

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. 12,730

APPLICATION OF LEONARD RESOURCE)
INVESTMENT CORPORATION FOR COMPULSORY)
POOLING, LEA COUNTY, NEW MEXICO)

ORIGINAL

REPORTER'S TRANSCRIPT OF PROCEEDINGS

EXAMINER HEARING

BEFORE: DAVID BROOKS, Hearing Examiner

September 20th, 2001

Santa Fe, New Mexico

This matter came on for hearing before the New Mexico Oil Conservation Division, DAVID BROOKS, Hearing Examiner, on Thursday, September 20th, 2001, at the New Mexico Energy, Minerals and Natural Resources Department, 1220 South Saint Francis Drive, Room 102, Santa Fe, New Mexico, Steven T. Brenner, Certified Court Reporter No. 7 for the State of New Mexico.

* * *

OCT-4 AM 10:11
OIL CONSERVATION DIV

I N D E X

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 Examiner Hearing
 CASE NO. 12,730

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A P P E A R A N C E S

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 By: J.E. GALLEGOS

ALSO PRESENT:

MICHAEL E. STOGNER
 Hearing Examiner
 New Mexico Oil Conservation Division
 1220 South Saint Francis Drive
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* * *

1 WHEREUPON, the following proceedings were had at
2 10:25 a.m.:

3 EXAMINER BROOKS: Case Number 12,731 will be
4 postponed until 1:30 this afternoon.

5 And at this time we'll call Case Number 12,730,
6 Application of Leonard Resource Investment Corporation for
7 compulsory pooling, Lea County, New Mexico.

8 Call for appearances.

9 MR. BRUCE: Mr. Examiner, Jim Bruce of Santa Fe,
10 representing the Applicant. I have the same two witnesses,
11 Mr. Leonard and Mr. Worrall, who were sworn in for the
12 prior case.

13 EXAMINER BROOKS: Okay.

14 MR. GALLEGOS: Representing Coates Energy Trust,
15 Gene Gallegos, Santa Fe, New Mexico. We have one witness.

16 EXAMINER BROOKS: Would all of the witnesses
17 please stand and each identify themselves for the record?

18 You all have been previously sworn, so you don't
19 have to be sworn again. Only the new witness needs to be
20 sworn.

21 MS. GREEN: Yes, I'm Sherrie Green, I'm with
22 Coates Energy Trust.

23 EXAMINER BROOKS: Okay.

24 (Thereupon, the additional witness was sworn.)

25 EXAMINER BROOKS: You may call your first

1 witness, Mr. Bruce.

2 MR. BRUCE: Call Mr. Leonard back to the stand.

3 EXAMINER BROOKS: Okay, you may proceed when
4 ready, Mr. Bruce.

5 MR. BRUCE: Mr. Examiner, if the record could
6 reflect that my first witness, Mr. Dan Leonard, was also
7 qualified as an expert petroleum landman?

8 EXAMINER BROOKS: That is correct. Are there any
9 objections to his credentials since this case is contested
10 and the previous one was not.

11 MR. GALLEGOS: No objection.

12 EXAMINER BROOKS: His credentials will be
13 accepted.

14 DAN LEONARD,
15 the witness herein, having been previously duly sworn upon
16 his oath, was examined and testified as follows:

17 DIRECT EXAMINATION

18 BY MR. BRUCE:

19 Q. Mr. Leonard, would you identify Leonard Resource
20 Exhibit 1 and describe what Leonard seeks in this case?

21 A. Exhibit 1 is a land plat of the area highlighting
22 in yellow the 40-acre tract that is the southeast quarter
23 of the northwest quarter of Section 2, Township 20 South,
24 Range 38 East, Lea County, New Mexico.

25 As with the previous case, we are requesting an

1 order pooling this quarter quarter from the surface to the
2 base of the Abo. The unit will be dedicated to Capataz
3 Operating, Inc.'s, White Owl Number 1 well, which will be
4 located 1650 feet from the north line and 2100 feet from
5 the west line of Section 2.

6 Q. And again, Leonard Resource requests that Capataz
7 Operating, Inc., be designated operator of this well?

8 A. Yes, sir.

9 Q. Let's do the same thing, and I might have messed
10 you up a little bit, on the interests being pooled again,
11 Mr. Leonard. But first go to the first page of Exhibit 2
12 and describe the interests as they currently exist.

13 A. The interest ownership at present, Leonard
14 Resource Investment Corporation, et al., owns 72.789063
15 percent of the -- We have 30 oil and gas leases covering
16 73.789 percent of the minerals in that 40-acre tract.

17 The parties with known addresses we are seeking
18 to force pool own 25.43457 percent. Parties with no known
19 addresses being force pooled, .77637 percent.

20 Q. Okay. Now, with respect to the parties with
21 known addresses, it's 25.4-plus percent. Of that, what
22 amount is Coates Energy Trust?

23 A. Twenty-five percent, an undivided quarter.

24 Q. An undivided equal one quarter?

25 A. Yes, sir.

1 Q. And again if you move to the spreadsheet at the
2 back, it lists certain locatable persons, in particular
3 Wells Fargo Bank Trustee; Levy Brothers, LLC; and Robert
4 Joe Reichert. Those who you could locate; is that correct?

5 A. Yes, sir.

6 Q. And you seek to force pool those parties?

7 A. Yes, we do.

8 Q. And the other locatable party you seek to force
9 pool is Coates Energy Trust?

10 A. Yes, sir.

11 Q. Okay. And then also on this list there's a
12 number of parties listed below the Reichert interest.
13 Those were all -- Those are all parties you were unable to
14 locate; is that correct?

15 A. Yes, sir.

16 Q. Okay. Let's discuss your efforts to obtain the
17 voluntary joinder of the parties. Let's first go to your
18 Exhibit 2 and your Exhibit 3A and discuss your efforts to
19 obtain the joinder of the bank, Levy Brothers and Mr.
20 Reichert.

21 A. The first interest is the Wells Fargo Bank,
22 Trustee for the J.M. Armstrong Estate in Midland, and this
23 is the same trust department that we addressed in the
24 previous case. Same exact problem, we contacted these
25 people back in March and we have an agreement in principle

1 to proceed. We have made numerous requests for a copy of
2 their oil and gas lease, which we've entered into with them
3 before and don't perceive that to be a problem; we just
4 simply can't get them to process the oil and gas lease and
5 present it to us. So at this point, since we've got a rig
6 lined up and preparing to drill the well, we have no option
7 but to proceed.

8 Q. And again, if you do come to terms with them you
9 will notify the Division that they should not be subject to
10 a pooling order?

11 A. Sure, we will.

12 Q. Now what about Levy Brothers, LLC.

13 A. Levy Brothers, as the right-hand column on Mr.
14 Votaw's spreadsheet suggests, we attempted to contact them
15 back in May. July we sent letters to them, we left more
16 messages. We got an answering machine that sounds like
17 that they have an ongoing business, but we've never
18 received a response, either in writing or by telephone,
19 from them.

20 Q. Okay, and what about Mr. Reichert?

21 A. The Reichert interest, we haven't found -- We've
22 got this address from him out of the records, but I believe
23 it's with the -- as in the previous case, with the known
24 address that we've gotten no response from. We've gotten
25 our correspondence returned from him as not deliverable.

1 We suspect that there's been a death here, but we just
2 don't have any information with which to proceed.

3 Q. And you did make a search to determine if this
4 was the proper address for them?

5 A. Yes, sir, we've searched the Lea County Offices,
6 the records, the tax rolls, we've gone through the
7 Internet, the directory assistances and all those things
8 that we typically have access to and have had no luck.

9 Q. And in your opinion as to these three parties,
10 has Leonard Resource made a good faith effort to obtain
11 their voluntary joinder in the well?

12 A. We have.

13 Q. All right, what about the unlocatable persons
14 listed on the spreadsheet attached to Exhibit 2? Could you
15 again just briefly go over the records that were examined
16 to try to determine the whereabouts of these people?

17 A. Well, as Mr. Votaw's spreadsheet suggests, the
18 same basic modus operandi. We went to the records, we've
19 searched the county records, the tax rolls, the deaths and
20 probates, the last known oil and gas lease that these
21 people entered into, which again were many, many years ago,
22 gave no known addresses for these people, and there's just
23 nothing in the records, or the Lea County records, to give
24 us a lead. So then we went to the Internet and the various
25 services that we have access to there through the Internet

1 to find either a phone number or an address for them and
2 didn't succeed.

3 Q. And these 11 people or so cumulatively own what,
4 about 3/4 of 1 percent of the well unit; is that correct?

5 A. Yes, sir, this is Lea County, New Mexico. You
6 know, we've got -- I think I indicated to you, we've got 30
7 oil and gas leases in this 40-acre unit, and we've got a
8 quarter interest, well over a quarter -- a little bit over
9 a quarter interest that we haven't gotten, so we've got 30
10 leases covering roughly 30 acres, and some of them are
11 three- or four- or five-acre interests. So you can tell
12 from this list. I mean, we've got relatively minor
13 interests here.

14 Q. Okay. In your opinion, has Leonard Resource and
15 its agents made a good faith effort to determine the
16 whereabouts of these parties who are deemed unlocatable?

17 A. Yes, sir, we have.

18 Q. Now let's move on to the Coates Energy Trust, and
19 correspondence with Coates Trust is marked Exhibit 3B, is
20 it not, Mr. Leonard?

21 A. Yes, sir.

22 MR. BRUCE: Why don't you go down -- Let me see.
23 Say the fifth -- Mr. Examiner, the fifth page from the top
24 of Exhibit -- Is it the fifth page? Maybe down a little
25 bit further.

1 EXAMINER BROOKS: Fifth page appears to be --

2 MR. BRUCE: Go below the -- Go below the first
3 oil and gas lease, Mr. Examiner.

4 EXAMINER BROOKS: Okay. Facsimile transmission
5 cover sheet?

6 MR. BRUCE: No --

7 THE WITNESS: No, sir, it's --

8 MR. BRUCE: -- there are two leases, Mr.
9 Examiner, but the first lease form, which is about three
10 pages long, legal-sized -- okay, to a letter dated January
11 19th, 2000.

12 EXAMINER BROOKS: Yes, sir.

13 MR. BRUCE: Okay, as long as we've found that.

14 Q. (By Mr. Bruce) Mr. Leonard, this January 19th,
15 2000, letter is from Glen Farmer. What was his
16 relationship to Leonard Resource?

17 A. Glen Farmer is a contract landman in Midland that
18 has done quite a bit of work for us over the last six or
19 seven years, helping us to assume the lease units we're
20 drilling.

21 Q. Okay, and he was the one who initially contracted
22 Coates Energy Trust; is that correct?

23 A. Yes, he was.

24 Q. And if you could, maybe using his letter as a
25 guideline, discuss when the contact was first made with

1 Coates Energy Trust and go through that, Mr. Farmer's
2 contact with Coates Trust up until the date of this letter.

3 MR. GALLEGOS: I object to the hearsay. His
4 letter is hearsay, and we're going to have hearsay on
5 hearsay as to what went on.

6 Q. (By Mr. Bruce) Mr. Leonard, were you familiar
7 with and did you supervise the negotiations over these
8 lease terms?

9 A. Oh, every bit of it. Mr. Farmer offices in the
10 same office that I do, and he would make contact and then
11 bring the response up to me and we'd talk about it and talk
12 about it and talk about where to go from here.

13 Q. Okay, so despite Mr. Farmer's letter, can you
14 discuss when the first contact was made with Coates Energy
15 Trust and what happened since then.

16 MR. GALLEGOS: This is from his own personal
17 knowledge?

18 MR. BRUCE: From his own personal knowledge.

19 THE WITNESS: Well, there are a whole host of
20 letters in here to confirm this. The first letter that we
21 wrote, down at the very bottom of this Exhibit 3B is a
22 letter dated June 30th, 19- --

23 MR. GALLEGOS: Object, this is not responsive.
24 That wasn't the question to the witness.

25 EXAMINER BROOKS: Sustained.

1 Q. (By Mr. Bruce) Mr. Leonard, just start with
2 June, 1999, and on your own personal knowledge what
3 contacts were made with Coates, without even referring to
4 the letters?

5 A. Well, Mr. Farmer made a telephone call, I
6 believe, a telephone contact with Sherrie Green, and
7 followed it up with a letter wherein we made her an offer
8 to lease the undivided quarter interest. And there are
9 multiple offers and counteroffers that were made over the
10 next six months, and without referring to the
11 correspondence or Mr. Farmer's summary, I may have a little
12 bit of difficulty remembering exactly the --

13 Q. Each and every one of them.

14 A. -- the point and the counterpoint for it, but --

15 Q. But the negotiations did start in June of 1999?

16 A. Yes, and they continued through the summer. And
17 in August, I believe, we were still countering with -- and
18 dealing with lease bonus, term of the lease and royalty
19 issues and specific provisions that we feel are terribly
20 important to the effort that we're making down there with
21 continuous development and earning rights to total depth
22 drilled.

23 Those terms were spelled out in each of the
24 responses or the counteroffers that we proposed to Coates,
25 and we were -- the negotiations were \$200 to \$250 an acre,

1 quarter royalties. Initially Coates' interest was in the
2 30-percent royalty interest, I believe, which greatly
3 exceeds the norm in Lea County. Quarter royalties are the
4 -- typically the toughest trade that we make.

5 Q. Okay --

6 A. \$200, \$250 an acre is in the area of the highest
7 prices that we've paid for leases, and we've been in this
8 area for ten to twelve years. We've put 24 units together
9 and successfully drilled and completed wells on them. We
10 administer something in the neighborhood of 360 leases in
11 this immediate vicinity, and we've been at this -- When I'm
12 talking about the norm of the terms, we come with some
13 background with that because we've --

14 MR. GALLEGOS: Mr. Examiner, this is --

15 THE WITNESS: -- done quite a bit of it --

16 MR. GALLEGOS: -- far from responsive. We've
17 gotten way off the track here.

18 MR. BRUCE: Well, I don't -- I disagree. He's
19 discussing part of the motion to dismiss his good faith
20 negotiations, and Mr. Leonard is discussing good faith
21 negotiations.

22 EXAMINER BROOKS: Well, you know --

23 MR. GALLEGOS: Well --

24 EXAMINER BROOKS: -- excuse me, I've said this
25 many times in my life but not at the OCD, we need to

1 proceed by question and answer in the matters properly
2 brought to the court's attention.

3 MR. BRUCE: Well --

4 EXAMINER BROOKS: You may proceed.

5 Q. (By Mr. Bruce) -- but starting -- Mr. Leonard,
6 you proceeded in negotiations in June of 1999. Didn't
7 negotiations both by letter and telephone call proceed on a
8 monthly basis through December of 1999?

9 A. Yes, sir.

10 Q. And did Coates -- And there were numerous letters
11 and phone calls?

12 A. Yes, sir.

13 Q. And then in January of 2000, did Coates and
14 Leonard agree on some certain lease provisions, royalty and
15 other?

16 A. On the -- We had an agreement that we reached in
17 late December -- well, from December through the 15th of
18 January, and I'm not sure exactly of the date but I think
19 our letter -- the last letter that we did was like December
20 1 of 1999 where we proposed a \$250-per-acre bonus
21 consideration, a 25-percent royalty that would increase to
22 27-1/2 percent after payout, two-year term, 180-day
23 continuous development rights, earn rights down to, I
24 think, the base of the Abo or roughly 7900 feet.

25 And my understanding is that we reached -- Well,

1 let me say that each of the efforts that we made in this
2 negotiation process, this rather lengthy process over a
3 six-month period, we -- Mr. Farmer repeatedly asked for a
4 copy of the oil and gas lease so that we could take a look
5 at it and include that in the negotiation process.

6 Q. Did Coates ever provide you with a lease form
7 before mid-January of 2000?

8 A. No, sir.

9 Q. Okay.

10 A. They did not.

11 Q. Now, when you reached certain lease terms -- and
12 that was by, I believe, a letter from Ms. Green to you
13 dated January 13, 2000, actually to Mr. Farmer?

14 A. Yes, sir.

15 Q. Okay. And then I believe the day after that she
16 mailed a lease form to Mr. Farmer?

17 A. Yes, sir.

18 Q. And was that lease form provided to you?

19 A. Yes, he brought it up to me immediately.

20 Q. Was that lease form acceptable to Leonard
21 Resource?

22 A. No, not at all. It was a 19-page lease form that
23 is chock-full of administrative -- It's a very burdensome
24 lease form for a small independent outfit like ours to
25 administer. It was not --

1 Q. Let's go down some of it. That lease form is
2 attached, is it not, to this correspondence --

3 A. It is.

4 Q. -- the second lease form in this file?

5 A. Yes, sir. It's got a number of blanks on it for
6 your identification that were not -- that haven't been
7 filled in on the first page of it.

8 Q. Okay. Now, it's 19 pages and you mentioned a
9 number of lease terms, but let's keep it short. What --
10 Could you pick out two or three provisions of this lease
11 form that were not acceptable --

12 A. Well --

13 Q. -- to Leonard Resource?

14 A. Yes, sir. Commencing on page 1 there's a royalty
15 provision that is -- one and a half, two and a half, three
16 and a half, four and a half, five pages long.

17 Q. Do you have a lease royalty provision like this
18 in any of the 300-plus leases you are administering in Lea
19 County?

20 A. No.

21 Q. Go ahead.

22 A. This -- Well, I don't want to go into more detail
23 than we have time to do here, but the main objective -- the
24 main objection we had to this royalty provision is that it
25 potentially obligates my partners and I to pay more for the

1 oil and gas that we sell off of this lease than we get.

2 It has -- It's complex, it's convoluted, it's a
3 little bit difficult to understand, but it's got -- On the
4 very first page, 3 (a), in paragraph 3 (a), kind of right
5 in the middle of that paragraph it's talking about the
6 price for oil and it says, "...at the same price received
7 by Lessee (but in no event for less than the value
8 thereof)..."

9 In paragraph 3 (b) right below that for gas it
10 has the same kind of reference to "...one-fourth of the
11 value of the gas (as defined herein)..."

12 It goes through a protracted deal on product
13 prices, and then in paragraph 3 (g) it attempts to define
14 value, and it says, The "value" of oil and gas, condensate
15 and other products for gas is, skipping down to the third
16 line, is the market value "...at the time and place at
17 which custody and risk of loss of the hydrocarbons are
18 transferred to an unaffiliated purchaser..."

19 If the market value of that or the value of that
20 is the value that we receive, we don't have any problem
21 with understanding it or administering it or paying it. We
22 administer a mess of leases with royalty provisions that
23 are more complex than we would like for them to be, but
24 none of them is it difficult for us to figure out what
25 we're supposed to pay.

1 And this -- I've had this provision in front of
2 my title attorney, and he can't define it. Market value in
3 his opinion is --

4 MR. GALLEGOS: Well, I object --

5 THE WITNESS: -- very difficult --

6 MR. GALLEGOS: -- I object --

7 THE WITNESS: -- to abide --

8 MR. GALLEGOS: -- to the hearsay

9 THE WITNESS: -- to define here --

10 EXAMINER BROOKS: Okay, I'll sustain the
11 objection.

12 THE WITNESS: Then if you go to provision 3 (h),
13 which is about midway down the page on paragraph 3, it
14 starts out with, "Notwithstanding any provision of this
15 lease to the contrary..." and it gets into definitions of
16 -- I presume, tied to the market value, which is -- it's
17 got market pooling points and the Houston Ship Channel and
18 the Henry Hub, and it requires us to, in essence track a
19 periodical for oil, which is Platt's Oilgram Price Report,
20 a periodical for gas called Inside F.E.R.C. Gas Marketing
21 Report, and an OPIS in 3 (k) on the next page for gas
22 products, that's another service that we would need to
23 track, called Oil Price Information Service or OPIS.

24 These would be tracked monthly, and monthly we
25 would be in a position of paying prices that are tied to

1 these particular periodicals.

2 Well, there are four people in my office. Two of
3 them are administrative assistants, and we don't have a way
4 to administer something like this. This would require us
5 to hire somebody to do nothing but administer the terms of
6 this royalty provision.

7 Q. (By Mr. Bruce) Would that be uneconomic to
8 Leonard Resource?

9 A. Oh, absolutely. The manner that we sell oil and
10 gas, we -- I mean, we participate with some other people
11 that drill and produce in this same area, and we track the
12 prices that we do, we contract for oil -- You know, this
13 isn't large sums of oil and gas, large volumes of oil and
14 gas. These are relatively small wells. Selling the oil
15 and gas, we don't have beating down our doors to do it, but
16 we do a very representative job, I think, of marketing oil
17 and gas. We bid the oil out every six months, and
18 consistently we are among -- with the people who we
19 participate with, we are very competitive if not constantly
20 above what they do.

21 Q. Okay.

22 A. So I think we do a decent job of doing it. Gas,
23 we're under contracts that are longer term than six months,
24 and trying to administer something where you have to adjust
25 an oil and gas price every month according to the highest

1 price of these different periodicals is just a -- It's a
2 burden we can't accept. We can't accept the risk of not
3 doing it correctly.

4 Q. Now, Mr. Leonard, you've gone over some of the
5 royalty. Just briefly, what are a couple of the other
6 clauses that you do not -- that you cannot accept in this
7 lease form?

8 A. Well, one of the things that Mr. Farmer
9 consistently asked Coates for over the life of this
10 negotiation that we did was for a 180-day continuous
11 development.

12 Q. Was the last offer from Leonard Resource to
13 Coates on December 19th, did that contain a 180-day
14 continuous drilling obligation?

15 A. Yes, it did.

16 Q. Now, when the letter was received from Coates
17 Energy Trust in January, did it say anything about a
18 continuous drilling obligation?

19 A. No.

20 Q. What did the proposed lease form contain?

21 A. Well, the lease has a 90-day continuous
22 development.

23 Q. And what is objectionable to you about that?

24 A. Well, the 90 days is objectionable because it's
25 not enough time. We asked for 180 for specific reasons,

1 and the 90 days cut that in half. But if you look at the
2 -- if you look at this 90-day continuous development in
3 detail, it really is about half of a 90-day deal because of
4 the definition of commencement. It's 90 days from
5 completion of one well to commencement of another well.

6 And if you look at the definitions of
7 commencement and completion, the way I read, commencement
8 is -- when you put the bit in the ground and you start
9 turning to the right on a well that you intend to drill to
10 total depth, that's very reasonable.

11 The completion part of it is what I have a
12 problem with. The completion part is in 5 -- well, it's in
13 provision 5 under the continuous development. Let me see
14 if I can find where it is.

15 Q. Without going into too much detail, what is --

16 A. This is -- let me -- I've found it, it's in 5 (h)
17 on the bottom of page 8. It defines completion, it's --
18 the first part of it, which is the little Roman numeral
19 (i), says completion shall be -- in the event a completion
20 is not going to -- an attempt is not going to be made, it's
21 "three days after the well reaches" TD. In the event a
22 completion is going to be attempted, Roman numeral (ii)
23 there says "thirty days after the date production casing is
24 cemented in the well..."

25 Well, we've drilled and completed a number of

1 these wells, and with the current difficulty that you have
2 of getting a drilling rig off the location and then getting
3 in line for a pooling unit to complete these wells, and the
4 way these completions of ours go, we're probably two weeks
5 from the date that the casing is cemented in the hole. The
6 best-case scenario, two weeks to having a well that we
7 would call completed which is actually producing. It's not
8 tested at that point, but it's capable of producing.

9 So you eat 15 days there, and then you've got a
10 -- you're looking at the length of time to line up the
11 pulling unit, and to -- after you get the cement in the
12 hole, and to complete the well, we're typically 45 days
13 trying to do this, and we're standing in line for
14 completion rigs constantly, because it's a very typical
15 problem in this business, and --

16 Q. So what is the net effect of this 90 days?

17 A. The net effect is, we're cut from 90 days to 45
18 days, practically. And that's a 45-day period to
19 production test a well, make a decision about whether or
20 not you want to offset that well and what formations you
21 want to go after and line up a drilling rig, get the
22 surface location built and move a drilling rig in. It's
23 simply not enough time. It's not the -- It's just not
24 something we can live with.

25 Q. Okay. Now, there are other provisions in here

1 that you don't agree -- Just pick out one more, say the
2 offset well obligation.

3 A. Well, the offset well obligation you'll find on
4 paragraph 9 [sic] of this lease, and it is a -- it is an
5 unusual provision, we don't see it much, we've seen it a
6 couple of times. But this one is particularly onerous
7 because of, a), the length of time that you have -- the
8 offset well obligation basically, in the very first part of
9 that it says for the purposes of this provision -- and this
10 is in paragraph 6 (a) -- "it will be presumed that any well
11 producing in paying quantities situated 700 feet or less
12 from any boundary line of this lease is draining the lands
13 covered hereby..." That's the presumption.

14 And under this lease you have 60 days from the
15 date that well is completed to drill an offset well to
16 protect this 40 acres from the purported drainage. That's
17 onerous.

18 But you have -- you have situations here where
19 you've got -- Let me get my thoughts and my notes here
20 together a little bit so I can explain this to you, because
21 it's a little bit complicated.

22 In typical -- not typical, because the offset
23 well obligation is not a typical provision in an oil and
24 gas lease in Lea County, New Mexico, but the ones that we
25 have, and there are several of them, they provide you with

1 three alternatives: You drill the well. If you're not
2 prepared to drill, you pay compensatory royalty. You pay
3 compensatory royalty based on the -- whatever the royalty
4 in the lease that you're negotiating is, and based on the
5 production that is purportedly draining your lease. The
6 other option that you have if you're not prepared to do any
7 of those is re-lease it.

8 Well, this provision doesn't doesn't do that.
9 This provision says, you drill it, you pay the compensatory
10 royalty. If you're not prepared to do either one of those,
11 then Coates has an option, the third option. Not me,
12 Coates does. Coates has the option to look at my leasehold
13 position in that 40 acres. If they like that leasehold
14 position, and I presume if they like the terms and
15 provisions of the oil and gas leases that we own and they
16 find them acceptable, they have the option to request that
17 Leonard Resource make an assignment of not only their lease
18 as to all rights, but all of the other leases that I own in
19 the unit as to all rights. And they will have the option,
20 then, to drill it or not drill it.

21 Q. Is that acceptable?

22 A. No, it's not fair or acceptable.

23 Q. In short, you looked at this lease term, it
24 wasn't acceptable to you?

25 A. The provisions of this lease?

1 Q. The provisions of this lease.

2 A. No, sir.

3 Q. And what -- Were you given a deadline? Was
4 Leonard Resource given a deadline to accept this lease
5 form?

6 A. Yes.

7 Q. And what was that deadline?

8 A. May I read to you from the exact --

9 Q. Sure, go ahead.

10 A. -- language in the letters? Now, this is a
11 letter that's directed to Leonard Resource. It's dated --
12 wrong lease -- wrong letter. This is not -- it's dated --
13 it's directed to Glenn Farmer, not to me. It's a two-
14 paragraph letter. It says that we're in receipt of your
15 fax --

16 MR. GALLEGOS: What date is it?

17 THE WITNESS: January 14th --

18 MR. BRUCE: January 14th.

19 THE WITNESS: -- 2000. It says, We are in
20 receipt of your faxed message of January 14th in which you
21 advised that Leonard Resource agrees to the following basic
22 terms set out in Coates' letter to you dated January 13th.
23 Accordingly for your review, we have enclosed a copy of the
24 Coates lease form. Please note that such form will need to
25 be changed to reflect the agreed-upon terms, the proper

1 parties and the correct references to the State of New
2 Mexico and State of Texas where applicable. If Leonard
3 finds the basic terms of the attached form acceptable,
4 please advise by 4:00 p.m. on January 22nd, 2000.

5 Now, this is a lease that we repeatedly asked
6 for, for six months. I get this lease on January 14, it's
7 a 19-page, very complex oil and gas lease, and I have a
8 week to accept it.

9 MR. GALLEGOS: Mr. Examiner, I don't think the
10 witness needs to argue the case. I move to strike the
11 answer --

12 MR. BRUCE: He is answering --

13 MR. GALLEGOS: -- confine himself to --

14 MR. BRUCE: He is stating --

15 EXAMINER BROOKS: Excuse me, one at a time. Mr.
16 Gallegos?

17 MR. GALLEGOS: If he would confine himself to
18 answering the question, which was -- which he has answered.

19 EXAMINER BROOKS: Response, Mr. Bruce?

20 MR. BRUCE: I think he's answering the question,
21 Mr. Examiner. But I would like --

22 EXAMINER BROOKS: I will overrule the motion to
23 strike.

24 Q. (By Mr. Bruce) But simply put, Mr. Leonard, by
25 4:00 p.m. on January 22, 2000, did Leonard Resource accept

1 this lease form?

2 A. No, we did not.

3 Q. Okay. Let's move on then.

4 A. Well, I think it --

5 Q. That's okay.

6 A. Okay.

7 Q. Now, what was your next contact with Coates
8 Energy Trust?

9 A. June of 2000.

10 Q. And is that letter about five pages down from the
11 top of Exhibit 3B?

12 A. Yes, sir.

13 Q. Okay. And without going into detail, now, as of
14 January 22, 2000, did you have a lease agreement or any
15 agreement --

16 A. Absolutely not.

17 Q. -- with Coates?

18 A. We had a lease form that was -- The whole premise
19 of our negotiations was based upon there being an
20 acceptable oil and gas lease, and --

21 Q. And you did not have a meeting of the minds
22 regarding an oil and gas lease?

23 A. No, we did not.

24 Q. With your June 26th letter, did you send a
25 proposed lease form to Coates?

1 A. I did.

2 Q. Is this lease form one that Leonard has used in
3 the recent past and that has been signed by lessors or
4 mineral interest owners in Lea County?

5 A. Yes, sir, it's a Producer's 88 Revised 1981 New
6 Mexico Form 342P Paid-Up Oil and Gas Lease. It's one that
7 we use -- Well, we've used it several -- 250, 300 times.

8 Q. Okay. Coates did not agree to that lease form?

9 A. No, they didn't.

10 Q. And they write back to you in July of 2000?

11 A. They did.

12 Q. And that letter is immediately above your June
13 letter, is it not?

14 A. Yes, sir.

15 Q. And they did not agree to that lease form, and so
16 at that point you also had no lease agreement?

17 A. No, sir.

18 Q. Then the final letter is on top. On July 27th,
19 did you write and propose the subject well to Coates Energy
20 Trust?

21 A. Yes, sir. When we succeeded in getting the rest
22 of these units together and we got this well scheduled in
23 our drilling program, then I -- as I indicated, I went to
24 her in my letter the previous year, when we got ready to
25 drill I would submit a well proposal letter and AFE to her

1 and encouraged Coates to participate with their quarter
2 interest in drilling the well.

3 Q. Okay. And were the letters sent out by Mr.
4 Farmer done -- performed -- prepared and sent out under
5 your supervision and control?

6 A. Oh, yes, sir.

7 Q. In your opinion, have you made a good faith
8 effort to obtain the voluntary joinder of the Coates Energy
9 Trust in the proposed well?

10 A. Yes, I believe we have.

11 Q. What is Exhibit 4, Mr. Leonard?

12 A. Exhibit 4. I don't think I have it in here.

13 Q. Would you identify that and discuss the cost of
14 the proposal?

15 A. Exhibit 4 is an authority for expenditure
16 prepared by Capataz Operating, Inc. It's for a 7800-foot
17 well, the White Owl Number 1, to be located in the
18 southeast of the northwest of Section 2, this 40-acre tract
19 in question.

20 Very similar to the other AFE. This -- The
21 dryhole cost in the left-hand column here is \$369,226, the
22 completed well cost in the far right-hand column of the
23 authority for expenditure is \$728,024. This was prepared
24 and signed by Capataz on July 26th of this year.

25 Q. And is this cost in line with the cost of other

1 wells drilled to this depth in this area of Lea County?

2 A. Yes, sir.

3 Q. And do you have a recommendation for the amounts
4 which Leonard Resource should be paid for supervision and
5 administrative expenses?

6 A. Well, those will go to Capataz, and I do. \$4500
7 a month for drilling well cost and \$450 a month for
8 producing well, operating overhead.

9 Q. And again, are these in line with the amounts
10 normally charged by operators of the wells of this depth?

11 A. Yes, they are.

12 Q. Do you request that these rates be adjusted
13 periodically according to the COPAS accounting procedure?

14 A. Yes, I do.

15 Q. And where the interest owners whom you could
16 locate notified of this hearing in writing?

17 A. Yes.

18 Q. And is Exhibit 5 my affidavit of notice?

19 A. It is your affidavit.

20 MR. BRUCE: And again, Mr. Examiner, Exhibit 6 is
21 simply an affidavit of publication of the Hobbs newspaper
22 regarding the unlocated interest owners.

23 Q. (By Mr. Bruce) Mr. Leonard, were Exhibits 1
24 through 6 prepared by your or under your supervision or
25 compiled from company business records?

1 A. Yes, sir.

2 Q. And is the granting of this Application in the
3 interests of conservation and the prevention of waste?

4 A. I believe it is.

5 MR. BRUCE: Mr. Examiner, I'd move the admission
6 of Exhibits 1 through 6.

7 MR. GALLEGOS: We object to Exhibit Number 2 and
8 move to strike all testimony concerning that exhibit. It's
9 clearly hearsay upon hearsay. It is evidently the -- an
10 attempt to reflect the efforts of some other party, a Mr.
11 Votaw, and the spreadsheet prepared by him, and none of
12 this is information or facts that were in the personal
13 knowledge of Mr. Leonard or that he's qualified to testify
14 to.

15 MR. BRUCE: He's testified that they were done
16 under his supervision and control, Mr. Examiner.

17 EXAMINER BROOKS: Okay, you may continue.

18 MR. GALLEGOS: And all the testimony concerning
19 what somebody else did and contacts they supposedly made
20 and conversations they had with third parties is absolutely
21 rank hearsay. In fact, it is double hearsay.

22 We have no objection to the other exhibits,
23 except we do have objection to Exhibit 3B. We reserve
24 concerning the last document, this purported July 27th,
25 2001, letter, Mr. Examiner --

1 EXAMINER BROOKS: Which one is that?

2 MR. GALLEGOS: It's on the very top of Exhibit
3 3B. It's a letter that's never been received by Coates
4 Energy, and I don't know that we have anything to establish
5 the authenticity of it.

6 So Exhibit 3B is not otherwise objectionable, but
7 it is as to inclusion of a purported letter of July 27,
8 2001, to Coates Energy.

9 We don't object to the other exhibits.

10 EXAMINER BROOKS: Okay, we'll overrule the
11 objection to Exhibit 2, and as to Exhibit 3B, Mr. Bruce,
12 I'm not sure that I followed the testimony that closely.
13 Did the witness testify that that letter was mailed to
14 Coates Energy, the July --

15 MR. BRUCE: Yes, he testified that that letter
16 was mailed to Coates Energy.

17 EXAMINER BROOKS: Okay.

18 MR. BRUCE: If he wants to affirm it at this
19 time, Mr. Leonard, was that letter mailed to Coates Energy
20 Trust?

21 THE WITNESS: Absolutely.

22 EXAMINER BROOKS: We're speaking of the letter of
23 July 27, 2001 --

24 MR. BRUCE: Yes, sir.

25 EXAMINER BROOKS: -- that appears as pages 1 and

1 2 of Exhibit 3B?

2 THE WITNESS: Yes, sir.

3 EXAMINER BROOKS: Very good.

4 THE WITNESS: We never received it back.

5 EXAMINER BROOKS: With that representation I will
6 overrule the objection, and Mr. Gallegos is free to offer
7 testimony to rebut the presumption of its receipt if he
8 chooses to do so.

9 I believe I've ruled on all the objections, have
10 I not?

11 MR. GALLEGOS: Yes, sir.

12 EXAMINER BROOKS: Okay, do you pass the witness,
13 Mr. Bruce?

14 MR. BRUCE: I pass the witness.

15 EXAMINER BROOKS: Very good.

16 MR. GALLEGOS: I'm going to place on the witness
17 stand our Exhibits 14, 15 and 16, which I think are
18 included in their Exhibit 3B, but it might be a little
19 easier to refer to them, instead of having to put them
20 through --

21 EXAMINER BROOKS: Okay --

22 MR. BRUCE: Could I get copies of the exhibits,
23 Mr. Gallegos?

24 MR. GALLEGOS: Oh, I'm sorry, sure.

25 EXAMINER BROOKS: Excuse me, I ruled on the

1 objections, but I'm not sure that I admitted the exhibits.
2 Applicant's Exhibits 1, 2, 3A, 3B, 4, 5 and 6 are admitted.

3 You may proceed, Mr. Gallegos.

4 MR. GALLEGOS: Thank you.

5 CROSS-EXAMINATION

6 BY MR. GALLEGOS:

7 Q. Mr. Leonard, what is Capataz Operating?

8 A. It's an independent involved in oil and gas
9 operations. Capataz operates practically everything that
10 we're involved in putting together. We have a relationship
11 where we do the land and the legal -- maintain the leases,
12 administer the lease files, and they do the actual physical
13 operations of the wells.

14 Q. Well, who owns the stock? I assume it's a
15 corporation.

16 A. This fellow right here, Mr. Davis.

17 Q. What is his full name?

18 A. H. Scott Davis.

19 Q. Is 100-percent owner of Capataz Operating?

20 A. He will need to address that, I can't --

21 Q. Does Leonard Resources Investment Corporation
22 have any ownership interest in --

23 A. No, sir, and he has no ownership in Leonard
24 Resource.

25 Q. And does Capataz Operating have any interest in

1 the leasehold on this acreage that you purport to have him
2 act as operator?

3 A. No, sir.

4 Q. No interest whatsoever?

5 A. No, sir. The operating agreement will reflect
6 that they have no interest.

7 Q. I think you've described -- I thought you
8 described earlier Capataz Operating as a collection of
9 independents, in your --

10 A. No.

11 Q. -- testimony in the prior case?

12 A. If I said that, I didn't communicate it clearly.
13 But this group that is operating in this area and has
14 drilled and completed these numbers of wells is a
15 collection of independents. John Worrall does our geology,
16 Scott does our operating, and I do the land function, and
17 then we've got other partners who are not actually involved
18 in the day-to-day operations.

19 Q. And where is Capataz Operating to be located, to
20 be found --

21 A. In the Wilco Build- --

22 Q. -- if it is a royalty owner and has an interest
23 in what's going on on the acreage?

24 A. The -- Capataz is located in the Wilco Building
25 in Midland, just on the 18th floor. I don't know the suite

1 number, but...

2 Q. Who markets the production from the wells that I
3 guess Leonard Resources has an interest in but Capataz
4 Operating operates?

5 A. Capataz does the marketing of the oil and gas.

6 Q. So what is the relationship, then, as far as how
7 Leonard Resources receives the revenues from that
8 marketing?

9 A. Leonard Resource doesn't actually receive any
10 revenues from the marketing, because Leonard Resource isn't
11 -- once we put a unit together and we establish production
12 on that unit -- We've been in this area a long time, and we
13 have a bunch of internal partners. And what we do is, we
14 submit -- when we get a well proposal, we submit a well
15 proposal to them and an AFE. Some- -- Most of the time,
16 most of them participate. Sometimes people don't
17 participate for one reason or another. We determine what
18 the ownership is. I have a company named JTD Resources
19 that actually owns the interest in these wells. I own
20 interest --

21 Q. JTD Resources?

22 A. JTD Resources, that's a limited liability
23 company, a Texas limited liability company.

24 Q. Did you say actually owns some of the interest in
25 the wells?

1 A. Yes, sir. And I own interest individually. We
2 have a number of partners that do that, and as we -- when
3 we submit the proposal to them and we understand what the
4 ownership is going to be, then we've got an operating
5 agreement that governs this whole area, and I prepare an
6 amendment to that operating agreement for that particular
7 unit reflecting the ownership and circulate that to
8 everybody for their files, so that everybody knows what
9 they own.

10 Q. Well, wait a minute, let's see. So if I
11 understand it, you sort of broker a drilling and you put it
12 together, and then you lay it off on various investors? Is
13 that about what it amounts to?

14 A. We have a host of investors that are built into
15 this project and have been for ten years, and they
16 participate in the wells.

17 Q. After the well is drilled or before the --

18 A. No, before the well is drilled, we give them a
19 well proposal and an AFE and an election to participate,
20 and they execute the election to participate, either they
21 will or they won't, and they sign the AFE and they prepay
22 the cost of the wells, and we go from there.

23 Q. And so every -- each of these investors is a
24 working interest owner, then?

25 A. Yes, sir.

1 Q. And --

2 A. And they receive their revenues directly.

3 Q. And every working interest owner under a lease
4 has an obligation to pay his or her or its own royalty;
5 isn't that true? Do you understand that's the way --

6 A. I'm not sure I'm following what you said.

7 Q. -- leaseholds work?

8 A. The leases are --

9 Q. If one is a working interest in a lease, and
10 there is production, that working interest owner has an
11 obligation to pay the royalty on whatever oil and gas is
12 attributable to his interest?

13 A. Well, no, sir, not in this program. Leonard
14 Resource takes the leases. We either do it through brokers
15 like Jeff Votaw or Glen Farmer, or we take the leases in
16 our name, we administer the leases, we make assignments,
17 once a well is drilled and completed we make assignments to
18 our working interest partners. But the day-to-day
19 administration of all of the lease provisions, Leonard
20 Resource and Capataz share that.

21 Q. Okay, but the legal obligation is between a
22 lessee and a lessor for the payment of royalties, you
23 understand that?

24 A. Yes, sir.

25 Q. What you're saying is, you have a bunch of

1 lessees, in other words you slice up the lessee interest
2 into various --

3 A. They get undivided --

4 Q. -- ownerships?

5 A. -- undivided interest, yes, sir.

6 Q. Right.

7 A. Leonard Resource actually ends up being the
8 lessee of record, and then we assign undivided interests in
9 those leases to our partners.

10 Q. And then somebody is supposed to take care of
11 their obligations -- by "their" I mean these lessees'
12 obligations -- to royalty owners?

13 A. Yes, sir.

14 Q. And to severance tax --

15 A. Yes, sir.

16 Q. -- obligations?

17 A. Yes, sir.

18 Q. And this is Capataz or it's Leonard Resources?
19 Who does that?

20 A. Well, the severance tax business is done by the
21 operator and -- or the purchasers.

22 Q. And what?

23 A. Or the purchasers. Severance tax is -- Capataz
24 distributes the gas revenues on this, we sell the gas to
25 Sid Richardson Hydrocarbons.

1 Q. Who does, Capataz?

2 A. Yes, we're under a term contract with Sid
3 Richardson. They distribute the revenues to -- they
4 distribute the revenues to Capataz. Capataz -- When we get
5 our checks from Capataz, the severance and the --

6 Q. Well, excuse me a minute. You say "we", so are
7 you a part of Capataz?

8 A. No, I'm one of the working interest owners in the
9 property.

10 Q. Okay, Capataz sells the gas to Sid Richardson?

11 A. Yes, sir.

12 Q. And then how is settlement made for the working
13 interest owners, the royalty owners, overrides, and taxes?

14 A. My understanding is, the purchasers are obligated
15 to pay the production taxes, and the oil production is --
16 comes direct from the purchaser, which is Seminole
17 Transportation. The gas production --

18 Q. So -- Excuse me. You don't know how the
19 settlement is made on the gas; is that what you're saying?

20 A. No, I'm fixing to address that. The gas --

21 Q. All right, well, let's --

22 A. -- the gas is distributed from -- by -- from Sid
23 Richardson to Capataz, and Capataz then distributes to the
24 working interest ownership and the royalty owners.

25 Q. So Capataz is the one who is responsible for

1 accurately performing whatever the lease terms are as to
2 the payment of royalty?

3 A. That's his job, yes, sir.

4 Q. Okay, does Capataz also market the oil?

5 A. Well, I've worked with Capataz in marketing that
6 oil, but yes, he basically does it. We bid that oil out
7 every six months, he does, and he's got three or four
8 entities that we bid it out to, and we negotiate a
9 typically six- to nine-month contract for the sale of the
10 oil.

11 Q. Well, who is the seller? On a contract to sell
12 where it says --

13 A. The Division orders --

14 Q. -- X is buyer, who is the seller?

15 A. The Division orders that we give Seminole, who is
16 the crude oil purchaser, a list of the working interest and
17 royalty owners' names and addresses. We do that. And they
18 submit Division orders to all the parties.

19 Q. Including --

20 A. And they pay directly, the oil.

21 Q. Seminole does?

22 A. Yes, sir.

23 Q. And they pay directly to working interest owners?

24 A. And they pay the royalty.

25 Q. And they pay the royalty?

1 A. Yes, sir.

2 Q. So is Seminole provided with copies of all your
3 leases so they are able to have and --

4 A. They don't -- they don't --

5 Q. -- understand your royalty clauses and your --
6 whatever you said, 300 leases?

7 A. We have a Division order title opinion that sets
8 forth all the terms and provisions of the leases. Any
9 special provisions such as royalty provisions that are
10 exceptional provisions, and all that Seminole or Capataz
11 requests from us is a copy of the Division order title
12 opinion, not the individual leases --

13 Q. Can you --

14 A. -- although we would provide them for them if
15 they needed them, we just --

16 Q. Can you -- Excuse me, I'm sorry. Can you tell us
17 whether Seminole pays any of the private royalty owners on
18 a different basis, or are they all paid -- one size fits
19 all?

20 A. My understanding, yes, that everybody's paid the
21 same. When we contract with Seminole, that contract covers
22 the gross barrels produced from the lease. They were all
23 paid on the same price, nobody receives anything any
24 different.

25 Q. Okay, and so as far as compliance with any

1 private royalty provisions, it's up to Seminole?

2 A. Well, if Seminole had a problem with it, they
3 would probably contact me --

4 Q. Well --

5 A. -- and we would work it out together. But yes,
6 they've got the Division order opinion with the
7 instructions from our title attorney about how to proceed.
8 And if it's complex enough to warrant a copy of the oil and
9 gas lease I'm sure they would ask me for it, and I would
10 give it to them. But we just typically don't have that,
11 don't have it all. They don't request the oil and gas
12 leases.

13 Q. Does Capataz charge a marketing fee for selling
14 the gas?

15 A. Not a marketing fee. They charge the working
16 interest ownership a fee for handling the distribution of
17 the gas, not the royalty owners or the working interest.

18 Q. What is that fee?

19 A. I think it's \$60 a month, to offset the cost of
20 that particular accounting. But he's got two -- he and a
21 lady in his office. He's about as huge as I am --

22 Q. So --

23 A. -- so he has a charge for doing that, that we all
24 have accepted and pay.

25 Q. So this selling of gas is not marketing in the

1 sense of daily or even weekly marketing of the production,
2 correct?

3 A. You mean in soliciting new contracts, weekly or
4 monthly?

5 Q. Right, I take it that it's sold under term
6 contracts?

7 A. Yes, sir.

8 Q. For what kind of period?

9 A. The contract that we entered into -- Capataz can
10 probably address this better than I can, but the contract
11 that we've entered into, it was in 1998 with Sid
12 Richardson, and it was a replacement contract for one that
13 we had earlier, and it's a seven-year contract.

14 Q. Seven-year contract --

15 A. Yes.

16 Q. -- for the sale of the gas?

17 A. Yes, sir.

18 Q. And --

19 A. That was a deal that we bid out to every company
20 in there that buys from these wells that we produce from,
21 and that was far and away the most appropriate and the best
22 deal that we could find for us and for our partners.

23 Q. So in January of 2001, what did the gas sell for
24 from this group of wells, Mr. Leonard?

25 A. I would have to get that information for you, I

1 don't have that right on the tip of my tongue. But I would
2 guess it was eight or nine -- it was big prices back in
3 December -- November, December and January, which we were
4 still getting.

5 Q. Oh, so the contract's not for a fixed price?

6 A. The contract is for -- It's a percentage of
7 proceeds. I think it's 88 percent.

8 Q. It's one of the -- Sid Richardson's contract,
9 percentage of proceeds?

10 A. Yes, sir, it was negotiated for us by an
11 independent gas contract guy.

12 Q. So supposedly you're depending on Sid Richardson
13 to get market value?

14 A. Well, we've had Sid Richardson audited, we do
15 that as a matter of course. And the audit that we had
16 performed in Midland by another independent gas guy found
17 absolutely no impropriety, and their dealing went through
18 -- I don't know how many months he looked at, their
19 dealings, spot checked it over the span of a year, a year
20 and a half.

21 In his opinion, it's one of the best gas
22 contracts he has witnessed, and he has no reason to believe
23 that Sid Richardson is not doing exactly what they said.
24 You know, this is -- it's a complicated area, and it needs
25 to be looked at by somebody that's got the background to

1 dissect the provisions of the contract and to make sure
2 that it's being handled properly, and that's why we had it
3 audited.

4 Q. In the wells that this group is developing, do
5 you have federal leasehold?

6 A. One.

7 Q. And there are some particular regulations
8 concerning calculation of royalties under federal lease
9 regulations, are there not?

10 A. I believe that's true.

11 Q. Well, who handles that?

12 A. Well, that again was handled through the Division
13 order title opinion. That's one of the few 40-acre
14 locations where we have one lease and one mineral owner,
15 and that Division order opinion was fairly simple, and
16 those provisions are spelled out in that Division order
17 opinion and the purchasers have access to it.

18 Q. And I take it in this 40 acres in Section 2
19 that's the subject of this Application there are no
20 federal --

21 A. No, sir.

22 Q. -- lease interests? They're all fee.

23 Do you have state leases --

24 A. I do not.

25 Q. -- your group?

1 A. This area is typically -- We have the one federal
2 lease, and then we've got three -- basically three or four
3 sections under lease, and we've got one federal lease and
4 no state lease.

5 Q. Okay.

6 A. Well, that's not true. I just took a farmout and
7 drilled two wells on a Phillips Petroleum agreement, and
8 that is a state lease. We are -- We haven't completed the
9 first well yet on that, but you've got two of them that
10 we've drilled. That's just immediately offsetting you to
11 the south.

12 Q. Is this project basically centered in Township 20
13 South, Range 38 East?

14 A. Yes, sir.

15 Q. And essentially within about five or six sections
16 within that township?

17 A. Yes, sir, 13, 14, 11 and 2.

18 Q. Okay, Section 14 has been heavily developed,
19 hasn't it? I mean, you have what, a dozen wells, maybe, in
20 that section?

21 A. Yeah, roughly a dozen. One of them we didn't
22 drill. Collins and Ware drilled one of them, called the
23 Diamondback. It's in the southeast quarter. But the other
24 locations we've drilled. There's some open locations in
25 the west half that are undrilled.

1 Q. Okay. As I understand it, you are willing to
2 accept a lease form that was provided by Wells Fargo as
3 trustee, I think of -- was it the Simmons estate?

4 A. Well, we haven't seen it yet, but we have leased
5 the Simmons estate previously when Wells Fargo was not the
6 trustee but another bank was. But we have several leases
7 in our portfolio that we administer that are Wells Fargo
8 Trust leases. And assuming that it's going to be the same
9 lease form -- and we don't know that because we haven't
10 seen it yet -- it would be acceptable to us.

11 Q. All right. So first of all, you don't know
12 whether you're going to have an acceptable lease form from
13 Wells Fargo?

14 A. I do not.

15 Q. Okay. But the lease forms that you've seen
16 before from Wells Fargo as trustee for some mineral
17 interest owner have been accepted by --

18 A. Yeah, we --

19 Q. -- from that --

20 A. -- I think we adjusted the continuous
21 development, they accepted the 180-day continuous
22 development, and they accepted the depth severance as to
23 100 feet below total depth drilled in this location, and I
24 think those are the two changes that we requested and they
25 made.

1 Q. All right. And do you have a copy of those lease
2 forms here with you?

3 A. No, sir, I don't have it with me.

4 Q. Let's put in temporal context, if we might, your
5 negotiations with Coates Energy Trust, all right? First of
6 all, you talked about some fairly active negotiations where
7 there's exchange of letters almost on a monthly basis over
8 a six-month period.

9 A. Yes, sir.

10 Q. And that was in the latter half of 1999 and
11 January of 2000; isn't that correct?

12 A. Yes, sir.

13 Q. So we're talking about roughly two years ago?

14 A. (Nods)

15 Q. Correct?

16 A. (Nods)

17 Q. Your answer is yes --

18 A. Yes.

19 Q. -- for the record?

20 A. Yes, sir.

21 Q. This Application was not filed until August, late
22 August, of the year 2001; isn't that true?

23 A. Application for this force pooling?

24 Q. Yes --

25 A. Yes, sir.

1 Q. -- that we're hearing here today.

2 A. Yes, sir.

3 Q. All right. Well, let me take first of all, then
4 -- call to your attention what I've placed on the stand as
5 Exhibit 14, which is part of your Exhibit 3B, and it's a
6 letter from Sherrie Green at Coates to Glen Farmer, dated
7 January 14th, 2000.

8 A. Yes, sir.

9 Q. Okay. Now, you're aware that this came about
10 because the very day before she had received a fax from Mr.
11 Farmer saying that the basic terms that have been
12 discussed, such as royalty, bonus and so forth, were
13 acceptable?

14 A. Yes, sir

15 Q. All right. So she writes then and says that
16 she's sending you this lease form, correct?

17 A. Yes, sir.

18 Q. And she simply says, here are the terms, "please
19 advise by 4:00 p.m. on January 22, 2000, and then Coates
20 will prepare a completed lease form for final review."
21 There's no ultimatum there, is there?

22 A. That's the reason, I presume, that date and time
23 were in there. That's a very unusual way for me to be
24 approached on a lease. I've not had that experience before
25 and I've been doing this a long time, but I perceive that

1 that's what it was.

2 Q. Well, she's just asking for an answer, she's just
3 asking for you to say, let us know whether you find the
4 lease terms acceptable?

5 A. Well, I think the implication there is that if
6 it's not acceptable by January 22nd at 4:00 p.m., it's a
7 dead deal.

8 Q. It doesn't say that at all, does it?

9 A. It does not, no. That's just the -- That's the
10 implication of it to me. That's the way I understood it.
11 That's the way that anybody that's looked at this in my
12 business has understood it.

13 Q. It's simply asking, let us know whether it's
14 acceptable, and we want to keep this thing moving along, so
15 let us know by January 22nd. That's what it says, isn't
16 it?

17 A. Yes, and you might go ahead and read the last
18 sentence in that letter.

19 Q. I read it. There's no agreement at this point.

20 A. Exactly.

21 Q. There's no dispute about that, correct?

22 A. Yes, sir.

23 Q. All right. So then there was no answer that
24 month or the next month or for several months that
25 followed, was there?

1 A. No.

2 Q. Just a blank, nothing from Leonard Resources in
3 response to this letter?

4 A. No.

5 Q. Okay. So the next thing that happens is your
6 letter of June 26th, 2000, some five and a half months
7 later?

8 A. Yes, sir.

9 Q. What happened to Glen Farmer in the meantime?
10 Did you quit using his services, or what happened?

11 A. He went into retirement. I drug him out of
12 retirement to begin with, and he went back into it.

13 Q. All right. So this letter, now, that we're
14 looking at would be -- would have been written
15 approximately 14 months prior to this Application here to
16 force pool the Coates Trust?

17 A. My June 26th letter?

18 Q. Yes.

19 A. Yes, sir.

20 Q. So you were -- You were obviously in no hurry
21 about drilling the well or doing anything between January
22 and June of 2000, correct?

23 A. Quite the opposite, we were compiling the rest of
24 the interests in this unit. Frankly, when I got the lease
25 from Sherrie, and as complicated as it was and as

1 unacceptable as it was to me, I just tabled it. We had a
2 -- Where I'm coming from, we've got three or four other
3 units we were trying to put together for drilling, we had a
4 number of leases that we still had outstanding in this 40
5 acres. My feeling about it was, there's absolutely no
6 sense in pursuing this lease form which is unacceptable at
7 this point in time. Let me get the rest of this unit
8 together, and then we'll see. If I hadn't gotten the rest
9 of the unit together it would have been a moot point. We
10 had a whole lot of other things going on besides the
11 negotiation of this one interest.

12 Q. Suffice it to say that neither by the end of
13 January of June 26th of 2000, did you specify to Coates
14 Energy anything particular about the lease form that was
15 unacceptable, did you?

16 A. Well in my June 26th letter I did. The third
17 paragraph, I think I'm fairly specific about it.

18 Q. Okay, that you didn't like the royalty clause and
19 the 90-day --

20 A. No, I didn't -- "The trade involves too much
21 money and royalty burden for a two-year term with 90 day
22 continuous development, particularly in" light of "a
23 stratigraphic play where every 40 acre location seems to be
24 a wildcat... The Coates lease form would require an
25 immense amount of administration to ensure compliance with

1 provisions such as No. 3, Royalties. We are a small
2 independent company administering a very complex surface
3 and mineral ownership for a reasonably aggressive drilling
4 and development program in this area, and simply do not
5 have the staff necessary to administer the type of lease
6 that you propose."

7 Q. It's a fact, isn't it, Mr. Leonard, first of all
8 the gas royalty payment is administered by Capataz
9 Drilling, or Capataz Operating?

10 A. Well, the --

11 Q. That's what you testified --

12 A. -- the gas royalties --

13 Q. -- just a few minutes ago?

14 A. -- the gas royalties are distributed by Capataz.

15 Q. And the oil royalties are administered,
16 distributed, paid by this oil purchaser that you've
17 identified as Seminole; isn't that true?

18 A. Oh, yes, but certainly with our involvement and
19 our assistance in the event that there's anything special
20 that needs to be addressed, we're the lessor. We don't --
21 We're ultimately the responsible party for the whole thing.

22 Q. Leonard Resources Investment does not make any
23 royalty settlements, does it?

24 A. No.

25 Q. While we're on the point, would you show us in

1 this correspondence you brought forward as Exhibit 3B where
2 at any time Mr. Farmer requested to see the Coates Energy
3 Trust lease form?

4 A. I think that what I have for Mr. Farmer is a copy
5 of a note, October of 1999, on -- it's written on the face
6 of Sherrie's October 6th, 1999, letter. No, it's not.
7 What Glen would do is, he would get a letter --

8 Q. No, what I'm asking you -- Just answer the
9 question.

10 A. I don't see it in the letter, sir.

11 Q. All right.

12 A. No, I don't.

13 Q. Okay. So the representation you made to the
14 Examiner about this repeated asking for the lease form was
15 based either just on your speculation or on some hearsay?

16 A. Not on speculation, sir. It's based on Mr.
17 Farmer's representations to me, and he would have no reason
18 to mislead me about that. He and I deal with each other
19 daily on -- while we were doing this relationship. He
20 offices in my building, he's in my office practically every
21 day. We go over every lease negotiation we're involved
22 with, and when he would make a note of a conversation he
23 had with Sherrie, he would bring it out and show it to me.

24 And it was in August of 1999 -- I can find it in
25 my file here -- a copy of her letter with his note on it

1 that said that he had asked her for a copy of that lease,
2 and he represented to me that he did it more than once over
3 that six-month period.

4 Q. And there's approximately five letters from Mr.
5 Farmer exchanged in that six-month period, and not one of
6 those letters says a word about we need to see your lease
7 form; isn't that true?

8 A. Not that I'm aware of. It was all done verbally
9 by him.

10 Q. All right. So six months goes by, and June 26th,
11 2000, you write your letter that's our Exhibit 15, and you
12 say now that the basic terms that Mr. Farmer and Ms. Green
13 had talked about and the lease form are unacceptable?

14 A. Yes, sir.

15 Q. Okay, and on the second page you say, and I
16 quote, "If those terms in the form of lease we propose are
17 unacceptable, then we will be happy to submit an AFE for
18 your consideration once we are ready to drill on your
19 acreage, so that you may join with your 25% interest in
20 drilling a proposed test well," end quote.

21 In other words, you are saying this is it, accept
22 our terms and our lease form, or we're sending you an AFE?

23 A. Well, we had reached kind of an impasse here,
24 because that's the communication that I had from Sherrie
25 for her lease. It was -- Her lease had to be the base

1 lease, the base form of lease that we would use.

2 I explained to her that trying to cut and paste
3 her lease form and make it acceptable to us was not
4 something we could do. My title attorney wouldn't suggest
5 that I do that, because it's too complicated.

6 Q. Do you explain to her what you say in this
7 letter, do you --

8 A. No.

9 Q. -- explain to here?

10 A. -- these were in telephone conversations.

11 Q. When was that telephone conversation, Mr.
12 Leonard?

13 A. Well, one of them was yesterday.

14 Q. I'm not talking about yesterday --

15 A. Yeah.

16 Q. -- I'm talking about concurrent --

17 A. I believe it was --

18 Q. -- with June 26th, when you --

19 A. -- I don't have --

20 Q. -- were apparently saying accept our terms, or
21 we're sending you an AFE.

22 A. It was in June of 2000 when I wrote this letter
23 and had the communication with her. It would have to be,
24 because I don't think I talked to her before that. But I
25 don't have a note to that --

1 Q. But you're representing you had a phone
2 conversation with her about this time?

3 A. Yes, sir.

4 Q. So your letter is basically a take-it-or-leave-it
5 letter, isn't that true?

6 A. Well, I didn't intend it as a take-it-or-leave-it
7 proposition, it was -- Her lease form was clearly
8 unacceptable. I offered her an alternative one that we've
9 used a jillion times and suggested that she consider that,
10 and if that's unpalatable to her, then maybe what Coates
11 should do is just consider joining and participating in the
12 well with their interest.

13 Q. Well, let's look at her response to your June
14 26th letter --

15 A. Okay.

16 Q. -- which is our Exhibit 16. So in spite of your
17 June 26th letter that says, Here's our terms or we send you
18 an AFE, on July 17, 2000, Ms. Green writes, and she's still
19 attempting to work out a mutually acceptable agreement;
20 isn't that true?

21 A. No, sir, that's not true. There was no mutually
22 acceptable part of this enterprise with her ever.

23 Q. I said --

24 A. It was accept this lease form -- she -- matter of
25 fact, she indicated to me in a telephone conversation that

1 of all the oil and gas leases that Coates submits for
2 people's use, I'm the only guy that's ever had a problem
3 with it. I doubt that seriously, but that's what she said.

4 There was no -- never any indication on her part
5 that there was a way to negotiate something other than her
6 base lease form, which wasn't acceptable to me.

7 Q. Oh, in other words, you -- there -- no matter
8 what reasonable modifications that Coates would make in its
9 lease form, you simply were not going to work off of that
10 form; is that what you're telling me?

11 A. I wasn't advised to, sir. There's a -- That's a
12 19-page lease with a very tightly drafted and -- provision
13 after provision tied to each other, and it's not something
14 my title lawyer advised me to try and get in to changing a
15 paragraph here, deleting a paragraph there, adding a
16 paragraph here and trying to make that lease something we
17 could live with.

18 It has -- I gave you three instances of things
19 that we couldn't handle in that thing, but I can take you
20 to five or six or seven more. There are too many of them,
21 and we never had any indication from talking to Sherrie
22 that Coates would have the kind of flexibility that would
23 handle, starting with a blank tablet, starting with a base
24 form, New Mexico paid up oil and gas lease and start from
25 scratch and see if we could negotiate something fair, we

1 never had any indication that that would be a do-able deal.
2 Her argumentative nature with me was, you're the only guy I
3 know that has a problem with this; what's your problem?

4 Q. Okay. Well, you recognize on the second page of
5 Exhibit 16, which is her July 17, 2000, fax to you, that
6 she says, and I quote, "We would like to recommend that you
7 advise what provisions or lease language Leonard finds
8 unacceptable in the Coates lease form," end quote. Well,
9 she goes on to say, "Coates will take into consideration
10 any requested changes to its lease form which are
11 reasonable," end quote. That's what she wrote you, right?

12 A. That's what she wrote, yes, sir.

13 Q. But you weren't willing to attempt to suggest any
14 changes in the lease form and allow them an opportunity to
15 agree to reasonable modifications?

16 A. Well, no, she had the same opportunity when I
17 submitted my lease form to her, and my lease form to her
18 was unacceptable. There was no point-by-point on her part
19 when I submitted my lease form to her to say, Well, we can
20 do this, we can't do this, we need to add this, we need to
21 add that. It was just, It's not acceptable.

22 There was never -- we just didn't have -- I mean,
23 I do this every day of the week of my life in this area of
24 negotiating oil and gas leases. We've got them with Amoco,
25 Apache, Texaco, Fina, Phillips, and all kinds of tough

1 independents. We don't do anything in my office more on a
2 daily basis than negotiate the terms of oil and gas leases.
3 We simply never had a posture from Sherry that would lead
4 us to believe that that would be a profitable enterprise.

5 Q. Are you -- Since you're so involved in that, Mr.
6 Leonard, then you are certainly aware of the great quantity
7 of litigation that's going on in virtually producing states
8 between royalty owners and lessees concerning claims of
9 underpayment of royalty, are you not?

10 A. Yes, sir.

11 Q. Okay, well, let's take a few minutes, since your
12 lease form is the one that you insist has to be worked off
13 of, and let's look at Exhibit 15 which has your --

14 MR. BRUCE: I'd object to that characterization.
15 Mr. Leonard never said his was the form that had to be
16 worked off of.

17 EXAMINER BROOKS: Well --

18 MR. GALLEGOS: Well --

19 EXAMINER BROOKS: -- the testimony will speak for
20 itself. You may continue, Mr. Gallegos.

21 MR. GALLEGOS: Thank you, Mr. Examiner.

22 Q. (By Mr. Gallegos) You say that this is a
23 Producer's 88 form. What about the indication at the lower
24 left-hand bottom of each page of this form, I quote, it
25 says, "LRIC-CoatesEnergy" lease, et cetera? Does that

1 indicate that there is some production of this form --

2 A. Yes, we have --

3 Q. -- by your office --

4 A. -- we --

5 Q. -- customizing of it?

6 A. We have it in our computer.

7 Q. So it --

8 A. We have the base form in our computer, and we --
9 it enables us to add and subtract provisions from a whole
10 lot more readily than trying to do what we used to do, mark
11 them up with rulers and draw lines and X stuff out.

12 Q. Okay, so it's customized somewhat from --

13 A. Well, the base form, I believe, is verbatim. We
14 have added the -- usually the extra provisions that we add
15 begin with paragraph 12, as it does in this lease, where we
16 added a continuous development provision, a Pugh clause and
17 a depth severance and a continuous development provision
18 along the lines of offers that we had made to her. 180-day
19 continuous development, depth severance 100 feet below
20 total depth drilled, all of that is in paragraph 12, and
21 that is -- to my knowledge, that's the only provision added
22 to this lease form, but we use this lease form a lot. We
23 add
24 -- as I said, we add and subtract from it, and so we have
25 it in our computer for ease of handling that.

1 Q. Okay. Well, let's look at what you propose to
2 Ms. Green, Coates Energy. First of all in the description
3 there is no depth limitation, is there?

4 A. No, the depth limitation is in paragraph 12, it's
5 not in the description. It's not in the description of
6 most of the leases we have. There's a depth severance on
7 the very back page of the lease that is under 12 (c). It
8 says, "At such time as Lessee...fails to commence...
9 continuous development, or...once commenced, fails to
10 continue same, this lease shall terminate as to all land
11 not then included in a proration unit assigned to a
12 well...and said proration unit shall be limited in depth
13 from the surface down to and including 100 feet below the
14 base of the deepest formation penetrated by drilling."
15 That's --

16 Q. So you're getting -- All of the discussions
17 between Ms. Green and Mr. Farmer had been with a depth
18 limitation of some 7000 or 7500 feet; isn't that true?

19 A. It's 7900, I believe, the last letter that -- the
20 last number that you wrote.

21 Q. And that's what you're asking for here, is to the
22 base of the base of the Abo?

23 A. Yeah, and --

24 Q. But you're sending her a lease that would be from
25 the surface to the center of the earth; isn't that right?

1 A. And at the expiration of that lease or the
2 continuous development program, all rights 100 feet below
3 the deepest formation penetrated would revert to Coates,
4 yes, sir. That's a very standard provision, we've got it
5 in hundreds of leases.

6 Q. Well, that had not been the subject whatsoever of
7 the negotiations between the parties, nor is it the subject
8 of --

9 A. Oh, I think early on it was. The letters that --

10 Q. That would be an unlimited depth?

11 EXAMINER BROOKS: Excuse me, gentlemen, you need
12 to speak one at a time. Please let the attorney finish his
13 question before you start your answer, and then let the
14 witness finish his answer before you start the next
15 question. Go on.

16 THE WITNESS: In his September 9, 1999, letter,
17 the last provision in the terms that he proposes is a Pugh
18 clause that says "Lessee will earn to total depth drilled;
19 lease to provide for continuous development with 180 days
20 between well after the end of the primary term."

21 Exactly how we got to 7900 feet, I think that
22 came from Coates Energy in a subsequent letter, and 7900
23 feet is 100 feet below TD in almost every well we drill out
24 there, so it was acceptable to -- that was something we
25 ought not to argue anymore, because from a practical

1 standpoint we don't drill Devonian or Ellenburger wells out
2 there, we drill to the base of the Abo.

3 Q. (By Mr. Gallegos) But you didn't put that -- you
4 didn't state that in your lease, that this lease was only
5 to that depth, did you?

6 A. No, what I'm saying is --

7 Q. So a lease that would have included those deep
8 formations just like you're talking about, Devonian and
9 Pennsylvanian, whatever, deep formations --

10 A. Had we drilled it, but we don't drill it. And
11 you know --

12 Q. But you would have leased it -- If this lease had
13 been signed, you would have had those formations?

14 A. Yeah, that's a very fair provision. You get what
15 you drill to evaluate. It's very commonly accepted in Lea
16 County, New Mexico.

17 Q. Okay, so under this lease, if you decided to
18 drill to deep formations, you would have been able to, or
19 you would have farmed them out --

20 A. Not --

21 Q. -- let somebody else drill it?

22 A. We wouldn't have held them without producing from
23 them. And if we were producing from them, how in the world
24 would Coates be harmed? If we didn't produce from them, at
25 the end of the primary term she gets back everything below

1 the -- well, she gets back everything below the base of the
2 deepest formation penetrated. So I guess obviously if we
3 did drill the Devonian, why, we would have earned it. If
4 it had produced, she would have gotten it; if it didn't
5 produce, it's kind of a moot point.

6 Q. Okay. And so for 30 months you would have held
7 that -- all those formations from the surface to the center
8 of the earth?

9 A. Yes, sir.

10 Q. Okay. Let's look at the royalty provisions.

11 A. You're going back to my lease?

12 Q. We're talking about your lease, that's what we're
13 talking about.

14 A. Okay.

15 Q. It's attached to Exhibit 15, which is --

16 A. I know --

17 Q. -- your June 26th --

18 A. I know where it is.

19 Q. -- 2000, letter, your letter of a year and four
20 months ago. Paragraph 3, I quote, "The royalties to be
21 paid by Lessee are: a) on oil, and other liquid
22 hydrocarbons saved at the well, 1/4 of that produced and
23 saved from said land, same to be delivered at the wells or
24 to the credit of Lessor in the pipeline to which the wells
25 may be connected".

1 A. Yes, sir.

2 Q. That is the only language in this lease that
3 specifies how royalty is to be paid on oil; isn't that
4 true?

5 A. I think that's true.

6 Q. Okay. Is that a payment to be on proceeds?

7 A. Value at the wellhead, which is where we sell oil
8 and gas.

9 Q. You --

10 A. We deliver the oil in tanks at the wellhead, and
11 we deliver gas into a pipeline at the wellhead, and we pay
12 on the value of what we receive --

13 Q. Well, what --

14 A. -- and this would be a quarter of whatever it is
15 that we receive.

16 Q. So that you would pay on the market value?

17 A. Well, we pay on what we receive.

18 Q. So if you --

19 A. That is the market value to us, but that's -- but
20 under the very complex terms that you provide in your
21 lease, that would be markedly different. A whole lot
22 easier to understand, it's just what we received, which
23 seems to me to be a very fair provision: You pay what you
24 get.

25 Q. It doesn't even say that, does it? It doesn't

1 even say that you pay based on what you receive, or on
2 proceeds or any other language to that effect, does it, Mr.
3 Leonard?

4 A. Well, if you read a little bit further down in
5 line 4, it says "on gas, casinghead..."

6 Q. I'm not talking -- I'm asking you about oil right
7 now.

8 A. On oil, I think a) -- 3 a) is the only thing
9 that's said about oil.

10 Q. Yeah, these are supposed to be oil wells, right?

11 A. No, probably two-thirds of the revenue that we
12 get is gas. They don't make a lot of gas, but they don't
13 make a lot of oil either. But they make -- The value of
14 the gas is about -- the total production stream we have out
15 there is about two-thirds gas. But they're oil wells,
16 though, yes, sir.

17 Q. That's why they're on 40-acre spacing, right?

18 A. Yes, sir.

19 Q. All right. So it doesn't say anything about
20 proceeds, and would we guess that it means gross proceeds,
21 or would the royalty owner find out when they get their
22 check that it means net proceeds?

23 A. Well, this provision is -- simply says what you -
24 - what -- one quarter of the value produced and saved at
25 the well, so --

1 Q. Where's the word "value"? I don't see that --

2 A. There's none there --

3 Q. -- on this --

4 A. There isn't "value" in that sentence.

5 Q. So --

6 A. We don't have a very complicated operation. We
7 sell crude oil and we get paid the value of what we sell at
8 the wellhead, and we get what everybody else gets. We
9 negotiate a contract that's got a posted price plus a
10 bonus, and that's what -- everybody gets the same price,
11 and -- the royalty owners, the working interest owners,
12 everybody. It's just not very complicated, and we --

13 Q. Well, do you think it's unfair that a royalty
14 owner would want to know that the production from its
15 minerals which it owns are not going to be sold at market
16 value? Is that too much to ask?

17 A. We do sell it at market value. I think everybody
18 has confidence that that's exactly what we're doing. We're
19 selling at what the market will pay us for the value of
20 that product. That is the market value that we get, and
21 that's the market value that 360 lessors accept and all of
22 my working interest partners and all the royalty interest
23 owners. It's a very fair deal. We pay their proportionate
24 percentage of what we receive.

25 Q. So then you don't have any problem --

1 A. That is the market value of it --

2 Q. So you --

3 A. -- under this lease.

4 Q. So then you don't have any problem with a lease
5 that specifies that, that the royalty for oil will be based
6 on market value?

7 A. Well, it would depend on what the definition of
8 market value is. I do have some of this, but the market
9 value is typically defined as what we receive.

10 The only thing that -- what the leases that we
11 negotiate that really deal with this deal with is less than
12 arm's length transactions, where you have an interest in
13 the oil purchasing company or the gas purchasing company.
14 Then they get into more specific definitions about what
15 market value is.

16 But we don't do that. We don't have an interest
17 in the crude oil company, and we don't have an interest in
18 the gas. It's an arm's length deal, and they typically
19 provide that market value is what we receive, and that's
20 what we give people.

21 Q. So whatever you get, that's market value as far
22 as you're concerned, whether the guy just down the road is
23 getting two dollars more a barrel for oil? As far as
24 you're concerned, what you get, that's market value?

25 A. Well, we bid this out every six months, and we do

1 the best job we can of getting the best price we can get
2 for what we produce, yes, sir. What we get is market
3 value. It's the only control I have. If Amoco is
4 producing for me down the road and Amoco's got a jillion
5 barrels of crude oil that they're delivering out of that
6 area to somebody, and they have a contract that's something
7 I can't get somebody to give me, I can't compete with that.
8 I can only do what I can do.

9 Q. Are there any deductions to come out of the
10 amount that is --

11 A. Just severance taxes and royalty.

12 Q. So there's no net -- no net back deduction for
13 transportation --

14 A. No, most all --

15 Q. -- or anything --

16 A. -- of our lease provide that -- not most all of
17 our leases, a lot of our leases provide that as the -- I
18 think they took that clause out of the University Lands
19 Lease in Texas, that there will be no deduction for
20 gathering, transportation, handling or whatever it is, and
21 no, we don't do that.

22 Q. Well, how is the oil -- how does the oil from
23 these wells reach market?

24 A. It's trucked to a pipeline input station close to
25 Hobbs and put into pipeline.

1 Q. And there's no trucking charges?

2 A. Those gone -- went away a long time ago. I
3 haven't seen a trucking charge out there in ten or twelve
4 years.

5 Q. So the -- As a practical matter, the price of the
6 oil at the point of receipt is net of the charge for
7 trucking; isn't that right? For transportation?

8 A. Well, it's tied to the contract price that we get
9 for it, and trucking is not a part of that contract. I
10 suppose that when a crude oil company gives me a contract
11 for the price, they take into consideration all of their
12 costs and they tell me what they're willing to pay me for
13 it. But they don't make any separate deduction for
14 anything.

15 Q. No, because it's netted. In other words, they
16 may be paying you \$20 a barrel for the oil, but that's
17 because they have already allowed a dollar a barrel for the
18 transportation from your well to the pipeline?

19 A. Well, I would have no way of knowing that. We
20 just -- We simply get a contract price from them, we bid it
21 out, and we bid it out to four or five or six companies,
22 and we take the best we can get --

23 Q. Well --

24 A. -- which is -- which is about what we can do.

25 Q. Well, is the value under this lease to be arrived

1 at at the well, or at some remote point?

2 A. It's arrived at the well, my understanding, for
3 oil and gas both. Gas is pipeline-connected at the well
4 and the tanks are located on each tank -- each tank battery
5 is located right adjacent to the well, and that's where the
6 delivery point for oil is. The delivery point for gas is
7 right on the lease --

8 Q. I thought you said -- Excuse me, I thought you
9 said the delivery point for the oil was at some place down
10 the way after it's been trucked.

11 A. That may be the delivery point for the crude oil,
12 but not for me. I thought you asked me if it was -- if --
13 what the crude oil company did with it. They take the
14 crude from our lease. It's gauged, measured and the value
15 is assigned when they take it from our lease, and my
16 understanding is that it's input into one of the multiple
17 pipeline stations around Hobbs and forwarded to market from
18 there.

19 But we're not involved in that, we don't have a
20 downstream kind of a contract. It's simply what we sell it
21 for at the wellhead.

22 Q. So it's a net price, right?

23 A. What's that mean?

24 Q. Well, it's a price net of the transportation to
25 get it to the point where the buyer puts it in the

1 pipeline?

2 A. It's a price that is the gross price, based upon
3 the contract that we have with that company. There's no
4 mention of transportation or a net out, anything like that.
5 It's what we're getting paid for.

6 Q. Okay, so the lease provisions here should really
7 read, both as to oil and gas, the royalty owner is to be
8 paid by the lessee on the basis of whatever the lesser can
9 get for the oil or the gas?

10 A. Market value of the oil or the gas is what we
11 receive for it, yes, sir.

12 Q. Okay, so it should read market value?

13 A. Well, that is the -- that would be the definition
14 of our market value, under this lease form, is what we get
15 paid for it. What we get paid, you get paid.

16 Q. So is it a market value? Should it be a market
17 value lease?

18 A. The term "market value" isn't in this particular
19 paragraph. But that's what you're talking about.

20 Q. But you'd be willing to put that in, that's --

21 A. Well, the value received is what you get. I
22 don't know about the term "market" because that has
23 connotations in your mind, I guess, of something far and a
24 cry from what I'm talking about. What you're getting is
25 your proportionate share of the value received that we get,

1 no more, no less.

2 Q. Whether you get market value or not, right?

3 A. Whether I get what you consider to be market
4 value or not, yes.

5 Q. Or what the market considers to be market value?

6 A. Oh, I think we do a pretty good job of that. I
7 suspect if your client researched that, she would see that.

8 Q. All right. So actually for your purposes and the
9 purposes of the White Owl Number 1 well, your need is only
10 for 40 acres of the minerals of Coates Energy Trust?

11 A. Well, we'd like to have the whole 160, but the
12 need for the White Owl is the 40 acres, yes, sir.

13 Q. Okay, so a lease of that 40 acres, of course,
14 wouldn't need a pooling clause, because one well, 40 acres
15 and -- That would be it, right?

16 A. Well, the pooling provision -- we have pooled six
17 units out there for gas. We found -- we drilled some deep
18 wells, oh, eight or ten years ago to the Abo and the
19 Drinkard and the Blinebry and did not succeed in the deep
20 wells, and we had a Yates-Seven Rivers gas formation at
21 roughly 2800 to 3000, 3200 feet, that we discovered, and we
22 formed 160-acre units. We've had to pool the various 40-
23 acre or 20-acre tracts that we had leased together into a
24 160-acre unit for the production of gas from those units.
25 So that's -- The pooling provision is in there. For the

1 oil that we're doing, we do not need it.

2 But what it's in there for is in the instance
3 that we don't succeed with the oil, and we end up being
4 fortunate enough to find some Yates-Seven Rivers gas or
5 some other gas, Queen gas or whatever, at 4000 -- 3800 to
6 4000 feet. We would have the right to pool these leases
7 together to form a 160-acre unit, which we would need from
8 the Commission here to produce that unit.

9 Q. Correct, because you're asking for 40-acre
10 spacing here in this Application, and you'd need 160-acre
11 spacing if it turns out to be a gas well?

12 A. Exactly.

13 Q. And in fact, some of your wells have turned out
14 to be gas wells --

15 A. Yes, sir.

16 Q. -- isn't that true? The Rhino Number 1, for
17 example, in Section 11, that's a gas well --

18 A. Yes, sir.

19 Q. -- in the Yates formation?

20 A. And we just drilled that one to the Yates, that
21 was not a deeper well. Rhino and the south offset, the
22 Amerada Wise was a shallow gas well also. The Corrigan
23 well, which is in the northeast of 14, was a deep well that
24 we plugged back to the Yates-Seven Rivers, and that's why
25 we subsequently drilled the Amerada Wise and the Rhino.

1 Q. Let me move along here, I see what's happening to
2 us on the time. But as I understand it, if you get a lease
3 from anybody, then you turn around and you assign portions
4 of that leasehold interest to your various investors?

5 A. Yes, sir.

6 Q. Okay. So if you enter into -- If Coates were to
7 enter into this lease that you proposed back in June of
8 2000, then there would be an assignment out to multiple
9 parties, 20 or 30 different investors?

10 A. Yes, sir.

11 Q. And under paragraph 8 of this form of lease,
12 then, you or -- when I say "you" I should refer to Leonard
13 Resources Investment -- would be relieved and discharged of
14 any obligations under the lease?

15 A. Well, we have to right to assign it.

16 Q. Yeah, and I read the language, which I quote, "An
17 assignment of this lease in whole or in part shall, to the
18 extent of such assignment, relieve and discharge Lessee of
19 any obligations hereunder..." and then I'll go on because
20 there's another part of that sentence that's very
21 interesting.

22 So first of all, under this lease language you'd
23 be relieved of any obligation?

24 A. Well, read the first paragraph of that, the first
25 sentence in that paragraph. It says, "The right of either

1 party hereunder may be assigned in whole or in part and the
2 provisions hereof shall extend to the heirs, executors,
3 administrators, successors and assigns; but no change in
4 the ownership of the land or in the ownership of, or rights
5 to receive, royalties or shut-in royalties, however
6 accomplished shall operate to enlarge the obligations or
7 diminish the rights of Lessee; and no change...shall be
8 binding upon Lessee...Lessee" --

9 Q. Yeah, that is all for protection of the Lessee.
10 There's nothing in there in that language that's for the
11 benefit of the Lessor, is there, Mr. Leonard?

12 A. Not that I've read so far.

13 Q. That's all biased for the Lessee. And then it
14 goes on to say once you've assigned this and you've got it
15 off into 25 or 30 different pieces, if some of those
16 assignees default in their performance, then the lease
17 remains in effect as to the other pieces that had been
18 assigned out. That's what it says, doesn't it?

19 A. Defaults in what regard?

20 Q. Well, fails to comply with the provisions of the
21 lease, fails to pay royalty.

22 A. Well, they don't pay the royalty. The royalty is
23 paid by the purchasers, and we see to it that it's paid.
24 My partners don't have anything to do with that. If they
25 default, they would -- The only default that my partners

1 would have would be to Scott Davis and I. They would
2 default in the payment of a lease operating expense or a
3 drilling cost in a well. That would be a default that
4 would affect us, but it wouldn't affect you guys at all.
5 It wouldn't affect any royalty owner.

6 Q. Under your present arrangement?

7 A. Under -- Yes.

8 Q. That arrangement could change tomorrow, couldn't
9 it?

10 A. How?

11 Q. By one of these assignees saying, I want my
12 interest separate, I don't want you selling my gas, I don't
13 want you selling my oil, I'm going to sell it on my own, I
14 can do a lot better, and I'll pay my royalties. They have
15 every right to do that; isn't that right?

16 A. Oh, I guess if you're looking for a bogeyman in
17 anything you can find it. I've been dealing with these
18 people for almost 20 years and I've never, ever had that
19 problem, never had it arise. They're silent partners, they
20 don't get involved in the administration of any of this
21 stuff.

22 Q. Okay, so again it's kind of like the royalty and
23 what we sell for, just believe in us? Is that what you're
24 telling me?

25 A. Check us out, ask the 350 people that are

1 currently involved with us --

2 Q. Well, Mr. Leonard --

3 A. -- I don't think you'll find --

4 Q. -- if I --

5 A. -- I don't think you'll find --

6 MR. BRUCE: I object --

7 THE WITNESS: -- any impropriety --

8 MR. MORROW: -- I object.

9 THE WITNESS: -- in any part of it.

10 EXAMINER BROOKS: Gentlemen, we're just becoming
11 argumentative here. Let's don't do that, let's go back to
12 question and answer --

13 THE WITNESS: I'm sorry.

14 EXAMINER BROOKS: -- and dealing with the facts.

15 Mr. Gallegos, you may continue.

16 Q. (By Mr. Gallegos) Did you check out any of the
17 many, many lessees who have worked with Coates Energy and
18 accepted their lease form? Did you check them out? VF
19 Petroleum in Midland, do you know those people?

20 A. Very well.

21 Q. Did you check them out?

22 A. I know them very well.

23 Q. Okay. Let me just ask you about another
24 provision here, paragraph 9, sort of a *force majeure*
25 clause. It says that "Should Lessee be prevented from

1 prevented from complying with any express or implied
2 covenant of this lease..." there's an excuse based on
3 "inability to obtain or use equipment or materials"? I
4 mean, if your people don't know how to use some equipment
5 that you're excused from performance of the lease?

6 A. I doubt that's what that means. That may be the
7 way that you read it, but I doubt that's what that means.

8 Q. Do you know that this Producer's 88 was written
9 probably 40 or 50 years ago and is totally one-sided in
10 favor of the lessees?

11 A. Well, I just know that I've got a huge lease
12 portfolio, and we operate a number of wells very
13 successfully under this lease and have no problems.

14 Q. And a lot of royalty owners and a lot of lessors
15 are very uninformed; isn't that true, Mr. Leonard?

16 A. We have a lot that are very informed, and we have
17 no problems with it.

18 Q. Well, just a couple of -- It is true, isn't it,
19 Mr. Leonard, that until your testimony today you had never
20 specified to Coates Energy Trust the objections to their
21 lease form, other than the continuous drilling obligation
22 of 90 versus 180 days?

23 A. And the royalty provision.

24 Q. Well, just your blanket statement that you didn't
25 like the royalty provision? I mean, you didn't specify any

1 particular term of it until today, did you?

2 A. I wasn't given any encouragement to.

3 Q. I see, all right. And on the continuous drilling
4 obligation did you ever consider, for example, let's see if
5 we can meet halfway, and instead of 90 days or 180 days,
6 let's say we'll use 120 days?

7 A. Well, as I indicated to you, we've dealt with
8 this lady and with Coates for a six- or seven-month period
9 of time, in our minds very unsuccessfully and not very
10 profitably.

11 When I got the oil and gas lease it was in its
12 entirety, almost its entirety, unacceptable to me. We had
13 no indication from the conversations that Glen Farmer had
14 had with this lady over a number of months that we would
15 have any success at item by item negotiating a successful
16 lease form. And as I indicated to you, the title lawyer
17 that I had gave me no encouragement to attempt to do it,
18 it's too complicated --

19 Q. Okay, just so --

20 A. -- to cut and paste this lease form.

21 Q. Just so the record is absolutely clear on this,
22 after your letter of June 26th, 2000, you did nothing to
23 attempt to negotiate a satisfactory lease with Coates
24 Energy Trust, and instead in August of the following year,
25 well over a year later, you filed this Application for

1 force pooling?

2 A. Well, I got some encouragement from Sherrie to do
3 that, sir. In her response to the lease that I sent her
4 she says, It would not be in Coates' best interest to lease
5 under the printed form lease that you enclosed, especially
6 since our lease form is acceptable to other companies.

7 Next paragraph says, "Additionally, Leonard
8 offered in its letter to submit an AFE to Coates for its
9 consideration so that it may participate in the
10 drilling..." of a well. When she interjected that
11 paragraph I presumed that a decision had already been made
12 by Coates to participate in the well.

13 Going through a very --

14 Q. Excuse me, I didn't follow that. What is there
15 that says they want to participate in the well?

16 A. She says --

17 MR. BRUCE: Is that Exhibit 16, Mr. Leonard?

18 THE WITNESS: Yeah, it's your exhibit, 16, it's
19 her July 17 letter. "Additionally, Leonard offered in its
20 letter to submit an AFE to Coates for its consideration...
21 In order for Coates to take into consideration
22 participation in any such well, please furnish Coates
23 geologic/geophysical data..." this, of course "...and your
24 proposed form of Joint Operating Agreement."

25 I presumed from that paragraph that a decision

1 had been made by her to -- or by Coates to participate in
2 this well.

3 Q. (By Mr. Gallegos) Oh, you did? Then why didn't
4 you send her the AFE and the geological information?

5 A. Didn't have it. We were -- That's why she didn't
6 hear from me for a year. I told her in my letter that at
7 such time as we got ready to drill the well, she'd hear
8 from me.

9 I don't do -- We've got six or seven wells we've
10 drilled since we did this. We've got a whole lot of other
11 things going on than -- and we had no AFE put together for
12 this well. We were drilling wells that were to determine
13 whether or not this unit was even going to be something
14 that we were going to want to drill. That's where our
15 attention was.

16 And I indicated to her in my letter that I would
17 get her the AFE at such time as we got ready to drill the
18 well, and that's what I did --

19 Q. Okay --

20 A. -- and that came in July of this year when we
21 finally made up our minds based on the encouragement that
22 we got from the Red Tag wells located immediately
23 offsetting our acreage that we would want to proceed and
24 drill up on the north half of 2.

25 EXAMINER BROOKS: If I may interject at this

1 point, we're getting into the lunch hour and we have other
2 people waiting for hearings. How long do you expect to be
3 with this witness?

4 MR. GALLEGOS: I'm just about finished with this
5 witness.

6 EXAMINER BROOKS: Okay. Well, if we can move
7 along it would be helpful to the hearing process.

8 MR. GALLEGOS: Yes --

9 EXAMINER BROOKS: Go ahead.

10 MR. GALLEGOS: -- yes. Yes, Mr. Examiner.

11 Q. (By Mr. Gallegos) So the record is clear, let me
12 phrase the question this way then: For one year you did
13 nothing to either attempt negotiation of a mutually
14 agreeable lease or to send an AFE and geological
15 information on the proposed well to Coates Energy Trust?

16 A. Yes, sir, and I think I've explained why.

17 MR. GALLEGOS: Okay. Thank you, Mr. Leonard,
18 that's all the questions that I have.

19 THE WITNESS: Okay.

20 EXAMINER BROOKS: Mr. Bruce?

21 MR. BRUCE: Could I have some redirect, Mr.
22 Examiner?

23 EXAMINER BROOKS: Go ahead.

24 MR. BRUCE: Well, I'll cut out most of what I
25 have to say.

REDIRECT EXAMINATION

BY MR. BRUCE:

Q. Mr. Leonard, to your knowledge has any royalty interest owner or overriding royalty complained of the administration of the leases in your dozen and a half or two dozen wells in this area of Lea County, New Mexico?

A. Absolutely not.

Q. Now, you made a proposal to Coates on a lease form. They're not obligated to accept your lease form, are they?

A. No.

Q. By the same token, you're not obligated to accept their lease form?

A. No.

Q. And no lease form has ever been signed by the parties?

A. No, sir.

MR. BRUCE: I think that's it, Mr. Examiner.

EXAMINER BROOKS: Thank you. Let me, if I may, clarify a few things.

EXAMINATION

BY EXAMINER BROOKS:

Q. You're asking only for a 40-acre unit. There was some discussion about a 160-acre unit, but are you asking only for a 40-acre unit?

1 A. Yes, sir.

2 Q. And that's from the surface to the base of the
3 Abo?

4 A. Yes, sir.

5 Q. And if it ended up being classified as a gas
6 well, you'd have to come back for a subsequent proceeding?

7 A. Exactly.

8 Q. What were the footages that -- there again, as in
9 the previous case, you went too fast for me.

10 A. I'm sorry. This is for the White Owl Number 1.
11 It is to be located 1650 from the north line.

12 Q. 1650 from the north.

13 A. And 2100 feet from the west line.

14 Q. 2100 feet from the west line.

15 A. Section 2.

16 Q. And your overhead was \$4500 for drilling rate?

17 A. Yes, sir.

18 Q. And what for producing?

19 A. \$450.

20 EXAMINER BROOKS: I guess that's all the
21 questions I have.

22 Mr. Stogner?

23 EXAMINER STOGNER: No questions.

24 EXAMINER BROOKS: Very good, the witness ma stand
25 down.

1 MR. BRUCE: I would call Mr. Worrall, the
2 geologist, again.

3 EXAMINER BROOKS: Okay. If possible, I would
4 like to get through this proceeding before we recess for
5 lunch, so you may go ahead.

6 MR. BRUCE: Mr. Examiner, if the record could
7 reflect that Mr. Worrall was qualified as an expert
8 petroleum geologist subject to any objection that Mr.
9 Gallegos may have.

10 MR. GALLEGOS: No objection.

11 EXAMINER BROOKS: I will modify what I said,
12 because I assume you're going to present a witness also --

13 MR. GALLEGOS: Yes.

14 EXAMINER BROOKS: -- and I don't think it's going
15 to be possible to get through this proceeding in its
16 entirety, but we will try to get through with this witness
17 before we recess.

18 JOHN WORRALL,
19 the witness herein, having been previously duly sworn upon
20 his oath, was examined and testified as follows:

21 DIRECT EXAMINATION

22 BY MR. BRUCE:

23 Q. Mr. Worrall, why don't you refer to your Exhibit
24 7, which is the production plat, and discuss the primary
25 zones of interest in this proposed well?

1 A. Exhibit 7 is a BOE production map. Shown on it
2 is the White Owl Number 1 located in the southeast quarter
3 of the northwest quarter. And elsewhere in Section 2, to
4 the north, there was a dryhole drilled, which is a key show
5 for us. That well was drilled in 1950. It's the only
6 other well drilled in the north half of Section 2.

7 And I'll be showing you in a minute a cross-
8 section that will run along that blue line A-A'. North of
9 that there's been two wells that have produced a modest
10 amount of oil, 15,000 and 73,000 barrels of oil equivalent,
11 from the dark blue is Blinebry, and then a little bit from
12 the Tubb and the Drinkard.

13 In the southern part of Section 2 you'll see two
14 wells that have produced from the Drinkard. These are much
15 older wells. One of them is currently plugged and one of
16 them currently makes four barrels a day, so they're
17 primarily depleted.

18 And then in the north half of Section 2 there's
19 two green dots that are new wells. The well that is in the
20 northwest of the southeast has been completed in the last
21 six months. It's a 12-barrel-a-day well called the Red Tag
22 Number 1. And the well that is in the northeast of the
23 southwest, the west offset that says A,B,T, is scheduled
24 for completion in the next one or two weeks. It has not
25 been completed. It's been drilled and we're waiting for a

1 pulling unit.

2 Q. Okay, Mr. Worrall, why don't you move to your
3 Exhibits 8 and 9, which are the Abo maps in connection
4 with, I think it's Exhibit 14, your cross-section. Why
5 don't you discuss the Abo geology in this area?

6 A. We've just finished drilling the Red Tag Number
7 2, which has at the top of the Abo dolomite a subsea top of
8 minus 3686, and our White Owl will be north of that well,
9 and then south of the Coll Number 1, which is minus 3670.
10 So structurally we should be similar to those two wells.

11 I'd like to just go ahead straight and show you
12 the cross-section --

13 Q. Go ahead.

14 A. -- I believe you call it Exhibit 14 -- so you get
15 an idea for our objectives.

16 Okay, This is a cross-section which shows the
17 logs on six wells, and it's labeled north to south, and
18 this is the same six wells that are shown A-A' on these
19 maps. And our objectives here are primarily the Blinebry,
20 which in the north offset, the Coll Number 1, which is the
21 third well from the left, is at a depth of 6050 feet. When
22 that well was drilled, they recovered some gas on a drill
23 stem test and some oil-cut mud, but they never completed
24 the interval.

25 That zone does not produce in Section 2, but we

1 believe it should when we complete the Blin- -- I'm sorry,
2 it has been recently been completed in the Blinbry from
3 the Red Tag Number 1, and we plan to complete it in the Red
4 Tag 2, as well look at it in the White Owl Number 1.

5 Our other objective is the Drinkard. The
6 Drinkard in the Coll is at 7000 feet. It also produces
7 from porous dolomites. The primary risk of that is getting
8 the porosity developed.

9 If you'll go to Exhibit -- the two maps on the
10 Drinkard, there's a structure map and a porosity map on the
11 Drinkard porosity. And the isopach shows that the Red Tag
12 2, relative to the Red Tag 1, went from two feet of
13 porosity to 43 feet in a matter of 700 feet of difference.
14 So it's very risky predicting where porosity goes in these
15 horizons, and that's why we consider each 40 acres a
16 wildcat, because it changes so rapidly, more rapidly than
17 40-acre offset drilling can predict.

18 Our third objective is the Abo, and you'll see on
19 our cross-section we label this as possible pay. It hasn't
20 been produced yet, but we have shows in some of the
21 intervals that suggest it should be productive. And what
22 we do in these -- in development out here and what we've
23 projected on the White Owl Number 1 is to commingle as any
24 of these pays as we obtain to try and make a commercial
25 well.

1 The well that we drilled to the south of us so
2 far has been a disappointment. That's the Red Tag Number
3 1.

4 EXAMINER BROOKS: Which one is that on this
5 cross-section?

6 THE WITNESS: It's not on the cross-section
7 because it's a newer well.

8 EXAMINER BROOKS: Okay.

9 THE WITNESS: It is this well in the northwest
10 southeast --

11 EXAMINER BROOKS: I think I've got it on the map.
12 I couldn't --

13 THE WITNESS: Okay.

14 EXAMINER BROOKS: -- wasn't finding it on the
15 cross-section because it's not on the --

16 THE WITNESS: Yes, it's a newer well than the
17 cross-section, sir.

18 EXAMINER BROOKS: Okay. Okay, proceed.

19 THE WITNESS: And that well's making 12 barrels a
20 day and 20 MCF of gas a day, and it's a fairly new well.
21 It's a noncommercial well right now, primarily due to some
22 completion risk. We also have completion risk. You have
23 to frac all these different zones, and your fracs sometimes
24 go where they're supposed to, and sometimes the technology
25 is not there to keep it in zone.

1 So in addition to drilling risk, we have
2 completion risk. And our objectives are to try to complete
3 the Abo, the Drinkard and the Blinebry.

4 Q. (By Mr. Bruce) With respect to a continuous
5 development, development of leases like this or wells like
6 this, is it important to have sufficient time between the
7 completion of one well and the commencement of another so
8 that you can evaluate the latest well's performance before
9 stepping out to another well?

10 A. Yes, very much so. We learn things on each well.
11 We're constantly redesigning our fracs using the latest
12 technology to get the best completion we can, as well as
13 remapping things. And obviously when you're spending
14 \$750,000 a well, you want to make sure you're commercially
15 developing it before you get too far down the road.

16 So yeah, we do everything one well at a time or
17 two wells at a time.

18 Q. And looking on your maps, it's not uncommon to
19 have a good well and then move one location away and have a
20 dry hole?

21 A. Correct.

22 Q. In your opinion, should the maximum cost-plus-
23 200-percent penalty be assessed against any nonconsenting
24 interest owner?

25 A. Yes.

1 Q. And were Exhibits 7 through 14 prepared by you or
2 under your supervision?

3 A. Yes, they were.

4 Q. And in your opinion is the granting of Leonard
5 Resource's Application in the interests of conservation and
6 the prevention of waste?

7 A. Yes.

8 MR. BRUCE: Mr. Examiner, I'd tender the
9 admission of Leonard Resource Exhibits 7 through 14.

10 MR. GALLEGOS: No objection.

11 EXAMINER BROOKS: 7 through 14 are admitted.

12 Pass the witness, Mr. Bruce?

13 MR. BRUCE: Yes, sir.

14 CROSS-EXAMINATION

15 BY MR. GALLEGOS:

16 Q. In this drilling project, Mr. Worrall, what
17 attempts have resulted in dry holes?

18 A. We have drilled no dry holes -- we've completed
19 every well we've drilled from a technical standpoint.

20 Q. Okay. What has been the average period for
21 payout, if you know?

22 A. We've got several wells that won't pay out at
23 all. Average payout is probably two years.

24 Q. In Section 2, what -- is that -- would this well
25 be within a designated gas pool?

1 A. This well would be in an oil pool.

2 Q. And what pool is that?

3 A. I believe it would be part of the House field.

4 Q. The House field?

5 A. Yes. And the pool would depend on which horizon.

6 Q. Okay. Does that pool have special pool rules as
7 to the oil-gas ratio?

8 A. Every well is considered an oil well, and I'm not
9 sure of the pool rules, but to date everything has been a
10 standard 40-acre proration unit, if that helps you.

11 Q. Well, you don't know of any --

12 A. I don't know of any special rules.

13 Q. -- any particular rule for that pool that's
14 different than what the standard ratio would be?

15 A. To my knowledge, it's just standard -- standard
16 ruling, sir.

17 MR. GALLEGOS: Okay, that's all the questions I
18 have.

19 EXAMINER BROOKS: Did you have anything further,
20 Mr. Bruce?

21 MR. BRUCE: I have nothing further of this
22 witness.

23 EXAMINATION

24 BY EXAMINER BROOKS:

25 Q. Okay. Do you know the pool names for those

1 various formations?

2 A. House-Drinkard.

3 Q. House-Drinkard.

4 A. And the Abo and the -- It's the House-Drinkard
5 and the House-Blinebry. It's pretty much everything is
6 House and then whatever the formation is.

7 Q. So it's House-Drinkard, House-Blinebry, and then
8 is it House-Abo?

9 A. House-Abo. The Abo hasn't been produced yet.

10 Q. Okay, there is no --

11 MR. BRUCE: It is within a mile of the House-Abo
12 Pool.

13 Q. (By Examiner Brooks) Okay, it's within a mile of
14 the House-Abo, but it's not presently in, correct?

15 A. Yes, sir.

16 EXAMINER BROOKS: Okay, that's all I have.

17 Mr. Stogner?

18 EXAMINER STOGNER: I have no questions.

19 EXAMINER BROOKS: Very good, the witness may
20 stand down.

21 How long do you anticipate you'll need with your
22 witness, Mr. Gallegos?

23 MR. GALLEGOS: Oh, I'm going to estimate 20, 25
24 minutes.

25 EXAMINER BROOKS: Well, I think it would be best

1 we go ahead and take our luncheon recess, and we'll stand
2 in recess until 1:30.

3 (Thereupon, a recess was taken at 12:25 p.m.)

4 (The following proceedings had at 1:35 p.m.)

5 EXAMINER BROOKS: Good afternoon.

6 (Off the record)

7 EXAMINER BROOKS: Okay, you may call your
8 witness, Mr. Gallegos.

9 MR. GALLEGOS: We call Sherrie Green.

10 EXAMINER BROOKS: Okay.

11 SHERRIE GREEN,

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

14 DIRECT EXAMINATION

15 BY MR. GALLEGOS:

16 Q. Would you state your name, please?

17 A. My name is Sherrie Green.

18 Q. Where do you live, Ms. Green?

19 A. I live in San Antonio, Texas.

20 Q. Are you employed by Coates Energy Trust?

21 A. Yes, I am.

22 Q. In what capacity?

23 A. I am now their land manager. I've been there
24 with their land department and now I'm their land manager,
25 but I've been with them for 26 years.

1 Q. And what are your general duties and
2 responsibilities as land manager for Coates Energy Trust?

3 A. Okay, primarily I maintain and I monitor their
4 mineral and royalty files, I assist them with the
5 negotiations on the leases on their mineral interests, I
6 monitor those properties once that they are found to be
7 productive, I monitor to make sure that the leases are
8 complied with. That's primarily what I do.

9 Q. Are you a certified professional landman?

10 A. Yes, I am.

11 Q. Landperson?

12 A. Yes, I am.

13 MR. GALLEGOS: I offer Ms. Green's qualifications
14 to state opinions concerning the subject of oil and gas
15 land issues.

16 EXAMINER BROOKS: Any objection?

17 MR. BRUCE: No objection, Mr. Examiner.

18 EXAMINER BROOKS: Her qualifications will be
19 accepted.

20 Q. (By Mr. Gallegos) Would you explain to the
21 Examiner just generally what is Coates Energy Trust?

22 A. The founder of Coates Energy Trust was George
23 Coates. He had purchased many mineral and royalty
24 interests in mine states, including New Mexico, in the
25 1920s, the 1930s, probably up to the 1950s.

1 Mr. Coates did drill and operate wells, and he
2 did participate in wells that were actually drilled on his
3 mineral interest.

4 Mr. Coates died in 1972. The company continued
5 to operate under the estate of George H. Coates until it
6 was settled in about 1980.

7 At that point, as per the will, Coates Energy
8 Trust was formed. Half of Mr. Coates' interest that he had
9 and his assets went to Coates Energy Trust, the other half
10 went to his wife, Elizabeth Maddox.

11 Through the years, Coates has divested itself of
12 working interests that it had, and at this point -- and it
13 doesn't own any -- currently it doesn't operate any
14 properties. At this point what the trustees -- there's two
15 trustees that manage Coates Energy Trust, and what they are
16 primarily focusing on is to manage these mineral and
17 royalty assets.

18 Q. What are the -- as you understand it, what are
19 the responsibilities of the trustees toward the
20 beneficiaries?

21 A. Okay, well, the two trustees, they do have a
22 fiduciary duty to these beneficiaries, and that is to
23 protect these assets and to get the most value that they're
24 worth, and that is their responsibilities.

25 Q. But just generally, what are the extent of the

1 assets held by the Coates Energy Trust?

2 A. Are you talking about how many?

3 Q. Yes.

4 A. Like I said, that they're mine states, they do
5 have mineral and royalty interests, and there's probably
6 about 350,000 gross acres.

7 Q. And in large part is that acreage leased to
8 various lessees and operators of oil and gas --

9 A. Right --

10 Q. -- production?

11 A. -- some of them are, right.

12 Q. Okay. With what frequency do your duties call
13 for you to communicate with, negotiate with and formulate
14 agreements concerning the development of the mineral
15 interests held by the trust?

16 A. Well, this is an ongoing -- it could be daily, it
17 could miss a day or so, but it's constant. With that many
18 mineral properties, you know, we're contacted often.

19 Q. All right. Now, there's already been some
20 testimony about what's been referred to as your -- as the
21 Coates form of oil and gas lease. Would you explain to the
22 Examiner just a bit of the history and evolution of that
23 document?

24 A. Sure. Really, the Coates lease form document has
25 evolved over many years, with the help of oil and gas

1 attorneys. And we felt the need to do that. After Mr.
2 Coates passed away in 1972, the company did start leasing
3 his minerals, a little bit more than it used to be. He
4 primarily didn't lease them as much as he would go ahead
5 and participate and drill.

6 So at that point what we did use was a printed
7 lease form. But what we attached to it was a list of
8 provisions, additional provisions, or riders as they're
9 known, and as the situations occur, the unfortunate
10 incidents that would occur in the day-to-day business of
11 working with some oil companies, some that were
12 unscrupulous, these provisions started to grow and the
13 riders started to grow.

14 So our lease form, you know, it really didn't
15 make much sense to have this printed lease form that we
16 were then trying to say, well, notwithstanding what this
17 provision is in the printed lease form, we want to change
18 that around. And we said this really doesn't make sense.
19 Why don't we have a typewritten lease form which will be
20 clear for all parties, and it will not only have numbered
21 provisions but the title to the provisions? That way
22 everyone can go and say, well, let's look at the royalty
23 provision, let's look at this provision, where everybody is
24 on the same page of what to expect when they're leasing the
25 Coates mineral interest.

1 Q. And what has been the practice, once you've had
2 that lease form, what has been the practice of the trust
3 concerning modifications of terms of that printed form as a
4 result of negotiations with prospective lessees?

5 A. Well, what we request whenever we do furnish our
6 lease form to a prospective lessee, and if they do make a
7 comment, well, there's some provisions with your lease form
8 that we would like to discuss with you, we say that's fine,
9 if you would go ahead and please just submit it in writing,
10 tell us which lease forms that you may have a problem with.

11 You know, what you need to understand is that we
12 do have properties not just in New Mexico, we have them in
13 Texas, a substantial amount of mineral properties, and this
14 lease form is a base lease form, and it is trying to be
15 very thorough to take care of any matters that could occur.

16 So perhaps maybe a company in New Mexico might
17 say, you know, can we work with you on this provision? I
18 don't know if it really is as much of a problem as maybe
19 somebody in Texas might consider it.

20 And we say, sure, let us -- you know, and we do.
21 We have -- unlike what might have been painted about Coates
22 Energy Trust or myself, we are very much cooperative in
23 negotiating whenever they come to us and talk to us. In
24 fact, I think the record shows that, especially with how
25 the negotiations went with Mr. Farmer.

1 Like I said -- Well, I won't get into that right
2 now. But like I said, the underlying point is, that I want
3 to try to make, is that we are very cooperative and we will
4 try and work with the oil companies on trying to come to an
5 acceptable, mutually acceptable lease form.

6 Q. And as a result, in fact, in practice have you
7 been able to do this with lessees who over time have
8 approached you and have worked with you to iron out any
9 issues they have concerning your form?

10 A. Exactly. I did a quick check before coming here,
11 and I noticed that in the last probably year and a half
12 we've leased five or six times, and the only one I looked
13 at were the ones that we've actually leased, they've
14 actually drilled, and there's producing wells.

15 So there could be other instances where we've
16 leased as well, more than likely, that we did within the
17 past year and a half, but I just looked at those.

18 And one specifically was in New Mexico, and it
19 was with VF Petroleum that we mentioned, and they did
20 contact us and they said, look, we do have some comments
21 here, would you consider them? And we said yes. We worked
22 back and forth. And it is primarily the lease form that
23 was sent to Leonard Resources.

24 Q. Okay. And though that operator is probably in
25 most of your properties of New Mexico, is VF Petroleum, a

1 Midland-based company?

2 A. Yes, it is.

3 Q. Now, you have on the witness stand before you, do
4 you not, Ms. Green Exhibits 1 through 16 --

5 A. Yes, I do.

6 Q. -- in that packet?

7 A. Yes.

8 Q. Are those exhibits copies of documents from the
9 records of Coates Energy Trust that are kept in the
10 ordinary course of business of that company?

11 A. Yes, they are.

12 Q. And in the case of their being copies, are they
13 true and correct copies of those records?

14 A. Yes.

15 Q. Okay. Would you, with the help of reference to
16 those exhibits -- and as you refer to any, please mention
17 the exhibit number so the reporter will have that and the
18 Examiner will have it --

19 A. Okay.

20 Q. -- describe the negotiations concerning leasing
21 and trust acreage to -- in the northwest quarter of Section
22 2 that is the subject of this Application.

23 A. Okay. Exhibit 1, this is just a piece of paper
24 of my handwritten notes, and it was just showing how the
25 negotiations commenced on June 24th, 1999. Apparently Mr.

1 Farmer called, and I returned his call and left a message
2 for him that I did call.

3 And then we were able to talk on June 28th, 1999.

4 At that point what our usual procedure is, is that we like
5 to find out a little bit about the company that we are
6 leasing to. We feel that it's important that we just don't
7 lease to anybody but someone who will -- who we believe
8 will be a responsible and reasonable and prudent operator.
9 He did explain to me a little bit about him --

10 Q. Let me interrupt you on that --

11 A. Sure.

12 Q. -- note, since -- that you wrote that. Because
13 of that, the necessity of having business relationships
14 with somebody who you know is responsible, does your form
15 of lease provide something in regard to assignment of the
16 lease?

17 A. Yes, it tries to protect us. We feel like
18 whenever we negotiate a lease, we are negotiating with that
19 company that we have talked to, that we've tried to learn a
20 little bit about them and their background. So we do have
21 a provision in our lease form concerning assignments that
22 we say that we would like to -- they will need to get
23 consent from us in order to grant assignments. That way we
24 can find out who they're assigning you to. You know, maybe
25 they're tired of having this lease, maybe the well isn't

1 producing like they want to, and they just want to give it
2 to anybody, and they really don't care what that person
3 does with it. Well, we care because we feel like it's on
4 our land and it's on our minerals.

5 Q. And are there considerable concerns, particularly
6 in the recent years, concerning environmental conditions
7 that have come to exist on most estates that might be --
8 might eventually become the responsibility and liability of
9 the mineral estate owner?

10 A. Oh, exactly, we have to be very concerned. So we
11 do provide in our lease form environmental protection
12 provisions and also -- we feel that the operator should be
13 responsible for the operations that they conduct on these
14 minerals.

15 Q. Okay. If you'll go ahead about your conversation
16 with Mr. Farmer on June 28th, 1999.

17 A. Okay, our discussion -- I did ask him at that
18 point what their intentions were, and he went ahead and
19 told me it was primarily oil and he was telling me what
20 formations that they wanted to go to.

21 I also inquired if any seismic had been done or
22 if they planned to do it, and at that point he said he
23 would send a lease proposal.

24 Q. Okay, proceed.

25 A. Okay, Exhibit 2, Mr. Farmer did send a lease

1 proposal to us. And, oh, at that -- Let me step back a
2 little bit. On that Exhibit 1 I probably did inform him of
3 the adjoining acreage that Coates also had an interest in
4 to the north.

5 In Exhibit 2 he does reference that, and besides
6 offering basic terms, which is what, you know, we basically
7 are doing at this point, is just asking for basic terms to
8 see if we can come to an agreement for the basic terms, and
9 he did, he offered basic terms.

10 And then he asked about our interest to the
11 north. We went ahead and replied on August 5th, 1999 --
12 that's Trust Exhibit Number 3 -- and at that point we were
13 telling him we would like to lease all of our acreage that
14 we have that's adjoining, as well as the acreage that he
15 had set out in his proposal. And we went ahead and set out
16 the basic terms that we would be interested in leasing to
17 them.

18 Q. And in summary, what had he proposed and what
19 were you countering at that time?

20 A. Okay, he proposed \$200 an acre, a quarter
21 royalty, three years payout. We went back at \$350 an acre.
22 We had leased to VF Petroleum at \$300 an acre, so we felt
23 like we should at least start out at \$350, you know, and
24 hopefully that we, you know, possibly could get to that.

25 We did have a delay rental of \$25 per net acre, a

1 two-year term. That is very customary for us, is to lease
2 for two years. Usually other companies are fine with that
3 and do not have a problem with a two-year lease.

4 Royalty, 30 percent. We have -- At that point we
5 have received 30-percent royalty, and we've received it,
6 you know, primarily in Texas, but we have received it. So
7 we definitely wanted to start out with that and see if we
8 would be able to obtain -- We weren't for sure exactly what
9 the royalty might be going for up there. It could possibly
10 -- you know, we weren't for sure, but we wanted to start
11 out on the terms that we have been receiving, and they were
12 around \$350 an acre with a 30-percent royalty.

13 Also, the depths we were asking that it be
14 limited to, we said we are willing -- we are always willing
15 to give down to the depth that they are interested in
16 drilling to. It is our policy not just to give a lease as
17 to all depths because we feel like, well, maybe these --
18 this company, they're only interested down to 6800. Well,
19 we may have somebody else that's interested in 11,000,
20 12,000, and they have no interest at all, maybe, have no
21 desire or the capabilities or whatever to drill that depth.
22 We feel like it's in our best interest not to tie up those
23 depths, whether it be for 30 months, three years or
24 whatever.

25 Q. Go ahead, the next exhibit?

1 A. The next exhibit is the Trust Exhibit Number 4,
2 and this was a counter from Mr. Farmer. And what I recall
3 between -- just as a comment, my negotiations with Mr.
4 Farmer, there was never any unpleasantness between us. I
5 mean, it was good, healthy negotiations going back and
6 forth, and I think the record will show that.

7 This Exhibit 4, he is trying to make a
8 counteroffer, so he's going to \$250. So he started at
9 \$200, we went back, I think, with \$300, and now he's going
10 to \$250. So we're you know, volleying on the bonus. They
11 really said let's make it a paid-up lease, term 30 months,
12 royalty 25 percent, earn to the total depth, the captioned
13 acreage only. So at that point he's letting me know that
14 he's really only interested in that one quarter section.

15 What you're seeing handwritten on there were my
16 notes after talking to the trustees and discussing what we
17 felt like would be fair to make us a counteroffer to this
18 offer. And that's what you'll see on Trust Exhibit Number
19 5.

20 Q. Is it fair to say at this point the negotiations
21 were going on as one would expect if the parties were
22 trying to arrive at an agreement, which is to say each of
23 you were responding on a timely basis within a couple of
24 weeks?

25 A. Right, they were -- You know, like I said, this

1 was continuous. And like I stated, I don't recall that
2 there was ever any type of unpleasantness between the
3 conversations between me and Mr. Farmer.

4 One point also. As you will note on -- and they
5 have brought it up also -- on the end of our
6 counterproposals, at the end of the letter we do state --
7 and the time -- the reason why we put a time limit is that
8 we like it to be going, you know, that we hear from each
9 other relatively soon, that there's not large gaps of time.
10 It really isn't to say, at this point if we don't hear from
11 you everything is off.

12 The last sentence addresses that, and it's for
13 both sides. It's not just saying -- Coates is saying that
14 we can back out of this anytime we want. It's for both
15 parties, for any reason, if it's not executed. So you
16 know, we were trying to be fair about that.

17 We would just like to have a time in there to be
18 able to keep it going where there is some type of
19 communication, will we know if they're still interested?

20 That was August 23rd.

21 Q. Okay. I think you went back with your
22 counterproposal at that time?

23 A. Right.

24 Q. Okay.

25 A. Okay, then we -- Exhibit 6 is a September 9th

1 counterproposal. And this seemed like we were going
2 backwards, it seemed like -- The bonus, they went down to
3 \$150. And then they said, all right, but we'll give you \$5
4 per net mineral acre delay rental and a term of two years.
5 I guess they felt like if they were going two years they'll
6 only pay us \$150. Royalty they still didn't want to go up
7 on. They did say, all right, we'll limit it to 7000 feet.
8 But then they wanted an option to renew, which really --
9 you know, that's taking as another year that basically
10 you're tying yourself to. The Pugh clause, and they were
11 talking about a continuous development.

12 How Coates looks at it is, whenever we're going
13 back and forth in negotiations, we're looking at basic
14 terms, what we consider basic terms to be, bonus, delay
15 rental, term, royalty and depth and acreage. As far as the
16 other goes about the continuous development or anything
17 else, we feel like -- our lease form will address that, and
18 we'll discuss it later on -- something like as simple as
19 continuous development of 180 days, we've done it many
20 times, you know. Yes, our lease form may say 90 days, but
21 we're very willing to -- Let's meet halfway, or let's see
22 what we can work out.

23 So at that point, let's see --

24 Q. Is there a mention in here of Mr. Farmer's letter
25 about a copy of your lease form?

1 A. Well, in this specific letter at the end it says,
2 If this offer is acceptable please fax me a copy of your
3 lease form. I think Mr. Farmer and I had an understanding
4 early on in the negotiations when he first called me.

5 And I said, Look, this is what our usual policy
6 is. We would like to be able to come to basic terms
7 agreement. At that time that we do reach an agreement on
8 the basic terms we will be happy to furnish you a copy of
9 our lease form. We've spent a lot of time and expense on
10 developing this lease form, and if we have somebody who
11 truly isn't interested in negotiating in good faith and
12 that, we really just don't want to send that out. We want
13 to make sure that we've agreed at least on the basic lease
14 terms.

15 And we hope and we believe that Mr. Farmer,
16 whenever he accepted, January 14th, that he said, Yes,
17 we're accepting these basic lease terms -- I am hoping that
18 that was in good faith and not just to receive a copy of
19 our lease. But I am taking it face value that I'm sure
20 that how our negotiations were going, that it was in good
21 faith.

22 And at the end of his fax on his letter whenever
23 he said, Yes, I agree to these terms -- I guess I'm moving
24 ahead a little bit before we get to that part --

25 Q. That's all right.

1 A. -- but he made the comment, you know, Yes, we
2 accept these basic terms; now let's work on the lease. It
3 wasn't like that he wasn't expecting that we wouldn't work
4 on the lease and, oh, we're going to change these basic
5 terms. You know, he implied let's work on the lease. But
6 like I said, I'm moving ahead of myself on that.

7 Q. Okay, let's just go to Exhibit 7, then.

8 A. Okay, Exhibit 7 was a counteroffer, and you can
9 see we're still going back and forth for the bonus. The
10 bonus, here we're saying let's go \$275. Two years paid-up.
11 We just said, All right, Coates will relinquish and not,
12 you know, require the rental anymore. We were still trying
13 to get a little bit more than a quarter royalty. Surface
14 to 7000 feet, we still wanted it the depth to what they
15 were interested in leasing to, we don't have a problem with
16 that. The acreage, that's fine, they only wanted 160
17 acres.

18 Again, we have our provision at the end, you
19 know, we're not trying to say it's just one-sided. We have
20 our provision that if it's not executed, a binding
21 agreement, that no party has any liability.

22 Okay, then Exhibit 8, it's a note that I wrote
23 concerning a conversation that I had with Glen Farmer in
24 October, and that was -- let's see. My last
25 counterproposal to him was October 6th, and he returned the

1 call October 11th. And it says I "Spoke to Glen Farmer.
2 He spoke to Leonard last week and they wanted to pass on
3 our terms at this time. I asked if they wanted to submit a
4 counterproposal of perhaps \$225 an acre. He said he would
5 talk to Mr. Leonard and ask."

6 I think that proves that we're definitely trying
7 to work out a lease here. I was not trying to -- or Coates
8 was not trying to be unreasonable. This is what we have to
9 have. In fact, I was even offering, after they were saying
10 Leonard doesn't want to do it, Well, how about going back?
11 The last time in my last proposal was \$275, how about \$225.

12 Q. Okay, so just to get this clear, the way you read
13 that it might not have been clear, but what -- he was
14 telling you that they wanted to pass on our terms, he was
15 basically saying --

16 A. -- they weren't interested.

17 Q. -- they weren't interested. But your effort,
18 then, was to keep the negotiations alive?

19 A. To keep the negotiations going, right?

20 Q. Okay.

21 A. Okay?

22 Q. So what did you do in order to do that?

23 A. Okay, well then we go to Coates Trust Exhibit
24 Number 9. My note that we just discussed, that was October
25 11th.

1 And about a month and a half later Glen Farmer
2 called me. And he said, Well, we have a new proposal. We
3 would like to offer you \$250 an acre, a quarter royalty,
4 two years, depths zero to 7900 and an after payout to 27
5 1/2 percent, and he said he would submit the offer in
6 writing. Those were the terms that he stated.

7 Trust Exhibit Number 10 --

8 Q. How did that look to you at that time --

9 A. That looked good. My first reaction, that's
10 good. I felt like the trustees would accept that.

11 Coates Trust Exhibit Number 10, that's a letter
12 from Mr. Farmer, and that was in response to our telephone
13 conversation. And he did set out the \$250 bonus, the two
14 years paid-up, the 25 percent before payout, the 27 1/2
15 percent after payout, well-by-well basis, surface down to
16 7900, acreage 160. Pugh clause, Lessee earns to the total
17 depth drilled; continuous development 180 days between
18 wells after end of primary term, with the option to renew
19 again.

20 Coates Trust Exhibit Number 11. I think at that
21 point we said let's look back, and this is my handwriting,
22 and I said let me look back and see how we've been
23 negotiating back and forth, all the way from the beginning.
24 I'm sure I did this in order to present this to the
25 Trustees. I do have a notation up at the top, you know, we

1 try and look around sometime and try to obtain a little bit
2 of information of what maybe the area might have been
3 leasing for.

4 And I had a notation -- somewhere I must have
5 checked and said in 1982 it was leasing for \$150. So I
6 thought, well, if we can come to \$250, which is what we
7 were going at, I think that sounds fair. It starts -- It
8 just shows a chronological history of the negotiations,
9 starting back in June, all the way to the last one that Mr.
10 Farmer sent to us. And at that point whatever you see
11 circled means that the trustee was saying that's
12 acceptable.

13 As far as the option to renew for the additional
14 year at \$150, we're not interested in doing that. You
15 know, we feel like two years is sufficient time to lease to
16 an oil company.

17 As far as the continuous development, it wasn't
18 even addressed. Again, like I said, in our mind that's
19 part of the lease form that we'll talk about whenever we
20 get to that point.

21 Exhibit 12 is a letter, is the counterproposal,
22 January 13th, 2000, to Mr. Farmer. And basically it was
23 setting out the \$250 that he offered, the two years paid-
24 up, the royalty that he offered, the depths that he
25 offered, the acreage that he wanted it to be on. And

1 again, we still have our last provision that basically says
2 just let us know by this time. Again, neither party is
3 going to be held liable if this does not get executed.

4 Q. Were you not offering the same terms, same basic
5 terms, that he offered in his December 1, 1999, letter?

6 A. Yes, yes.

7 Q. Okay.

8 A. Okay, and then Coates Trust Exhibit Number 13,
9 this is when Mr. Farmer -- he sent back on my fax
10 transmittal of the lease -- I mean, excuse me, of that last
11 counterproposal, he sent back a note to me, to Sherrie
12 Green from Glen E. Farmer: "Sherrie, we agree to the
13 following basic terms. Please fax me your lease form so
14 that we can work out the rest of the lease. Glen".

15 And he attached --

16 Q. Now, let me interrupt you.

17 A. Uh-huh.

18 Q. Not only here, but at any time in the
19 communications, instead of Mr. Farmer saying send us your
20 lease form so we can work it out, did he indicate to you,
21 no, we're going to use our lease form --

22 A. Never.

23 Q. -- for this --

24 A. Never.

25 Q. All right.

1 A. Never.

2 Q. So what did you do as a result of his --

3 A. Well, that same day --

4 Q. -- January 14th fax?

5 A. -- that same day I responded, and I went ahead
6 and I said we received your -- Excuse me, this is Trust
7 Exhibit Number 14. And we went ahead and said, we received
8 your fax message, and accordingly here is the lease form.
9 And it does state that changes would have to be made to
10 reflect the agreed-upon terms. For example, if we would
11 only agree to a one-year term we would have had to take out
12 the rental clause. But in this case, you know, that is not
13 the case.

14 Also that we would have to correct any references
15 to the State of New Mexico instead of Texas.

16 Q. All right. Now, up to this point is it fair to
17 say negotiations had been moving along the way you would
18 normally expect and what you normally have seen in practice
19 on these kind of matters?

20 A. Yes.

21 Q. And then what happened?

22 A. Okay, that was January 14th. Exhibit -- See if I
23 can find the next exhibit.

24 Q. January 14th of the year 2000, correct?

25 A. Right, year 2000. Then we go to Coates Trust

1 Exhibit Number 15.

2 Q. So are you telling us that between January 14th,
3 your letter, and June -- or sometime after June 26th, 2000,
4 you heard nothing from Leonard Resource?

5 A. Right. And in this letter of June 26th when we
6 received it -- and I know that we've already read parts of
7 it for the Examiners, but it's basically kind of saying --
8 This is the first time we've heard from Leonard Resource.
9 All the negotiations have been through Mr. Farmer, and I
10 guess it's because, as he's explained that Mr. Farmer had
11 retired. And it just sets out how Glenn Farmer and Sherrie
12 Green had been in negotiations.

13 Then they put, "Under cover letter dated January
14 13th, 2000, Ms. Green provided us with a counter proposal
15 and a copy of the Coates lease form for review. After
16 careful consideration of both the counter proposal and your
17 lease form, we are unable to accept either."

18 When I first read that I said, Now wait a minute.
19 To me, he's implying that they never accepted those basic
20 lease forms, and whenever I responded in the following
21 exhibit I did try and correct that. It didn't mean that we
22 were saying at this point we're holding you still to it,
23 but to me it implied that we never agreed upon those, and I
24 felt like that wasn't right.

25 He does go into -- to say, like I said, that he

1 explained earlier about the lease form. He doesn't go into
2 anything specific, he just says royalties. He is right,
3 you know, we do have -- it's not just a one-sentence
4 royalty provision like for oil, it is different. It isn't
5 just a small one paragraph, it is a little bit more. But
6 we have leased to many companies that have accepted that
7 lease form with that royalty provision, and we have made
8 modifications where it's necessary.

9 And you know, I was expecting to hear from him of
10 what he really didn't like about it or if there was a
11 certain part. You know, it's not usual that somebody says,
12 I don't all of that. You know, I'm expecting him to say,
13 well, here, maybe this provision.

14 Q. Please let me direct your attention to the last
15 full paragraph on the second page, and what did you
16 understand to be the message that was being conveyed by Mr.
17 Leonard?

18 A. Well, how I took this last paragraph, it was
19 pretty much, this is our lease form, take it or leave it.
20 "If those terms and form of lease we propose are
21 unacceptable, then we will be happy to submit an AFE for
22 your consideration once we are ready to drill on your
23 acreage, so that you may join with your 25% interest in
24 drilling a proposed test well."

25 Which lease form is -- He may say that he has

1 acquired 300 lease forms like this, and if that's the case
2 then I feel sorry for the land owners that have signed
3 this, because I feel like it is an extremely poor lease
4 form. It's very ambiguous, it's very broad, it's very
5 vague and it gives them almost unlimited power on how they
6 can -- and it's very slanted. Just a comment, Producer's
7 88: That's right, it is for the producer. It's definitely
8 not for the protection of any rights for the royalty
9 owners.

10 Q. In spite of the delay of almost six months and
11 Mr. Leonard's last paragraph, Ms. Green, did you
12 nonetheless attempt to keep the negotiations alive?

13 A. Yes. I think I have it on here, or do I? Oh,
14 yes, I do.

15 Q. It should be Exhibit 16.

16 A. Right. Yes, excuse me. Yeah, that's right. His
17 letter was June 26th.

18 So I sent another letter July 17th, and this is
19 the one that I had made some comments on -- this is Coates
20 Trust Exhibit Number 16 -- where I said, Yes, we've
21 received this letter. And like I had commented earlier, I
22 wanted to correct that I felt like we indeed at one point
23 did agree on those basic terms. Not to say that we're
24 still bound by them or they're still bound by them, but
25 there was an agreement at one point on that.

1 And then I do go on to say, I don't think it's in
2 our best interest to accept the lease form that he
3 attached. And I agreed.

4 And he mentions that our lease form is 19. Well,
5 their lease form is two and a quarter pages. And something
6 as important as leasing a mineral interest, there's lots of
7 ground to be covered, lots of area to be covered and not
8 just something that just says, look at us, we're going to
9 do good, trust us. We know in today's climate with all the
10 litigation that is going on, that is not the case.

11 I feel like a lot of the landowners that lease
12 under those lease forms probably are unsophisticated, and
13 they don't have the resources. And they believe them
14 whenever they feel like, oh, good -- and they probably have
15 a very small interest, not a quarter royalty interest, as
16 Coates does here, and they probably want to believe, oh,
17 good, maybe we'll get some kind of money. It's not going
18 to be very much, we have a small interest, why not sign
19 this? It's not worth the expense. And we want to believe
20 that this oil company is going to do right to us. They
21 want to believe that, but that's not the case in today's
22 environment.

23 Q. Okay. And did you in this letter convey to Mr.
24 Leonard that you wanted to know what provisions of your
25 lease form were unacceptable and that you would try and

1 work out reasonable solutions to those things?

2 A. Exactly, I was still trying to keep the
3 negotiations going. We had really been going strong,
4 myself and Mr. Farmer, for six months. All of a sudden we
5 didn't hear anything. He's coming back and saying this,
6 that he does not want to accept our lease form, basically
7 saying, here, it's either our lease form or we're just
8 going to -- You know, that was the attitude that I got.

9 I think he's implying that there's a lot of --
10 that I'm being argumentative for that, but I think his
11 attitude was more of a take it or leave it, I'll go and
12 I'll get protection from the Division and they will force
13 pool you, too bad. And I don't feel like that's right.

14 Q. Yeah, I see a note down -- handwritten note on
15 the first page of this July 17, 2000, letter, Exhibit 16.
16 Would you explain that?

17 A. Well, right. We -- After a certain amount of
18 time, that was July 17th that I did write and ask him. I
19 asked him one of two things, if he could please let us know
20 what language that he found unacceptable in the Coates
21 lease form and that we would take those -- any requested
22 changes into consideration if they're reasonable. We do it
23 all the time.

24 I also asked him -- You know, he's saying that
25 he's reading this to mean that we really don't want him to

1 do that, we really don't want to leave. I feel like that's
2 pure speculation on his part. We -- That is probably what
3 we really want to do. Like I explained, we would prefer to
4 do that, than to -- we're not into having any working
5 interests, nor do we operate any wells. So we would prefer
6 to lease. But if he's going to --

7 Q. What I was asking -- I was asking you about the
8 part handwritten on the first page there.

9 A. Right, "No response", "9/11/00 No response". So
10 at that point we hadn't heard anything from him --

11 Q. Basically, you --

12 A. -- in that given amount of time.

13 Q. -- you figure at that time it's a closed matter?

14 A. Right, that he has not contacted us, that he is
15 not interested.

16 Q. All right. Was the next thing that you heard
17 concerning Leonard Resources and this particular acreage a
18 notification from Mr. Bruce that -- of an application for
19 force pooling your acreage, which would have been -- which
20 would have arrived over a year after the last
21 communication?

22 A. Right.

23 Q. Now, in Exhibit 3B there is a letter that Mr.
24 Leonard referred to dated in July of this year. Do you see
25 that?

1 A. Yes, I do.

2 Q. Is that letter in your file?

3 A. No, it is not.

4 Q. Did you receive that letter, as far as --

5 A. Not that I'm aware of. Whenever it was first
6 brought to light over there, that's the first thing I said,
7 I've never seen this letter.

8 Q. Did you receive all communications otherwise that
9 were sent to you by Glen Farmer and by Dan Leonard?

10 A. Yes.

11 MR. GALLEGOS: That's all the questions, I pass
12 the witness.

13 EXAMINER BROOKS: Okay, Mr. Bruce?

14 CROSS-EXAMINATION

15 BY MR. BRUCE:

16 Q. Ms. Green, let's just go down your exhibit pile
17 here. Certainly early on in June you knew that Leonard
18 Resource Investment Corporation was the party seeking the
19 lease, did you not?

20 A. Yes.

21 Q. Okay. And going on to your Exhibit 3, where I
22 believe -- I don't know if this is an offer or a
23 counteroffer, but when you mentioned the terms that you
24 prefer down at the bottom, you say it's "subject to
25 Leonard's acceptance of the Coates lease form", did you

1 not?

2 A. That's right.

3 Q. And Coates -- or, excuse me -- yeah, Coates
4 hadn't sent that lease form to Leonard, had it?

5 A. That's right.

6 Q. So Leonard had no idea what was in the lease
7 form?

8 A. No, I explained to Mr. Farmer early in the very
9 beginning of our negotiations that Coates would supply a
10 lease form once we agreed to basic terms. We were agreeing
11 to these basic terms, bonus, rental, term and royalty and
12 depth.

13 Q. And then if you move on to your Exhibit 5,
14 another counteroffer, you say the same thing, "subject to
15 Leonard's acceptance of the Coates lease form..." Again,
16 Leonard didn't have that lease form to -- Leonard Resource
17 did not have that lease form to review, did they

18 A. That's correct.

19 Q. And Exhibit 6, Mr. Farmer did request a copy of
20 the lease form for review, did he not?

21 A. If our offer is acceptable, and it was not
22 acceptable.

23 Q. Okay, and then Exhibit 7, the next counteroffer,
24 "subject to Leonard's acceptance of the Coates lease
25 form..." You didn't send Coates -- Coates did not send

1 Leonard Resource a lease form, did it?

2 A. No, it did not, as Mr. Farmer understood.

3 Q. Now let's move on to your Exhibit 10. There's
4 several terms -- Let's go to Exhibit 10 and 11 together,
5 Ms. Green.

6 A. Okay.

7 Q. A couple of things. Mr. Farmer proposed a 180-
8 day continuous development obligation, and surface down to
9 and including 7900 feet. Now, I believe you testified that
10 Exhibit 11 is -- That's your handwritten notes on the
11 negotiations; is that correct?

12 A. Right.

13 Q. So down there at 12-1-99 you agreed to surface to
14 7000, this says, earning to depth drilled; is that correct?

15 A. That's what he had offered.

16 Q. Well, I mean, what does that "OK" mean over
17 there?

18 A. Okay, well, what we okay'd was the 250, the two
19 years, the 25, 27 1/2 percent after payout. This was my
20 own notes. And I probably -- Now that I'm looking at it, I
21 put 7000 instead of 7900. I was just trying to put
22 verbatim what he had --

23 Q. Okay --

24 A. -- okay? --

25 Q. -- but --

1 A. -- but as far as what is set out and what -- the
2 trustee said okay, even though it says "OK" here, what was
3 put in the letter of January 13th is what the counteroffer
4 was.

5 Q. But doesn't this "OK" say "earn to depth
6 drilled"? It was circled --

7 A. Well --

8 Q. -- with the "OK".

9 A. -- apparently I didn't circle -- I shouldn't have
10 circled that bottom part, is what I'm saying. These were
11 my notes, just to try and rehash what they put. But what
12 really was the offer, what was actually made to Leonard, is
13 on page -- is Exhibit 12.

14 In fact, if you will notice, I put surface down
15 to 7900 feet instead of putting 7000, which I said was okay
16 on here. So that was just, like I said, my own personal
17 notes.

18 Q. And then your letter, the next exhibit, Exhibit
19 12, the January 13th letter, once again it says, "subject
20 to Leonard's acceptance of the Coates lease form..."
21 Correct?

22 A. That's right.

23 Q. And it also says in the last paragraph that
24 neither party "will have any liability to the other in the
25 event a binding oil and gas lease is not executed for any

1 reason." Is that correct?

2 A. That's correct.

3 Q. Then finally, let's move to your Exhibit 14.
4 That's when you provided the lease form?

5 A. Correct.

6 Q. And now in the December 1 letter from Mr. Farmer,
7 he talks about a 180-day continuous development obligation.
8 That's Exhibit 10. Your Exhibit 13 doesn't say anything
9 about the continuous development provision, does it?

10 A. 13, you say?

11 Q. Exhibit 12, Exhibit 12 does not say anything
12 about the continuous development --

13 A. No, this was our counteroffer.

14 Q. Okay.

15 A. It does not address the 180 days continuous
16 development --

17 Q. And then --

18 A. -- or the option --

19 Q. But the lease --

20 A. -- to renew.

21 Q. -- but the lease form has a 90-day continuous
22 development obligation?

23 A. Right. Like I explained earlier, we consider
24 that that's something that's not a basic term that we're
25 discussing back and forth in counteroffers. That's why

1 we've never mentioned it but why we do have it in our lease
2 form.

3 Q. Now, on your Exhibit 11 you circled and said "OK,
4 earn to depth drilled". That's not what the lease provides
5 for, does it?

6 A. And I explained that to you just a minute ago.
7 These were my own personal notes.

8 If I try to state again, it was even incorrect as
9 to surface to 7000. The counterproposal that was actually
10 made is on January 13th, 2000, where I do say, yes, you get
11 surface to 7900. As I explained, I did -- I incorrectly,
12 apparently did not -- I should have only, you know, circled
13 that. These are my own personal notes, what was not
14 offered.

15 Q. And the lease only provides for surface to bottom
16 perforations in the well, does it not?

17 A. Correct. And I believe, if you look at the
18 letter that you have in your exhibits, that it was from Mr.
19 Farmer to Mr. Leonard, he explained that. He said Coates
20 says they will, in their lease form, have it where it's
21 down to the producing depth, not to TD.

22 Q. And then finally your Exhibit 16, at the end of
23 that letter you again say no party "will have any liability
24 to the other in the event a binding oil and gas lease...is
25 not executed for any reason." Is that correct?

1 A. That's right.

2 Q. No agreement was ever executed, was it?

3 A. That's right.

4 Q. And you're not any obligation to accept the lease
5 form of Leonard Resource, are you?

6 A. No.

7 Q. And Leonard Resource isn't obligated to accept
8 your lease form?

9 A. No.

10 Q. And in that final letter you said, you know, show
11 us the geology and a JOA and we might consider joining.

12 A. Which letter are you talking about?

13 Q. The final.

14 A. Oh.

15 Q. Exhibit 16.

16 A. Right. And you know, that was the last
17 correspondence that we heard. And in my opinion, if really
18 negotiations were going on -- I know Mr. Leonard explained
19 that he didn't have that information ready, but it looks
20 like just a simple note back. You know, we're still
21 interested in negotiating with Coates. We don't have this
22 at this point, but some time in the future we'll get back
23 with you. But we never received anything like that.

24 Q. Now, regarding the proposal letter, part of our
25 Exhibit 3B, July 27th, 2001, is it possible it could have

1 been misplaced in your office?

2 A. Anything is possible, but I'm telling you I did
3 not see it, nor is it in my -- in our files.

4 Q. Okay.

5 A. Is there any way possibly it could have been sent
6 certified or faxed from Mr. Leonard?

7 MR. BRUCE: That's all I have, Mr. Examiner.

8 EXAMINER BROOKS: Mr. Gallegos?

9 MR. GALLEGOS: No further questions.

10 EXAMINER BROOKS: I don't have any questions for
11 this witness.

12 Mr. Stogner?

13 EXAMINER STOGNER: (Shakes head)

14 EXAMINER BROOKS: Okay, do you have anything
15 further, Mr. Gallegos?

16 MR. GALLEGOS: Nothing further, thank you.

17 EXAMINER BROOKS: The witness may stand down.

18 Do you want to make a closing statement, Mr.
19 Bruce?

20 MR. GALLEGOS: Do you want to make a closing
21 statement, written or oral, Mr. Gallegos?

22 MR. GALLEGOS: I don't think so, no. We'll leave
23 it to the sound judgment of the court.

24 MR. BRUCE: I would just -- very -- very brief --

25 EXAMINER BROOKS: Go ahead.

1 MR. BRUCE: -- Mr. Examiner. The parties agree
2 there's no lease form. Since there isn't, they negotiated
3 for a while.

4 And really under the statutes and under the
5 Division's interpretation of the statutes, all that was
6 required was to send out an AFE and a proposal letter.
7 Leonard Resource did that. The parties haven't agreed, I
8 think it's cut and dried. They ought to be force pooled.

9 MR. GALLEGOS: Well, yeah, I would like to
10 respond. I don't think a party's mineral interest should
11 be expropriated on the basis of failure to agree when
12 there's been no good faith effort on the part of the
13 prospective lessee to make such an agreement. Clearly what
14 has been offered by the lessee, particularly in terms of a
15 lease, is totally unacceptable, and no party should be
16 entitled to give up valuable mineral interest on that
17 basis.

18 And I don't think the statute prevents that, and
19 I think it has always been the standard of this Division
20 that the absence of agreement can only be found in the case
21 that there has been actual good faith and reasonable
22 efforts to arrive at such agreement, and that has not been
23 the case here.

24 EXAMINER BROOKS: Mr. Bruce?

25 MR. BRUCE: Well, I would just say there's no

1 expropriation, they still have their mineral interest. If
2 there was expropriation, the pooling statute would probably
3 be void under the Constitution.

4 EXAMINER BROOKS: Probably. Could I speak to
5 counsel in the hallway a minute.

6 (Off the record)

7 EXAMINER BROOKS: Very good, if there's nothing
8 further, Case Number 12,730 will be taken under advisement.

9 (Thereupon, these proceedings were concluded at
10 2:18 p.m.)

11 * * *

12
13
14
15 I do hereby certify that the foregoing is
16 a correct and true copy of the proceedings in
17 the examination hearing of Case No. _____,
 heard by me on _____ 19____.

18 _____, Examiner
19 Oil Conservation Division

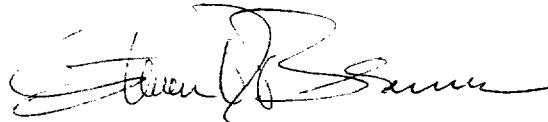
CERTIFICATE OF REPORTER

STATE OF NEW MEXICO)
) ss.
COUNTY OF SANTA FE)

I, Steven T. Brenner, Certified Court Reporter and Notary Public, HEREBY CERTIFY that the foregoing transcript of proceedings before the Oil Conservation Division was reported by me; that I transcribed my notes; and that the foregoing is a true and accurate record of the proceedings.

I FURTHER CERTIFY that I am not a relative or employee of any of the parties or attorneys involved in this matter and that I have no personal interest in the final disposition of this matter.

WITNESS MY HAND AND SEAL September 23rd, 2001.



STEVEN T. BRENNER
CCR No. 7

My commission expires: October 14, 2002