

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

APPEARANCES:

FOR APPLICANT:

Michel E. Curry
Mike Myers
Karen Myers
Molly Battenfield

APPLICANT:

Capco Offshore, Inc.

PROPOSAL FOR DECISION

PROCEDURAL HISTORY

DATE OF REQUEST FOR HEARING:	February 22, 2005
DATE OF NOTICE OF HEARING:	March 4, 2005
DATE OF HEARING:	April 4, 2005
HEARD BY:	James M. Doherty, Hearings Examiner Thomas H. Richer, Technical Examiner
DATE RECORD CLOSED:	May 4, 2005
DATE PFD CIRCULATED:	May 25, 2005

STATEMENT OF THE CASE

This application of Capco Offshore, Inc. ("Capco"), was docketed as an application pursuant to Statewide Rule 78(g) for a reduction in the amount of financial security required for certain offshore wells operated by Capco. At the hearing, Capco requested clarification of the amount of financial security required, a stay of severances of Capco's leases, a grant of more time for Capco to reactivate, plug, or transfer currently inactive wells, and removal of a bar to the transfer of certain wells to Capco caused by delinquency of Capco's Form P-5 organization report.

The application is unopposed. A hearing was held on April 4, 2005, and Capco appeared and presented evidence. The record was held open until May 4, 2005, to permit Capco to file additional evidence concerning its acquisition of leases on certain State tracts, transfer of certain inactive wells to other operators, and plugging or return to production of certain inactive wells.

APPLICABLE LAW

Pursuant to §91.103 of the Texas Natural Resources Code (“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.

Pursuant to §91.104 of the 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.

Pursuant to §§91.1041(b) and 91.1042(b) of the Code, the Commission is authorized to set by rule the amount of the 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.

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 \$50,000.¹

Statewide Rule 78(g)(3)(A) provides for the filing of additional financial security for operators of offshore wells. All operators of offshore wells must file entry level financial security of no less than \$100,000 in addition to the financial security required by Statewide Rule 78(g)(1). Statewide Rule 78(g)(3)(B) requires additional financial security of \$100,000 for each *inactive* offshore well in excess of one.

Statewide Rule 78(g)(4) provides that an operator may request a reduction in the entry level financial security for offshore wells and/or the additional financial security for inactive offshore wells required by Statewide Rule 78(g)(3)(B), which can be approved administratively if the operator provides documentation that it currently has acceptable financial security in place to satisfy requirements established by local authorities and such financial security can be called on by or assigned to the Commission.

¹ At the time of the hearing, Capco was the operator of 35 wellbores.

Statewide Rule 78(g)(5) provides that an operator of offshore wells may request the Commission to consider a reduction in the additional financial security required by Statewide Rule 78(g)(3)(B) for inactive offshore wells. The Statewide Rule 78(g)(5) 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 active bay and/or offshore wells.

Under Statewide Rule 78(g)(5)(A), a reduction may be approved administratively if: (1) the operator has either five or fewer bay and offshore wells or at least one-half of the operator's bay and offshore wells are producing; (2) the operator provides certification of net worth from an independent auditor who has employed generally accepted accounting principles; (3) the reduction does not exceed 25% of the operator's certified net worth less the Commission's estimate of the operator's plugging liability for all active bay and offshore wells; and (4) the operator's wells have not been found by Commission staff to be violating or to have violated any Commission rule that resulted in pollution or in any hazard to the health and safety of the public in the last 12 months.

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 acquiring the well or lease has on file with the Commission financial security in an amount sufficient to cover both its current operations and the wells or leases being transferred.

DISCUSSION OF THE EVIDENCE

At the time of the hearing, Capco was the operator of 35 wellbores, all of which were offshore, and of these, 17 were classified by the Commission as inactive. The examiners have officially noticed that as of the date of the hearing, Capco's total financial security requirement was \$1,750,000, comprised of \$50,000 base amount financial security, \$100,000 entry level financial security for operators of offshore wells, and \$1,600,000 additional financial security for the inactive offshore wells (in excess of one) operated by Capco.

The examiners have also officially noticed that Capco last filed a Form P-5 organization report on January 9, 2004, and Capco's organization report has been delinquent since January 1, 2005. The Commission has served notice of intent to sever Capco's leases based on Form P-5 delinquency, but the severances have been stayed pending the outcome of this proceeding.

As a part of a purchase and sale agreement pursuant to which Capco acquired some of its offshore wells from Dominion Oklahoma Texas Exploration & Production, Inc., Capco posted with Dominion a \$1,300,000 surety bond to protect Dominion against well plugging liability. In addition, the purchase and sale agreement grants Dominion a 25% net profits interest in production from the wells covered by the agreement, provided that funds generated by this interest are to be deposited into escrow until the escrow account reaches \$1,700,000, at which time the escrow account will substitute for the \$1,300,000 surety bond. The surety bond and escrow account in Dominion's favor are subject to being reduced in amount as Capco properly plugs and abandons the wells covered by

the purchase and sale agreement. A total of 19 of Capco's active offshore wells are covered by the surety bond and escrow account in favor of Dominion.² The surety bond and escrow account are not subject to being assigned to the Railroad Commission.

A separate purchase and sale agreement pursuant to which Capco acquired ownership of seven additional offshore wells provides that Dominion and Northwestern Mutual Insurance Co. will contribute up to \$1,000,000 toward the abandonment cost of the wells covered by the agreement³ upon proof by Capco of the abandonment cost incurred and that abandonment has been completed. The seven offshore wells covered by this agreement were inactive as of the date of the hearing, and as of that date, Capco held no effective oil and gas lease on the State tracts on which the wells are located. At the hearing, Capco stated that State tracts on which six of the wells are located had been nominated by Capco, and Capco hoped to be the successful bidder at public sale. The State tract on which the Brazos 446-NW-3 (API No. 704-30223) is located had been awarded to another operator, and Capco intended to negotiate with this operator for the transfer of this well. However, a posthearing exhibit filed by Capco stated that Capco had assigned these wells to Permico Energy, Inc., and had filed Forms P-4 to change the operator of the wells from Capco to Permico.⁴

At the hearing, Capco stated that three additional inactive offshore wells of which Capco was the operator⁵ are located on State tracts which had been awarded to another operator, Fairways Offshore Exploration, Inc., and that Capco had agreed to assign these wells to Fairways. However, the posthearing exhibit filed by Capco stated that these wells had been assigned to Permico and change of operator Forms P-4 had been filed for the wells.

Five additional inactive offshore wells of which Capco was the operator as of the date of the hearing⁶ are located on State tracts for which Capco held no effective oil and gas lease as of that date. Capco had nominated these tracts and hoped to be the successful bidder at the next public sale. Capco stated at the hearing that three of these wells were capable of being returned to production within a matter of hours or days if Capco is able to obtain a lease, and Capco intended to plug the other two wells within about 60 days, depending on rig availability. The posthearing exhibit filed by Capco stated that Forms W-3A (Notice of Intent to Plug) had been filed for four of these wells.

² API Nos. 704-00007; 704-00031, 704-00029, 704-00003, 704-30301, 704-30310, 704-30253, 704-30254, 704-30272, 704-30300, 704-30239, 704-30242, 704-30250, 704-30249, 704-30244, 704-30258, 704-30291, 704-30313, and 704-30316

³ API Nos. 704-00035, 704-00039, 704-30260, 704-00016, 704-30080, 704-30092, and 704-30223

⁴ The examiners have officially noticed that the officers and organization address of Permico Energy, Inc., are the same as those of Capco.

⁵ API Nos. 704-30123, 704-30220, and 704-30293

⁶ API Nos. 703-30054, 703-30254, 703-30246, 703-30271, and 703-30276

Capco has agreed to acquire two additional inactive offshore wells from Dominion⁷, but, as of the date of the hearing, the transfer of these wells to Capco was being prevented by delinquency of Capco's Form P-5 and financial security. If these wells are transferred, Capco plans to plug one of the wells (API No. 715-30025), and hopes to become the successful bidder for an oil and gas lease on the other (API No. 703-30383).

EXAMINERS' OPINION

The examiners recommend that the Capco application be denied. Statewide Rule 78 does not authorize any of the forms of relief requested by Capco at the hearing.

Reduction In Amount of Financial Security

Although Capco's letter requesting this hearing suggested that Capco would seek a reduction in the amount of financial security required for offshore wells by Statewide Rule 78(g), Capco did not specifically request a reduction at the hearing or attempt to justify a reduction based on any of the financial security reduction provisions of the rule.

There is no evidence that Capco has filed financial security with local authorities that can be called upon by the Commission. Accordingly, the examiners cannot recommend a reduction in financial security for Capco's offshore wells pursuant to Statewide Rule 78(g)(4). Capco presented no evidence of its financial condition, including its net worth. Accordingly, the examiners cannot recommend a reduction in financial security for Capco's inactive offshore wells pursuant to Statewide Rule 78(g)(5), based on Capco's independently audited and certified net worth. There are no other financial security reduction provisions in Statewide Rule 78(g).

The surety bond provided by Capco to Dominion to protect Dominion against liability for plugging certain of Capco's active offshore wells does not justify a reduction in the financial security required by Statewide Rule 78(g) because: (1) this surety bond does not protect the Commission or the Oil Field Clean Up Fund against liability for the plugging of these wells; and (2) Dominion's potential liability, protected by the surety bond, is at least in question because Dominion is no longer the designated operator of the wells.

The Dominion/Northwestern commitment to contribute up to \$1,000,000 to plug and abandon seven of the wells operated by Capco does not justify a reduction in the financial security required by Statewide Rule 78(g) because it represents no more than a contractual right of Capco. A promise by one operator to assist another in the plugging and abandonment of wells is not an acceptable form of financial security under Statewide Rule 78.

Delaying Application of Financial Security Requirements to Capco

⁷ API Nos. 703-30383 and 718-30025

The bay and offshore well financial security requirements in Statewide Rule 78(g) have been in effect since September 1, 2004. No provision of Statewide Rule 78(g) authorizes the examiners to recommend that the application of these financial security requirements to Capco be delayed while Capco attempts to obtain oil and gas leases, transfer wells to other operators, restore wells to production, or plug wells.

The examiners held the record open until May 4, 2005, to allow Capco additional time to submit evidence that it had taken steps to reduce the number of its inactive offshore wells. However, the posthearing exhibit filed by Capco on May 2, 2005, showed that not much had changed since the hearing. Capco stated that it had assigned 10 of its inactive offshore wells to Permico Energy, Inc., which is affiliated with Capco at least through common management, but Forms P-4 to change the operator of these wells from Capco to Permico cannot be approved by the Commission until Permico files \$1,025,000 in financial security. At the time of preparation of this proposal for decision, Permico's financial security was in the amount of \$25,000. The posthearing exhibit filed by Capco also stated that Capco had filed Forms W-3A (Notice of Intent to Plug) four of Capco's inactive offshore wells, but until the wells are plugged, they account for \$400,000 in financial security that Capco is required to file.

Delaying Severance of Capco's Leases

When Capco failed to renew its Form P-5 organization report and file the required financial security on or before January 1, 2005, the Commission issued notice to Capco of the Commission's intent to sever Capco's leases. Capco has already secured a considerable stay of these severances by requesting this hearing, during which stay Capco apparently has continued to produce its active wells even though its Form P-5 and financial security are delinquent. No further stay of the severances is justified. Statewide Rule 1 provides that no organization shall perform operations within the jurisdiction of the Commission without having on file with the Commission an approved organization report and required financial security.

Removal of Bar to Transfer of Wells to Capco

No rule or policy of the Commission currently prevents the transfer of wells from Capco to another operator having an active organization report and the required amount of financial security on file with the Commission. If, as indicated in Capco's posthearing exhibit, Capco follows through with approved transfers of 10 inactive offshore wells to Permico or another operator and plugs four

inactive offshore wells, it will reduce its total financial security requirement by \$1,400,000, regardless of whether the Commission grants any of the relief requested by Capco in this case.⁸

⁸ On May 20, 2005, Capco filed a further letter stating that "Capco Offshore, Inc. stands ready, and is indeed anxious, to meet its financial assurance requirements with the State of Texas and to conclude this matter."

Apparently there are two inactive offshore wells that Capco wishes to obtain from Dominion. This will increase Capco's financial security requirement until Capco either restores the wells to active status or plugs them. The transfer of these two wells to Capco apparently is being prevented by the delinquency of Capco's Form P-5 organization report and financial security. The examiners cannot recommend that Capco be allowed to become the operator of these wells without filing the required amount of financial security. Statewide Rule 78(j)(1) provides that the Commission may not approve a transfer of operatorship submitted for any well or lease unless the operator acquiring the well or lease has on file with the Commission financial security in an amount sufficient to cover both its current operations and the wells or leases being transferred.

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

FINDINGS OF FACT

1. At least ten (10) days notice of the hearing in this docket was sent to all parties entitled to notice. Capco Offshore, Inc. ("Capco"), appeared at the hearing and presented evidence.
2. Capco's request for hearing in this docket stated that Capco was seeking a reduction in the financial security required by Statewide Rule 78. At the hearing, Capco stated that by its application it is requesting that the Commission clarify the amount of financial security required of Capco, delay the application of the Statewide Rule 78(g) financial security requirements to Capco, delay severance of Capco's leases based on delinquency of Capco's Form P-5 organization report and financial security, and allow Capco to accept a transfer of certain inactive offshore wells from another operator without filing the financial security required by Statewide Rule 78(g).
3. Capco last filed an approved Form P-5 organization report on January 9, 2004. The renewal date for Capco's Form P-5 organization report and the required financial security was January 1, 2005. Capco did not renew its Form P-5 or file the required financial security on or before January 1, 2005, and its Form P-5 has been delinquent since that date.
4. The Commission has issued notice to Capco of the Commission's intent to sever Capco's leases, based on the delinquency of Capco's Form P-5 organization report and its required financial security. These severances have been stayed during the pendency of this docket.
5. As of the date of the hearing, Capco was the operator of 35 offshore wellbores, of which 17 were classified by the Commission as inactive.
6. Fifteen of Capco's inactive offshore wellbores are located on State tracts for which Capco held no effective oil and gas lease as of the date of the hearing. Four of these inactive offshore wellbores are on State tract leases that have been awarded by the State to other operators.

7. As of the date of the hearing, based on the number of offshore wells operated and the number of such wells which were classified as inactive, Capco's total financial security requirement was \$1,750,000, comprised of \$50,000 base amount of financial security for operators of 11-99 wells, \$100,000 entry level financial security for operators of offshore wells, and \$1,600,000 additional financial security for the inactive offshore wells, in excess of one, operated by Capco.
8. Capco presented no evidence that it currently has acceptable financial security in place to satisfy requirements of any local authorities and that such financial security can be called on by or assigned to the Commission.
9. Capco presented no evidence of its financial condition or of its independently audited and certified net worth.

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. Capco Offshore, Inc. ("Capco"), 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, Capco 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, Capco is required by the Commission's Statewide Rule 78(g)(1) [Tex. R.R. Comm'n, 16 TEX. ADMIN. CODE §3.78(g)(1)] to file financial security in the base amount of \$50,000.

7. As the operator of offshore wells, Capco is required by the Commission's Statewide Rule 78(g)(3)(A) [Tex. R.R. Comm'n, 16 TEX. ADMIN. CODE §3.78(g)(3)(A)] to file additional entry level financial security in the amount of \$100,000.
8. As the operator of inactive offshore wells, Capco is required by the Commission's Statewide Rule 78(g)(3)(B) [Tex. R.R. Comm'n, 16 TEX. ADMIN. CODE §3.78(g)(3)(B)] to file additional inactive offshore well financial security in the amount of \$100,000 for each inactive offshore well in excess of one.
9. In order to receive the Commission's approval of a transfer of operatorship of wells or leases, Capco is required by the Commission's Statewide Rule 78(j)(1) [Tex. R.R. Comm'n, 16 TEX. ADMIN. CODE §3.78(j)(1)] to file financial security in an amount sufficient to cover both its current operations and the wells or leases being transferred.
10. Capco is not entitled to a reduction in the entry level financial security for offshore wells and/or the additional financial security required for inactive offshore wells under the financial security reduction provisions of the Commission's Statewide Rule 78(g)(4) [Tex. R.R. Comm'n, 16 TEX. ADMIN. CODE §3.78(g)(4)] because Capco did not provide documentation or otherwise prove that it currently has acceptable financial security in place to satisfy requirements established by local authorities and such financial security can be called on by or assigned to the Commission.
11. Capco is not entitled to a reduction in the additional financial security required by the Commission's Statewide Rule 78(g)(3)(B) [Tex. R.R. Comm'n, 16 TEX. ADMIN. CODE §3.78(g)(3)(B)] for inactive offshore wells under the financial security reduction provisions of the Commission's Statewide Rule 78(g)(5) [Tex. R.R. Comm'n, 16 TEX. ADMIN. CODE §3.78(g)(5)] because Capco did not prove its independently audited and certified net worth.
12. Capco did not make proof sufficient to justify the granting of an exception to the financial security requirements of the Commission's Statewide Rule 78(g) [Tex. R.R. Comm'n, 16 TEX. ADMIN. CODE §3.78(g)] or the Commission's Statewide Rule 78(j) [Tex. R.R. Comm'n, 16 TEX. ADMIN. CODE §3.78(j)].
13. Pursuant to TEX. NAT. RES. CODE ANN. §91.142(f), the Commission may suspend any certificate of compliance approved under TEX. NAT. RES. CODE ANN. Chapter 85 for failure of an operator to maintain on file with the Commission an organization report and financial security as required.
14. Pursuant to Statewide Rule 73(b) [Tex. R. R. Comm'n, 16 TEX. ADMIN. CODE §3.73(b)], the Commission may cancel a certificate of compliance if it appears that the operator of a well has violated, or is violating, in connection with the operation of the well, any of the oil, gas, or geothermal resource conservation laws or any of the permits, rules, or orders of the

Commission.

15. The application of Capco for a reduction in the amount of financial security required by Statewide Rule 78(g) [Tex. R. R. Comm'n, 16 TEX. ADMIN. CODE §3.78(g)], for a delay in the application of this rule, for an exception to the rule, or for a delay in cancellation of certificates of compliance for Capco's leases, based on delinquency of Capco's organization report and financial security, should be denied.

RECOMMENDATION

The examiners recommend that the application of Capco Offshore, Inc., be denied and that the attached final order be issued.

Respectfully submitted,

James M. Doherty
Hearings Examiner

Thomas H. Richter, P.E.
Technical Examiner