ORAL ARGUMENT – 10/20/04
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SEAGULL ENERGY V. RAILROAD COMMISSION

MCELROY: Texas law has long recognized the right of a property owner to a well in each of the separate reservoirs beneath that owner's land. Texas courts have held that this is a vested property right. The issue before the court today is whether the legislature has authorized the RRC to take away that property right? The leading case...

HECHT: The commission says that you are entitled to whatever oil and gas is below your property one way or the other, whether it's more out of one formation or less of another formation. Is that your understanding of their argument?

MCELROY: My understanding is, is that the commission says that we can deprived of what we have in what we call the C sand, and we can make up for it out of some other reservoir.

HECHT: What's wrong with that?

MCELROY: That's the same argument that was made in Benz-Stoddard in the 4th CA. That's the CA's opinion in Benz-Stoddard. The protestant said Benz-Stoddard who had .115 acres of land with one completion to get many times more than her share out of one completion than if you added all of the different reservoirs up together.

HECHT: The court said the commission should regulate that through allowables.

MCELROY: That is correct, not through permitting. And here, the commission is trying to regulate through permitting not allowables. They are trying to deny us a permit.

HECHT: What practical difference does it make?

MCELROY: You don't have the right to an allowable unless you have a well that is legally permitted. It's a two-step process. There are several cases cited in our brief that discusses the two-step process: from getting a permit; to having an allowable. The right to a well is a vested property right; however, the right to an allowable is not a vested property right. Once we have a permit for a well, then we are entitled to an allowable, and that's where the commission adjusts the correlative rights of the various owners in the competing reservoir. That's how it gets balanced out, not through the denial of the right to a well to begin with, which is the issue here.

HECHT: Do you agree that even if you were allowed to operate two wells simultaneously, that steps should be taken to restrict production so you didn't recover more than what you own below the surface?

MCELROY: Yes. I think the way the commission could easily handle the situation is to say, Seagull you get your permit for the Davis No. 1 well in the C Sand, and you've got your permit for the Davis No. 4 in the Stroud and Taylor Sands. And that's okay, but you can't ever have two wells in only one of those Sands at the same time.

HECHT: Can they also say that below the land in the three Sands, we think there is this much and that's all you are ever going to get?

MCELROY: That's never been the law in Texas. There are several cases - RR Commission v. Texas Company, where the Texas Company was held by the court to be entitled to a well to recover not only what was under its land but also that which migrated to its land. It's part of the rule of capture. So far up to now there's never been a situation where somebody who has a permit to produce their oil and then the RRC says, King X, you've got to plug that well, you got what we said was your share. Because the law says you get not only what's there originally, but if something migrates to your land you are entitled to recover that also.

OWEN: There's production surrounding you, so can't they effectively do that through the allowable?

MCELROY: Yes. They can regulate everybody's fair share through the allowable. That is how it's done.

OWEN: I need to know the details of that. First of all, I want to hear your best read of the statutory scheme. When it talks about co-mingling, are they talking about co-mingling somewhere in the region or co-mingling on a specific lease in the statute?

MCELROY: They are talking about co-mingling these several separate reservoirs that make up - for example, in this cotton valley reservoir, the Waskom Cotton Valley Field, there are three separate reservoirs. The first one is called the Stroud.

OWEN: I understand that. I understand all that. But do you look at whether there is co-mingling lease by lease, or do you look at it on a field-wide basis?

MCELROY: In the statute, that was designed to permit co-mingling on a field-wide basis between separate common reservoirs.

OWEN: So if there's been co-mingling off your lease, that gives the commission the right to set allowables based on the co-mingling for your lease even if there's no physical co-mingling on your lease?

MCELROY: That's correct. The commission is still setting allowables as though we're co-mingling even though we're not able to co-mingle to C Sand, because we don't have a well in.

OWEN: And you don't take issue with that?

MCELROY: No. The legislature did that to correct what the SC found to be failing in the statutes under Gage and Graford.

OWEN: So in setting the allowables for the existing well that you have that's currently able to produce, they could take in to account what is being produced somewhere else out of the C Sand and set your allowable higher for the other two sands?

MCELROY: They can't legally do that.

OWEN: How do the allowables work? Why is it that you can't be made whole from allowable on your existing well in the two sands taking into account what you would get from the C Sand if you had a well on the C Sand?

MCELROY: Because the law says that we have a right to have a mine or a wellbore in that C Sand also. Until you have the well in and you are producing and you see how a well is going to perform, you really don't know...

OWEN: What if they give you a very, very low allowable on the C Sand. Can they give you a higher allowable on the other sands to make up for your fair share of the pie?

MCELROY: It doesn't work that way. The way it works is, the Waskom Cotton Valley Field consists of three separate reservoirs. Under the law, the commission has authority to permit the co-mingling, and under the statute that was enacted in 1981 the commission has the authority to set allowables, prorate those co-mingled reservoirs. And so the prorated allowable applies to all three reservoirs together. So it's not an allowable for a discrete sand. It's an allowable for the co-mingled reservoirs together.

OWEN: But it's allowable per well is what I'm getting at. It's a per well allowable and in setting the allowable for the well that's in the 2 Sands, not the C Sand, can they take into account had you had a wellbore in the C Sand, and allow you to get your fair share out of all three reservoirs?

MCELROY: We do not believe they can legally do that.

OWEN: Why not?

MCELROY: Because that is depriving us of the right to a well in the C Sand. That's the very same argument that was made in Benz-Stoddard in the CA.

OWEN: Assume you have a well in the C Sand. They just give you low allowable for that well, and they give you a higher allowable for the other well so that in the end of the day you are still recovering the same percentage that you would have otherwise.

MCELROY: From a regulatory standpoint, the way the commission sets allowables it's set on field basis. Under that statute, 86.081, the commission sets the allowables on the combined reservoirs, not on individual discrete Sands. So the first step is, as the legislature authorized the co-mingling of the separate gas sands, and then the legislature says, Commission you can prorate those co-mingled Sands for allowable purposes. And they are prorate collectively. We don't have a problem with prorating the Sands collectively. The problem we have is, we don't even have a permit to be in all of the Sands that are underneath our lease. It would be a different case altogether if it wasn't so clear that these are separate reservoirs. There may be a situation where you can't tell the difference. But here we have 300 feet of separation.

OWEN: I'm just trying to get - at the end of the day how are you better off having wellbore in the C Sand than you are today? Can they or can they not do the same thing through the allowables?

MCELROY: No. They can not.

OWEN: I need details on why they can't.

MCELROY: Because without a completion in the C Sand we're not getting our gas out of the C Sand. And those reserves which are beneath our property today belong to us and we can't get to them.

OWEN: How does that affect your allowable for your well?

MCELROY: It doesn't affect the allowable. We're talking two different processes. One process is getting a permit to a well. Once you have the permit, then the allowable is set.

OWEN: Let's say you get both wells permitted. You are producing them both. Would your allowable be any different for one well or for the two wells combined?

MCELROY: The allowable is different, because there are factors that are used to set the allowable in the field. A percentage of the allowable is assigned based on acreage, and a percentage is assigned based on the capability of the wells.

OWEN: So it does make a difference in your allowable?

MCELROY: Yes. If we have two wells, then we have less acreage for our two wells as compared to other people, so we get - that's how they make up for it, is by using acreage as a factor. And so the issue is the right to the permit to begin with, and the commission's view that Benz-Stoddard isn't the law anymore.

HECHT: In Benz-Stoddard we said at the end that we were concerned about whether this was going to work out right or not. And then we said, the right to control the rate of flow in

order to prevent waste also enables the commission to offset the advantage obtained by one who is given an exception to the spacing rule by limiting his allowable production to the extent necessary to overcome this advantage. Do you think that this can be done or cannot be done?

MCELROY: Yes. It can be done. And it's done by using acreage as a factor in assigning allowables. And as long as everybody is assigned allowables on the same basis without discrimination based on their prorate share of acreage, then the commission has done its job legally. And that's how you fix the problem. You don't fix it by saying you don't get a well in this reservoir. Imagine a situation if we had drilled our first well and we had gotten one of the Sands and we didn't get the other two or three or four. And the commission says, That's okay. We will take care of it with allowables. The law says you get the well first, and then you get allowables adjusted to keep everything in balance. And we don't think the commission has been given the authority by the legislature that overrules Benz-Stoddard.

OWEN: Now here you're saying something different and that's why I'm having trouble with this. I thought you just got through saying, Yes, it does affect your allowable and it would be higher if you get permission to produce from the C Sand as opposed to if you don't get permission. I think you just said to J. Hecht that No, they can even it all out.

MCELROY: It's even out based on acreage. The allowable is adjusted to keep everything fair. And we agree that they have the authority to do that. There's no question about that. What they don't have the authority to do is to say you don't get a well. And that's how we are going to protect somebody else's...

OWEN: So the only way you can get acreage is to have a producing well?

MCELROY: Yes. You've got to have a well first and then once you have a permit for the well, and that's what we are asking for - a permit for the well. Once you have a permit, then you go to the next step and ask for the assignment of the allowable. And the permit or the right to a well in the first place is a vested property right under Texas law. Whereas, the right to a specific allowable over a long period of time, that's not a vested right, and the commission has authority to adjust the allowables as necessary. If the commission perceives that there is some imbalance, then that's how the problem is fixed, but it's not fixed by depriving a property owner of the right to a well.

O'NEILL: If there were ten fields here as there were in Benz-Stoddard, could you put 10 different wells all together, produce them all? Because I think they are arguing Benz-Stoddard is limited to a single wellbore.

MCELROY: Benz-Stoddard is one hole in the ground but it's three separate wells. And the SC's analysis there is based on the statute that talks about each completion in a single wellbore is treated as a separate well. You have one piece of pipe that produces from one zone, another piece of pipe in the same hole producing from another zone.

O'NEILL: So your answer would be yes, you could go put 10 different wells. You could drop 10 wells if there were 10 different fields.

MCELROY: Yes.

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RESPONDENT

HUBENAK: The commission's authority in this case stems directly from §86.081 of the Natural Resources Code. This provision authorizes the commission to regulate the production from multiple Sands as a single common reservoir.

OWEN: Let's say there was no well out there at all. And Seagull came to the commission and said, I want to drill one well and I want a permit to perforate in three different Sands. Would the commission have the legal authority to say no, you can only perforate in one?

HUBENAK: No. Because this well is co-mingled.

OWEN: No. There is no well out there. This would be a brand new well. We don't know what's down there.

HUBENAK: And that happens all the time. When someone has a tract and they are drilling their first well in the Waskom Cotton Valley Field, they can perforate every Sand that they encounter. Because this field has been co-mingled, they are able to take one string of casing, one straw if you will, down the wellbore and out of that straw wherever they encounter a Sand they can produce gas.

In the clerk's record in vol. 2, there's a copy of the field rules in this field. And what the field rules show is - at the time in 1991 in the last hearing they held in this case on the field rules, there were 12 identifiable Sands present in the Waskom Cotton Valley Field. So if the well was lucky enough to produce 12 Sands, it's going to have better production. The findings of the commission at that time are that a well's performance is incumbent about how many Sands they encounter.

HECHT: Can they drill in the one Sand and then move over 100 feet and drill in to the second Sand?

HUBENAK: They don't have to drill - if they can crack it they don't have to move the well over.

HECHT: Can they drill multiple wells in different Sands?

HUBENAK: No. The resolution of the issues before this court, it is important for this court

to understand not only the proceedings surrounding the Davis Well that we have before you, but the proceeding that happened at the commission years ago when the commission held a hearing at the request of an operator to co-mingle all the Sands in the field as one single common reservoir.

OWEN: Do you agree with your opponent that co-mingling is looked at on a field basis and not a lease by lease basis?

HUBENAK: Yes.

OWEN: So, I own a track, there's no well on it at all, but there's been co-mingling of Sands somewhere else. So when I drill my first well on my lease can the RRC say No, you can only hit this Sand and no other?

HUBENAK: No.

OWEN: Where do you get the statutory authority for that?

HUBENAK: The commission cannot prevent - when they co-mingle that's where it is.

OWEN: It's co-mingled. That's the key. We agree it's co-mingled.

HUBENAK: The commission does not - when a field is co-mingled and you drill your first well in the track, you can perforate whatever Sand you encounter.

OWEN: Where do you get the statutory authority for saying first well and no other well?

HUBENAK: Because a mineral interest owner on a tract is entitled to the hydrocarbons beneath their tract, their fair share or the equivalent. As a matter of right people get a first well.

OWEN: Where does the statute say you get a first well and no other well?

HUBENAK: 86.081 allows the commission to prorate, allocate and regulate the co-mingled production as if it is a single common reservoir. In a single common reservoir, in one reservoir you are entitled to one well to get your fair share.

OWEN: Again, I'm saying where do you get the statutory authority that says we have to give you one but we don't have to give you more?

HUBENAK: It's protection of correlative rights and prevention of waste, the overall mandates that the commission does. The commission is required to adjust correlative rights of all the mineral interests owners in the field rule, and when the field rule hearing was held years ago, spacing and density and operation of the wells in the entire field was done on the basis that all the

mineral interests owners...

OWEN: It's been co-mingled off my lease. I drill my first well and I only encounter one Sand. And then later I do some more work and I say, I can encounter three if I drill a second well. Would the commission have the right to say no, you cannot drill the second well into the other three Sands?

HUBENAK: The commission would give you the opportunity as they did Seagull to come to the commission and show that this well that you have, the hydrocarbons you are going to get out of that well will not get you your fair share of the hydrocarbons in the lease. That is what Seagull failed to show the commission.

OWEN: How do you set the allowables? Under my example, you said, I drill into one sand, I want to drill into three others, and you say no. Do you increase my allowable on my existing well to get me my hydrocarbons?

HUBENAK: The way allowables are done as a practical measure in this field, as most fields in Texas today is what they call AOF, absolute open flow. What you can produce, you get to produce.

OWEN: So I'm not getting my fair share of hydrocarbons because I don't have a well under these other three Sands.

HUBENAK: Keep in mind. When the commission co-mingles this field, the separateness of these gas accumulations cease to exist.

OWEN: But from my standpoint, I only have a straw into this reservoir, and my open flow is only what I can get out of that straw.

HUBENAK: Right. And what you have to show the commission is that first well in the co-mingled field will not give you fair share. You come to the commission and you say, I have got X amount of hydrocarbons beneath my tract. What Seagull should have done. The Davis mineral interest owners have X amount of hydrocarbons beneath the Davis tract. The current well that I have will only give me Y. X minus Y is a deficit. I am entitled to a second well. That's what Seagull failed to show the commission.

HECHT: If the operator drills a first well, and it produces in all three Sands (3 sands in this case), then that's one situation. But if an operator drills the first well and it only produces in one, you are going to tell them whether they can drill into the other two or not. And why should that depend on whether the luck that you produced in three Sands or one Sand?

HUBENAK: That is the nature of this field. It is discontinuing Sands. They appear. They don't honor property lines. They come and go. And so at one location, just as it happened here,

Seagull was able to complete two Sands in Well No. 4, this newer well they drilled, but they only were able to complete one in the older well, Well No. 1.

HECHT: I know that. What sense does that make is what I'm asking?

HUBENAK: The sense is that it's a way for the commission to regulate. The field rules were adopted on the basis of the field being treated, all the Sands collectively as a whole. What Seagull wants is the advantage of taking one string of casing and being able to perforate wherever in that casing it encounters Sand. But it wants to pull the sea Sand out for spacing and density purposes. That is contrary to...

HECHT: Well why would that matter? What difference does it make that the sea is producing in another well instead of this well if they hit it, which is what they wanted to do?

HUBENAK: That's why it's called fair share or the equivalent. What they may be getting off the Davis tract in the Taylor and Stroud, and the record shows this. They are draining an adjacent lease. Some other tract is producing from the sea reservoir on adjacent tract, and they are draining from the Davis mineral interest owners. What Seagull failed to show the commission is that as a whole, all the Sands treated as one they didn't combine all the hydrocarbons and show the commission that you're not getting your fair share from your current well, that one well in the field.

HECHT: I agree that's the position. If they hit in all three sands they don't have to prove that.

HUBENAK: No.

HECHT: But if they don't, they do. Why should they have to prove one thing if they are lucky in one if they are not?

HUBENAK: Because that's the way the field rules set up spacing and density. The field rules require that you have a minimum amount of 80 acres for a well. So once you have your first well as a matter of right, you have 80 acres devoted to that well. This tract is 115 acres. So it doesn't have another 80 acres for the second well. That happens in fields everywhere. That would happen in Benz-Stoddard. In Benz-Stoddard, they were completing each individual reservoir through a separate stream of casing. Three straws or six straws. I think the CA opinion said they were capable of putting 6 completions in that wellbore. And so Benz-Stoddard in that case they are able to pull from wherever. But those reservoirs were not co-mingled. Each completion was a first well in that separate reservoir. In the co-mingled field the commission's authority is to prorate, allocate and regulate the co-mingled field, and regulate as this court recognized in the Ponderei(?) case gives the commission discretion.

OWEN: That's where I have trouble with the statutory language. If you say co-mingled, the authority is there from the get go once it's co-mingled somewhere in the field. The

logical conclusion of that is that the commission has the authority as you say to limit any wells once it's co-mingled.

HUBENAK: Once it's co-mingled what someone is entitled to as a matter of law is that they still get that first well, whatever sands they encounter if they are fortunate...

OWEN: I don't understand where you get the statutory language for that. If it's co-mingled and you have this authority that's out there. Period. Where do you say, okay, we have to give you one well but we don't have to give you two? And we have to give you one well with 6 perforations, but we don't have to give you one well if you have more than one.

HUBENAK: Because we regulate the field on a field wide basis. Once the field is regulated as a single common reservoir, the individual sands cease to exist.

O'NEILL: Tell me what that hearing looks like to get it designated as a co-mingled field?

HUBENAK: First of all, the commission doesn't choose to do it. There's an implication in some of the briefing that the commission just decides they are going to co-mingle. It's only done at the request of an operator. The statutory requirement in 86.012(b), we have to give notice, we have to have a hearing and we have to have evidence.

O'NEILL: I'm more concerned about what the nature of the evidence is.

HUBENAK: The evidence is that wells in this field are going to encounter a random of sands. That's in the record in the field rules where the examiner when they amended the fields rules in 1991 says well performance is incumbent upon the number of sands that you encounter.

O'NEILL: Is this a fairly unique thing for a field to be co-mingled?

HUBENAK: Not at all. The reason that you have the history of the Graford case, the Gage case, Mote Resources and this case, is that co-mingling is an important tool for the industry. At one point some of the briefing indicates that it's an administrative convenience for the commission and that's not true. It's a requests of the industry. It is so much better for someone when you have these small sands to be able to put one wellbore down one straw, if you will, wherever you encounter sand, you can produce those sands altogether as one. It prevents the unnecessary drilling of wells.

The evidence that they show is that spacing and density on a certain basis is fair to all the mineral interest owners, all the property owners in the field, all operators will be on the same basis. And a certain spacing and a certain density is appropriate for wells that may be encountering one sand or more. The testimony, I think, is that a well could drain anywhere from 59 acres to something over 600. That's the nature of a lenticular sand.

Seagull's own witness at the commission, at page 45 of the administrative

hearing, acknowledged that when the commission has a co-mingled field lenticular zones are not differentiated. The commission doesn't differentiate about whether...they don't permit on the basis of the Taylor and the Stroud. They don't permit on the basis of the sea. They permit on the basis of the Waskom Cotton Valley Field.

HECHT: But here's the problem. And I don't understand the commissions response to it. You have two landowners right next to one another and the same size tracts, not enough for two wells, 90 acre tracts. So one fellow drills a well and hits all three sands. The other fella hits a well and he only hits one sand. You are going to tell the second guy he can't drill anymore, and the first guy can. The first guy was lucky enough to hit all three sands. Unless the second guy could come in and prove that he's not going to get his fair share of this water.

HUBENAK: That's correct. We're not depriving people of their property rights. We are requiring to adjust all the correlative rights of all the operators in the field. The person who says this one sand I got it wasn't enough they have to show the commission that.

HECHT: But why would you treat the two differently. There are two people, they seem to be on equal footing except one was luckier than the other.

HUBENAK: It truly is a matter of luck. But you don't treat them differently. What Seagull is trying to do is treat the sea sand separate. He's attacking the field rules where all the sands are treated the same. He's basically wanting a field rule change. Seagull could go to the commission and ask that the sea sand be set up as a separate reservoir, as its own single common reservoir. He could pull the sea sand out. That's what he is trying to do here by asking this court to allow him to drill a well on the basis of just the sea: But commission, I want to perforate whatever sands I encounter because you co-mingled, and you can prorate on the co-mingled basis, but I want to treat the sea sand differently. That's counter to the field rules.

HECHT: They shut in well No. 1. Now suppose they say, okay, given where we are we're going to shut in no. 4, we're going to move over and drill another one, and hopefully produced in all three sands. The commission would let them do that?

HUBENAK: We would let them do that.

HECHT: That doesn't strike me as making much sense.

HUBENAK: It's based on the field rules, and if the field rules don't make sense to the operator, then the operator should ask the commission to change the field rules for all the operators. Keep in mind that all the operators on adjacent leases are doing the same thing. They are drilling wells and are encountering anywhere from one to three to more sands.

BRISTER: In the hypothetical J. Hecht puts forward is Seagull going to be able at the end of the day to produce more gas?

HUBENAK: It's very possible that it could be produce more than its fair share. Unless we have an operator in an adjacent lease that comes in and says this operator is producing more than their fair share and we need an adjustment of correlative rights, the commission doesn't really stop someone once they got 12 sands producing telling them that they can't produce more.

WAINWRIGHT: If there were in that hypothetical we've been talking about 80 acres for an additional well, then you wouldn't have a problem with another one?

HUBENAK: No. That's the nature of spacing and density. The whole rule 37, rule 38, everyone is entitled to a first well on a tract, but if your tract is too small for a second well, then you need a spacing exception or a density exception.

WAINWRIGHT: Even if you can't hit all three sands?

HUBENAK: You could hit all three sands.

OWEN: Going back to J. Hecht's hypothetical. Again, I'm struggling with your statutory authority. Let's say Seagull shuts in both wells that they currently have that are permitted, they drill a third well. You say you would permit that?

HUBENAK: Like they did in the case, if they voluntarily shut in these two wells and they agree they will not simultaneously produce two wells on the tract, they could drill a third well.

OWEN: Are they entitled to statutorily to drill the third well?

HUBENAK: It would become essentially, what we call the first well on the tract.

OWEN: That's what I am struggling with. We've got two wells. They are permitted. They are just shut in. And you say that statutorily you would have to give them a third well. Where does that come from?

HUBENAK: Because they are entitled to their fair share of the hydrocarbons.

OWEN: Where does that come from in the statute?

HUBENAK: It's not in the statute.

OWEN: They co-mingled. You could say, No, you've got two wells. Take your pick. We are not going to give you a third.

HUBENAK: It's a right that they have. It's a matter of Texas law that a mineral interest owner is entitled to recover their share of the hydrocarbons beneath their tract. That is the law in Texas. And what the commission does is regulate that. That's long history of the commission's

regulation. So the commission is regulating people's fair share, they are adjusting correlative rights. If Seagull chooses to shut in two wells and try a third well to get as many sands as it wants, then it can do that so long as it doesn't have on this tract more than one well.

OWEN: But under your construction of the statute they have co-mingled. There's been co-mingling off the lease, there's been co-mingling on the lease. And under your construction of the statute once they've co-mingled you have the right to control production. So why can't you say to them, No, you can't have a third well.

HUBENAK: If the third well is the only well producing on the tract, that is their mechanism to get their fair share.

OWEN: But they've got two wells. They could produce out of either. Where in the statute does it say you have to give them the third well?

HUBENAK: They are entitled to obtain their fair share. If that third well needed an exception of some type, they would have to come to the commission and show the commission...

OWEN: No. They just voluntarily...this is where the disconnect for me is.

HUBENAK: This tract is a 115 acre tract. The field rules require that you have 80 acres to produce a well. If they want to drill a new well no. 5 and devote the 80 acres to that well, that is their economic business choice. If they want to do that to get as many hydrodcarbons as they can out of the field, the commission doesn't stand in their way. That's their business choice. Economically, I would wonder why they would want to do that. 86.081 gives the commission to prorate, allocate and regulate co-mingled fields. This court, J. Cornyn in this case, in the Ponderi(?) case by this court said, that language gave the commission broad discretion over co-mingled fields. So the commission doesn't look at the individual sands. We don't look at the Taylor or the Stroud. We look just at the co-mingled field.

O'NEILL: I'm always fascinated when a case, each side says the sky will fall if we rule the other way. And they say that if the CA's decision is allowed to stand it's going to turn oil and gas on its head. What do you think the effect will be if we were to hold that they are entitled to drill under the sea sand?

HUBENAK: I'm going to give you two versions. One, is that it's possible that the commission will do the same thing that it did following Graford and Gage, and the Ponderi(?) case and J. Cornyn cites Smith and Weaver where they say that after the commission couldn't control the field, it was reluctant to co-mingle fields because it affected the integrity of the proration system. If the commission cannot control space and density on a co-mingled field basis, and like Seagull wants them to pull sand out by sand, then the field rules that are in effect the commission can't enforce it. And they might be very reluctant to co-mingle fields. That's an economic advantage for operators. The second possibility is the commission could do nothing and wait for operators on

adjacent leases to come to the commission and complain because people are drilling far more wells than are necessary for the efficient drainage of the co-mingled field.

O'NEILL: And then what? I understand their position would be well that's the way you should handle it. Let them sink their well and fight it out at that level. What would be wrong with that?

HUBENAK: It's an attack on the field rules. The field rules have been set up for all the property owners to be protected on a field wide co-mingled basis. And the commission wouldn't be able to protect the property rights of people, the operators in this instance.

O'NEILL: They couldn't take care of that by adjusting the allowable?

HUBENAK: It would be very difficult in this day in age with the industry being what it is. The commission really does not curtail production. It's really absolute open flow. That probably is a third scenario, is that the commission could go back to setting allowables based on what your fair share is in the field and say to Seagull you haven't show us that you are not getting your fair share out of the co-mingled field. And you can have your permit, but we will give you a very small allowable if any.

O'NEILL: So the sky wouldn't fall?

HUBENAK: The sky wouldn't fall, but I think it would affect all co-mingling fields in Texas not just this field. And I think that co-mingled fields are commonly done. They are an economic advantage to the business operator and I would hate to see there being a concern about not co-mingling.

OWEN: But basically what you just said, Seagull is going to get drained, because the allowable is full up in flow and you aren't going to cut it back. So the guy who is on the other side that are draining the two leases in which Seagull has a well, plus the well that Seagull doesn't have a well in, so they are going to get drained.

HUBENAK: But Seagull didn't show the commission...this is a substantial evidence case...

OWEN: You just said though as a practical matter the allowable is absolute open flow and you're not going to give anybody a lower allowable. So if Seagull had hit two...

HUBENAK: But the very evidence in this case is that the Taylor and Stroud is draining the adjacent lease. That's why the protestant showed up and complained that well no. 4 is draining his lease. That's how you get your equivalent. If you have the Davis mineral tract, you don't get the very specific hydrocarbons that are there.

OWEN: You get the wells, and then the commission after that doesn't do anything with

the allowable. They just let everybody produce like they want to. In one of the amicus briefs someone mentioned 86.081(b) which talks about 86.095. Can you address that?

HUBENAK: It's not applicable here

WAINWRIGHT: You've suggested that based on the 80 acre rule and the allowables and other things the commission does, that it's seeking to promote an efficient development of the field.

HUBENAK: Correct.

WAINWRIGHT: That's something of an odd argument that the government is going to be more efficient in an area of private enterprise than independent, individual businesses. Isn't it?

HUBENAK: The commission historically has regulated the oil and gas industry. It's sort of like the umpire at the game.

WAINWRIGHT: I'm not questioning the commission's ability or right to regulate. I'm wondering how the commission as the government bureaucracy is going to be more efficient than businesses who are seeking to maximize value and have assets at risk.

HUBENAK: The evidence that the commission relies upon to co-mingle a field comes from the industry. The commission doesn't make up evidence. It's presented to us by the industry. So we rely upon evidence presented to us by the industry to make our finding.

O'NEILL: I understood you to say the industry favors co-mingling and is behind that concept, and, therefore, would logically be against Seagull's position in this case. But we have no amicus briefing from anybody in the industry.

HUBENAK: The amicus briefs from my perspective are concerned about the commission depriving property rights. And I think that's a misunderstanding of what we're doing. The commission is not depriving property rights of anyone. If a mineral interest owner has hydrocarbons to which they are entitled, they are entitled to produce them. The difference being of course is that in this case that these three sands, they are not separate anymore, they are co-mingled. And the commission regulates them as co-mingled. And so to that extent they don't need to have another well. They failed to show the commission, that's the substantial evidence standard, they failed to show them.

Typically and it's also in the Ponderei(?) case that economically it's an advantage for the industry. So I think from some of the amici curiae there was a concern that they were going to be deprived of property rights out of hand.

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REBUTTAL

MCELROY: J. O'Neill, there won't be any amicus brief from the industry in support of the commission's position for the reason that J. Hecht has pointed out. Here Seagull had a well producing in the C Sand. And they tried to do what the commission said to do: drill one well and get all three. There's no question, they had a valid permit to have a well in all three sands in the Davis No. 4 well, but as luck or the lack thereof would have it, they couldn't make a well in the C sand. So now are we to go out and drill a third well to try to be lucky. The issue in Texas is not a vested right to be lucky. It's a vested right to a well in each sand. Each separate reservoir. And this is not a confused situation. These are sands separated by hundreds of feet. In one case thousands of feet.

HECHT: Why isn't it fair for you to show that you are not getting your fair share?

MCELROY: This is a case involving legal confiscation. This is not a case necessarily where there is drainage. But there wasn't really any testimony of drainage in the administrative record. The fellow got up and said, we think the commission ought to regulate this as three. We've got a problem with the City of Waskom. And if we can't drill our well, we don't want them to have this well.

The difficulty is, it's almost an impossible task. And as J. O'Neill pointed out, in an AOF field if everybody is blowing and going, then how will you ever be able to prove that the well that you have in the Stroud and Taylor Sands, which you have a right to get what's coming out from under your ground, but also what comes from other land, that's a legally protected right. Now how can that be used, that legally protected right be used to offset and deny you another legally protected right in the C Sand.

This is a new interpretation that the commission has come up with with statutory authority over the last several years. And it is a big concern to the industry as demonstrated by the amicus briefs.

O'NEILL: How do you respond to the prediction that this will result in reluctance to co-mingle fields, to protect correlative rights?

MCELROY: Because now we know that if you co-mingle clearly separate reservoirs and you are not lucky on that first well, if you go back to the commission, you have a virtually impossible burden to meet in order to get another well to a separate sand. So the solution is not do it.

O'NEILL: You agree then that it will discourage co-mingling?

MCELROY: Absolutely. It is already discouraging co-mingling. And imaging a situation if you had a less than honorable lessee. You go out and you ask the RRC to consolidate from the surface down to the center of the earth. Nobody protest. So along comes a lessor and says, well you owe me a well under Amoco v. Alexander. I'm being drained from the Jason Tract. The RRC isn't going to give me a well lessor because it's all been consolidated and the commission now says it's not separate reservoirs even though physically it's a separate reservoir.

O'NEILL: So you disagree that operators like the co-mingling concept and are promoting it.

MCELROY: Operators like the co-mingling concept. Operators don't like how the RRC interprets its rules when applied to clearly separate reservoirs that have been co-mingled. You look at Smith and Weaver cited in our brief, the professors point out that field rules are applicable to each separate producing horizon. Until the last several years as this case has gone through the process, I think everybody thought that was the law, that was Benz-Stoddard. That's the cases that followed Benz-Stoddard. That you would apply the field rules to each separate reservoir. So if you have three reservoirs as here, then you can have one well in all three, or you can have a series of wells 2 in 1, 1 in the other, as we're asking for, or 1 well in each. But not without an exception two wells in the common source of supply.

When you look at the legislative history, the legislature was asked in 1979 and 1981 to change the definition of common reservoir, which is at the root of Benz-Stoddard. And the legislature refused to do that. Instead the legislature adopted - first they allowed co-mingling in the 1979 legislative session, and then they come back in 1981 and they amend the statute concerning regulation of production. 86.081 deals with regulation of allowables, not the regulation of the right to a well in the first place.

HECHT: But if you say the field rules apply per reservoir, you don't need an exception.

MCELROY: That's exactly right. You shouldn't need an exception.

HECHT: But you asked for one.

MCELROY: Well we tried to comply. I wouldn't want to come in here and ask y'all on the declaratory judgment action to rule that the way they interpret the rules to interpret them as applicable collectively rather than individually needs to be addressed by the court. You would tell me, how do you know the RRC is going to do that? Go try it. We tried it. And we failed. The commission is adamant in its position. The position should be corrected by this court. Just apply the rules to the reservoirs individually. When the facts show as they do here they are clearly separate reservoirs, it's not hard to regulate them to say, okay, you get your Davis No. 1 in the C. Don't be putting it in the Stroud and the Taylor. Don't complete it in the Stroud and the Taylor reservoir unless you come back and get an exception.

HECHT: Does a conclusion that field rules apply per reservoir go too far? Doesn't that strip the commission of the authority to make sure that at least in unusual cases, spacing and density are provided for?

MCELROY: If the reservoirs are clearly distinct, as they are here, where there's hundreds of feet of separation, there is no reason why the rules shouldn't be applied individually. But if I can't prove that these are not all in communication, if I can't prove it's not a common reservoir, then I'm

stuck with that and I'm going to be stuck with the commission's regulation...

HECHT: But it might be different if the geological structure was different?

MCELROY: If the geological structure was different, we might not be able to prove that we have three separate common reservoirs as we have here. But we proved it here.

OWEN: But we don't have to say that field rules apply reservoir by reservoir to resolve this case do we?

MCELROY: I think you might have to. I think that might be what it takes is to confirm what I think we all thought was the law, that where there is separate distinct reservoirs, the commission should apply its rules to those reservoirs individually for permitting purposes. Because the legislature says, once you get your well made, then we can co-mingle the allowable. That's okay. We will regulate the co-mingled allowable But for permitting purposes it has to be applied individually. And the reason is, if you don't go there we are talking about a constitutional problem, an interpretation of the rules that would bring those rules unconstitutional where the RRC could say over here we have three separate reservoirs, we are going to regulate those separately. On the other side of the county, we've got three separate reservoirs. Somebody has to co-mingle. We're are going to regulate those collectively.

Property law in Texas should not be so uncertain as to be left to the discretion of the RRC. This court in Poole and in King Ranch said there should be certainty to property rights.

O'NEILL: Is it possible that the commission's position in a particular case could result in nonproduction of a reservoir?

MCELROY: As in this case, yes.

O'NEILL: But I understand the C Sand is being produced by someone else who doesn't want you to be producing it as well. Presume that there was no production in the C Sand at all.

MCELROY: Then that would be the result. It would cause wait, which is also inconsistent with the commission's statutory authority. And in fact, the commission has never articulated a justification for this interpretation.