

OIL & GAS DOCKET NO. 04-0247766

ENFORCEMENT ACTION AGAINST IBC PETROLEUM, INC., (OPERATOR NO. 421759) FOR VIOLATIONS OF STATEWIDE RULES ON THE STATE TRACT 456 LEASE, WELL NO. 1 (RRC NO. 012788), RED FISH BAY-MUS. IS (COMMON 10) FIELD, TEN SAND GAS UNIT 421 LEASE, WELL NO. 3 (RRC NO. 043367), RED FISH BAY-MUS. IS (COMMON 10) FIELD, AND STATE TRACT 397 LEASE, WELL NO. 6 (RRC NO. 076517), RED FISH BAY-MUS. IS (COMMON 10) FIELD, NUECES COUNTY, TEXAS

APPEARANCES:

FOR MOVANT:

Susan German
Bill Drury

MOVANT:

Enforcement Section
Railroad Commission of Texas

FOR RESPONDENT:

Matthew W. Babb

RESPONDENT:

IBC Petroleum, Inc.

FOR INTERVENOR:

J. David Hall

INTERVENOR:

Cinco Natural Resources Corporation

PROPOSAL FOR DECISION

PROCEDURAL HISTORY

DATE OF ORIGINAL COMPLAINT:

June 16, 2006

DATE OF NOTICE OF HEARING:

September 6, 2006

DATE OF HEARING:

October 19, 2006

HEARD BY:

James M. Doherty, Hearings
Examiner

DATE PFD CIRCULATED:

November 17, 2006

STATEMENT OF THE CASE

This proceeding was called by the Commission on the recommendation of the District Office to determine the following:

1. Whether the respondent IBC Petroleum, Inc. (“IBC”), should be required to plug or otherwise place into compliance with Statewide Rule 14(b)(2) [Tex. R.R. Comm’n, 16 TEX. ADMIN. CODE §3.14(b)(2)] the State Tract 456 Lease, Well No. 1 (RRC No. 012788), the Ten Sand Gas Unit 421 Lease, Well No. 3 (RRC No. 043367), and the State Tract 397 Lease, Well No. 6 (RRC No. 076517), Red Fish Bay-Mus. IS (Common 10) Field, Nueces County, Texas (“subject wells”);
2. Whether IBC violated Statewide Rule 3 [Tex. R.R. Comm’n, 16 TEX. ADMIN. CODE §3.3] on the State Tract 456 Lease, Well No. 1 (RRC No. 012788) and on the State Tract 397 Lease, Well No. 6 (RRC No. 076517) by maintaining identification signs at the wells that displayed incorrect information;
3. Whether IBC violated Statewide Rule 14(b)(3) [Tex. R.R. Comm’n, 16 TEX. ADMIN. CODE §3.14(b)(3)] by failing to perform required H-15 tests (Test on an Inactive Well More than 25 Years Old) on the State Tract 456 Lease, Well No. 1 (RRC No. 012788) and the Ten Sand Unit 421 Lease, Well No. 3 (RRC No. 043367);
4. Whether IBC violated provisions of Title 3, Oil and Gas, Subtitles A, B, and C, Texas Natural Resources Code, Chapter 27 of the Texas Water Code, and Commission rules and laws pertaining to safety or prevention or control of pollution by failing to plug the subject wells or otherwise failing to place the subject wells into compliance with Statewide Rules 3, 14(b)(2), and 14(b)(3);
5. Whether, pursuant to Texas Natural Resources Code §81.0531, IBC should be assessed administrative penalties of not more than \$10,000 per day for each offense committed regarding the subject wells; and
6. Whether any violations of Statewide Rules 3, 14(b)(2), and 14(b)(3) by IBC should be referred to the Office of the Attorney General for further civil action pursuant to Texas Natural Resources Code §81.0534.

A hearing was held on October 19, 2006. Susan German, Staff Attorney, appeared representing the Enforcement Section of the Office of General Counsel (“Enforcement”). Matthew W. Babb, attorney, appeared to represent IBC, and presented evidence and argument. J. David Hall, attorney, appeared to represent intervenor Cinco Natural Resources Corporation and presented argument and statements of counsel. Enforcement’s certified hearing file was admitted into evidence.

APPLICABLE LAW

Statewide Rule 3(2) requires the posting of an identification sign at each well site, showing the name of the property, name of the operator, and well number. Statewide Rule 14(b)(2) requires that a well be plugged after 12 months of inactivity, unless a plugging extension is obtained.

Statewide Rule 14(b)(3) requires the operator of any inactive well more than 25 years old to successfully perform a fluid level or hydraulic pressure test establishing that the well does not pose a potential threat of harm to natural resources, including surface and subsurface water, oil and gas.

BACKGROUND

In 1999, IBC acquired a number of bay wells in the Red Fish Bay area in Nueces County, Texas. Some of these wells were inactive at the time they were acquired by IBC, and many were more than twenty years old in 1999. Included in the group of bay wells acquired by IBC in 1999 were the three wells involved in this docket. The State Tract 456 Lease, Well No. 1 (RRC No. 012788) was drilled and completed in 1953. The Ten Sand Gas Unit 421 Lease, Well No. 3 (RRC No. 043367) was drilled and completed in 1967. The State Tract 397 Lease, Well No. 6 (RRC No. 076517) was drilled and completed in 1978. All three wells were active when acquired by IBC in 1999.

IBC produced some of the bay wells it acquired in 1999, and some it never produced. All three wells involved in this docket were produced for a time by IBC, and all three became inactive while IBC was still the operator. Production was last reported to the Commission for these three wells in March 2002.

During 2003, the Commission began to consider adoption of amendments to Statewide Rule 78 to provide for additional financial assurance requirements for operators of bay and offshore wells. IBC was aware of the additional financial assurance requirements under consideration¹, and decided to divest itself of its bay wells in the Red Fish Bay area. An agreement was reached pursuant to which IBC sold its Red Fish Bay assets to Boss Exploration & Production Corporation (“Boss”) and Cinco Natural Resources Corporation (“Cinco”), as evidenced by a Purchase and Sale Agreement executed on August 11, 2004, and made effective June 1, 2004. The Purchase and Sale Agreement provided for a Closing Date of August 31, 2004.

By the Purchase and Sale Agreement, Boss and Cinco each acquired equal undivided ownership interests in all of IBC’s working interests in all valid oil and gas leases comprising the Red Fish Bay project (with exceptions not here relevant) and all of IBC’s working interests in producing and inactive wells situated on valid leases or leases which had terminated in the Red Fish Bay area. IBC retained a 2.0% of 8/8ths back in working interest in the valid leases that were subject to the Agreement. Exhibit A-2 to the Purchase and Sale Agreement classified about 85% of the wells subject to the Agreement as “Inactive.” The three wells that are the subject of this docket were covered by the Agreement, and all three were classified on Exhibit A-2 as “Inactive.” The purchase price for these, and other IBC assets listed in the Agreement, was \$4,500,000, subject

¹ The Proposal for Decision in Oil & Gas Docket No. 04-0241509; *Application of Boss Exploration & Production Corporation to Consider An Exception to the Financial Security Requirements for Bay Wells in Various Red Fish Bay Fields, Nueces County, Texas*, sponsored by IBC as an exhibit in this docket, recited that IBC filed written comments on the bay and offshore well financial assurance proposals in December 2003.

to adjustments.

By the Purchase and Sale Agreement, Boss and Cinco also assumed certain of IBC's liabilities, including a \$236,000 indebtedness and IBC's wellbore obligations related to all of the inactive wells covered by the Agreement. The Agreement also provided that Boss and Cinco would indemnify and hold IBC harmless from and against any and all liability arising out of, in connection with, or resulting from Boss' and Cinco's ownership of the assets covered by the Agreement, for periods from and after June 1, 2004.

By Forms P-4 (Certificate of Compliance and Transportation Authority) approved by the Commission on October 14, 2004, Boss became the operator of six of the wellbores covered by the Purchase and Sale Agreement. On January 13, 2005, Boss filed a request with the Commission for a hearing to consider its application for an exception to Statewide Rule 78, in order that Boss might take a transfer of the remainder of IBC's bay wells in the Red Fish Bay area, without posting the required financial assurance.

IBC's Form P-5 organization report and financial assurance were due for renewal on February 1, 2005, and although at that time IBC was still the operator of record of about 29 inactive bay wellbores covered by the Purchase and Sale Agreement, IBC did not renew its Form P-5 or post the required financial assurance. IBC's organization report and financial assurance have remained delinquent since February 1, 2005.

By Forms P-4 approved on April 28, 2005, May 16, 2005, and May 23, 2006, Boss became the operator of three more IBC bay wells that had been covered by the Purchase and Sale Agreement. In the meantime, Boss' application for an exception to the bay well financial security requirements of Statewide Rule 78 was docketed as Oil & Gas Docket No. 04-0241509, *Application of Boss Exploration & Production Corporation to Consider An Exception to the Financial Security Requirements for Bay Wells in Various Red Fish Bay Fields, Nueces County, Texas*. Hearing in this docket was held on March 10, 2005, and a proposal for decision was served on April 12, 2005. By Final Order dated June 22, 2005, the Commission denied the relief sought by Boss.

The proposal for decision in the *Boss* docket indicated that as of the date of the hearing in that docket, March 10, 2005, 15 of the wellbores that Boss proposed to acquire from IBC were located on State tracts having no then effective oil and gas leases.²

On September 13, 2005, counsel for IBC sent Boss and Cinco a letter stating: (1) pursuant to the Purchase and Sale Agreement effective June 1, 2004, Boss and Cinco assumed IBC's obligations associated with the bay wellbores covered by the Agreement; (2) Boss and Cinco had failed to post sufficient financial assurance with the Commission in order to effectuate a transfer of

² The State tracts on which leases were represented to have lapsed were State Tracts 352, 397, 414, 416, 422, 423, 424, 444, 445, and 456. This appears to have included two of the three State Tracts on which the subject wells in this enforcement docket are located.

the wells; and (3) the Commission had issued a final order denying Boss' request to lower the financial assurance requirement for the wells. This letter made a formal demand that Boss and Cinco immediately either plug the wells or comply with the Commission's financial assurance requirements and do anything else necessary to effectuate a transfer of the wells to Boss.³

Boss did not elect to take a transfer of any more of the IBC bay wells covered by the Purchase and Sale Agreement until January 27, 2006, when the Commission approved Forms P-4 for 10 more wells, and took this transfer only for the purpose of a same day transfer of the wells from Boss to Cinco. On September 16, 2005, the Commission transferred to the Oil Field Clean Up Fund, a \$50,000 cash deposit previously posted by IBC as financial assurance, because IBC had allowed its Form P-5 organization report to become delinquent on February 1, 2005, at a time when, under Commission rules, it retained liability for 29 wellbores with total depth of 310,651 feet.

On February 8, 2006, about seven months after the Commission had issued its Final Order denying Boss' application for an exception to the Statewide Rule 78 bay well financial assurance requirements and about twenty months after the effective date of the Purchase and Sale Agreement between IBC, Boss and Cinco, Cinco filed a request for hearing on Cinco's application for a reduction in Statewide Rule 78 bay well financial assurance requirements. Cinco requested the Commission's approval of this application in order that Cinco could take a transfer of the remainder of the IBC bay wells covered by the Purchase and Sale Agreement, without posting the full amount of bay well financial assurance required by Statewide Rule 78.

The Cinco application was docketed as Oil & Gas Docket No. 01-0246234, *Application of Cinco Natural Resources Corp. to Consider Reduction of the Amount of Financial Security Required Pursuant to Statewide Rule 78(g) and to Consider An Exception to the Financial Security Requirements for Bay Wells in Various Red Fish Bay Fields, Nueces County, Texas*. This application was heard on March 6, 2006, and a proposal for decision was issued on April 28, 2006. By Final Order dated June 6, 2006, based on a finding that as of December 31, 2004, Cinco had a certified net worth of \$22,816,754, the Commission approved a reduction in the amount of financial assurance that Cinco would otherwise have been required to file under Statewide Rule 78 in order to take a transfer of the IBC bay wells.⁴

On June 23, 2006, IBC sent Boss and Cinco another demand letter. This letter asserted that: (1) Boss and Cinco had assumed IBC's obligations with respect to the bay wells covered by the

³ This demand letter made note of the fact that the Commission was threatening to collect and transfer to the Oil Field Clean Up Fund \$50,000 of financial assurance that IBC previously posted with the Commission.

⁴ This Final Order approved the filing by Cinco of \$650,000 of financial assurance on the premise that Cinco would take a transfer of 24 of the bay wellbores covered by the Purchase and Sale Agreement between IBC, Boss, and Cinco. The Final Order also concluded that Cinco could not be recognized as the operator of five IBC wellbores, including the State Tract 397 Lease, Well No. 6 (RRC No. 076517) involved in this enforcement docket, because Cinco could not establish that it had a good faith claim of right to operate the wells.

Purchase and Sale Agreement; and (2) despite notice, Boss and Cinco had still failed to comply with their contractual obligations. The letter enclosed copies of Commission letters to IBC indicating that the Commission had filed formal enforcement complaints against IBC seeking administrative penalties respecting 12 wells covered by the Purchase and Sale Agreement. IBC demanded that Boss and Cinco immediately take action to correct any violations of Commission rules and formally demanded that Boss and Cinco indemnify and hold IBC harmless from the complaints, including any legal fees and penalties.

On July 21, 2006, the Commission approved a transfer from Boss to Cinco of five bay wellbores, which Boss had formerly acquired from IBC. On October 13, 2006, the Commission approved a transfer from Boss to Cinco of one more bay wellbore, which Boss had formerly acquired from IBC. On October 18, 2006, the day before the hearing in this enforcement docket, the Commission approved the transfer from IBC to Cinco of twelve more bay wellbores that had been covered by the Purchase and Sale Agreement effective twenty-eight months earlier. Included in the group of bay wells transferred to Cinco as a result of the approval on October 18, 2006, were two of the three wells involved in this enforcement docket, the State Tract 456 Lease, Well No. 1 (RRC No. 012788) and the Ten Sand Gas Unit 421 Lease, Well No. 3 (RRC No. 043367).

As of the date of the hearing in this enforcement docket, five of the bay wellbores covered by the Purchase and Sale Agreement between IBC, Boss, and Cinco remained in the name of IBC, including the State Tract 397 Lease, Well No. 6 (RRC No. 076517) involved in this enforcement docket.⁵

DISCUSSION OF THE EVIDENCE

Matters Officially Noticed

The examiner has officially noticed: (1) Commission P-5 Master Inquiry and P-5 Financial Assurance Inquiry databases for IBC; (2) Commission Oil Ledger and Gas Ledger databases reflecting the production history of all IBC wells in the Red Fish Bay area, including those transferred to Boss and/or Cinco; (3) Commission On-Schedule Leases, Wells, Wellbores by Operator database for IBC, Boss, and Cinco; (4) Commission Oil and Gas W-2/G-1 Record database for all IBC wells in the Red Fish Bay area, including those transferred to Boss and/or Cinco; (5) Commission certified letter dated September 16, 2005, collecting and transferring to the Oil Field Clean Up Fund the \$50,000 of financial assurance previously posted by IBC; (6) Commission P-4 Inquiry database for all IBC leases, including those transferred to Boss and/or

⁵ Cinco represented that it has no oil and gas lease covering this well, but still hopes to acquire one. The proposal for decision in Oil & Gas Docket No. 01-0246234; *Application of Cinco Natural Resources Corp. to Consider Reduction of the Amount of Financial Security Required Pursuant to Statewide Rule 78(g) and to Consider An Exception to the Financial Security Requirements for Bay Wells in Various Red Fish Bay Fields, Nueces County, Texas* found that the General Land Office does not recognize Cinco as the current holder of the mineral interest in State Tract 397 and that this Tract is under lease to an unrelated entity.

Cinco; (7) Commission 14(b)(2) Well History Inquiry database for the subject wells, and (8) Commission's Final Order in Oil & Gas Docket No. 04-0241509; *Application of Boss Exploration & Production Corporation to Consider An Exception to the Financial Security Requirements for Bay Wells in Various Red Fish Bay Fields, Nueces County, Texas.*

Enforcement

The most recent Form P-5 organization report of IBC approved January 21, 2004, stated that IBC is a corporation, and its officers were Franz Scheitz, President, and Michael Joseph Pawelek, Vice President.⁶ IBC designated itself as the operator of the subject leases and wells by filing Forms P-4 (Certificate of Compliance and Transportation Authority) which were approved on September 9, 1999, effective July 6, 1999. IBC remained the designated operator of all three of the subject wells until the day before the hearing in this docket, October 18, 2006, when the Commission approved Forms P-4 transferring two of the wells, the State Tract 456 Lease, Well No. 1 (RRC No. 012788) and the Ten Sand Gas Unit 421 Lease, Well No. 3 (RRC No. 043367) to Cinco. As of the date of the hearing, IBC remained the designated operator of the State Tract 397 Lease, Well No. 6 (RRC No. 076517).

Statewide Rule 3 Violations

Photographs taken by the District Office on May 22, 2006, and September 21, 2006, of the State Tract 456 Lease showed that the identification sign required by Statewide Rule 3(2) to be posted at Well No. 1 displayed an incorrect operator name. Photographs taken by the District Office on the same dates of the State Tract 397 Lease showed the same violation at Well No. 6. The signs posted at Well Nos. 1 and 6 on these dates showed the name of Boss, rather than IBC.

An affidavit of Mark England, Engineering Specialist, Field Operations ("England Affidavit"), stated that in the event of a pollution or safety violation or other emergency, the lack of legible signs and identification displaying correct information may cause confusion as to the responsible operator to be contacted and actual location of the violation or emergency, causing delay in containing and remediating the violation or emergency, which is serious and may threaten the public health and safety.

Statewide Rule 14(b)(2) Violations

District Office inspections on May 22, 2006, and September 21, 2006 ("the District Office inspections"), disclosed that the State Tract 456 Lease, Well No. 1 (RRC No. 012788) was inactive. The inspection report dated May 22, 2006, stated that the platform had no steel grating and was in bad condition. The inspection report dated September 21, 2006, stated that the Xmas tree valves and Master and Wing valves were inoperable, and the surface casing valve was in bad condition (See

⁶ The proposal for decision in Oil & Gas Docket No. 04-0241509; *Application of Boss Exploration & Production Corporation to Consider An Exception to the Financial Security Requirements for Bay Wells in Various Red Fish Bay Fields, Nueces County, Texas* stated that Pawelek was a Vice President of IBC from July 2000 until January 2005, and that Pawelek is now President of Boss.

Photo Nos. 155, 303, and 304 attached). No production for Well No. 1 had been reported to the Commission since March 2002. The last plugging extension granted to IBC for this well expired on January 31, 2005, when IBC's Form P-5 became delinquent. This well was transferred to Cinco by Form P-4 approved October 18, 2006.

The District Office inspections also disclosed that the Ten Sand Gas Unit 421 Lease, Well No. 3 (RRC No. 043367) was inactive. No production for Well No. 3 had been reported to the Commission since March 2002. The last plugging extension granted to IBC for this well also expired on January 31, 2005, when IBC's Form P-5 became delinquent. This well was also transferred to Cinco by Form P-4 approved October 18, 2006.

The District Office inspections further disclosed that the State Tract 397 Lease, Well No. 6 (RRC No. 076517) was inactive. The May 22, 2006, inspection report stated that this well had no platform (See Photo No. 144 attached). No production for Well No. 6 had been reported to the Commission since March 2002. The last plugging extension for this well was canceled on October 4, 2004, based on failure of IBC to perform a required H-15 test. As of the date of the hearing, IBC was still the designated operator of Well No. 6. The estimated cost to the State to plug this well is \$75,000.

The Commission's Secretary certified that as of the date of the certification, October 17, 2006, no plugging record (Form W-3) or Cementing Affidavit (Form W-15) had been filed or approved, and no plugging extensions were in effect, for the subject wells.

The England Affidavit stated that a well that is in violation of Statewide Rule 14 must be plugged in order to prevent pollution of usable quality surface and subsurface waters. Any wellbore, cased or otherwise, is a potential conduit for flow from oil or saltwater zones to zones of usable quality water or to the surface. Holes or leaks may develop in cased wells, allowing oil or saltwater to communicate with usable quality zones or to flow to the surface. Uncased wells allow direct communication between zones and provide unimpeded access to the surface.

Statewide Rule 14(b)(3) Violations

The State Tract 456 Lease, Well No. 1 (RRC No. 012788) was completed in April 1953, and the well is more than 25 years old. The last H-15 test of the well was performed on June 2, 2004. A further H-15 test was due in May 2005, and had not been performed as of the date of the hearing.

The Ten Sand Gas Unit 421 Lease, Well No. 3 (RRC No. 043367) was completed in November 1951, and this well is also more than 25 years old. The last H-15 test of the well was performed on July 13, 2000. A further H-15 test of the well was due in May 2005, and had not been performed as of the date of the hearing.

The England Affidavit stated that any inactive well that is more than 25 years old must be plugged or tested to determine whether the well poses a potential threat of harm to natural resources, including surface and subsurface water, oil and gas. Casing leaks and/or fluid levels above the base

of usable quality water indicate a possible pollution hazard. Without the required test and filing of Form H-15, the Commission cannot determine if a well poses a threat to natural resources.

Attempts to Obtain Voluntary Compliance

On March 14, 2006, the District Office corresponded with IBC to request immediate action to correct the Statewide Rule 14(b)(2) violations on the subject leases. When IBC did not respond, the District Office sent IBC a copy of a memorandum to the Commission's Deputy Director, Field Operations, dated April 11, 2006, recommending the scheduling of a plug hearing and advising IBC that this would be its last opportunity to place the subject leases and wells into compliance without payment of a penalty. IBC did not respond by placing the leases into compliance, except that on October 18, 2006, the day before the hearing in this docket, the Commission approved Forms P-4 transferring two of the subject wells, the State Tract 456 Lease, Well No. 1 (RRC No. 012778) and the Ten Sand Gas Unit 421 Lease, Well No. 3 (RRC No. 043367) to Cinco.

Penalties Recommended by Enforcement

Enforcement recommends that a total penalty of \$34,500 be imposed against IBC, calculated on the basis of two Statewide Rule 3 violations at \$250 each, three Statewide Rule 14(b)(2) violations at \$10,000 each, and two Statewide Rule 14(b)(3) violations at \$2,000 each.

IBC Petroleum, Inc.

IBC presented no testimony, but did present exhibits consisting of: (1) the Purchase and Sale Agreement between IBC, Boss, and Cinco, effective June 1, 2004; (2) the proposal for decision and final order in Oil & Gas Docket No. 01-0246234, *Application of Cinco Natural Resources Corp. to Consider Reduction of the Amount of Financial Security Required Pursuant to Statewide Rule 78(g) and to Consider An Exception to the Financial Security Requirements for Bay Wells in Various Red Fish Bay Fields, Nueces County, Texas*; (3) the proposal for decision in Oil & Gas Docket No. 04-0241509, *Application of Boss Exploration & Production Corporation to Consider An Exception to the Financial Security Requirements for Bay Wells in Various Red Fish Bay Fields, Nueces County, Texas*; (4) a copy of IBC's Form P-5 organization report approved January 16, 2004; and (5) copies of IBC's September 13, 2005, and June 23, 2006, demand letters to Boss and Cinco.

IBC did not dispute Enforcement's allegations that the violations involved in this docket were committed, but argued that there are mitigating circumstances that weigh against the imposition of administrative penalties against IBC.

IBC asserted that by the Purchase and Sale Agreement, IBC transferred its interest in all of its wells in the Red Fish Bay area, including the three wells involved in this docket, to Boss and Cinco, effective June 1, 2004, and pursuant to the Agreement, Boss and Cinco assumed all of IBC's wellbore obligations respecting these wells. At the time of this contractual transfer, IBC's Form P-5

organization report was active.

IBC argued further that after the effective date of the Purchase and Sale Agreement, there was an “ongoing process” through which first Boss, then Cinco, pursued applications before the Commission for relief from the bay well financial assurance requirements of Statewide Rule 78, so that Boss or Cinco could accept a transfer of IBC’s wells covered by the Agreement. When the Commission threatened to collect and transfer to the Oil Field Clean Up Fund the \$50,000 cash previously posted by IBC as financial assurance, and later filed formal enforcement complaints against IBC respecting 12 bay wells covered by the Agreement, IBC tried to move the process along by sending demand letters to Boss and Cinco to honor their obligations under the Agreement.

IBC also asserted that some of the violations involved in this docket occurred after the effective date of the Purchase and Sale Agreement. According to IBC, its “hands were tied,” because after the effective date of the Agreement, IBC was divested of well ownership and could not operate the wells or plug them. Because most of IBC’s wells in the Red Fish Bay area have now been transferred to Cinco, IBC does not believe that it should be penalized for “interim violations.” IBC accorded significance to the fact that the Commission has already collected and transferred to the Oil Field Clean Up Fund IBC’s \$50,000 cash deposit.

Cinco Natural Resources Corporation

Cinco participated at the hearing in this docket as an intervenor. No evidence relevant to this docket was presented by Cinco, but it did offer statements and argument of its legal counsel. Cinco argued that it originally was contemplated that Boss would become the operator of the wells acquired by Boss and Cinco pursuant to the Purchase and Sale Agreement with IBC. Boss took a transfer of some of these wells, but could not obtain approval from the Commission for an exception to bay well financial assurance requirements in order to take the remainder. Cinco agreed that the Commission properly denied Boss’ request for financial assurance relief, because, according to Cinco, Boss did not have sufficient net worth.

After denial of the Boss application, Cinco decided to become the operator of the bay wells covered by the Purchase and Sale Agreement, both those formerly acquired by Boss and those that were still in the name of IBC. According to its counsel, Cinco will become the operator of all of these wells “one way or the other.” Because the Commission has already collected and deposited to the Oil Field Clean Up Fund IBC’s \$50,000 cash deposit, Cinco does not believe that the imposition of administrative penalties against IBC is appropriate.⁷

EXAMINER’S OPINION

Because the alleged violations are plainly proved by Enforcement’s evidence and not disputed by IBC, the only remaining issues are: (1) the amount of administrative penalties, if any, that should be imposed; and (2) what compliance should be ordered.

⁷ Cinco’s counsel declined to take a position on the issue of whether Cinco is contractually bound under the Purchase and Sale Agreement to indemnify IBC for any penalties that may be assessed in this docket.

It is well settled by Commission decisions in enforcement cases that the signing of a private contract to transfer ownership of oil or gas wells does not transfer responsibility for compliance with Commission rules unless a Form P-4 (Certificate of Compliance and Transportation Authority) requesting a change of operator is approved by the Commission. Pursuant to Texas Natural Resources Code §89.002(a)(2), in the event of a sale or conveyance of an unplugged well or the right to operate an unplugged well, a person ceases being the operator with the duty to plug the well only if the well was in compliance with Commission rules relating to safety or the prevention or control of pollution at the time of sale or conveyance and the person who acquires the well or right to operate the well, among other things, specifically identifies the well as a well for which the person assumes plugging responsibility on forms (Forms P-4) required and approved by the Commission and has a Commission approved bond, letter of credit, or cash deposit under §§91.103-91.107 covering the well. Under Statewide Rule 58, an approved Form P-4 binds an operator to comply with Commission rules with respect to a particular lease or well until another operator files a subsequent Form P-4 that is approved by the Commission, and the lease or well has been transferred on Commission records to the subsequent operator.

Consequently, IBC's responsibility to comply with Commission rules respecting the State Tract 456 Lease, Well No. 1 (RRC No. 012788) and the Ten Sand Gas Unit 421 Lease, Well No. 3 (RRC No. 043367) endured from July 6, 1999, when Forms P-4 transferring these wells to IBC were effective, until the day before the hearing in this docket, October 18, 2006, when the Commission approved Forms P-4 transferring the same wells to Cinco. IBC has retained responsibility to comply with Commission rules respecting the State Tract 397 Lease, Well No. 6 (RRC No. 076517) since the Form P-4 transferring this well to IBC was effective on July 6, 1999, because as of the date of the hearing in this docket, this well remained in the name of IBC on Commission records.

Notwithstanding the able argument made by IBC's counsel, it cannot be concluded that IBC is blameless respecting the violations proved by Enforcement. In the first instance, if it was IBC's objective to divest itself of regulatory responsibility for its Red Fish Bay area wells immediately upon the closing of the Purchase and Sale Agreement with Boss and Cinco, it would have been prudent for IBC through due diligence to confirm that Boss and/or Cinco had the ability and willingness to do those things necessary, including the posting of financial assurance, to take an immediate Form P-4 transfer of the wells and to require by contract that this be accomplished. At the time of closing, IBC was aware of the bay well financial assurance requirements then under consideration by the Commission, and knew or should have known that the ability or willingness of Boss or Cinco to post this financial assurance would be a factor in determining when IBC's regulatory responsibility for its Red Fish Bay area wells would end.

It is now known that at or about the time of closing of the Purchase and Sale Agreement, Cinco had a net worth of more than \$22,000,000. Boss, on the other hand, was a newly organized company that did not have audited financial statements. By the Agreement, IBC agreed to execute Forms P-4 to transfer its Red Fish Bay area wells to Boss as operator, even though the Agreement transferred equal undivided ownership of the wells to both Boss and Cinco. This was a choice that the parties were free to make, but it is reasonable to infer that IBC should have anticipated that

compliance by Boss with bay well financial assurance requirements then under consideration might be problematical. Even Cinco now concedes that the Commission correctly denied bay well financial assurance relief to Boss, because Boss did not have the net worth to justify such relief.

It appears from the evidence that the three wells that are involved in this docket became inactive after March 2002, while IBC was the operator, more than two years before the effective date of the Purchase and Sale Agreement with Boss and Cinco. It further appears that IBC's oil and gas leases respecting at least the State Tract 456 Lease, Well No. 1 (RRC No. 012788) and the State Tract 397 Lease, Well No. 6 (RRC No. 076517) were allowed to lapse. IBC could have anticipated that this might be a factor as to when IBC's regulatory responsibility for these wells might end, because since 1999, the Commission has followed a policy of placing a hold on transfer of bay and offshore wells identified by the Oil and Gas Division as noncompliant and requiring any proposed new operator to provide verification that a valid lease exists for the wells.

It cannot be concluded that IBC's "hands were tied" by the Purchase and Sale Agreement with Boss and Cinco. Statewide Rule 1(a)(3) provides that each organization performing activities subject to the jurisdiction of the Commission must maintain a current organization report with the Commission until all duties, obligations, and liabilities incurred pursuant to Commission rules, the Texas Natural Resources Code, Titles 3 (Subtitles A, B, C, and Chapter 111 of Subtitle D) and 5, and the Texas Water Code, Chapters 27 and 29, are fulfilled. As of February 1, 2005, when IBC's organization report was due for renewal, IBC continued to have unfulfilled plugging liability for all but six of its Red Fish Bay area wellbores, and the Purchase and Sale Agreement did not constrain IBC from complying with Statewide Rule 1 by renewing its organization report and using at least a portion of the proceeds realized from the sale to Boss and Cinco to file the required amount of financial assurance. Instead, IBC made the decision not to renew its organization report, which has been delinquent since February 1, 2005. This resulted in the expiration on January 31, 2005, of Statewide Rule 14(b)(2) plugging extensions for the State Tract 456 Lease, Well No. 1 (RRC No. 012788) and the Ten Sand Gas Unit 421 Lease, Well No. 3 (RRC No. 043367) and several other IBC bay wells for which plugging extensions had not already been canceled for other reasons.⁸

After the Purchase and Sale Agreement was closed, Boss apparently proceeded to post its identification signs on at least some of the wells covered by the Agreement, notwithstanding the fact that the Commission had not approved Forms P-4 transferring the wells to Boss. When the District Office inspected the State Tract 456 Lease and State Tract 397 Lease on May 22, 2006, the identification signs posted at Well Nos. 1 (RRC No. 012788) and 6 (RRC No. 076517), which should have identified IBC as the operator, displayed Boss' name instead. An inspection five months later on September 21, 2006, disclosed that the signs still displayed the wrong operator name. It has not been established that the Purchase and Sale Agreement prohibited IBC from maintaining proper identification signs on wells for which it retained regulatory responsibility during the period between May 22, 2006, and September 21, 2006, or that Boss was unwilling to cooperate in this regard. The complaint in this docket was filed on June 16, 2006, and included an allegation that the above-referenced wells were out of compliance with Statewide Rule 3 in that the

⁸ The plugging extension for the State Tract 397 Lease, Well No. 6 (RRC No. 076517) had already been canceled on October 4, 2004, based on IBC's failure to perform a required H-15 test.

identification signs displayed incorrect information. IBC presented no evidence at the hearing in this docket to show that it made any effort to correct this violation.

IBC argues that the involved Statewide Rule 14(b)(2) and Statewide Rule 14(b)(3) violations had their inception after the effective date of the Purchase and Sale Agreement transferring ownership of the subject wells to Boss and Cinco. This appears to be true, but not particularly significant. All of the subject wells became inactive on IBC's watch, long before the effective date of the Agreement. A plugging extension for the State Tract 397 Lease, Well No. 6 (RRC No. 076517) was canceled on October 4, 2004, because IBC failed to perform a required fluid level test. Plugging extensions for the State Tract 456 Lease, Well No. 1 (RRC No. 012788) and the Ten Sand Gas Unit 421 Lease, Well No. 3 (RRC No. 043367) expired on January 31, 2005, when IBC made the choice not to renew its organization report and financial assurance as it was required to do by Statewide Rule 1. The involved Statewide Rule 14(b)(3) violations arose in May 2005, when IBC failed to perform required H-15 tests on the State Tract 456 Lease, Well No. 1 (RRC No. 012788) and the Ten Sand Gas Unit 421 Lease, Well No. 3 (RRC No. 043367). Thus, these violations arose on dates after the effective date of the Purchase and Sale Agreement, but while IBC was still the operator with the responsibility for compliance with Commission rules respecting the wells.

The dilemma perceived by IBC that the Statewide Rule 14(b)(2) and Statewide Rule 14(b)(3) violations arose after the effective date of the transfer of well ownership to Boss and Cinco, while IBC still retained the responsibility for regulatory compliance, resulted simply from: (1) the decision made by IBC not to renew its Form P-5 organization report on February 1, 2005; and (2) the choice made by IBC, Boss, and Cinco to make transfer of well ownership effective June 1, 2004, rather than on the date when the Commission approved a transfer of the wells from IBC to Boss or Cinco. There appears to be nothing in the Purchase and Sale Agreement that expressly prevented IBC from complying with Commission rules respecting the subject wells while IBC remained the operator of record, either by performing required fluid level tests or doing the other things necessary to perpetuate plugging extensions for the wells, and any such provision in the Agreement would most likely have been void as against public policy. IBC's concern that it could not plug any of the subject wells after the effective date of the ownership transfer to Boss and Cinco must be weighed in light of the statements in the proposal for decision in Oil & Gas Docket No. 04-0241509; *Application of Boss Exploration & Production Corporation to Consider An Exception to the Financial Security Requirements for Bay Wells in Various Red Fish Bay Fields, Nueces County, Texas* that Boss had determined that 14 of the 29 wellbores acquired from IBC required plugging, and from July 2000 through January 2005, while Michael Pawelek was a Vice President of IBC, IBC did not plug and abandon any of its inactive wells.

In determining an appropriate administrative penalty, Texas Natural Resources Code §81.0531 requires that the Commission consider the respondent's history of previous violations, the seriousness of the violations, any hazard to the health or safety of the public, and the demonstrated good faith of the respondent.

According to Enforcement's complaints, IBC has no prior history of enforcement orders entered against it for violations of Commission rules. On the other hand, the involved violations

presented at least a threat of pollution and a potential hazard to the health or safety of the public. None of the evidence weighs particularly in IBC's favor on the issue of good faith. Two of the subject wells were approved for transfer to Cinco the day before the hearing, but this was little more than a partial and belated culmination of IBC's effort to dispose of its Red Fish Bay area wells, a large majority of which were inactive and involved significant plugging liability. Other than to demand that Boss and Cinco bring the wells into compliance, IBC appears to have done nothing to respond to District Office requests for IBC's voluntary compliance.⁹

The penalties recommended by Enforcement are consistent with the recommended standard penalty schedule for enforcement cases. However, because it appears that delays by Boss and Cinco in requesting and obtaining Commission approval for the transfer to either of them of the State Tract 456 Lease, Well No. 1 (RRC No. 012788) and the Ten Sand Gas Unit 421 Lease, Well No. 3 (RRC No. 043367) may have contributed at least to the duration of the violations committed by IBC, and because these wells were, in fact, approved for transfer to Cinco on October 18, 2006, the examiner will recommend that the standard penalties for the violations respecting these two wells be reduced by 25 percent. The total recommended penalty is \$28,437.50, calculated on the basis of one violation of Statewide Rule 3(2) on the State Tract 456 Lease, Well No. 1 (RRC No. 012788) at \$187.50, one violation of Statewide Rule 3(2) on the State Tract 397 Lease, Well No. 6 (RRC No. 076517) at \$250, two violations of Statewide Rule 14(b)(2) on the State Tract 456 Lease, Well No. 1 (RRC No. 012788) and the Ten Sand Gas Unit 421 Lease, Well No. 3 (RRC No. 043367) at \$7,500 each, one violation of Statewide Rule 14(b)(2) on the State Tract 397 Lease, Well No. 6 (RRC No. 076517) at \$10,000, and two violations of Statewide Rule 14(b)(3) on the State Tract 456 Lease, Well No. 1 (RRC No. 012788) and the Ten Sand Gas Unit 421 Lease, Well No. 3 (RRC No. 043367) at \$1,500 each.

Based on the record in this case, the examiner recommends adoption of the following Findings of Fact and Conclusions of Law.

FINDINGS OF FACT

1. IBC Petroleum, Inc. ("IBC") was given at least ten (10) days notice of this hearing by certified mail, addressed to IBC's most recent Form P-5 organization report address. IBC appeared at the hearing and presented evidence.
2. IBC is a corporation, and IBC's most recent Form P-5 organization report approved January 21, 2004, shows that its officers were Franz Scheitz, President, and Michael Joseph Pawelek,

⁹ The fact that the Commission collected and transferred to the Oil Field Clean Up Fund the \$50,000 cash deposit previously posted by IBC as financial assurance is not significant in determining whether administrative penalties should be assessed. This deposit appears to have been an asset sold and conveyed to Boss and Cinco by the Purchase and Sale Agreement. In addition, Texas Natural Resources Code §91.1091 provides that the Commission shall refund this cash deposit if (1) the conditions that caused the proceeds to be collected are corrected; (2) all administrative, civil, and criminal penalties relating to those conditions are paid; and (3) the Commission has been reimbursed for all costs and expenses incurred by the Commission in relation to those conditions.

Vice President.

3. As officers, Franz Scheitz and Michael Joseph Pawelek were persons in a position of ownership or control of IBC at the time the violations involved in this docket were committed.
4. The violations involved in this docket were violations of Commission rules related to safety and the prevention or control of pollution.
5. IBC's Form P-5 organization report has been delinquent since February 1, 2005. At the time this organization report became delinquent, IBC had financial assurance on file with the Commission in the form of a \$50,000 cash deposit.
6. On September 16, 2005, the Commission transferred IBC's \$50,000 cash deposit to the Oil Field Clean Up Fund because IBC's Form P-5 organization report had become delinquent on February 1, 2005, and IBC then retained well plugging liability for 29 wellbores with total depth of 310,651 feet.
7. IBC designated itself the operator of the State Tract 456 Lease, Well No. 1 (RRC No. 012788), the Ten Sand Gas Unit 421 Lease, Well No. 3 (RRC No. 043367), and the State Tract 397 Lease, Well No. 6 (RRC No. 076517) ("subject wells") by filing Forms P-4 (Certificate of Compliance and Transportation Authority), which were approved on September 9, 1999, effective July 6, 1999. All the subject wells are bay wells.
8. On the occasion of District Office inspections on May 22, 2006, and September 21, 2006, the identification signs required to be posted at Well No. 1 (RRC No. 012788) on the State Tract 456 Lease and at Well No. 6 (RRC No. 076517) on the State Tract 397 Lease displayed an incorrect operator name.
9. During the period from February 1, 2005, to October 18, 2006, the State Tract 456 Lease, Well No. 1 (RRC No. 012788) and the Ten Sand Gas Unit 421 Lease, Well No. 3 (RRC No. 043367) had been inactive for more than one year, did not have Statewide Rule 14(b)(2) plugging extensions, and had not been plugged.
 - a. District Office inspections on May 22, 2006, and September 21, 2006, disclosed that these wells were inactive.
 - b. No production had been reported to the Commission for these wells since March 2002.
 - c. No Plugging Record (Form W-3) or Cementing Affidavit (Form W-15) had been filed or approved for these wells.
 - d. The last Statewide Rule 14(b)(2) plugging extension granted to IBC for these wells expired on January 31, 2005.

10. The State Tract 397 Lease, Well No. 6 (RRC No. 076517) has been inactive for more than one year, does not have a Statewide Rule 14(b)(2) plugging extension, and has not been plugged.
 - a. District Office inspections on May 22, 2006, and September 21, 2006, disclosed that this well was inactive.
 - b. No production has been reported to the Commission for this well since March 2002.
 - c. No Plugging Record (Form W-3) or Cementing Affidavit (Form W-15) has been filed or approved for this well.
 - d. The last Statewide Rule 14(b)(2) plugging extension approved for this well was canceled on October 4, 2004, based on failure of IBC to perform a required H-15 test on the well.
11. On October 18, 2006, the Commission approved Forms P-4 transferring the State Tract 456 Lease, Well No. 1 (RRC No. 012788) and the Ten Sand Gas Unit 421 Lease, Well No. 3 (RRC No. 043367) from IBC to Cinco Natural Resources Corporation (“Cinco”).
12. As of the date of the hearing in this docket, IBC remained the operator of record of the State Tract 397 Lease, Well No. 6 (RRC No. 076517), and neither IBC or Cinco possessed an effective oil and gas lease covering this well.
13. The estimated cost to the State for plugging the State Tract 397 Lease, Well No. 6 (RRC No. 076517) is \$75,000.
14. The State Tract 456 Lease, Well No. 1 (RRC No. 012788) was completed in April 1953, and the well is more than 25 years old. The last H-15 test (Test On An Inactive Well More Than 25 Years Old) of the well was performed on June 2, 2004. A further H-15 test of the well was due in May 2005, and had not been performed as of the date of the hearing.
15. The Ten Sand Gas Unit 421 Lease, Well No. 3 (RRC No. 043367) was completed in November 1951, and the well is more than 25 years old. The last H-15 test of the well was performed on July 13, 2000. A further H-15 test of the well was due in May 2005, and had not been performed as of the date of the hearing.
16. On March 14, 2006, the District Office sent IBC a letter requesting immediate action to correct the Statewide Rule 14(b)(2) violations on the subject wells. On April 11, 2006, the District Office sent IBC a copy of a memorandum to the Deputy Director, Field Operations recommending the scheduling of a plug order hearing and advising IBC that this would be IBC’s last opportunity to bring the subject wells into compliance without the payment of a

- penalty.
17. In the event of a pollution or safety violation or other emergency, incorrect, illegible, or missing identification signs may cause delays in containing or remediating the violation or emergency.
 18. Inactive wells must be plugged as required by Statewide Rule 14 in order to prevent pollution of usable quality surface and subsurface waters. Any wellbore, cased or otherwise, is a potential conduit for flow from oil or saltwater zones to zones of usable quality water or to the surface. Holes or leaks may develop in cased wells, allowing oil or saltwater to communicate with usable quality zones or to flow to the surface. Uncased wells allow direct communication between zones and provide unimpeded access to the surface.
 19. Any inactive well that is more than 25 years old must be plugged or tested to determine whether the well poses a potential threat of harm to natural resources, including surface and subsurface water, oil and gas. Casing leaks and/or fluid levels above the base of usable quality water indicate a possible pollution hazard. Without the required test and filing of Form H-15, the Commission cannot determine if a well poses a threat to natural resources.
 20. No prior final enforcement orders have been entered against IBC for violations of Commission rules.
 21. IBC has not demonstrated good faith.
 - a. IBC did not renew its Form P-5 organization report when due on February 1, 2005, and file financial assurance, as required by Statewide Rules 1 and 78.
 - b. IBC did not maintain any of the subject wells in compliance with Commission rules after January 31, 2005.
 - c. IBC did not respond to requests from the District Office for voluntary compliance with Statewide Rule 14(b)(2), except to the extent that the State Tract 456 Lease, Well No. 1 (RRC No. 012788) and the Ten Sand Gas Unit 421 Lease, Well No. 3 (RRC No. 043367) were transferred to Cinco as a result of Forms P-4 approved by the Commission on October 18, 2006.

CONCLUSIONS OF LAW

1. Proper notice of hearing was timely issued to appropriate persons entitled to notice.
2. All things necessary to the Commission attaining jurisdiction have occurred.
3. IBC Petroleum, Inc., was the operator of the State Tract 456 Lease, Well No. 1 (RRC No. 012788) and the Ten Sand Gas Unit 421 Lease, Well No. 3 (RRC No. 043367), Red Fish Bay-Mus. IS (Common 10) Field, Nueces County, Texas, as defined by Statewide Rules 14, 58, and 79 [Tex. R.R. Comm'n, 16 TEX. ADMIN. CODE §§3.14, 3.58, and 3.79] and Chapters

85 and 89 of the Texas Natural Resources Code, from July 6, 1999, until October 18, 2006.

4. IBC Petroleum, Inc., was and is the operator of the State Tract 397 Lease, Well No. 6 (RRC No. 076517), Red Fish Bay-Mus. IS (Common 10) Field, Nueces County, Texas, as defined by Statewide Rules 14, 58, and 79 [Tex. R.R. Comm'n, 16 TEX. ADMIN. CODE §§3.14, 3.58, and 3.79] and Chapters 85 and 89 of the Texas Natural Resources Code.
5. As operator, IBC Petroleum, Inc., had the primary responsibility for complying with Statewide Rules 3 and 14 [Tex. R.R. Comm'n, 16 TEX. ADMIN. CODE §§3.3 and 3.14], Chapters 89 and 91 of the Texas Natural Resources Code, and other applicable statutes and Commission rules respecting the subject leases and wells.
6. IBC Petroleum, Inc., violated Statewide Rule 3(2) [Tex. R.R. Comm'n, 16 TEX. ADMIN. CODE §§3.3(2)] on the State Tract 456 Lease, Well No. 1 (RRC No. 012788) and the State Tract 397 Lease, Well No. 6 (RRC No. 076517), Red Fish Bay-Mus. IS (Common 10) Field, Nueces County, Texas, by failing to post identification signs at the wells that displayed the correct operator name. These wells were out of compliance with Statewide Rule 3 from at least May 22, 2006, through at least September 21, 2006.
7. IBC Petroleum, Inc., violated Statewide Rule 14(b)(2) [Tex. R.R. Comm'n, 16 TEX. ADMIN. CODE §3.14(b)(2)] by failing to plug the State Tract 456 Lease, Well No. 1 (RRC No. 012788), the Ten Sand Gas Unit 421 Lease, Well No. 3 (RRC No. 043367), and the State Tract 397 Lease, Well No. 6 (RRC No. 076517), Red Fish Bay-Mus. IS (Common 10) Field, Nueces County, Texas, within one year after operations ceased, or by otherwise placing these wells into compliance with Statewide Rule 14(b)(2). The State Tract 456 Lease Well No. 1 (RRC No. 012788) and the Ten Sand Gas Unit 421 Lease, Well No. 3 (RRC No. 043367) were out of compliance with Statewide Rule 14(b)(2) from February 1, 2005, until October 18, 2006. The State Tract 397 Lease, Well No. 6 (RRC No. 076517) has been out of compliance with Statewide Rule 14(b)(2) since October 4, 2004.
8. IBC Petroleum, Inc., violated Statewide Rule 14(b)(3) [Tex. R.R. Comm'n, 16 TEX. ADMIN. CODE §3.14(b)(3)] by failing to perform required H-15 tests (Test On An Inactive Well More Than 25 Years Old) on the State Tract 456 Lease, Well No. 1 (RRC No. 012788) and the Ten Sand Gas Unit 421 Lease, Well No. 3 (RRC No. 043367), Red Fish Bay-Mus. IS (Common 10) Field, Nueces County, Texas. IBC was out of compliance with Statewide Rule 14(b)(3) with respect to these wells from May 2005, until October 18, 2006.
9. The documented violations committed by IBC Petroleum, Inc., constitute acts deemed serious and a hazard to the public health and safety within the meaning of Texas Natural Resources Code §81.0531.

10. IBC Petroleum, Inc., has not demonstrated good faith within the meaning of Texas Natural Resources Code §81.0531.
11. As officers of IBC Petroleum, Inc., at the time IBC violated Commission rules related to safety and the prevention or control of pollution, Franz Scheitz, President, and Michael Joseph Pawelek, Vice President, and any organization subject to the Commission's jurisdiction in which they, or either of them, may hold a position of ownership or control, are subject to the restrictions of Texas Natural Resources Code §91.114(a)(2).

RECOMMENDATION

The examiner recommends that IBC Petroleum, Inc., be ordered: (1) to pay an administrative penalty of \$28,437.50; and (2) to plug, or otherwise place into compliance with Commission rules, the State Tract 397 Lease, Well No. 6 (RRC No. 076517).

Respectfully submitted,

James M. Doherty
Hearings Examiner