

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

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

Case No. 13957 (de novo)
Order No. R-1960-B

THE APPLICATION OF ENERGEN RESOURCES
CORPORATION TO AMEND THE COST RECOVERY
PROVISIONS OF COMPULSORY POOLING ORDER NO.
R-1960, TO DETERMINE REASONABLE COSTS, AND
FOR AUTHORIZATION TO RECOVER COSTS FROM
PRODUCTION OF POOLED MINERAL INTEREST,
RIO ARriba COUNTY, NEW MEXICO

ORDER OF THE COMMISSION

IN THIS MATTER, having come before the New Mexico Oil Conservation Commission ("Commission") on May 27, 2009 at Santa Fe, New Mexico, on (i) Energen Resources Corporation ("Energen") Application to the New Mexico Oil Conservation Division ("Division") for reformation of compulsory pooling order No. R-1960 and (ii) JAS Oil and Gas Co., LLC's Application for Hearing De Novo, the Commission, having carefully considered the evidence and other materials submitted by the parties, now, on this 13th day of August, 2009:

FINDS THAT:

1. Applicant, Energen Resources Corporation, ("Energen") is the operator of a Pictured Cliffs formation well located in Rio Arriba County. The well at issue is one of a number of properties acquired in 1997 from Energen's predecessor operator, Burlington Resources. The well is subject to a compulsory pooling order issued in 1961 ("Pooling Order"), which pooled certain unleased mineral interests. (Energen Ex.1).
2. The Pooling Order is Order No. R-1960, entered by the Commission in Case No. 2249 on May 5, 1961 ("Pooling Order"). That order established a compulsory pooled unit ("Unit") comprised of SW/4 of Section 2, Township 25 North, Range 3 West, NMPM, in Rio Arriba County, New Mexico, as to the Pictured Cliffs formation in the Tapacito-Pictured Cliffs Gas Pool (985920).
3. The Unit was dedicated to the well at issue, the Martinez Well No. 1 (API No. 30-039-06124), located 790 feet from the South line and 790 feet from the West line (Unit M) of Section 2 ("Well No. 1"). Southern Union Production Company ("Supron"),

the applicant in the original pooling case, was designated operator. (Comp. Energen Exs. 2 and 6).

4. Well No. 1 was drilled and completed by Supron in 1961. Initially, the well was operated by Supron. (Tr., p. 20).¹

5. Through a series of transfers and acquisitions, in August 1997 Taurus Exploration USA, Inc. acquired Supron's interests in Well No. 1 and became the operator.

6. Subsequently, on October 1, 1998, through a corporate change of name, Taurus Exploration USA, Inc. became Energen Resources Corporation. Energen continues to operate Well No. 1. (Tr., pp. 20, 93).

7. At the time Well No. 1 was drilled, Joseph A. Sommer ("Sommer") was the owner of an unleased mineral interest in the S/2 SW/4 of Section 2 comprising approximately 8.33333% of the Unit. Pursuant to NMSA 1978, § 70-2-17, one-eighth of Sommer's interest is treated as a royalty interest, and seven-eighths of Sommer's interest is treated as a working interest. Tr., p. 22; Energen Ex. 6).

8. Sommer did not contractually commit his interest to Well No. 1 and did not otherwise elect to participate under the Pooling Order. Accordingly he became a nonconsenting party, as to his working interest. Tr., p. 22).

9. Sommer's interest was subsequently conveyed to the Joseph A. Sommer Trust and currently is owned by JAS Oil and Gas Co., LLC's (collectively the Sommer's/Trust/JAS interest will be referred to herein as "JAS." (Energen Ex. 7); Tr., p. 97).

10. By letter dated March 17, 1992, Meridian Oil Inc. ("MOI"), a predecessor in Energen's interest, advised all of the working interest owners in the properties it operated, including the Martinez No. 1, that it would discontinue selling gas on behalf of the other working interest owners beginning on May 1, 1992 (Energen Ex. 4). By that same letter MOI advised the non-marketing interest owners to make arrangements for marketing their gas.

11. By letter dated September 28, 1995, MOI notified JAS that MOI's affiliate, Meridian Oil Trading Inc. would no longer purchase gas from the working interest owners in Well No. 1. (Energen Ex. 5).

12. When Energen took over operation of Well No. 1, in August 1997, JAS was overproduced in the amount of 1031 mcf of gas. (Tr., p. 23).

13. At least since August 1997, JAS has not made arrangements for the sale of its share of gas from Well No. 1, and it has not authorized Energen to market gas on its

¹ References to the transcript of the May 27, 2009, hearing of this matter are denoted by a "Tr." followed by the cited page number.

behalf. ("... Energen commenced and continued to sell my 8.3333% of the total gas produced to which it had no title and for which sale it had no authorization. ... Nothing in the Pooling Order of May 1961 purports to authorize Southern Union Production Company as owner of a 50% operating interest to produce and sell more gas than is required for the payment of reasonable costs of its production.") (Energen Ex. 14).

14. The Pooling Order is silent as to the sale of a nonoperating interest owner's share of production. (Energen Ex. 1).

15. If it is the case that JAS' gas has not been marketed, as of January 2009, JAS was underproduced in the amount of 8,378 mcf of gas. (Energen Ex. 25).

16. Evidence was not tendered to show whether Energen received a credit for JAS's overproduction when Energen purchased its predecessor's interest in Well No. 1.

17. It is a custom and practice of the oil and gas industry to implement gas balancing when less than all interest owners in a well have their gas sold. (Tr., pp. 24, 26).] Doing so allows gas for marketing parties in a well to be sold and avoids the shut-in of the well when less than 100% of the interest owners have made arrangements for the disposition of their share of gas. In such situations, the accounts of selling interest owners become "overproduced" and nonmarketing parties become "underproduced." When an underproduced party sells its gas, the operator often inflates its interest to allow it to "make-up" its underproduced position. If the non-selling interest owner's gas is treated as though it has not been produced by its owner and is not in the ground at depletion of the well, the operator typically will pay the non-selling interest owner at the historical price. (Tr., pp. 24-27)

18. There is no gas balancing agreement between JAS and Energen or any of its predecessors-in-interest with respect to Well No. 1.

19. Energen has suggested that JAS make up its underproduction by taking 40% more gas than it is entitled to for its 8 1/3% working interest. At that rate, it would take JAS 49 years to make up its underproduction. (Energen Ex. 16; Tr., p. 70.

20. Credible evidence was not introduced at the hearing that Well No. 1, drilled in 1961, could be economically produced until 2058.

21. If JAS's gas is treated as though it is underproduced, and if JAS cannot take sufficient amounts of gas to make up for its underproduction before the end of the life of Well No. 1, then, when it is no longer economically feasible to produce Well No. 1, JAS's gas must be left in the ground, which amounts to waste and/or an infringement of JAS's correlative rights.

22. NMSA 1978, § 70-2-2 prohibits "the production or handling of crude petroleum oil or natural gas of any type or in any form, or the handling of products thereof, in such manner or under such conditions or in such amounts as to constitute or result in waste...."

23. NMSA 1978, § 70-2-11 provides that "[t]he division is hereby empowered, and it is its duty, to prevent waste prohibited by this act and to protect correlative rights, as in this act provided. To that end, the division is empowered to make and enforce rules, regulations and orders, and to do whatever may be reasonably necessary to carry out the purpose of this act, whether or not indicated or specified in any section hereof."

24. NMSA 1978 70-2-17(A) provides that "[t]he rules, regulations or orders of the division shall, so far as it is practicable to do so, afford to the owner of each property in a pool the opportunity to produce his just and equitable share of the oil or gas, or both, in the pool, being an amount, so far as can be practically determined, and so far as such can be practicably obtained without waste, substantially in the proportion that the quantity of the recoverable oil or gas, or both, under such property bears to the total recoverable oil or gas, or both, in the pool, and for this purpose to use his just and equitable share of the reservoir energy."

25. If it is uncertain that JAS's share of the gas may be balanced prior to the time that Well No. 1 is no longer capable of being economically produced, and if leaving JAS's gas in the ground results in prohibited waste and/or an infringement of JAS's correlative rights, the Commission must treat JAS's gas as though it has been sold by Energen.

26. NMSA 1978 70-2-17(C) provides that "[a]ll orders effecting such pooling shall be made after notice and hearing, and shall be upon such terms and conditions as are just and reasonable and will afford to the owner or owners of each tract or interest in the unit the opportunity to recover or receive without unnecessary expense his just and fair share of the oil or gas, or both. ... Such pooling order of the division shall make definite provision as to any owner, or owners, who elects not to pay his proportionate share in advance for the pro rata reimbursement solely out of production to the parties advancing the costs of the development and operation, which shall be limited to the actual expenditures required for such purpose not in excess of what are reasonable, but which shall include a reasonable charge for supervision and may include a charge for the risk involved in the drilling of such well, which charge for risk shall not exceed two hundred percent of the nonconsenting working interest owner's or owners' pro rata share of the cost of drilling and completing the well."

27. Supervision charges for Well No. 1 are not specified in the Pooling Order, and it does not provide for escalation of such charges. (Energen Ex. 1).

28. Certain unleased mineral owners in Well No. 1 (excluding JAS) executed a December 12, 1984 operating agreement with Union Texas Petroleum Corporation, an Energen predecessor-in-interest. That operating agreement provided for overhead rates for a producing well of \$350/month, subject to escalation under the COPAS accounting procedure. (JAS Ex. 12). Under the cost escalation provision, operating costs for the well would be \$866.16/month in 2009. (Energen Ex. 22).

29. Over the years, although JAS did not execute the 1984 operating agreement, Energen has billed JAS for operating expenses, including an overhead charge calculated

pursuant to the 1984 operating agreement. JAS has refused to pay those expenses, and has objected that the overhead rate is not reasonable. (Energen Ex. 14).

30. JAS and Energen are subject to an operating agreement dated March 1, 2006 for the McCroden Well No. 1, a well completed in the Mesa Verde formation located in the W/2 of the same Section 2, Township 25 North, Range 3 West, NMPM. Energen Ex.18. The initial producing well overhead rates in the agreement are \$350/month.

31. Energen's list of producing overhead rates for its non-operated Pictured Cliffs wells shows that a majority of the overhead rates are in the \$500/month range or lower. Energen Ex. 20.

32. The Ernst & Young overhead rate survey for 2008-2009 reflects a median rate for wells in the San Juan Basin completed at depths of 5000-10000 feet of \$550/month. Tr., p. 57.

33. Energen Exhibit 21 reflects the Cumulative COPAS Escalation Percentage as of April 1, 2008.

34. Based on the evidence presented at the hearing, the Commission finds that an overhead rate of \$550 for 2009 is a reasonable rate.

CONCLUSIONS

A. The Commission has jurisdiction over this matter and the parties hereto.

B. The Commission must treat JAS's gas as though it has been sold by Energen.

C. Retrospectively, for JAS to obtain its fair share of production, it should receive the price at which gas actually was sold by Energen.

D. Because JAS refused to market its own production, and refused to authorize Energen to market JAS's share of production, Energen is not subject to penalty interest.

E. NMSA 1978, § 70-10-1 *et seq.*, the Oil and Gas Proceeds Payment Act, is instructive on interest rates. Under the Oil and Gas Proceeds Payment Act, if a person entitled to payment may not be located or may not be determined, the operator is obliged to create a suspense account, into which payment is to be made. The person entitled to such payment is required to receive that payment, plus interest that is equal to the discount rate charged by the federal reserve bank of Dallas to member banks plus one and one-half percent ("OGPPA Rate").

F. Additionally, because JAS has paid no expenses to Energen, JAS must account to Energen for reasonable expenses, including overhead charges.

G. If \$550 is a reasonable overhead charge for 2009, reasonable annual historic charges may be calculated using the Cumulative COPAS Escalation Percentage that is Energen Exhibit 21.

H. Prospectively, in order to prevent the current situation from arising again, if Energen and/or its successors-in-interest are marketing production from Well No. 1, Energen and its successors in interest will also need to market JAS's share of production from Well No. 1, and pay and account to JAS for same, if JAS does not do so.

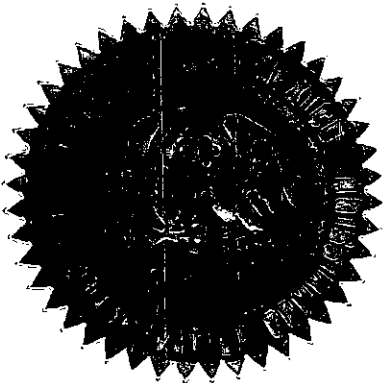
IT IS THEREFORE ORDERED THAT:

- (a) Energen will select and pay for an independent auditor to audit the JAS account related to Well No. 1. The audit will cover the period of time from the date in 1997 when Energen purchased its predecessor's interest in Well No. 1 to the present ("Audit Period"). The audit will determine for each historic sale by Energen of production from Well No. 1 during the Audit Period (i) the amount of such production that is attributable to JAS's interest in Well No. 1, as though Energen was marketing JAS's interest in production at that time, (ii) the historic price at which Energen sold such production, (iii) the amount that Energen charged working interest owners for the actual operating expenses of Well No. 1, and (iv) assuming that Energen was marketing JAS's share of production from Well No. 1 during the Audit Period, anything else necessary for calculating JAS's share of the historic proceeds received by Energen. The auditor also will calculate the Recalculated Overhead (hereinafter defined) and the Lump Sum Payment (hereinafter defined).
- (b) Results of the audit will be used to calculate a Lump Sum Payment by Energen to JAS for the net value of JAS's production, deemed to have been sold by Energen during the Audit Period. In part, the Lump Sum Payment will be the volume of gas produced during the Audit Period that is attributable to JAS's interest in Well No. 1, as though Energen were marketing JAS's gas at the time, sold at the historic prices received by Energen, less the actual operating expenses. Additionally, the payment should be net of an overhead charge. In determining the overhead charges, however, the charges historically levied by Energen shall not be used. For 2009 the overhead charge will be JAS's share of \$550 per month. Monthly charges for prior years shall be calculated by using \$550 per month in 2009 as a base and deescalating the monthly overhead charge in any given year using the Cumulative COPAS Escalation Percentages that are Energen Exhibit 21. Overhead charges so calculated may be referred to herein as "Recalculated Overhead."
- (c) Interest due from Energen to JAS on any historic sale of gas will be calculated from the historic date of payment to Energen to the date that Energen makes payment to JAS. Interest shall be calculated on any given sale at the historic OGPPA Rate.
- (d) The Lump Sum Payment, then, shall be, for each sale of Well No. 1 production by Energen: (i) the volume of gas produced during the Audit Period that is attributable to JAS's interest in Well No. 1, as though Energen were marketing JAS's gas at the time, (ii) sold at the historic prices received by Energen, (iii) less the actual operating expenses,

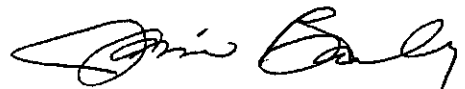
- (iv) less Recalculated Overhead, plus interest on the net amount at the historic OGPPA Rate.
- (e) The audit shall be completed no later than six months after the date that this Order is entered. Upon completing the audit, the auditor will deliver a complete copy of the audit to Energen and to JAS. Either party, within 30 calendar days of receiving the auditor's report, may appeal all or a portion of the report to the Commission, which retains jurisdiction for that purpose and as otherwise allowed by law.
- (f) From the date of this Order forward, if Energen and/or its successors-in-interest are marketing production from Well No. 1, Energen and its successors-in-interest also shall market JAS's share of production from Well No. 1, and pay and account to JAS for same, until 30 days after Energen receives written notice from JAS of arrangements that have been made by JAS to market its own production from Well No. 1. From the date of this Order forward, Energen may deduct from the total sales price of JAS's production, actual operating costs, as well as JAS's working interest share of an overhead charge of \$550/month for 2009, escalated annually at the relevant COPAS escalation percentage.
- (g) Order No. R-1960-A is hereby vacated and of no further force and effect
- (h) Energen will file a division order that accurately sets forth the percentage interest of all interest owners in the Well No. 1 (see, e.g. NMSA 1978, 70-10-3.1(B)) and that is consistent with the terms of the Commission's Order. JAS will execute the Division Order.

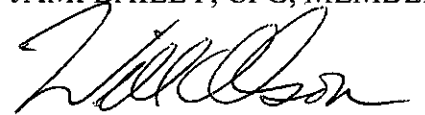
DONE at Santa Fe, New Mexico on the 13th of August 2009.

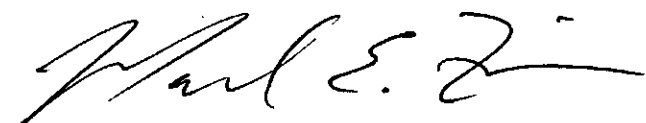
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