

April 28, 2006

OIL & GAS DOCKET NO. 01-0246234

APPLICATION OF CINCO NATURAL RESOURCES CORP. TO CONSIDER REDUCTION OF THE AMOUNT OF FINANCIAL SECURITY REQUIRED PURSUANT TO STATEWIDE RULE 78(G) AND TO CONSIDER AN EXCEPTION TO THE FINANCIAL SECURITY REQUIREMENTS FOR BAY WELLS IN VARIOUS RED FISH BAY FIELDS, NUECES COUNTY, TEXAS.

APPEARANCES:

FOR APPLICANT:

J. David Hall
Leigh Prieto

APPLICANT:

Cinco Natural Resources Corp.
“ ”

FOR INTERVENOR:

Brian Sullivan

INTERVENOR:

IBC Petroleum, Inc.

PROPOSAL FOR DECISION

PROCEDURAL HISTORY

DATE OF REQUEST FOR HEARING:

February 8, 2006

DATE OF NOTICE OF HEARING:

February 17, 2006

DATE OF HEARING:

March 6, 2006

HEARD BY:

Mark Helmueller, Hearings Examiner

DATE RECORD CLOSED:

April 28, 2006

DATE PFD CIRCULATED:

April 28, 2006

STATEMENT OF THE CASE

In this application, Cinco Natural Resources Corp. (“Cinco”) seeks a reduction to the financial security requirements of Statewide Rule 78 for bay wells in various Red Fish Bay Fields, Nueces County, Texas. The requested exception relates to \$650,000 in financial security which Cinco currently has on file with the Commission for its operations, including 10 non-producing bay wells. Cinco asserts that its certified net worth of \$22,816,754 as of December 31, 2004 gives the Commission the discretion to reduce its financial security for non-producing wells to zero.

Cinco has also requested to be recognized as the operator of 16 non-producing well bores in Corpus Christi Bay presently operated by IBC Petroleum, Inc. (“IBC”), 8 active well bores and 5 non-producing well bores operated by Boss Exploration & Production Corporation (“Boss”). Further, based on its net worth, Cinco requests the additional financial security requirements for the non-producing bay wells be waived.¹ A spreadsheet identifying the well bores by American Petroleum Institute (API) number, Commission gas well or oil lease identification number, State Tract Number, Well Number, Commission Field Name, Production Status, and Lease Status is attached as Exhibit A.

In sum, Cinco requests to be recognized as the operator of 39 bay well bores while posting financial security of \$110,000 instead of the \$1,910,000 which would be required for the operation of 31 non-producing bay wells under Statewide Rule 78(g). Cinco asserts that its certified and independently audited net worth justifies relaxation of the non-producing bay well financial security requirements.

The examiner recommends requiring Cinco maintain the financial security it currently has on file with the Commission of \$650,000 at least until the next renewal of its Organization Report. The examiner further recommends granting Cinco’s request to be recognized as the operator of all 13 well bores operated by Boss and 11 well bores operated by IBC for which it can establish it has a current right to operate. This would raise the total number of bay well bores operated by Cinco to 34, but would not require Cinco to post any additional financial security. Finally, the examiner recommends denying without prejudice Cinco’s request to be recognized as the operator of the remaining 5 IBC well bores subject to reconsideration if Cinco can establish that it has obtained a right to operate.

APPLICABLE RULES

Statewide Rule 78(g)(1) provides the base amount of financial security required of all operators. The base amount of blanket bonds, letters of credit, or cash deposits required of operators of 11-99 wells is \$50,000.²

Statewide Rule 78(g)(2) requires the filing of additional financial security for operators of bay wells. As relevant here, in addition to other financial security required under Rule 78(g)(1), an operator of offshore wells must file entry level financial security of \$60,000 and an additional \$60,000 for each non-producing bay well in excess of one.

¹ Commission records show that one of the multi-completion well bores, API 355-02763, Well No. 7 on State Tract 414 is split in its operator designation for the three existing completions in the well. Boss is the operator of the gas well completion, RRC Gas ID No. 186047, which is currently producing. IBC is listed as the operator of the two shut-in oil completions, ID Nos. 02290 and 02298. Hence, the total well bore count is 39.

² At the time of the hearing, Cinco was the operator of 10 well bores and therefore subject to a minimum base financial security amount of \$25,000. If the examiner’s recommendation is approved, Cinco would become the operator of 35 well bores thereby increasing the minimum base financial security amount to the \$50,000 level.

Statewide Rule 78(g)(5) provides if an operator of bay and/or offshore wells is not eligible for an administrative reduction of any additional financial security required for non-producing offshore wells, that the operator may request a hearing to submit evidence supporting a reduction. The reduction may not exceed 25% of the operator's certified and independently audited net worth for the most recently completed fiscal year less the Commission's estimate of the operator's plugging liability for all producing bay and/or offshore wells.

Statewide Rule 78(j)(1) provides that the Commission will not approve a transfer of operatorship submitted for any well or lease unless the operator has filed financial security in an amount sufficient to cover both current operations and the wells being transferred.

MATTERS OFFICIALLY NOTICED

The examiner has officially noticed the Proposal For Decision, Final Order and exhibits in Oil & Gas Docket No. 04-0241509: *Application of Boss Exploration and Production Corporation to Consider an Exception to the Financial Security Requirements for Bay Wells in Various Red Fish Bay Fields, Nueces County, Texas* ("Boss docket"), Final Order entered June 22, 2005.

In addition, the examiner has officially noticed: (1) Commission Organization Report (Form P-5) records from the mainframe computer database for Cinco, Boss, and IBC; (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 drilling permit records from the Drilling Permit Query database reflecting drilling permits issued to Boss between January 1, 2005 through the date of the hearing; (4) Commission well bore records from the mainframe computer database reflecting re-entry and plugging operations for wells operated by Boss; and, (5) a summary of lease records obtained from the General Land Office confirming that either through an assignment, or through a new lease agreement, Cinco has the right to develop the mineral interests on 18 of the 21 Corpus Christi Bay tracts containing Cinco, Boss and/or IBC wells.

At the time of the hearing in the *Boss docket*, Boss was the operator of 11 bay well bores in the Redfish Bay area of Corpus Christi Bay. Boss acquired the wells effective June 1, 2004, when Boss purchased 100% of the assets of IBC. According to Boss, IBC was owned by a German investment company that has ceased funding IBC's operations.

In the *Boss docket*, Boss requested to be designated as the operator of 29 non-producing IBC wells without posting financial security of \$2,090,000³ as required under Statewide Rule 78. Boss made this proposal despite the fact that 15 of the wells were located on State tracts with no current effective oil and gas leases. Additionally, Boss identified 15 well bores as potential reentry candidates, and admitted 14 well bores would require plugging.

³ This was based on base financial security of \$50,000 for an operator of 11-99 wells, entry level financial security of \$60,000 for an operator of bay wells, and additional financial security for a total of 33 nonproducing bay wellbores of \$1,980,000.

The Commission denied Boss' request in a Final Order entered June 22, 2005. Finding of Fact No. 10 adopted by the Final Order determined that 15 well bores were reentry candidates and 14 well bores required plugging as represented by Boss at the hearing.

Commission Organization Report records show Cinco was first recognized as an operator on February 5, 2004. Cinco is required to renew its Organization Report annually by December 1st. Cinco currently has financial security on file with the Commission in two letters of credit totaling \$650,000. As of April 17th, Commission records list Cinco as the operator of 10 bay well bores, none of which are producing, with a total depth of 121,032 feet.

Commission Organization Report records show Boss has an active organization report, and was first recognized as an operator on August 31, 2004. Boss has filed financial security with the Commission in the form of a \$410,000 bond. As of April 12, 2006 Commission records list Boss as the operator of 13 bay well bores, 8 of which are active and 5 of which are non-producing with a total depth of 148,293 feet. Additionally, Boss currently has 7 open permits to drill new bay wells.⁴

Commission Organization Report records show IBC was first recognized as an operator on February 5, 1998, IBC last filed an Organization Report with the Commission on January 21, 2004, and IBC's Organization Report has been delinquent since February 1, 2005. As of April 12, 2006 Commission records list IBC as the operator of 19 well bores, 2 of which are non-producing land wells and 17 of which are non-producing bay wells. The total depth of IBC's wells is 189,619 feet.

Commission Production Records for January 2005 through December 2005 show neither Cinco nor IBC has reported any production. Boss has reported total production over the same time period of 71,605 barrels of oil/condensate and 1.807 Bcf of natural gas.

Commission permitting records from January 1, 2005 through the hearing show that 14 drilling permits were issued to Boss. Four of the permits were for new bay wells on properties that were not part of the IBC acquisition. Five permits were to re-enter IBC well bores. Finally, five permits were for new wells on bay well tracts in Corpus Christi Bay previously operated by IBC.

Commission mainframe well bore records show that Boss has plugged one well acquired in the IBC transaction, Well No. 187910 located on State Tract 344. This well was plugged in April 2005. Boss has also recompleted and is currently producing 3 of the 5 wells for which it obtained re-entry permits. Finally, Commission records show that drilling operations have commenced for new wells on State Tracts 344 and 392, but that completion reports have not yet been filed.

The summary of lease records provided by the General Land Office confirm Cinco's right to develop the mineral interests on 18 of the 21 tracts at issue. However, Tract 416, which contains two IBC bay wells; Tract 352, which contains one IBC bay well; and, Tract 397, which contains two IBC bay wells, are all currently under lease to unrelated entities.

⁴ Permit Nos. 557687, 604905, 600960, 600961, 607225, 609149 and 612130.

DISCUSSION OF EVIDENCE

Cinco submitted its complete financial statement for the fiscal years concluding December 31, 2004 and 2003 to support its application.⁵ Cinco confirms that the financial statement was audited by an independent auditor, Ernst & Young, LLP consistent with generally accepted accounting principles.

The financial statement reports total assets of \$26,827,741 as of December 31, 2004. The assets include: cash and equivalents totaling \$6,771,549; \$19,831,772 in property and equipment listed under "Oil and Gas Properties, at cost using the successful efforts method of accounting."; prepaid expenses of \$1,532,063, and, \$3,790,044 in accounts receivable. Less accumulated depreciation of \$5,284,975, the net asset value for property and equipment is listed as \$14,727,477. The financial statement also list liabilities totaling \$4,010,987. Accordingly, the shareholders' equity or net worth of the company (assets less liabilities) is \$22,816,754.

Cinco asserts that subtracting its required additional financial security from the calculation of 25% of its shareholders' equity of \$7,879,547 under the formula set forth in Rule 78(g)(5), entitles it to a complete waiver of any additional financial security required for the 10 non-producing bay well bores it currently operates and also allows it to acquire all of the non-producing bay wells operated by Boss or IBC. This would result in Cinco's designation as the operator of 39 bay well bores, of which 8 are currently producing. Additionally, Cinco's current financial security of \$650,000 would be reduced to \$110,000.

EXAMINER'S OPINION

Cinco is requesting a midstream evaluation of its financial security requirements relating to its current and proposed operation of bay wells. In part, Cinco's stated motivation will enable it to acknowledge responsibility for 39 well bores in Corpus Christi Bay. As such, this application, while unique in seeking an evaluation of financial security requirements outside of the normal time period for renewing an Organization Report, is timely with respect to its proposed recognition as the operator of the Boss and IBC well bores. This interpretation is supported by Texas Natural Resources Code §91.107 and Statewide Rule 78(j)(1) which preclude the Commission from recognizing an operator of a well unless the entity files financial security as required for the operation of its existing wells and any wells being acquired.

⁵ Cinco requested that the complete financial statement only be submitted into evidence for the examiner's in camera inspection, but represented that it would not object if the examiner required the entire financial statement to be included in the evidentiary record. Because the complete financial statement includes statements regarding the independent auditor's analysis and a statement that generally accepted accounting principles were followed in conducting the audit, and these statements are necessary evidence to support proposed Finding of Fact No. 12, it is the examiner's determination that the complete financial statement must be included in the evidentiary record for this proceeding.

However, the application is not timely with respect to Cinco's request that its current financial security be reduced. Cinco's Organization Report is due to be renewed on December 1, 2006. Cinco currently operates no producing wells and is not entitled to an administratively granted exception to Statewide Rule 78 non-producing well financial security requirements. The examiner recommends that Cinco be required to maintain the \$540,000 in additional financial security for its non-producing bay well bores at least until the next annual renewal of its Organization Report on December 1, 2006.

The recommendation that Cinco maintain the \$540,000 in additional financial security currently in effect is also based on the potential recognition of Cinco as the operator of additional bay well bores currently operated by Boss and IBC as it has requested. It is the examiner's conclusion that there are five factors, which support this recommendation: 1) the ratio of non-producing wells to producing wells; 2) prior findings by the Commission that 13 well bores require plugging; 3) the inherent limitations in relying on a financial statement as of December 31, 2004 for a midstream reduction in financial security requirements in 2006; 4) the limited reduction in financial security that would have been available based on the financial statement for 2003; and, 5) Cinco's inability to establish a valid lease for 3 bay well tracts with a total of 5 well bores.

Evaluation of Cinco's Financial Statement

Cinco submitted its most recent audited financial statement in support of its application. This statement addresses the financial health of the company as of December 31, 2004. It was prepared by Ernst & Young, LLC, who confirmed in their report that it had conducted the audits "in accordance with auditing standards generally accepted in the United States." The report ultimately concludes that the financial statements:

[P]resent fairly, in all material respects, the financial position of the Company as of December 31, 2004 and 2003, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States.

The report is therefore consistent with the standard in Statewide Rule 78(g)(5)(A)(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. (Emphasis added)

There are no disclosures made by the auditor in the Notes to the Financial Statement which question Cinco's status as a going concern. Additionally, there is no cautionary language that Cinco lacked the financial assets to meet any business obligations or regulatory requirements.

Cinco's December 31, 2004 financial statement valued the shareholder's equity in this private company at \$22,816,754. This is nearly a 300% increase over the shareholder's equity value as of December 31, 2003 of \$8,351,464. The 300% increase is mirrored in the asset evaluations. On December 31, 2004, Cinco's current assets (cash, equivalents, accounts receivable and prepaid expenses) totaled \$12,093,656. Current assets as of December 31, 2003 were \$4,499,795. Additionally, property and equipment evaluated under the successful efforts method of accounting,⁶ less accumulated depreciation, was valued at \$14,727,477 on December 31, 2004, an approximately 300% increase over the valuation of \$4,565,197 on December 31, 2003.

Additionally, the Statement of Operations in the financial statement show a significant swing between the two years evaluated. Operations ending December 31, 2003 showed a net loss of \$1,350,726. This is contrasted against a profit of \$2,595,966 as of December 31, 2004.

Finally, the Statement of Cash Flows in the financial statement provides some insight on the changes in shareholder's equity, asset evaluations, and yearly operations. In 2004, Cinco's investors added \$11,869,324 in paid in capital into the company in exchange for common stock. Cinco spent \$17,758,852 in exploration, acquisition and development costs and another \$1,511,948 in drilling advances, but offset those expenditures by the sale of oil and gas properties totaling \$5,743,502. Finally, Cinco's operating activities resulted in an inflow of cash of \$6,235,962.

Based on the audited financial statements, it appears that Cinco had a good financial year in 2004. It raised significant capital from its investors. It actively acquired or developed producing oil and gas properties and consummated a significant sale of some properties. Finally, its operations resulted in a net cash increase into the company of \$6,235,962 and a net profit of \$2,595,966. All of these factors collectively support the Commission's consideration, at least in part, of Cinco's net worth in determining the amount of financial security required to be posted for its current and proposed operations of non-producing bay wells.

Net Worth Reduction Amount and Reduction of Current Financial Security

Cinco's net worth as of December 31, 2004 is \$22,816,754. Cinco asserts that subtracting its required additional financial security from 25% of its net worth of \$7,879,547 under the formula set forth in Rule 78(g)(5), entitles it to a complete waiver of any additional financial security required for its 10 non-producing bay wells currently held in its name as well as the 29 non-producing bay wells currently operated by Boss or IBC.

The determination of the 25% net worth starting point of \$7,879,547 is accurate. Under the calculations set forth in Statewide 78 for potential reduction of the financial security requirements,

⁶ The successful efforts method of accounting capitalizes all costs associated with productive wells and nonproductive wells while nonproductive exploration costs and geological and geophysical expenditures are characterized as expenses. The valuation therefore reflects actual capital expenditures in the development of producing oil and gas wells.

as applied to both its current and prospective operation of 39 bay well bores, 8 active and 32 non-producing, no additional financial security would be required to be posted for Cinco's acquisition of the 30 Boss and IBC well bores. The formula would be applied as follows:

\$7,879,547(25% of net worth) - \$480,000 (estimated active well liability) = \$7,399,547

\$7,399,547 - \$1,800,000 (\$60,000 x 30 nonproducing bay wells) = Complete Waiver

The calculation of the maximum reduction amount based on certified net worth is set out in Rule 78 for both administrative reductions and the Commission's consideration of a reduction application after a hearing is requested. As noted in the *Boss docket*, the determination of whether the Commission should grant exceptions to the financial security requirements of Statewide Rule 78 is a policy decision for the Commissioners.

To date, the Commissioners have expressed their policy decision in Final Orders issued in four 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*, (the "*American Coastal*" docket), (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 Leases, El Gordo (Miocene) and Middle Bank Reef Fields, Matagorda County, Texas*, (hereinafter the "*Capco Docket*"), (Final Order entered June 21, 2005); and, *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*, (hereinafter the "*VTEX docket*"), (Final Orders entered March 23, 2005 and February 7, 2006); and the previously cited *Boss docket*.⁷

In all four dockets, the Commission applied the required accounting standards expressed in Statewide Rule 78(g)(5)(A)(ii) for administrative reduction applications to its consideration of applications after a hearing is requested. All four dockets found that the evaluation of the applicants' "net worth" required the applicant to present accounting evidence in the same format necessary for an administrative reduction, i.e., a certification of net worth from an independent auditor employing generally accepted accounting principles. The *American Coastal*, *Boss*, and *Capco* dockets, all denied the requested reductions, in part, for the failure to present evidence in this format.

In the *VTEX docket*, the Commission acknowledged that VTEX presented its accounting

⁷ As of the issuance of this proposal for decision, the Commission entered an Interim Order in Oil & Gas Docket No. 03-0241972: *Application of Masters Resources, L.L.C. and Masters Oil & Gas, L.L.C. to Consider a Reduction in the Amount of Financial Assurance Required Pursuant to Statewide Rule 78(g), for Bay Wells in Various Fields, Galveston and Chambers Counties, Texas*. As this is not a Commission Final Order, and does not directly address the issue of whether an exception to the financial security requirements was granted, it is not directly on point to the issues being considered in Cinco's application.

evidence in the required format and then evaluated whether or not to grant the administrative reduction based on the evaluation of the evidence. The Commission also acknowledged that the VTEX's reported net worth was sufficient under the administrative standard to grant the requested reduction. However, the Commission's evaluation did not end with those acknowledgments. Review of the financial statements in the *VTEX docket* revealed several factors raised by required auditor disclosures, which the Commission considered in denying the requested reduction.

As in the *VTEX docket*, there are several factors in Cinco's application which warrant careful consideration. These factors include: 1) the ratio of non-producing wells to producing wells; 2) prior findings by the Commission based on Boss' admission that 13 of the well bores require plugging; 3) Boss' bay well operations and open permits; 4) the limited reduction in financial security that would have been available based on the Financial Statement for 2003; and, 5) Cinco's inability to establish a valid lease for 3 bay well tracts with a total of 5 well bores.

The ratio of producing to non-producing wells is one of the factors set in Statewide Rule 78 to determine whether an administrative reduction may be applied to an operator's non-producing well financial security requirements. The rule recognizes that a strict ratio determination may not be a valid measure if an operator only has 5 or fewer well bores. But for operators with more than 5 well bores, an operator must have at least as many producing wells as non-producing wells to qualify for an administrative reduction. As applied to Cinco's current and proposed operations of 39 bay well bores, this means that Cinco's well bore inventory would have to include at least 20 producing well bores to qualify for an administrative reduction. At the present time, only 8 of the well bores are producing wells, with 31 non-producing wells.

One of the stated rationales in the adoption of the financial security requirements for non-producing bay and offshore wells was reducing the number of abandoned bay and offshore wells. The amendments adopting non-producing well financial security requirements recognized that this would be facilitated by providing an incentive to operators to either plug wells or restore them to production to eliminate the required additional financial security.

The record indicates some progress in the producing/non-producing well bore ratio. Commission records confirm Boss plugged one well and successfully recompleted three wells. Additionally, Boss has obtained drilling permits to reenter two other non-producing well bores. However, this still leaves 10 non-producing well bores currently in Cinco's name for which no re-entry permits have been filed, and another 16 non-producing well bores under IBC for which there are no re-entry permits. Accordingly, it is the examiner's opinion that this factor does not support reducing the financial security presently posted with the Commission.

Similarly, the Commission has previously recognized, as provided in the evidence submitted in the *Boss docket* related to the same inventory of wells, that 13 well bores require plugging. The estimated plugging cost using the presumed \$60,000 amount in Statewide Rule 78, is \$780,000. This amount is equal to the additional financial security Cinco and Boss have collectively posted

for their 15 non-producing well bores.⁸ Accordingly, this factor does not support reducing Cinco's financial security currently posted with the Commission.

The next factors to consider are the limitations of the financial statements with respect to Cinco's current financial conditions. Cinco's request is based largely on a financial statement for a good financial year that ended 15 months ago. Accordingly, this financial data, while the most recently available, may be somewhat stale, as it does not reflect the current financial condition of Cinco. The examiner therefore believes that Cinco's request for a midstream reduction in current financial security posted should be deferred until the renewal of its Organization Report, at which time, the financial statement for Cinco as of December 31, 2005 will be available.

Additionally, it is not clear whether Cinco's fiscal year 2004 was an aberration. Therefore, it is illustrative to compare the calculation of a reduction based on 25% of the net worth as of December 31, 2003 to Cinco's current request. Assuming Cinco's net worth on that date is equal to the stated valuation of shareholders' equity of \$8,351,464, the calculation of eligible deduction would be applied as follows:

\$2,087,866 (25% of net worth) - \$480,000 (estimated active well liability) = \$1,607,866

\$1,607,866 - \$1,800,000 (\$60,000 x 30 non-producing bay wells) = \$192,134 to be posted

The \$192,134 in required additional financial security for the complete Cinco/Boss/IBC non-producing well bore inventory using Cinco's fiscal year ending in 2003 indicates that it may be appropriate to limit reliance on the December 31, 2004 financial data to reduce the amount of financial security Cinco currently has posted for its non-producing bay wells. The examiner therefore concludes this factor also weighs in favor of requiring Cinco to maintain its financial security at the current level.

The final factor considered is the current status of Cinco's right to operate all of the well bores in the Cinco/Boss/IBC well bore inventory. The information officially noticed by the examiner obtained from the General Land Office indicates that Cinco does not hold a leasehold interest to three tracts which have non-producing well bores currently held under IBC: State Tracts 352, 397, and 416. These three tracts include 5 non-producing well bores. Even if Cinco were to post the required financial security for these non-producing well bores, they would still be out of compliance with the plugging requirements of Statewide Rule 14(b)(2) because they are not eligible for plugging extension without proof of a good faith claim of a continuing right to operate. These 5 wells represent an immediate presumed plugging liability of \$300,000. Therefore, this factor also supports requiring Cinco to maintain the \$540,000 in financial security it currently has posted for its non-producing bay well bores.

⁸ Because operators are only required to post financial security for any non-producing wells in excess of one the financial security posted under Statewide Rule 78 by Boss and IBC is based on 13 well bores instead of 15 well bores.

Analysis of the cited factors, in the examiner's judgment, supports requiring Cinco to maintain financial security at current levels for its existing and proposed operation of non-producing bay wells. However, it is the examiner's opinion that the net worth reduction calculation supports recognition of Cinco as the operator of any of the 39 bay well bores for which it has a confirmed right to operate without posting additional financial security. This would allow Cinco to accept responsibility for 12 abandoned bay well bores currently held by IBC, a delinquent operator. These well bores would become subject to Cinco's existing financial security, an important consideration in the event of threatened or actual pollution from the abandoned IBC well bores.⁹

Accordingly, it is the examiner's recommendation that Cinco's net worth be given limited consideration by the Commission. The net worth reduction should only apply prospectively to any additional financial security that would be required for the operation of non-producing bay well bores that Cinco seeks to be recognized as the operator of record. Cinco should be required to maintain its current financial security at \$540,000 for the operation of 10 non-producing bay well bores at least until the renewal of its Organization Report on December 1, 2006. At that time, Cinco may request a further reduction if warranted by its updated financial statements.

Recognition of Cinco as Operator

Finally, as discussed above in the determination of the impact of Cinco's net worth on reduction of the financial security required for non-producing well bores, Cinco's request to be recognized as the operator of all of the Cinco/Boss/IBC bay well bore inventory is complicated by the General Land Office's records showing that it does not hold a leasehold interest in three tracts which have non-producing well bores currently held under IBC: State Tracts 352, 397, and 416. These three tracts include 5 non-producing well bores.

The Commission does not approve a transfer of a bay or offshore well if the new operator cannot show that a valid lease exists for the subject well. This policy was adopted by in a memorandum approved unanimously by the Commissioners on March 3, 1999, a copy of which is attached as Exhibit B. Accordingly, the examiner cannot recommend granting Cinco's request to be recognized as the operator of all of the Cinco/Boss/IBC bay well bore inventory as it does not have a good faith claim of a continuing right to operate the 5 non-producing well bores on State Tracts 352, 397, and 416.

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

⁹ The examiner recommends that no findings be made with respect to Cinco's request concerning Boss' financial security requirements. Boss has 9 open permits for new bay wells. Three of these permits are for properties outside of the area under consideration, and under the most recent amendments to Statewide Rule 78 adopted by the Commission, Boss would be required to at least maintain its entry level financial security requirement as an operator of bay wells based on these permits.

FINDINGS OF FACT

1. At least ten (10) days notice of the hearing in this docket was sent to all parties entitled to notice.
2. Cinco Natural Resources Corp. (“Cinco”) seeks a reduction to the financial security requirements of Statewide Rule 78 for bay wells in various Red Fish Bay Fields, Nueces County, Texas. The requested exception relates to \$650,000 in financial security which Cinco currently has on file with the Commission for its operations, including 10 non-producing bay wells.
3. Cinco has also requested 16 non-producing well bores in Corpus Christi Bay presently operated by IBC Petroleum, Inc. (“IBC”), 8 active well bores and 5 non-producing well bores operated by Boss Exploration & Production Corporation (“Boss”) be transferred to Cinco, and, based on its net worth, requests the additional financial security requirements for the non-producing bay wells to be acquired be waived.
4. Official notice was taken of the Proposal For Decision, Final Order and exhibits in Oil & Gas Docket No. 04-0241509: *Application of Boss Exploration and Production Corporation to Consider an Exception to the Financial Security Requirements for Bay Wells in Various Red Fish Bay Fields, Nueces County, Texas* (“Boss docket”), Final Order Entered June 22, 2005.
 - A. At the time of the hearing in the *Boss docket*, Boss was the operator of 11 bay well bores in the Redfish Bay area of Corpus Christi Bay. Boss acquired the wells effective June 1, 2004, when Boss purchased 100% of the assets of IBC. According to Boss, IBC was owned by a German investment company that has ceased funding of IBC’s operations.
 - B. In the *Boss docket*, Boss requested to be designated as the operator of 29 non-producing IBC wells without posting financial security of \$2,090,000 as required under Statewide Rule 78. Boss portrayed the 29 IBC well inventory as including 15 potential reentry candidates, and 14 wells which would require plugging.
 - C. The Commission denied Boss’ request in a Final Order entered June 22, 2005. Finding of Fact No. 10 adopted by the Final Order in the *Boss docket* determined that 15 wells were reentry candidates and 14 wells required plugging.
5. Commission Organization Report records show Cinco has an active organization report, and was first recognized as an operator on February 5, 2004. Cinco has filed financial security with the Commission in two letters of credit totaling \$650,000. As of March 31, 2006, Commission records list Cinco as the operator of 10 non-producing bay well bores, with a total depth of 121,032 feet.

6. Commission Organization Report records show Boss has an active organization report, and was first recognized as an operator on August 31, 2004. Boss has filed financial security with the Commission in the form of a \$410,000 bond. As of March 9, 2006 Commission records list Boss as the operator of 13 bay well bores, 8 of which are active and 5 of which are non-producing with a total depth of 148,293 feet. Additionally, Boss currently has 7 open permits to drill new bay wells.
7. Commission Organization Report records show IBC was first recognized as an operator on February 5, 1998, IBC last filed an Organization Report with the Commission on January 21, 2004, and IBC's Organization Report has been delinquent since February 1, 2005. As of March 9, 2006 Commission records list IBC as the operator of 19 well bores, 2 of which are non-producing land wells and 17 of which are non-producing bay wells. The total depth of all of IBC's wells is 189,619 feet.
8. Commission Production Records for January 2005 through December 2005 show neither Cinco nor IBC has reported any production from the well bores which those entities operate. Boss has reported total production over the same time period of 71,605 barrels of oil/condensate and 1.807 Bcf of natural gas.
9. Commission drilling permit records from January 1, 2005 through the date of the hearing show that 14 drilling permits were issued to Boss. Four of the permits were for new bay wells on properties that were not part of the IBC acquisition. Five permits were to recomplete existing wells acquired from IBC. Finally, five permits were for new wells on bay well tracts in Corpus Christi Bay previously operated by IBC.
10. Commission mainframe well bore records show that Boss has plugged one well acquired in the IBC transaction, Well No. 187910 located on State Tract 344. This well was plugged in April 2005.
11. Boss has recompleted and is currently producing 3 of the 5 wells for which it obtained re-entry permits. Commission records show that drilling operations have commenced for new wells on State Tracts 344 and 392, but that completion reports have not yet been filed.
12. A summary of lease records obtained from the General Land Office show that either through an assignment, or through a new lease agreement, Cinco has the right to develop the mineral interests on 18 of the 21 Corpus Christi Bay tracts with Cinco, Boss and/or IBC wells.
 - A. The General Land Office recognizes Cinco's right to develop the mineral interests on State Tracts 342, 342, 344, 348, 349, 350, 392, 395, 396, 414, 421, 422, 423, 424, 444, 445, and 456.

- B. State Tract 416, which contains two IBC bay wells, (API Nos. 355 02653 and 355 02655) is under lease to an unrelated entity according to the General Land Office records.
 - C. State Tract 352, which contains one IBC bay well, (API No. 355 30840) is under lease to an unrelated entity according to the General Land Office records.
 - D. State Tract 397, which contains two IBC bay wells, (API Nos. 355 02694 and 355 02696) is under lease to an unrelated entity according to the General Land Office records.
13. Cinco submitted a Financial Statement for the fiscal years concluding December 31, 2004 and 2003. The Financial Statement was audited by an independent auditor, Ernst & Young, LLP consistent with generally accepted accounting principles.
14. Cinco's financial statements include several determinations pertinent to its certified net worth.
- A. As of December 31, 2004, the shareholder's equity in this private company was valued at \$22,816,754. This represents approximately a 300% increase over the evaluation of shareholder's equity as of December 31, 2003 which valued the shareholder's equity at \$8,351,464.
 - B. On December 31, 2004, Cinco's current assets (cash, equivalents, accounts receivable and prepaid expenses) totaled \$12,093,656. Current assets as of December 31, 2003 were \$4,499,795.
 - C. Property and equipment evaluated under the successful efforts method of accounting, less accumulated depreciation, was valued at \$14,727,477 on December 31, 2004, an approximately 300% increase over the valuation of \$4,565,197 on December 31, 2003.
 - D. The Statement of Operations in the Financial Statement shows a significant positive swing between the two years evaluated. Operations ending December 31, 2003 showed a net loss of \$1,350,726. This is contrasted against a profit of \$2,595,966 from operations ending December 31, 2004.
 - E. In 2004, Cinco's investors added \$11,869,324 in paid in capital into the company in exchange for common stock. Cinco spent \$17,758,852 in exploration, acquisition and development costs and another \$1,511,948 in drilling advances, but offset those expenditures by the sale of oil and gas properties totaling \$5,743,502. Finally, Cinco's operating activities resulted in an inflow of cash of \$6,235,962.

15. Based on its certified net worth as of December 31, 2004, Cinco would be eligible for a reduction in the amount of financial security required to be posted for the operation of the non-producing bay wells currently operated by Boss and IBC.
 - A. 25% of Cinco's certified net worth as of December 31, 2004 was \$7,879,547.
 - B. Cinco currently operates 10 bay well bores, all of which are non producing wells that require the posting of \$60,000 in additional financial security for a total of \$540,000.
 - C. Cinco has posted the required financial security for the non-producing bay wells it currently operates.
 - D. Cinco requests to be recognized as the operator of 13 bay well bores currently operated by Boss, 5 of which are non-producing wells that require the posting of \$60,000 in additional financial security for a total of \$300,000.
 - E. Cinco requests to be recognized as the operator of 16 bay well bores currently operated by IBC, all of which are non-producing wells that require the posting of \$60,000 in additional financial security for a total of \$960,000.
 - F. If recognized as the operator of the additional 29 bay well bores currently operated by Boss and IBC, Cinco would be required to post additional financial security of \$1,260,000 for the 24 non-producing well bores.
 - G. The estimated plugging costs for the 8 active well bores currently operated by Boss for which Cinco requests to be recognized as the operator is \$480,000, using the presumed plugging cost of \$60,000 per well.
 - H. Subtracting the estimated plugging costs for the 8 active well bores which Cinco requests to be recognized as the operator of \$480,000 from 25% of its certified net worth as of December 31, 2004 or \$7,879,547, leaves a remainder of \$7,399,547.
 - I. \$7,399,547 exceeds the required additional financial security of \$1,260,000 which Cinco would be required to post to be recognized as the operator of the 24 non-producing well bores currently operated by Boss and IBC.
16. Cinco's certified net worth as of December 31, 2004, is not a sufficient basis for reducing the \$540,000 in financial security it currently has posted with the Commission for the operation of 10 non-producing bay wells due to the ratio of 8 producing well bores to 31 non-producing well bores in the total inventory of well bores for which Cinco requests to be recognized as the operator.

17. Cinco's certified net worth as of December 31, 2004, is not a sufficient basis for reducing the \$540,000 in financial security it currently has posted with the Commission for the operation of 10 non-producing bay wells due to the Commission's previous adoption of Findings of Fact in the *Boss docket* which determined that 13 well bores would require plugging in the total inventory of well bores for which Cinco requests to be recognized as the operator.
18. Cinco's certified net worth as of December 31, 2004, is not a sufficient basis for reducing \$540,000 in financial security it currently has posted with the Commission for the operation of 10 non-producing bay wells due to the difference in certified net worth as of December 31, 2003.
 - A. 25% of Cinco's certified net worth as of December 31, 2003 was \$2,087,866.
 - B. Subtracting the estimated plugging costs for the 8 active well bores which Cinco requests to be recognized as the operator of \$480,000 from 25% of its certified net worth as of December 31, 2003, leaves a remainder of \$1,487,866.
 - C. \$1,487,866 is less than the total additional financial security of \$1,860,000 (\$60,000 x 31 non-producing bay wells) which Cinco would be required to post for its 10 non-producing bay wells and the additional 21 non producing bay wells it seeks to be recognized as the operator. The difference would require Cinco to post \$192,314 in financial security for the operation of non-producing bay wells.
19. Cinco's certified net worth as of December 31, 2004, is not a sufficient basis for reducing the \$540,000 in financial security it currently has posted with the Commission for the operation of 10 non-producing bay wells due to its inability to establish a current right to the mineral interest for 5 non-producing well bores.
 - A. Pursuant to the officially noticed summary of lease records provided by the Texas General Land Office, Cinco is not the current holder of the mineral interest in 3 State Tracts on which 5 non-producing well bores are currently operated by IBC.
 - i. State Tract 416, which contains two IBC bay wells, (API Nos. 355 02653 and 355 02655) is under lease to an unrelated entity.
 - ii. State Tract 352, which contains one IBC bay well, (API No. 355 30840) is under lease to an unrelated entity.
 - iii. State Tract 397, which contains two IBC bay wells, (API Nos. 355 02694 and 355 02696) is under lease to an unrelated entity.
 - B. The 5 well bores represent an immediate presumed plugging liability of \$300,000.

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. Cinco is required to file financial security in the form of a bond, letter of credit, or cash deposit pursuant to §91.103 of the Texas Natural Resources Code (“Code”).
4. Pursuant to §91.104 of the Code, Cinco must 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 Code, the Railroad Commission is authorized to set by rule the amount of financial security for an operator of bay and offshore wells at a reasonable amount that exceeds the amount provided by §91.104(a) and 91.1042(a) of the Code.
6. As the operator of more than ten but less than 100 wells, Cinco is required by the Commission’s Statewide Rule 78(g)(1) to file financial security in the base amount of \$50,000.
7. As the operator of bay wells, Cinco is required by the Commission’s Statewide Rule 78(g)(2)(A) to file additional entry level financial security in the amount of \$60,000.
8. As the operator of non-producing bay wells, Cinco is required by the Commission’s Statewide Rule 78(g)(2)(B) to file additional non-producing bay well financial security in the amount of \$60,000 for each non-producing bay well in excess of one.
9. In order to receive approval of a transfer of operatorship of wells or leases Cinco is required by the Commission’s Statewide Rule 78(j)(1) to file financial security in an amount sufficient to cover both its current operations and the wells or leases being transferred.
10. The General Land Office recognizes Cinco’s right to develop the mineral interests on State Tracts 342, 343, 344, 348, 349, 350, 392, 395, 396, 414, 421, 422, 423, 424, 444, 445, and 456.

11. The General Land Office does not recognize Cinco as the current holder of the mineral interest in 3 State Tracts on which 5 non-producing well bores currently operated by IBC.
 - A. State Tract 416, which contains two IBC bay well bores (API Nos. 355 02653 and 355 02655), is under lease to an unrelated entity according to the records of the General Land Office.
 - B. State Tract 352, which contains one IBC bay well bore (API No. 355 30840), is under lease to an unrelated entity according to the records of the General Land Office.
 - C. State Tract 397, which contains two IBC bay well bores (API Nos. 355 02694 and 355 02696), is under lease to an unrelated entity according to the records of the General Land Office.
12. The financial statement submitted by Cinco satisfies the requirements under Statewide Rule 78(g)(5)(A)(ii) for consideration of Cinco's certified net worth to reduce the financial security requirements for the operation of the 17 non-producing bay well bores currently operated by Boss and IBC which Cinco has requested to be recognized as the operator.
13. Applying the formula under Statewide Rule 78(g)(5) to 25% of Cinco's certified net worth as of December 31, 2004, the most recently available financial statement, provides the basis for waiving Cinco's requirement to post additional financial security of \$1,020,000 for the 17 non-producing bay well bores on the State Tracts which the General Land Office recognizes Cinco's right to develop the mineral interest.
14. Cinco has satisfied the requirements to be recognized as the operator of the 25 bay well bores located on State Tracts 342, 343, 344, 348, 349, 350, 392, 395, 396, 414, 421, 444, 445, and 456.
 - A. State Tract 342 contains one active bay well bore, (API No. 355-30107, RRC ID Nos. 070607,070721, and 209458) currently operated by Boss.
 - B. State Tract 343 contains two active bay well bores, (API No. 355-33595, RRC ID No. 199935 and API No. 355-33634, RRC ID No. 206082) currently operated by Boss.
 - C. State Tract 344 contains one active bay well bore, (API No. 355-32248, RRC ID No. 111396) currently operated by Boss.
 - D. State Tract 348 contains three non-producing bay well bores, (API No. 355-02745, RRC ID No. 052271; API No. 355-06219, RRC ID No. 044835; and, API No. 355-32576, RRC ID No. 12539) currently operated by Boss.

- E. State Tract 348 contains one non-producing bay well bore, (API No. 355-32575, RRC ID No. 127065) currently operated by IBC.
- F. State Tract 349 contains three non-producing bay well bores, (API No. 355-02745, RRC ID No. 157066; API No. 355-31297, RRC ID Nos. 081572 and 09257; and, API No. 355-32571, RRC ID No. 05438) currently operated by Boss.
- G. State Tract 350 contains one non-producing bay well bore, (API No. 355-31424, RRC ID No. 143219) currently operated by IBC.
- H. State Tract 392 contains one active bay well bore, (API No. 355-32820, RRC ID No. 13290) currently operated by Boss.
- I. State Tract 395 contains one non-producing bay well bore, (API No. 355-30323, RRC ID No. 054731) currently operated by IBC.
- J. State Tract 396 contains one active bay well bore, (API No. 355-31219, RRC ID No. 126833) currently operated by Boss.
- K. State Tract 414 contains one active bay well bore, (API No. 355-32573, RRC ID Nos. 186047, 02290 and 02298)) currently operated by Boss.
- L. State Tract 414 contains four non-producing bay well bores, (API No. 355-02669, RRC ID Nos. 186038 and 04194; API No. 355-02670, RRC ID Nos. 164604, 02290 and 02298; API No. 355-02671, RRC ID Nos. 02298 and 04194; and, API No. 355-02672, RRC ID Nos. 186060, 02290 and 04194) currently operated by IBC.
- M. State Tract 421 contains one non-producing bay well bore, (API No. 355-02652, RRC ID No. 043367) currently operated by IBC.
- N. State Tract 444 contains one non-producing bay well bore, (API No. 355-30632, RRC ID No. 11552) currently operated by IBC.
- O. State Tract 445 contains one non-producing bay well bore, (API No. 355-30722, RRC ID No. 074631) currently operated by IBC.
- P. State Tract 456 contains one non-producing bay well bore, (API No. 355-02553, RRC ID No. 012788) currently operated by IBC.

15. Cinco has not satisfied the requirements to be recognized as the operator of the 5 bay well bores located on State Tracts 352, 397 and 416.
- A. State Tract 352, which contains one IBC bay well bore (API No. 355 30840, RRC ID No. 087886), is under lease to an unrelated entity according to the records of the General Land Office.
 - B. State Tract 397, which contains two IBC bay well bores (API Nos. 355 02694, RRC ID No. 077615, and API No. 355 02696, RRC ID No. 076517), is under lease to an unrelated entity according to the records of the General Land Office.
 - C. State Tract 416, which contains two IBC bay well bores (API Nos. 355 02653, RRC ID No. 08690, and API No. 355 02655, RRC ID No. 12740), is under lease to an unrelated entity according to the records of the General Land Office.

RECOMMENDATION

The examiner recommends requiring Cinco maintain its existing financial security of \$540,000 it currently has posted with the Commission for the operation of 10 non-producing bay wells. The examiner further recommends recognizing Cinco as the operator of all 13 well bores operated by Boss and 12 well bores operated by IBC based on the Texas General Land Office's confirmation of Cinco's right to develop the mineral interests. This would raise the total number of well bores operated by Cinco to 34, but would not require Cinco to post any additional financial security. Finally, the examiner recommends denying without prejudice Cinco's request to be recognized as the operator of the remaining 5 IBC well bores.

Respectfully submitted,

Mark J. Helmueller
Hearings Examiner