CAMPBELL, CARR, BERGE
& SHERIDAN, P.A.
LAWYERS

MICHAEL B CAMPBELL
WILLIAM F CARR
BRADFORD C BERGE
MARK F SHERIDAN
MICHAEL H FELDEWERT
ANTHONY F MEDEIROS
PAUL R. OWEN

JACK M. CAMPBELL
OF COUNSEL

JEFFERSON PLACE
SUITE 1 - 110 NORTH GUADALUPE
POST OFFICE BOX 2208
SANTA FE, NEW MEXICO 87504-2208
TELEPHONE: (505) 988-4421
FACSIMILE: (505) 983-6043
E-MAIL: ccbspa@ix.netcom.com

July 10, 1997

VIA HAND-DELIVERY

Michael E. Stogner
Hearing Examiner
New Mexico Oil Conservation Division
New Mexico Energy, Minerals and
Natural Resources Department
Porter Hall
2040 South Pacheco
Santa Fe, New Mexico 87504

Re: ***In Re Amended Application of Doyle Hartman***, Case No. 11792.
OXY USA INC.'S PROPOSED ORDER AND DISCOVERY SCHEDULE

Dear Mr. Stogner:

Please find enclose the following:

1. Original Supplemental Affidavit executed by Patrick H. Martin.

Thank you for your attention to this matter.

Very truly yours,

William F. Carr

WFC/jmg
Enclosure(s)
cc: Counsel of Record, by Hand-Delivery

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

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

CASE NO. 11792

AMENDED APPLICATION OF DOYLE HARTMAN, TO GIVE FULL FORCE AND EFFECT TO COMMISSION ORDER R-6447, TO REVOKE OR MODIFY ORDER R-4680-A, TO ALTERNATIVELY TERMINATE THE MYERS LANGLIE-MATTIX UNIT, LEA COUNTY, NEW MEXICO

AFFIDAVIT OF PATRICK H. MARTIN
IN SUPPORT OF OXY USA INC.'S MOTION TO DISMISS

STATE OF NEW MEXICO §
§
COUNTY OF SANTA FE §

BEFORE ME, the undersigned authority, on this day personally appeared **PATRICK H. MARTIN**, being by me duly sworn, who deposed and stated as follows:

1. My name is Patrick H. Martin. I am over the age of twenty-one (21) years, and of sound mind, capable of making this Affidavit. I have personal knowledge of the facts herein stated and each such fact is true and correct.

2. I have previously filed an Affidavit in this proceeding under date of June 30, 1997, together with my resume. In response to the request made at the hearing, I now file this supplemental affidavit.* The testimony stated in this Affidavit is the same that I would give in Court or before the agency under oath if called to testify as a witness.

3. An important issue in this administrative proceeding and the related lawsuit is the proper treatment to be given to the finding in Order R-6447 that the Myers Langlie-Mattix Unit Operating Agreement provides for unit operation on "terms that are fair, reasonable, and

* As stated prviously, Louisiana State University and Law Center are in no way involved in my participation in this matter; the opinions expressed herein are based on my own experience and expertise and do not represent any view of the University or Law Center.

equitable," and which includes "a provision for carrying any working interest owner on a limited, carried or net-profits basis, payable out of production, upon such terms and conditions which are just and reasonable . . ." [Order R-6447 ¶ 21(d)]. This finding tracked the requirements of the pertinent statute.

4. In my previous affidavit I stated that "It is my opinion that there is a reasonable basis for the agency to have concluded in 1980 that the statutory criteria for a unit were satisfied by the Unit Operating Agreement." I will now explain that "reasonable basis".

5. It is to be noted that the statute and the finding refer to the unit operating agreement "carrying" a working interest owner "on a limited, carried or net-profits basis . . . " The concept of carrying is simply this: that the party doing the carrying is responsible for the operating costs and expenses attributable to the non-carrying interest. The concern of the statute and the conservation agency in having one party responsible for carrying another interest in a unit is two-fold: a) fairness to a party forced into a unit, and b) having some interest who must bear the costs of the interest in the unit. On the latter point, if there is not some party or parties carrying all costs in the unit, there will be a portion of unit costs -- such as those incurred for plugging and abandonment, remediation, possible well-blowouts and the like -- that will leave the state holding the bag on such costs. See NMSA 1978, § 70-7-7E.

6. The "carrying" party can accomplish the carrying by means of one of three methods of carrying: a) a limited basis; b) a carried basis; or c) a net-profits basis. Each of these three is different. I will address these in last-to-first order.

7. A net profits interest is defined as "A share of gross production from a property, measured by net profits from operation of the property. It is carved out of the working interest." 8 P. Martin & B. Kramer, *Williams & Meyers Oil and Gas Law* 679 (1996). The term "net profits interest" has been construed by a New Mexico court in *Christy v. Petrol Resources Corp.*, 102 N.M. 58, 691 P.2d 59 (N.M. Ct. App. 1984). In this case, the plaintiff sought to quiet title, alleging that he was "the owner and holder in fee simple of (i) a 10% net profits interest, and (ii) an overriding royalty of 1% of the amount of all oil, gas,

casinghead gas and other hydrocarbon substances . . . " The court concluded that in New Mexico law "the phrase 'net profits interest' has no independent meaning . . . " 691 P.2d at 62. Under the circumstances of the case, the court found that the plaintiff's "net profits interest" was an interest in a certain cash payment and was not an interest in the proceeds of production. The Utah Supreme Court in *Atlas Corp. v. Clovis Nat'l Bank*, 737 P.2d 225 at 231 (Utah 1987), similarly concluded that the term "net profits interest" has not "acquired a fixed and immutable meaning such that all interests so formed automatically are entitled to treatment as estates in land. There is no body of law that clearly defines the nature and incidents of the net profits interest."

8. A "carried interest" has been defined as follows:

> A fractional interest in oil and gas property, usually a lease, the holder of which has no personal obligation for operating costs, which are to be paid by the owner or owners of the remaining fraction, who reimburse themselves therefor out of production, if any. The person advancing the costs is the carrying party and the other is the carried party. Three general types of carried interest are recognized: the Abercrombie-type carried interest, the Herndon-type carried interest, and the Manahan-type carried interest.

8 P. Martin & B. Kramer, *Williams & Meyers Oil and Gas Law* 135 (1996). This same *Treatise*, for which I am co-author for update and revision with Professor Kramer, makes the further observation that there is no standard carried interest arrangement. It states:

> The details of a carrying agreement vary considerably, e.g., whether the operator (the party who is putting up the cost of development) has control of the oil and the right to sell it or the carried party can sell his part of the oil; whether the carried interest is to be carried for the initial development period only of the operation or for the life of the lease; whether interest is to be charged and, if so, the rate; who would own the equipment, such as pipe, motors and pumps, if and when production ceased; etc. See Ashland Oil & Refining Co. v. Beal, 224 F.2d 731, 5 O.&G.R. 387 (5th Cir. 1955), cert. denied, 350 U.S. 967 (1956). As observed by Professor Masterson, Discussion Notes, 5 O.&G.R. 396 (1956):

> "The numerous different forms these interests are given from time to time make it apparent that the terms 'carried interest' and 'net profits interest' do not define any specific form of agreement but rather serve merely as a guide in preparing and interpreting instruments."
>
> Professor Masterson further noted the close kinship between carried interests and net profits interest. Either type may be employed where one coowner is to advance the entire costs of drilling.

Id., 135-36.

9. Although a "carried interest" and a "net profits interest" have a kinship, they are different. The same *Treatise* goes on to describe the usual difference between the treatment of the two:

> The major difference between the two interests is that it is customary for a carried interest relationship to cease when all costs as to the carried interest are paid; thereafter the carried and carrying parties jointly own the working interest and share in costs and receipts. A net profits interest, on the other hand, usually continues for the duration of the leasehold, one party continuing to bear costs and the other receiving a share of proceeds after payment of such costs.

8 P. Martin & B. Kramer, *Williams & Meyers Oil and Gas Law* 136 (1996)

10. As observed earlier, the statute and order provide that "carrying" can be on a "limited" basis. The same *Treatise* I have been quoting from states the following definition for a "Limited carried interest":

> A Carried interest (q.v.) which is to be carried for the initial development phase only of the operation. After the operator has recouped his advances to the carried interest, the carry terminates.

8 P. Martin & B. Kramer, *Williams & Meyers Oil and Gas Law* 589 (1996). When there is a carrying on a limited basis the carry terminates, and the non-carrying party must be responsible for its share of costs or the interest itself may terminate or be relinquished. This has been the treatment in New Mexico law for such an interest. The meaning of carrying a working interest owner on a limited basis is seen in a New Mexico case decided the very same year that the unit operating agreement was signed. This was in *Bolack v. Sohio Petroleum Co.*,

475 F.2d 259 (10th Cir. 1973). In this case, Tom Bolack sold and assigned to Sohio Petroleum Company a producing Federal oil and gas lease, reserving an interest described as a "limited term carried working interest." Bolack's interest was not to begin until seven-eighths of the production subsequent to the sale and transfer of the producing lease amounted to 1,500,000 barrels, and the interest was then to terminate when the "reasonably estimated quantity of oil that is recoverable from said lands has declined to four hundred thousand (400,000) barrels." The question in the case concerned whether the limiting condition had occurred, and the court concluded that it had indeed occurred and that the carrying party's obligations ceased and the noncarrying party's interest had terminated. Thus, it should be clear that at the time the New Mexico legislature in 1975 adopted the statute in question in this proceeding, the concept of carrying another interest on a limited basis was recognized in the New Mexico courts.

11. Other states' statutes providing for options for working interest owners in pooling and unitization have provided for carrying on a "limited" basis as well as a "carried" basis. The Kansas Statute is quite similar to the New Mexico statute with provision for "carrying any nonoperating working interest owner on a limited, carried or net-profits basis, . . ." K.S.A. § 55-1305(g). The West Virginia pooling statute, W. Va. Code § 22C-9-7(b)(5)(ii), enacted originally in 1972, provides for options available to the owner of an operating interest who does not elect to participate in the risk and cost of the drilling of a deep well: "To participate in the drilling of the deep well on a ***limited*** or ***carried*** basis on terms and conditions which, if not agreed upon, shall be determined by the commissioner to be just and reasonable." [emphasis added]. The Kentucky pooling statutes, Ky. Rev. Stat. § 353.640(3), contain a provision whereby the nonconsenting owner may be afforded certain options, including one in which the owner "May elect to participate in the drilling, deepening or reopening of the well on a ***limited*** or ***carried*** basis upon terms and conditions determined by the director to be just and reasonable." [emphasis added]. A similar provision is contained in the Pennsylvania statutes 58 Pa. Stat. § 408(c).

12. The concept of a working interest owner participating on a "limited" as opposed to "carried" basis in unitization operating agreements has been brought forward in requests by parties for such carrying. An especially significant case for this proceeding is *Newkirk v. Bigard*, 125 Ill.App. 454, 80 Ill.D. 791, 466 N.E.2d 243, *affirmed in part and reversed in part*, 109 Ill.2d 28, 92 Ill.D. 510, 485 N.E.2d 321 (1985), cert. denied, 475 U.S. 1140, *reh. denied*, 477 U.S. 909 (1986). In this case the applicant for an order for a unit requested that the Illinois Mining Board "Provide that Walter Newkirk may elect to participate in the drilling and operation or operations of the well on a limited or carried basis upon the terms and conditions to be just and reasonable." 466 N.E.2d at 245. Newkirk did not attend the hearing. The order was issued in 1980 but did not provide for Newkirk's participation on "a limited or carried basis" but instead that he was simply responsible for his share of costs. The order failed to state a time and manner in which Newkirk could elect to participate in the unit and did not provide, as requested by the applicants, one or more equitable alternatives if Newkirk elected not to participate in the risk and cost of the drilling and operations; it did state Newkirk would participate in the costs and risks of the drilling units and set out the participation factors. Omission of the election of the statutory alternatives to participation in the drilling of the well rendered the order voidable, not void; thus it was not subject to collateral attack. The order was defective because it did not give alternatives, but this did not mean the board was without jurisdiction to enter the order. The nonconsenting party could not now challenge the order. As an appendix to this Affidavit I have reproduced pertinent pages from B. Kramer & P. Martin, Pooling and Unitization, §25.06[7] (1996), for which I am the co-author, concerning the fact that a conservation agency's failure to afford a nonconsenting party the statutory alternatives cannot be attacked collaterally later by that nonconsenting party.

13. From the foregoing discussion of the New Mexico statute, it should be obvious that the terms "carrying" on a "limited" basis or a "carried" basis or a "net-profits" basis refer to several different conceptual bases on which the "carrying" might be accomplished. After reviewing the Unit Operating Agreement for the Myers Langlie-Mattix Unit, I am of the

opinion that the responsible New Mexico agency in 1980 in Order R-6447 had a very reasonable basis for concluding that the Operating Agreement did provide for "carrying" on a "limited basis" under terms that were just and reasonable.

The unit operating agreement does provide for a limited carrying of nonconsenting parties. If, for example, the nonoperating party fails to authorize and pay for certain operations he may do so for a time. The other working interest owners will have a right to a lien on the production. If the operations are successful, the nonoperating party will have his share of costs deducted out of production and then can resume taking his share of production after the carrying parties have recouped their costs. If it appears the operations are to be unsuccessful, the nonconsenting party may relinquish his interest and thereby avoid any liability for costs incurred subsequent to his relinquishment. This example would certainly qualify as carrying the nonconsenting party on a limited basis. Because the working interest owners had all participated the Unit Operating Agreement for some seven years and had enjoyed substantial benefits thereunder, it is very reasonable to conclude that the limited carrying provision of the agreement was "just and reasonable".

14. I am also of the opinion that any challenge to the agency's 1980 conclusion and Order R-6447 must be dismissed by this agency or by a court as a collateral attack on the order. It is further my opinion that there is no reasonable basis on which the agency could conclude that the statute or Order R-6447 imposes a particular method for carrying on "limited" basis or "carried" basis, or "net profits" basis. Such an end could only be achieved by rewriting the Unit Operating Agreement since none of these terms has a precise meaning that could imported, and the statute in no way indicates which of these three broad concepts should be employed. While it may be open to question whether in 1980 the agency could have refused to approve the Unit and the Unit Operating Agreement for not containing a satisfactory carrying provision when no working interest owner made complaint, it is my opinion that the agency has no statutory authority and no power under the circumstances to impose a new

operating agreement upon parties to an existing unit operating agreement. It is quite simply unheard of and unprecedented in case law.

FURTHER AFFIANT SAYETH NOT.

Patrick H. Martin

SUBSCRIBED AND SWORN TO BEFORE ME on this 9th day of July 1997, to certify which witness my hand and official seal of office.

Notary Public, In and for the
State of Louisiana

My commission expires:

is for life

[7] Illinois

The Illinois conservation act allows suit by any interested person affected by the act or by any rule, regulation, or order of the Illinois Mining Board in the circuit court of the county where any part of the affected land.[92] Any such suit is to be determined as expeditiously as possible. The burden of proof is on the party challenging the validity of the act or rule, regulation, or order and any rule, regulation, or order is deemed prima facie valid.

Omission of election of statutory alternatives to participation in drilling of well rendered order voidable, not void, thus it was not subject to collateral attack — The case of *Newkirk v. Bigard*[93] involved an order of the Illinois Mining Board, which had force-pooled and integrated 40 acres into two drilling units of 20 acres each. The complainants had a one-half interest in 30 acres and contended the order was void as it had not spelled out any election they could make as to whether they paid costs up front or whether they were to be carried to payout or given some other basis for paying costs. Notice had been given, but they had not taken part in the hearing. They also contended the other one-half interest, which was a term interest, had expired as there were no operations on the land itself but instead on unit lands for a void unit. The order failed to state the time and manner in which Newkirk could elect to participate in the unit and did not provide, as requested by the applicants, one or more equitable alternatives if Newkirk elected not to participate in the risk and

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ty-day provision for challenging an order of the commission thereby giving the plaintiff a full year to bring a suit against the commission claiming that the order of the agency is in violation of the statute. It could seem to refer to tort suits between private parties for claims based on violations of commission regulations and orders, such as a well blowout, pollution, or failure to account for production. However, is it also a restriction on the authority of the commission to enforce its own statutes or regulations or orders? In a doubtful matter, the authors do not think a court should read a restriction to limit the ability of the state to enforce its exercise of the police power.

[92] Ill. Rev. Stat. ch. 96, § 5416, at § 30.13A *infra*.

[93] Newkirk v. Bigard, 92 Ill. Dec. 510, 485 N.E.2d 321, 87 O.&G.R. 266 (Ill. 1985), *cert. denied*, 475 U.S. 1140, *reh'g denied*, 477 U.S. 909 (1986).

cost of the drilling and operations; it did state Newkirk would participate in the costs and risks of the drilling units and set out the participation factors. The Mining Board said that inasmuch as it had the authority to enter orders pertaining to the integration of mineral interests, and as notice had been given to all affected owners, its integration order could not be attacked collaterally. The court of appeals, however, disagreed. It stated: "[T]he Mining Board, as an administrative agency, is a creature of statute, having no general or common-law powers. It must find within the statute the authority to act, and if it lacks the inherent power to make or enter the particular order involved,' that order may be attacked at any time or in any court, either directly or collaterally."[94] Interestingly enough, the court found that the order was not completely void so the term interest had not expired; it was only void as to the interest of the claimants. In other words, the board had jurisdiction, but not to make part of the order it had entered. This approach makes the collateral attack rule almost meaningless and encourages parties not to take part in unit hearings.

The Illinois Supreme Court reversed. Omission of the election of the statutory alternatives to participation in the drilling of the well rendered the order voidable, not void; thus it was not subject to collateral attack. The order was defective because it did not give alternatives, but this did not mean the board was without jurisdiction. The board had personal jurisdiction over Newkirk and had subject matter jurisdiction. It had inherent authority to issue the order. The order was authorized by statute and not subject to collateral attack; agency jurisdiction or authority is not lost merely because its order might be erroneous.[95] The general rule is that a party cannot collaterally attack an agency order in a proceeding such as this unless the order is void on its face as being unauthorized by statute.[96] The court observed:

> Plaintiffs' argument would allow a collateral attack on an order whenever the agency has failed to follow the

[94] 466 N.E.2d at 247, 82 O.&G.R. at 247-248.

[95] 485 N.E.2d at 324-325, 87 O.&G.R. at 273.

[96] 485 N.E.2d at 325-326, 87 O.&G.R. at 274.