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

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

CASE NO. 11666 (DeNovo)
APPLICATION OF INTERCOAST OIL AND GAS COMPANY FOR COMPULSORY POOLING AND AN UNORTHODOX GAS WELL LOCATION EDDY COUNTY, NEW MEXICO

CASE NO. 11677 (DeNovo)
APPLICATION OF YATES PETROLEUM CORPORATION FOR COMPULSORY POOLING AND AN UNORTHODOX GAS WELL LOCATION, EDDY COUNTY, NEW MEXICO

ORDER NO. R-10731-B

YATES PETROLEUM CORPORATION'S PROPOSED ORDER OF THE COMMISSION

BY THE COMMISSION:

This cause came on for hearing at 9:00 a.m. on February 13, 1997, at Santa Fe, New Mexico, before the Oil Conservation Commission of New Mexico, hereinafter referred to as the "Commission".

NOW, on this _____ day of February, 1997, a quorum being present and having considered the testimony, the exhibits received at said hearing, and being fully advised in the premises,

FINDS THAT:

A. JURISDICTION:

(1) Due public notice having been given as required by law, the Commission has jurisdiction of this cause, the parties hereto and the subject matter thereof.

B. ISSUES:

(1) Yates Petroleum Corporation ("Yates") requests that the Commission review the following matters:

(a) Adopt as a matter of policy in competing compulsory pooling applications which involve the same well location and the same spacing unit orientation shall be **granted** to that applicant who, **at the time the application was filed**, was able to consolidate on a voluntary basis the largest percentage of working interest ownership in the spacing unit;

(b) Vacate Division Order R-10731 because, as a matter of policy, it is contrary to the custom and practice before the Division and in violation of Section 70-2-17(C) NMSA (1978), to allow InterCoast to prematurely institute compulsory pooling action without first undertaking a good faith and reasonable effort to form an appropriate spacing unit on a voluntary basis for the drilling of a specific well; and

(c) Vacate Division Order R-10731 because it awards operations to InterCoast whose conduct in this matter created an environment of hostility because InterCoast filed for compulsory pooling as a negotiation strategy against Yates rather than as a remedy of last resort when all efforts for obtaining a voluntary agreement had failed.

(2) The Commission FINDS THAT IT should address these issues based upon its statutory obligation to prevent waste and protect correlative rights when it uses the police powers of the State of New Mexico to confiscate an interest owners property in compulsory pooling cases and decide this case based upon the following criteria and analysis:

B. APPLICATIONS:

(1) The applicant in Case 11666, InterCoast Oil and Gas Company ("InterCoast"), seeks an order pooling all mineral interests from the surface to the base of the Morrow formation underlying the E/2 of Section 20, T20S, R28E, forming a standard 320-acre gas spacing unit for any and all formations and/or pools spaced on 320-acre gas spacing including but not limited to the Burton Flat-Morrow Gas Pool, to be dedicated to its InterCoast State "20" Well No. 1 to be drilled at an unorthodox gas well location 990 feet from the North and East lines (Unit A) of said Section, Eddy County, New Mexico.

(2) The applicant in Case 11677, Yates Petroleum Corporation ("Yates"), seeks an order pooling all mineral interests from the surface to the base of the Morrow formation underlying the E/2 of Section 20, T20S, R28E, forming a standard 320-acre gas spacing unit for any and all formations/pools spaced on 320-acres, including but not limited to the Burton Flat-Morrow Gas Pool, to be dedicated to its Stonewall AQK State Com Well No. 1 to be drilled at an unorthodox gas well location 990 feet from the North and East lines (Unit A) of said Section, Eddy County, New Mexico.

(3) Each applicant (InterCoast and Yates) has the right to drill and each proposes to drill a well in this spacing unit, as described above in Findings (2) and (3), to a depth sufficient to test the Morrow formation.

(4) Cases Nos. 11666 and 11677 were consolidated for the purpose of hearing and should be consolidated for purpose of issuing an order since the granting of one application would require the denial of the other because these cases involve a dispute over operatorship and development of the same 320-acre spacing unit.

C. YATES' REQUEST FOR A STAY:

(1) On December 19, 1996, the above-referenced competing pooling applications of Yates Petroleum Corporation ("Yates") in Case 11677 and InterCoast Oil & Gas Company ("InterCoast") in Case 11666 came on for hearing before Division Examiner David R. Catanach.

(2) On January 13, 1997, the Division entered Order R-10731 granting the application of InterCoast and denying the companion application of Yates.
Order R-10731 pooled the E/2 of Section 20, T20S, R28E, NMPM, Eddy County, New Mexico, designated InterCoast operator of the well, and provided that the well shall be commenced on or before April 15, 1997.

(3) On January 21, 1997, Yates filed an Application for Hearing De Novo. At that time the next Commission hearing was scheduled for February 13, 1997.

(4) On January 24, 1997, in accordance with Division rules, Yates requested a Stay of Division Order No. R-10709 to enable it to have the Commission review these competing pooling applications in a **de novo** hearing prior to InterCoast commencing to drill the well and in doing so contended that:

> (a) If a Stay was not granted, by the time of the next Commission hearing the well will be drilling, the issues which Yates had a right to have reviewed by the Commission would be moot and Yates' right to a hearing would effectively be lost.
>
> (b) Yates sought an opportunity to show the Commission that Order R-10731 is contrary to the precedents established by the Division in prior cases for resolving competing compulsory pooling case because:
>
> > it awarded operations to InterCoast because it was the first working interest owner to propose a farmout agreement for a well **despite** the fact that InterCoast filed for compulsory pooling prior to providing Yates with an AFE and **despite** the fact that the Yates Group controls 52.465% of the working interest in this spacing unit while InterCoast controls only 24.101% of the working interest.

(5) On January 28, 1997, InterCoast filed a response requesting the Division deny Yates' request for a Stay because InterCoast's farmout would expired on February 18, 1997 unless InterCoast commenced the well prior to that date.

(6) On January 31, 1997, the Division Director denied the Stay because *"(4) Granting the "Stay" would delay the drilling of the well which would risk the loss of valuable farmout rights."* **See Order R-10731-A.**

(7) However, at the Commission hearing, evidence was introduced that:

> (a) on January 21, 1997, InterCoast had obtained an extension of this farmout until March 30, 1997;
>
> (b) prior to filing its response, InterCoast had received and reviewed Yates' Motion for a Stay;

(c) InterCoast had received, reviewed and approved a response prepared by its attorney which argued that the Stay should be denied because the InterCoast farmout would expire on February 18, 1997, when in fact InterCoast knew that its farmout would not expire until March 30, 1997;

(e) InterCoast **failed** to notify its attorney that InterCoast had obtained the farmout extension and thereby caused its attorney to file a pleading that was false; and

(f) on Saturday, February 8, 1997, InterCoast placed a drilling rig on location and commenced drilling this well.

(8) The Commission **finds** that InterCoast's conduct constituted a deception of the Commission and resulted in this well being **prematurely** commenced to the detriment of Yates.

D. PARTY CONTROLLING MAJORITY INTEREST:

(1) Section 20 is divided such that the W/2, the SE/4 and 5% of the NE/4 is subject to a working interest owner agreement ("Unit Agreement") operated by Yates and the balance of NE/4 is subject to a lease held by Kerr-McGee. (now owned by Devon).

(2) As of the date of the Examiner hearing, Yates controlled approximately 52.465% of the working interest ownership within the spacing unit:

Yates Group: 37%	
Yates Petroleum Corporation	19.635%
Yates Drilling Company	7.742%
Abo Petroleum Corp.	2.581%
Myco Industries, Inc.	7.742%
Stonewall Unit Owners:	14.765%

(3) As of the date of the hearing, InterCoast controlled only 24.101% of the working interest ownership within the spacing unit as a result of a farmout from Kerr-McGee Corporation, with the remaining 23.416% interest controlled by Diamond Head Properties who was neutral in this matter and who had indicated its desire to join in whichever operator was approved by the Division.

(4) As of the date of the Commission hearing:

(a) seventeen other working interests owners, **including Kerr-McGee,** had approved Yates as operator;

(b) no other working interest owner had approved of InterCoast as the operator.

(5) The Commission **FINDS** THAT:

(i) The Division has established the precedent of awarding operations to the applicant who has consolidated the largest percentage of working interest ownership even if it was **not the first owner to propose its well**:

> See: Order R-10626 (Findings 6 and 9) in the "Hummer State dispute" where Nearburg (14%) conceded and allowed Mewbourne (70% consolidated) to have the first opportunity to drill its location even though Nearburg's location was different and Nearburg had proposed its well location first.

(ii) The Division has established the precedent of awarding operations to the applicant who has control of the largest percentage of working interest ownership when each group desires to drill **a different location**:

> See: Order R-10520 (Findings 13 and 15) involving different locations in the "Boyd X dispute" where Yates (37.5%) prevails over Nearburg (37.5%) when Unit (24.5%) supports Yates at the second hearing.

(iii) Even in cases where there are different locations proposed, geologic disputes and differences in AFEs, the percentage controlled is a significant factor in deciding these disputes:

> See: Order R-10358 (Findings 8, 13 and 27) where Yates (33%) and Nearburg (50%) in the "Holmquist dispute" each want a different location and Nearburg is granted operations.

See: Order R-10434 (Findings 10, 27 and 28) where Yates (51%) and Nearburg (46%) in the "Ross EG 14 dispute" each want a different well, and Yates is granted operations because Conoco (6.25%) supports Yates.

(iv) The **minority owner** prevailed only in unique circumstances such as

See: R-10709 where in the "Trainer-Prince dispute" Burlington (13%) was granted a pooling order only after first giving the majority owners (Trainer & Prince (82%) some 17 months to commence the well only to have Trainer and Prince attempted to avoid being pooled by transfer their interest to Penwell.

See: Order R-10742 where Penwell (50% consolidated) and Santa Fe (50%) used compulsory pooling to resolve a significant geologic dispute over different well locations instead of attempting to reach a voluntary agreement and which was decided in favor of Penwell.

(v) The Yates Group (Yates Petroleum Corporation, Yates Drilling Company, Abo Drilling Corp. and Myco Industries, Inc. and Nearburg, in cases where there is no geologic dispute, are now settling the issue of operations based upon the operator who has consolidated and controlled the largest working interest in the spacing unit.

(6) Based upon these prior precedents, Yates, Nearburg and others have settled their competing pooling cases and have thereby avoid bring numerous cases to the Oil Conservation Commission.

(7) Order R-10731, now disrupts the current settlement practices being used by the industry because it will cause other minority working interest owners to attempt to obtain operations in future pooling cases based upon who first proposes a farmout or other "deal" so that such a minority owner will be awarded operations despite the objections of a substantial majority of the working interest owners in the unit.

(8) In summary, the Commission **finds that** Yates should be awarded operations because it controls 52.5% of the working interest and has the support of 17 different working interest owners while InterCoast controls only 24% has been unable to obtain the approval of any working interest owner.

E. EFFORTS TO OBTAIN VOLUNTARY AGREEMENT:

(1) On September 3, 1996, Yates received a letter from InterCoast dated August 30, 1996 which is referenced a "**Farmout Request**" and in which InterCoast requested Yates to farmout its interest in the NE/4 of said Section 20, **but failed** to submit an AFE, failed to designate a spacing unit and failed to request Yates to join in the well.

(2) InterCoast did not indicate to Yates that there was any urgency to this matter nor did InterCoast request a reply to the farmout request by any specific date.

(3) InterCoast failed to put Yates on notice that InterCoast would institute compulsory pooling action against Yates in the absence of Yates' acquiescence to InterCoast's request.

(4) On September 17, 1996, InterCoast advised that it would provide Yates with a proposed Authority for Expenditure ("AFE") and Joint Operating Agreement.

(5) Instead, on September 24, 1996, InterCoast filed its compulsory pooling application for the N/2 of said Section 20 some 15 days **before** Yates received InterCoast's AFE and well proposal letter on October 9, 1996.(NMOCD Case 11634)

(6) On October 9, 1996, more than 14 days after InterCoast filed its compulsory pooling application, Yates received InterCoast's first written proposal for a N/2 spacing unit which included a AFE for the well.

(7) InterCoast refused to allow Yates to operate the well in the E/2 of Section 20 despite the fact that this spacing unit Yates has consolidated the largest percentage of working interest owners and is the operators of the Stonewall Unit which Yates has drilled and operated 21 wells since 1973.

(8) On November 12, 1996, InterCoast filed its compulsory pooling application seeking to operate the E/2 of Section 20 (NMOCD Case 11666).InterCoast filed its compulsory pooling application some 6 days **before** Yates received InterCoast's AFE and well proposal letter on November 18, 1996. (NMOCD Case 11666).

(9) On November 18, 1996, Yates received InterCoast's well proposal for the E/2 of Section 20.

(10) InterCoast's conduct compelled Yates to file a competing compulsory pooling application on November 26, 1996 in an attempt to obtain operations of the well.

(11) The Commission **FINDS THAT:**

(a) The Division's pooling authority may be exercised **only after** a good faith effort has been made to reach a voluntary agreement for the development of the spacing unit. See Section 70-2-17(C) NMSA (1978). The reason for this requirement is that the pooling of mineral interest involves the taking of property interest from one owner and giving that interest to another.

(b) The Oil and Gas Act requires that the affected parties be given an opportunity to voluntarily "pool their interest and develop their lands as a unit" before the Division makes that decision for them. Until now, the Division has consistently dismissed compulsory pooling cases which were filed **prior** to the date the party to be pooled has received a written proposal specify the well, its location, its spacing unit and its estimated costs ("AFE"). **See Order R-10242, Order R-10545, Also see Cases 10635, 10636, 9939 and 11461.**

(c) The activities initiated by **InterCoast** amount to "bad faith" contrary to the Division's policy and practice that compulsory pooling be used as a last resort only after the applicant has engaged in good faith negotiations rather than as "negotiating weapon" to be used against other working interest owners.

(d) Division Order R-10731 is contrary to past precedent established by the Division.

F. Geologic Evidence-Well Location:

(1) Both Yates and InterCoast are in agreement as to the proposed well location and both have relied upon similar geologic evidence and evaluations.

(2) The Commission finds that this case cannot be decided based upon geologic evidence.

G. Operations and Estimated Well Costs ("AFE"):

(1) Yates contends it should be awarded operations because:

(a) numerous and significant operational decisions are made during drilling and completing the well which are within the sole control of the operator

(b) it has the majority interest and therefore the greatest financial incentive to effectively and efficiently drill, complete and operate this well;

(c) its well program is more realistic than that proposed by InterCoast who is new to New Mexico and has no operations in the area while Yates operates some 20 wells in this immediate area.

(2) InterCoast contends it should be awarded operations because:

(a) it initiate the prospect first.

(3) InterCoast admits its still retains the same interest in this spacing unit even if Yates operates the well.

(4) InterCoast failed to submit an analysis of its AFE, failed to present a petroleum engineer to compare the type of well it proposed to drill with that proposed by Yates.

(5) Yates presented its petroleum engineer who prepared a comparison between the InterCoast AFE and Yates' AFE which demonstrated that:

(a) InterCoast's AFE failed to provide adequate estimates of casing, logging, cementing, and drilling costs,

(b) the InterCoast's original AFE was for total completed well cost $697,000. but at the Examiner hearing increased to $755,725 and again increased after the Examiner order to $818,625.

(c) that the Yates' AFE was $861,500 **but** when appropriate adjustments were made, then the Yates' AFE was only $42,000 more than the InterCoast AFE;

(3) InterCoast is using a 4-1/2" casing instead of 5-1/2" casing which Yates contends is essential in order to provide a wellbore adequate to test shallower zones for production.

(5) The Commission finds that:

(a) it is concerned that the InterCoast AFE has failed to properly account for the costs of drilling and completing this well;

(b) that Yates should be awarded operations becuase it has the greatest financial risk in the well, it's AFE is more realistic, it operates some 20 wells in this immediate area while Intercoast has no operations and no experience in this area.

H. Issues Irrelevant in the Subject Case:

The Division finds that while in certain cases these topics may have some relevance, they are not of significance in deciding this case: risk factor penalty or overhead rates.

I. Unorthodox well location:

Both Yates and InterCoast have agreed with OXY USA Inc. (the offset operator in Section 16 and 17) that in exchange for OXY waving any objection to the unorthodox well location, they will provide to OXY USA Inc. all well data from the subject well and will waive any objection to a similar unorthodox location for OXY in Sections 16 and 17 not closer than 990 feet to the common section line or corner.

J. Conclusion:

(a) Based upon the forgoing, Yates' application should be approved and Yates Petroleum Corporation should be designated as operator.

(b) InterCoast should be ordered to immediately surrender operations of this well to Yates.

(c) Yates' request for a Stay of Order R-10731 should immediately be granted.

(d) Overhead charges for supervision should be set at $5,400.00 while drilling and $540.00 while producing.

(e) Since risk of an unsuccessful completion at this location is very high, the risk penalty should be set at 200%.

(f) Approval as set out in the above findings and in the following order will avoid the drilling unnecessary wells, protect correlative rights, prevent waste and afford the owner of each interest in said unit the opportunity to recover or receive without unnecessary expense his just and fair share of the production in any pool resulting from this order.

IT IS THEREFORE ORDERED THAT:

(1) That Yates' request for a Stay of Order R-10731 is hereby granted effective immediately and Order R-10731 is vacated in its entirety.

(2) The application of InterCoast in Case No. 11666 as described in this order is hereby DENIED.

(3) The application of Yates in Case 11677 as described in this order is hereby GRANTED.

(4) That effective at _____am on the ____ day of February, 1997, InterCoast shall surrender all operations and control of this well to Yates.

(5) All mineral interests, whatever they may be, from the surface to the base of the Morrow formation including but not limited to Burton Flat-Morrow Gas Pool underlying the E/2 of Section 20, Township 20 South, Range 28 East, NMPM, Eddy County, New Mexico, are hereby pooled to form a standard 320-acre gas spacing and proration unit to be dedicated to a well to be drilled at an unorthodox well location 990 feet from the North line and 990 feet from the East line (Unit A) of said Section 20.

PROVIDED HOWEVER THAT, the operator of said unit shall continue the drilling of said well on or before the 30th day of March, 1997, and shall thereafter continue the drilling of said well with due diligence to a depth sufficient to test the Morrow formation of the subject pool.

PROVIDED FURTHER THAT, in the event said operator does not commence the drilling of said well on or before the ___th day of _____, 1997, Decretory Paragraph No. (3) of this order shall be null and void and of no effect whatsoever, unless said operator obtains a time extension from the Division for good cause shown.

PROVIDED FURTHER THAT, should said well not be drilled to completion, or abandonment, within 180 days after commencement thereof, said operator shall appear before the Division Director and show cause why Decretory Paragraph No. (3) of this order should not be rescinded.

(4) Yates Petroleum Corporation is hereby designated the operator of the subject well and unit.

(5) After the effective date of this order and prior to commencing said well, the operator shall furnish the Division and each known working interest owner in the subject unit an itemized schedule of estimated well costs.

(6) Within _____ days from the date the schedule of estimated well costs is furnished to him, any non-consenting working interest owner shall have the right to pay his share of estimated well costs to the operator in lieu of paying his share of reasonable well costs out of production, and any such owner who pays his share of estimated well costs as provided above shall remain liable for operating costs but shall not be liable for risk charges.

(7) The operator shall furnish the Division and each known working interest owner an itemized schedule of actual well costs within 90 days following completion of the well; if no objection to the actual well cost is received by the Division and the Division has not objected within 45 days following receipt of said schedule, the actual well costs shall be the reasonable well costs; provided however, if there is an objection to actual well costs

within said 45-day period the Division will determine reasonable well costs after public notice and hearing.

(8) Within 60 days following determination of reasonable well costs, any non-consenting working interest owner who has paid his share of estimated costs in advance as provided above shall pay to the operator his pro rata share of the amount that reasonable well costs exceed estimated well costs and shall receive from the operator his pro rata share of the amount that estimated well costs exceed reasonable well costs.

(9) The operator is hereby authorized to withhold the following costs and charges from production:

A. The pro rata share of reasonable well costs attributable to each non-consenting working interest owner who has not paid his share of estimated well costs within 30 days from the date of schedule of estimated well costs is furnished to him; and

B. As a charge for the risk involved in the drilling of the well, 200 percent of the pro rata share of reasonable well costs attributable to each non-consenting working interest owner who has not paid his share of estimated well costs within 30 days from the date the schedule of estimated costs is furnished to him.

(10) $5,400.00 per month while drilling and $540.00 per month while producing are hereby fixed as reasonable charges for supervision (combined fixed rates); the operator is hereby authorized to withhold from production the proportionate share of such supervision charges attributable to each non-consenting working interest, and in addition thereto, the operator is hereby authorized to withhold from production the proportionate share of actual expenditures required for operating such well, not in excess of what are reasonable, attributable to each non-consenting working interest.

(11) Any unleased mineral interest shall be considered a seven-eighths (7/8) working interest and a one-eighth (1/8) royalty interest for the purpose of allocating costs and charges under the terms of this order.

(12) Any well costs or charges which are to be paid out of production shall be withheld only from the working interest's share of production, and no costs or charges shall be withheld from production attributable to royalty interests.

(13) All proceeds from production from the subject well which are not disbursed for any reason shall be placed in escrow in Eddy County, New Mexico, to be paid to the true owner thereof upon demand and proof of ownership; the operator shall notify the Division of the name and address of said escrow agent within 30 days from the date of first deposit with said escrow agent.

(14) Should all the parties to this compulsory pooling reach voluntary agreement subsequent to the entry of this order, this order shall thereafter be of no further effect.

(15) The operator of the subject well and unit shall notify the Director of the Division in writing of the subsequent voluntary agreement of all parties subject to the compulsory pooling provisions of this order.

(16) Jurisdiction of this cause is retained for the entry of such further orders as the Commission may deem necessary.

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

STATE OF NEW MEXICO
OIL CONSERVATION COMMISSION

JAMI BAILEY, Member

WILLIAM W. WEISS, Member

WILLIAM J. LEMAY, Chairman

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