OIL & GAS DOCKET NO. 03-0251356

APPLICATION OF JEFFERSON BLOCK 24 OIL & GAS, LLC TO REDUCE ITS FINANCIAL ASSURANCE REQUIREMENT FOR INACTIVE OFFSHORE WELLS PURSUANT TO STATEWIDE RULE 78(g), HIGH ISLAND BLK. 24L FIELD AREA, OFFSHORE JEFFERSON COUNTY, TEXAS

APPEARANCES:

FOR APPLICANT:	**APPLICANT:**
Philip Whitworth Erich A. Krause John Jordan Randal W. Bradford	Jefferson Block 24 Oil & Gas, LLC
FOR INTERESTED PARTY:	**INTERESTED PARTY:**
Robert Hatter	Texas General Land Office

PROPOSAL FOR DECISION

PROCEDURAL HISTORY

DATE APPLICATION FILED:	April 5, 2007
DATE OF NOTICE OF HEARING:	April 16, 2007
DATE OF HEARING:	May 2, 2007
HEARD BY:	James M. Doherty, Hearings Examiner Andres J. Trevino, Technical Examiner
DATE PFD CIRCULATED:	June 13, 2007

STATEMENT OF THE CASE

By this application, Jefferson Block 24 Oil & Gas, LLC ("Jefferson") requests that the Commission approve a reduction in the financial assurance which Jefferson will be required to file in order to take a transfer of 19 inactive offshore wellbores from Sterling Exploration & Production Co., LLC ("Sterling"). A list of the 19 wellbores in question is attached to this proposal for decision as Appendix 1.

Jefferson has filed Forms P-4 (Certificate of Compliance and Transportation Authority) requesting a change of operator of the 19 wellbores from Sterling to Jefferson, and processing of these Forms P-4 has been held in abeyance pending the filing of required financial assurance by Jefferson. Although Jefferson was organized with the Commission as a Form P-5 operator on February 20, 2007, it is currently exempt from financial assurance requirements because it does not operate any wells or otherwise conduct activities subject to the Commission's jurisdiction. Pursuant to Statewide Rule 78(g), Jefferson is required to file financial assurance in the amount of $1,950,000 in order to take a transfer from Sterling of the 19 inactive offshore wellbores identified in Appendix 1.[1] The reduction in financial assurance requested by Jefferson is in the amount of $1,950,000. Jefferson thus requests that the Commission authorize it to become the operator of the 19 inactive offshore wellbores with a zero financial assurance requirement.

A hearing was held on May 2, 2007, and Jefferson appeared and presented evidence. The Texas General Land Office ("GLO") also appeared as an interested party.

BACKGROUND

Wells in the High Island Block 24L Field area offshore Jefferson County, Texas, started producing in the late 1960's, and ceased to produce when the holder of State leases in the area, BP America Production Company ("BP") determined in about the year 2000 to let the leases lapse and abandon the field area. In August 2004, BP, Sterling, and the GLO entered into a "Facility Abandonment, Escrow Payment and Release of Liability Agreement" ("Facility Agreement") relating to wells and other facilities in the field area, formerly operated by BP.

In 2003, Sterling had acquired new oil and gas leases from GLO covering certain offshore State tracts in High Island Blocks 7L and 24L, some of the same tracts formerly operated by BP. Pursuant to the "Facility Agreement," BP deposited into a GLO escrow account the sum of $9,564,913 ("GLO Escrow Fund") to be used at GLO's sole direction for "well plugging and abandonment costs, platform and pipeline removal costs, remediation costs and any other necessary operations with regard to Blocks 7L, 23L, 24L, 25L, 32L, 33L, and 90S". This deposit into the GLO escrow account was made in return for a release of BP by the State of Texas and GLO from all liability relating to all of BP's area leases, including obligations for well plugging and abandonment, platform and pipeline removal, contamination, and remediation.

Pursuant to the "Facility Agreement," Sterling assumed responsibility to properly decommission, plug, abandon, remove, or remediate "Offshore Facilities," which included platforms, associated facilities, wells, pipelines, and flowlines located in and around BP's former

[1] This amount of financial assurance is comprised of the $50,000 base amount required by Rule 78(g)(1)(B) of all operators of more than 10 and fewer than 100 wells, the $100,000 entry level amount required by Rule 78(g)(3)(A) of all operators of offshore wells, and the $100,000 of additional financial assurance required by Rule 78(g)(3)(B) for all inactive offshore wells in excess of one.

State leases (19 offshore wellbores, 16 satellite platforms, 2 Bridge connected platforms, four production platforms and equipment, pipelines between production and satellite platforms and between existing production platforms, an 8" pipeline from the High Island 24L A platform to the Shorebase, and previously abandoned in place pipelines between existing production platforms and the subsea tie-in in Block 33L). Sterling also agreed to become the designated operator of 19 offshore wellbores formerly operated by BP, which are the same wellbores now proposed to be transferred to Jefferson.

The "Facility Agreement" also provided that in the event Sterling failed to comply in any material respect with its obligations under the agreement and failed to cure the default, GLO, in its sole discretion, could require that one or more of the 19 wellbores acquired from BP be plugged and abandoned. The Agreement provided that if Sterling plugged and abandoned any such well at GLO's direction, and the plugging and abandonment costs were approved by GLO, Sterling would be entitled to reimbursement of the costs from the GLO Escrow Fund.

The "Facility Agreement" imposed on Sterling special obligations with respect to seven of the 19 wellbores acquired from BP. In particular, with respect to State Tract 24L, Well Nos. 5, 11, and C10, Sterling was required to commence reworking operations within 90 days of the Commission's approval of the Forms P-4 transferring the wells to Sterling, and with respect to State Tract 24L, Well Nos. 4, C9, C11, and C12, Sterling was required to commence reworking operations within nine months of the Commission's approval of the Forms P-4 transferring the wells to Sterling. These seven wells were required to be either placed on production within the time frames indicated or plugged.[2] The "Facility Agreement" provided that if Sterling failed to restore production or plug these wells, the GLO "may proceed with the required activities or operations."

The Commission approved Forms P-4 transferring the 19 wellbores from BP to Sterling in August 2004. In July 2005, Sterling filed an application with the Commission requesting a reduction in the financial assurance required for the 19 inactive offshore wellbores acquired from BP. This application was docketed as Oil & Gas Docket No. 01-0243653, *Application of Sterling Exploration & Production Co., L.L.C. Pursuant to Statewide Rule 78(g) to Have the Railroad Commission Reduce Its Financial Assurance for Inactive Offshore Wells* (*"Sterling").*[3] Sterling based its request for a financial assurance reduction on the contention that sufficient financial assurance that the 19 wellbores acquired from BP would be plugged already existed in the form of the GLO Escrow Fund, and, according to the examiner's proposal for decision in Docket No. 01-0243653, characterized the BP/Sterling/GLO "Facility Agreement" as a "win-win" situation for all involved. In its Final Order

[2] Jefferson's Exhibit No. 12 indicates that GLO has classified these seven wells as "unstable wells," and GLO's Director of Mineral Leasing testified that GLO has serious concerns about the condition of these wells.

[3] As requested by Jefferson, the examiners have officially noticed the proposal for decision and final order issued in this docket.

served March 29, 2006, the Commission approved a reduction of Sterling's financial assurance requirement by concluding that Sterling need not file any additional financial assurance for the 19 wellbores acquired from BP.[4]

Although Sterling apparently spent a good bit of its investors' money and performed some work on surface facilities, it did not restore to production any of the 19 wellbores acquired from BP and did not plug any of the wells, including the seven "unstable wells" for which Sterling had assumed the obligation to restore production or plug and abandon the wells within 90 days or nine months, depending on the well, after the Commission approved the Forms P-4 transferring the wells to Sterling in August 2004. GLO notified Sterling that it was in breach of the "Facility Agreement," but did not spend any of the GLO Escrow Fund to plug the wells.[5]

By January 2007, Sterling's principal financial backer, BlackRock Energy Capital, Ltd. ("BlackRock") decided to take over the subject properties. An "Agreement" effective January 15, 2007, between BlackRock, Sterling, and GLO incorporated the agreement of Sterling to release its "deep rights" in the High Island Block 24L Field area and to assign to BlackRock's designee the retained shallow rights down to depths, depending on the lease, from 7,500' to 12,600'. BlackRock or its designee agreed to take over Sterling's ownership interest and obligations, and to take over operations, in the High Island Block 24L Field area. BlackRock, or its designee, also assumed the benefits and obligations of Sterling under the "Facility Agreement," including the right to reimbursement of plugging costs from the GLO Escrow Fund. BlackRock subsequently underwent a name change to BlueRock Energy Capital, Ltd. Jefferson became BlueRock's designee to operate the properties acquired from Sterling. BlueRock and Jefferson each now own a 50% interest in the High Island Block 24L Field area properties formerly owned by Sterling.

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[4] The examiners have officially noticed from Commission records that this was not approval for Sterling to file zero financial assurance. At the time, Sterling had 10 other producing offshore wells and 21 bay wells of which 11 were non-producing. Even with the reduction approved by the Commission, Sterling was required to file $710,000 of financial assurance to cover the base amount required by Rule 78(g)(1), the entry level amount required by Rule 78(g)(3)(A), and the additional amount for inactive bay wells required by Rule 78(g)(2)(B). The reduction approved for Sterling did amount, however, to $1,900,000 that otherwise would have been required for the 19 inactive offshore wellbores acquired from BP.

[5] The examiners have officially noticed that an enforcement action has been commenced against Sterling by complaint filed on May 9, 2007, in the matter styled Oil & Gas Docket No. 03-0251481, *Enforcement Action Against Sterling Expl. & Prod. Co., LLC (Operator No. 819006) for Violations of Statewide Rules On the State Tract 59455 Lease, Well No. 2L (RRC #047121), High IS Blk 24L (FB-C, HC) Field, High IS LB County; State Tract 59455 Lease, Well No. 4 (RRC #047266), High IS Blk 24L (FB-C, HC) Field, High IS-LB County; and State Tract 59455 Lease, Well No. 5L (RRC #047122), High IS Blk 24L (FB-C, HC) Field, High IS-LB County, Texas* alleging violations of Statewide Rules 14(b)(2) and 14(b)(3).

DISCUSSION OF THE EVIDENCE

Jefferson[6]

The 19 wellbores proposed to be transferred from Sterling to Jefferson are located in the Gulf of Mexico, in open water four to six miles offshore Jefferson County, Texas. The wells are in water which is 35' to 40' deep. The 19 wellbores include some multiple completions, so that there are a total of 26 wells for which Jefferson proposes to become the operator. The financial assurance reduction sought by Jefferson pertains to the 19 wellbores only, as Jefferson does not currently operate any other wells in Texas.

As of February 14, 2007, Sterling assigned to Jefferson oil and gas leases made with GLO in October 2003, covering the offshore tracts where the subject wells are located. These leases are still in their primary term. Because Sterling released its deep rights, the rights now held by Jefferson are, depending on the lease, down to 7,500' to 12,600'. A Sterling affiliate also assigned to Jefferson ownership of the field area pipeline facilities which had been acquired from BP.

An "Agreement" between BlackRock, Sterling, and GLO effective January 15, 2007, pursuant to which BlackRock acquired Sterling's ownership interest and obligations related to the High Island Block 24L Field area properties, provided, among other things, that BlackRock or its designee (now Jefferson) would restore to production or plug the seven wells identified by GLO as "unstable wells" within specified time frames. Specifically, BlackRock committed that it or its designee would return Well Nos. A-5, A-11, and C-10 to production in paying quantities, or plug the wells, within six months, or pay liquidated damages of $200,000 for each well not timely restored to production or plugged. BlackRock committed that it or its designee would return Well Nos. A-4, C-9, C-11, and C-12 to production in paying quantities, or plug the wells, within 12 months, or pay liquidated damages of $200,000 for each well not timely restored to production or plugged. For any well not timely plugged, BlackRock, and its designee, are obligated by the agreement to cause a Form P-4 transfer of the well to an operator designated by GLO.

Jefferson has commenced to make necessary repairs and improvements to surface facilities acquired from Sterling and has incurred capital costs attendant to the transaction with Sterling and GLO. Pursuant to agreement with Sterling and GLO, Jefferson has paid off one-half of Sterling's accounts payable attributable to the High Island Block 24L Field area properties in the amount of $1,475,000, and has paid BlueRock the sum of $252,000 as one-half reimbursement of lease bonus money paid by BlueRock to GLO. Jefferson has also committed to an initial budget for capital expenditures of $6,420,000 associated with the subject properties. Jefferson's parent, Tammany Oil & Gas LLC ("Tammany"), has incurred finance costs of about $2,000,000 in connection with acquisition of the subject properties.

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[6] This discussion is in addition to the discussion of Jefferson's evidence presented in the preceding "Background" section of this proposal for decision.

Jefferson and Tammany have performed an inspection of the subject wells and the associated platforms to formulate a plan to restore production. Structural problems were found to exist with respect to at least two production platforms that Sterling had loaded up with processing equipment potentially exceeding the structural design of the platforms. Jefferson ran a structural analytical model and performed structural work to cure this problem. Hurricane damage to platform ladders was also discovered, and a number of new ladders have been constructed and are presently onshore awaiting installation. During the three week period preceding the hearing, Jefferson had a crew of 20 working on structural problems and piping and electrical issues. An expenditure of $350,000 to $400,000 has been made thus far to recondition platforms, and Jefferson expects to make a total expenditure of $2,700,000 in refurbishing surface facilities. Downhole inspection of the 19 wellbores involved to determine which wells need to be plugged immediately and which can be restored to production is awaiting Commission approval of the Forms P-4 requesting a change of operator from Sterling to Jefferson. Jefferson has also acquired 3-D seismic data for the field area and has retained a geophysicist to evaluate this seismic data. Once the Commission has approved Forms P-4 to transfer the subject wellbores from Sterling to Jefferson, Jefferson anticipates restoration of production in those wells that are found to be capable of production in a period of about four weeks.

An engineer with reservoir engineering duties for Tammany has estimated anticipated proven reserves recoverable by the 19 wellbores proposed to be operated by Jefferson. His best estimate of remaining recoverable reserves from these wellbores is 16.666 BCF of gas. This Tammany engineer believes that these reserves are not recoverable without the use of the 19 wellbores in question.

Jefferson contends that it should be entitled to the same reduction in offshore well financial assurance approved for Sterling, which Jefferson interprets as a reduction in the amount of $1,950,000 for the 19 presently inactive wellbores in question. Tammany's engineer estimated that at today's costs, each of these 19 wellbores should cost from $300,000 to $500,000 to plug, assuming no unusual problems are encountered, although he had no estimate for the potential cost of platform decommissioning and pipeline removal. Jefferson does not contend that it is unable to file financial assurance in the amount of $1,950,000, but suggests that this would be an added burden on a less than lucrative project.

GLO

Jefferson essentially is stepping into the shoes of Sterling for the purposes of the 2004 "Facility Agreement" between BP, Sterling, and GLO. The GLO Escrow Fund is still intact to reimburse well plugging expenditures that may be made by Jefferson pursuant to the terms of the Facility Agreement. However, GLO is not willing or able to make the Railroad Commission an assignee of the GLO Escrow Fund or enable the Commission to call on the Fund for the purpose of plugging the wells proposed to be transferred to Jefferson. Under the terms of the Facility Agreement, it is the obligation of Jefferson to spend its own funds to plug the subject wells before it gains any entitlement to disbursement of money from the GLO Escrow Fund.

GLO believes that there are three wells that need Jefferson's immediate attention, and GLO has serious concern about the condition of seven wells. GLO wants Jefferson to restore the wells to production or plug them within relatively short time frames provided by the agreement between BlackRock, Sterling and GLO. The agreement obligates BlackRock, or Jefferson as BlackRock's designee, to pay liquidated damages to GLO if this does not happen.

The 2004 Facility Agreement between BP, Sterling, and GLO imposed the same sort of obligation on Sterling with respect to the seven wells about which GLO has serious concern. Sterling was obligated to restore production of three wells, or plug the wells, within 90 days of Form P-4 approval transferring the wells from BP to Sterling, and Sterling was obligated to restore production of four additional wells, or plug the wells, within nine months of Form P-4 approval. Sterling did not restore these wells to production and did not plug them. GLO determined that Sterling had breached the Facility Agreement and so notified Sterling. However, GLO did not spend any money out of the GLO Escrow Fund to plug the wells.

According to GLO's Director of Mineral Leasing, even assuming that the money in the GLO Escrow Fund is insufficient to cover the expense of plugging the 19 wellbores in question, decommissioning platforms, and removing pipelines as necessary, in terms of expenditure of money from the Fund, it is the intention of GLO to give first priority to plugging the wells. A late-filed exhibit submitted by Jefferson consists of a letter from Jerry Patterson, Commissioner, Texas General Land Office, stating, among other things, that GLO legal counsel has taken the position that it would be inadvisable to amend the conditions of the GLO Escrow Fund to enable the Railroad Commission to call on the Fund as financial assurance under Statewide Rule 78. However, this letter also states that it is Commissioner Patterson's intent to use the GLO Escrow Fund solely for the plugging of the 19 wellbores and for the removal of any associated structures. The letter states further that in the event such liabilities should fall to the state, the Fund would be used for paying reasonable costs to the extent allowed by law until the Fund is depleted, with any excess being retained by GLO.

EXAMINERS' OPINION

The examiners are unaware of any previous case where the Commission has approved a zero financial assurance requirement for an operator of offshore wells. To accept a transfer of 19 wells, whether land based, in bays, or offshore, Jefferson is required by Statewide Rule 78(g)(1)(B) to file so-called base amount financial assurance of $50,000. Under §91.107 of the Texas Natural Resources Code, the Commission must require the filing of this financial assurance as a condition

of transfer of the wells, and the base amount of financial assurance is not subject to reduction under the terms of either the statute or Statewide Rule 78.[7]

Pursuant to Statewide Rule 78(g)(3)(A), all operators of offshore wells, active or inactive, are required to file so-called entry level financial assurance in the amount of $100,000. Statewide Rule 78(g)(4) provides that an operator may request a reduction in entry level financial assurance for offshore wells. The only specific basis for such a reduction spelled out in Statewide Rule 78(g)(4) is a showing that the operator has acceptable financial assurance in place to satisfy financial assurance requirements established by "local authorities" and that such financial assurance can be called on by or assigned to the Commission. If this type of reduction is denied administratively, the operator may request a hearing to determine whether the reduction should be granted.

The Commission's decision in *Sterling* did not grant relief to Sterling from the requirement to file the required base amount and entry level amount of financial assurance. Although it is true that Sterling was not required to file additional financial assurance attributable to the 19 offshore wellbores acquired from BP, it also true that at the time, Sterling was the operator of 10 other producing offshore wells and 21 bay wells of which 11 were non-producing. Even with the reduction approved by the Commission, Sterling was required to file $710,000 of financial assurance to cover the base amount required by Rule 78(g)(1), the entry level amount required by Rule 78(g)(3)(A), and the additional amount for inactive bay wells required by Rule 78(g)(2)(B).[8] The *Sterling* decision is not a precedent for granting approval to a proposed operator of 19 inactive offshore wells to file zero financial assurance.

Accordingly, the examiners believe that Jefferson should be required to file the required base amount of financial assurance ($50,000) and the required entry level amount applicable to all operators of offshore wells ($100,000), regardless of the merits of Jefferson's contention that it is entitled to a reduction in the additional financial assurance required for inactive offshore wells.

As to Jefferson's request for a reduction in the amount of additional financial assurance for inactive offshore wells required by Statewide Rule 78(g)(3)(B), the examiners have the following concerns: (1) pursuant to the 2004 "Facility Agreement" which created the GLO Escrow Fund, GLO is required to reimburse Jefferson for the approved cost of plugging the subject wells only if Jefferson first spends its own money to plug the wells, and Jefferson has presented no evidence of

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[7] Section 91.107 of the Texas Natural Resources Code provides that if a well is transferred, the Commission *shall* require the party acquiring the well to file the financial assurance required by §91.104(b). Section 91.104(b) requires the filing of financial assurance as provided by §91.1041 or §91.1042. Sections 91.1041 and 91.1042 refer to the base amount of financial assurance required to be filed by all operators.

[8] Though associated with base amount and entry level amount financial assurance and financial assurance attributable to other wells, this financial assurance was nonetheless available to ensure that one or more of the 19 offshore wells acquired by Sterling from BP would be plugged without the use of State funds.

its financial ability to plug the wells; (2) Jefferson has stepped into the shoes of Sterling for the purposes of the 2004 "Facility Agreement," which authorizes, but does not *require*, GLO to spend money from the GLO Escrow Fund to plug the subject wells, if Jefferson does not do so; (3) the GLO Escrow Fund was created to cover the cost not only of plugging wells, but also platform and pipeline removal costs, remediation costs, and costs of any other "necessary operations;" (4) Using the upper range of plugging cost estimated by Jefferson's engineer assuming that no unusual problems are encountered ($500,000 per well), the total cost of plugging the 19 offshore wellbores would roughly equal the total amount of the GLO Escrow Fund, without regard to any potential cost for platform and pipeline removal, remediation, and other "necessary operations"[9]; (5) GLO is unwilling or unable to make the Railroad Commission an assignee of the GLO Escrow Fund or enable the Commission to call on the Fund for the purpose of plugging Jefferson's wells; and (6) no express provision of Statewide Rule 78(g) provides for a reduction in the financial assurance required by Rule 78(g)(3)(B) for inactive offshore wells based on a well plugging fund held and controlled by a sister agency.

Even assuming that the GLO Escrow Fund contains enough money to plug the 19 inactive offshore wellbores which Jefferson has acquired from Sterling and GLO will spend the money to plug these wellbores as necessary, nonetheless it is clear that if Jefferson does not plug the wells, it is GLO, and not the Railroad Commission, that will determine *when* the wells are plugged. Nothing demonstrates this more clearly than the fact that when the 2004 "Facility Agreement" was made between BP, Sterling, and GLO, GLO had already determined that seven of the wells were "unstable wells" or wells about which GLO had "serious concern" as to their condition. The 2004 "Facility Agreement" required Sterling to restore three of these wells to production by November 2004 (90 days after Form P-4 approval) and to restore the other four to production by May 2005 (nine months after Form P-4 approval) or otherwise plug the wells. Sterling did not restore these wells to production and did not plug them, and GLO did not spend any money from the GLO Escrow Fund to plug the wells either.

Currently, GLO has an agreement with BlueRock (fka BlackRock) and Jefferson (as designee of BlueRock) to restore the seven "unstable wells" to production, in the case of three wells within six months and in the case of the other four wells within twelve months, or otherwise plug the wells. If Jefferson does not do either, the agreement provides that BlueRock/Jefferson must pay GLO liquidated damages of $200,000 per well and cause Form P-4 transfers to yet another operator designated by GLO. It appears clear that whereas the Railroad Commission retains the jurisdiction to order, in the proper circumstances, that these wells be plugged, the timing of expenditure of money from the GLO Escrow Fund to plug the wells is within the sole discretion of GLO.

Notwithstanding these concerns, the examiners are bound to recognize that in the *Sterling* case, the Commission determined that the existence of the GLO Escrow Fund was sufficient basis

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[9] The examiners note, however, that GLO has stated its intent that the GLO Escrow Fund is to be used first to plug the wells.

for the granting of an exception to the additional financial assurance requirements for inactive offshore wells provided by Statewide Rule 78(g)(3)(B). With this in mind, the examiners recommend that an exception likewise be granted to Jefferson affording at least partial relief from the requirements of Statewide Rule 78(g)(3)(B). The examiners recommend that the Commission enter an order that Jefferson may take a transfer of the 19 inactive offshore wellbores it has acquired from Sterling by filing the base amount of $50,000 required by Statewide Rule 78(g)(1)(B), the entry level amount of $100,000 for all operators of offshore wells required by Statewide Rule 78(g)(3)(A), and additional financial assurance of $600,000 as required by Statewide Rule 78(g)(3)(B). The recommended $600,000 of additional financial assurance is attributable *but not limited to* the potential immediate plugging liability arising from transfer to Jefferson of the seven inactive and "unstable wells." This recommendation would permit Jefferson to take a transfer of the 19 inactive offshore wellbores acquired from Sterling by filing financial assurance in the total amount of $750,000, which, in practical terms, is a "reduction" of $1,200,000 in the total amount otherwise required under Statewide Rules 78(g)(1)(B), 78(g)(3)(A), and 78(g)(3)(B).[10]

The examiners' recommendation is based on the fact that seven "unstable wells" proposed to be transferred to Jefferson will most likely need immediate plugging.[11] A financial assurance requirement of $750,000 does not seem to much too ask of an operator proposing to take a transfer of 19 inactive offshore wellbores from which the operator expects to recover 16.666 BCF of gas. Furthermore, Jefferson has the ability to use self-help to reduce even this minimal financial assurance requirement. Jefferson has estimated that if the 19 wellbores can be restored to production, this will be achieved within about four weeks from the date of Commission approval of the Forms P-4 transferring the wells to Jefferson. If all wells are thus restored to production, Jefferson's financial assurance requirement, as a matter of law, will be reduced to $150,000, consisting of only the base and entry level amounts required by Statewide Rules 78(g)(1)(B) and 78(g)(3)(A). If some wells cannot be restored to production, such as the seven "unstable wells," Jefferson may proceed to plug these wells, and apply to GLO for reimbursement of its plugging costs from the GLO Escrow Fund. At the end of the day, if all of the 19 wellbores have either been restored to production or plugged, Jefferson's financial assurance requirement will be $150,000.

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[10] Coincidentally, this is roughly comparable to the financial assurance Sterling was required to file ($710,000), notwithstanding the "reduction" approved in the *Sterling* docket. Recognizing that the financial assurance Sterling was required to file was attributable to the required base and entry level amounts and other inactive bay wells, nonetheless Sterling's financial assurance was subject to call for plugging any of Sterling's wells, including the 19 offshore wellbores here in question.

[11] The examiners have officially noticed the Commission's Well Bore Completion Remarks Database for these wells. These remarks disclose that Well Nos. 4, C9, C10, C11, and C12 were temporarily abandoned as of March 2004, to determine the source of sustained casing pressures and that the operator had stated that the wells would be plugged and abandoned in the near future. According to the Commission's H-15 Data Inquiry database, Well No. 5L has a delinquent H-15 test which was due in May 2005. According to Commission production records which have also been officially noticed, the seven "unstable wells" have been inactive for periods ranging from 3 ½ to 12 years. Two of the "unstable wells" appear to be the subject of the pending enforcement action against Sterling in Oil & Gas Docket No. 03-0251481.

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

FINDINGS OF FACT

1. Notice of this hearing was mailed to Jefferson Block 24 Oil & Gas, LLC ("Jefferson") at the address shown on its most recent Form P-5 organization report and to Jefferson's attorney at the address provided in his request for the hearing. Jefferson appeared at the hearing and presented evidence.

2. Jefferson has filed with the Commission Forms P-4 (Certificate of Compliance and Transportation Authority) requesting a change of operator from Sterling Exploration & Production Co., LLC ("Sterling") to Jefferson of 26 offshore wells ("subject wells") in the High Island Block 24L Field area, offshore Jefferson County, Texas. Some of these wells are dual completions, and there are 19 wellbores involved. These wells and wellbores are further identified in Appendix 1 to this proposal for decision, which is incorporated into this finding by reference.

3. All of the wells proposed to be transferred from Sterling to Jefferson are inactive. These wells are located in the Gulf of Mexico, in open water 35' to 40' deep, four to six miles offshore Jefferson County, Texas.

4. Jefferson currently has an active Form P-5 organization report, but is exempt from any financial assurance requirement because Jefferson does not currently operate any wells or perform any other operations subject to the Commission's jurisdiction.

5. Pursuant to Statewide Rule 78, in order to take a transfer of the 19 inactive offshore wellbores in question, Jefferson is required to file financial assurance in the amount of $1,950,000.

6. Jefferson requests that the Commission allow Jefferson to take a transfer of the 19 inactive wellbores without filing any financial assurance.

7. Prior to August 2004, the subject wells were operated by BP America Production Company ("BP"). In about the year 2000, BP made the decision to let its leases of the associated State tracts lapse and to abandon the field area.

8. In 2003, Sterling acquired new leases from the Texas General Land Office ("GLO") covering certain offshore State tracts in High Island Blocks 7L and 24L, some of the same tracts formerly operated by BP.

9. In August 2004, BP, Sterling, and GLO entered into a "Facility Abandonment, Escrow Payment and Release of Liability Agreement" ("Facility Agreement"). Pursuant to the Facility Agreement, Sterling agreed to become the operator of the subject wells and to assume the responsibility to decommission, plug, abandon, remove, or remediate "offshore facilities" for which BP formerly was responsible. These offshore facilities included the 19 offshore wellbores, 16 satellite platforms, 2 Bridge connected platforms, four production platforms and equipment, pipelines between production and satellite platforms and between existing production platforms, an 8" pipeline from the High Island 24L A platform to the Shorebase, and previously abandoned in place pipelines between existing production platforms and the subsea tie-in in Block 33L.

10. The Facility Agreement provided BP with a release of all liability for the offshore facilities transferred to Sterling. In return for this release, BP deposited into a GLO escrow account the sum of $9,564,913 ("GLO Escrow Fund") to be used at GLO's sole direction for well plugging and abandonment costs, platform and pipeline removal costs, remediation costs and any other necessary operations with regard to Blocks 7L, 23L, 24L, 25L, 32L, 33L, and 90S.

11. The Facility Agreement provided that in the event Sterling failed to comply in any material respect with its obligations under the agreement and failed to cure the default, GLO, in its sole discretion, could require that one or more of the 19 wellbores be plugged and abandoned. The Facility Agreement also provided that if Sterling plugged and abandoned any such well at GLO's direction, and the plugging and abandonment costs were approved by GLO, Sterling would be entitled to reimbursement of the approved costs from the GLO Escrow Fund.

12. With respect to three of the subject wells, identified as State Tract 24L, Well Nos. 5, 11, and C10, the Facility Agreement required Sterling to commence reworking operations within 90 days of the date of Commission approval of Forms P-4 transferring the wells to Sterling. With respect to four additional wells, identified as State Tract 24L, Well Nos. 4, C9, C11, and C12, the Facility Agreement required Sterling to commence reworking operations within nine months of the date of Commission approval of Forms P-4 transferring the wells to Sterling. Sterling was required to restore these wells to production or plug them, and the Facility Agreement provided that if Sterling did not accomplish this, GLO "may proceed with the required activities or operations."

13. GLO made special provision in the Facility Agreement for Well Nos. 4, 5, 11, C9, C10, C11, and C12 ("unstable wells") because it has serious concern about the condition of these wells. An April 26, 2007 Jefferson Project Status Report stated that GLO had categorized these seven wells as "unstable wells." Wellbore completion remarks in official completion records of the Commission state that Well Nos. 4, C9, C10, C11, and C12 were temporarily abandoned as of March 2004, to determine the source of sustained casing pressures, and the wells would be plugged and abandoned "in the near future." Official Commission records regarding H-15 test status of wells, state that a H-15 test of Well No. 5L has been delinquent

since May 2005. The seven "unstable wells" have been inactive for periods ranging from 3 ½ to 12 years.

14. The Commission approved Forms P-4 transferring the subject wells from BP to Sterling in August 2004.

15. In July 2005, Sterling filed an application with the Commission requesting a reduction in the financial assurance required for the 19 inactive offshore wellbores acquired from BP, based on the existence of the GLO Escrow Fund which was said by Sterling to be sufficient financial assurance that these wellbores would be plugged as necessary. By final order served March 29, 2006, the Commission determined that Sterling would not be required to file any additional financial assurance of the type required by Statewide Rule 78(g)(3)(B) for these 19 wellbores. At the time, Sterling was also the operator of 10 other producing offshore wells and 21 bay wells of which 11 were non-producing, and Sterling was required to file financial assurance of $710,000 to cover the base amount required by Statewide Rule 78(g)(1), the entry level amount for operators of bay and offshore wells required by Statewide Rule 78(g)(3)(A), and the additional amount for inactive bay wells required by Statewide Rule 78(g)(2)(B).

16. Sterling failed to restore any of the subject wells to production, including the seven "unstable wells" and did not plug any of the wells. As a consequence, GLO gave notice to Sterling that Sterling had breached the Facility Agreement. However, GLO did not plug any of the "unstable wells" by use of money from the GLO Escrow Fund.

17. In January 2007, Sterling's principal financial backer, BlackRock Energy Capital, Ltd. ("BlackRock") decided to take back the subject properties from Sterling. Pursuant to agreement effective January 15, 2007, between BlackRock, Sterling, and GLO, Sterling released its deep rights in the subject State tracts, and assigned its shallow rights to Jefferson, who was BlackRock's designee operator. BlackRock and its designee also assumed the benefits and obligations of Sterling under the Facility Agreement between BP, Sterling, and GLO, including the right to reimbursement of plugging costs from the GLO Escrow Fund. BlackRock subsequently underwent a name change to BlueRock Energy Capital, Ltd., and BlueRock and Jefferson each now own a 50% interest in the High Island Block 24L Field area properties.

18. The January 15, 2007, agreement between BlackRock, Sterling, and GLO obligates Jefferson, as BlackRock's designee, to give priority treatment to the seven "unstable wells." These wells must be returned to production in paying quantities or be plugged within six months in the case of three of the wells and within 12 months in the case of the other four wells. The agreement provides for payment of liquidated damages of $200,000 per well if this obligation is not met and if one or more of the wells is not plugged as required, Jefferson must cause a Form P-4 transfer of the well to GLO's designee.

19. The leases on the subject State tracts assigned from Sterling to Jefferson are still in their primary term and are effective.

20. Jefferson has commenced to inspect and repair or improve surface facilities associated with production of the subject wells, including structural repairs to platforms and construction of ladders to provide platform access, and as of the date of the hearing had spent $350,000 to $400,000 for this work. Jefferson expects to make a total expenditure of $2,700,000 to refurbish surface facilities.

21. As of the date of the hearing, Jefferson had paid off one-half of $1,475,000 in Sterling's account payables as provided for in the January 15, 2007, agreement, and had also paid BlueRock the sum of $252,000 as one-half reimbursement of lease money paid by BlueRock to GLO. Jefferson has committed to an initial budget for capital expenditures of $6,420,000 associated with the subject properties. Jefferson's parent, Tammany Oil & Gas, LLC, has incurred finance costs of about $2,000,000 in connection with acquisition of the subject properties.

22. A Jefferson engineer estimated that remaining reserves recoverable by the subject wells are 16.666 BCF of gas.

23. Jefferson estimates that at today's costs, the subject wells should require $300,000 to $500,000 per well to plug, assuming that no unusual problems are encountered. Jefferson did not furnish any estimate of the cost of platform or pipeline removal.

24. To gain entitlement to reimbursement of plugging costs from the GLO Escrow Fund, Jefferson must first spend its own funds to plug wells, as necessary.

25. Jefferson did not present any financial statement or other evidence concerning its present financial position.

26. Jefferson believes that the GLO Escrow Fund is sufficient financial assurance to cover the subject wells and that it should be afforded the same relief from financial assurance requirements as was approved for Sterling.

27. Regardless of whether the GLO Escrow Fund is in a sufficient amount to pay the cost of plugging wells, and removing all platforms and pipelines, it is the present intent of GLO to make plugging of wells, as necessary, a priority expenditure from the fund. The Commissioner of GLO has stated by letter that it is his intent to use the GLO Escrow Fund solely for the plugging of the subject wells and removal of any associated structures. This letter states also that in the event such liabilities fall to the state, the GLO Escrow Fund would be used for paying reasonable costs to the extent allowed by law until the Fund is depleted, with any excess funds to be retained by GLO.

28. GLO is unwilling or unable to make the Railroad Commission an assignee of the GLO Escrow Fund or enable the Commission to call on the Fund for the purpose of plugging the wells proposed to be transferred to Jefferson. Expenditure of money from the GLO Escrow Fund to plug wells, and the timing of any such expenditures, is within the sole discretion of GLO.

CONCLUSIONS OF LAW

1. Proper notice of hearing was timely given to all persons legally entitled to notice.

2. All things have occurred and been accomplished to give the Commission jurisdiction to decide this matter.

3. Pursuant to Statewide Rule 78(g)(1)(B) [Tex. R.R. Comm'n, 16 TEX. ADMIN. CODE §3.78(g)(1)(B)], Statewide Rule 78(g)(3)(A) [Tex. R.R. Comm'n, 16 TEX. ADMIN. CODE §3.78(g)(3)(A)], Statewide Rule 78(g)(3)(B) [Tex. R.R. Comm'n, 16 TEX. ADMIN. CODE §3.78(g)(3)(B)], Statewide Rule 78(j)(1) [Tex. R.R. Comm'n, 16 TEX. ADMIN. CODE §3.78(j)(1)], and §91.107 of the Texas Natural Resources Code, Jefferson Block 24 Oil & Gas, LLC ("Jefferson") is required to file financial assurance in the amount of $1,950,000 as a prerequisite to becoming the designated operator of the 19 wellbores identified in Appendix 1 to the proposal for decision in this docket, which appendix is adopted and incorporated into this Conclusion of Law by reference, unless the Commission approves a reduction in the amount of required financial assurance pursuant to Statewide Rules 78(g)(4) and/or 78(g)(5) [Tex. R.R. Comm'n, 16 TEX. ADMIN. CODE §3.78(g)(4) and/or §3.78(g)(5)].

4. Pursuant to Statewide Rule 78(g)(4), an operator may request administrative approval for a reduction of the entry level financial assurance required by Statewide Rule 78(g)(3)(A) for all operators of offshore wells based on the operator's showing that it has acceptable financial assurance in place to satisfy financial assurance requirements established by local authorities. If such a requested reduction is administratively denied, the operator may request a hearing to determine whether the reduction should be granted.

5. Pursuant to Statewide Rule 78(g)(5), an operator may request administrative approval for a reduction of the additional financial assurance required by Statewide Rule 78(g)(3)(B) for inactive offshore wells in an amount not to exceed the remainder of 25% of the operator's certified net worth based on the independently audited calculation for the most recently completed fiscal year minus the Commission's estimate of the operator's total plugging liability for all of the operator's active bay and/or offshore wells. If such a requested reduction is administratively denied, the operator may request a hearing to determine whether the reduction should be granted.

6. Jefferson did not prove that a reduction in the amount of financial assurance required by Statewide Rules 78(g)(3)(A) and/or 78(g)(3)(B) is warranted on the basis of acceptable financial assurance in place to satisfy financial assurance requirements established by local authorities or Jefferson's independently audited and certified net worth.

7. Pursuant to §91.107 of the Texas Natural Resources Code, the Commission is without discretion to approve a reduction in the base amount of financial assurance required by Statewide Rule 78(g)(1) to an operator proposing to accept a transfer of a well or wells.

8. Pursuant to Statewide Rules 78(g)(4) and 78(g)(5), upon proper notice and hearing, the Commission may, in its discretion, order a reduction in the financial assurance required of an operator by Statewide Rules 78(g)(3)(A) and/or 78(g)(3)(B), but the Commission is not required to approve a reduction, and the amount of any such reduction is a matter within the sound discretion of the Commission.

9. In determining whether there is some other category of financial assurance subject to use for plugging and abandonment of wells and/or clean up of pollution that may warrant a reduction in the case of a particular operator of the financial assurance required by Statewide Rules 78(g)(3)(A) and 78(g)(3)(B), the Commission has the discretion to consider any factor relevant to the issue of whether other sufficient financial assurance exists to ensure that the well or wells in question may be properly and timely plugged and abandoned in conformity with Commission rules without resort to use of funds from the Oil Field Clean Up Fund.

10. Jefferson has not established that the existence of the GLO Escrow Fund warrants a reduction to zero in the amount of financial assurance which Jefferson is required to file in order to accept a transfer the 19 inactive offshore wellbores for the following reasons: (a) Jefferson does not have on file, or propose to file, any financial assurance attributable to other wells; (b) the GLO Escrow Fund may not be called on by or assigned to the Commission; (c) it is not clearly established that the GLO Escrow Fund is in an amount sufficient to cover all of the purposes for which the Fund was created; (d) Under the Facility Agreement, Jefferson has the first obligation to bear the expense of plugging and abandonment before gaining entitlement to reimbursement from the GLO Escrow Fund, and Jefferson did not establish its financial ability to bear such expense; (e) it is not clearly established that GLO is legally obligated by the Facility Agreement which created the GLO Escrow Fund to use the Fund to plug and abandon the wellbores which Jefferson proposes to acquire if Jefferson does not do so; (f) at least seven of the wells proposed to be acquired by Jefferson may be in imminent need of plugging; and (g) the Commission has no authority to supervise or control the expenditure of funds from the GLO Escrow Fund, or the timing of any such expenditures, for the purpose of plugging and abandoning wells.

11. The existence of the GLO Escrow Fund and the assurances of GLO that money in this Fund will be utilized for the purpose of plugging the subject wells should liability fall to the State for such plugging warrants a partial reduction in the additional financial assurance required for inactive offshore wells by Statewide Rule 78(g)(3)(B).

12. Based on all relevant factors, Jefferson has established that it should be permitted to acquire by transfer from Sterling Exploration & Production Co., LLC the 19 wellbores identified in Appendix 1 to the proposal for decision and final order in this docket by filing financial assurance as follows: the $50,000 required by Statewide Rule 78(g)(1)(B), the $100,000 entry level financial assurance required by Statewide Rule 78(g)(3)(A) for all operators of offshore wells, and $600,000 of additional financial assurance for inactive offshore wells, which amounts to a reduction of $1,200,000 in the financial assurance that otherwise would be required under Statewide Rules 78(g)(1)(B), 78(g)(3)(A), and 73(g)(3)(B).

RECOMMENDATION

The examiners recommend that the Commission enter the attached final order providing that Jefferson may take a transfer of the 19 offshore wellbores identified in Appendix 1 to this proposal for decision and the final order upon the filing of financial assurance in the amount of $750,000.

Respectfully submitted,

James M. Doherty
Hearings Examiner

Andres J. Trevino
Technical Examiner