

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

IN THE MATTER OF THE McELVAIN OIL
& GAS PROPERTIES, INC. FOR COMPULSORY
POOLING AND AN UNORTHODOX WELL
LOCATION, RIO ARRIBA COUNTY, NEW MEXICO.

Case No. 12284
Order No.

ORDER OF THE DIVISION
(Energen's Draft)

BY THE DIVISION:

This cause came on for hearing at 8:15 a.m. on December 2, 1999, at Santa Fe, New Mexico, before Examiner Mark Ashley.

NOW, on this ___ day of _____, 1999, the Division Director having considered the testimony, the record, and the recommendations of the Examiner and being fully advised in the premises,

FINDS THAT:

(1) Due public notice having been given as required by law, the Division has jurisdiction of this case and its subject matter thereof.

(2) The applicant, McElvain Oil and Gas Properties Inc. ("McElvain") seeks an order pooling all mineral interests from the base of the Pictured Cliffs formation to the base of the Dakota formation the following acreage in Section 33, Township 26 North, Range 2 West, NMPM, Rio Arriba County, New Mexico, in the following manner:

(a) The S/2 to form a standard 320 acre gas spacing and proration unit for any and all formations and/or pools developed on 320 acre spacing within this vertical extent which presently includes but is not necessarily limited to the Blanco-Mesaverde Pool-Basin-Dakota pool, and the undesignated Gavilan Greenhorn-Graneros-Dakota oil pool;

(b) The SE/4 to form a standard 160 acre spacing and proration unit for any and all formations, and/or pools developed on 160 acre spacing within this vertical extent which presently includes, but is not necessarily limited to, the undesignated Ojito Gallup-Dakota oil pool; and

(c) The NW/4 SE/4 to form a standard 40 acre oil spacing proration unit for any and all formations and/or pools developed on 40 acre spacing within this vertical extent.

(3) Said units are to be dedicated to the Applicant's proposed Cougar Com "33" Well No. 1 to be drilled 1,970 feet from the south line and 2,125 feet from the east line (Unit J) of said Section 33. The proposed location is considered standard for the Blanco-Mesaverde pool and for all formations spaced on 40 acres.

(4) By the Division's Administrative Order NSL-4370, dated October 25, 1999, the proposed well has been approved as an unorthodox gas well location for the Basin-Dakota pool. The location is considered unorthodox for the Undesignated Gavilan Greenhorn-Graneros-Dakota oil pool and for all formations spaced on 160 acres.

(5) There are one or more working interest owners in the proposed spacing and proration units who have not agreed to pool their interests.

(6) Energen Resources Corporation ("Energen") owns the oil and gas leasehold rights under the E/2 SW/4, SW/4 SW/4, SW/4 SE/4 of said Section 33.

(7) NM&O Operating Company ("NM&O") owns the oil and gas leasehold rights under the N/2 SE/4 of said Section 33.

(8) At the time of the hearing, Energen appeared through legal counsel and provided witness testimony in opposition to the pooling of its interests.

(9) Energen did not oppose the proposed unorthodox location, the estimated costs of drilling, completing and producing the well, or the designation of the Applicant as operator.

(10) NM&O also appeared through legal counsel at the hearing in opposition to the application.

(11) In addition to opposing the pooling of its interests, NM&O Operating Company opposed the risk penalty sought by the Applicant.

(12) Energen presented witness testimony in support of its contention that the Applicant failed to make a good faith effort to secure the voluntary joinder as required under NM Stat. Ann. § 70-2-17 C and § 70-2-18A and B. The evidence presented by Energen established the following:

(13) Applicant first proposed the drilling of the Cougar 33 Com Well No. 1 well to Energen on September 1, 1999.

(14) On September 28, 1999, the Applicant requested Energen waive any objections to the proposed unorthodox well location for the subject well. Energen received the request for waiver on

October 8, 1999. Subsequently, on October 15, 1999, the Applicant submitted another waiver request amended to correct an earlier error in addressing. Energen approved the unorthodox well location waiver on October 25, 1999.

(15) There were no further communications between the Applicant and Energen until October 25, 1999 when McElvain filed its application for compulsory pooling with the Division. McElvain's application was received by Energen on November 2, 1999.

(16) Landmen for both the Applicant and Energen discussed the well proposal by telephone on November 2, 1999 and again on November 4, 1999. In those conversations, Energen proposed that it participate in Applicant's well according to the same terms for the farmout of Energen's interest as the Applicant proposed for its Siefert Com No. 1 well located in Section 22, T 26 N, R 2 W, giving Energen a retained 6.25 percent overriding royalty interest on its committed interest. The Applicant rejected those proposed farmout terms citing the risk involved with the drilling of the Cougar Com 33 No. 1 well.

(17) On November 4, 1999, Energen proposed another farmout which provided for the applicant to earn 100 percent of Energen's interest in the drilling units subject to Energen's retention of a 5 percent overriding royalty interest which would be convertible to a 40 percent back-in working interest at payout. These terms were also rejected by the Applicant.

(18) Subsequently, Energen revised the terms of its proposed farmout to allow for Energen to retain a 2.5 percent overriding royalty, proportionately reduced, convertible to a 25 percent back-in working interest after payout. Energen explained that its before payout interest was 11.71875 percent of the proposed spacing unit and, consequently, the revised farmout would represent a before payout burden of 0.2926 percent overriding royalty convertible to a 2.9268 percent back-in working interest after payout. Energen further explained that the reduction in the overriding royalty interest from 6.75 percent to 2.5 percent was equivalent to a 270 percent reduction, while the 40 percent back-in working interest was reduced to a 25 percent interest, also equivalent to a 160 percent reduction.

(19) Testimony by Energen's landman established that the farmout terms offered by Energen were more generous than those typically offered by industry for comparable drilling prospects in the area of the Cougar Com 33 No. 1 well.

(20) Subsequently, the Applicant rejected Energen's revised farmout proposal, demanding that Energen reduce its override burden to .14648 percent net ORRI, proportionately reduced, with a zero back-in working interest after payout.

(21) Energen subsequently agreed to reduce its override to the 0.15658 percent demanded by McElvain. Energen also proposed that it would retain the same 25 percent back-in working interest it had earlier agreed to reduce.

(22) Energen's landman testified that the Applicant had represented to it that the difference between the 0.29296 percent overriding royalty proposed to be retained by Energen and the 0.14648 percent override demanded by McEvain would render the drilling project uneconomic.

(23) Energen's landman witness testified that the very small net revenue of the overriding royalty interest it proposed to retain under its farmout was substantively the same as a farmout of 100 percent of Energen's interest.

(24) The Applicant's landman witness agreed that the after-payout back-in interests proposed by Energen had no bearing on the economics of the actual drilling and completion of the proposed well.

(25) Energen's landman also testified that it was his belief that the Applicant would have rejected a proposed tender of a farmout of 100 percent of Energen's interest in the well. From such conduct, the Energen landman concluded the sole purpose of the negotiations and compulsory pooling application was to enable the Applicant to recoup a risk penalty of 200 percent above the actual costs of drilling and completing the proposed well.

(26) Energen's landman further testified that the Applicant's proposal was for a Dakota completion only, and that the testing of any other interval was never discussed.

(27) While the Applicant's witnesses testified to the possibility of a completion in the Mesaverde formation, the Applicant offered no testimony or evidence of a proposed allocation of costs. Energen's expert petroleum landman witness testified that he had worked as a landman in the San Juan Basin for twenty years and has been involved in negotiating participation in over 100 wells. Energen's landman witness also testified that he was familiar with the custom and practice of industry in the San Juan Basin with respect to the negotiation of voluntary participation in the drilling of a new prospect. Energen's landman witness further opined that the Applicant's conduct in this case fell below the applicable standards for San Juan Basin operators in negotiating voluntary participation in well proposals and that McElvain's negotiation efforts did not constitute a good faith effort to secure Energen's voluntary participation in the well.

(28) The Applicant's landman and engineering witnesses testified that the Applicant refused to agree to the farmout terms proposed by Energen because those terms did not satisfy the Applicant's "economic criteria." The Applicant's witnesses failed to present any evidence of its economic criteria for this prospect and further refused to explain the same over the objections of its counsel.

(29) The Applicant's landman further testified that the standards of good faith in negotiating voluntary participation in a well proposal are established by the customs and practices of the industry in the area. However, the witness was unable to specify those customs and practices or otherwise identify the applicable standards in this case.

(30) The Applicant offered no other evidence establishing that its negotiation efforts met the standard of good faith for obtaining the voluntary participation of other working interest owners in a well proposal.

(31) At the hearing, the Applicant's witnesses testified that the Dakota formation is the primary objective for the well while the Mesaverde formation is the secondary objection.

(32) The AFE and other well costs evidence offered by the Applicant related to a completion in the Dakota formation only. The Applicant presented no evidence for a proposed allocation of costs between a Dakota completion and a Mesaverde completion.

(33) The Applicant presented no geologic testimony or other evidence of the geology of the area.

(34) The only evidence presented by the Applicant as a basis for the application of a 200 risk penalty against the owners of the unjoined interests was the absence of any other wells in the area penetrating the Dakota formation. However, additional testimony established that the applicant has drilled and is presently drilling a number of other Mesaverde wells in the immediate vicinity of the Cougar Com 33 No. 1 well. The Applicant presented no evidence establishing the presence or absence of risk involved in the drilling of a Mesaverde well in the area.

(35) Under the Division's compulsory pooling statutes, N.M. Stat. Ann. 70-2-17 and 70-2-18, an applicant is required to do more than show only that owners have not been able to voluntarily agree to pool their interests for the drilling of a well. An applicant for compulsory pooling must also prove by a preponderance of the evidence that a good faith effort was made during negotiations to obtain the voluntary commitment of interests.

(36) The evidence in this case established that while it did make an initial effort to obtain Energen's voluntary participation, the applicant failed to act in good faith in further negotiations for the commitment of Energen's interests.

(37) The evidence establishes that Energen offered to farm-out its interests on terms that were more generous than those typically offered by other operators and interest owners for comparable drilling prospects in the San Juan Basin.

(38) The Applicant's contention that Energen's farmout proposal did not meet its economic criterion, without more explanation, is insufficient to demonstrate that the Applicant met its burden of proving it made a good faith effort to obtain Energen's voluntary participation in the proposed well.

(39) The Applicant failed to establish by a preponderance of the evidence that it made a good faith effort to obtain the voluntary agreement pooling the interests of Energen and NM&O.

(40) The Applicant's request to pool the interest of Energen Resource Corporation and NM&O Operating Company should therefore be denied.

(41) Because the Division finds that the Applicant failed to exercise good faith in negotiating the voluntary participation of Energen and NM&O Operating Company, that portion of the application seeking to pool the interests of those working interests owners should be dismissed.

(42) That portion of the application seeking the approval of the proposed unorthodox well location referenced in Paragraph 14 above should be approved.

IT IS THEREFORE ORDERED:

(1) The Applicant's request to pool the interests of those owners who have not voluntarily agreed to the pooling of their lands is hereby denied.

(2) The application, to the extent it seeks the compulsory pooling of the interests of those owners who have not voluntarily agreed to pool their lands, is hereby dismissed.

(3) The request in the application for approval an unorthodox well location 1,970 feet from the south line and 2,125 feet from the east line (Unit J) of Section 33 is approved with respect to the undesignated Gavilan Greenhorn-Graneros-Dakota oil pool and for all formations spaced on 160 acres.

(4) The Division's earlier approval of the unorthodox gas well location for the Basin-Dakota pool by Division Administrative Order NSL-4370, dated October 25, 1999 is incorporated herein and made a part of this order.

(5) The Applicant's request that it be designated operator of the proposed well and unit is hereby denied.

(6) All other relief requested in the application is also denied.

(7) Jurisdiction of this cause is hereby 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 hereinafter designated.

STATE OF NEW MEXICO
OIL CONSERVATION DIVISION

LORI WROTENBERY, DIRECTOR

SEAL