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:

APPLICATION OF NEARBURG EXPLORATION COMPANY, L.L.C., FOR COMPULSORY POOLING, LEA COUNTY, NEW MEXICO

CASE NO. 11,722

ORIGINAL

REPORTER'S TRANSCRIPT OF PROCEEDINGS

EXAMINER HEARING

BEFORE: DAVID R. CATANACH, Hearing Examiner

March 20th, 1997

Santa Fe, New Mexico

This matter came on for hearing before the New Mexico Oil Conservation Division, DAVID R. CATANACH, Hearing Examiner, on Thursday, March 20th, 1997, at the New Mexico Energy, Minerals and Natural Resources Department, Porter Hall, 2040 South Pacheco, Santa Fe, New Mexico, Steven T. Brenner, Certified Court Reporter No. 7 for the State of New Mexico.

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I N D E X

March 20th, 1997
Examiner Hearing
CASE NO. 11,722

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* * *

A P P E A R A N C E S

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By: WILLIAM F. CARR

* * *

WHEREUPON, the following proceedings were had at 10:44 a.m.:

EXAMINER CATANACH: At this time we'll call Case 11,722.

MR. CARROLL: Application of Nearburg Exploration Company, L.L.C., for compulsory pooling, Lea County, New Mexico.

EXAMINER CATANACH: Call for appearances.

MR. KELLAHIN: Mr. Examiner, I'm Tom Kellahin of the Santa Fe law firm of Kellahin and Kellahin, appearing on behalf of the Applicant, and I have three witnesses to be sworn.

EXAMINER CATANACH: Additional appearances?

MR. CARR: May it please the Examiner, my name is William F. Carr with the Santa Fe law firm Campbell, Carr, Berge and Sheridan.

We enter our appearance in this case for Penwell Energy, Inc. I have no witnesses.

EXAMINER CATANACH: Any additional appearances?

Will the witnesses please stand and be sworn in?

(Thereupon, the witnesses were sworn.)

MR. KELLAHIN: Mr. Examiner, by way of introduction, if you'll look at Exhibit Number 1 that we have sponsored, you'll note that the Application and some of the earlier documents refer to this as the Tomahawk well.

We've had to change the name to the Opal 28 Federal Com well. The name we were using conflicts with a name used by Mitchell Energy in the west half of the section, which is the Tomahawk Federal Com Number 1 well.

Mr. Carroll may remember the west half of this spacing unit, because it involved the compulsory pooling of the Strata interests and the issue of notifying and obtaining pooling over various partners that are associated with that interest. When we deal with the east half of the section, you're going to find the same parties involved.

In addition, you'll find out that while this is a federal section, we are in the oil-potash area, and so we are continuing to pursue meeting the requirements of the BLM for drilling in the potash area.

At this point we believe we are generally successful in consolidating efforts, but there are interests not yet committed, and while we have verbal agreements with Mr. Murphy and the interest owners, all those agreements are not fully executed, and therefore in order to timely commence the drilling of this well, we're asking that you issue a compulsory pooling order.

My first witness is Mr. Duke Roush.

DUKE ROUSH,

the witness herein, after having been first duly sworn upon his oath, was examined and testified as follows:

DIRECT EXAMINATION

BY MR. KELLAHIN:

Q. Mr. Roush, for the record, sir, would you please state your name and occupation?

A. Yes, my name is Duke Roush. I'm a land consultant, currently doing work for Nearburg Exploration Company.

Q. And has it been your responsibility on behalf of Nearburg Exploration Company to attempt to consolidate on a voluntary basis the interest owners involved in participating in a deep gas well in the east half of Section 23?

A. Yes, it is.

Q. I'm sorry, 28. I said 23. 28.

A. 28.

Q. Have you utilized the services of an attorney that's an expert in examining title and rendering opinions as to the status of ownership?

A. Yes, we have. We had a title opinion prepared by Woerndle, Patterson, Strain and Miller.

Q. To the best of your knowledge and belief, have you identified and attempted to negotiate in good faith a voluntary agreement with all the proper interest owners?

A. Yes.

Q. Let's turn to Exhibit 1 and have you identify and describe that display.

A. Exhibit 1 is an orientation map which shows the proposed proration unit and the location, which is 660 from the east line, 1980 from the south line.

Q. To the best of your knowledge, will this be a standard well location for complying with the Division requirements for well locations in this type of area?

A. Yes, it will.

Q. The Exhibit Number 2, would you identify and describe that display?

A. Exhibit Number 2 is a breakdown by tract of the individual owners in each portion of the proration unit, showing the location.

Q. All right. We have four leases, if you will, or parts of leases, that would be consolidated in the spacing unit?

A. That's correct.

Q. What's the status of the commitment of the Penwell interest?

A. Penwell has agreed to participate in the well.

Q. So there's a voluntary agreement with Penwell?

A. That's correct.

Q. There is a 160-acre portion, I guess, of the spacing unit that starts off with the caption, Mitchell Energy. Do you see that?

A. Yes.

Q. What's the status of the commitment of Mitchell to the well?

A. Mitchell has given us a verbal approval to drill, but we have yet to see any follow-up paperwork.

Q. So we'll still need a pooling order against Mitchell's interest at this time?

A. That's correct.

Q. And how about the Santa Fe Energy interest?

A. Santa Fe Energy has not made an election.

Q. So we'll have to have a pooling order as to their interest?

A. (Nods)

Q. Penwell and CoEnergy are associated together, if my memory is correct?

A. That's correct.

Q. And is Penwell committed, as to this tract, to the spacing unit?

A. Yes.

Q. And what about the interest of CoEnergy Central Exploration?

A. They are also committed.

Q. When we go to the southern two 40-acre tracts, the southeast of the southeast is a Nearburg tract. When we deal with the southwest of the southeast, that's a 40-acre tract that involves Mark Murphy and others; is that not true?

A. That's correct.

Q. You've identified for purposes of this display three companies, Murphy, Arrowhead and Branko?

A. Yes, sir.

Q. Why have you chosen to divide it in that fashion?

A. Murphy Petroleum acquired the interest of the Strata, et al., group, for lack of better words, numerous group of individuals. Branko did not sell to them, neither did Arrowhead, so they still have a vested title interest, which was shown to us in the title opinion which was rendered.

Q. All right, let's deal with the Branko interest first. What is the status of your efforts to obtain a voluntary agreement from Branko?

A. I've spoken with him on numerous occasions. He has elected to do whatever Mr. Murphy does.

Q. So we need a force pooling order against Branko at this time?

A. That's correct.

A. How about Arrowhead Oil Corporation?

A. Arrowhead, we've negotiated a term assignment, and we're in the process of executing that.

Q. So at least temporarily you expect that you'll need an order against Arrowhead, but hopefully if the documents are executed we can dismiss them from a pooling order?

A. That's correct.

Q. Let's deal with the Murphy Petroleum Corporation interest. Am I correct in understanding that Mark Wheeler and you, Mr. Wheeler as a landman on behalf of Penwell and you on behalf of Nearburg, have had extensive and repeated contact with the interest owners involved in what we characterize as the Murphy Petroleum Corporation interest?

A. That's correct.

Q. Explain to the Examiner in a summary fashion what has happened when Mr. Murphy consolidated those interests back into Murphy Petroleum Corporation in terms of committing that interest to overriding royalty burdens.

A. When Mr. Murphy took the assignments from the original owners, he allowed the original owners to excessively burden the lease. There is approximately 34 percent override out of that group now attached to that lease.

Q. Typically, when you look at a tract in a spacing unit, you're accustomed to seeing a base royalty paid to the State of New Mexico or the federal government; is that not true?

A. That's correct.

Q. And that general base royalty is about 12.5 percent?

A. 12.5 on the federal.

Q. Yes.

A. Yes.

Q. When we get to dealing with overriding royalty burdens on a federal lease, you will see ranges of overriding royalty burdens from none up to maybe 12.5 percent; is that not true?

A. That's correct.

Q. When you add those two together, the common practice in the industry, is it not, is to do your very best to obtain a net revenue interest associated with that lease, where the total royalty burdens do not exceed 25 percent?

A. That's correct.

Q. Is that a fair characterization?

A. Yes, yes.

Q. In this instance, the overriding royalty burdens, in combination with the royalty, burden the lease by 50 percent?

A. That's correct.

Q. What have you done in -- Have any of these parties recognized that additional overriding royalty burden to be excessive?

A. Yes, they have. We've been in negotiations via Mark Wheeler with Murphy Petroleum trying to acquire their interest on a term assignment. We have gotten a verbal agreement with the group that they will deliver us an 80-percent net revenue for a fairly tidy little sum of money.

Q. In exchange for compensation paid by you and Mr. Wheeler in terms of a bonus, the verbal agreement is that they will reduce the excessive overriding royalty burdens to the point where they can deliver you a net lease interest of 80 percent?

A. That's correct.

Q. Has that agreement been fully executed by all the parties and recorded?

A. No, it has not.

Q. At this point you're requesting the Examiner to go ahead and issue a pooling order, and hopefully we can dismiss them if all the verbal agreements materialize in the form of enforceable written documents?

A. That's correct.

Q. In addition, you're asking the Examiner to use his authority to reduce the excessive overriding royalty burdens?

A. That is correct.

Q. All right. Let's look at the specifics of the interest. If you'll turn to Exhibit 3, identify and describe for me what I'm seeing when I look at Exhibit 3.

A. Exhibit 3 is just consolidated Exhibit 2 into a 320-acre spacing unit, prorationing everyone's working interest to the spacing unit.

Q. Now, this tabulation simply shows a gross percentage of working interest in the spacing unit?

A. That's correct.

Q. It does not show the net revenue interest applicable here?

A. No, it does not.

Q. All right. Let's turn now to Exhibit Number 4 and have you identify and describe for us what Exhibit 4 is.

A. Exhibit 4 was the original proposal we mailed out January 7th, attaching to it our AFE, sent out certified. As you'll see in the distribution list on the second page, at the time we sent this out, our title did not reflect that the Strata group had assigned their interest into Murphy Petroleum.

Q. All right, let's start with this so that it's clear to the Examiner what you and I are characterizing as the Murphy group.

A. Okay.

Q. It may be easier if we look at this list and simply exclude those companies and individuals that are not part of the Murphy group that we're discussing.

A. Okay.

Q. Delete those for me.

A. With the exception of the six -- first six companies, which is Nearburg, Penwell, Mitchell, Santa Fe and Arrowhead, the remaining balance of those owners have now been consolidated into Murphy.

Q. All right. Let's take the balance of those interests and describe for the Examiner how those interests move from the sheet shown here into the Murphy Petroleum Corporation interest.

A. It was done via an assignment.

Q. All right, each of these individuals and companies, I think, with the exception of Branko -- Branko did not?

A. Right, Branko did not, I'm sorry.

Q. Strata and the rest of these made assignments into Murphy Petroleum Corporation?

A. That is correct.

Q. And in doing so retained overriding royalty percentages?

A. Correct.

Q. The net effect of that is to collectively have an overriding royalty burden of 38 percent, give or take?

A. Give or take, that's correct.

Q. The balance of that interest, then, Mr. Murphy put into Murphy Petroleum Corporation?

A. That's correct.

Q. Okay. The first proposal was to all these individuals and companies prior to knowledge about the assignments into Murphy Petroleum Corporation?

A. That's correct.

Q. And you sent out all these notices and requests for participation?

A. (Nods)

Q. All right.

A. Correct.

Q. When did you become aware that these Murphy partners had made assignments into Murphy Petroleum Corporation?

A. Actually, in following up with our proposal, we were informed that -- from certain individuals that they had, in fact, assigned their interest into Murphy.

And at that point in time, Mark Wheeler had had prepared an assignment -- I mean a title opinion, which he gave us a copy of, which we have provided as Exhibit 5.

Q. All right, Mr. Wheeler had Rudy Woerndle of

Woerndle, Patterson, Strain and Miller prepare a title opinion?

A. That's correct.

Q. And that's what Exhibit 5 is; is that not true?

A. That's correct.

Q. Let's direct the Examiner and Mr. Carroll to the portion of the title opinion that shows them the division of interest among the Murphy partners. Where do we find that?

A. On page 2, Oil and Gas Leasehold Estate, B, southwest of the southeast.

Q. Halfway down the page it starts with sub B, it shows the 40-acre tract, and then what does it show?

A. It shows the individual calculation of net interest.

If you will turn to page 3 and look at the very bottom, it shows -- At the very top, in bold letters, it shows the total overriding royalty that's just been retained being 34.6875.

Going below that is a calculation of the operating rights, showing the breakdown between Murphy, Arrowhead and Branko. It shows the working interest and the associated net revenue interest with each tract.

As you can see, the total working interest on this tract is 100 percent with a net revenue interest of

52.8125, which gives you a total burden of 47 and some change.

Q. Describe for us why that burden, in your opinion, is excessive and what your company does in situations involving tracts and spacing units that have a burden to an extent where they have to deliver you, or propose to deliver, less than a 75-percent net revenue interest.

A. Generally, we do not drill any tracts that have a net revenue interest less than 75.

Q. And why is that so?

A. We feel that is about the economic cutoff, seeking the rate of return we'd like to see on our wells, and when the burdens start getting below 75, the economics of the project start hurting.

Q. Is that unique to Nearburg?

A. No, I don't believe so. I think if you would look probably as an industry standard, about the lowest leases that I've been farmed out to or assigned to, about the lowest burden that you can stomach is about a 25-percent burden.

Q. And this has to do with the deep-gas, high-risk wells such as this?

A. That's correct.

Q. Okay. When we look at the -- that 40-acre tract, it does not appear from Mr. Woerndle's title opinion that the Branko interest bears an overriding royalty burden?

A. That's correct, that's -- Branko and Arrowhead, neither one, have got the excessive burden.

Q. Okay, so the overriding royalty burden that you consider to be excessive is unique to the Murphy -- It says Murphy Production Company, I think I've also characterized it as Murphy Petroleum Corporation.

A. It is Murphy Petroleum Corporation.

Q. That's the right name?

A. That's the right name. I've talked with Rudy since, and they have amended their JOA -- I mean their title opinion.

Q. All right, having been told by certain of the Murphy partners that they either were or had made assignments back to Murphy Petroleum Corporation, what then did you do?

A. The first thing I did was immediately have our title landman go back out and run the records. Discussing this with Mark Wheeler, he informed me that they had recently had a title opinion, so between the two we compared our title checkout with their title opinion. And at that point in time, we started conversations with Murphy.

Q. All right. What were the summary of conversations with Mr. Murphy, and where are we now today with that interest?

A. First of all, we re-sent the proposal, since it had not been sent to Murphy Petroleum. It had been sent to Strata at the same address as Mr. Murphy, and Mr. Murphy did accept it, but as a precaution we felt we needed to re-propose it to Murphy Petroleum to see if they would like to participate.

Q. Okay.

A. They indicated verbally that they did not want to participate, that they would be willing to give us a term assignment.

I discussed this with Mark. Mark had a better relationship, for lack of better words, with Murphy Petroleum, so he said he would take the negotiations.

We have currently had a situation where they are circulating for assignment from the partners a reassignment of the excessive burden back into Murphy so that Murphy could deliver to us an 80-percent net revenue. We've been told they're circulating -- we have no proof of that, other than they've said they were circulating it -- and that hopefully they would get it all tied up in the next three or four weeks and we can proceed.

Q. Other than Mr. Wheeler and your conversations with Mark Murphy, have either of you pursued direct contacts with any of the parties who initially had the working interest share, the Murphy partners, if you will?

A. Yes, I spoke with Branko -- I think his name is actually Branko Jovanovitch or something, I've got it written down and -- on two occasions, and on the last occasion he did say that he would do whatever Murphy Petroleum did. We confirmed that further with Murphy Petroleum.

Q. How about Arrowhead?

A. Arrowhead has agreed and we have -- Like I say, we have a formal document on my desk, which needs to be amended a little bit, but I think it would be an acceptable term assignment form, and I feel that we'll get that tied up.

Q. What about the balance of the individuals and entities that we've characterized as the Murphy partners? Have you had direct contacts with any of those?

A. No.

Q. You've simply relied on Mark Murphy's representation that he was acquiring those interests and had -- and that those interests are now of record, are they not?

A. That's -- well, they -- Yes, yes.

Q. So the assignments from these parties are of record back to Murphy Petroleum Corporation?

A. That's correct.

Q. The problem with those assignments is, they carry the excessive overriding royalty burdens?

A. That's correct.

Q. All right. And you're dealing with Mr. Murphy in order to attempt to negotiate and pay for reduction of the burden?

A. That's correct.

Q. And he says he's trying to get that done?

A. That's correct.

Q. All right. Let's turn to Exhibit 6 and have you identify and describe what this is.

A. This is the documentation between Mark [*sic*] C. Chase, who says that he is now the owner of Arrowhead -- when I say Arrowhead, we're dealing with Chase. They are attempting as part of acquiring that interest to perfect the title into Chase.

He informed me that Arrowhead was now a defunct company, so we have some title curative here, and that's part of the problems we have with the current form of term assignment that I have on my desk.

Q. Okay.

A. But I'm working with him on that.

Q. And Exhibit 7?

A. Exhibit 7 is just confirmation of the trade showing -- Again, he's saying that Arrowhead was absorbed by Mark Chase and that he will remedy the situation and prepare the assignment.

Q. Let's look at Exhibit 8 now.

A. Exhibit 8 was the reproposal to Mark Murphy of the well when we discovered that they now had the interest.

Q. The second paragraph describes the concern over the excessive royalty burdens?

A. That's correct.

Q. And part of that triggered, then, follow-up verbal discussions with Mr. Murphy about what to do?

A. That's correct.

Q. Okay. Have any of the parties notified, interjected any objection to the AFE you submitted to them?

A. No, they have not.

Q. The proposed overhead rates?

A. $6000 and $600.

Q. All right. Do you have a forecast or an estimate of the time frame in which to commence the well?

A. The well, for the benefit of Nearburg, must be spudded by July 1st, 1997.

Q. And why is that necessary?

A. Our interest was acquired from Pitch Energy Company.

Q. Pitch?

A. Yes.

Q. Okay. And we have a term assignment which expires -- originally expired 5-1-97. We have been successful in acquiring a two-month extension and have been told that that would be our last extension.

Q. Okay.

A. The company is called Pitch Energy Corporation.

Q. And July 1st is the end of that extension, and you don't believe it's possible to get additional extensions?

A. Not without paying a very exorbitant amount of money, no.

MR. KELLAHIN: All right, sir.

Mr. Examiner, Exhibit 17 that's before you is my certificate of mailing and notice of hearing. I have attached a tabulation of the parties and individuals that notice was sent to.

With your permission, we would move the introduction of Mr. Roush's Exhibits 1 through 8 and Exhibit 17.

EXAMINER CATANACH: Exhibits 1 through 8 and 17 will be admitted as evidence.

MR. KELLAHIN: That concludes my examination of this witness.

EXAMINER CATANACH: I guess I'm a little unclear, Mr. Kellahin, as what Nearburg is asking the Division to do in this case. You're asking us to issue a pooling order. Are you asking us to, within the pooling order, reduce the overriding burden on this particular tract?

MR. KELLAHIN: Yes, sir, we've done that, not in the recent past, but there are occasions where I have requested and the Division has done that. If you like, I can give you some examples.

In Order R-7998, from my Application on behalf of Hawkins Oil Company, the Division entered an order that reduced an excessive burden that Meridian Oil Company had on the track at that time. And there's language contained in that order that I may submit to you as a way to accomplish that. That was in the Hawkins case.

It was also done in a Chandler case, Order R-8047. That ultimately was a Commission hearing. There was an excessive burden in that case, which was ultimately reduced.

There is another example, Rio Pecos Corporation, Order R-7335, in which Ralph Nicks had put a 50-percent overriding royalty burden on one of his interests to his son and daughter in an effort to avoid having a working interest share committed to the costs of a well, and that was ordered reduced by that order.

So in a quick check I found three examples in the past where we had done that. So that's what I'm asking you, is that as to the interests in that 40-acre tract, which we think will, by negotiation and payment of consideration, be voluntarily reduced, but in the event that that somehow doesn't work, we would ask that you reduce the overriding royalty burden so that it's a net revenue interest of 75 percent as to that interest.

And if you look at the title opinion, you can see which parties of the Murphy partnership were responsible for achieving that level of percentage, and we'll simply ask that it all be proportionately reduced.

That doesn't wipe out the entire overriding royalty burden, you understand. That still allows about 12.5 percent to remain in effect. We're just going to knock off about -- I don't know, 16, whatever the percentage difference is.

EXAMINER CATANACH: Okay, you're asking us to reduce that burden such that your net revenue interest on that tract is 75 percent?

MR. KELLAHIN: Yes, sir.

EXAMINER CATANACH: Aren't you negotiating with Murphy for an 80-percent figure?

MR. KELLAHIN: That's right, for consideration he's going to give us the additional 5, but we're not going to ask that that difference be considered. We're paying considerable money for this, and if it doesn't work, we want 75 percent.

EXAMINER CATANACH: If this is put within the pooling order, doesn't that give you what you're asking for, and you have no reason to continue negotiations with Murphy at that point?

MR. KELLAHIN: We would not do that, Mr. Examiner.

THE WITNESS: No, we will continue, we've made a good-faith offer, and we're making a good-faith effort to control this, and I would prefer to have the 80 percent, even paying the bonus, versus the 75.

EXAMINER CATANACH: So you will continue to negotiate with Murphy?

THE WITNESS: Oh, most definitely, yes.

MR. KELLAHIN: And that's their desire, and my caution as the attorney for Mitchell in the adjoining dispute was to make absolutely certain that all the documents had been fully executed and recorded. Because the time led line of spudding this well is close, we wanted the action taken in the pooling order in the event that Mr. Murphy changes his mind. The mind to be changed here would not be ours, it would be his.

EXAMINATION

BY EXAMINER CATANACH:

Q. Well, in your opinion, Mr. Roush, what do you think the chances are of executing this agreement with Murphy?

A. I think they're very good, but I have no guarantees that they'll perform.

Q. Does the -- Is this agreement with Murphy contingent upon Murphy obtaining these assignments from each of his interest owners?

A. That's correct.

Q. Each of these has to reduce theirs back to Murphy in order for Murphy to make this deal with you?

A. That's correct, and that's my concern.

Q. If one or two of them do not do that, then he can't make the deal; is that correct?

A. Well, the deal we've made has been on the full 92-percent working interest, and at this point in time he has assured us that all the parties will reduce their overriding royalty so that he can make the deal.

I'm sure that some of the consideration that we're giving Mr. Murphy will probably flow through to his partners. I don't know that, but I would assume.

Q. But again my question is, if one or two elect not to do that, what happens then?

A. If one or two elected not to do it, and we could see that of the 92 percent, that we had 88 percent of it, we would proceed with the 88 and just have to deal with the remaining 2, or however we want to do it. And we'd be reasonable about it.

But on the other hand, if only half of them sign, then you've still got half that interest out there with an excessive burden, and that would be one that we would have to sit back and probably scratch our head.

But from a practical standpoint, if we get to within, you know, 90 percent of that group executing it, we'll probably proceed. We have a term assignment here that's expiring 7-1-97, so practicality will overcome, you know, whatever you have down on paper.

Q. So if you can't reach an agreement with Murphy, you've got this Division order to fall back on?

A. That's correct. And if we didn't have such a tight time frame on our term assignment, I'd be much more comfortable with letting this drag along a little bit longer and trying to get it typed up. But I don't know that, you know, this thing will be tied up in 30 or 60 days, and then we're in a world of hurt with our assignment.

Q. Okay. You've got a drilling deadline. Is it July 1st?

A. July 1st, our term assignment expires if we're not drilling.

Q. Has Murphy expressed to you in what time frame he might have this accomplished?

A. He's been dealing mainly with Mark, and Mark indicated he hoped that they would have it done in the next three weeks. But that's a lot of individuals to get a lot of paper from and, if you'll notice, they're all over the country. Mr. Branko is actually in Canada.

Q. Well, Branko's interest doesn't affect the deal with Murphy?

A. No, but again, Branko would probably want to tie all of it up. The majority of the interests, I believe they're located in -- we've got some in Albuquerque, some in Salt Lake City, some in Roswell. So quite a few places. It's not that it can't be done; I just think it will take a little time to circulate that much paper and get it executed.

Q. Do you anticipate joinder by Santa Fe Energy?

A. Yes, I do. I don't know why they haven't elected. I've talked to them on numerous occasions. I was employed with Santa Fe for 15 years. I can't imagine them not participating for 3 1/8. But I have not been able to get them to give me an election.

EXAMINATION

BY MR. CARROLL:

Q. Mr. Roush, it appears that the assignments from all these Strata partners to Murphy Petroleum were made in

June of last year?

A. Uh-huh.

Q. This was quite a few months before the well was proposed?

A. Yes.

Q. I'm a little confused. It looks like Scott Exploration, Inc., has two overrides?

A. George L. Scott and Scott Exploration.

Q. Scott Exploration, Inc., it's the second page of the title opinion.

A. I see them once.

MR. KELLAHIN: Here it is.

THE WITNESS: Did I miss it?

MR. KELLAHIN: He's looking at this plus.

THE WITNESS: Oh, yeah, combined, I believe they have a 9 1/2. It could have come from two separate --

Q. (By Mr. Carroll) I'll ask -- Scott, I think, was a working interest owner?

A. Yeah, it could have been a previous override, and then when they made the assignment in the Murphy attached another override.

MR. CARROLL: Yeah. That's all I have.

EXAMINER CATANACH: I don't have anything further of this witness.

MR. KELLAHIN: Mr. Examiner, my next witness is

Ted Gawloski. Mr. Gawloski is a petroleum geologist.

TED GAWLOSKI,

the witness herein, after having been first duly sworn upon his oath, was examined and testified as follows:

DIRECT EXAMINATION

BY MR. KELLAHIN:

Q. For the record, sir, would you please state your name and occupation?

A. I'm Ted Gawloski. I'm a petroleum geologist for Nearburg Producing Company in Midland.

Q. On prior occasions, Mr. Gawloski, have you testified and qualified as an expert petroleum geologist?

A. Yes, I have.

Q. Have you made a geologic examination of the opportunity for a deep gas well in the east half of Section 28?

A. Yes, I have.

Q. As part of that study, do you now have an opinion as to the appropriate risk factor penalty to be associated with this project and to be attached to a compulsory pooling order?

A. Yes.

Q. You're aware that the Commission is authorized to impose a penalty of cost plus a maximum of 200 percent to any party that has a working interest that elects not to participate? Are you aware of that?

A. Yes, I am.

Q. What do you recommend as a geologist in terms of that penalty percentage?

A. 200 percent.

Q. Let's talk about how you get to that conclusion. If you'll start with Exhibit 9 --

A. Okay.

Q. -- give us the setting of what you're dealing with.

A. Exhibit 9 is an Atoka/Morrow production map covering portions of Township 20 South, 33 East, and the proposed location and the proration unit shown there in the green box.

There are essentially two fields in this area, the Teas field up to the north, and the Salt Lake/Hat Mesa complex down the south. Where we are drilling is in between these two areas. There's -- The well in the west half of 28 has made about 1.5 BCF of gas and 21,000 barrels of condensate, and it's currently at a rate of about 400 MCF a day.

The well in 27 did not make a Morrow well after some attempts to establish production, and they made an Atoka well, made about half a BCF.

The other closest well is in Section 26. That well has made about 200 million, and it's currently producing at a pretty low rate.

Q. Why are you seeking a maximum 200 percent?

A. There is significant risk attached to the well in here. Some that -- We can show you off the map, some that deal with the actual reservoir rock itself.

Q. Well, let's start that process, let's look at Exhibit 10. You have a three-well stratigraphic cross-section. The line of that cross-section shown on 9. It's also in the locator map at the bottom of 10.

A. That's correct.

Q. You're utilizing the closest available well control you have to this location, I guess?

A. That's correct.

Q. And what do we see when we look at the cross-section?

A. Well, this is a cross-section that goes from the Strawn formation up on the top, down to the Barnett shale, on the bottom of the cross-section.

Mainly -- Our main interest here is the sands within the Morrow formation. We've split out the sands here into the Morrow "A", which is the uppermost sand complex; the Morrow "B", which we've split to an upper and lower section here; and then the Morrow "C", which is the lower sand package.

The well on the west end, the Mitchell Tomahawk 28 Federal, is the well we plan on offsetting. It is currently producing out of a sand in the lower Morrow "B". To the best of my knowledge, it has not been recompleted in any of the other sands. The well was produced naturally initially and then frac'd with an algal foam frac, and it is now, I believe, on a compressor, producing now.

The well in Section 27 and the well in Section 26, you'll notice that there is quite a large amount of sand in the Morrow "B" and "C" sections. These two wells really are not going to be commercial wells. The well in 27 tested a whole bunch of these sands and never really had any production established with them.

The well in 26 has actually good reservoir parameters in here but was damaged, I believe, while it was drilled and then frac'd and then shut in, and the well has never produced at that high a rate. It makes about a quarter of a million a day on a compressor.

One of the things that we noted in here is that the sands have a high susceptibility to damage due to the clays and stuff that are in the rock. So that adds an inherent risk in this area here, that sometimes you cannot see in the isopachs because they do show some pretty good porosity, but they haven't performed up to what their expectations were.

Q. Characterize for us the continuity of these sand lenses in the Morrow as you move from well to well.

A. Well, the individual sands are quite erratic in nature, but when we isopach them we take a group of sands and try to develop them as a package, otherwise we wouldn't have any continuity at all. So we map them and try to break out blocks of sands and then map them in that manner, and that's what I've done here.

Q. The isopach masks the difficulty of -- masks the characteristic that these lenses really are discontinuous and very heterogeneous?

A. That's correct.

Q. Let's look at those isopachs, if you'll start with Exhibit 11.

A. Exhibit 11 is the isopach of the Morrow "C" sands -- it should be the lowest member of the cross-section -- and essentially they are northwest-southeast-trending channel sand complexes in here. We've projected a sand thick through the east half of 28. Although there is some development in the wells on either side of us, they have not been productive in this section.

Q. It looks to be a pretty interpretive map, Mr. Gawloski, when you look at the well control in relation to identifying this channel and establishing a thickness to it?

A. That is correct. The only producing well that we see within that channel is down in Section 1, the township to the south.

Q. Okay, Exhibit 12, identify and describe that display.

A. Exhibit 12 is the isopach of the lower Morrow "B", and it's a pretty thick sand package in here. The Mitchell well in the west half of 28 is producing out of an individual sand in the lower part of that section. This is probably the main objective of what we're after in our east half of 28.

This well also -- I had worked for Mitchell when we drilled this well, and this well was cored and it had lots of minerals and clays and stuff within the sands themselves, and the well had to be stimulated in a fashion that wouldn't damage it. And we know this about this area here, and therefore the wells have to be treated when you drill them with respect to not damaging the formation.

Q. Okay, let's turn your attention to Exhibit 13 and have you identify and describe that display.

A. Exhibit 13 is the isopach of the upper Morrow "B" sands. They are productive in the area, but only to the southwest and to the northeast of the prospect.

The Mitchell well in the west half of 28 has some thin sand lenses, but they have not been tested yet.

The well in Section 27 tested those sands, but they were nonproductive.

The well in Section 26 has not tested that interval yet.

So there is some productive in here. These things are oriented in a strike fashion. There are more marine bar complexes here.

Q. Still very speculative on the interpretation here?

A. Right. As you can see on the cross-section, especially on the Mitchell well, it is a bunch of thin sand lenses, and so they're discontinuous by their nature.

Q. All right, Exhibit 14. Identify and describe this one.

A. Exhibit 14 also is an isopach of a marine bar complex, and you can see there's numerous individual pods in here. There is a sand that's in the well in Section 28, the west half. That sand has not been tested yet.

Q. Okay, and finally the structure map, Exhibit 15?

A. The structure map is a structure map on the top of the Morrow, which is that blue line on the cross-section. It shows the big structure associated with the Salt Lake/Hat Mesa field complex to the south and the faulted area to the north, and then a pronounced structural low across Section 33. And our location would be on the flank of that as -- coming up out of that low. And we'll essentially be flat to the Mitchell well in Section -- west half of 28.

Q. In summary, then, Mr. Gawloski, what's your conclusion about the penalty and the geologic risk?

A. I believe the penalty of 200 percent is warranted. There is inherent risk in here with the individual lenticular nature of the sands and also the clays that are within these sands.

MR. KELLAHIN: That concludes my examination of Mr. Gawloski.

We move the introduction of his exhibits. They are 9 through 15.

EXAMINER CATANACH: 9 through 15?

MR. KELLAHIN: Yes, sir.

EXAMINER CATANACH: Exhibits 9 through 15 will be admitted as evidence.

I have no questions of Mr. Gawloski.

TIM McDONALD,

the witness herein, after having been first duly sworn upon his oath, was examined and testified as follows:

DIRECT EXAMINATION

BY MR. KELLAHIN:

Q. All right, sir, would you please state your name and occupation?

A. My name is Tim McDonald. I'm a petroleum engineer for Nearburg Producing Company in Dallas, Texas.

Q. Mr. McDonald, on prior occasions you've testified as a petroleum engineer before the Division?

A. Yes, I have.

Q. At my request, Mr. McDonald, did you prepare an analysis of the effect of what we characterize to be the excessive overriding royalty burdens associated with the tract that's involved in this spacing unit?

A. Yes, I have.

Q. And based upon that analysis, do you now have conclusions and recommendations?

A. Yes, I do.

MR. KELLAHIN: We tender Mr. McDonald as an expert petroleum engineer.

EXAMINER CATANACH: He is so qualified.

Q. (By Mr. Kellahin) Let's look at Exhibit Number 16, Mr. McDonald, and let's look at the parameters and let me ask you some questions.

A. All right.

Q. Where did you get the parameters and what do they mean?

A. The parameters are based on a study of the area around this prospect, including both the Salt Lake South field and the Hat Mesa field. There's -- I believe I looked at about 50-some-odd wells and took production curves and projected those to their economic limits and came up with ultimate recoveries.

And based on those wells, I came up with an average initial gas rate of about 2 million a day, a condensate yield of .012 barrels of condensate per MCF, ultimate reserves per well of 3.5 BCF, decline rate of about 19 percent per year, and I used our average operating costs in the area of about $1200 a month, and I escalated those at 3 percent a year.

I used a $2-an-MCF gas price, escalated 2 percent per year to a maximum of $3.50 per MCF. I used a condensate price of $20 a barrel, escalated 2 percent to a maximum of $35.

I used a chance of success of 35 percent. And basically the way I set the program to do that, it risks the initial rate, the ultimate production and the completion cost amounts by 65 percent.

The dryhole cost I used from the AFE of $699,220, the completed well cost of $1,159,273. In both cases, I used the Nearburg current working interest in the unit.

Q. The attachments to that are the spreadsheets that you could analyze, or the Examiner could analyze, that will show him how you got to the results?

A. Right, those show an economic forecast and also the input data behind each case.

Q. All right. In your opinion, are the parameters that you've selected to make this analysis fair and reasonable?

A. I feel like they are, yes.

Q. What is the effect on the project in terms of the return on investment or rate of return if you use the current burdens that the Murphy interests have on their lease?

A. The economics show an internal rate of return projected with the current burdens of 20 percent and a return on investment of 1.89.

Q. If those burdens are reduced -- and I'm not sure if you reduced it to the 80 percent or the NRI of 75 percent. What did you use?

A. Seventy-five.

Q. You used 75 percent NRI, like we've asked the Examiner to use?

A. That's right.

Q. When you reduce the burden to a net revenue interest, setting aside the excessive burden, what happens?

A. I came up with an internal rate of return of about 25 percent and a return on investment of a little over 2, 2.11.

Q. Still a very risky, very marginal prospect, isn't the input data behind each case.

Q. All right. In your opinion, are the parameters that you've selected to make this analysis fair and reasonable?

A. I feel like they are, yes.

Q. What is the effect on the project in terms of the return on investment or rate of return if you use the current burdens that the Murphy interests have on their lease?

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Q. When you reduce the burden to a net revenue interest, setting aside the excessive burden, what happens?

A. I came up with an internal rate of return of about 25 percent and a return on investment of a little over 2, 2.11.

Q. Still a very risky, very marginal prospect, isn't it?

A. Yeah, we look at -- On a deep Morrow test like with all the risks involved, a minimum of -- we try to achieve a minimum of a risked rate of return of 25 percent, an ROI of two or greater.

Q. Yeah, and this just barely does it, even if you take the excessive burdens down?

A. That's correct.

Q. And if the burdens are left on, what happens to the viability of the project economically?

A. It's really sub what we like to proceed with. Its economics are substandard for our typical prospect of this type.

Q. The ability to drill this well and the priority in which it is rated among other prospects certainly diminishes, does it not?

A. That's true.

Q. What is your recommendation to the Examiner with regards to the excessive burdens?

A. I feel like we need to get to the 75 percent to justify the prospect economically.

MR. KELLAHIN: That concludes my examination of Mr. McDonald.

We move the introduction of his Exhibit 16.

EXAMINER CATANACH: Exhibit 16 will be admitted as evidence.

EXAMINATION

BY EXAMINER CATANACH:

Q. Mr. McDonald, how did you use the chance of success, the 35 percent? Where did that fall into your equation there, your calculations?

A. Well, the -- First, the number came from our experience in the area, basically, when you look at all the wells that have been drilled, and what it means is the chance of obtaining a well that ultimately cums 3.5 BCF and will initially start off at a rate of 2 million a day.

And the way it worked in the calculations where the program actually takes one minus the risk factor, so it takes the 2 million a day initial rate and takes -- risks it by 65 percent, so it takes 65 percent of the 2 million. It takes 65 percent of the 3.5-BCF ultimate, and it takes 65 percent of the completion costs and runs the economics based on that case. And that just -- it allows us -- We use that as a way of rating our prospects against one another to decide which ones need to be drilled and in which order we ought to drill them for the best economic success.

And that's shown on the detail, if you look on a -- you'll see the ultimate gas is like 1.2 BCF on the overrun, on the economic run. And what that is, that's 65 percent of the 3.5.

Q. So what you're saying is, you have about a one-in-three chance of obtaining a well that has these --

A. That's correct.

Q. Okay. Well, doesn't that -- I mean, you're significantly reducing the -- I guess I'm just not clear on how you do that or why do you do that.

A. It's fairly typical. Most economics programs are set up that way. It's a way of rating prospects, more or less.

If you assign a risk factor to them, it allows you to take a prospect, you know, with varying -- It allows you to equate everything on an internal-rate-of-return basis, different-size prospects, different types of prospects.

EXAMINATION

BY MR. CARROLL:

Q. Is this a commercially available --

A. Sure, this is --

Q. -- program?

A. This is OGRE, yeah, this is -- There's two industry standards. This is one of the two that people generally use. It's called OGRE.

Q. OGRE?

A. OGRE, it's been around for years. David P. Cook.

And that's the way that they've built their program, to -- you can -- to risk prospects like this.

FURTHER EXAMINATION

BY EXAMINER CATANACH:

Q. So let me ask you this: If you take your numbers, your 2000 MCF per day and your 3.5-BCF ultimate recovery, and you use that in your equations, isn't that going to significantly increase your rate of return?

A. Yes, it will, because you'll have a higher initial. Certainly you'll get your money back faster, but you'll also spend a little more because you'll also have your full completion costs, whereas I only used 40 percent of my completion costs or 45 -- 35.

And if we're successful, it also makes the dollar value of the 5 percent greater than what's shown on these runs.

Q. If you were to obtain a well that produced this much and had that much ultimate reserves, wouldn't that still be very economic, even with the excessive burdens on the lease?

A. No, we really shoot for a minimum of 25 percent on this type of well.

Q. But if you use the calculations, if you use the figures of 2000 MCF per day and 3.5 BCF, I mean, wouldn't that increase that rate of return?

A. That would increase that.

Q. To where it was economic?

A. It probably would be.

Q. But you're saying that you only have a one-in-three chance --

A. Right.

Q. -- of getting a well like this?

A. Right, and I have to have some way to risk the prospect.

Q. Is this -- I mean, you do this typically with other prospects?

A. We do it with all of our prospects, yes, sir.

EXAMINER CATANACH: Okay, I have nothing further of the witness.

MR. CARROLL: I have one more question.

FURTHER EXAMINATION

BY MR. CARROLL:

Q. Your actual operating costs are $1200 a month in this area?

A. Yes, on a pulling gas well, without a compressor.

MR. CARROLL: That's all I have.

EXAMINER CATANACH: Anything further?

MR. KELLAHIN: Mr. Examiner, if I have not already done so, Exhibit 17 is my certificate of mailing of notice to all the interest owners. The parties that