

**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.**

APPEARANCES:

FOR APPLICANT:

James DeGraffenreid
Land Manager

APPLICANT:

Sterling Energy, Inc.

AMENDED PROPOSAL FOR DECISION

PROCEDURAL HISTORY

DATE OF REQUEST FOR HEARING:	January 27, 2006
DATE OF NOTICE OF HEARING:	February 17, 2006
DATE OF HEARING:	March 7, 2006
HEARD BY:	Marshall Enquist, Hearings Examiner
DATE RECORD CLOSED:	March 21, 2006
DATE PFD CIRCULATED:	August 16, 2006
HEARING RE-OPENED:	November 16, 2006
RE-OPENED HEARING CLOSED:	November 28, 2006
AMENDED PFD CIRCULATED:	January 19, 2007

STATEMENT OF THE CASE

This is the application of Sterling Energy Inc. (hereinafter "Sterling") filed pursuant to Statewide Rule 78(g) for a reduction in the amount of financial security required for Sterling's offshore wells. A hearing was held on March 7, 2006. Sterling appeared and presented evidence. The record was held open until March 21, 2006 to allow delivery of a late-filed exhibit. At Conference on November 14, 2006, the Commissioner's directed that the case be re-opened for the admission of additional evidence.

APPLICABLE RULES

Statewide Rule 78(g)(3) requires the filing of additional financial security for offshore wells. As relevant here, in addition to other financial security required under Rule 78(g)(1), Sterling Energy must file entry level financial security of \$100,000 for operating offshore wells and an additional \$100,000 for each inactive offshore well in excess of one.

Statewide Rule 78(g)(4)(A) provides that the director may administratively approve a reduction if the operator provides documentation that it currently has acceptable financial assurance in place to satisfy any financial assurance requirements established by local authorities. The operator must show that the bond or other form of financial assurance can be called on by or assigned to the Commission under the following circumstances: if the well is likely to pollute or is polluting any ground or surface water, is allowing uncontrolled escape of formation fluids, is not being maintained in compliance with Commission rules or state law relating to plugging or the prevention or control of pollution, or if the operator fails to renew and maintain a P-5 Organization Report.

BACKGROUND

At the time of the original hearing, on March 7, 2006, the Form P-5 Organization Report of Sterling had been renewed on February 7, 2006. Sterling has posted \$850,000 in financial security for its P-5 year ending the last day of January, 2007.

In the original hearing, the examiner officially noticed Commission "On-Schedule Leases, Wells, Wellbores By Operator" records showing that as of March 7, 2006, Sterling was the operator of 24 offshore wells, of which eight were non-producing. As of March 1, 2006, these wellbores had a total depth of 288,440 feet. Sterling had a bond in place in the amount of \$850,000 that expires on August 1, 2007. The examiner officially noticed all records, dockets and other documents held by the Commission pertaining to this application. Commission maps of the subject area were also officially noticed.

When the hearing was re-opened on November 16, 2006, the examiner requested that Sterling provide a copy of the bond it posted with the City of Corpus Christi as well as any renewal certificates. Sterling was also requested to provide a list of the number of wells it had subject to the jurisdiction of the City of Corpus Christi. Additionally, the examiner informed Sterling that Official Notice was being taken of the most current list of Bay and Offshore Wells operated by Sterling and of Chapter 35 of the Ordinances of the City of Corpus Christi (dealing with the City's requirements for oil and gas operations within its jurisdictional boundaries). Sterling provided the requested information and did not object to the taking of Official Notice. The re-opened hearing was closed November 28, 2006.

STERLING'S EVIDENCE

Sterling currently (per letter dated November 27, 2006) has nine wells subject to the jurisdiction of the City of Corpus Christi. Six are active wells and three are inactive offshore wells. Pursuant to its ordinances, Corpus Christi requires that an oil and gas operator with wells within the city's jurisdiction post a bond of \$500,000. Corpus Christi's bond requirement is not dependent on the number of wells an operator has, but is simply a blanket amount covering any number of wells

an operator has subject to the city's jurisdiction. Sterling has posted the bond required by Corpus Christi for three inactive wells, as well as the bond required by the Commission for the 8 inactive offshore wells it had at the time of the original hearing in March, 2006. Since the time of the original hearing, Sterling has acquired an additional offshore well and now has a total of 25 offshore wells. Sterling's inactive well count has increased from eight to twelve, but it still has only three inactive wells subject to the jurisdiction of the City of Corpus Christi. Sterling argues that bonding the same three inactive wells with both the City Of Corpus Christi and the Commission is unnecessarily duplicative. Therefore, Sterling asks for relief from the Commission in the form of a reduction in its required bond amount. Sterling's P-5 renewal is due February 1, 2007, at which time it will be required to post a bond of \$1,250,000, consisting of \$50,000 for 25 wells, \$100,000 as the entry level requirement for operating offshore wells, and \$1,100,000 for the inactive wells. If Sterling's bond reduction request is granted, Sterling would be required to post a bond of \$950,000.

The three inactive wells that are bonded under both Commission rules and the ordinances of the City of Corpus Christi are Well No. 1U (ID# 046044), State Tract 903-S; Well No. 2U, (ID# 111506), State Tract 903-S; and Well No. 3 (ID# 136359), State Tract 904 [see Attachment I]. Sterling asserts that double coverage is unnecessary, especially given the fact that Sterling has been financially responsible at all times, and maintains insurance through AON Natural Resources Group with an Energy Package and a Pollution Liability Package, both underwritten by Lloyd's of London. The Energy Package provides coverage in the amount of \$50,000,000 for "control of well, any one accident or occurrence", \$37,760,940 in coverage for platforms and pipelines and \$2,485,000 for onshore facilities. The Pollution Liability Package provides \$35,000,000 in coverage per incident.

EXAMINER'S OPINION

Sterling has already conducted discussions with the City of Corpus Christi regarding adding the Commission to its \$500,000 bond as an additional obligee. The City of Corpus Christi informed Sterling that it would not agree. Corpus Christi Municipal Code Chapter 35-80(c) requires the posting of \$200,000 in the form of bond, letter of credit or cash deposit "for any number of well permits required by this chapter". Chapter 3-80(g) allows the city manager to adjust the limits and types of coverage upon 30 days notice to affected parties. By memo dated August 2, 2000, on the advice of the City's Oil and Gas Advisory Committee and with the approval of the city manager, the operator bond requirement was increased from \$200,000 to \$500,000. This is the bond amount that Sterling has posted with the City. The bond posted with the City of Corpus Christi is intended to cover the cost of well abandonment, including plugging the well, pollution clean-up and removal of all flowlines, production platforms, facilities and equipment associated with the well.

Sterling has indicated that it is a responsible company and maintains insurance for its wells through AON Natural Resources Group. However, Sterling did not show that its coverage applies to the plugging of the insured wells.

Sterling is aware that Commission Statewide Rule 78(g) (4)(a) allows an operator to apply

for a reduction in financial security if it currently has financial security in place that satisfy financial assurance requirements established by local authorities. “Local authorities” include cities acting under their police powers as municipalities. Sterling is also aware of the requirement that such financial security be callable by the Commission. Statewide Rule 78(g)(4)(A) states, in part:

...The operator must show that the bond or other form of financial assurance can be called on by or assigned to the Commission under the following circumstances:

- (i) a well is likely to pollute or is polluting any ground or surface water or is allowing the uncontrolled escape of formation fluids from the strata in which they were originally located; or
- (ii) a well is not being maintained in compliance with Commission rules or state law relating to plugging or the prevention or control of pollution; or
- (iii) the operator has failed to renew and maintain an organization report filing as required by §3.1 of this title (relating to Organization Report; Retention of Records; Notice Requirements) and this section.

(emphasis added) The use of the term “must”, underlined in the above excerpt, demonstrates this showing by the operator is mandatory, not discretionary.

In a prior instance, the Commission allowed bond money held by another entity to be used in lieu of additional financial security. In an administrative decision involving Lamar Oil & Gas (Op. # 483925), the Commission allowed Lamar to offset the financial security obligation for one inactive bay well (\$60,000) by convincing its Guarantor to add the Commission as an additional Obligee to its \$500,000 bond with the City of Corpus Christi and its \$10,000 bond with the City of Aransas Pass. The Commission accepted Obligee status on \$510,000 in bond money as a substitute for the \$60,000 required for the single inactive bay well. However, this is not an option currently, as the City of Corpus Christi objected to the action of Lamar and has taken steps to prevent a recurrence.

One provision in Sterling’s bond with the City is notable. Subparagraph A allows the surety to cancel its obligation by giving 30 days written notice to the City:

This obligation may be cancelled by said Surety by giving thirty (30) days notice in writing of its intention to do so to said Obligee; and the said Surety shall be relieved of any further liability under this bond thirty (30) days after receipt of said notice by said Obligee.

It is possible that if Sterling is granted the relief requested at the Commission, and Sterling’s surety then gives thirty days notice of its intent to cancel coverage to the City, then the three inactive wells at issue might lack bonding altogether.

The \$500,000 bond posted with the City of Corpus Christi cannot be “...called on by or assigned to the Commission...”. The application of Sterling for a reduction in additional financial security pursuant to Statewide Rule 78(g)(4)(A) should be denied.

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. At least ten (10) days notice of the hearing in this docket was sent to all parties entitled to notice. Sterling Energy, Inc. (“Sterling”) appeared at the hearing and presented evidence. The hearing was re-opened on November 16, 2006, additional evidence was admitted, and the re-opened hearing was closed November 28, 2006.
2. By the application in this docket, Sterling requests, pursuant to Statewide Rule 78(g), a reduction of \$300,000 in the amount of financial security required for Sterling’s inactive offshore wells (within the jurisdiction of the City of Corpus Christi) as required by Statewide Rule 78(g)(3).
3. At the time of the original hearing, Sterling had posted financial security in the amount of \$850,000 as the designated operator of 24 offshore wells. These wellbores had total depth of 288,440 feet. Of the 24 offshore wells, 8 were inactive under Commission rules. At the time of the re-opened hearing, Sterling operated 25 offshore wells, twelve of which were inactive. Three of these inactive wells are subject to the jurisdiction of the City of Corpus Christi.
4. At the time of the hearing, Sterling’s Form P-5 Organization Report had been renewed February 7, 2006, effective for the P-5 year ending the last day of January, 2007. As of February 1, 2007, Sterling will be required to renew its P-5 Organization Report and update its bond, which will be \$1,250,000; consisting of \$50,000 for 25 wells, \$100,000 entry level requirement for operating offshore wells and \$1,100,000 for its inactive offshore wells.
5. On January 27, 2006, Sterling requested the hearing in this docket, as permitted by Statewide Rule 78(g).
6. Pursuant to Statewide Rule 78(g)(4)(A), an operator may receive an administrative reduction in required financial security if the operator provides documentation that it currently has acceptable financial security in place to satisfy any financial assurance requirements established by local authorities. The operator must show that the bond or other form of financial assurance can be called on by the Commission under defined circumstances.
7. Sterling has posted \$500,000 in financial assurance for three inactive offshore wells subject to the jurisdiction of the City of Corpus Christi.
8. The City of Corpus Christi will not allow the Commission to be named as an additional obligee on the \$500,000 bond posted by Sterling Energy Inc.

9. Sterling did not demonstrate that the \$500,000 bond held by the City of Corpus Christi can be called on by or has been assigned to the Commission.

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 offshore 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)(3) [16 TEX. ADMIN. CODE §3.78(g)(3)].
7. Sterling is not entitled to a reduction, pursuant to Statewide Rule 78(g)(4)(A), in the amount of its financial security required by Rule 78(g)(3).

RECOMMENDATION

The examiner recommends that the application of Sterling Energy, Inc., pursuant to Statewide Rule 78(g) for a reduction in the amount of financial security required by Statewide Rule 78(g)(3) be denied.

Respectfully submitted,

Marshall Enquist
Hearings Examiner