling order of the division shall make definite provision as to any owner, or owners, who elects not to pay his proportionate share in advance for the prorata reimbursement solely out of

> production to the parties advancing the costs of the development and operation . . . . [NMSA 1978, Section 70-2-17, as amended].[1]

However, the statute then in effect did provide that, "[a]ll orders requiring such pooling shall be upon terms and conditions that are just and reasonable." If the Pooling Order were construed as allowing non-consenting pooled parties their share of production without charge for reasonable operating costs, the Pooling Order would not just and reasonable.

(12) Accordingly, to the extent that the Pooling Order may be subject to any different construction, it should be amended, retroactively to the date of its issuance, to provide that the parties incurring costs of operation of the subject well and the Unit shall be entitled to recover the proportionate share of those costs, but not exceeding such amounts as are reasonable, from a non-consenting pooled party's working interest share of production from the Unit, but solely out of such party's share of production.

(13) However, as to operating costs other than producing overhead charges, the record in this case is not sufficient for the Division to determine what amounts are reasonable, either with respect to costs incurred in the past or those being incurred currently. Applicant's witness specifically stated that he was not testifying as to the reasonableness of costs other than administrative overhead. JAS's witness testified that operating costs were not reasonable. However, it was unclear whether he referred to all operating costs, or only overhead charges, and he premised his testimony of an exhibit (Energen Exhibit 22) that is confusing, and which he did not clearly explain. Furthermore, JAS's witness was not qualified as an expert, and therefore was not competent to give opinion testimony.

(14) In view of the deficiencies of the record in this respect, the Division should direct Applicant to furnish JAS a full accounting of past operating costs, and periodic statement of currently incurred costs, and JAS should be allowed a period of time to object to those costs (excluding producing well overhead charges, as provided below), following which, if necessary, the Division will determine the reasonableness of such costs in a subsequent hearing.

Producing Well Overhead

(15) The Pooling Order, in the second proviso, evidences an intention to allow the operator to recover "a reasonable charge for supervision." This intent was in accord with the requirement of the then-applicable statute, which provided for recovery of "costs of development and operation . . . including a reasonable charge for supervision." Laws 1961, Ch. 65, Section 1. However, the Pooling

[1] An amended pooling statute in substantially identical language to present NMSA 1978, Section 70-2-17, including the quoted language, had been adopted by the Legislature prior to the issuance of the Pooling Order, but was not yet effective on that date. *See* Laws 1961, Ch. 65, Section 1.

Order does not prescribe either an amount or a formula for determining a reasonable charge for supervision.

(16) Energen's evidence establishes that the producing well overhead charges it has charged to the other non-operators in the subject well, including the periodic escalations of those charges, are customary, fair and reasonable. Accordingly, the Pooling Order should be amended, retroactively, to provide for recovery of the producing well overhead charges allocable to the Sommer/JAS interest, solely out of production from the Unit, in the manner hereinafter provided concerning recovery of past costs and future costs, respectively.

(17) Retroactive amendment of the pooling order to provide for recovery of overhead charges based on testimony as to what is now fair and reasonable is appropriate in this case only because (a) the Pooling Order is silent as to any amount or formula for such charges, and (b) there is no evidence that a different basis for such charges would have been fair and reasonable when the Pooling Order was issued. This order should not be read as a precedent for retroactive amendment of pooling orders to increase the overhead charges provided if those orders specifically provide the amount of such charges or a formula for computing the same, or for amendment of such orders to provide for escalation of overhead rates if the orders provide a specific amount and do not provide for escalation.

Provisions Concerning Future Production and Operating Costs

(18) Applicant has asked that the Division authorize it to sell the share of gas applicable to the Sommer/JAS 7/8ths working interest in production from the Unit, and to recover, out of the proceeds of such sale, the Sommer/JAS share of expenses of operating the Unit. The Division has authority, pursuant to NMSA 1978, Section 70-2-17, to provide in pooling orders such terms as are just and reasonable. The evidence in this case supports the conclusion that, with respect to future production from the Unit and expenses hereafter incurred, such an arrangement would not be just and reasonable. Accordingly, from August 1, 2008 forward, the operator of the Unit should be authorized to sell for the account of Sommer/JAS the share of gas produced from the Unit allocable to Sommer/JAS's deemed 7/8ths working interest, and to withhold therefrom reasonable and necessary costs of operating the Unit hereafter incurred, accounting to Sommer/JAS for any amounts remaining after withholding such costs.

Provisions Concerning Past Production and Operating Costs

(19) Presumably the Division would have authority, pursuant to its general power to include in pooling orders terms that are just and reasonable, to authorize the unit operator to sell a pooled party's share of gas produced from the Unit, or to treat such share as accruing to the account of such party in a gas balancing account, according to what the Division might conclude, in a particular

case, would be just and reasonable. However, there is nothing in the Pooling Order to suggest that the Division intended to impose either such provision, or that it found that either such provision would be fair and reasonable in the case of this Unit. To amend the Pooling Order retroactively to provide for disposition of past production, assuming the Division would have authority to do so, would not be just and reasonable at this time, as it would attempt to assign to the parties' past actions an effect different from what they may have intended when they undertook those actions.

(20) Determining the effects of sale of production in which a pooled party owns an interest under a pooling order that is silent on the subject is a more appropriate function for a court than for the Division. Accordingly, the parties should be left to their remedies in the courts for determining when, and in what manner, Sommer/JAS shall receive its share of past production from the Unit for which it has not received payment.

(21) Since Sommer/JAS may incur delay in receiving its share of past production, while Applicant has received the entire proceeds of selling 100% of the production from the Unit, it would not be just and reasonable to allow applicant to recover past costs out of Sommer/JAS's share of future production. Applicant should recover those costs out of proceeds of past production payable to Sommer/JAS as and when recovered by Sommer/JAS.

Applicability of Division Rule 414

(22) Applicant has asked for relief under Division Rule 414, which provides:

> **19.15.6.414GAS SALES BY LESS THAN ONE HUNDRED PERCENT OF THE OWNERS IN A WELL:**
> When there are separate owners in a well and where any such owner's gas is not being sold with current production from such well, such owner may, if necessary to protect his correlative rights, petition the division for a hearing seeking appropriate relief.

(23) Rule 414 provides that where an owner's gas is not being sold with current production, "*such owner*" may petition the Division for appropriate relief. Applicant is not an owner whose gas is not being sold with current production. Sommer/JAS has not applied for any relief under Rule 414. Clearly Rule 414 has no application to this case, and Applicant's petition, to the extent it seeks relief under that rule, should be denied.

IT IS THEREFORE ORDERED THAT:

(1) Pursuant to the application of Energen Resources Corporation, Order R-1960 is hereby amended, effective as of the date of first production from the Martinez Well No. 1 (API No. 30-039-06124) in Section 2, Township 25 North, Range 3 West, Rio Arriba County, New Mexico, to include the following provision:

> Reasonable charges for supervision (combined fixed rates) are hereby fixed at $350 per month while producing, as of 1984, provided that these rates shall be adjusted annually, from 1984 forward, pursuant to Section III.1.A.3. of the COPAS form titled "*Accounting Procedure-Joint Operations.*" The operator is authorized to withhold from production attributable to each pooled party's deemed working interest, the proportionate share of both the supervision charges and the actual expenditures required for operating the well, not in excess of what are reasonable, attributable to pooled working interest owners.

(2) For all production from the Unit occurring from and after August 1, 2008, at 7:00 a.m., the operator of the Unit shall be authorized, unless otherwise provided by agreement between the parties, to sell each non-consenting pooled party's working interest share of gas produced from the Unit for such party's account. Operator shall account to such non-consenting working interest owner for its share of proceeds received after deducting such party's share of operating costs for the period of time to which such sales apply (and for any prior periods, after August 1, 2008, for which Operator has not recovered such costs previously), including charges for supervision, as provided above. The operator shall, within 70 days after the end of any month in which it sells a pooled party's share of gas under this provision, provide such pooled party a detailed statement or statements showing proceeds received and expenses deducted therefrom. The non-consenting pooled party shall have 45 days after receipt of such statement to file objections thereto with the Division. If no objection is filed, the expenses shown on such statement shall be deemed to constitute reasonable costs. If the pooled party objects to any expenses deducted, the Division will determine reasonable costs after notice and hearing.

(3) Within thirty days after the issuance of this Order, Energen shall provide to Sommer/JAS a full and complete accounting of all costs of operating the Unit incurred prior to August 1, 2008, for which it claims that it is entitled to reimbursement out of the working interest share of production from the Unit allocable to Sommer/JAS. Sommer/JAS shall have 45 days after receipt of such statement to file objections thereto with the Division. If no objection is filed, the expenses shown on such statement shall be deemed to constitute reasonable costs. If Sommer/JAS objects to any such expenses, the Division will determine reasonable costs after notice and hearing.

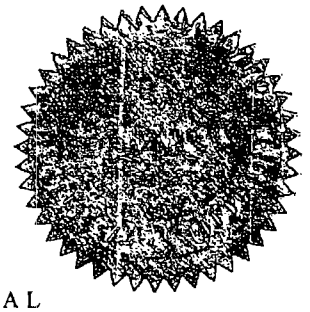
(4) Unless a court otherwise decrees, or the parties otherwise agree, Energen shall be entitled to offset the reasonable costs determined as provided in Ordering Paragraph (3) against any amount recovered by Sommer/JAS as proceeds allocable to its working interest share of production from the Unit occurring prior to August 1, 2008, whether recovered by judgment of a court, pursuant to gas balancing, or otherwise.

(5) Applicant's petition for relief under Division Rule 414 is denied.

(6) The parties may override this Order in whole or in any part by mutual agreement.

(7) Jurisdiction of this case is retained for the entry of such further orders as the Division may deem necessary.

DONE at Santa Fe, New Mexico, on the day and year hereinabove designated.



STATE OF NEW MEXICO
OIL CONSERVATION DIVISION

MARK E. FESMIRE, P.E.
Director

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