STATE OF NEW MEXICO
ENERGY, MINERALS AND NATURAL RESOURCES DEPARTMENT
OIL CONSERVATION DIVISION
STATE LAND OFFICE BUILDING
SANTA FE, NEW MEXICO

12 July 1989

EXAMINER HEARING

IN THE MATTER OF:

Application of ORYX Energy Company, formerly Sun Exploration and Production Company, for an order pooling all mineral interests in the Gavilan-Mancos Oil Pool underlying a certain 640-acre tract of land in Rio Arriba County, New Mexico. CASE 9694

BEFORE: Michael E. Stogner, Examiner

TRANSCRIPT OF HEARING

A P P E A R A N C E S

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# I N D E X

# E X H I B I T S

E X H I B I T S Cont'd

MR. STOGNER: The hearing will come to order.

I'll call next Case Number 9694, which is the application of ORYX Energy Company, formerly Sun Exploration and Production Company, for an order pooling all mineral interests in the Gavilan Mancos Oil Pool underlying a certain 640-acre tract of land in Rio Arriba County, New Mexico.

At this time I'll call for appearances.

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

MR. STOGNER: Are there any other appearances?

MR. PEARCE: May it please the Examiner, I am W. Perry Pearce of the Santa Fe law firm of Montgomery & Andrews, appearing in this matter on behalf of Mallon Oil Company, and, Mr. Examiner, contrary to what I said earlier, I do believe I will have one very short witness to present.

MR. STOGNER: Okay, are there any other appearances in this matter?

MR. LOPEZ: Mr. Examiner, my

name is Owen Lopez with the Hinkle Law Firm of Santa Fe, New Mexico, appearing on behalf of Mesa Grande, Limited, and not contrary to what I said before, we don't have any witnesses.

MR. STOGNER: Are there any other appearances?

Okay, I have ORYX, Mallon and Mesa Grande, Limited, is that correct?

Okay, will the witnesses please stand, or potential witnesses please stand and be sworn at this time?

(Witnesses sworn.)

MR. STOGNER: Mr. Kellahin?

MR. KELLAHIN: Thank you, Mr. Examiner.

Mr. Examiner, let me see if I can frame for you the issues that -- or the major issues that we would like you to consider the resolution of this morning.

We are again visiting Section 12 in Gavilan Mancos. I'm certain you'll remember from the May 10th/11th hearings in Case 9671 that we came before you with a proposition that the east half of Section 12 be included in an expansion of the Canada Ojitos Unit.

After that application was denied, then we have sought to consolidate the undeveloped east half of Section 12 with the currently developed west half of Section 12. The west half is held by production from the Mallon Oil Company operated Johnson Federal 12-5 Well in the west half.

This is a pooling of undeveloped acreage into developed acreage for an existing well. This is not the first occasion in which this has been proposed to the Division nor which the Division has acted. There are a number of other cases like this in Gavilan Mancos, particularly -- all of which we will discuss with you.

The fundamental issue which we are unable to obtain unanimous consent for is what should the interest owners, the working interest owners, if you will, in the east half of 12 pay to the owners in the west half for participation in the remaining reserves of the well, and that is the issue on which we will spend most of our presentation.

I have two witnesses. Miss Marlene Staley is a petroleum landman for ORYX and she will talk about her efforts to obtain voluntary joinder on 640-acre spacing.

The second witness is Mr. Richard Dillon. He's a petroleum engineer who testified before you on other occasions and specifically testified in the case in May, 9671. Mr. Dillon has studied the subject well and has proposals to you with regards to what he believes is a method by which all parties can share in the remaining reserves for the well in the section and what he proposes to be an equitable allocation.

There are a couple of issues that I want to tell you are not issues in this case. In past pooling cases such as this one of the disputes that Mr. Lopez and I have wrestled with in the Loddy case is what should be the effective date of participation of the owners in the undeveloped tract and whether that date is the date of the spacing change where we went to 640s or whether that's the effective date of the order.

In this case our specific application is to make the effective date of participation of the east half with the west half the date of this hearing, July 12th, and the pooling order be effective as of this date.

As best I know that is not an issue for which anyone disputes or contests.

The -- another issue that has been discussed and is sometimes confusing, if you'll look at some of the prior cases, is the issue of what the risk factor penalty is in the event the undeveloped interest owners elect not to participate. That is not an issue here. We are proposing that that be 200 percent. If a party elects not to pay its share of what is determined to be the cost of participation, then we believe the 200 percent would be appropriate.

Now, the Johnson Federal 12-5 has already been the subject of a pooling case where there was a transition into 320-acre spacing and there was a case between Mallon and Mesa Grande on that issue for the Johnson Federal Well.

The issue we are focusing on, though, is what the interest owners in the east half of 12, if they are consenting interest owners, what they ought to pay to the other owners in the west half to participate, then, in the remaining reserves, and that is the issue that has given all the parties difficulty in this case and one of the primary reasons we're before you today is to ask you to decide that for us.

Thank you, Mr. Examiner.

MR. STOGNER: Mr. Pearce? Mr. Lopez? Do you all have anything?

MR. PEARCE: Nothing, Mr. Examiner.

MR. LOPEZ: Well, Mr. Examiner, I think Mr. Kellahin has pointed out at least some of the issues correctly. I believe that the issue of the basis of participation in the well is -- has also been fairly well established in these pooling orders. When Sun and Mesa Grande wrestled with the pooling of the Loddy No. 1 Well, we did disagree at the time with respect to the method of participation. We felt that in joining the well we should pay our pro rata share of the well costs but that we should be entitled to share in the production revenues from the date of initial production. That request was denied us.

We also felt that the pooling order at the time should be as of the date of the main Gavilan order changing the spacing. That request was also denied us and it was made effective the date of the hearing.

We do not disagree with Mr. Kellahin that a compulsory pooling order in this hearing based on the (unclear) precedent should be the date of this hearing.

Further, we do not disagree that a 200 percent penalty for nonconsent participation would be an appropriate penalty, although I might point out to the examiner that in the Loddy case there was a 100 percent penalty.

However, and it is remarkable that -- that all three companies are represented in this hearing today on a well that's capable of producing 1-1/2 barrels a day, but be that as it may, it would seem that the basis of participation in the Loddy that the Commission established, which is participation in production from the date of the hearing with the pro rata payment of well costs plus the 12 percent interest factor is the appropriate one and I think that we are going to hear a great amount of discussion about remaining reserves and what have you, which I feel is irrelevant. This well has been on production for four years; it will never pay out, and the basis on which the applicant is requesting to participate is just inappropriate and we cannot consent to it.

One further collateral issue in this respect, although we do not object to the applicant exercising his clear rights under the Gavilan order to join and form -- in our well or into Mallon's well, and to form a 640, we do feel that it is appropriate that the Commission do, or the Division enter this order, particularly in light of the fact that there does seem to exist some exposure to royalty owners on a dilution of their interest under the general Gavilan order.

Thank you.

MR. STOGNER: Thank you.

Mr. Kellahin?

MR. KELLAHIN: Mr. Examiner, we'd like to go ahead with our evidentiary presentation to you and then at the conclusion of that presentation perhaps we can in turn, and as appropriate under your direction, discuss with you the specific issues again.

At this time, Mr. Examiner, we would call Marlene Staley.

MARLENE STALEY,

being called as a witness and being duly sworn upon her oath, testified as follows, to-wit:

DIRECT EXAMINATION

BY MR. KELLAHIN:

Q Ms. Staley, you've been sworn by the Examiner, have you not?

A Yes.

Q Would you please state your name and occupation?

A My name is Marlene Staley, S-T-A-L-E-Y. I'm employed by ORYX Energy Company as a landman in their Unitization Department.

Q Ms. Staley, would you describe for us

your educational background?

A Yes. I have a Bachelor of Science degree in chemistry from the University of Dayton in 1971, a Master of Science degree in geology from the University of Wisconsin in Milwaukee in 1974.

From 1974 to 1976 I was employed by ARCO as a geologist in their Uranium Group.

From 1976 through 1980 I was employed by Sun as a geologist in their Uranium Group.

From 1980 through 1982 I was employed by Sun's Uranium Group as a minerals landman and permit coordinator, obtaining their State, Federal and Forest Service, county permits for drilling projects.

And from 1982 to the present I've been employed in the Unitization Group as a landman.

Q And what is your current occupation and capacity with ORYX Energy?

A I'm a certified professional landman; became a certified professional landman in 1986 and am a landman in their Unitization Group.

Q Describe the general scope of the activities you were asked to perform by your company with regards to this particular application.

A Okay. With regard to this application I was asked to contact the operator of the Johnson Federal

Well 12-5 in the west half of Section 12, Township 25 North, Range 2 West, and also to contact the working interest owners in the east half of said Section 12, to determine their interest in pursuing the formation of a voluntary 640-acre pooling unit.

Q And have you completed that effort?

A Yes, I have.

MR. KELLAHIN: At this time, Mr. Examiner, we tender Ms. Staley as an expert petroleum landman.

MR. STOGNER: Are there any objections?

There being none, Ms. Staley is so qualified.

Q Ms. Staley, before we go into the specifics of the exhibit book that you have organized, would you simply summarize for us the general information that's contained in your exhibit book?

A Sure. The first set of exhibits is a series of maps and plats that identify the general area, show the general area where Section 12 in question is located and the next series of plats shows ownership, lease status information, working interest percentage, information on various acreage or tract bases.

There is a working interest ownership

table that summarizes the same working interest ownership information which is shown on the previous plat.

There's a short chronology of events that shows some of the steps that I took in my responsibility for this application. Also included is our letter to all the working interest owners in Section 12 requesting their assistance in the formation of a voluntary unit. In response to that we have a series of letters we received in reply or ballots that were returned to us.

And the final exhibit is a copy of the State of New Mexico lease in which Sun and Dugan own an interest that covers the northeast quarter of Section 12.

Q Let's go to what is marked as Exhibit Number One and have you identify that exhibit for us.

A Exhibit Number One is an index map that shows the location of Section 12, Township 25 North, Range 2 West that's the subject of this application. It's noted by the diagonal hachures, the section where we propose a 640-acre proration unit. It's also located just adjacent to the western boundary of the Canada Ojitos Unit.

Q At the time you commenced -- well, at what point did you commence working on your efforts to consolidate this as a 640-acre spaced unit dedicated to the Johnson Federal 12-5 Well?

A Okay. Shortly after Sun received the

denial of their application to have the east half of Section 12 committed or -- or taken into the Canada Ojitos Unit I was asked to pursue a voluntary 640-acre proration unit.

Q What is the basis of the data or the land information that you utilized in order to satisfy yourself that you were dealing with the appropriate parties in your effort to consolidate the acreage?

A Okay. We had a land check conducted of both the BLM state record and of the county records in Rio Arriba County to determine the ownership in the area.

Q Did you contact the operator of the Mallon Johnson Federal 12-5 Well to determine whether or not the information that had been supplied to you was verifiable with their records?

A Yes. In addition to our records check we have also tendered a copy of the communitization agreement that was prepared in 1986 for Mallon and compared the interest with that, and I had several conversations with their Division Order Analyst who handled this well and she assisted me with some of the overriding royalty interests that we were not quite sure of.

Q Let's turn to Exhibit Number Two and have you describe the basic tracts that make up or compose the mineral ownership in Section 12.

A Okay. On Section 12 there's a plat in which we show interest on the tract basis and the basis of a tract was the individual lease, individual State of New Mexico lease, comprised a tract.

At the top of each tract you'll see the major lessee of record on the BLM records.

Below that we show the status of the individual lease.

Below that is the tract number.

Below that, the tract acreage.

And that basically is what is summarized on this exhibit.

Q When we look at the Johnson Federal 12-5 Well, what is the current spacing unit dedicated for the Gavilan Mancos production from that well?

A Well, the current spacing unit for that well is a 320-acre unit comprised of the west half of Section 12 and, as those are all Federal leases, they have been communitized to a 320-acre unit.

Q When we look at the east half of Section 12 are we also dealing with all Federal leases --

A Yes, all --

Q -- Federal mineral ownership?

A All the royalty ownership and mineral ownership is Federal.

Q When you look at the southeast quarter of Section 12, you've got that divided into Tracts 5 and 6?

A That's correct.

Q Are the base leases in either one of those tracts held by production from wells in other formations?

A Yes, they are.

Q When we look at the northeast quarter of Section 12, what's the status of that lease?

A The status of the Sun and Dugan lease is that it's in a nondevelopment status and has an expiration date of July 31st, 1989.

MR. STOGNER: And which one -- which tract is due for July 31st?

A Tract No. 1 in the northeast quarter of Section 12.

Q And the working interest ownership in that tract is as shown on the display?

A Yes, it is.

Q Divided between Sun, now ORYX, and Dugan?

A Yes.

Q All right, let's turn now to Exhibit Number Three, Ms. Staley, and have you identify and describe that display.

A Okay. On Exhibit Number Three we still show working interest ownership on the tract basis but on this exhibit I've put the owners of the oil and gas leasehold present working interest as opposed to just the major lessees of record which were shown on the previous plat, and I hope you can read the interest on here. We wanted to fit them all on one plat so they're rather small.

Q Have you attempted to verify with the various working interest owners in the individual tracts that to the best of your knowledge, information and belief, this information is correct?

A Yes, I have.

Q All right, let's turn now to Exhibit Number Four. What have you demonstrated in this display, Ms. Staley?

A Okay. On Exhibit Number Four I've shown the ownership of the working interest in the west half based on the 320-acre existing unit and I've shown the working interest on the east half if it were in a 320-acre spaced unit as opposed to the individual leases or tracts that make up the east half.

Q All right, let's turn to Exhibit Number --

MR. STOGNER: Before we leave that one, what's on that one? Now looking at the west half you have the initials BPO and APO? What are those?

A Okay, I'm sorry. BPO stands for before payout and APO stands for at payout.

MR. STOGNER: And in all instances those are different numbers, is that correct?

A No, I don't believe in all instances.

MR. STOGNER: Could you give me a little knowledge on why that is, why the (unclear changes as after payout and before?

A Well, some of the assignments there were involved in Mallon's leases assigned a certain working interest from inception of the well, I guess you could say inception of the lease. And other of the assignments actually assign a before payout interest and an after payout interest, or had overrides that were convertible to a working interest at payout; just according to Mallon's contract.

MR. STOGNER: Okay, so it depended on -- it all depended on each individual --

A Each individual contract or assignment.

MR. STOGNER: Thank you. Mr. Kellahin?

Q Let's turn now to Exhibit Number Five, Ms. Staley, and have you describe for us the information shown on this display.

A Okay, on Exhibit Number Five I've shown the working interest again before payout and after payout and those numbers do not change in all cases. They just do it in some cases, again, according to individual assignments or contracts. And I've shown, or attempted to show, what the working interest ownership would be if Section 12 was -- became one 640-acre pooling unit.

Q In contacting the various interest owners with regards to their position on formulating a 640-acre spacing unit for the subject well, what type of individuals did you notify?

A We notified all of the working interest owners in the section.

Q If you'll turn to Exhibit Number Six, as a result of those contacts have you tabulated the results of your efforts to obtain voluntary participation of the east half of the west half in the subject well?

A Yes, I have. On the table that's marked Exhibit Number Six we show the working interest ownership in the lefthand column. Moving across to the right I've summarized the percentage of working interest ownership on different acreage bases, which corresponds with the previous exhibit we just looked at so that one could attempt to see that at a glance.

For the 640-acre basis, in the interest

of fitting plat into where it was readable, I only included the after payout figures for the working interest owners.

The last two columns I'll discuss next. The second to the last column is headed ORYX Proposed Cost Allocation and that is the summary of parties responses to our letter that was sent out to them on June 8th requesting their interest in the formation for the approval or disapproval of the formation of a 640-acre unit with specific cost allocation.

The last column which is (unclear) 640-acre spacing unit summarizes that party's position just on the formation of a 640-acre spacing unit.

Q Let me ask you, as of today in response to all of the inquiries you've made of the various working interest owners in both the undeveloped and the developed 320, have you had any party request you to delay the hearing or request that they need more time in order to make a decision about your application?

A No, I have not.

Q Have you had any party object to the inclusion of the undeveloped east half with the developed west half?

A No, we've had no one say that they were against forming a 640-acre unit. Of course, if you look at the second to last column on my Exhibit Six, you will see that a number of parties were against the formation of the unit as proposed in ORYX's June 8th letter.

Q The proposal for the formation had to do with the -- the compensation the owners in the east half would pay the owners in the west half for the remaining reserves of the well.

A That's correct.

Q And that is what's in intended to be shown the second to last tabulation --

A Yes.

Q -- where is says proposed cost allocation?

A That's correct.

Q Can you summarize what is shown in that tabulation so that we can see in relation to east half and west half owners how they have lined up on that issue?

A Okay. If you look at the second last column, we've had approximately -- if you look on a 640-acre basis, we've had approximately 25.39 percent of the working interest ownership in favor of the 640-acre unit as ORYX proposed.

And if you look at the last column, I didn't total up the interest of those parties in favor but the most important point is that I did have no party object at all to the formation of the 640-acre unit, including the east half owners with the west half owners.

Q In your opinion based upon your efforts with regards to voluntary joinder in consolidating the acreage on some participation basis, will more time allow you to successfully obtain 100 percent voluntary joinder?

A No.

Q Let's turn now to Exhibit Number Seven and talk about some of the events that you have personally been involved in with regards to discussions with various interest owners on consolidating the acreage.

Would you summarize your particular activity?

A Sure. As I have stated earlier, after we received the application denying the inclusion of the east half of Section 12 in the Canada Ojitos Unit, I was asked to contact the operator of the Johnson Federal Well 12-5 and the working interest owners in the east half of that section to determine their interest in the formation of a 640-acre spacing unit.

When I contacted both Mallon Oil and Mesa Grande they indicated they would still probably be in favor of forming a 640-acre unit and asked that we send them a letter regarding such formation of a pooled unit and said they would respond to the letter.

Most of the owners in the east half of

the section also said they would like to see a letter proposal and they would respond to that.

So on June 8th a letter providing Sun's proposal for a voluntary and a forced pooling unit was sent to all the working interest owners in Section 12 with a ballot attached where the party could indicate their response as far as approval or disapproval of the proposal.

Then I've included from July -- from June 11th to June 20th we were receiving replies to that June 8th letter and ballot from some of the working interest owners.

After receiving responses from Mesa Grande and from Mallon on behalf of a number of their owners, it became evident we had a disagreement over the participation or the cost allocation for forming a 640-acre unit and both Mallon and Mesa Grande's letter indicated they thought the best forum for forming a 640-acre spacing unit would be come to the Commission and have a compulsory pooling hearing.

So on June 20th application was filed in this case for the compulsory pooling.

Subsequent to that I --

Q Let me stop you for a moment.

A Okay.

Q On the June 20th entry you've indicated that the application of pooling was filed. Did you prepare the tabulation of working interest owners names and addresses for notices for that hearing purposes?

A Yes, I did.

Q In addition did you cause to be prepared the royalty and overriding royalty interest tabulation of owners and their addresses?

A Yes, I did.

Q Let me show you a copy of the application that was filed in this case and ask you to review for me Exhibit A, B and C to that application and make sure that those exhibits are the same ones that you caused to be prepared.

A Yes, those are the same exhibits.

Q To the best of your knowledge, information and belief are the working interest, royalty owners and overriding royalty owners in the entire section reflected on Exhibits A, B and C to the application?

A Yes, they are.

Q Apart from the contacts and unable to resolve the issue of participation, did you also discuss with Mallon and/or Mesa Grande their joint operating agreement by which they currently operate the well?

A I didn't have too much discussion with them other than I'd asked their landman to send me the applicable JOA to the west half and she indicated they operated under three separate JOAs and she would send all those to me, and she did, and I have reviewed those. I've not discussed them further with them.

Q Within each of those JOAs do you have a tabulation of what is set forth in those joint operating agreements for overhead rates?

A Yes, I do.

Q Can you recite those for us?

A Yes. One of the JOAs has a $3500 drilling well rate; $350, producing well rate.

The second JOA has $4000 -- I'm sorry, yes, $4000 drilling well rate; $400, producing well rate.

And the third has $4108.08 drilling well rate, and $410.08, I believe, producing well rate.

Q It is common for pooling orders to include approval of an overhead rate.

A That's correct, from -- from my knowledge of reading several of the past orders in these cases.

Q Do you have any recommendation or suggestion to the Examiner as to which of these rates to utilize in his pooling order?

A I think that ORYX Energy could probably live with the overhead rate of about $4000, producing well rate; $400, drilling well rate. If that's not acceptable, I feel certain we could negotiate a rate that would be agreeable to all the parties.

Q Of the three rates that you are aware of, none of those is so far out of line that it would merit an objection from ORYX?

A That's correct.

Q Are you currently aware of exactly what Mallon is charging for a producing well rate for the wells?

A No, I only know what is stated in the joint operating agreements.

Q All right. Let's turn now to the exhibits that are contained behind what is a title page, Mr. Examiner. The title page is marked as Exhibit Eight and then behind that title page we have included a number of documents and correspondence that apply to the June 8th letter.

Ms. Stacey, would you simply describe what you have set forth behind that exhibit page for us?

A Okay. Behind that exhibit page that's in front of Exhibit Number Eight is a copy of the June 8th, 1989 letter that went to working owners with Sun's proposal for the formation of a voluntary 640-acre spacing unit.

Attached to that letter is the address mailing list for that letter.

Also attached behind that are -- or is

proof of mailing and delivery. All of the deliveries with the exception of two were made by Federal Express. The other two we could not obtain street addresses on so they were sent by certified U. S. mail.

The bulk of the attachment you'll see with delivery of record is the Federal Express proof of delivery.

Q Let me go -- the June 8th letter, then, has been sent out over your signature?

A Yes, it has.

Q Let's turn to the third page of that letter, --

A Okay.

Q -- which is the page that has your signature at the bottom.

A Okay.

Q If you'll look at the first full paragraph on that page and then the last half of that first paragraph where you put forth in writing, then, ORYX's proposed participation formula for the undeveloped interest owners to participate with the developed owners, would you tell the Examiner specifically what ORYX was proposing so he'll have that in mind as we continue our discussion?

A Okay. ORYX was proposing that the working interest owners in the east half of Section 12 pay to the working interest owners in the west half their pro rata share of $40,000 which ORYX Energy stated represented 50 percent of the current net present value of Mallon's Federal -- Johnson Federal No. 12-5 Well discounted at 15 percent.

Q The current net present value calculations based upon remaining reserves were performed by what engineering individual with ORYX?

A These calculations were performed buy Richard Dillon.

Q And is Mr. Dillon present in the hearing room today?

A Yes, he is.

Q All right, let's turn after the mailing list and all the ballots and information contained in Exhibit A, and have you locate for us the next numbered exhibit.

A Okay. The next numbered exhibit is Exhibit Number Nine. It's noted by a cover page that says returned ballot (not clearly understood) from working interest owners to June 8th, 1989, letter, and it follows the last sheet or delivery record for the Federal Express proof of delivery.

Q All right, what have -- what have you placed in the exhibit book after this page showing Exhibit

Number Nine as the cover sheet?

A Okay. After the cover page for Exhibit Number Nine, we've included any of the letter responses we had to our June 8th letter from any of the working interest owners and in addition any of the ballots that the working interest owners sent back to us with either their approval or disapproval or abstention as far as the voluntary 640-acre spacing unit that was proposed in our letter.

Q All right, and after the additional correspondence and returned ballots, what is the next exhibit that you have?

A The next exhibit, which is also the last exhibit, which is marked Exhibit Number Ten, is a copy of the State of New Mexico Oil and Gas Lease -- I'm sorry, not the State of New Mexico, Federal Lease No. 58855.

This lease covers the northeast quarter of Section 12, 25 North, 2 West, and the the leasehold is owned by Sun Operating Limited Partnership and Dugan Production Corp. and this lease shows that unless it is placed in a development status by July 31st of 1989, it would expire under its own terms.

ORYX Energy is therefore respectfully requesting the Commission to issue an expedited order that would place this lease in a development status prior to July 31st with an effective date for the pooling unit of

July 12th, the date of this hearing. We feel that as there was no other alternative as our enlargement of Canada Ojitos Unit was turned down, that at this point the most viable way to put this lease in a producing status for the east half owners to recover any reserves out of their tract is to include it in a 640-acre unit.

Q Thank you, Ms. Staley.

MR. KELLAHIN: I have not marked this as an exhibit yet, and I'll have to take a moment and find what the last exhibit number is, but I have a certificate of mailing that corresponds to Ms. Staley's testimony about the prepared mailing list for the working interest owners, royalty and overriding royalty owners, which we have sent out from my office to notify parties of the hearing, Mr. Examiner, and at this point let me locate my last exhibit and I'll mark it for you.

This will be Exhibit Number Forty, Mr. Examiner.

That concludes our examination of Ms. Staley, Mr. Examiner.

We would move the introduction of her Exhibits One through Ten, as well as our certificate of mailing which is marked Exhibit Number Forty.

MR. STOGNER: Are there any objections?

Exhibits -- if not, Exhibits One through Ten and Exhibit Number Forty will be admitted into evidence at this time.

Mr. Pearce, your witness.

MR. PEARCE: Thank you, Mr. Examiner.

CROSS EXAMINATION

BY MR. PEARCE:

Q Ms. Staley, I have just a couple of things I want to clear up with you, if I may.

I'd ask you to turn back to the early part of your exhibit booklet. Let's look at Exhibit Number Three, please, and I notice that, as was discussed, the before payout and after payout figures?

A Yes.

Q Do you know if the Johnson 12-5 Well has paid out?

A I do not.

Q And I assume you therefore wouldn't know if it hadn't paid out how much remains to be paid out.

A That's correct, I do not know.

Q Let's look, if we may, Ms. Staley, at your letter of June 8th. I want to focus on the same paragraph that Mr. Kellahin talked to you about. It's the top paragraph on page 4. The third page, I apologize.

MR. STOGNER: I'm sorry, the third page of Exhibit Four, you said?

MR. PEARCE: Actually it's the third page of a letter, the fourth page of the exhibit, if you count that preference sheet and Exhibit Number Eight, the June 8th letter.

MR. STOGNER: Okay.

Q The third page of that letter, the top paragraph that begins with the word "historical". Do you have that paragraph, Ms. Staley?

A Yes.

Q Thank you, ma'am.

A Uh-huh.

Q As I understand the first sentence of that paragraph, it's discussing the way the Division has historically handled pooling cases of this type. Is that what you intended to convey with that?

A Yes.

Q And that was, as I understand it, a paragraph similar to what the Division did in the Loddy case, is that correct?

A That's correct.

Q Let's keep that with you, a finger in that page, but let's turn back to Exhibit Number Nine, which are the ballots you received.

A Okay. I found Exhibit Number Nine.

Q And the first ballot shown is from Mallon Oil Company, is that correct?

A Yes.

Q I'd ask you to turn to the last paragraph of that letter from Mallon.

A Okay.

Q And would you read into the record, please, the last sentence of that letter, beginning with the word "Mallon"?

A Okay. "Mallon, et al, would have no objection to the forced pooling through a Commission hearing and under terms consistent to those ordered by the Commission in the 640-acre pooling of the Loddy No. 1 Well."

Q Now let's flip back up, if we could, to your Exhibit Number Eight, the June 8th letter. What did the Loddy order do?

A The Loddy order communitized or I should say formed a 640-acre spacing unit with undeveloped acreage into an existing well, much the same as the application here today.

The Loddy order, from my recollection of reading the copy of it, came up with a figure for the cost of the drilling and completing of the well and the owners who were coming into that well, I believe the order stated, would pay the cost for drilling, equipping, completing the well plus an interest rate. I believe that interest rate was 12 percent, as a basis for coming into the well.

Q Do you remember from what date the 12 percent interest ran?

A I'm not certain. I believe it ran from -- I'm sorry, I can't recollect. I've got several pooling orders mixed up, I apologize.

Q Do you know what the cost of drilling, equipping and completing the Johnson Federal 12-5 -- I forgot how I started that, I apologize. Do you know what those costs are?

A The cost that I -- the cost figure I've seen for the Johnson Federal 12-5 Well was in the order issued, I believe, when Mesa Grande was being communitized into that well and I believe it was a figure of $565,840, indicated by Mallon Oil in that hearing. Of my own knowledge that is from reading it in the order.

Q Mr. Kellahin mentioned that the $40,000 cost figure set forth in that paragraph of the letter had been worked up by Mr. Dillon, is that right?

A That's correct.

Q Is he going to testify?
A Yes, Mr. Dillon is going to testify --
Q I won't ask --
A -- today.
Q -- you to crank that number in for me.
A Okay.
Q Thank you.

MR. PEARCE: I don't think I have anything further of this witness, Mr. Examiner. Thank you.

MR. STOGNER: Thank you, Mr. Pearce.

Mr. Lopez?

MR. LOPEZ: No questions.

CROSS EXAMINATION

BY MR. STOGNER:

Q I need to get a few things straight here in my mind.

Let's talk about the page 2 of the Mallon letter, that being Exhibit Number Nine.

Now we've been talking about this Loddy order and it's coming up -- came up several times.

Does anybody have that order number?

MR. KELLAHIN: We have it in

our exhibit book, the actual order. The Loddy order is R-8639 and it will be in Mr. Dillon's exhibit book.

MR. STOGNER: Okay. R-8639?

MR. KELLAHIN: Yes, sir.

Q Now, Ms. Staley, you mentioned a number just a little while ago when Mr. Pearce first cross examined you, $565,848?

A 840.

Q 840 dollars and that comes out of an order. What order are you referring to?

A Okay, it --

Q That wasn't that Loddy order, was it?

A No.

MR. KELLAHIN: No, sir. Mr. Examiner, that's Order No. R-8262, which is the order entered on the Mallon application to pool Mesa Grande when the Johnson Federal spacing unit went to 320 in the west half of the section.

You may remember that the Gavilan Mancos went through a series of spacings, if you will; went from 40s to 320s to 640s, so this well has been the subject of a prior pooling case. Mr. Dillon's exhibit book also contains a copy of that order.

MR. STOGNER: And at that time that went from 160 to 320 --

MR. KELLAHIN: Mr. Sweet may remember better than I do, but it was drilled on 40s. It went from 40s to 320s as a result of the Gavilan orders.

And then -- and the Gavilan spacing change in '87 to 640s resulted in the Loddy Well, Seifert Well and the Wildfire Well.

MR. STOGNER: I'm going to take administrative notice of those two orders on the record right now, Order R-8639 and R-8260, just the orders alone at this point.

Q On Exhibit Number Three, all the working interest owners, do you have a recollection of which ones were force pooled at that time or which ones were voluntarily communitized?

A No, I do not.

MR. PEARCE: Mr. Examiner.

MR. STOGNER: Yes, sir.

MR. PEARCE: If I may step in, if you'd look at Exhibit Number Three, if in that case the well went from 40 to 320, it appears that all of the interest owners in Tract 3 own a common interest in one lease, so the interest owners in Tract 2 and the interest owners in Tract 4 had to be pooled into that well in addition to half of Tract 3, because if the well was on a 40, it was the southwest quarter of the northwest quarter of

Section 12 because that's where the well is, as shown on Exhibit Number Two.

MR. LOPEZ: Mr. Examiner, if I might jump in here, too.

The order that changed the spacing from 320 to 640 excepted 320, as well, -- exempted 320 in the Gavilan Pool, which was part of the problem and why we're here.

MR. STOGNER: Thank you, Mr. Lopez.

Q Ms. Staley, in Exhibit Number Six, that is the results of the ballot, I would assume. This is information that was obtained from June 11th to June 20th, is that correct?

A Yes, those were written responses that I received during that time.

Q Have you had any other responses after June 20th that is not shown on this particular tally?

A I did have a phone conversation with Mountain States Petroleum Company just last week and one with Ibex Partnership and PC Limited. They just called indicating they would hold their official response until they saw the results of this July 12th (unclear). They indicated there that they did not expect to have any opposition to the formation of the unit.

Q So with that conversation the information that's shown here is accurate.

A Yes.

Q Even after that conversation.

A Yes.

MR. STOGNER: Gentlemen, help me keep on track here, Mr. Kellahin, Mr. Pearce, we seem to be agreeing on everything but this $40,000. Is that where we're heading?

MR. KELLAHIN: Yes, sir, and that's the focus of Mr. Dillon's testimony, is cost application.

MR. STOGNER: Do you agree with that statement, Mr. Pearce?

MR. PEARCE: Yes, sir.

MR. STOGNER: All right. Thank you, Ms. Staley.

I have no further questions of the witness. Is there any other questions of Ms. Staley?

MR. KELLAHIN: Nothing.

MR. STOGNER: The witness may be dismissed.

MR. KELLAHIN: Mr. Examiner, at this time I'd call Mr. Richard Dillon.

MR. STOGNER: Mr. Kellahin,

you may continue.

MR. KELLAHIN: Thank you, Mr. Examiner.

RICHARD G. DILLON,

being called as a witness and being duly sworn upon his oath, testified as follows, to-wit:

DIRECT EXAMINATION

BY MR. KELLAHIN:

Q Mr. Dillon, for the record you please state your name and occupation?

A My name is Richard Dillon. I'm a staff reservoir engineer for ORYX Energy Company in Midland, Texas.

Q Mr. Dillon, have you on prior occasions testified before the Oil Conservation Division of New Mexico?

A Yes, I have.

Q Were your qualifications accepted and made a matter of record on those occasions?

A Yes, sir.

Q Did you testify before Examiner Stogner on the May 10th and 11th hearings in Case 9671 with regards to the application to include the east half of 12 into an expansion of the Canada Ojitos Unit?

A Yes.

Q Some of the information that you presented in that case you have reexamined and propose to present today?

A Correct.

Q What specifically did you do as a staff reservoir engineer with regards to this particular application, Mr. Dillon?

A In regards to this application my responsibility was to determine what an equitable and fair cost basis for participation in the Johnson Federal 12-5 Well would be from ORYX's viewpoint in terms of joining that well under a compulsory pooling.

In order to do that I would have to do a reservoir analysis, reserve estimation, some economic calculations in order to determine that and it was my objective to come up with a conclusion and a recommendation of what would be a fair and equitable value to pay to the existing owners of the well.

Q In making that study did it include examining the orders the Commission had entered in the Johnson Federal 12-5 when the 320-acre spacing order was entered?

A Yes.

Q And did it also include an examination of the pooling order on the Seifert Well in Order No. R-8641?

A Yes.

Q And you've examined the production from both those wells?

A Yes.

Q In addition, did you examine the production and the order entered for the Wildfire Well in Order No. R-8664?

A Yes.

Q And finally in the Loddy Well, Order No. R-8639?

A Yes, I did.

Q And have you completed your study?

A Yes, I have.

MR. KELLAHIN: At this time, Mr. Examiner, we tender Mr. Dillon as an expert reservoir engineer.

MR. STOGNER: Are there any objections?

Mr. Dillon is so qualified.

Q What did your conclusions show you, Mr. Dillon? What did you conclude?

A My conclusions showed me that, one, at this point, and we might want to refer to Exhibit Eleven in the exhibit book, which is immediately in front of Tab A, so, first of all, we find that we are down to two options at this point in order to put this tract of land, the east half of Section 12, into production in the Mancos, we can at this point either drill a new well or, as we have proposed today, pool the entire 640-acre section into the existing Johnson Federal Well.

I found from studying the reservoir that the main reserves can be effectively recovered with the existing wells and a new well was unnecessary and would be uneconomic in all likelihood, and that pooling the east half of the section with the west half allows the working interest owners and royalty owners in the east half an opportunity to participate in the Mancos which they otherwise would not have.

Pooling all of the section protects the correlative rights of all the owners in the section. I believe it would be the fair -- be the -- the natural thing to do at this point.

Q Before we talk about the reasons and the facts that you have elicited to support your summary, let's talk generally how you've organized your exhibit book.

Let me ask you to turn behind Tab A and let's examine, without going into the detail of all the entries, but examining generally where you're taking us with an examination of your study.

A As you can see there listed on the index, the first section is Section B, which is the land section, which Ms. Staley presented, there is an opportunity to add those exhibits in the book here.

My first section that I have prepared was Section C, entitled Reservoir. We have pressure plots, a map, tabulation of pressure data, and we'll draw conclusions from that data as to what status the reservoir is in at this point.

Section D outlines what's termed the drilling option whereby we would drill a new well in the east half of the section. We have data from surrounding wells and which we've used as an analogy to what we'd expect in terms of reserves for a new well. We present our conclusions from that.

Section E we have what we term the pooling option, which is our recommendation. We have an analysis that the Johnson Federal 12-5, the economics and the present value of that well and what we propose as our basis for participation.

Behind that we have a review of previous poolings. We have a map showing where the wells at that have been pooled, a summary of previous orders, production plots.

Behind that we have Section G, which is a copy of those orders.

And in conclusion we have our summary and what we would recommend.

Q Let's commence now with your reservoir study, Mr. Dillon. Let me ask you to turn behind Tab B. The first display is unnumbered. It's simply identical to Ms. Staley's display, showing the well locations in the area?

A That's correct.

Q Let's turn behind Tab C, then, which is your first numbered Exhibit Twelve?

A That's correct.

Q In conducting your reservoir study, would you identify for us the area that you've studied?

A Shown on this map is a partial area of the Gavilan Mancos Pool along with a small section of the West Puerto Chiquito Pool. This is all in Township 25 North, Range 2 West, and a portion of Range 1 West.

Centered in the plat, stippled with a slash going from northwest to southeast, is the subject Section 12, wherein the Johnson Federal 12-5 Well is. This is our proposed 640-acre proration unit.

Surrounding that we have a dashed line

which is indicated as the reservoir study area. This includes four wells which I've analyzed in some detail as to remaining reserves, which we will here in a bit pursue in terms of running economics for what we'd expect to get from a new well drilled in this area.

The pressure data that's available from the surrounding wells is tabulated in the next two exhibits that we'll discuss in just a moment.

Q All right, let's turn now to Exhibit Number Thirteen. Before you describe your conclusions from this display, simply tell us what it is.

A Exhibit Thirteen is a partial reproduction of a previous exhibit that has been entered in numerous occasions in the past in Gavilan Mancos Pool hearings. It's a plot of cumulative oil production from the pool versus reservoir pressure. The cumulative oil production is shown on the horizontal axis, the X axis.

Q You've done something to that basic display subsequent to hearing. What was it?

A The most recent data that we are aware of and that we have obtained has been plotted on this and we have extrapolated to be a graph downward, expanded it so that we can include all the data that we presently have obtained.

Q What does an interpretation of this reservoir data show you as a reservoir engineer?

A This graph shows, as we've stated in previous occasions, that one, there's effective communication in terms of pressure throughout the pool. You can see the trend is shown in the upper lefthand portion of the graph. As you come down you see there's a difference. There's a grouping of two separate groups of wells in terms of what their -- their actual production -- or, excuse me, their pressure is in terms of -- versus the cumulative production from the pool; however, you can see the trends are very similar. There's not a great difference in the pressure of the data which we have added to the bottom of this graph from the Canada Ojitos Unit B No. 17 Well, which is shown extrapolated there, which goes through the 1600 barrel of oil per psi indication.

It shows that as we have seen in the past, we are still on a severely rapid decline in pressure in the pool. The present pressure of that well, which is an observation well in the unit, is approximately 600 pounds as of April of this year. This is at a datum of +370 feet above sea level.

A pressure taken from the ORYX Native Son No. 1, which is within the interior of the pool, shows again about that same date that we are on the order of 470 pounds at the datum of 370 feet. It shows that again we're somewhere in the order of 450 to perhaps 600 pounds in the pool, which is less than one third of the original pressure of 1800 pounds that we found upon discovery of the Gavilan Mancos Pool.

It shows that, one, we have established a severe state of depletion for the reservoir, that certainly we would expect an extended long life after this point.

It shows that we've recovered substantially, essentially all of the oil that we would term from the early primary stages of the reservoir and that, as we've seen in performance, we'll see in performance from the well plots that we examine later, that we certainly aren't within the early what we would call prolific production that we experienced and were able to enjoy. We're in a, if you would permit me, a depleted state at this point, simply trying to show that one, we are in pressure communication; two, that we are in the unit nearing the end of the life of the reservoir.

Q How does that information and conclusion fit into your analysis, then, for purposes of this hearing?

A One, in analyzing whether or not we would drill a well in the area which includes the pressures we've shown here that are on the order or 550 to 600 pounds, so that we would certainly not expect to find certainly virgin pressure and that we'd find a pressure that certainly wouldn't enable us to produce a sufficient amount of oil to pay for the well.

At the same time it tells us that the oil that in all likelihood underlies the tract that we are speaking to today will be recovered, I believe, by the existing wells.

Q Do you have an opinion with regards to your study as to whether a well in the east half of 12 would be an unnecessary well in the Gavilan Mancos Pool?

A Yes, I believe it would be unnecessary.

Q Turn to Exhibit Number Fourteen, Mr. Dillon. Will you tell us how to read that display?

A Exhibit Fourteen again is a plot of pressure; at this point, however, it's versus date. As you can see, we have points, vertical reference marks, annual intervals here, starting with all the available data that we know of in the map that has been -- going back to Exhibit Twelve.

Q Does this plot all the producing well pressure information within your specific area of study for this application?

A Yes, it does. It's all that I'm aware of.

Q What does it show you?

A It shows me, as you can see, we indicated by various symbols and colors that all of the wells with the exception, perhaps, of the Howard Federal Well Reading & Bates operates, are on a very similar trend, once again showing effective pressure communication.

Shown in red with the circular symbols is the Johnson Federal Well. Again it falls on trend, for example, with the Canada Ojitos Well E-6. Again we are in effective pressure communication, again showing the data that we obtained recently on the Canada Ojitos Unit B-17, it shows around the order of 600 pounds and extrapolating that down, you can see, as we end of the graph that there is not a lot of time left in terms of the life of the reservoir should we -- assuming a reasonable abandonment pressure along the order of some say around 200 pounds. we're looking at a few years of productive life.

Q Turn to Exhibit Number Fifteen now and identify that information.

A Exhibit Fifteen is simply a tabulation of the pressure data that is presented on the previous plot.

Q All right, let's turn now to the information behind Tab D and that is the section in which you have studied and proposed conclusions on the drilling options.

A That's correct.

Q All right. My first exhibit is Sixteen?

A Yes.

Q Describe what you've summarized here.

A I've summarized here again, once the two options that we are down to, one, of course, is drilling a new well. Looking at that we find that we've essentially come up with reasons not to do that.

First of all, once again, reserves will be recovered by existing wells; an additional well was unnecessary. If it were drilled it would be an uneconomic investment; very, very small probability of obtaining a economic, successful well.

If it were to be drilled and under cer0 tain circumstances it could necessitate an offset well in the Canada Ojitos Unit in order to prevent any sort of drainage, and again, this would be an unnecessary well, so we would in this case perhaps have two unnecessary wells.

On the other hand, our recommendation today, that the pooling option, we find nothing but pros on that side. We would have an opportunity for the east half working owners (unclear) to participate in the Mancos development. I believe it would protect the correlative rights in terms of those owners under both tracts of land to be able to obtain their fair share of remaining reserves. Again, should we pool it, I believe we would avoid any drilling of unnecessary wells. I don't believe there would be a well proposed, at least ORYX would not propose a well should that area be pooled.

Q Let's turn to Exhibit Number Seventeen, Mr. Dillon. What's the purpose of this exhibit?

A Seventeen shows the cumulative production data; shows the performance of the wells in the area.

The first four wells that have been tabulated there are in the direct study area, as I have termed it, around the subject tract.

The other wells are on the previous plat, again, that we looked at previously.

As you can see, there've been a variety of dates of initial production and to a certain extent there's a correlation between wells of equal ability to produce in terms of cumulative oil over that period of time. We've had some wells that have come on relatively late that have been poor. The Davis Federal Well, for example.

On the other hand a well such as the Canada Ojitos Unit F-7, the No. 38 Well in the Unit, date of first production was December of '87, it has produced 26,000 barrels already to date.

So it shows that, again, as we've seen

before, there's erratic production in terms of -- of you cannot make a consistent estimate in terms of how productive a well is going to be in Gavilan simply by analysis of offsetting wells; however, it's one of the few ways that we can make a reasonable estimate of what we'd expect from -- from a new well.

As you see, though, we do have a variety of recoveries.

Q Your production information is cumulative through February of 1989?

A Correct.

Q And when we look specifically at the Johnson Federal 12-5 Well, from initial production through February of '89 its cumulative oil and gas is shown on the display?

A Yes.

Q Are you proposing in your conclusions that the east half owners share in this past production?

A No, I'm not.

Q Go to Exhibit Number Eighteen, Mr. Dillon. What have you shown here?

A Exhibit Eighteen is a plot of the production history of the Johnson Federal 12-5 Well, which is in the west half of Section 12.

We have on the lefthand axis barrels of

oil, MCF per day, and GOR plotted versus that scale; again date along the bottom.

As you can see, the solid green line is the oil production.

Gas is shown by a dashed line, with long dashes intermittent with two smaller dashes, and the GOR is shown with a dashed line consistently.

Q After that, then, you have interpreted a decline for the oil and the gas production?

A That's correct, based on the intuitive knowledge of what the pressure history has been along with past performance from the well, we've estimated what the future performance might be. That's shown by the -- again, a dashed green line for the oil. That number has been probably optimistically estimated to be relatively consistent as a barrel and a half a day throughout the remaining life of the well.

The gas is expected to decline at a rate of 38 percent per year starting from its current rate of approximately 180 MCF per day.

That would leave a remaining reserve for the well of 1,500 barrels of oil and 105-million cubic feet of gas.

This graph, along with the next three, are the basis for our estimate of reserves for a new well, or using the surrounding offset wells from that tract as analogy wells as to what we might expect from a new well drilled on that tract.

Q Is this a conventional, widely accepted method by which engineers determine remaining reserves for a well?

A Yes, it is.

Q All right, let's go through Exhibits Nineteen, Twenty and Twenty-one.

A Okay. Exhibit Nineteen is a plot for the Howard Federal 1-11. This is the north offset to the subject tract. Again we have the past production plotted and the forecast for the oil and gas shown in dashed green and red lines.

We have observed in state reports that the well is capable of producing more than is shown. This is a -- the previous production has been shown on a per calendar day basis, should the well, you know, be allowed to produce or to flow a month, we'd expect to see the rates that we've shown on our forecast.

The oil we'd expect to decline at rough- 90 percent per year; the gas at about a 64 percent decline, which means there's about a 3-year life for the well, which would leave remaining reserves of 1.6-million barrels -- excuse me -- thousand barrels of oil, 335.8-million cubic feet of gas.

Q Exhibit Twenty is the same methodology applied to the Post Federal 13-6 Well?

A That's correct.

Q And Twenty-one is the same methodology applied to the Canada Ojitos Unit F-7.

A That's correct.

Q All right. Exhibit Twenty-two, then, shows us what?

A Exhibit Twenty-two is a tabulation and the calculation for our estimate of remaining reserves. Again we're using analogy of these four wells to determine what we might expect for a new well.

As shown in the columns, we first of all have the well name. We have the decline for a year we expect for the oil, the initial rate, or what is exactly the current rate for the oil; remaining reserves are calculated from those numbers. The same for the gas.

As we can see, if we consider all four wells, we would have the total remaining reserves of 70,000 barrels of oil or an average of the four would be 18,000 barrels.

Remaining reserves in terms of gas would be 274-million cubic feet.

If we were to not consider the Canada

Ojitos Unit F-7, which we believe to a certain extent is benefitting from the gravity drainage and from the structural position of the well, it's performance, as you can see, is somewhat different and it's more, certainly, prolific than the other wells in the Gavilan area in terms of oil production.

If we were to remove that well we'd see that we would have an average of only 1200 barrels of oil and 170-million cubic feet of gas. This would establish a range in which we think we would encounter the reserves for any new well.

At the bottom of the page is a similar calculation for what we expect initial potential for the well would be based on current rates of the existing wells.

Q Have you taken your estimate of the upper range of remaining reserves for the well and applied it to the east half of 12 to determine whether or not a new well could be drilled in that half section and be economic?

A Yes, I have.

Q And that's what's shown on Exhibit Twenty-three?

A That's correct.

Q And what do you conclude?

A Exhibit Twenty-three, which is a before Federal income tax non-escalated simple cash flow analysis, shows that based on our estimated cost of a new well of $750,000, and using a current oil price of $19.00 per barrel and $1.70 per MCF gas, which does not represent what ORYX would obtain or any particular individual, but simply an educated guess as to what the average price that might be in this area, shows that upon calculating based on the oil production per month and gas production per month, and counting the revenues and subtracting the operating expenses, severance and ad valorem taxes, that we would end up with a net revenue, not counting investment, of $560,000, but seeing as how we would have a drilling cost of $750,000, our net cash flow would be a negative $190,000 in this case. Again, this is the upper limit. This assumes we would obtain 18,000 barrels of oil and 274-million cubic feet of gas from the well.

Q If you use the lower range of estimated reserves, you're using 1200 barrels of oil?

A That's correct.

Q And that's going to be much worse.

A Yes.

Q And the conclusion, then, is shown at the bottom right of Exhibit Number Twenty-four. It's a -- it's a loss of $560,000 plus?

A That's correct.

Q One of the issues we discussed at length at the past hearing was what activities Sun and Dugan had undertaken prior to seeking expansion into the unit for drilling of a well in the east half of 12, and I don't propose that you tell us in detail all that discussion, but would you simply highlight the information shown on Exhibit Number Twenty-five and Twenty-six?

A Exhibit Number Twenty-five and Twenty-six, which were again presented at the May 10th, Case Number 9671, first of all, we have the application to drill that was submitted by Jerome P. McHugh.

Behind that, again on Exhibit Twenty-five, we have the OCD Form C-102 for the well.

Behind that, Exhibit Twenty-six, we have a letter that outlines the various problems that were encountered in trying to drill the originally proposed Continental Divide No. 1, which would have been in the east half of Section 12. The second paragraph shows that initially the east half was force pooled. The well, you know, was proposed, was force pooled; however, there were other complications, a right-of-way with the National Forest Service. The forced pooling order expired, reinstated, and as it turns out, the Forest Service required a road that would be in excess of $100,000 to -- to get into the location and all of these things coupled with the fact that at this point in time in late 1986, early '87, the rules for the pool were somewhat in a state of flux and the reservoir was under a great deal of study. The pressure was dropping at a serious rate that would cause consideration and certainly review of a drilling plan. It shows that there were serious efforts made in order to initially develop this by drilling a new well and at that point in time it simply wasn't a prudent thing to do.

Q Let's go to your conclusions, then, on the drilling options which are shown on Exhibit Twenty-seven, Mr. Dillon.

A Four basic conclusions show that, one, the reservoir data indicates that the existing wells again will recover all the reserves that there are in Section 12, east half and west half. An additional well is unnecessary and again it would only drain reserves away from the existing wells, including the Johnson Federal Well. A new well would be uneconomic and thus is not an effective way to develop the east half of the section. That would be a very short term solution if it were economic from the date of initial potential.

Previous efforts to drill a well again met with numerous obstacles and again that avenue was explored and since it wasn't an option then, it's not an option now.

Q Having concluded that the only remaining viable option for putting the east half into a producing status is participation of the Johnson Federal Well?

A That's correct.

Q Let's turn to Tab E and the information behind that display and see how you have analyzed the method of participation in that well.

What is Exhibit Twenty-eight?

A Exhibit Twenty-eight is a repetition of the previous exhibit that we looked at that showed the production history plotted for the Johnson Federal 12-5. Again we have our forecast plotted here as to what we think the oil and gas production will be in the future from this well. Again we're looking at remaining reserves of 1.5-thousand barrels of oil and 105-million cubic feet of gas.

Q Turn to Exhibit Twenty-nine. What is that?

A Exhibit Twenty-nine is again a net cash flow analysis of the well, present day economics, if you will. Again it's before Federal income tax. There are no escalations. The same assumptions were made. Again, reserves, we just stated, were used.

It shows, taking out operating expenses and severance taxes and ad valorem taxes that our net revenue or our net cash flow at the end of the life of the well when we expect it would be shut in due to being uneconomic at the end of approximately 32 months, would be approximately $84,000.

Q Is this a method that would be utilized if you were making a study to determine whether or not you would recommend to your company to purchase or acquire a producing property?

A Yes.

Q What, if any, relationship does this present value analysis have to the actual cost of the well itself?

A There's really no correlation between this and what the well cost to drill back in 1985.

Q Should there be, Mr. Dillon?

A At this point if we were to again, as you said, using this as an analysis to buy into the well or if we were -- if we owned the well and were considering selling the well, this would be the type analysis that we'd use and any money that had been spent in the past could be somewhat irrelevant in the future value of the well.

Q What does your present value cash flow analysis show you as a bottom line number?

A Again the bottom line undiscounted cash flow would be approximately $84,000.

Q How have you utilized that to determine what your recommendation is for the participation in the well by the undeveloped east half interest owners?

A Taking that data and the suggestion that was received in the previous hearing from the OCD in terms of what a reasonable -- what would be expected to be a cost basis for participation in the well, as you can see in Exhibit Number Thirty, first of all, we've -- we've taken the cash flow and discounted it at various rates.

What we show here are 100 percent cost for the well. We have not broken out 50 percent of it for the east half, we're looking at 100 percent and we'll try to keep that clear as we go through here. We're looking at thousands of dollars plotted here.

You can see in the first group of discount rates we go from zero to 20 percent. We assume that there's no pooling cost. We're looking at simply what the discounted cash flow is from the well. We're looking at no discount again as approximately $84,000. If we were to discount that at 20 percent annually, we would have a discounted cash flow of $70,000.

We can simply apply that, that number versus a current pooling cost which we would expect to pay in order to obtain a net total discounted cash flow of zero, thus giving us various rates of return for our investment. Again it would show that if we had a pooling cost of approximately $84,000 that with no discount rate, we would simply obtain no rate of return. We would simply pay out our investment with the proceeds we would receive from the well.

If we were to pay $80,000 or our share of $80,000, it would be $40,000, for the east half owners, we would obtain a 5 percent rate of return.

If we were to obtain a reasonable rate of return that's accepted industry-wide at 15 percent, we would see that we'd be looking on the order of $73,000, half of which would be approximately $37,000 for the east half owners to pay. Again this is something that if we were to purchase, be purchasing an interest in the well as opposed to a formal forced pooling, this is a type of number that we would be expecting to look at.

Q The bottom of the display shows the original well cost of $565,408?

A Correct.

Q What's the source of that information?

A The source of that information was the order that was entered in 1986 for the original pooling for the Johnson Federal Well.

Q And the $826,000 number is simply a 12 percent annual escalation of the original cost of the well?

A That's correct. If we were to receive

an order that would propose that we pay a basis that was equal to this amount, which -- and this was taken from the Loddy order again, the 12 percent annual interest rate, we would be expected to pay our share or the half of the $826,000. You see there on the righthand side what kind of discounted cash flow we would see and you can see there's clearly no way that that type of investment would be economic for the east half owners for the remaining reserves from the well.

Q Turn now to Exhibit Number Thirty-one, Mr. Dillon.

What is your proposed basis for participation in the well?

A Our basis would be that, one, we'd have an effective date of July 12th, which we had asked for.

The pooling cost would be shared proportionately according to their interest amongst the east half working interest owners again in the unpooled area. These would be paid to the west half owners proportionately according to their interest in the -- in the existing pool.

Our proposal is, as taken from the previous page, a pooling cost of -- for the east half owners of $36,000, which would allow us a reasonable rate of return of 15 percent. It would be also based on the current cash flow of existing wells, certainly would be an influx of money for the existing owners.

The income distribution upon pooling would be shared proportionately, of course, amongst the owners in the entire pool. Of course, for those that consented, royalty owners on both sides again would share proportionately according to their interest. We're proposing a nonconsent penalty for those who do not join in the pooling of 200 percent and again we'd like to point out that, one, the east half owners show only future production. We're not asking for a retroactive order. We don't propose to ask for any compensation for the reserves that have been produced and at the same time we -- the east owners, (unclear) owners, are still at risk in that this analysis is subject to, you know, the different conditions of the reservoir and we certainly don't have any guarantee that we would receive 15 percent or any, any rate of return that the well could become economic in the next month.

And by the same token we aren't asking for any guarantees. We're simply asking for a fair and equitable rate to join in the existing well.

Q Have you also studied the other wells that have been subject to pooling orders in the Gavilan Mancos where existing wells were involved?

A Yes, I have.

Q And is that the information that's shown behind Exhibit F?

A That's correct.

Q All right. Let's go to the orientation display which is Exhibit Thirty-two and have you identify for us the other pooling cases that you have studied.

A Yes. There have been four orders entered for the cases in which wells have been pooled from some acreage to a larger acreage spacing basis. Three of those have been 640s. One, as we've discussed before has been the Johnson Federal Well in question, where it went from 40 to 320 acres.

The other 640-acre proration units are shown by the northeast-southwest dashed lines within the sections.

We have the Amoco Seifert Gas Com No. 1 in Section 22 of 26 North; the ORYX Wildfire Well in Section 26, that same township; and the ORYX Loddy No. 1, which is in Section 20, Township 25 North.

Q All right, sir, have you summarized some of the basic terms of those various orders?

A Yes, I have.

Q That's Exhibit Number Thirty-three?

A That's correct.

Q And what do you find when you look at those various orders?

A Exhibit Thirty-three shows when you look at the basis for pooling costs and nonconsent, that there had not been a real consistent basis that had been provided by previous orders.

We have shown here on this table the well, the date of the order, the basis for pooling.

There's data for the Loddy No. 1. The basis there was 100 percent of the total well cost plus an interest rate applied to that between the date that the well was drilled and the date of the pooling order.

The Seifert Gas Com No. 1 was based on 125 percent of actual drilling cost. It was based on what was a turnkey type of operation from a drilling company and it was not related to (not clearly understood) either.

The Wildfire No. 1 was based on 100 percent of actual total well cost with no other monies involved at all.

The Johnson Federal 12-5, back in 1986, again was 100 percent of actual well cost.

The case in question again is not unique in that the Wildfire and the Seifert cases again involved leases that within a relatively short time after the date of the hearing expiring and were simply ways of putting the tracts into production that otherwise probably would not be able to get into production in the Mancos Pool.

Q Excuse me, which ones were other cases that were generated because of short term leases?

A That would be the Seifert Gas Com No. 1 and the Wildfire No. 1.

Q Do you have an opinion, Mr. Dillon, as to whether or not the Examiner ought to adopt as a participation formula a sharing of the actual total costs on the Johnson Federal 12-5 Well for the east half owners now?

A Yes, I do.

Q And what is that opinion?

A Based on the (unclear) of these four previous pooling, which were all entered and were all accomplished early in the life of the wells, within a time when the wells were still in a clearly economic state, the -- what was appropriate at that point was some basis of the pooling cost that was relative to the actual drilling costs.

The Johnson Federal at this point is somewhat an exception to that in that we're nowhere near the initial date of completion. There is no question that the remaining reserves are certainly not sufficient to pay out what would be the well cost should we redrill the well at this point in time.

So that at this point in order for a fair basis to be established, the participation would be --

have to be done on some other basis, which I believe would have to be related to the remaining reserves from the well.

Q Let's turn to your production history on the Loddy No. Well, Well No. 1, Exhibit Thirty-four.

A Yes.

Q At what point in the producing life did the Division enter a pooling order as you've described?

A The Loddy No. 1 had been producing for a little over a year at the point that a pooling order was issued there. You can see that annotated at the bottom of the graph. Again we have oil, gas and GOR plotted here.

We can see that the well was consistent in production and in trend actually was stable, if not somewhat trending upward in terms of production. The fluctuation was due primarily to various allowables that were stated as we -- as we know in the pool over the last few years.

In general it shows that the well was certainly still economic and still certainly capable of producing a substantial number of reserves at the time that the pooling was initiated.

Q Let me make sure I understand. At the time of the pooling initiation the -- what's the general range of the cost of these wells that we're dealing with in the Gavilan?

A The, as we can see, the Johnson Federal was on the order of $565,000. Our most recent estimates are on the order of $750,000. Wells have been drilled for everything in between those two numbers. An average number might be somewhere on the order of $650-to-700,000.

Q In reviewing the information from the Loddy order and identifying the decision date in relation to its producing date, was there anyone, or can you contend, based upon this data, could anyone contend that the remaining future reserves for the well were going to be insufficient to pay for the cost of contributing 50 percent of the cost of the Loddy well?

A I don't believe so.

Q Correspondingly, then, the remaining reserves should have been sufficient at that point that the order was entered, to pay for the cost of contributing 50 percent of the well by those owners that had not yet participated.

A Yes.

Q When we look at Exhibit Number Thirty-five what do we see?

A On Exhibit Thirty-five we see the same type of plot for the Seifert Gas Com No. 1. Again the date of the pooling order was in late April of '88. At that point the well was -- had not established a trend. It was producing on the order of 30 barrels of oil per day, around 150 MCF per day.

Again it was clearly economic at that point and based on surrounding history certainly was in all probability capable of paying out and there would not be any basis for saying that it was clear that the well would not pay out and that there was no basis for tying the pooling cost to the original well cost of the well.

Q I believe you've shown us in a prior display that the Seifert solution was for the undrilled or undeveloped 320 to pay 125 percent of the actual cost of the well for participation in the well?

A That's correct.

Q And that, and the Seifert interest owners in the undeveloped tract participated from the date of first production, did they not?

A I believe there's a question as to when that date was, but, yes, that's -- that's what the order established, I believe.

Q And again with the Seifert Well based upon the production history at the time of the order, there's no question that the data showed that the remaining reserves would pay for the cost of buying your way into the well at 50 percent of the actual cost?

A Yes. There was -- that interpretation

certainly is -- can be made, yes.

Q Let's go to the Wildfire Well, Mr. Dillon. That's Exhibit Number Thirty-six. What did you find when you examined the Wildfire Well?

A At the time that the Wildfire Well was pooled there was no significant trend in production data due to a number of complicating factors, gas line hook-up, marketing, and such. There was -- there was not a significant amount of production prior to the time that the pooling was performed. There were early tests that indicated that the well was a -- certainly is a very capable well, somewhat high in GOR, but yet the total revenue from the well certainly would be -- make it an economic venture. Again the decision there would be it would require some engineering and economic judgment, but it certainly wasn't an obvious case where the well was going to be uneconomic.

Q All right, sir, and Exhibit Thirty-seven?

A Exhibit Thirty-seven is the -- again the Johnson Federal Well. As we see back in 1986 when that well was pooled initially, it's initial production from the first part of 1986 was on the order of 90 to 100 barrels of oil per day. You can see with that type of an initial performance that that certainly is going to be a well that you would expect at that point in time and based on individual engineering judgment, you would assume that it would easily pay out any portion of the original well cost.

Q Turn to Exhibit Number Thirty-eight and have you detail for us your conclusions again.

A Again conclusions from study of previous pooling shows that once again consistently all these were done early in the producing life of the existing wells at a point when the wells were clearly economic and producing at rates that certainly would give you some comfort in the fact that they would compensate you for your pooling cost if it were tied to the original well cost, and it appears, it shows that looking at the previous order, that compensation of original owners of a pooled well included some consideration of the potential future recovery from the well. There was never any question brought up that all the wells would be economic in any of the orders or findings that I can find. When a well is pooled early in its life, of course, a pooling cost near the actual well cost, may be appropriate and probably is appropriate, and there's no -- certainly no reason that a -- some compensation shouldn't be made for the risk that was taken at that point in a well's life but, however, based on an expected return for the pooling cost of a well relatively late in its life, I believe should be downward, be adjusted according to -- to what we expect it to produce in the future.

Q Let's turn to Tab G, Mr. Dillon. What have you included in that section of your exhibit book?

A Tab G is -- contains a copy of each of the orders of the four previous poolings that we've talked about, the Loddy, the Seifert, the Wildfire and the previous order on the Johnson Federal Well.

Q All right, then finally, Exhibit Thirty-nine?

A Exhibit Thirty-nine is simply restating the conclusions that we've come to as we've gone through this study and that certainly drilling an additional well to develop the east half of Section 12, we believe from a reservoir standpoint would be unnecessary and certainly would be a waste of economic resources. Pooling of all of Section 12 into the Johnson Federal Well, we believe is the -- is the correct way to pursue this. It would allow the working interest and royalty interest owners to -- in the east half, to have an opportunity to participate in production from the Mancos, which they otherwise would not have.

Pooling all of Section 12 would protect the correlative rights of all the ownership of the section. Any new well, again, is going to further decrease the cash flow, the economics; would drain reserves from any of the existing wells.

And again the pooling basis can be made

fair, we believe, to those now joining in the proration unit without creating additional burdens for those who are already interest owners in the well or reducing their value.

We have come to this conclusion and pursued this avenue based primarily on the suggestion of the -- of the Commission at the previous hearing, that some basis other than the well cost might be appropriate, and that's why we're here today and that's why we have this recommendation.

MR. KELLAHIN: Mr. Examiner, that concludes my examination of Mr. Dillon.

We would move the introduction of his Exhibits Eleven through Thirty-nine.

MR. STOGNER: Are there any objections?

Exhibits Eleven through Thirty-nine will be admitted into evidence at this time.

Mr. Pearce, your witness.

MR. PEARCE: Thank you, Mr. Examiner.

CROSS EXAMINATION

BY MR. PEARCE:

Q Mr. Dillon, just a few questions. I am unclear. There was a June 8th letter from ORYX to other working interest owners that we discussed with the previous witness. Are you familiar with that?

A Yes.

Q That letter made a reference to paying your -- the costs assessed against ORYX if they are pooled into this well out of production from the well. Do you recall that?

A Specifically that option, I -- I really don't recall. No, I have to admit that. I've got (unclear) in front of me here.

Q Okay. If you would turn to the third page of the letter which is Exhibit Number Eight that we discussed earlier.

A Yes.

Q It says that they shall have the option to either pay the $40,000 or recoup it out of production. About four lines from the bottom of that paragraph, do you see that sentence I'm talking about?

A Okay, yes.

Q Has ORYX made a decision, if it gets the order it seeks in this case, whether or not it would pay those -- what you now propose, $36,300 participation costs, whether you would pay that or pay that out of production?

A That approval has not been obtained from management. It would be my recommendation to them, and I would anticipate that that would occur; however, I cannot guarantee what -- what our management would approve, but that is what I would recommend, yes.

Q Okay, and if I understand correctly, the payment of that sum in your best engineering judgment would result in a 15 percent return, is that correct?

A That's correct.

Q Okay. We talked about a couple of other wells. If we can look at them one at a time and we may need to do some flipping back and forth.

Let's look first at the Seifert Well. Do you recall who operates the Seifert Well?

A That's operated by Amoco.

Q And someone pooled into that well, as I understand it?

A That's correct.

Q And who was that?

A I believe that was initiated by Dugan Production.

Q And by the terms of your exhibit which summarized those previous orders, and if you could help me with an exhibit number, I do not remember it.

A The summary? That would be behind Tab F, about the second page.

Q Thank you. Under the provisions of the Seifert order, which is located behind Tab G, the party who pooled into that well was to pay Amoco 125 percent of the actual costs of drilling and 100 percent of surface equipment cost, is that right?

A That's correct.

Q Do you know if those payments were made or if those parties are going nonconsent in that well?

A The Seifert, I do not know the results of that.

Q Do you know whether or not the Seifert Well has paid out?

A I would anticipate based on its life that it probably has not, but I do not know that for a fact.

Q Do you know whether or not the Seifert Well will pay out during the course of its life?

A I have not made an analysis of -- of the future production from that well, no.

Q Do you know what the current production rates from the Seifert Well are?

A According to the information which I have, which would be the plot that would -- that I have included as Exhibit Number Thirty-five, that shows that the current oil rate from the well is -- has been fluctuating.

The latest one that I have is approximately 18 barrels of oil per day, producing about 180 MCF per day.

And that would -- based on the past performance, it would -- it would be difficult to determine it. It's certainly possible that the well could pay out. I would be certainly speculating if I were to hazard a guess as to whether or not that well will pay out.

Q I assume from the way you answered that question that you don't think the Seifert Well is going to make anybody rich.

A It's not an obvious decision, no.

Q Let's look at the Wildfire Well, please. Could you tell me who operates the Wildfire Well?

A That's operated by ORYX.

Q And someone pooled into the Wildfire Well?

A That's correct.

Q And who was that?

A That was Hixon.

Q And the terms of that pooling, looking back to our summary again?

A That was 100 percent of the actual cost.

Q Has the Wildfire Well paid out?

A No, it has not.

Q Do you expect it to?

A Based on the amount of data that we have, again it's certainly possible that that well could pay out. I do not have those figures. I have not made that analysis for these purposes.

Again, it's very possible based on its gas rate. It's a fairly high GOR well. It's not a prolific oil well; however, it certainly would generate a considerable amount of revenue.

Q And, I'm sorry, who pooled into that well? I've forgotten.

A The Wildfire, it was Hixon.

Q And did Hixon pay that 100 percent of cost or are they going nonconsent?

A I believe in that case their option, to the best of my recollection, is to go nonconsent.

Q The Loddy Well was pooled 100 percent of total cost plus the interest from drilling pooling?

A That's correct.

Q Who pooled into that well?

A That was a unit, an ORYX operated well, and it was pooled into by Mesa Grande.

Q And did Mesa Grande pay their portion of well costs or are they going nonconsent?

A I believe their option is to go nonconsent.

Q Do you believe the Loddy Well will pay out? Or has it? I apologize, I've assumed something. Has the Loddy Well paid out?

A From initial production I cannot say whether or not it's paid out. It certainly, if it hasn't, it probably is close. I believe it will and I believe it will probably pay out again from the date of the order.

Q Look, please, with me at your Exhibit Number Thirty-nine. Looking at the last conclusion stated there, the pooling basis can be made fair for those now joining in the proration unit without creating additional burden or reducing value to the current working interest owners.

Could you describe for me what you believe the value to the current working interest owners is?

A Their value certainly is what revenue they would obtain from future production from the well.

If it were pooled, obviously part of that value would be the compensation they would receive from the east half owners. That compensation they would receive would be current value, money, cash that they would put into the bank at his point. Any future production would be subject to discounting in terms of bringing it to present value and would subject to, of course, any risks in obtaining those additional reserves.

Q What is the value to the current working interest owners if the east half is not pooled with the west half?

A According to my cash flow calculation that would be for 100 percent basis, approximately $84,000.

Q That $84,000 consists of pooling into the west half.

A No, that's the simply the undiscounted cash flow that the west half owners would see from this point forward from the well.

Q If the east half is not pooled with the west half, what is the value to the current working interest owners of the east half?

A If I understand what you're saying, if it's not pooled?

Q Yes.

A The -- I'll say there is no value if there is no compensation to the east half owners.

Q And one of the analyses you did was the amount that would be lost if the east half were drilled separately, and that was between $190 and, I believe, $560,000, is that correct?

A Yes, I believe that is correct.

Q Mr. Dillon, when you began your testimony a little while ago, you had some -- some comments about what the purpose of your study was, as I recall.

What -- what was the purpose of your study that you've been discussing with us?

A As part of the continuing effort to put the east half into production was to look at all options that we might have. We've explored those on some previous occasions, and, as we say, we're down to two. The final objective, as we've seen in the majority of the study as we see it here today, was to determine what kind of a value basically that we believe the east half owners could pay and expect to participate in the pooling and the additional production we expect from the Johnson Federal 12-5.

Q The object was to analyze the best way to get the east half of Section 12 on production.

A Yes.

Q Is that accurate?

A That's accurate.

Q And you just indicated that the current value of the east half standing alone is a negative number ranging from 197 to $560,000. Is that correct?

A Correct.

Q And your proposal summarizing your study would in your best engineering judgment provide to ORYX a 15 percent return on its proposed investment in a well on a 640-acre spacing unit.

A Yes.

Q I have a feeling that at another hearing you've answered this question for me or someone else did, and I apologize, I don't remember the answer.

In the lease that you hold of this acreage that's due to expire on July 31st, 1989, is there any other acreage covered by that lease or is that just a quarter section of acreage?

A That is just a quarter section of acreage, to my knowledge.

Q Looking at the summary behind Tab F that we've discussed a couple of times for other pooling cases that have been heard, you're proposing participation in this well on payment of $36,300. What kind of percentage number of total well costs would that result in compared to the 100 and 125 and the 100 and 100 numbers on that summary? Isn't that the order you wanted and summarized it in this form?

A Uh-huh.

Q What would that summary say?

A Relative to total well costs, of course, it would be the -- simply the 36,000, whatever, divided by the original well cost, being $565 - $566,000, approximately. It's going to be less than 10 percent of the -- I'm not sure exactly, 7 or 8 percent, probably, of original well cost.

Q I think for -- for clarification looking at the 100 percent, 125 percent figure set forth on Exhibit Thirty-three, I think you would find that those are for full wells, so in this case the numerator, I think, would be 72 rather than -- 72-6 rather than 565, but roughly that sounds like it's 13, 14 percent, and I haven't figured it out, but it's 72,000 over 565,000, so we would have a string of pooling orders which provide for 100 percent and 125 percent and 100 percent and 100 percent and 13 percent.

MR. PEARCE: I don't think I have any questions. Thank you, sir.

MR. STOGNER: Mr. Pearce. Mr. Lopez, your witness.

CROSS EXAMINATION

BY MR. LOPEZ:

Q Mr. Dillon, in general, when ORYX drilled the well to recover anticipated reserves underlying (unclear) I believe ORYX would expect to recover its well cost plus how much rate of return would, 3-to-1, 2-to-1, what in general does ORYX hope to recover when it takes on the risk of drilling a well?

A There are a number of economic indicators that are looked at. It's usually not one single indicator. Certainly something on the order of what you've just stated would be something that we would expect to find here.

Q I'd like you to refer to your Exhibit Number Twenty-nine and where you're estimating the current remaining value of the Johnson Federal Well, and you arrived at the net revenue cash flow of 83.73 thousand. This figure doesn't provide any value or compensate the operator of the well for any of his drilling (unclear)?

A No, it does not.

Q Nor does it include the salvage value of the equipment that might be sold after (not clearly audible).

A No, that's correct. The assumption is made that any salvage value would be simply equal to whatever costs are involved in actually salvaging that equipment so that that would be a net zero negative and no cash flow at that time.

MR. LOPEZ: No further questions.

MR. STOGNER: Mr. Kellahin, any redirect?

MR. KELLAHIN: No, sir.

CROSS EXAMINATION

BY MR. STOGNER:

Q I want to clarify one thing that I'm still a little fuzzy about. Where did you come up with 36.3? I want to make sure I have exactly where I can put my finger on that figure, and, let's see, the way I interpret that in your letter of June 8th is half of the current net present value of the subject well, is that correct?

A Yes.

Q And where do I find that present value at?

A That present value is on the exhibit we were just talking about, Exhibit Number Twenty-nine.

Q Okay.

A And at this point our -- we've refined to just a very small degree since that letter that number. We're looking on the order of $84,000 a day in undiscounted net cash flow rate, net revenue for that well.

Q So it's half of 83.73?

A Well, the -- now, that's again undiscounted. In order to come up with the number we assumed that in order to simply more than just pay out the well, rather than simply obtain, you know, our last dollar of revenue at the same time that would simply compensate our last dollar of cost in getting the well, Sun sort of returned with the same by ORYX, and that is shown on the next exhibit, Number Thirty, where if you look, you know, both the middle set of discount rates, a 5 percent discount rate on that $83.7 thousand would be $80,000.

If we go down to the 15 percent number that we've proposed, we've proposed that half of that -- again, this 84,000 or the 73,000, which is discounted, is for 100 percent of the well as it exists today.

When -- once it goes from the 320 to the 640, the east half would be essentially involved in one-half of that well, so we would take half of that number, so that's where we come up with the 36,000-odd number.

MR. STOGNER: Any other questions of this witness?

If not, he may be excused.

Let's take about a 15 minute recess.

(Thereupon a recess was taken.)

MR. STOGNER: The hearing will come to order.

Mr. Pearce?

MR. PEARCE: Thank you, Mr.

Examiner.

If I may, I would like to call Mr. Joe Cox to the stand, please.

JOE COX,

being called as a witness and being duly sworn upon his oath, testified as follows, to-wit:

DIRECT EXAMINATION

BY MR. PEARCE:

Q Mr. Cox, for the record would you please state your name and your employer?

A Joe Cox. I'm employed by Mallon Oil Company as Production Manager.

Q Mr. Cox, have you testified before the New Mexico Oil Conservation Division or one of its hearing examiners previously?

A Yes, I have.

Q And were your credentials at that time accepted as an expert in the field of petroleum engineering?

A They were.

Q And are you familiar with the case being heard by the Examiner today?

A Yes, I am.

Q And have you conducted a study, the results of which you propose to present at this hearing?

A Yes, I do.

Q All right.

MR. PEARCE: At this time, Mr. Examiner, I tender Mr. Cox as an expert in the field of petroleum engineering.

MR. STOGNER: Is there any objection?

MR. KELLAHIN: No objection.

MR. STOGNER: Mr. Cox is so qualified.

Q All right. At this time, sir, I'd ask you to refer to what we've marked as Mallon Exhibit Number One and would you please describe that for the examiner and those in attendance?

A Okay. This is an AFE recap, a summary of all the costs in the drilling and completion phase of the Johnson Federal 12-5 Well.

Q Were you in the hearing room this morning when the first part of this case was heard?

A Yes, I was.

Q And you heard the testimony that a cost figure for the Johnson 12-5 Well had been derived from the previous order, is that correct?

A Yes, I heard that.
Q Do you recall what that number was?
A Roughly $565,800 and some.
Q And $40.00.
A $40.00.
Q And I'm taking that from Exhibit Number Thirty previously admitted into evidence.
I would ask you, sir, to turn to the second page of your Exhibit Number One. There is a figure shown at the bottom of those columns, far lefthand column, of $566,971. Do you see that number, sir?
A Yes.
Q Is that the most recent accounting summary which relates to the $565,000 number we talked about before?
A Yes. This is from a June 28th accounting statement on those costs.
Q So about $1100 has been added to the drilling and completion accounting for this well since the time of that hearing?
A Correct.
Q And to the best of your knowledge the 566,971 is the -- is presently the most accurate accounting number available?
A Yes.

Q Mr. Cox, have you reviewed the production history and economics of the Johnson 12-5 Well prior to coming to this hearing?

A Yes, not in any great detail or evaluationwise, but I've reviewed the history and know the current production status and everything.

Q Has the 12-5 Well paid out yet?

A No, it has not.

Q What is the current sum due to be paid before payout is reached on this well?

A It still has $348,020 remaining to payout.

Q And, under current operating conditions, Mr. Cox, is the Johnson 12-5 Well ever going to pay out?

A Not under present circumstances, I don't foresee that.

Q I assume, therefore, that Mallon as the party who spent the money to drill this well and bore the risk, is not going to get 15 percent, is that accurate?

A That's the prospect facing Mallon and its partners.

Q Mr. Cox, during testimony of Ms. Staley earlier in the morning, she made reference to a letter and we discussed a letter which she had received from Mallon Oil Company in response to the request for the pooling. Do you recall that discussion?

A Yes.

MR. PEARCE: That is, Mr. Examiner, the first letter shown in Exhibit Number Nine to the previous -- to Ms., I'm sorry, to Ms. Staley's testimony.

I have just handed a copy of that letter to the witness.

Q I would ask you, Mr. Cox, to turn to the second page of that letter. The last paragraph indicates that Mallon at that time was willing to agree to ORYX' participation in this well on terms similar to those which Mesa Grande received in the Loddy pooling case. Do you see that?

A Yes.

Q And is that still Mallon's position, that that is an appropriate order to be entered in this case?

A Yes, that would be agreeable to us with some returns.

MR. PEARCE: I don't think I've got anything further, Mr. Examiner. Thank you.

MR. STOGNER: Thank you, Mr. Pearce.

Mr. Kellahin?

MR. KELLAHIN: Thank you, Mr.

Examiner.

CROSS EXAMINATION

BY MR. KELLAHIN:

Q Mr. Cox, did you participate in any way on behalf of your company in the hearing on the Johnson Federal 12-5 Well that resulted in the pooling of the Mesa Grande interest?

A No, I was not directly involved with that.

Q Were you employed at that time with Mallon Oil Company?

A I was employed but I was involved with other areas operations then.

Q Did you bring with you your economics to show the status of payout? You said you reviewed some data. Did you bring those with you?

A I have another Accounting Department statement that shows that.

There are some additional copies (unclear).

Q You were here in the hearing room when Mr. Dillon testified about his study of the well and the specific area involved, were you not, sir?

A I was.

Q Do you have any available data to you that would give you a contrary conclusion from Mr. Dillon's about the drilling of a well in the east half of 12?

A No, I would not dispute his conclusions about the noncommerciality of drilling a well in the east half.

Q You concur, then, that the -- a well in the east half of 12 for the Gavilan Mancos would in fact be an unnecessary well?

A Yes, without having studied it, I would.

Q Do you have any disagreement with Mr. Dillon's reserve calculations using his methodology to show the remaining producable reserves for the Johnson Federal 12-5 Well?

A There are a few concerns that I have had, one being the fact that no consideration was given for the mechanical status of the well with -- for the producing months that the initial producing rate was established from and the well's been affected by gas plant shut-ins and by changing of lift systems and at present we don't have any lift system on the well. We're in between running rods back in the well and a plunger lift.

Q Have you done an economic analysis -- I'm sorry, a reserve analysis to determine what are the remaining reserves for the Johnson Federal 12-5 Well?

A I really haven't done a formal analysis of that current completion.

Q Has anyone in Mallon Oil Company done that?

A There have been a number of economics run on various Mallon properties recently and I'm sure that there has been, but I did not bring one with me.

Q Do you know what Mallon is utilizing for your remaining reserves for the Johnson Federal 12-5 Well?

A I do not, no.

Q I'm trying to understand the basis upon which you told Mr. Pearce that you doubt that the well would pay out and that was my only purpose in the question, is to see to what extent you'd attempted to quantify the degree of payout you might achieve in the well.

A Well, just with the -- with the reserves recovered so far being recovered at so much higher rate, so much further above the economic limit, and still having a fairly large amount of money left to recover to pay out, it does not appear that we're going to be able to sustain production long enough to get the well paid out.

Q Do you know or have you determined whether or not the parties that were pooled as a result of the first Johnson Federal order in fact exercised the election to participate in that well?

A I do not know.

Q Do you know what parties were in fact pooled by the Johnson Federal order that was entered to change this to 320 pool spacing?

A Mesa Grande originated the action for pooling.

Q All right. But do you know what parties were subject to the order?

A Mallon, et al, original working interest in the well, and Mesa Grande.

Q Let me show it to you. It's Order R-8262. It was entered August of '86. It's Mallon's application.

Have you studied to determine whether or not Mesa Grande paid its share and participated then with Mallon in -- in the production from the Johnson Federal 12-5 Well?

A No, I just very briefly got a look at that pooling procedure and I really don't recall whether they did or not.

Q Is it your proposal that the current interest owners in the west half of 12 will in fact keep the past production from the well and not have to share that part production with the owners in the east half?

A Yes, I think that would be a reasonable way of proceeding on this well, just looking at the production figures versus the date of the change to 640-acre spacing in the pool. About 95 percent of the production occurred prior to that date.

Q You propose not to allow the east half owners to participate in past production but your proposal is that they ought to pay 50 percent of the actual costs of the well as originally drilled?

A Yeah, I would feel like the precedent that has been set by previous poolings should be followed in this for consistency purposes.

Q Is there any other basis for your opinion that that is fair other than it's simply consistent?

A Just that any future unrealized potential, unevaluated potential, from the well would not be covered and the partners that have put their money at risk would be giving away a good deal should that occur.

Q Have you attempted to evaluate what this property is worth now, meaning the west half of Section 12?

A I've done a rough calculation, just to see where my calculation stands compared to ORYX's. I come up with a figure that's not too far, within 50 percent of their figure.

Q What figure do you come up with, Mr. Cox?

A About $125,000 but that again is a very rough calculation.

Q What's the basis for a difference between you and Mr. Dillon on how you got your number?

A Probably initial production rate and then the fact that his gas/oil ratio shows a decrease with time and in reality I held mine constant, but up till the present it has been continually increasing.

Q Mr. Dillon's economics were based upon remaining oil reserves of about 1500 barrels of oil, I believe.

What did you use?

A Again, in this rough calculation, this was not a formal computer evaluation run, but I think it was about 2800 barrels. And again, that is at the present mode of operation of the well without any changes or work done on it.

Q Have you determined what level of contribution the east half owners would have to pay the west half owners in order to have a break even investment for the remaining future production on the well?

A Well, not having a number that I'm very comfortable with as far as an evaluation for the reserves under the present producing situation, it would be somewhere around this figure that I threw out, the 124,000, plus -- their share of that, plus the balance to pay out, plus a reasonable amount for a risk factor on their money.

Q The actual cost on the well is on your exhibit, the 566,971, right?

A That's correct.

Q And so you're proposing that the east half owners pay something in excess of $283,000 to share in their share of the 2800 barrels of oil and other hydrocarbons that are yet to be produced from the well.

A Yes, it would be in excess of that, yes.

Q If you were in their position would you make that payment to participate in the remaining reserves?

A I don't know exactly what they have in mind so I really can't make a judgment for them, but I probably would not elect -- I would probably not consent to that.

Q Yeah, you wouldn't write your check and participate on a pooling order, would you?

A No.

Q Would you do it for $200,000?

A I doubt it.

Q 150,000?

A You're asking me personally.

Q I'm asking you as a recognized expert that's qualified before the Commission as an engineer --

A No, I --

Q -- and testifying about this particular well of which you have personal knowledge.

A I would not.

Q How about 100,000?

A I may at 100,000, yeah. That again is without any consideration that any production beyond what's (not clearly understood) production history of the well, without any further knowledge.

MR. KELLAHIN: No further questions.

MR. STOGNER: Any redirect?

MR. PEARCE: A couple more, Mr. Examiner, if I may.

REDIRECT EXAMINATION

BY MR. PEARCE:

Q Mr. Cox, you went through some analysis with Mr. Kellahin about the payments to get into this well.

If an order consistent with orders previously entered results from this case and the cost to participate is $286,000 or whatever the number is, will the royalty owners under the east half begin receiving royalty immediately?

A Yes, that's the way the other orders

have been issued.

Q And do you understand that the lease would be held if that were done?

A Yes.

Q Mr. Kellahin asked you a question about what payments would be necessary to break even to allow a party to participate in this well in the future. What's 50 percent of the cost of this well ignoring its operating expenses, looking at your Exhibit Number One? What's 50 percent of that number?

A It would be $283,500.

MR. PEARCE: Nothing further, Mr. Examiner.

One matter for clarification before we go further.

Mr. Examiner, we -- we put before the other parties in this room, but not before you, a summary of a recap of the payout statement on the Johnson 12-5 Well. Would you like that made an exhibit to this proceeding?

MR. STOGNER: We might as well.

MR. PEARCE: All right. I will, if it's all right, I'll mark it as Mallon's Two, if that's acceptable. It is called a recap of payout statement.

Nothing further, Mr. Examiner.

MR. STOGNER: I guess we should enter this at this time. Is there any objection?

MR. KELLAHIN: No objection, Mr. Examiner.

MR. STOGNER: Exhibit -- Mallon Exhibit Number Two will be admitted into evidence at this time.

Mr. Kellahin?

RECROSS EXAMINATION

BY MR. KELLAHIN:

Q Mr. Cox, let me follow up with you on Mr. Pearce's question. Let me show you Ms. Staley's exhibit book which has Exhibit Three in it. I put in front of the witness, Mr. Examiner, Exhibit Three from the ORYX exhibit book.

Mr. Pearce asked you whether or not the royalty owners in the east half of the section would as a result of the pooling participate then in receiving royalties from future production and the answer was yes.

My question for you, sir, the royalty owners are the same for the east half and the west half, are they not? It's the Federal government, isn't it?

A There are some overriding royalty owners that are different in the west half than from the east half.

Q The royalty owners, apart from the overriding royalty owners, the royalty owners are common, that's the same.

A Yeah, to my understanding, yes.

Q What are you using for your overhead rates for the well? Ms. Staley talked about three different JOA's, each of which had a slightly different overhead rate? If the Examiner enters a pooling order and utilizes a rate, what is the current rate?

A The current rate that apparently comes out in the average of the monthly rates that you use, is $389 per month, producing.

MR. KELLAHIN: Thank you, Mr. Examiner.

MR. STOGNER: Thank you, Mr. Kellahin.

Is there any other questions of this witness?

He may be excused.

Are there any other witnesses to be called by either party?

I believe we're ready for

closing statements if there's any to be made.

Mr. Lopez, I'll let you go first. Mr. Pearce, second, and Mr. Kellahin, you may go last.

MR. LOPEZ: Thank you, Mr. Chairman, Mr. Examiner.

I believe as I stated at the opening, Mesa Grande has no objection to the tract being pooled as a 640-acre tract. That's not at issue.

The issue is the basis on which ORYX should participate.

It is our position that since it is manifestly clear, even based on ORYX's own testimony and evidence that, as they calculate the value of the remaining reserves in place to be $83,730, that with the operator, Mallon, looking at $348,000 to recoup it's investment, to allow ORYX to come in on the basis that they have requested is just simply unfair.

They can elect to go nonconsent, as most of the force pooled parties have in the other orders, and play the game that way, or they can allow the lease to lapse. They have other options rather than coming on a well that Mallon and Mesa Grande, who elected to participate, have paid significant sums of money which they never expect to recuperate; they will never to compensated for the risk they undertook, and for ORYX to expect at this point in the game to come in and obtain a reasonable return just doesn't make sense.

That's all I have to say.

MR. STOGNER: Thank you, Mr. Lopez.

Mr. Pearce.

MR. PEARCE: Thank you, Mr. Examiner.

I think it's an unusual proceeding. Witnesses have testified that the value of the east half of Section 12 is somewhere between minus 200,000 and minus $560,000.

Witnesses have testified that the cost of drilling the Johnson Federal 12-5 Well was $566,000.

Witnesses testified that remaining to be paid before payout of the Johnson 12-5 Well is about $348,000.

The application is to pool into the Johnson 12-5 Well, pay $36,300 and get a 15 percent return. That's in the face of a rather extended and rather well documented Commission position on these matters. We've been referenced to four cases in which a party has pooled into a well because of an increase in spacing in this particular pool.

One of those parties paid 100 percent of cost and one of those parties paid 125 percent of cost. A third of those parties paid 100 percent of cost. A fourth of those, the fourth of those, the order provided for 100 percent of your share to get into the well.

We're confronted with that application which seeks to contribute 13 or 14 percent and according to -- to the witness, would be the only party who gets any return out of the investment in this well.

I'd just like to echo Mr. Lopez' sentiment that that's not fair. If ORYX is desirous of holding the lease in the east half of Section 12, ORYX may do so, but the tradition of the Commission has set forth the conditions under which it has to do that in two other cases which involve leases with very short expiration dates.

I don't know those parties, I don't know what they did, but that's what they had to live with, what other people who have come before this body have had to live with, and I don't think there's anything different about this case. If the lease is that important to them, then they can pay their share of the fair cost, and if it is not that important to them, they may either ride the well so that it's paid out of production or they can let the lease lapse.

The function is running rampant that somehow this property has to be brought on production, although it can't be developed (unclear). It has a negative present value. Something's awry and the Commission knows how to handle these cases and people ought to be able to the decision of what they're going to do and get on with it.

Nothing has been presented at this hearing which shows that this differs radically from anything else that the Commission has considered in this type of case and I suggest that an order along the line of the Loddy order, referenced as what's been done historically in ORYX's correspondence, is the appropriate order to have entered in this case.

Thank you.

MR. STOGNER: Thank you, Mr. Pearce.

Mr. Kellahin.

MR. KELLAHIN: Thank you, Mr. Examiner.

I'd like to reference you to the pooling statute for a couple of items that I think are of importance.

We're looking at 70-2-17, Subparagraph C. You'll find in the top of the continuation of the paragraph from the bottom of the page, it says the Commission can do certain things concerning forced pooling orders, and it's interesting language that I must say I hadn't recognized until recently. We often talk to you about waste and correlative rights with an "and" between the words, but you are entitled by statute to enter a pooling order that accomplishes no other purpose than the avoidance of the drilling of an unnecessary well. It's an interesting sentence. It says, "The Division, to avoid the drilling of unnecessary wells or to protect correlative rights or to prevent waste...". It doesn't say "and" in there. It says "or" and "or" must have some meaning or they wouldn't have put it in there.

We think that you can enter the order simply for the undisputed, uncontested fact that this well is unnecessary.

This reservoir is highly connected fracturally; that the reserves in the east half for which those owners are entitled to compensation is being depleted by other wells.

To say it has no value simply means that it no longer affords or supports the cost of drilling a new well to get those reserves, but there is no one here contending this is goat pasture. This is not one of those pooling cases where someone is seeking to participate with barren lands. No one has raised that yet in this case and certainly no one will.

I think that's an interesting point.

The other one in the statute is that well costs. If you'll read the next full paragraph and it takes some patience to get through all the complicated sentences, but if you read the next full paragraph, you'll find that well costs are pegged only against nonconsenting owners when you determine risk factor. There is nothing in here about pegging well costs as the basis upon participation for a consenting owner. The language is in the top of that paragraph and it says, "On such terms and conditions as are just and reasonable and will afford the owners, or owners of each tract or interest in the unit the opportunity to recover or receive without unnecessary expense his just and fair share."

We say our just and fair share is 50 percent of the remaining reserves and we ought not to have to pay 50 percent of the original cost of the well and let Mallon and Mesa Grande keep some 30,000 barrels of oil. There's nothing fair about that. How are we ever going to participate? We can't. And so what occurs is what has happened in all the rest of these pooling orders that Mr. Pearce took great patience with Mr. Dillon to explore. They're absolute failures. Are we going to repeat that again?

None of those were constructed in a way that induced the people to participate.

Look at the Loddy order, the Seifert order. They were all constructed well in the early life of the property in which parties could make a conscious choice based upon those decline curves, they say yes, they had remaining reserves that were going to pay for their contribution.

That is not the case here. And even in those cases where there was remaining future production, people didn't exercise the choice to join. How is that going to be fair? To do that now in the later life of a well that obviously is not going to return to the east half owners the $268,000 that Mr. Cox would like to get from them for which he certainly recommend anyone paying.

If we follow the solution in the Loddy order I think it's factually distinguishable and it's certainly no solution at all. We'll simply end up being nonconsent interest owners. We think that's a poor choice. It's inconsistent with the statutory language in the rule. We have brought forth to you what we think is the way to value this property and it's the way it's commonly done in terms of buying and selling producing properties.

There is no windfall to us for making an investment. We're getting a modest return. It's certainly not three times our money. The risk that Mallon and Mesa Grande took is not one that we can now share in. That's a risk that's long gone and they get to keep their production up to now.

We're asking to simply value the remaining production and let us contribute, to consolidate the properties for the ultimate purpose of avoiding the drilling of a well that is totally unnecessary.

We would like you to enter an order according to our presentation.

Thank you.

MR. STOGNER: Thank you, Mr. Kellahin.

Does anybody else have anything further in this case?

I realize that we have a little time constraint; however, I would like a rough draft order from both parties.

MR. KELLAHIN: All right, sir.

MR. STOGNER: Would you care

to suggest a date when you may have these in?

MR. KELLAHIN: We'll have you one by Tuesday.

MR. STOGNER: Mr. Pearce?

MR. PEARCE: That's fine.

MR. STOGNER: Tuesday it is, and we'll hold the record open just for those two documents and in that case we're through with this case today.

(Hearing concluded.)

C E R T I F I C A T E

I, SALLY W. BOYD, C. S. R. DO HEREBY CERTIFY that the foregoing Transcript of Hearing before the Oil Conservation Division (Commission) was reported by me; that the said transcript is a full, true and correct record of the hearing, prepared by me to the best of my ability.

Sally W. Boyd CSR

I do hereby certify that the foregoing is a complete record of the proceedings in the Examiner hearing of Case No. 9694, heard by me on 12 July 1989.

Michael E. Stogner, Examiner
Oil Conservation Division