

**APPLICATION OF CINCO NATURAL RESOURCES CORP. (OPERATOR NO. 153474)
PURSUANT TO STATEWIDE RULE 78(g) FOR AN EXCEPTION TO THE FINANCIAL
SECURITY REQUIREMENTS FOR ALL APPLICANT OPERATED WELLS WITHIN THE
STATE OF TEXAS.**

APPEARANCES:

FOR APPLICANT:

J.D. Hall, Attorney
Leigh Prieto, CFO

APPLICANT:

Cinco Natural Resources Corp.
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PROPOSAL FOR DECISION

PROCEDURAL HISTORY

DATE OF REQUEST FOR HEARING:	October 30, 2006
DATE OF NOTICE OF HEARING:	November 8, 2007
DATE OF HEARING:	December 6, 2006
DATE OF RE-OPENED HEARING:	March 14, 2007
HEARD BY:	Marshall Enquist, Hearings Examiner Thomas H. Richter, Technical Examiner
DATE RECORD CLOSED:	March 14, 2007
DATE PFD CIRCULATED:	May 3, 2007

STATEMENT OF THE CASE

This is the application of Cinco Natural Resources Corp. (hereinafter “Cinco”) filed pursuant to Statewide Rule 78(g) for a reduction in the amount of financial security required for Cinco’s bay wells. A hearing was held on December 6, 2006. Cinco appeared and presented evidence. The record was held open until March 14, 2007 to allow Cinco to be recognized as the operator of five wells formerly operated by IBC Petroleum, Inc., a predecessor in interest. The record was also left open to allow the examiner to gather copies of Commission documents of which Official Notice was taken and to deliver copies to Cinco.

This is Cinco’s second application for a reduction in financial security pursuant to the provisions of Statewide Rule 78. At the time of its first application, Oil & Gas Docket No. 01-0246234, heard March 6, 2006, Cinco was the operator of 10 bay wells, all non-producing. Cinco had posted financial security in the amount of \$650,000 with the Commission. Cinco presented its financial statement for the fiscal year ending in December 31, 2004 as evidence that it was entitled, pursuant to Statewide Rule 78(g)(5), to a complete waiver of any financial security required for the

10 non-producing bay wells it then operated. However, Cinco not only requested a reduction in financial security for the ten wells it then operated, but also for 16 non-producing bay wells it intended to acquire from IBC Petroleum (“IBC”), as well as eight active well bores and 5 non-producing wells it intended to acquire from Boss Exploration & Production Corporation (“Boss”) for a total of 39 wells.

The Commission declined to reduce Cinco’s financial security requirement, which remained as posted at \$650,000, but did allow Cinco to become the recognized operator of the IBC and Boss wells for which it could demonstrate a valid good faith claim to operate.¹

At the time of the initial hearing in the present docket, December 6, 2006, Cinco was the operator of 34 bay wells. Cinco stated that it had recently entered farm-out agreements with the leaseholders of State Tract 416 on which IBC Well Nos. 2 and 4 are located and would present documents to that effect and the necessary P-4 transfer documents at a later time.

APPLICABLE RULES

Statewide Rule 78(g)(1)(B)(2) requires the filing of a base amount of \$50,000 for a person operating more than 10 but fewer than 100 wells. Statewide Rule 78(g)(2)(A) requires all operators of bay wells to file additional financial security of no less than \$60,000. Statewide Rule 78(g)(2)(B) requires operators of inactive bay wells to file additional financial security for each inactive, injection, or disposal well in excess of one. As relevant here, in addition to other financial security required under Rule 78(g)(1), Cinco must file entry level financial security of \$50,000 for operating 34 wells, an additional \$60,000 for operating bay wells and an additional \$60,000 for each inactive bay well in excess of one.

Statewide Rule 78(g)(5) provides that an operator may request a reduction in additional financial security required for bay and/or offshore wells that are not actively producing oil and natural gas. An operator may request that the Commission consider a reduction in any additional financial security requirement for the operation of bay and/or offshore wells that are not actively producing oil and natural gas or that are used for disposal or injection in an amount not to exceed the remainder of 25% of the operator’s certified net worth based on the independently audited calculation for the most recently completed fiscal year minus the Commission’s estimate of the operator’s total plugging liability for all of the operator’s active bay and/or offshore wells.

Statewide Rule 78(g)(5)(A) provides that the director may administratively grant a full or

¹ Assuming the accuracy of Cinco’s 2004 financial statement, application of the formula in Statewide Rule 78(g)(5) would have resulted in a complete waiver of Cinco’s additional financial security requirements. Its remaining financial security requirement would have been \$50,000 as an operator of more than ten but fewer than 100 wells, and an entry level amount of \$60,000 as the operator of bay wells, for a total financial security requirement of \$110,000. The Commission declined the reduction, due to a combination of factors, including the fact that Cinco had not produced its most recent financial statement (it offered its financial statement for 2004 rather than 2005), that it had a high ratio of non-producing wells, that there was a the prior admission by Boss that 13 of its wells required plugging, and Cinco’s inability to produce valid leases for 5 of the IBC wells it proposed to take over.

partial reduction if the operator meets the following criteria: (i) the operator has five or fewer bay and offshore wells or at least half of the operator's bay and offshore wells are actively producing oil and natural gas; (ii) the operator provides to the Commission certification of its net worth from an independent auditor that has employed generally accepted accounting principles to confirm the operator's stated net worth based on the most recently available and independently audited calculation; (iii) the reduction is less than or equal to the remainder of 25% of the operator's certified net worth minus the Commission's estimate of the operator's total plugging liability for all of the operator's active bay and offshore wells; and (iv) none of the operator's wells or operations, including any land-based wells, have been found by Commission staff to be violating or to have violated any Commission rule that resulted in pollution or in any hazard to the health or safety of the public in the last 12 months.

Statewide Rule 78(g)(5)(B) provides that if the director administratively denies the requested reduction, an operator may request a hearing to determine if a full or partial reduction should be granted.

Statewide Rule 14(b)(2)(C)(i) provides for the revocation or denial of a plugging extension. The Commission or its delegate may revoke a plugging extension if the operator of the well that is the subject of the extension fails to maintain the well and all associated facilities in compliance with Commission rules; fails to maintain a current and accurate organizational report on file with the Commission; fails to provide the Commission, upon request, with evidence of a continuing good faith claim to operate the well; or fails to obtain or maintain financial security as required by 3.78 of this title (relating to Fees and Financial Security Requirements) (Statewide Rule 78).

Statewide Rule 14(b)(2)(C)(ii) provides: If the Commission or its delegate declines to grant or continue a plugging extension or revokes a previously granted extension, the operator shall either return the well to active operation or, within 30 days, plug the well or request a hearing on the matter.

Statewide Rule 14(b)(3) provides: The operator of any well more than 25 years old that becomes inactive and subject to the provisions of this subsection or the operator of any well for which a plugging extension is sought under the terms of subparagraph (A) of paragraph (2) of this subsection shall plug the well or successfully conduct 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.

Statewide Rule 14 (b)(3)(A) provides that a fluid level test is sufficient for purposes of this paragraph (being SWR 14(b)(3)).

MATTERS OFFICIALLY NOTICED

The examiner has officially noticed the Proposal for Decision, Final Order and Exhibits in Oil & Gas Docket No. 01-0246234: *Application of Cinco Natural Resources Corp. to Consider*

Reduction in 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, Final Order entered June 6, 2006.

The examiner has officially noticed the Proposal for Decision, Final Order, Exhibits, District Office Inspection Reports and attached photos in Oil & Gas Docket No. 04-0247783: *Enforcement Action Against IBC Petroleum, Inc. (Operator No. 421759) for Violations of Statewide Rules on the State Tract 352 Lease, Well No. 1 (RRC No. 087886), Red Fish Bay (9000-C) Field, State Tract 348 Lease, Well No. 2 (RRC No. 127065), Red Fish Bay (Frio 8300) Field, and State Tract 350 Lease, Well No. 3 (RRC No. 143219), Wildcat Field, Nueces County, Texas, Final Order entered January 11, 2007.*

The examiner has officially noticed the Proposal for Decision, Final Order, Exhibits, District Office Inspection Reports and attached photos in Oil & Gas Docket No. 04-0247768: *Enforcement Action Against IBC Petroleum, Inc. (Operator No. 421759) for Violations of Statewide Rules on the State Tract 395 Lease, Well No. 1 (RRC No. 054731), Red Fish Bay (Zone 29) Field, T.S.T. 444 (11552) Lease, Well No. 1, Red Fish Bay (Zone 29) Field, and State Tract 445 Lease, Well No. 1 (RRC No. 074631), Red Fish Bay (Zone 43) Field, Nueces County, Texas, Final Order entered January 11, 2007.*

The examiner has officially noticed the Proposal for Decision, Final Order, Exhibits, District Office Inspection Reports and attached photos in Oil & Gas Docket No. 04-0247767: *Enforcement Action Against IBC Petroleum, Inc. (Operator No. 421759) for Violations of Statewide Rules on the State Tract 416 (08690) lease, Well No. 2, Red Fish Bay (Zone 9) Field, State Tract 416 (12740) Lease, Well No. 4, Red Fish Bay (Zone 15) Field, and State Tract 397 Lease, Well No. 4, (RRC No. 077615), Red Fish Bay (Zone 18) Field, Nueces County, Texas, Final Order entered January 11, 2007.*

The examiner has officially noticed the Proposal for Decision, Final Order, Exhibits, District Office Inspection Reports and attached photos in 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, Final Order entered January 11, 2007.*

In addition, the examiner has noticed: (1) Commission Organization Report (Form P-5) records for Cinco; (2) Commission production records from the Production Data Query database reflecting production of oil or gas from the wells involved in this proceeding; (3) Commission *H-15 Data Inquiry* records for the wells involved in this proceeding maintained on the Commission mainframe; (4) Commission spreadsheets dated December 4, 2006 and February 28, 2007 recording the wells that Cinco is responsible for, their current status and Cinco's financial security requirements ; (5) a Commission Spreadsheet dated February 28, 2007 emailed to the General Land

Office and returned with modifications made by the GLO showing the current status of Cinco's leases of state tracts; (6) an estimate of bay well plugging costs provided to Arnold Ott, a Commission employee in the Corpus Christi District Office, by Inland Bay Plugging with a photo of the rig and barge used by Inland Bay Plugging to plug bay wells; (7) a Commission spreadsheet showing the SWR 14(b)(2) listings for Cinco dated November 30, 2006; (8) Commission spreadsheets for IBC, Boss and Cinco dated October 11, 2006, showing the wells each was responsible for at that time; and (9) a Purchase and Sale Agreement, with attachments, executed August 11, 2004, obligating Boss Exploration and Production Company and Cinco Natural Resources Corporation to purchase numerous wells and leases in Redfish Bay, Nueces County, from several related IBC entities.

CINCO'S EVIDENCE

At the hearing on December 6, 2006, Cinco presented as its Exhibit No. 1 its Financial Statement for 2005, prepared by the firm of Ernst & Young using generally accepted accounting procedures. The exhibit demonstrates that the net worth (assets minus liabilities) of Cinco is \$27,662,234. Cinco's Exhibit No. 2 is a November 21, 2006 letter from the P-5 Financial Assurance Department indicating that Cinco's most recent P-5 filing cannot be processed until its financial assurance reduction request is "taken care of". The letter also returns a Form W-1X (Application for Future Re-Entry of Inactive Wellbore and 14(b)(2) Extension Permit) filed by Cinco on October 20, 2006, stating that such forms are no longer used.

Cinco indicated that was attempting to take over five wells that it did not have leases on in a prior Statewide Rule 78 hearing, Oil & Gas Docket No. 01-0246234. Cinco stated that as the result of the settlement of a lawsuit, and its acquisition of assignments of acreage from Spirit Energy, LLC, Cinco would soon be filing the paperwork necessary to take over Well Nos. 2 (RRC ID# 08690) and 4 (RRC ID# 12740), on State Tract 416. Because the assignments had yet to be signed by all parties, Cinco requested that the hearing be kept open so that it might late-file evidence of the settlement, assignments, and Form P-4 transfer requests for the two wells.

After taking official notice of a Commission spreadsheet dated December 3, 2006 showing the lease listings for Cinco, and a Commission SWR 14(b)(2) listing spreadsheet dated November 30, 2006 for Cinco, the examiner noted that Cinco's leases had 13 SWR 14(b)(2) extension denials and 13 H-15 violations. Cinco responded that these problems were largely the fault of the prior operator, IBC Petroleum, which allowed its P-5 to become delinquent, resulting in the noted SWR 14(b)(2) extension denials. Cinco stated that the SWR 14(b)(2) extension denial problem would go away as soon as the Commission reached a decision in this docket, and Cinco once again has an active P-5.

As to the H-15 problems, Cinco noted that the wells have access problems, some being in water only two or three feet deep, and a few in water as shallow as 18 inches. Cinco stated that, in part, this problem is due to spoil left by the Army Corps of Engineers encroaching on the wells. Cinco stated that it has requested dredging permits from the Corps and is working to resolve the H-

15 problems as quickly as possible.

The examiner agreed to recess the hearing, keeping it open to allow Cinco to file documents related to its efforts to take the Form P-4 responsibility for State Tract 416, Well Nos. 2 and 4. The examiner also informed Cinco that he would use the time to take Official Notice of Commission documents relating to Cinco's financial security reduction request and the apparently outstanding H-15 violations.

At the re-opened hearing on March 14, 2007, Cinco presented its Exhibit No. 3, consisting of several documents demonstrating Cinco's attempt to take the P-4 responsibility for Well Nos. 2 and 4 on State Tract 416. Included in the packet is a check for \$500 to the Commission accompanying the two-signature P-4s filed for Well Nos 2 and 4 on State Tract 416, a Commission Form OW-2 for the two wells, an assignment of the acreage involved (320 acres in State Tract 416) from Spirit Energy, LLC and a Release and Settlement Agreement entered into between Plaintiffs Boss Exploration and Production and Cinco Natural Resources and Defendants Spirit Energy, LLC et al. The Release and Settlement Agreement, as one of its terms, provided for the assignment of State Tract 416 to Cinco.

Cinco's Exhibit No. 4, also presented on March 14, 2007, is a packet of several Commission-generated documents which chronicle the P-4 responsibility for wells held in the name of Boss and IBC, starting on October 6, 2005 and tracking the various P-4 transfers to February 23, 2007. In that time, wells held in 2005 by Boss and IBC have been transferred to Cinco, to the point that, as of February 23, 2007, Boss continued to hold the P-4s on only 4 wells while IBC held the P-4s on 5 wells. Upon resolution of this docket, Cinco will re-file P-4s for two more wells, for a total of 36, further reducing the IBC inventory to 3 wells.

Cinco adds that it is trying to settle a lawsuit with Cenote Resources Management, LLC, concerning State Tract 397, and when this occurs, will be able to take two more wells from IBC. According to Cinco, the last remaining IBC well is on a tract controlled by a company named Cabot, and Cabot refuses to talk to Cinco.

In light of its net worth of approximately \$27,000,000, Cinco requests the minimum financial security required under Statewide Rule 78. As operator of more than 10 wells, but less than 100, Cinco would post an entry level amount of \$50,000 plus \$60,000 as an operator of bay wells, for a total financial security amount of \$110,000.

EXAMINERS' OPINION

As of February 28, 2007, Cinco was the operator of 34 bay wells, 11 of which were producing and 23 non-producing. For the year ending December 31, 2005, the financial statement of Cinco, prepared by Ernst & Young using generally accepted accounting practices, showed that Cinco had a net worth of \$27,662,234. Under the formula set forth in Statewide Rule 78(g)(5), 25% of Cinco's net worth minus its estimated liability for active wells yields the following result:

\$6,915,558 (25% of net worth) - \$660,000 (estimated active well liability) = \$6,255,558

\$6,255,588 - \$1,380,000 (23 inactive wells x \$60,000) = book net worth exceeds
estimated plugging liability

Cinco plans to take the P-4 responsibility for 2 additional wells once its financial security obligation is settled, for a total of 36 bay wells. Although the two additional wells are also inactive, Cinco believes that, due to its net worth, application of the formula set forth in SWR 78(g)(5), would still be sufficient to cover the two additional wells with no need to post additional financial security.

If nothing more than the net worth of Cinco is considered in this case, Cinco could be granted a reduction in required financial security amounting to a complete waiver, leaving them responsible for posting only \$50,000 as the operator of more than 10 but fewer than 100 wells, and \$60,000 as the entry level amount for operation of bay wells, for a total posted financial security amount of \$110,000.

However, a reduction in financial security pursuant to the provisions of Statewide Rule 78 is not an entitlement. The Commission has decided financial security reduction cases based on the provisions related to administrative grants as described in Statewide Rule 78(g)(5)(A)(i) through (iv), as well as additional considerations. The decision to grant full or partial reduction is a discretionary policy decision and the Commission has previously considered a variety of relevant factors in making its decisions², including but not limited to: 1.) whether a financial report was prepared by a third party accounting firm using generally accepted accounting procedures; 2.) whether auditor disclosures cast doubt on the continued viability of the applicant operator; 3.) an operator's inability to establish its good faith claim to operate a well for which it requests financial security relief; 4.) whether an existing bond is subject to call by the Commission; 5.) the ratio of producing to non-producing wells; and 6.) findings in prior dockets regarding the same wells for which relief is sought in a subsequent docket.

FACTORS IN CINCO'S FAVOR:

In the present case, the above-mentioned factors 1 through 3 are in Cinco's favor. Cinco has presented a financial report prepared by a third party accounting firm using generally accepted

² The Commissioner has expressed its policy decisions in the following dockets - Oil & Gas Docket No. 02-0240478: Application of American Coastal Energy, Inc. to Consider Reduction of the Amount of Financial Assurance Required Pursuant to Statewide Rule 78(g) for Various Leases in Railroad Commission Districts 2 and 3, Calhoun County, Texas (Final Order entered January 25, 2005); Oil & Gas Docket No. 03-0241973: Application of Capco Offshore, Inc. to Consider a Reduction in the Amount of Financial Assurance Required Pursuant to Statewide Rule 78(g) for Various Wells on Various State Tract lease, El Gordo (Miocene) and Middle Bank Reef Fields, Matagorda County, Texas (Final Order entered June 21, 2005); Oil & Gas Docket No. 04-0240479: Application of VTEX Energy, Inc. to Consider Reduction of the Amount of Financial Assurance Required Pursuant to Statewide Rule 78(g) for Various leases in Railroad Commission District 4, Kleberg County, Texas (Final Orders issued March 23, 2005 and February 7, 2006); 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 (Final Order entered June 22, 2005); Oil & Gas Docket No. 01-0246234: Application of Cinco 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 (Final Order entered June 7, 2006); and Oil & Gas Docket No. 03-0246972: Application of Sterling Energy Inc. Pursuant to Statewide Rule 78(g) to Reduce the Amount of Financial Assurance Required to Operate Wells Within the State of Texas. (Final Order entered February 23, 2007).

accounting procedures indicating Cinco has a net worth of approximately \$27,000,000. There are no auditor disclosures in the report that cast doubt on the continued viability of Cinco. The record also contains a Commission-generated spreadsheet dated February 28, 2007 which was sent by the examiner to the General Land Office for a review of Cinco's continued possession of valid leases for its wells. The General Land Office returned the spreadsheet, with modifications, indicating that Cinco does have valid leases for all of its wells. The GLO modified spreadsheet shows that 27 of Cinco's leases show no gas or oil production, but that delay rentals have been paid. Factor 4 mentioned above, whether an existing bond can be called by the Commission, was not an issue raised in this hearing and no evidence on the matter was introduced into the record.

FACTORS NOT IN CINCO'S FAVOR:

a.) Ratio of producing to non-producing wells

Cinco has a high ratio of non-producing wells. A Commission-generated spreadsheet dated February 28, 2007 shows that Cinco presently is the operator of 34 wells, of which 23 are non-producing. Thus, considering only its present well inventory, 67% of Cinco's wells are non-producers.

It should be noted that Cinco has filed the proper forms to become the P-4 operator of 2 wells on State Tract 416, Well Nos. 2 and 4, which are also non-producers. Those forms have not been processed due to the pendency of this hearing. After a Final Order is issued in this hearing, if Cinco re-files for the two wells, Cinco will then be the operator of 36 wells, 25 of which are non-producers, resulting in 69% of its wells being non-producers. As noted in Cinco's presentation at the hearing, it is also trying to settle a suit with Cenote, and if a successful conclusion is reached, Cinco will take over 2 wells on State Tract 397, Well Nos. 4 and 6, also non-producers, making it the operator of 38 wells, 27 of which would be non-producers, resulting in 71% of its wells being non-producers.

b.) Findings in prior dockets regarding the same wells

There are findings in prior dockets regarding the same wells for which relief is sought in this docket. In a series of four Enforcement dockets³ against IBC Petroleum, Inc. (Operator No. 421759), nine wells operated by IBC were found to be in violation of Statewide Rule 14(b)(2) plugging requirements and, of the nine, six were found to be in violation of Statewide Rule 14(b)(3) for delinquent H-15 tests. Findings in prior dockets are considered in financial security reduction cases under the provisions of Statewide Rule 78(a)(2).

An "Outstanding Violation" is defined in Statewide Rule 78(a)(2) as "a violation for which:

(A) either:

(i) a Commission order finding a violation has been entered and all appeals have been

³ Oil & Gas Docket Nos. 04-0247766; 04-0247767; 04-0247768; and 04-0247783.

- (ii) exhausted; or
 - (ii) an agreed order between the Commission and the organization relating to a violation has been entered; and
- (B) one or more of the following conditions still exist:
 - (i) the conditions that constituted the violation have not been corrected;
 - (ii) all administrative, civil and criminal penalties, if any, relating to the violation of such Commission rules, orders, licenses, permits or certificates have not been paid; or
 - (iii) All reimbursements of any costs and expenses assessed by the Commission relating to the violation of such Commission rules, orders, licenses, permits or certificates have not been paid.” (emphasis added)

In Docket No. 04-0247767, Well Nos. 2 (RRC ID# 08690) and 4 (RRC ID# 12740) were found to be in violation of Statewide Rule 14(b)(3). In Docket No. 04-0247783, Well No. 3 (RRC ID# 143219) was found to be in violation of Statewide Rule 14(b)(3). In Docket No. 04-0247766, Well Nos. 1 (RRC ID# 012788) and 3 (RRC ID# 043367) were found to be in violation of Statewide Rule 14(b)(3). In Docket No. 04-0247768, Well No. 1 (RRC ID# 054731) was found to be in violation of Statewide Rule 14(b)(3). In each of the four dockets, the violations of Statewide Rule 14(b)(3) were found for delinquent H-15s and, in each, a finding of fact was included stating “The violations involved in this docket were violations of Commission rules related to safety and the prevention or control of pollution”. Cinco became the operator of seven of the wells involved in these dockets on October 18, 2006, including four wells⁴ that continue to be in violation of Statewide Rule 14(b)(3).

Cinco has applied to become the Commission recognized P-4 operator of two other wells involved in the IBC Enforcement Dockets, State Tract 416 Well Nos. 2 (RRC ID# 08690) and 4 (RRC ID# 12740), both found to be in violation of Statewide Rule 14(b)(3) due to delinquent H-15s.

The four IBC enforcement dockets are being appealed in the District Court of Travis County, but have not yet been assigned to a judge. Because the orders in the dockets have been appealed, they are not considered final because all appeals are not exhausted, and it can be argued that these findings in prior dockets cannot be considered under the terms of Statewide Rule 78(a)(2)(i). However, Statewide Rule 78 has a provision broadening the scope of the violations the Commission may consider, which is discussed below.

c.) Other Violations of Commission Rules

Although “other violations of Commission rules” is not listed as a factor the Commission has previously considered in determining whether an applied-for reduction in financial security should be granted, Statewide Rule 78 is clearly written in such a way that allows such consideration. Statewide Rule 78 distinguishes between “Violations” of Commission rules and regulations pursuant to Statewide Rule 78(a)(1) and “Outstanding violations” pursuant to Statewide Rule 78(a)(2).

⁴ State Tract 350, Well No. 3 (RRC ID# 143219); State Tract 456, Well No. 1 (RRC ID# 012788); State Tract 421, Well No. 3 (RRC ID# 043367); and State Tract 395, Well No. 1 (RRC ID# 054731).

Statewide Rule 78(a)(1) defines a “Violation” as “Noncompliance with a Commission rule, order, license, permit, or certificate relating to safety or the prevention or control of pollution.” There would have been no purpose including this definition in Statewide Rule 78 if the Commission intended to confine itself only to consideration of rule violations that had been determined through the hearings process, issuance of a Final Order, and exhaustion of appeals.

Additionally, Statewide Rule 78(g)(5)(A)(iv) requires that “none of the operator’s wells or operations, including any land-based wells, have been found by Commission staff to be violating or to have violated any Commission rule that resulted in pollution or in any hazard to the health and safety of the public in the last 12 months.” As stated before, violations of Statewide Rule 14(b)(3) for H-15 violations are understood by the Commission to be violations of “a Commission rule related to safety and the prevention or control of pollution.” The noncompliance, pursuant to Statewide Rule 78(a)(1), that should be considered here relates to Statewide Rule 14(b)(3), which requires:

(3) The operator of any well more than 25 years old that becomes inactive and subject to the provisions of this subsection or the operator of any well for which a plugging extension is sought under the terms of subparagraph (A) of paragraph (2) of this subsection shall plug the well or successfully conduct 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. (emphasis added)

On January 27, 2006, Cinco became the operator of twelve bay wells, ten formerly operated by Boss Exploration and 2 formerly operated by IBC. Of the twelve, seven have H-15 tests that are delinquent or not approved. On October 18, 2006, Cinco became the operator of a total of thirteen wells formerly operated by IBC.⁵ Of those thirteen wells, six have H-15 tests that are delinquent or not approved. In total, Cinco is presently the operator of 13 wells with H-15 tests that are delinquent or not approved (see attached Exhibit 1, with the H-15 delinquent wells highlighted in yellow). The delinquent H-15 tests have resulted in the denial of the SWR 14(b)(2) extension for each of these 13 wells. As can be seen on Exhibit 1, or the table below, each of the wells is either sealed or severed.

State Tract	Well No.	API#	Well Status
S.T. 414	5L	355 02671	severed
S.T. 414	4U	355 02670	severed
S.T. 350	3	355 31424	sealed
S.T. 395	1	355 30323	sealed
Ten Sand GU 421	3	355 02652	sealed
S.T. 456	1	355 02553	sealed
S.T. 422	6	355 31380	severed

⁵ Boss and Cinco are obligated to become the operators of IBC’s wells pursuant to a Purchase and Sale Agreement dated August 11, 2004.

S.T. 423	10	355 30826	sealed
S.T. 424	8	355 31267	severed
S.T. 350	1	355 30872	severed
S.T. 423	12	355 31419	severed
S.T. 421	1	355 31528	sealed
S.T. 349	6	355 02746	sealed

When a well is sealed or severed, a certified letter is sent to the operator 30 days before the sealing or severance, warning the operator of the violation leading to the severance. If there is no response, 30 days later the well is sealed or severed, and another letter is sent to the operator. If a new operator takes over wells that have been previously sealed or severed, the new operator is sent a letter informing them of the severance and they are given 30 days to respond. Cinco admitted in hearing that it is aware of the wells' H-15 problems.

At hearing, Cinco represented that the SWR 14(b)(2) extension denials resulted from a former operator's (IBC's) failure to maintain a current P-5. This is not a correct statement. As stated above, the SWR 14(b)(2) extension denials are a direct result of the failure of Boss, IBC and Cinco to conduct the H-15 tests on inactive wells over 25 years old as required by Statewide Rule 14(b)(3). So long as the SWR 14(b)(3) violations remain, that is, so long as the H-15 tests for these wells remain delinquent, the SWR 14(b)(2) extensions will remain denied and the wells will continue to be noncompliant with a Commission rule relating to safety or the prevention and control of pollution. A decision in this docket as to the amount of financial security required of Cinco will not affect the Statewide Rule 14(b)(2) extension denials.

The cause of the denial or revocation of the Statewide Rule 14(b)(2) extensions as to Cinco's 13 wells with H-15 problems is easily verified by reference to the Commission mainframe. A review of the Commission Mainframe's "14(b)(2) Well History Inquiry" shows that the wells' plugging extensions were denied due to the delinquent H-15s. Likewise, a review of the Commission Mainframe's "H-15 Data Inquiry" screens indicates that the H-15s for these wells are either not approved or delinquent, supporting the denial or revocation of the SWR 14(b)(2) extensions. As a percentage of total wells, 13 of Cinco's 34 wells (38%) are noncompliant with Statewide Rule 14(b)(2) due to noncompliance with the H-15 requirements of Statewide Rule 14(b)(3).

It is again worth noting that Cinco has applications pending to take over two additional IBC wells, on State Tract 416, being Well Nos. 2 and 4. Both of these wells are noncompliant with Statewide Rule 14(b)(3) due to delinquent H-15 tests. Furthermore, if Cinco successfully settles its suit with Cenote, it will then be in a position to take over two more IBC wells on State Tract 397, Well Nos. 4 and 6, also with delinquent H-15s. Cinco would then be the operator of 17 wells with cancelled SWR 14(b)(2) extensions due to noncompliance with SWR 14(b)(3), or 17 out of a total of 38, or 44%.

Statewide Rule 14(b)(2)(C)(ii) states, "If the Commission or its delegate declines to grant or continue a plugging extension or revokes a previously granted extension, the operator shall either

return the well to active operation or, within 30 days, plug the well or request a hearing on the matter.” In the present case, this means that after Cinco became the P-4 operator of wells from Boss and IBC that had delinquent H-15s, Cinco was obligated to return such wells to active operation or, within 30 days, plug the wells or request a hearing. Commission records show that none of the 13 wells have been returned to active status or plugged. Cinco did not request a hearing on the H-15 status of the wells within 30 days of becoming the recognized P-4 operator of the H-15 delinquent wells taken on January 27, 2006 or the wells taken on October 18, 2006. The District 4 Office, as of April 24, 2007 confirms that Cinco has not filed any W-3As for the H-15 delinquent wells. Cinco’s failure to avail itself of any of the remedies offered in Statewide Rule 14(b)(2)(C)(ii) places it in noncompliance with Commission rules.

Cinco’s disregard of its duty to correct H-15 problems is confirmed by reference to another Commission Mainframe screen. If a required H-15 test is not timely filed, the report becomes delinquent and the delinquency appears on the “14(b)(2) Well History Inquiry” screen. However, an operator may request an extension of time in which to conduct fluid level tests or MITs to correct the delinquency. If an extension is granted, it appears on the Mainframe “Wellbore H-15 Remarks Inquiry”. A review of that screen for the subject wells shows no instance in which Cinco has requested an extension of time in which to correct an H-15 delinquency problem.

The Commission’s “H-15 Data Inquiry” and “Change H-15 Data” screens record a single attempt to bring a well into compliance with SWR 14(b)(3). On July 25, 2006, IBC Petroleum performed a fluid level test on State Tract 422, Well No. 6. The screen shows that IBC reported the usable quality water protection zone to a depth of 100 feet meaning the fluid level could be no higher than 100 feet plus 250 feet (350 feet) in the well bore. The fluid level test showed fluid at 96 feet in the wellbore, thus failing the test. Shortly before acquiring this well by Form P-4 from IBC on October 18, 2006, Cinco conducted a Mechanical Integrity Test on the well on October 14, 2006. The Commission’s “Change H-15 Data” screen shows the well failed the Mechanical Integrity Test, again reporting the usable quality water protection zone to a depth of 100 feet. Pursuant to Statewide Rule 14(b)(2)(B)(ii), and due to the failed Mechanical Integrity Test, Cinco had 30 days after it acquired State Tract 422, Well No. 6, in which to repair the well, plug the well or request a hearing on the matter. At the end of that 30 day period, by November 17, 2006, Cinco had done none of these things. Cinco was then obligated to plug the well, but has not filed a W-3A with the Commission indicating that it is going to do so. The District 4 Office, as of April 24, 2007, confirms that Cinco has not filed a Form W-3A for State Tract 422, Well No. 6, API# 355 31380.

According to the failed H-15 tests for the above well filed by IBC and Cinco, the base of usable quality water in the area is 100 feet. This was confirmed by the Surface Casing Section (previously a division of the Texas Water Board) of the Texas Commission on Environmental Quality. The examiner hereby takes Official Notice of Water Board Letters provided by the Surface Casing Section indicating a water protection depth for the following tracts in Corpus Christi Bay:

Applicant	Date	Location	Protection Depth
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IBC Petroleum	10/29/03	S.T. 349, Well #6	0-100 feet
IBC Petroleum	10/29/03	S.T. 350, Well #1	0-100 feet
IBC Petroleum	10/29/03	S.T. 395, Well #1	0-100 feet
Boss Explor.	1/10/06	S.T. 395, Well #2	0-100 feet
IBC Petroleum	10/29/03	S.T. 414, Well #5	0-100 feet
IBC Petroleum	10/29/03	S.T. 416, Well #2	0-100 feet
RRC, Dist. 4	3/28/07	S.T. 416, Well #2	0-100 feet
IBC Petroleum	10/29/03	S.T. 348, Well #3	0-100 feet
IBC Petroleum	10/29/03	S.T. 392, Well #4	0-100 feet
IBC Petroleum	10/29/03	S.T. 352, Well #1	0-100 feet
IBC Petroleum	10/29/03	S.T. 397, Well #4	0-100 feet
IBC Petroleum	10/29/03	S.T. 341, Well #1	0-100 feet

The Water Board Letters listed are those currently in effect for the area (the letters are valid for only 6 years) and for the tracts in which IBC, Boss and Cinco are involved.

Statewide Rule 14(b)(3) is not limited to protection of the base of usable quality water. It requires testing of wells more than 25 years old “establishing that the well does not pose a potential threat of harm to natural resources, including surface and subsurface water, oil and gas.” The rule is intended to protect all waters of the state, including surface waters, whether they are fresh or salt water. Violation of Statewide Rule 14(b)(3) is listed in the Commission’s Administrative Penalty Guidelines, May 2002 [under its former designation, 14(b)(2)(E)], with a penalty of \$2,000. Page 9 of the Guideline recommends an Enhancement to the penalty of \$5,000 to \$25,000 for “pollution, actual or threatened, of bay, estuary or marine habitat.” The Enhancement for pollution, actual or threatened, of a Minor Freshwater Source (such as beneath the subject area) is only \$2,500 to \$7,500. Pollution, actual or threatened, of a Major Freshwater Source (major aquifer, creeks, rivers, lakes and reservoirs) carries the same penalty as pollution of bay, estuary or marine habitat; \$5,000 to \$25,000. The examiners note that the Penalty Guidelines regard pollution of bay waters as seriously as pollution of a major aquifer or river.

The Commission most recently imposed an Enhancement for pollution of bay waters in the Shoreham case⁶ involving discharge of saltwater into Galveston Bay. The Guideline further allows doubling of the total penalty if the conduct of the operator is found to be reckless, and allows tripling of the total penalty amount if the conduct of the operator is found to be intentional.

The provisions of SWR 14(b)(3) protecting surface waters apply to the protection of the bay waters and offshore waters of Texas, a conclusion supported by the provisions in the Penalty Guidelines. Furthermore, the rule also contemplates protection of oil and gas. In practice, this means an H-15 test is necessary to establish that there is no breach of well integrity that might result in cross-flow from a producing formation to a non-producing formation, or vice versa. For

⁶ Oil & Gas Docket No. 03-0241675: Enforcement Action Against Shoreham Oil & Gas Company, Inc. (Operator No. 778499) for Violations of Statewide Rules on the State Tract 288 Lease, Redfish Reef, SW (Vicksburg) Field, Chambers County, Texas.

example, cross-flow from a saltwater saturated formation into a gas sand could cause a water buildup in the gas sand precluding recovery of the gas, thus resulting in waste.

It is indisputable that the 13 H-15 delinquent Cinco wells are due for testing. A few of the wells with H-15 violations are over 50 years old:

State Tract	Well No.	API#	Historic Well Date
S.T. 414	5L	355 02671	03/06/58
S.T. 414	4U	355 02670	03/08/54
S.T. 350	3	355 31424	08/22/79
S.T. 395	1	355 30323	01/18/73
Ten Sand GU 421	3	355 02652	11/29/51
S.T. 456	1	355 02553	04/30/53
S.T. 422	6	355 31380	08/19/79
S.T. 423	10	355 30826	01/07/79
S.T. 424	8	355 31267	07/15/78
S.T. 350	1	355 30872	12/05/77
S.T. 423	12	355 31419	10/03/79
S.T. 421	1	355 31528	07/04/80
S.T. 349	6	355 02746	12/04/71

Once again, it should be remembered that Cinco has previously submitted the proper forms to become the P-4 operator of Well Nos. 2 and 4 on State Tract 416, as it is obligated to do under the Purchase and Sale Agreement with IBC. Cinco also has stated in this hearing that it hopes to settle a lawsuit enabling it to become the P-4 operator of Well Nos. 4 and 6 on State Tract 397, which it is also obligated to do under the Purchase and Sale Agreement with IBC. All four wells have delinquent H-15s and Statewide Rule 14(b)(2) extension denials. These wells are clearly due for testing:

State Tract	Well No.	API#	Historic Well Date
S.T. 416	2	355 02653	12/13/53
S.T. 416	4	355 02655	08/05/54
S.T. 397	4	355 02694	03/13/52
S.T. 397	6	355 02696	04/30/78

Cinco states that it intends to correct the H-15 problems, but has access issues preventing testing. In hearing, Cinco admitted that many of the delinquent H-15 wells are in shallow water, perhaps only 2 or 3 feet deep, with a few in water as shallow as 18 inches. Cinco states that spoil piles from dredging operations conducted by the Corps of Engineers (“Corps”) has resulted in these access issues, but presented no evidence to support that claim.

The allegation that the Corps is to blame for access issues is contradicted by District Office

inspection reports filed in the four IBC Enforcement cases indicating that these wells are simply in very shallow waters. A District 4 Inspection Report dated September 21, 2006 for the Ten Sand Gas Unit 421, Well No. 3 (RRC ID# 043367) states, "Unable to get close to well because of low tide and the well is in shallow water. Could not see the well from the boat." A District 4 Inspection Report dated May 22, 2006 for State Tract 395, Well No. 1 (RRC ID# 054731) states, "Ran boat aground 75 yards from the well. Around well - 1 foot of water, 75 yards from well, 3 feet of water." As to the 2 wells Cinco has applied to become P-4 operator of on State Tract 416, Well Nos. 2 (RRC ID# 08690) and 4 (RRC ID# 12740), a District 4 Inspection Report dated September 21, 2006 states, respectively, "Unable to get close to the well because of shallow water and low tide" and "Low tide and shallow water, unable to see the well from the boat."

The channels dredged 25 or more years ago that were used to drill the subject wells appear to have simply silted in due to normal currents and wave action in Redfish Bay. If any of Cinco's access issues have truly resulted from Corps action, Cinco should seek redress from the Corps. Cinco argues that it would have to acquire dredging permits from the Corps of Engineers to test these wells and stated in hearing that it had applied for five dredging permits from the Corps. Cinco provided no evidence that it has actually requested such permits from the Corps.

Regardless of whether the channels to the wells have filled in due to Corps action or natural wave action, dredging permits are not necessary to access these wells for fluid level tests. The equipment necessary to conduct a fluid level test is commonly contained in two portable cases, comparable in size to two large briefcases or two small suitcases. Cinco can take this equipment to the well sites in any shallow draft vessel, attach the testing equipment and open the wellhead valves (if operable) for testing.

Cinco's reluctance to test may rest on the possibility that the wells may fail fluid level tests. In that case, the Commission's H-15 Testing/Extension Guideline updated as of February 2005 indicates that a failed fluid level test must be followed by an MIT (Mechanical Integrity Test). An MIT would require the greater expense of rigging up over the well, which would require a larger vessel and, in some cases, dredging to access the well. In some instances, an operator can save on expenses by employing a mudboat rig (a tracked barge) which would be floated as near as possible to the well and then the tracks engaged to crawl through the mud up to the well. The possible subsequent failure of an MIT leads in turn to further expense due to the necessity of either repairing the well or plugging it. Either possibility might result in the need for even larger equipment than could be carried on a mudboat, requiring expensive access to the well by dredged channel.

The examiners have discussed bay dredging costs and bay plugging costs with Commission personnel and hereby take Official Notice of those discussions. Shallow water adds considerably to the cost of repairing or plugging a well in Texas bays. For example, one dredging contractor charges a \$250,000 mobilization/demobilization fee, plus \$35,000 per day on the job. Each channel can take several days to dredge. Plugging barges may have a draft of 4 to 5 feet and the tugs used to place them commonly have a draft of 7 feet. Even if the cost is split between several wells, the expense of dredging alone can easily exceed \$200,000 per well. In addition, the cost of the actual

workover or plugging must also be considered. Attached as Exhibit 2 is a photo of a plugging barge with cost estimates for plugging a bay well . The exhibit provides insight as to the expense of plugging bay wells, possibly \$100,000 or more (which is in excess of the required financial security for a bay well), as well as the size of the equipment used which can be inferred from the safety lines on the perimeter of the barge. The plugging barge pictured, or one similar to it, would require a dredged channel 50 to 70 feet wide.

The H-15 delinquency status of these wells was known by the prior operators. Those prior operators, and Cinco, have merely been the nominal operators of these wells, each hoping to transfer the well to a successor before the inevitable day when H-15 testing or plugging might be required by the Commission, with the resulting expense. The delay of required H-15 testing carries increased risk for both the State and the operator. H-15 testing not only serves to protect the waters of the state and prevent pollution, but also is used to detect casing integrity problems while they can still be repaired. Absent H-15 testing, if downhole problems are ignored and allowed to deteriorate, the result can be casing collapse or formation intrusion, either of which makes the plugging of the well more expensive. Accordingly, for wells such as these, any reduction in financial security should be conditioned on the operator's submission of a report that the well has passed the required testing under Statewide rule 14(b)(3).

Cinco states that it is a robust company, with a net worth of \$27,662,234, far exceeding the asset retirement obligation (plugging liability) for its inactive wells of \$2,242,130 as stated in its 2005 balance sheet. Cinco is in a better financial position to correct the delinquent H-15 violations of its wells than some other companies which operate on the margins of fiscal responsibility.

EXAMINERS' RECOMMENDATION:

The examiners recommend that Cinco be granted partial relief in its financial security obligations, and be required to maintain financial security of \$60,000 per well for each of the 13 wells with a delinquent or failed H-15 test that it presently operates. The examiners also note that Cinco will soon become the operator of Well Nos. 2 and 4 on State Tract 416, which it has applied to do and is contractually obligated to do. Because both of these wells have delinquent H-15s, the examiners recommend that Cinco be required to post additional financial security for each of these wells, for a total of 15 H-15 delinquent wells (15 x \$60,000 = \$900,000) plus \$50,000 as the operator of more than 10 but fewer than 100 wells, for a total posted amount of financial security of \$950,000.

In addition, because Cinco has done nothing to correct the violations of Commission rules evidenced by the delinquent H-15s for the 13 wells listed on Exhibit No. 1, the examiners recommend that the matter be referred to Enforcement for penalty action.

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

FINDINGS OF FACT

1. At least ten (10) days notice of the hearing in this docket was sent to all parties entitled to notice. Cinco Natural Resources Corp. (“Cinco”) appeared at the hearing on December 6, 2006 and presented evidence. The hearing was re-opened on March 14, 2007, additional evidence was admitted, and the re-opened hearing was closed March 14, 2007.
2. On October 30, 2006, Cinco requested the hearing in this docket, as permitted by Statewide Rule 78(g).
3. By the application in this docket, Cinco requests, pursuant to Statewide Rule 78(g), a reduction in the amount of financial security required for Cinco’s inactive bay wells from \$1,430,000 to \$110,000.
4. Cinco had posted financial security in the amount of \$650,000 with the Commission. Cinco is the operator of 34 bay wells, with 23 classified as non-producing and inactive.
5. Cinco’s financial statement for 2005, prepared by the firm of Ernst & Young using generally accepted accounting procedures, shows that Cinco has a net worth (assets minus liabilities) of \$27,662,234.
6. Under the formula set forth in Statewide Rule 78(g)(5), 25% of Cinco’s net worth minus its estimated plugging liability for active wells yields the following result: $\$6,915,558$ (25% of net worth) - $\$660,000$ (estimated active well liability) = $\$6,255,558$. $\$6,255,558$ - $\$1,380,000$ (23 inactive wells x $\$60,000$) = book net worth exceeds estimated plugging liability.
7. Several factors weigh in Cinco’s favor for a reduction in financial security required by the Commission:
 - a. Cinco’s financial statement was prepared by Ernst & Young using generally accepted accounting procedures; and
 - b. Auditor disclosures do not cast any doubt on the continuing financial viability of Cinco; and
 - c. A spreadsheet from the General Land Office indicates that Cinco has a good faith claim to operate the leases its wells are on.
8. Several factors do not weigh in Cinco’s favor for a reduction in financial security required by the Commission:
 - a. Cinco has a high ratio of non-producing wells. Cinco presently is the operator of 34 wells, of which 23 are non-producing. Thus, considering only its present well inventory, 67% of Cinco’s wells are non-producers.

- b. Cinco has filed the proper forms to become the P-4 operator of 2 wells on State Tract 416, Well Nos. 2 and 4, which are also non-producers. Those forms have not been processed due to the pendency of this hearing. After a Final Order is issued in this hearing, if Cinco re-files for the two wells, Cinco will then be the operator of 36 wells, 25 of which are non-producers, resulting in 69% of its wells being non-producers.
 - c. Cinco trying to settle a suit with a company named Cenote, and if a successful conclusion is reached, Cinco will take over 2 wells on State Tract 397, Well Nos. 4 and 6, also non-producers, making it the operator of 38 wells, 27 of which would be non-producers, resulting in 71% of its wells being non-producers.
9. Cinco is the operator of 13 wells with Statewide Rule 14(b)(2) extension denials due to failure to file or non-approval of Forms H-15 as required by Statewide Rule 14(b)(3). The wells are noncompliant with Statewide Rules 14(b)(2) and 14(b)(3). Cinco was given at least 30 days notice of the Statewide Rule 14(b)(2) and 14(b)(3) violations concerning each of these wells but has failed to place them in compliance. These wells are :

State Tract	Well No.	API#	Well Status
S.T. 414	5L	355 02671	severed
S.T. 414	4U	355 02670	severed
S.T. 350	3	355 31424	sealed
S.T. 395	1	355 30323	sealed
Ten Sand GU 421	3	355 02652	sealed
S.T. 456	1	355 02553	sealed
S.T. 422	6	355 31380	severed
S.T. 423	10	355 30826	sealed
S.T. 424	8	355 31267	severed
S.T. 350	1	355 30872	severed
S.T. 423	12	355 31419	severed
S.T. 421	1	355 31528	sealed
S.T. 349	6	355 02746	sealed

- 10. Thirteen of Cinco’s 34 wells (38%) are noncompliant with Statewide Rule 14(b)(2) due to noncompliance with the H-15 requirements of Statewide Rule 14(b)(3).
- 11. Cinco has filed the proper forms to become operator of two additional IBC wells, on State Tract 416, being Well Nos. 2 and 4. Both of these wells are noncompliant with Statewide Rule 14(b)(3) due to delinquent H-15 tests.
- 12. If Cinco successfully settles its suit with a company named Cenote, it will then be in a position to become the P-4 operator of two IBC wells on State Tract 397, Well Nos. 4 and 6. These wells have delinquent H-15s and are noncompliant with Statewide Rule 14(b)(3).

13. Commission records show that none of Cinco's 13 H-15 delinquent wells have been returned to active status or plugged.
14. Commission records show that Cinco did not request a hearing on the H-15 status of its 13 H-15 delinquent wells within 30 days of becoming the operator of the wells on January 27, 2006 or October 18, 2006.
15. Commission records show that Cinco did not request an extension of time in which to conduct fluid level tests or MITs for its 13 H-15 delinquent wells.
16. On July 25, 2006, IBC Petroleum performed a fluid level test on State Tract 422, Well No. 6:
 - a. IBC reported the usable quality water protection zone to a depth of 100 feet meaning the fluid level could be no higher than 100 feet plus 250 feet (350 feet) in the well bore. The fluid level test showed fluid at 96 feet in the wellbore, thus failing the test.
 - b. Shortly before acquiring this well by Form P-4 from IBC on October 18, 2006, Cinco conducted a Mechanical Integrity Test on the well on October 14, 2006. The Commission's "Change H-15 Data" screen shows the well failed the Mechanical Integrity Test, again reporting the usable quality water protection zone to a depth of 100 feet.
 - c. Pursuant to Statewide Rule 14(b)(2)(B)(ii), and due to the failed Mechanical Integrity Test, Cinco had 30 days after it acquired State Tract 422, Well No. 6, in which to repair the well, plug the well or request a hearing on the matter. At the end of that 30 day period, by November 17, 2006, Cinco had done none of these things.
 - d. After failing the MIT, Cinco was obligated to plug the well, but has not filed a W-3A with the Commission indicating that it is going to do so. The District 4 Office, as of April 24, 2007, confirms that Cinco has not filed a Form W-3A for State Tract 422, Well No. 6, API# 355 31380.
17. The base of usable quality water in the Redfish Bay area is demonstrated by "Water Board Letters" provided by the Surface Casing Section of the Texas Commission on Environmental Quality. Those letters show:

Applicant	Date	Location	Protection Depth
IBC Petroleum	10/29/03	S.T. 349, Well #6	0-100 feet
IBC Petroleum	10/29/03	S.T. 350, Well #1	0-100 feet
IBC Petroleum	10/29/03	S.T. 395, Well #1	0-100 feet

Boss Explor.	1/10/06	S.T. 395, Well #2	0-100 feet
IBC Petroleum	10/29/03	S.T. 414, Well #5	0-100 feet
IBC Petroleum	10/29/03	S.T. 416, Well #2	0-100 feet
RRC, Dist. 4	3/28/07	S.T. 416, Well #2	0-100 feet
IBC Petroleum	10/29/03	S.T. 348, Well #3	0-100 feet
IBC Petroleum	10/29/03	S.T. 392, Well #4	0-100 feet
IBC Petroleum	10/29/03	S.T. 352, Well #1	0-100 feet
IBC Petroleum	10/29/03	S.T. 397, Well #4	0-100 feet
IBC Petroleum	10/29/03	S.T. 341, Well #1	0-100 feet

18. Violation of Statewide Rule 14(b)(3) is listed in the Commission’s Administrative Penalty Guidelines, May 2002 [under its former designation, 14(b)(2)(E)], with a penalty of \$2,000. Page 9 of the Guideline recommends an Enhancement to the penalty of \$5,000 to \$25,000 for “pollution, actual or threatened, of bay, estuary or marine habitat.”
19. The 13 H-15 delinquent Cinco wells are subject to the effect of a corrosive marine environment. All of the wells are over 25 years old and a few of the noncompliant wells are over 50 years old:

State Tract	Well No.	API#	Historic Well Date
S.T. 414	5L	355 02671	03/06/58
S.T. 414	4U	355 02670	03/08/54
S.T. 350	3	355 31424	08/22/79
S.T. 395	1	355 30323	01/18/73
Ten Sand GU 421	3	355 02652	11/29/51
S.T. 456	1	355 02553	04/30/53
S.T. 422	6	355 31380	08/19/79
S.T. 423	10	355 30826	01/07/79
S.T. 424	8	355 31267	07/15/78
S.T. 350	1	355 30872	12/05/77
S.T. 423	12	355 31419	10/03/79
S.T. 421	1	355 31528	07/04/80
S.T. 349	6	355 02746	12/04/71

20. Cinco has submitted forms to become operator of Well Nos. 2 and 4 on State Tract 416, both of which are noncompliant with Statewide Rule 14(b)(3). These wells are over 50 years old:

State Tract	Well No.	API#	Historic Well Date
S.T. 416	2	355 02653	12/13/53
S.T. 416	4	355 02655	08/05/54

21. Cinco is settling a lawsuit with a company named Cenote. If successful, Cinco will file Forms P-4 to become the operator of two more IBC wells, both of which are noncompliant with Statewide Rule 14(b)(3). One of these wells is over 50 years old:

State Tract	Well No.	API#	Historic Well Date
S.T. 397	4	355 02694	03/13/52
S.T. 397	6	355 02696	04/30/78

22. Cinco admits that well access is complicated by shallow waters. Cinco stated in hearing that some wells are in water only 2 or 3 feet deep, with some in water as shallow as 18 inches.
23. District Office Inspection Reports indicate the waters around many of these wells are shallow:
 - a. A District 4 Inspection Report dated September 21, 2006 for the Ten Sand Gas Unit 421, Well No. 3 (RRC ID# 043367) states, "Unable to get close to well because of low tide and the well is in shallow water. Could not see the well from the boat."
 - b. A District 4 Inspection Report dated May 22, 2006 for State Tract 395, Well No. 1 (RRC ID# 054731) states, "Ran boat aground 75 yards from the well. Around well - 1 foot of water, 75 yards from well, 3 feet of water."
 - c. Cinco has applied to become P-4 operator of two IBC wells on State Tract 416, Well Nos. 2 (RRC ID# 08690) and 4 (RRC ID# 12740). A District 4 Inspection Report dated September 21, 2006 states, regarding the respective wells, "Unable to get close to the well because of shallow water and low tide" and "Low tide and shallow water, unable to see the well from the boat."
24. The equipment necessary to conduct a fluid level test on a well fits into two portable cases, comparable in size to two large briefcases or two small suitcases. Any shallow draft vessel will provide well access.
25. If a fluid level test fails, the Commission's H-15 Testing/Extension Guideline updated as of February 2005 indicates that the failed fluid level test must be followed by an MIT (Mechanical Integrity Test).
26. An MIT requires rigging up over the well, which in the case of wells in shallow water, would require the use of expensive equipment or possibly require dredging a channel to the well.
27. Failure to pass an MIT means the well must be repaired or plugged. Repair or plugging requires rigging up over the well, and would require the use of large equipment, possibly requiring dredging a channel to the well.
28. Dredging costs alone to reach a well in shallow waters can exceed \$200,000.
29. Plugging costs for a well in bay waters can exceed \$100,000.

CONCLUSIONS OF LAW

1. Proper notice of hearing was timely issued by the Railroad Commission to appropriate persons legally entitled to notice.
2. All things necessary to the Commission attaining jurisdiction over the subject matter and the parties to this hearing have been performed or have occurred.
3. Pursuant to §91.103 of the Texas Natural Resources Code, any person, including any firm, partnership, joint stock association, corporation, or other organization, required to file an organization report under §91.142 of the Code must execute and file with the Commission a bond, letter of credit, or cash deposit.
4. Pursuant to §91.104 of the Texas Natural Resources Code, a person required to file a bond, letter of credit, or cash deposit under §91.103 of the Code who is an inactive operator or who operates one or more wells must, at the time of filing or renewing an organization report required by §91.142 of the Code, file an individual bond as provided under §91.1041 of the Code, a blanket bond as provided under §91.1042 of the Code, or a letter of credit or cash deposit in the same amount as required for an individual bond under §91.1041 of the Code or a blanket bond under §91.1042 of the Code.
5. Pursuant to §§91.1041(b) and 91.1042(b) of the Texas Natural Resources Code, the Commission is authorized to set by rule the amount of the bond for an operator of bay and offshore wells at a reasonable amount that exceeds the amount provided by §§91.1041(a) and 91.1042(a) of the Code.
6. Operators of bay wells are required to file with the Commission the amount of financial security provided by the Commission's Statewide Rule 78(g)(1) [16 TEX. ADMIN. CODE §3.78(g)(1)] and the additional amount of financial security provided by Statewide Rule 78(g)(2) [16 TEX. ADMIN. CODE §3.78(g)(2)].
7. With the exception of its 13 H-15 delinquent or not approved wells, Cinco is entitled to a partial reduction, pursuant to Statewide Rule 78(g)(5), in the amount of its financial security required by Rule 78(g)(2).

RECOMMENDATION

The examiners recommend that the application of Cinco Natural Resources Corp., pursuant to Statewide Rule 78(g) for a reduction in the amount of financial security required by Statewide Rule 78(g)(3) be granted in part and that Cinco be required to maintain financial security of \$60,000 for each of the 13 wells with delinquent or failed H-15 tests that it is the operator of. Because Cinco has applied to become the Commission-recognized Operator of State Tract 416 Well Nos. 2 and 4, both with delinquent H-15s, the examiners recommend that Cinco be required to post financial security for these wells, for a total of 15 H-15 delinquent wells (15 x \$60,000 = \$900,000) plus \$50,000 as the operator of more than 10 but fewer than 100 wells, for a total posted amount of financial security of \$950,000.

The examiners also recommend that the matter of the thirteen H-15 delinquent wells be referred to Enforcement for penalty action.

Respectfully submitted,

Marshall Enquist
Hearings Examiner

Thomas H. Richter
Technical Examiner