RAILROAD COMMISSION OF TEXAS

OFFICE OF GENERAL COUNSEL

OIL & GAS DOCKET NO. 09-0265924

APPLICATION OF CHESAPEAKE OPERATING, INC. PURSUANT TO THE MINERAL INTEREST POOLING ACT FOR THE FORMATION OF THE PROPOSED 50.371-ACRE GLEN GARDEN MIPA UNIT, WELL NO. 1H, NEWARK, EAST (BARNETT SHALE) FIELD, TARRANT COUNTY, TEXAS

APPEARANCES:

FOR APPLICANT:	**APPLICANT:**
Glenn E. Johnson Brenda Clayton Bill Spencer Ray Oujesky Elizabeth Prykryl Alan Jackson Steve Mills	Chesapeake Operating, Inc.

PROPOSAL FOR DECISION

PROCEDURAL HISTORY

DATE APPLICATION FILED:	May 14, 2010
DATE OF NOTICE OF HEARING:	June 7, 2010
DATE OF HEARING:	September 10, 2010
HEARD BY:	Marshall Enquist Andres J. Trevino
DATE TRANSCRIPT RECEIVED:	September 15, 2010
DATE OF APPLICANT'S LAST SUBMISSION:	October 20, 2010
DATE PFD CIRCULATED:	May 12, 2011

STATEMENT OF THE CASE

This is a case brought by Chesapeake Operating, Inc. ("Chesapeake") pursuant to the Mineral Interest Pooling Act, Chapter 102, Texas Natural Resources Code. Chesapeake requests that the Commission order compulsory pooling of all mineral interests in 78 separate tracts of land into the 50.371-acre Glen Garden MIPA Unit for the drilling of Well No. 1H ("MIPA well"), a proposed horizontal well in the Newark, East (Barnett Shale) Field, Tarrant County, Texas.

Chesapeake has currently effective oil and gas leases covering 74 of the 78 tracts of land proposed to be included in the Glen Garden MIPA Unit. There are four tracts of land, Tract Nos. 2, 22, 46, and 63, within the perimeter of the proposed MIPA unit that are currently unleased. The proposed MIPA well does not traverse any of these unleased tracts. The leased acreage included in the proposed MIPA unit is currently a part of Chesapeake's 192.161-acre Glen Garden Unit, a voluntary pooled unit. As of the date of the hearing, Chesapeake had already permitted five horizontal wells in the Newark, East (Barnett Shale) Field on this voluntary pooled unit. These wells included Well No. 1H (the "MIPA" well) for which Chesapeake was issued a Rule 37 exception permit on March 3, 2010, at the same location where the well is proposed to be drilled if the Commission approves the formation of the requested compulsory unit. There is no evidence as to whether Well No. 1H has yet been drilled. The other wells on the Glen Garden voluntary unit have been drilled and are producing. The Glen Garden Unit Well No. 2H (RRC No. 239760) was completed on June 20, 2008, and through February 2011 had produced 606,908 MCF. The Glen Garden Unit Well No. 3H (RRC No. 246850) was completed on July 6, 2008, and through February 2011 had produced 532,047 MCF. The Glen Garden Unit Well No. 4H (RRC No. 246865) was completed on June 21, 2008, and through February 2011 had produced 800,536 MCF. The Glen Garden Unit Well No. 5H (RRC No. 246865) was completed on July 4, 2008, and through February 2011 had produced 730,381 MCF.[1]

Notice of this application was mailed by the Commission to all owners of mineral interests within the proposed MIPA unit as identified by Chesapeake. Notice was also published in the Fort Worth Commercial Recorder on June 9, 16, 23, and 30, 2010.[2] The hearing initially was called on July 12, 2010, but then recessed at the request of Chesapeake. The hearing was rescheduled for September 10, 2010. When the hearing was called on September 10, 2010, no one appeared in opposition to the application, but a hearing nonetheless was required under §102.017 of the MIPA. Chesapeake's last submission was made on October 20, 2010. The case was assigned to Examiner James M. Doherty to assist in preparation of a proposal for decision on April 13, 2011. The examiners recommend that the application be dismissed for want of jurisdiction because Chesapeake did not make a fair and reasonable offer to the unleased owners to pool voluntarily as required by §102.013 of the MIPA. Alternatively, the examiners recommend that the application be denied

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[1] By letter dated July 23, 2010, Examiner Mark Helmueller, who was then assigned to this docket, provided notice to Chesapeake that official notice would be taken of permitting, completion, and production records for the Glen Garden Unit, Well Nos. 1H, 2H, 3H, 4H, and 5H. Official notice of these records has been taken.

[2] Chesapeake contends that the Fort Worth Commercial Recorder, which according to the 2010 Texas Newspaper Directory published by the Texas Press Association has a circulation of 311, is a newspaper having general circulation in Tarrant County. This is an issue presently under consideration in other pending dockets, but need not be decided here. As far as the hearing file shows, only one envelope containing the notice of hearing sent by mail to mineral interest owners in the proposed MIPA unit was returned to the Commission by the postal service. A supplemental notice was issued to this owner, and this notice was not returned to the Commission. Because all mineral interest owners in the proposed unit appear to have received the notice by direct mail, the issue of whether notice was published in a newspaper of general circulation is moot. Section 102.016 of the MIPA requires notice by publication only if there are unknown owners or owners whose whereabouts are unknown.

because compulsory pooling was not shown to be required to avoid the drilling of unnecessary wells, prevent waste, or protect correlative rights as required by §102.011 of the MIPA.

DISCUSSION OF THE EVIDENCE

The well proposed to be drilled on the Glen Garden MIPA Unit, if compulsory pooling is ordered, is Well No. 1H ("MIPA well"). On February 3, 2010, Chesapeake filed a Form W-1 (Application for Permit to Drill, Recomplete, or Re-Enter) seeking a Rule 37 exception permit for Well No. 1H on the 192.16-acre Glen Garden Unit, a voluntary pooled unit, in the Newark, East (Barnett Shale) Field, Tarrant County, Texas. A Notice of Application regarding this Form W-1 filing was issued on February 9, 2010, to 11 owners of tracts that were then unleased and closer to the proposed well than allowed by the well spacing rule applicable to the field. No protests were filed, and on March 3, 2010, Chesapeake was issued Rule 37 Exception Permit No. 690726 permitting the drilling of Well No. 1H on the 192.16-acre Glen Garden Unit. The well configuration and location of Well No. 1H authorized by Rule 37 Exception Permit No. 690726 are the same as the configuration and location of Well No. 1H now proposed to be drilled on the proposed MIPA unit.

Appendix 1 to this proposal for decision is a copy of the plat (Chesapeake Exhibit No. 1) filed with the Form W-1 seeking a Rule 37 exception for Well No. 1H on the 192.16-acre voluntary Glen Garden Unit. Appendix 2 to this proposal for decision is a copy of the plat (Chesapeake Exhibit No. 5) filed with this MIPA application. The proposed MIPA unit contains 50.371 acres. This same 50.371 acres is a part of the 192.16-acre Glen Garden voluntary pooled unit on which Chesapeake obtained a Rule 37 exception permit for drilling Well No. 1H and on which four other horizontal wells, Well Nos. 2H, 3H, 4H, and 5H already have been drilled. Some tracts that were unleased in February 2010 when Chesapeake filed the Form W-1 application for a Rule 37 exception permit for Well No. 1H and in May 2010 when Chesapeake filed this MIPA application had been leased by Chesapeake as of the date of the hearing in this docket in September 2010. At the time of the hearing in this docket, there were four unleased tracts within the perimeter of the proposed MIPA unit, Tract Nos. 2, 22, 46, and 63. The other 74 tracts within the perimeter of the proposed MIPA unit are leased to Chesapeake pursuant to oil and gas leases that allow Chesapeake to pool the tracts into a voluntary pooled unit. Appendix 3 to this proposal for decision is a plat (Chesapeake Exhibit No. 13) of the proposed MIPA unit updated to the date of the hearing. The proposed MIPA well will not traverse any unleased tract within the perimeter of the proposed MIPA unit. Tract Nos. 2, 22, 46, and 63, which are unleased, appear to be, respectively, 149 feet, 116 feet, 225 feet, and 154 feet away from Well No. 1H.

The Newark, East (Barnett Shale) Field has special field rules providing for 330' lease line spacing, and there is no between well spacing requirement. As to horizontal wells, where the horizontal portion of the well is cased and cemented back above the top of the Barnett Shale formation, the distance to any property line, lease line, or subdivision line is calculated based on the distance to the nearest perforation in the well, and not based on the penetration point or terminus.

Where an external casing packer is placed in a horizontal well and cement is pumped above the external casing packer to a depth above the top of the Barnett Shale formation, the distance to any property line, lease line, or subdivision line is calculated based on the top of the external casing packer or the closest open hole section in the Barnett Shale. The standard drilling and proration unit for gas in the Newark, East (Barnett Shale) Field is 320 acres. An operator is permitted to form optional drilling units of 20 acres.

According to Chesapeake, Dale Property Services, LLC ("Dale") made an effort to lease the four unleased tracts within the perimeter of the proposed MIPA unit. Leases could not be obtained from the owners of these tracts, and so, on April 28, 2010, Chesapeake sent the unleased owners a formal offer to pool voluntarily. This offer recited that the unleased owners had not responded affirmatively to a lease offer made by Dale, so that Chesapeake assumed that the unleased owners did not wish to lease. The voluntary pooling offer stated that all offers to lease were withdrawn. No evidence was presented as to the terms on which Dale had attempted to lease the unleased tracts.

Chesapeake's voluntary pooling offer to the unleased owners stated that Chesapeake proposed to form a 50.371-acre pooled unit and to drill a horizontal well in the Newark, East (Barnett Shale) Field.[3] This offer stated that the estimated cost to drill the proposed horizontal well was $2,808,000. Chesapeake's voluntary pooling offer provided the unleased owners with a single option, that is, to participate in the drilling and completion of the proposed well as working interest owners by paying their proportionate share of all well costs. The offers stated that the proportionate share of the unleased owners would be as follows: Erma Taylor Mitchell (0.493 acres) - $27,482.74; Christine Barrett (0.401 acres) - $22,351.21; City of Fort Worth (0.082 acres) - $4,571.14; Secretary of HUD (0.224 acres) - $12,487.18; and Ricardo Sanchez (0.447 acres) - $19.037.70.[4] The offer required that each unleased owner's share of well costs be paid at least 15 days prior to commencement of drilling operations or that the unleased owners reimburse Chesapeake by paying 200% of the unleased owner's share out of his or her share of production. The offer also stated that if an unleased owner elected to participate as a working interest owner, Chesapeake would forward the owner a Joint Operating Agreement ("JOA") which would be a standard AAPL JOA. The unleased owners were required by the offer to notify Chesapeake of their election to participate as working interest owners within 14 days, failing in which they would be deemed to have elected not to pool voluntarily and Chesapeake would seek a compulsory pooling order from the Railroad Commission under the MIPA.[5]

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[3] The offer did not disclose that the 50.371 acres were included in the 192.161-acre Glen Garden voluntary pooled unit already formed by Chesapeake, that Chesapeake had already obtained a Rule 37 exception permit to drill Well No. 1H on the 192.161-acre voluntary unit, or that Chesapeake already had drilled and completed, and was producing, four other horizontal wells on the 192.161-acre voluntary unit.

[4] The City of Fort Worth leased to Chesapeake subsequent to the date of the voluntary pooling offer.

[5] The offer to the Secretary of HUD was sent to an address in Addison, TX. There is no evidence on this point, but the examiners assume that the U. S. Department of Housing and Urban Development must have some

At the hearing, Chesapeake presented its Exhibit No. 17, which is a copy of an AAPL Form 610-1982 Model Form Operating Agreement. This is the JOA in effect for the 192.16-acre Glen Garden voluntary pooled unit, and Chesapeake requests that this JOA be approved for the proposed MIPA unit in the event the proposed compulsory pooling is approved. The JOA describes the interests of the parties, has provisions relating to title examination and loss of title, designates and defines the responsibilities of the operator, and has provisions relating to drilling and development of the unit, expenditures and liability of the parties, acquisition, maintenance or transfer of interests, internal revenue code election, claims and lawsuits, force majeure, notices, the term of the JOA, compliance with laws and regulations, and miscellaneous provisions.[6]

At the hearing, a Chesapeake geologist presented a structure map on top of the Barnett Shale showing a north to south trending anticlinal feature bounded to the east and west and a bit to the southwest by normal faults. This geologist also presented a stratigraphic cross section of two wells to the north and south of the proposed MIPA unit showing relatively consistent formation thickness and rock quality between the wells. An isopach map of the Barnett Shale formation from the top of the formation to the Ordovician Unconformity contoured from pilot wells in the area was also presented, and Chesapeake's geologist estimated that the proposed MIPA well should encounter a formation thickness of about 350 to 360 feet. Chesapeake's geologist expressed the opinion that all of the acreage within the perimeter of the proposed MIPA unit is reasonably productive of hydrocarbons.

A Chesapeake reservoir engineer presented an Authorization for Expenditure ("AFE") showing that the cost of drilling and completing the proposed MIPA well will be $2,010,380. Bar graphs of costs of surrounding wells and of average drilling, completion, and production equipment costs for Barnett Shale wells over time from July 2008 to April 1, 2010, were also presented to show that the estimated costs of the proposed MIPA well are reasonable.

Chesapeake's reservoir engineer also presented a plot of estimated ultimate recoveries versus drainhole length for producing wells within 5 miles of the proposed MIPA unit which predicts that a horizontal well drilled in this area should recover 1.1745 MMCF per foot of drainhole plus the plot's intercept of 619.05 MMCF.[7] The proposed MIPA well will have effective drainhole length

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nature of office in Addison. However, there is no evidence that there is any HUD employee located at Addison, TX authorized to act on a voluntary pooling offer, much less within 14 days, and the examiners officially notice that the Secretary of HUD is not located in Addison.

[6] Although the JOA is an AAPL Model Form Operating Agreement as described in Chesapeake's voluntary pooling offer, this JOA, by strike through, insertions, or additions, has more than 40 modifications made by Chesapeake, some of which are minor and others of which might be of significance to persons considering participation as a non-operating working interest owner.

[7] Chesapeake's reservoir engineer did not say how many wells were studied in this plot, but there are roughly 105 data points on the plot.

of 1,520 feet. Assuming this well will recover 619.05 MMCF plus 1.1745 MMCF per foot of drainhole, the well will recover about 2.4 BCF. If Chesapeake were required to drill the proposed MIPA well in the same location but keep all perforations at least 330 feet away from all unleased tracts, only 360 feet of drainhole could be perforated. A well with effective drainhole length of only 360 feet would be expected to recover only about 1.04 BCF. A vertical well drilled in this area would be expected to recover 0.6 BCF and would not be economic.

Chesapeake's reservoir engineer believes that the proposed MIPA well will drain the proposed unit, including the unleased tracts within the perimeter of the unit. He does not believe that the acreage in the proposed unit will be drained by any other existing well or any future well drilled at a regular location. No evidence was presented by Chesapeake as to the current recoverable gas beneath the 192.16-acre Glen Garden voluntary pooled unit as a whole or beneath the 50.371 acres included in the proposed MIPA unit.

Chesapeake's reservoir engineer also testified that there are risks associated with drilling of wells in the Barnett Shale, including encountering unknown faults, variations in rock quality that may affect production, and mechanical or operating problems. Chesapeake's reservoir engineer used a plot of rate of return versus estimated ultimate recovery and a plot of "EUR Cumulative Probability" to support his testimony that for a typical Barnett Shale well with typical costs, assuming an average gas price of $5.50 per MCF, a recovery of 2,225 MMCF is required to achieve a 10% rate of return on investment and recovery of 1,350 MMCF is required for the well to pay-out the cost to drill and complete the well. According to this reservoir engineer, approximately 82% of Chesapeake's Barnett Shale wells achieve a recovery greater than 1,350 MMCF and approximately 56% of wells achieve a recovery of 2,225 MMCF.

EXAMINERS' OPINION

The Railroad Commission is a creature of the Legislature and has no inherent authority. *Public Util. Comm'n v. GTE-SW Corp.*, 901 S.W.2d 401, 407 (Tex. 1995). Like other state administrative agencies, the Commission has only those powers that the Legislature expressly confers upon it and any implied powers that are necessary to carry out the express responsibilities given to it by the Legislature. *Public Util. Comm'n v. City Pub. Serv. Bd.*, 53 S.W.3d 310, 316 (Tex. 2001). It is not enough that the power claimed by the Commission be reasonably useful to the Commission in discharging its duties; the power must be either expressly conferred or necessarily implied by statute. The agency may not exercise what is effectively a new power, or a power contradictory to the statute, on the theory that such a power is expedient for administrative purposes. *Id.*

The Commission, therefore, does not have unlimited authority to compel the pooling of mineral interests whenever it is presented with a compulsory pooling application that in some sense may be deemed conceptually sound. Compulsory pooling may be ordered only as expressly authorized by the MIPA, which is a limited compulsory pooling statute unique to Texas. Smith and

Weaver, *Texas Law of Oil and Gas*, Vol. 3, Chapter 12, §12.1(B) at page 12-5 (LexisNexis Matthew Bender 2010).

The examiners are of the opinion that the Chesapeake application must be dismissed because Chesapeake did not make a fair and reasonable offer to pool voluntarily, and, accordingly, the Commission does not have jurisdiction. In the event it is concluded that the examiners are mistaken in this, the examiners are of the opinion that the application must be denied because Chesapeake did not establish the compulsory pooling is necessary to avoid the drilling of unnecessary wells, prevent waste, or protect correlative rights.

No Fair and Reasonable Offer

The examiners conclude that the Commission is required to dismiss the application because Chesapeake did not make a fair and reasonable offer to owners of the other interests in the proposed unit to pool voluntarily. Section 102.013 of the MIPA requires that the applicant for forced pooling "set forth in detail the nature of voluntary pooling offers made to the owners of the other interests in the proposed unit." This section also provides that the Commission *shall* dismiss the application if it finds that a fair and reasonable offer to pool voluntarily has not been made by the applicant. The Commission does not have jurisdiction under the MIPA unless a fair and reasonable offer to pool voluntarily has been made. *Carson v. Railroad Com'n of Texas*, 669 S.W.2d 315, 316 (Tex. 1984). The MIPA has thus been characterized by scholars as a "compulsory voluntary pooling act," because a force pooling order will not issue unless the applicant has made a strong effort to secure pooling voluntarily and has been rebuffed. See Smith and Weaver, *Texas Law of Oil and Gas*, Vol. 3, Chapter 12, §12.1(B) at page 12-5 (LexisNexis Matthew Bender 2010).

A fair and reasonable offer to pool voluntarily is one which takes into consideration those relevant facts, existing at the time of the offer, which would be considered important by a reasonable person in entering into a voluntary agreement concerning oil and gas properties. *Carson v. Railroad Com'n of Texas*, *supra* at page 318. Whether an offer to pool voluntarily is "fair and reasonable" is to be judged from the standpoint of the party being forced to pool. *Windsor Gas Corp. v. Railroad Com'n of Tex.*, 529 S.W.2d 834, 837 (Tex.Civ.App.-Austin 1975, writ dism'd as moot); *Pend Orielle Oil & Gas Co., Inc. v. Railroad Com'n of Texas*, 788 S.W.2d 878 (Tex.App.-Austin 1990, writ granted), affirmed in part, reversed in part on other grounds 817 S.W.2d 36 (Tex. 1991).

When judged from the standpoint of the parties being forced to pool, Chesapeake's voluntary pooling offer to the unleased owners was not fair and reasonable. The only option provided to the unleased owners by the offer was a working interest participation, which required the unleased owners to commit to a contributions in the range from $4,571.14 to $27,482.74 prior to the drilling of the well. The proportionate cost to the three unleased residential owners was $27,482.74 in the case of Erma Taylor Mitchell, $22,351.21 in the case of Christine Barrett, and $19,037.70 in the case of Ricardo Sanchez. If the unleased owners did not have this kind of money to invest, the only alternative provided by the offer was an election to be carried as working interest owners with the

unleased owners' share of costs to be reimbursed out of their share of production. If this election were made, Chesapeake's offer required that the unleased owners be subjected to a 100% risk penalty, which, according to the offer, would have increased Erma Taylor Mitchell's share of costs to $54,965.48, Christine Barrett's share to $44,702.42, and Ricardo Sanchez's share to $38,075.40. Providing the *sole* option to the unleased residential owners of committing within 14 days to an investment in Chesapeake's well of $19,037.70 to $27,482.74, or suffering a 100% risk penalty if they did not have the money to invest, was not fair and reasonable when judged from the standpoint of the unleased owners.

The voluntary pooling offer made to the unleased owners overstated these owners' proper share of costs because the estimate in the offer of the total amount of drilling and completion costs was also overstated by $797,620.[8] Furthermore, the voluntary pooling offer did not provide the unleased owners with the option of leasing to Chesapeake on terms comparable to those contained in Chesapeake leases covering other tracts in the proposed unit, an option that would not have required the unleased owners to pay a pro rata share of the costs of the proposed well. The offer recited that the unleased owners had not responded affirmatively to a prior offer to lease from Dale Property Services, LLC, and so Chesapeake made the assumption that the unleased owners did not wish to lease. However, if, in fact, Dale made such an offer, no evidence was presented as to the lease terms offered to the unleased owners from which the reasonableness of the offer could be judged, and the more important point is that Chesapeake's voluntary pooling offer stated specifically that "All offers to lease your tract are hereby withdrawn."

A voluntary pooling offer that includes only a working interest participation option may be unfair and unreasonable when viewed from the standpoint of an unleased mineral interest owner who is unable to accept the offer. See Smith & Weaver, *Texas Law of Oil and Gas*, Vol. 3, Chapter 12, §12.3(B) at pages 12-38 and 12-39 (LexisNexis Matthew Bender 2010). For recent comparable MIPA cases considered by the Commission that involved a voluntary pooling offer containing a lease option in addition to a working interest participation option, see Oil & Gas Docket No. 09-0252373; *Application of Finley Resources, Inc. for the Formation of A Unit Pursuant to the Mineral Interest Pooling Act for the Proposed East Side Unit, Newark, East (Barnett Shale) Field, Tarrant County, Texas* (Final Order served August 26, 2008); Oil & Gas Docket No. 09-0261375; *Application of XTO Energy, Inc. Pursuant to the Mineral Interest Pooling Act for the Proposed Rosen Heights 262.192045 Acre Pooled Unit, Well No. 1H, Newark, East (Barnett Shale) Field, Tarrant County,*

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[8] The estimated costs in the voluntary pooling offer sent to the unleased owners in April 2010 was $2,808,000. The language in the offer that disclosed that this was an estimate at least implied that the proportionate share of costs to each owner might be more: "This is an estimated cost, which could change considerably due to numerous factors faced while drilling, stimulating and completing a well, in addition to verifying title and the acreage amounts in each tract within the Unit." The costs of drilling and completing Well No. 1H as shown by the AFE presented at the hearing in September 2010 are $2,010,380. Chesapeake's reservoir engineer attempted to explain the difference by saying that the estimated costs had been "updated" to reflect then current costs which were said to be *lower*. The examiners do not find it credible that Chesapeake's costs for drilling and completing the proposed well decreased by $797,626, or 28.4%, during the five month period between April and September 2010.

Texas (Final Order served August 19, 2009); Oil & Gas Docket No. 09-0261248; *Application of XTO Energy, Inc. Pursuant to the Mineral Interest Pooling Act for the Proposed Texas Steel "B" Pooled Unit, Newark, East (Barnett Shale) Field, Tarrant County, Texas* (Final Order served February 10, 2010; motion for rehearing granted to permit XTO to withdraw application); Oil & Gas Docket No. 09-0260202; *Application of XTO Energy, Inc., for Creation of A Force Pooled Unit Pursuant to the Mineral Interest Pooling Act for Its Texas Steel "A" Unit, Well No. 1, Newark, East (Barnett Shale) Field, Tarrant County, Texas* (Final Order served February 10, 2010).

Furthermore, Chesapeake's voluntary pooling offer did not provide an opportunity to the unleased owners to participate, even as working interest owners, on the same yardstick basis as other working interest owners in the Glen Garden Unit. The 50.371-acre voluntary unit proposed in the voluntary pooling offer was fictional. The offer did not disclose that the 50.371 acres in the proposed MIPA unit were part of the 192.16-acre Glen Garden voluntary pooled unit which Chesapeake had already formed or that four horizontal wells already had been drilled on the 192.16-acre voluntary unit. The existing working interest owners presumably are participants in *all* wells drilled on the 192.16 acre unit, and prospectively in the proposed MIPA well, while the unleased owners were provided an opportunity to participate as working interest owners in the proposed MIPA well only.

The failure of Chesapeake to provide the unleased owners with a copy of the Joint Operating Agreement that Chesapeake proposed in the voluntary pooling offer is a further reason why the offer was not fair and reasonable when judged from the standpoint of the unleased owners. The JOA is the basic agreement that defines the rights, obligations, and liabilities of the working interest owners and the relationship of the operator and the non-operating working interest owners. The voluntary pooling offer stated that the proposed JOA was "a standard AAPL Joint Operating Agreement" and "the same form Chesapeake has used for working interest owners participating in its wells in the area." However, Chesapeake offered to provide the unleased owners with a copy of the JOA only *after* the unleased owners had elected to pool their interests and participate as working interest owners.

At the hearing, it was disclosed that the JOA in effect for the 192.16-acre Glen Garden voluntary pooled unit is an AAPL Form 610-1982 Model Form Operating Agreement with more than 40 modifications made by Chesapeake by strike through of pre-printed provisions in the AAPL form, or by insertions or additions of provisions of Chesapeake's choosing. Many of these modifications are minor, but others might be of significance to persons considering participation as non-operating working interest owners. Just as examples, the unleased owners might have been interested to know that Chesapeake was proposing a JOA form that Chesapeake had modified so as to provide that costs incurred by Chesapeake in processing "spacing and pooling orders including fees paid outside attorneys" would be borne by all working interest owners and that Chesapeake had stricken a pre-printed provision in the AAPL form that required the agreement in writing of the working interest owners before drilling operations commenced of the rate of charges for employment by Chesapeake of its own tools and equipment in the drilling of wells.

A further reason that Chesapeake's voluntary pooling offer was not fair and reasonable is that the offer allowed the unleased owners to reimburse Chesapeake for their proportionate share of well costs out of their share of production only if the unleased owners were subject to a 100% risk penalty. This is not the type of case wherein 100% risk penalties traditionally have been deemed fair and reasonable, for example, a case where a small tract owner willingly seeks to force his way into an adjacent tract where a well has been drilled in a reservoir carrying considerable risk. Here, the unleased small tract owners are the parties being force pooled. In the two "reverse MIPA" cases involving the Barnett Shale that have been approved by the Commission, where small tract owners were force pooled into a unit on the application of the lessee of an adjacent large block of acreage, the Commission declined to impose a risk penalty against the owners being force pooled.[9] Even in more traditional MIPA cases, a 100% risk penalty is fair and reasonable only where drilling of the proposed well poses a high degree of risk.

To support its position that there is "risk" involved in drilling of Barnett Shale wells, Chesapeake attempted to show that a "typical" well with "typical" costs needs a recovery of 2,225 MMCF to achieve a 10% rate of return and a recovery of 1,350 MMCF to pay out the cost of drill and complete the well. According to Chesapeake, 82% of its Barnett Shale wells have estimated ultimate recoveries of greater than 1,350 MMCF and 56% of its wells have estimated ultimate recoveries of greater than 2,225 MMCF. This does not mean, however, that only 82% of Chesapeake's Barnett Shale wells pay out and only 56% achieve a 10% rate of return. To know this, a well-by-well comparison of well costs and estimated ultimate recoveries would be required.

Even if it is assumed that 82% of the Barnett Shale wells drilled by Chesapeake pay out the cost to drill and complete the wells, a 100% risk penalty is not justified. This is particularly true of drilling on any portion of the Glen Garden Unit, where four horizontal wells already have been drilled, apparently successfully. Chesapeake's evidence is to the effect that the Barnett Shale is productive beneath all of the acreage in the proposed MIPA unit and there is consistent formation thickness and rock quality across this acreage. Chesapeake projects that the proposed MIPA well will recover about 2.4 BCF, which is substantially in excess of the amount of gas, based on Chesapeake's gas price assumption, to achieve a 10% rate of return. There is no "risk" involved in drilling of the proposed MIPA well, other than the normal risk associated with drilling any horizontal well, certainly no risk that would justify imposition of a 100% risk penalty on those unleased residential owners unable to pay their proportionate share of well costs in advance of drilling.

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[9] Oil & Gas Docket No. 09-0252373; *Application of Finley Resources, Inc. for the Formation of A Unit Pursuant to the Mineral Interest Pooling Act for the Proposed East Side Unit, Newark, East (Barnett Shale) Field, Tarrant County, Texas* (Final Order served August 26, 2008); Oil & Gas Docket No. 09-0261375; *Application of XTO Energy, Inc. Pursuant to the Mineral Interest Pooling Act for the Proposed Rosen Heights 262.192045 Acre Pooled Unit, Well No. 1H, Newark, East (Barnett Shale) Field, Tarrant County, Texas* (Final Order served August 19, 2009).

Compulsory Pooling Not Required

Chesapeake is clearly able to drill the Glen Garden Unit, Well No. 1H on its leased acreage and thus protect its own correlative rights and those of its lessors *without the need for compulsory pooling*. This is true because Chesapeake is not only able to drill a well at a Rule 37 location on its leased acreage, but has already obtained a Rule 37 exception permit allowing the drilling of precisely the same well now proposed as the MIPA well. As shown on Appendix 1 to this proposal for decision, the Rule 37 well for which Chesapeake has a drilling permit can be drilled without the slightest chance of any unintentional trespass on any unleased tract. Under the MIPA, the Commission may order compulsory pooling only if it is necessary to avoid the drilling of unnecessary wells, protect correlative rights, or prevent waste. Smith & Weaver, *Texas Law of Oil and Gas*, Vol. 3, Chapter 12, §12.3[A][6] at page 12.23. The Commission previously has determined that compulsory pooling may not be ordered if the applicant has the ability to drill wells at Rule 37 locations on a voluntarily formed unit that will serve these statutory purposes just as well as the proposed MIPA well.[10]

Chesapeake suggests that compulsory pooling as proposed will protect the correlative rights of the mineral interest owners of unleased tracts within the perimeter of the proposed unit. But Chesapeake represents its own interest and the interests of non-operating working interest owners and its lessors, not the interests of the unleased owners who have indicated their preference not to participate in Chesapeake's unit and well by declining to accept Chesapeake's voluntary pooling offer. It is immaterial that some may think that the unleased owners have not acted wisely in declining to lease and/or pool their mineral interests. Unless the application conforms strictly to the requirements of the MIPA, neither Chesapeake nor the government has authority to make this decision for them.[11]

Chesapeake's claim that compulsory pooling will avoid the drilling of unnecessary wells on the unleased tracts is not factually supported. There is little likelihood that an unnecessary well could or would be drilled on the unleased tracts, which are very small tracts in a residential area

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[10] See Oil & Gas Docket No. 09-0260202; *Application of XTO Energy, Inc. for Creation of A Force Pooled Unit Pursuant to the Mineral Interest Pooling Act for the Texas Steel "A" Unit, Well No. 1H, Newark, East (Barnett Shale) Field, Tarrant County, Texas* (Final Order served February 10, 2010) wherein a MIPA application was denied based, in part, on Finding of Fact No. 22 to the effect that with a Rule 37 exception, and without compulsory pooling, a horizontal well could be drilled on a voluntarily pooled unit with drainhole length in excess of the proposed MIPA well. A similar finding was adopted in the Final Order served February 10, 2010, in Oil & Gas Docket No. 09-0261248; *Application of XTO Energy, Inc. Pursuant to the Mineral Interest Pooling Act for the Proposed Texas Steel "B" Pooled Unit, Newark, East (Barnett Shale) Field, Tarrant County, Texas* (Motion for Rehearing granted for the purpose of permitting applicant to withdraw application).

[11] The examiners have officially noticed that Chesapeake has permitted and drilled Well Nos. 2H, 3H, 4H, and 5H on the 192.16-acre Glen Garden voluntary pooled unit without compulsory pooling. Well Nos. 2H, 3H, and 5H have Rule 37 permits. Well No. 3H was permitted 171' feet from an unleased tract internal to the Unit, and Well No. 2H was permitted 208 feet from an unleased tract internal to the Unit.

ranging in size from 0.224 acres to 0.493 acres.

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

FINDINGS OF FACT

1. Notice of this hearing was provided by mail to all interested parties at mailing addresses provided by the applicant at least 30 days prior to the hearing. One envelope containing the notice was returned to the Commission, but in this instance a supplemental notice was issued and was not returned.

2. By this application, Chesapeake Operating, Inc. ("Chesapeake") requests that the Commission enter an order pursuant to the Mineral Interest Pooling Act ("MIPA"), Chapter 102, Natural Resources Code, force pooling all mineral interests in 78 separate tracts of land into the proposed 50.371-acre Glen Garden MIPA Unit for the drilling of proposed Well No. 1H ("MIPA well"), a proposed horizontal well to be completed in the Newark, East (Barnett Shale) Field, Tarrant County, Texas.

3. On February 3, 2010, prior to the filing of this MIPA application, Chesapeake filed a Form W-1 (Application for Permit to Drill, Recomplete, or Re-Enter) seeking a Rule 37 exception permit for Well No. 1H on the 192.16-acre Glen Garden Unit, a voluntary pooled unit, in the Newark, East (Barnett Shale) Field, Tarrant County, Texas. Rule 37 Exception Permit No. 690726 was issued for Well No. 1H on March 3, 2010. The well authorized to be drilled by Rule 37 Exception Permit No. 690726 is the same well as the MIPA well proposed to be drilled in the present application.

4. Appendix 1 to this proposal for decision, incorporated into this finding by reference, is a copy of the plat (Chesapeake Exhibit No. 1) filed with the Form W-1 seeking a Rule 37 exception permit for Well No. 1H on the 192.16-acre Glen Garden voluntary pooled unit. Appendix 2 to this proposal for decision, incorporated into this finding by reference, is a copy of the plat (Chesapeake Exhibit No. 5) filed with this MIPA application.

5. Chesapeake has currently effective oil and gas leases covering 74 of the 78 tracts of land proposed to be included in the Glen Garden MIPA Unit. Chesapeake's oil and gas leases allow Chesapeake to pool the 74 leased tracts into a voluntary pooled unit. There are four tracts of land, Tract Nos. 2, 22, 46, and 63, within the perimeter of the proposed MIPA unit that are currently unleased. The unleased tracts are small lots ranging in size from 0.082 acres to 0.493 acres.

6. The leased acreage included in the proposed 50.371-acre MIPA unit is currently a part of Chesapeake's 192.161-acre Glen Garden Unit, a voluntary pooled unit. As of the date of the

hearing, Chesapeake had already permitted five horizontal wells in the Newark, East (Barnett Shale) Field on this voluntary pooled unit, including Well No. 1H (the "MIPA" well). The other wells on the Glen Garden voluntary unit have been drilled and are producing. The Glen Garden Unit Well No. 2H (RRC No. 239760) was completed on June 20, 2008, and through February 2011 had produced 606,908 MCF. The Glen Garden Unit Well No. 3H (RRC No. 246850) was completed on July 6, 2008, and through February 2011 had produced 532,047 MCF. The Glen Garden Unit Well No. 4H (RRC No. 246865) was completed on June 21, 2008, and through February 2011 had produced 800,536 MCF. The Glen Garden Unit Well No. 5H (RRC No. 246865) was completed on July 4, 2008, and through February 2011 had produced 730,381 MCF.

7. Appendix 3 attached to this proposal for decision is a copy of a plat (Chesapeake Exhibit No. 13), updated to the date of the hearing, showing the proposed MIPA unit and well, and leased and unleased tracts withing the perimeter of the proposed MIPA unit. The proposed MIPA well will not traverse any unleased tract within the perimeter of the proposed MIPA unit. Tract Nos. 2, 22, 46, and 63, which are unleased, are, respectively, 149 feet, 116 feet, 225 feet, and 154 feet away from Well No. 1H.

8. The Newark, East (Barnett Shale) Field was discovered on October 15, 1981. This field has special field rules providing for 330' lease line spacing, and there is no between well spacing requirement. As to horizontal wells, where the horizontal portion of the well is cased and cemented back above the top of the Barnett Shale formation, the distance to any property line, lease line, or subdivision line is calculated based on the distance to the nearest perforation in the well, and not based on the penetration point or terminus. Where an external casing packer is placed in a horizontal well and cement is pumped above the external casing packer to a depth above the top of the Barnett Shale formation, the distance to any property line, lease line, or subdivision line is calculated based on the top of the external casing packer or the closest open hole section in the Barnett Shale. The standard drilling and proration unit for gas in the Newark, East (Barnett Shale) Field is 320 acres. An operator is permitted to form optional drilling units of 20 acres.

9. On April 28, 2010, Chesapeake sent the unleased owners within the perimeter of the proposed MIPA unit a formal offer to pool voluntarily. Taking into consideration those relevant facts, existing at the time of the offer, which would be considered important by a reasonable person in entering into a voluntary agreement concerning oil and gas properties, and when judged from the standpoint of the unleased owners being forced to pool, the Chesapeake voluntary pooling offer was not fair and reasonable.

   a. The only option provided to the unleased owners by the offer was a working interest participation, which required the unleased owners to commit to contributions in the range from $4,571.14 to $27,482.74 prior to the drilling of the well. The proportionate cost to the three unleased residential owners, as stated in Chesapeake's voluntary pooling offer, was $27,482.74 in the case of Erma Taylor Mitchell, $22,351.21 in the case of Christine Barrett, and $19,037.70 in the case of Ricardo Sanchez.

b. Prior to Chesapeake's voluntary pooling offer, Dale Property Services, LLC, apparently attempted to lease the unleased tracts, but no evidence was presented at the hearing as to the lease terms offered to the unleased owners by Dale from which the reasonableness of the lease offer could be judged.

c. The Chesapeake voluntary pooling offer stated that "All offers to lease your tract are hereby withdrawn." The voluntary pooling offer to the unleased owners required by §102.013 of the MIPA did not include an option to lease on terms comparable to those contained in Chesapeake leases covering other tracts in the proposed unit, an option that would not have required the unleased owners to pay a pro rata share of the costs of the proposed well.

d. The voluntary pooling offer made to the unleased owners overstated these owners' proper share of costs because the estimate in the offer of the total amount of drilling and completion costs was also overstated by $797,620. The estimated cost of drilling and completing the proposed MIPA well stated in Chesapeake's voluntary pooling offer sent to the unleased owners was $2,808,000. The costs of drilling and completing this well as shown by the AFE presented at the hearing in September 2010 is $2,010,380.

e. If the unleased owners did not have the required amount money to invest prior to drilling of the proposed MIPA well, the only alternative provided by the offer was an election to be carried as a working interest owners with the unleased owners' share of costs to be reimbursed out of their share of production. If this election were made, Chesapeake's offer required that the unleased owners be subjected to a 100% risk penalty, which, according to the offer, would have increased Erma Taylor Mitchell's share of costs to $54,965.48, Christine Barrett's share to $44,702.42, and Ricardo Sanchez's share to $38,075.40.

f. Providing the sole option to the unleased residential owners of committing within 14 days to an investment in Chesapeake's well of $19,037.70 to $27,482.74 or suffering a 100% risk penalty if they did not have the money to invest was not fair and reasonable when judged from the standpoint of the unleased owners.

g. Chesapeake's voluntary pooling offer to the unleased owners to allow them to reimburse Chesapeake for the unleased owners' pro rata share of well costs out of their share of production only if the unleased owners were subjected to a 100% risk penalty was not fair and reasonable taking into consideration the relevant facts existing at the time of the offer.

I. There is no extraordinary risk involved with the drilling of Barnett Shale wells in the area of the proposed MIPA unit.

ii. At the time of Chesapeake's voluntary pooling offer, Chesapeake already had drilled four horizontal wells on the 192.161-acre Glen Garden voluntary

pooled unit, with apparent success. No evidence was presented by Chesapeake to establish that any extraordinary operational difficulties or costs were experienced in the drilling of these four wells.

iii. The Barnett Shale is present and productive throughout the area of the proposed MIPA unit and there is consistent formation thickness and rock quality across the acreage in the proposed MIPA unit.

iv. Chesapeake projected that the proposed MIPA well will recover about 2.4 BCF of gas, which is substantially in excess of the amount of gas, based on Chesapeake's analysis and gas price assumption, to achieve a 10% rate of return.

v. Chesapeake projected that a "typical" Barnett Shale well with "typical" costs must recover, based on Chesapeake's gas price assumption, 1,350 MMCF to pay out the cost to drill and complete the well and 2,225 MMCF to achieve a ten percent rate of return. Chesapeake estimated that 82% of its Barnett Shale wells have estimated ultimate recoveries of more than 1,350 MMCF and 56% have estimated ultimate recoveries of more than 2,225 MMCF. Chesapeake did not, however, present a well-by-well comparison of well costs and estimated ultimate recoveries to establish what percentage of its Barnett Shale wells pay out and what percentage achieve a 10% rate of return.

h. Chesapeake's failure to provide the unleased owners with a copy of Chesapeake's proposed Joint Operating Agreement with the voluntary pooling offer was not fair and reasonable.

I. A Joint Operating Agreement did not accompany the voluntary pooling offer sent to the unleased owners by Chesapeake.

ii. The voluntary pooling offer stated that if the unleased owners elected to participate as working interest owners, Chesapeake would forward to the unleased owners a Joint Operating Agreement which would be a standard AAPL Joint Operating Agreement, being the same form Chesapeake had used for working interest owners participating in Chesapeake's wells in the area.

iii. Chesapeake's voluntary pooling offer required the unleased owners to elect to participate in the proposed unit as working interest owners before the unleased owners were provided with a copy of the Joint Operating Agreement.

iv. A Joint Operating Agreement is the basic agreement that defines the rights, obligations, and liabilities of the working interest owners and the relationship of the operator and the non-operating working interest owners.

v. The Joint Operating Agreement in effect for the 192.16-acre Glen Garden voluntary pooled unit, which is the agreement that the Commission is requested to approve if compulsory pooling is ordered, is an AAPL Form 610-1982 Model Form Operating Agreement with more than 40 modifications made by Chesapeake by strike through of pre-printed provisions in the AAPL form, or by insertions of additional provisions.

vi. Some of the modifications in the AAPL Form 610-1982 Model Form Operating Agreement made by Chesapeake concern matters which might be considered important by a reasonable person in entering into a voluntary agreement concerning oil and gas properties.

I. Chesapeake's voluntary pooling offer did not provide the unleased owners with an opportunity to participate as working interest owners on the same yardstick basis as other working interest owners in the Glen Garden Unit.

I. The unleased owners were offered working interest participation in a well proposed to be drilled on a 50.371-acre unit.

ii. The voluntary pooling offer did not disclose that the 50.371 acres in which the unleased owners were offered participation were included in the 192.16-acre Glen Garden voluntary pooled unit which Chesapeake had already formed or that four horizontal wells already had been drilled on the 192.16-acre voluntary unit.

iii. The voluntary pooling offer to the unleased owners did not provide them with the same opportunity afforded the existing working interest owners to participate as working interest owners in all wells drilled on the 192.16-acre voluntary unit.

10. No evidence was presented to establish the amount of current recoverable gas beneath the proposed MIPA unit.

11. Compulsory pooling is not necessary to avoid the drilling of unnecessary wells, prevent waste, or protect the correlative rights of Chesapeake and its lessors.

a. The Glen Garden Unit Well No. 1H can be drilled by Chesapeake on the 192.16-acre Glen Garden voluntary pooled unit, without compulsory pooling, in exactly the same configuration and at the same location, pursuant to Rule 37 Exception Permit No. 690726 issued for Well No. 1H on March 3, 2010.

b. There is no gas that would be recovered by the proposed MIPA well that could not be recovered equally as well by Well No. 1H if drilled on the 192.16-acre Glen Garden voluntary pooled unit pursuant to Rule 37 Exception Permit No. 690726 issued for Well No. 1H on March 3, 2010.

c. There is no evidence that unnecessary wells could or would be drilled on the four unleased 0.224-acre to 0.493-acre tracts within the perimeter of the proposed MIPA unit in the absence of compulsory pooling.

d. For the Commission's regulatory purposes Chesapeake represents its own interest and the interests of its lessors, but does not represent the interests of the owners of unleased tracts within the perimeter of the proposed MIPA unit who have indicated their preference not to participate in Chesapeake's unit and well by declining to accept Chesapeake's voluntary pooling offer.

CONCLUSIONS OF LAW

1. Pursuant to Texas Natural Resources Code §102.016, notice of the hearing was given to all interested parties by mailing the notices to their last known addresses at least 30 days before the hearing.

2. Chesapeake Operating, Inc. did not make a fair and reasonable offer to pool voluntarily to the owners of other interests in the proposed unit, and the Commission is required to dismiss the application pursuant to Texas Natural Resources Code §102.013(b).

3. Chesapeake Operating, Inc. did not prove that compulsory pooling as proposed is necessary to avoid the drilling of unnecessary wells, prevent waste, or protect correlative rights.

RECOMMENDATION

The examiners recommend that the application be dismissed for lack of jurisdiction under Texas Natural Resources Code §102.013(b). Alternatively, in the event it is determined that the Commission has jurisdiction, the examiners recommend that the application be denied.

Respectfully submitted,

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Hearings Examiner

Marshall Enquist
Hearings Examiner

Andres J. Trevino
Technical Examiner