RAILROAD COMMISSION OF TEXAS

HEARINGS DIVISION

EXAMINERS' REPORT AND RECOMMENDATION

OIL & GAS DOCKET NO. 08-0302755: THE APPLICATION OF COLGATE OPERATING, LLC PURSUANT TO THE MINERAL INTEREST POOLING ACT FOR THE FORMATION OF A POOLED UNIT FOR THE CANTALOUPE MIPA UNIT, WELL NO. 1H, PHANTOM (WOLFCAMP) FIELD, REEVES COUNTY, TEXAS

APPEARANCES

For Applicant Colgate Operating, LLC:

John Hicks, Attorney at Law
James H. Walter, Co-CEO
Brandon Gaynor, Senior Vice President - Land
Rick Johnston, Consulting Engineer

Observers:

Gloria Gochicoa
Julie Gochicoa

PROCEDURAL HISTORY

Date application filed:	December 6, 2016
Date of Notice of Hearing:	December 13, 2016
Date of hearing:	January 17, 2017
Transcript received:	January 25, 2017
Record closed:	January 25, 2017
Heard by:	Ryan M. Lammert, Administrative Law Judge Karl Caldwell, Technical Examiner

STATEMENT OF THE CASE

Colgate Operating, LLC ("Colgate") has filed an application under the Texas Mineral Interest Pooling Act (the "MIPA"), Chapter 102 of the Texas Natural Resources Code. By its application, Colgate requests that the Commission enter an order creating the force-pooled Cantaloupe MIPA Unit, Well No. 1H (the "1H Unit"). If the application is approved, Colgate intends to drill the MIPA well as a horizontal oil well in the Phantom (Wolfcamp) Field (the "Field") in Reeves County, Texas.

The application is unprotested. The Administrative Law Judge and Technical Examiner (collectively, the "Examiners") recommend approval.

APPLICABLE LAW

Subject to limitations found elsewhere in the act, Section 102.011 of the MIPA provides that "[w]hen two or more separately owned tracts of land are embraced in a common reservoir of oil or gas for which the commission has established the size and shape of proration units, whether by temporary or permanent field rules, and where there are separately owned interests in oil and gas within an existing or proposed proration unit in the common reservoir and the owners have not agreed to pool their interests, and where at least one of the owners of the right to drill has drilled or has proposed to drill a well on the existing or proposed proration unit to the common reservoir, the commission, on the application of an owner specified in Section 102.012 of [the MIPA] and for the purpose of avoiding the drilling of unnecessary wells, protecting correlative rights, or preventing waste, shall establish a unit and pool all of the interests in the unit within an area containing the approximate acreage of the proration unit, which unit shall in no event exceed 160 acres for an oil well or 640 acres for a gas well plus 10 percent tolerance."

DISCUSSION OF THE EVIDENCE

Colgate's Evidence

The proposed 1H Unit is partially within the city of Pecos, Reeves County, and situated in Sections 5, 6, and 8, Block 5 H. & G. N. Railroad Company Survey.[1] The proposed 1H Unit contains 157.49 total acres comprised of multiple separate tracts.[2] Colgate has leases on multiple tracts containing 137.58 net mineral acres, which is 87% of the total acreage in the 1H Unit.[3] The 1H Unit includes 65 unleased mineral interest owners (41 affected tracts), whose combined interests total 19.92 net mineral acres, which is 13% of the total acreage.[4]

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[1] Applicant's Exs. 5 and 6.

[2] Applicant's Exs. 8 and 12.

[3] Applicant's Ex. 10.

[4] Applicant's Exs. 10 and 11.

Field, Discovery Date, and State of Texas Ownership

The MIPA does not apply in fields discovered and produced before March 8, 1961, and it does not apply to land in which the State of Texas has an interest unless the State has given consent.[5] These exceptions do not apply in this case—the proposed 1H Unit lies within the productive limits of the Phantom (Wolfcamp) Field, which was not discovered until 1983, and no State-owned minerals exist within the proposed 1H Unit. [6]

Oil Field Rules for the Phantom (Wolfcamp) Field relevant to Colgate's application include: 1) Special Rules, 320 acres per unit; 2) Optional Rules, 40 acres per unit; and 3) operators shall file for each oil well a Form P-15 *Statement of Productivity of Acreage Assigned to Proration Units.*[7] Stacked Lateral Rules apply.[8]

The Voluntary Pooling Offer

On or about December 16, 2016, Colgate sent a voluntary pooling offer to all mineral owners of unleased tracts within the boundaries of the proposed 1H Unit.[9] Colgate offered these unleased mineral owners three options for inclusion of their interests in the proposed 1H Unit: one lease option, a working-interest participation option, and a farm-out option.[10]

The lease option included a 20% royalty, a bonus of $1,500 per net mineral acre, and a primary term of three years.[11] The oil, gas and mineral lease attached to the offer letter provided that Colgate was authorized to pool the tract owner's mineral interest into a pooled unit.

The participation option provided each unleased owner an opportunity to participate as a working interest owner in the proposed 1H Unit. By electing this option, the owner would be responsible for a proportionate share of the costs of drilling and completing the well or wells in the unit and would share proportionately in the production from the well. Each offer letter had as an attachment an AFE (Authorization for Expenditure) indicating the estimated cost to complete and drill the proposed 1H Unit to be $8,251,856.[12] This option stated that if the owner failed to fully pay his or her proportionate share of costs to Colgate within 15 days prior to commencement of actual drilling operations, then the owner would be subject to the non-consent penalties set forth in the standard Joint Operating Agreement ("JOA") proposed by Colgate.[13] Colgate represented to each owner that the proposed JOA

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[5] MIPA §§ 102.003, 102.004.

[6] Applicant's Exs. 2 and 17.

[7] Applicant's Ex. 16

[8] *Id.*

[9] Applicant's Ex. 9.

[10] *Id.*

[11] *Id.*

[12] *Id.*

[13] *Id.*

would not contain any of the following: (1) a preferential right of the operator to purchase mineral interests in the unit; (2) a call on or option to purchase production from the unit; (3) operating charges that may include any part of district or central office expenses other than reasonable overhead charges; or (4) a prohibition against non-operators questioning the operation of the unit.[14]

The farm-out option proposed to each unleased owner that he or she convey to Colgate an 80% net revenue interest attributable to his or her mineral interest and retain an overriding royalty interest equal to 20% of 8/8ths, proportionately reduced to the extent that each owner's mineral interest bears to all of the mineral interests in the unit, until payout of all well costs (to drill, test, fracture stimulate, complete, equip, and connect the well for production).[15] At payout, the electing owner would have the option to convert the retained override to a 25% working interest, proportionately reduced.[16]

Colgate concludes that the lease terms included in its voluntary offer were fair and reasonable.[17]

Need for MIPA Wells

Colgate offered into evidence a model to predict recovery from wells completed in the Phantom (Wolfcamp), Two Georges (Bone Springs), and Wolfbone (Trend Area) Fields—all with varying drainhole lengths.[18] Colgate also presented a map showing Phantom (Wolfcamp), Two Georges (Bone Springs), and Wolfbone (Trend Area) wells within an approximate 5 ½ mile radius of the proposed 1H Unit.[19] Colgate also proffered a cross-section over that area showing the Phantom (Wolfcamp), Bone Springs, Wolfcamp A, Wolfcamp B, Wolfcamp C, and Wolfcamp D formations.[20] From the location of existing wells and the study of the cross-section, Colgate concluded that the Phantom (Wolfcamp) Field is present throughout the proposed 1H Unit and expected to be productive over the entirety of the area within the 5 ½ mile radius study area.[21]

For every well within the 5 ½ mile radius study area with sufficient data (99 wells), Colgate plotted the estimated drainhole length of the well versus the well's estimated ultimate oil recovery ("EUR"). Colgate then calculated the estimated ultimate recoveries (the "EURs") by decline curve analysis. Using the EUR as the y-coordinate and the estimated drainhole length as the x-coordinate, Colgate created a scatter plot of the data points.[22] A

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[14] *Id.*

[15] *Id.*

[16] *Id.*

[17] Tr., pg. 50, ln. 2.

[18] Applicant's Exs. 22 and 23.

[19] Applicant's Ex. 18.

[20] Applicant's Ex. 21.

[21] Tr., pg. 63, lns. 19 – 24.

[22] Applicant's Ex. 22.

computer-generated least-squares regression of the plotted data points resulted in a line through the points with a positive slope of 0.0378 and an R-squared coefficient of 0.3267.[23] The inference of this resulting equation is that an average well within the 5 ½ mile radius will recover 0.0378 MBbls (37.8 barrels) of oil for each incremental foot of drainhole length.[24]

Colgate's plat showed that, in spite of the percentage of acreage under lease, there was no path for the planned wellbore that would not encounter some unleased, unpooled interest.[25] Colgate contends that, absent MIPA approval of the proposed well, the underlying reserves could not be recovered and would therefore be wasted.[26] Colgate also testified that MIPA approval was necessary to protect correlative rights by giving Colgate and its lessors a reasonable opportunity to recover their fair share of the oil and gas underlying the proposed 1H Unit.[27]

Charge for Risk

Colgate's application requested that the Commission's MIPA pooling order include a 100% charge for risk attached to the working-interest component, as authorized under Section 102.052 of MIPA.[28] In addition, the Notice of Hearing for the MIPA application gave notice that Colgate was seeking a 100% charge for risk[29]—but no party appeared to protest the 100% charge for risk, or any other aspect of the application.

Colgate demonstrated that private joint operating agreements in the area of the proposed 1H Unit provide for non-consent penalties up to a maximum of 400%.[30] To further support the proposed 100% charge for risk, Colgate offered testimony relating to the Society of Petroleum Evaluation Engineers' *Thirty-Fourth Annual Survey of Parameters Used in Property Evaluations*—summarily, a study conducted of reservoir reserves for purposes of determining fair market value of oil and gas assets or "risking" the reserves.[31] Colgate's testifying expert witness (a professional engineer) opined that the Phantom (Wolfcamp) Field reserves in the area of the proposed 1H Unit is most similar to the "proved undeveloped" reserve category identified on the "Unconventional Reserve Adjustment Factors" table.[32] Colgate's testifying expert opined that the study fully

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[23] R-squared is a statistical measure of how close the data are to a fitted regression line. R-squared is measured on a scale of 0 – 100%. The "higher" the R-squared value, the better the regression line "fits" the data.

[24] Tr., pg. 65, lns. 9 – 13.

[25] Applicant's Ex. 8.

[26] Tr., pg. 76, lns. 1 – 15.

[27] *Id.*

[28] Applicant's Ex. 2.

[29] Applicant's Ex. 3.

[30] Applicant's Ex. 31.

[31] Applicant's Ex. 24; *See* Tr., pgs. 69 – 71.

[32] Tr., pg. 69, lns. 13 – 23.

supports the requested charge for risk.[33]

Colgate asserts that there exists significant risk that a well completed in the Phantom (Wolfcamp) Field in the area of the proposed 1H Unit will be uneconomic, meaning the well will not recover the cost of drilling and completing the well.[34] Using an average cost of drilling and completing equal to roughly $8.2 million, an gas price of $3.50 per MCF, an oil price of $52 per barrel, production/severance tax rates for oil and gas equivalent to 0.046 and 0.075, respectively, and a net revenue interest amount of 75%, Colgate concluded that the break-even oil recovery point, at which the well's cost would be recouped, was approximately 195,720 barrels of oil.[35] Of the 99 wells within approximately 5 ½ miles of the proposed 1H Unit, 80—or, 80.8%—had estimated ultimate recoveries below a payout amount necessary for a well to be considered economic.[36] However, the scatter plot of the estimated ultimate recovery of wells within a 5 ½ mile radius shows significant variability in individual well performance.[37]

But, Colgate stated on the record that it would not be adverse to a recommended charge for risk equivalent to 50% or greater.[38]

EXAMINERS' OPINION

Under the MIPA, the Commission may order compulsory pooling only if it is necessary to avoid the drilling of unnecessary wells, protect correlative rights, or prevent waste. The evidence in this unprotested proceeding demonstrates that compulsory pooling is necessary to protect correlative rights.

Due to the locations of the unleased tracts within the proposed 1H Unit, the well could not be drilled as proposed without compulsory pooling. To illustrate, the proposed well would traverse or be less than the minimum spacing distance from 21 unleased (or, partially unleased) tracts inside the proposed 1H Unit.[39] Colgate cannot drill the well, as proposed, unless compulsory pooling is ordered because of the impracticality of drilling around the unleased tracts. Therefore, in the absence of compulsory pooling, each mineral interest owner within these proposed units would not be afforded a reasonable opportunity to recover his fair share of hydrocarbons.

Compulsory pooling as proposed by Colgate, wherein the proposed horizontal well will extend the length of the unit, protects correlative rights because all tract owners, whether leased or unleased, will have their fair share of hydrocarbons produced.

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[33] Tr., pg. 70, lns. 2 – 21.

[34] *See* Tr., pgs. 71 – 74.

[35] Applicant's Ex. 25; *See* Tr., pgs. 71 – 74.

[36] Applicant's Ex. 25.

[37] Applicant's Ex. 22.

[38] Tr., pg. 52, lns. 9 – 16.

[39] Applicant's Ex. 8.

Furthermore, the well and unit proposed by Colgate would allow the Commission to fashion an order in compliance with Section 102.017 of the MIPA, which requires that a MIPA order be made on terms that are fair and reasonable and will afford the owner of each tract in the unit the opportunity to produce and receive their fair share.

The Examiners believe that Colgate's voluntary pooling offer was fair and reasonable. Its offer followed the framework—providing a lease, participation, and farm-out options—that the Commission has determined to be fair and reasonable in recent approved MIPA applications.

Charge for Risk

Section 102.052(a) of the MIPA provides that, "As to an owner who elects not to pay his proportionate share of the drilling and completion costs in advance, the commission shall make provision in the pooling order for reimbursement solely out of production, to the parties advancing the costs, of all actual and reasonable drilling, completion, and operating costs plus a charge for risk not to exceed 100 percent of the drilling and completion costs."

Colgate's unprotested application requested a 100% charge for risk be applied to the working interest portion of an owner who elects not to pay his proportionate share of the drilling and completion costs in advance. The Examiners are not persuaded that a 100% charge for risk is warranted in the instant docket and recommend a 50% charge for risk. However, Colgate stated on the record that it would not consider a recommended 50% charge for risk adverse—thereby negating the need to issue a Proposal for Decision.

"Appendix 1" to this Examiners' Report and Recommendation is a plat for the proposed Cantaloupe MIPA Unit, Well No. 1H, showing the proposed wellbore path of Well No. 1H and the unleased tracts and partially-leased within the 1H Unit. "Appendix 1A" to this Examiner's Report and Recommendation is the legal description of the proposed 1H Unit.

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. Notice of the hearing was mailed to all interested parties at mailing addresses provided by the Applicant, Colgate Operating LLC ("Colgate"), at least 30 days prior to the hearing date.

2. Notice of the hearing was published in the *Pecos Enterprise* on December 13, December 20, December 27, 2016; and January 3, 2017.

3. No one appeared at the hearing in opposition to Colgate's application.

4. On or about December 16, 2016, Colgate sent a voluntary pooling offer to all mineral owners of unleased tracts within the boundaries of the proposed MIPA unit. The unleased mineral owners were offered three options for inclusion of their interests in the proposed units: a lease option, a working-interest participation option, and a farm-out option.

   a. The lease option included a 20% royalty and a bonus offer of $1,500 per net mineral acre, for a three-year primary term. The oil, gas, and mineral lease attached to the offer letter provided that Colgate was authorized to pool the tract owner's mineral interest into a pooled unit and drill a horizontal well beneath the surface of the leased premises.

   b. The participation option provided each unleased owner an opportunity to participate as a working interest owner in the respective proposed unit. By choosing this option, the owner would be responsible for his or her proportionate share of the costs of drilling and completing the well or wells in the unit and would share proportionately in the production from the well. Each offer letter had as an attachment an AFE (Authorization for Expenditure) indicating the estimated cost to complete and drill the relevant well.

   c. The estimated cost for Well No. 1H is $8,251,713. The participation option stated that if the owner failed to fully pay his or her proportionate share of costs to Colgate within 15 days prior to commencement of actual drilling operations, then the owner would be subject to the non-consent penalties set forth in the standard Joint Operating Agreement (the "JOA") proposed by Colgate.

   d. Colgate represented to each owner that the proposed JOA would not contain any of the following: (1) a preferential right of the operator to purchase mineral interests in the unit; (2) a call on or option to purchase production from the unit; (3) operating charges that may include any part of district or central office expenses other than reasonable overhead charges; or (4) a prohibition against non-operators questioning the operation of the unit.

   e. The farm-out option proposed to each unleased owner that he or she convey to Colgate an 80% net revenue interest attributable to his or her mineral interest and retain an overriding royalty interest equal to 20% of 8/8ths, proportionately reduced to the extent that each owner's mineral interest bears to all the mineral interests in the unit, until payout of all well costs (to drill, test, fracture stimulate, complete, equip, and connect the well for production). At payout, the electing owner would have the option to convert the retained override to a 25% working interest, proportionately reduced.

5. Colgate provided the essential terms of the participation option and the farm-out option in its offer letter. Colgate did not enclose copies of its participation agreement or farm-out agreement, but instead offered to provide a copy of its participation agreement and farm-out agreement to any mineral owner who was interested in one or both of those options.

6. The tracts within the proposed MIPA unit are embraced in the Phantom (Wolfcamp) Field, a common reservoir of oil or gas for which the Commission has established the size and shape of proration units. The Phantom (Wolfcamp) Field is present and reasonably productive in the area covering all the proposed units.

7. The Phantom (Wolfcamp) Field was discovered in 1983. This field has special field rules providing for 330-foot lease-line spacing, and there is no between-well spacing requirement. The standard oil unit for the Phantom (Wolfcamp) Field is 320 acres. An operator is permitted to form optional units of 40 acres.

8. Colgate estimated the volumetrically-calculated oil in place beneath the proposed MIPA unit. Using a 20 percent recovery factor, Colgate calculated that the recoverable oil in place beneath the proposed 1H Unit is 6,823.4 MBO.

9. Colgate created a scatter plot of the estimated ultimate recoveries (the "EURs") versus the estimated drainhole length for comparable wells within 5 ½ miles of the proposed MIPA unit. A computer-generated least-squares regression of the plotted data points resulted in a line with a positive slope of 0.0378 and an R-squared coefficient of 0.3267. The inference of this resulting equation is that an average well within the 5 ½ mile radius will recover 37.8 barrels of oil for each incremental foot of drainhole length.

10. Colgate cannot drill the proposed well unless compulsory pooling is ordered as requested. The proposed well cannot be drilled to its full planned length without traversing one or more unleased tracts.

11. There are no regular locations within the proposed unit where a feasible horizontal well could drain the proposed unit.

12. Compulsory pooling within the proposed unit as requested by Colgate will protect correlative rights and prevent waste. Without compulsory pooling, Colgate will not be able to drill the proposed well, Colgate and its lessees will not have a reasonable opportunity to recover their fair share of hydrocarbons from the reservoir, and the underlying hydrocarbons will be left unrecovered.

13. Colgate presented evidence supporting a charge for risk of 50 percent of the drilling and completion costs of the proposed well.

14. Colgate stated on the record that it waived issuance of a Proposal for Decision and Colgate requested on the record that, pursuant to Tex. Gov't Code §2001.146(e), the Final Order would be come effective on the date that the Final Order is issued by the Commission.

CONCLUSIONS OF LAW

1. Pursuant to Texas Natural Resources Code § 102.016, notice of the hearing was given to all interested parties by mailing the notices to their last known addresses at least 30 days before the hearing and, in the case of parties whose whereabouts were unknown, by publication of notice for four consecutive weeks in a newspaper of general circulation in the county where the proposed unit is located at least 30 days before the hearing.

2. The Commission has jurisdiction over the parties and the subject matter and has authority to issue a compulsory pooling order pursuant to Texas Natural Resources Code § 102.011.

3. Colgate made a fair and reasonable offer to pool voluntarily to the mineral owners of the unleased tracts within each of the proposed units, as required by Texas Natural Resources Code § 102.013.

4. Compulsory pooling of the owners of the unleased tracts within each of the proposed proration units as owners of a 25% royalty and 75% working interest, proportionately reduced, with these owners' share of expenses, subject to a charge for risk of 50%, payable only from the owners' working-interest component, and subject to a no-surface-use restriction, is fair and reasonable within the meaning of Texas Natural Resources Code § 102.017.

5. Compulsory pooling of the mineral interests in all tracts within the boundaries of the 1H Unit will serve the purpose of protecting correlative rights.

6. The terms and conditions of the Commission's Final Order in this proceeding are fair and reasonable and will afford the owner of each tract or interest in each respective unit the opportunity to produce or receive his fair share.

RECOMMENDATION

The Examiners recommend that Colgate's application be approved, subject to conditions, as set forth in the attached recommended Final Order.

Respectfully Submitted,

Ryan M. Lammert
Administrative Law Judge

Karl Caldwell
Technical Examiner