

PETROLEUM, INC.
PENNZOIL CO.

IBLA 87-767

Decided July 3, 1990

Appeal from a decision of the Dickinson District Office, Bureau of Land Management, upholding its prior decision to assess compensatory royalties for drainage from oil and gas lease M 15243 (ND).

Affirmed in part and set aside in part; referred for hearing.

1. Oil and Gas Leases: Compensatory Royalty--Oil and Gas Leases: Drainage

When the same party is the operator of both the Federal tract being drained and the offending well, BLM need not prove as a part of its cause of action that a protective well would be economic. In such cases the burden of producing evidence and the ultimate burden of persuasion on this issue rest with the common lessee.

2. Oil and Gas Leases: Compensatory Royalty--Oil and Gas Leases: Drainage

Compensatory royalties commence upon passage of a reasonable time following the date the lessee knew or should have known that drainage is occurring. The common operator who drills the offending well is in the best position to know that drainage is occurring. In such case BLM need not assume the initial burden of showing that the common operator knew or that a reasonably prudent operator should have known that drainage was occurring. The common operator is presumed to have knowledge of drainage upon first production from its offending well. This presumption is rebuttable by the common operator, who bears the ultimate burden of persuasion as to notice of drainage.

APPEARANCES: Laura Lindley, Esq., Denver, Colorado, for Pennzoil Company; Hugh V. Schaefer, Esq., Denver, Colorado, for Petroleum, Inc.; Roger W. Thomas, Esq., Office of the Field Solicitor, Billings, Montana, for the Bureau of Land Management.

OPINION BY ADMINISTRATIVE JUDGE KELLY

Petroleum, Inc. (PI), and Pennzoil Company (PZ) appeal an August 11, 1987, decision of the Dickinson, North Dakota, District Office (District Office), Bureau of Land Management (BLM), upholding its prior decision that oil and gas were being drained from lease M 15243 (ND). Although PI is the lessee of record for the lease allegedly being drained, PZ holds operating interests in that lease.

BLM informed PI that portions of its lease were subject to drainage by PZ's well No. 19-21, located in the NE $\frac{1}{4}$ NW $\frac{1}{4}$ sec. 19, T. 148 N., R. 101 W., fifth principal meridian, McKenzie County, North Dakota, in a letter dated June 29, 1984. The letter specified that only certain portions of the lease, specifically the W $\frac{1}{2}$ NW $\frac{1}{4}$ sec. 20; W $\frac{1}{2}$ SW $\frac{1}{4}$ sec. 17; and W $\frac{1}{2}$, W $\frac{1}{2}$ E $\frac{1}{2}$, E $\frac{1}{2}$, NE $\frac{1}{4}$, NE $\frac{1}{4}$ SE $\frac{1}{4}$ sec. 18, T. 148 N., R. 101 W., fifth principal meridian, McKenzie County, North Dakota, were subject to drainage. ^{1/} BLM advised that PI would be expected to drill a protective well unless it could demonstrate such a well would have little or no chance of profitable operation, and that in the event a protective well would be uneconomic, compensatory royalties would be assessed unless PI could show reservoir conditions prevent any drainage.

The first response to BLM's letter was received on August 31, 1984, and was prepared, not by PI, but by PZ. The conclusions of PZ's document were that no drainage was occurring from secs. 17 and 20 and, although those portions of lease M 15243 (ND) located within sec. 18 were being drained by well No. 19-21, an offset well would not be economic. By letter dated February 13, 1985, PI concurred with PZ's conclusions.

In a decision dated June 4, 1986, BLM indicated that oil and gas were not being drained from lease M 15243 (ND), and, consequently, neither an offset well nor compensatory royalties would be required. The copy of this decision received by PI does not indicate a drainage file number and nowhere does the letter specify that it is limited to any particular portion of PI's lease. BLM did not serve PZ with a copy of this document; however, according to both appellants, PI provided PZ with a copy.

BLM prepared a geologic review, dated May 27, 1985, and an engineering report, dated August 6, 1986, and issued another decision on August 12, 1986. In this decision, BLM agrees with PI and PZ that drainage is occurring from the southern portions of sec. 18, but disagreed with PZ's assertion that an economic well could not have been drilled. BLM states: "The information provided by Pennzoil was used in conjunction with additional reservoir data to calculate a drainage area. In addition, it was determined that an economic well could have been drilled during the life of the offending well to protect the subject federal acreage from drainage" (Aug. 12, 1986, Decision at 1). The decision indicates that the drainage

^{1/} Well No. 19-21 is located 706 feet from the boundary between secs. 19 and 18.

factor is 33.5 percent, and that a notice for payment of compensatory royalty would be sent by the Minerals Management Service (MMS). The final paragraph of this decision reads: "You may request a technical and procedural review [TPR] of any instructions, orders, or decisions issued by the Bureau of Land Management as described in 43 CFR 3165.3, or you may appeal pursuant to 43 CFR 3165.4 and 43 CFR 4.400, either directly or following a technical and procedural review" (Aug. 12, 1986, Decision at 2). BLM did not serve a copy of its August 12, 1986, decision on PZ and appellants assert that PI did not provide a copy of this document to PZ.

By decision dated May 1, 1987, MMS assessed PI \$123,821.02 in compensatory royalty for the period from December 20, 1982, through June 30, 1986. MMS did not serve a copy of this document on PZ; however, appellants both state that PI gave a copy of this document to PZ. The record includes a copy of PZ's appeal of the MMS assessment, which is dated June 5, 1987. According to PI, on June 4, 1987, it also appealed the MMS royalty assessment.

In a May 14, 1987, letter to the District Office, PI requested that BLM reconsider its decision of August 12, 1986. PZ requested a TPR by letter dated May 20, 1987. In response to PZ's request, the Montana State Office, BLM, declined to perform a TPR as it found the request to be untimely.

On May 28, 1987, BLM received a letter from PZ which summarized the results of its economic analysis of an offset well in the southern half of sec. 18. By letter dated June 4, 1987, BLM responded to PZ's economic data, indicating it would not change its drainage decision of August 12, 1986. By letter dated June 22, 1987, PZ again requested a TPR. This request was denied as untimely by letter dated July 1, 1987.

On July 1, 1987, BLM performed a computer economic analysis, which showed a 3.09-year payout period for an offset well. By letter dated July 6, 1987, BLM informed PI a protective well would be economic and declined to modify its August 12, 1986, decision.

BLM received technical objections to the drainage decision from PI on July 10 and 21, 1987. PZ filed technical objections on July 16 and 23, 1987. In addition, District Office personnel met with PI and PZ representatives on July 13 and 16, 1987, respectively. In its August 11, 1987, decision considering appellants' objections, BLM declined to change its 33.5-percent drainage factor. The decision states: "The Red River structure maps you presented were based primarily on seismic interpretation; due to the lack of precision associated with interpreting seismic highs, we do not believe that the information you submitted was adequately conclusive as to require a change in our drainage assessment" (Aug. 11, 1987, Decision at 1). PI filed a notice of appeal from this decision on August 24, 1987, and PZ filed its notice of appeal on September 10, 1987.

Although issues have been raised relating both to the timeliness of the notices of appeal and to PZ's standing before this Board, we find it

unnecessary to dwell on these issues. Although BLM arguably issued a final decision relating to drainage from lease M 15243 (ND) on August 12, 1986, it continued to discuss the drainage question with both PI and PZ, and, in fact, it analyzed data submitted by the companies. Finally, in its August 11, 1987, decision, BLM declined to change its drainage factor.

That decision constituted BLM's final action on the companies' objections to BLM's drainage conclusions regarding the lease. Each company filed a timely appeal of that decision. Each is properly before us and we will proceed to entertain their objections to BLM's drainage determination.

Two regulations are applicable to appellants' arguments concerning drainage. The first, 43 CFR 3100.2-2 (1986), provides:

Where lands in any leases are being drained of their oil or gas content by wells either on a Federal lease issued at a lower rate of royalty or on non-Federal lands, the lessee shall both drill and produce all wells necessary to protect the leased lands from drainage. In lieu of drilling necessary wells, the lessee may, with the consent of the authorized officer, pay compensatory royalty in the amount determined in accordance with 30 CFR 221.21.

The second, 43 CFR 3162.2(a) (1986), provides:

The lessee shall drill diligently and produce continuously from such wells as are necessary to protect the lessor from loss of royalty by reason of drainage. The authorized officer may assess compensatory royalty under which the lessee will pay a sum determined as adequate to compensate the lessor for lessee's failure to drill and produce wells required to protect the lessor from loss through drainage by wells on adjacent lands.

[1 & 2] In Cordillera Corp., 111 IBLA 61 (1989); Atlantic Richfield Co., 105 IBLA 218, 95 I.D. 235 (1988); and Atlantic Richfield Co. (On Reconsideration), 110 IBLA 200, 96 I.D. 363 (1989), we held that in the case of a common lessee, once BLM has established drainage, it need not prove as a part of its cause of action that a protective well would be economic. In such cases, the burden of producing evidence and the ultimate burden of persuasion rest with the common lessee. Furthermore, we held that although usually compensatory royalties commence upon passage of a reasonable time after the lessee knew or should have known that drainage is occurring, a common lessee is presumed to have knowledge of drainage upon first production from the offending well. See CSX Oil & Gas Corp., 104 IBLA 88, 95 I.D. 148 (1988).

These findings were based on the potential for unfair dealing and the fact that the common lessee possesses superior knowledge to BLM concerning both drainage and the economics of an offset well. Atlantic Richfield Co., *supra* at 225-26, 95 I.D. at 239-40. We think it reasonable to regard a common operator as equivalent to a common lessee when, as is the case here, PZ, the common operator, "shall conduct and direct and have full control of

all operations on the Contract Area" (Article V.A. of the January 14, 1982, Operating Agreement); has access to the Contract Area "to inspect or observe operations" and "to information pertaining to the development and operation thereof" (Article VI.D. of the Operating Agreement); and, of course, has the information about the offending well.

Thus, in this case, as in the common lessee cases, BLM need not prove as a part of its cause of action that a protective well will be economic. Rather, the burden of producing evidence and ultimate burden of persuasion on this issue rest with the common operator. Further, we hold that the common operator is presumed to have knowledge of drainage upon first production from the offending well, that this presumption is rebuttable, and that the common operator bears the ultimate burden of persuasion with respect to notice of drainage. See Cordillera Corp., *supra*; Atlantic Richfield Co., *supra*. 2/

The record clearly establishes that in the southern portion of sec. 18 lease M 15243 (ND) is being drained by PZ's well No. 19-21. In its

2/ BLM argues that we erroneously held in Gulf Oil Exploration & Production Co., 94 IBLA 364 (1986), modified, Atlantic Richfield Co., *supra*, and Nola Grace Ptasynski, 63 IBLA 240, 89 I.D. 208 (1982), that notice of drainage is a requirement for assessment of compensatory royalties. In support of this position, BLM submits a copy of the SOR it filed in Chevron U.S.A. Inc., 107 IBLA 126 (1989). We rejected these arguments in Chevron U.S.A. Inc. and we reject them here.

Further, we iterate our response in Chevron to BLM's argument that our holding in Gulf Oil, *supra*, and Ptasynski, *supra*, "conflicts with the BLM's policy * * * the BLM believes it is contrary to lease terms, regulations, and precedent * * * [and] [t]hus the BLM has not incorporated into its manual an allowance of a reasonable time after notice before assessing compensatory royalties * * *" (BLM Answer at 17):

[I]t is simply wrong to say that Board decisions are not binding on BLM outside the context of particular cases adjudicated by the Board. As we said long ago in Milton D. Feinberg (On Reconsideration), 40 IBLA 222, 228, 86 I.D. 234, 237 (1979), to the extent this Board interprets "regulations, statutes and Departmental policies as requiring or prohibiting certain actions, such interpretation establishes Departmental policy which is fully binding upon the Bureau until such time as it is altered by competent authority." (Emphasis in original.) Our ruling in Ptasynski that the obligation to protect a lease from drainage arose a reasonable time after notice by the lessor constituted such an interpretation of a Departmental regulation which was thereafter binding on BLM.

107 IBLA at 130, n.4.

August 31, 1984, submission PZ estimated the drainage at 6.299 percent, ^{3/} while in its letter dated July 22, 1987, PZ's estimate of the drainage factor is 11.3 percent. Before the Board, PI defers to PZ's technical conclusions and BLM estimates the drainage factor at 33.5 percent. Although the parties do not agree on the amount of drainage, they do agree that drainage is occurring. In Atlantic Richfield Co., supra at 224, 95 I.D. at 236, we concluded that a drainage factor of 4.4 percent was sufficient to require a finding as to whether or not an economic well could be drilled.

However, in addition to the drainage factor (and the amount of drainage that could have been prevented), whether an offset well would be economic in this case is a highly controverted issue. We are authorized to refer a case to an Administrative Law Judge for a hearing on issues of fact, 43 CFR 4.415, and we should do so "when there are significant factual or legal issues remaining to be decided and the record without a hearing would be insufficient for resolving them." Woods Petroleum Co., 86 IBLA 46, 55 (1985). We therefore refer this case to an Administrative Law Judge for a hearing on these issues, and on the issue of the amount of compensatory royalty due, if any. We note that the economics of an offset well are properly calculated from a reasonable time after first production of the offending well, i.e., June 22, 1982. Atlantic Richfield Co., supra at 228, 95 I.D. at 241. Because the presumption that the common operator had notice of drainage on that date is rebuttable, PZ shall be afforded an opportunity at the hearing to rebut this presumption; on this issue, as well as on the issue of the economic viability of an offset well, it bears the ultimate burden of persuasion, as discussed above. See also NGC Energy Co., 114 IBLA 141 (1990).

Accordingly, pursuant to the authority delegated to the Board of Land Appeals by the Secretary of the Interior, 43 CFR 4.1, BLM's decision is affirmed in part and set aside in part, and the case is referred to the Hearings Division, Office of Hearings and Appeals, for a hearing by an Administrative Law Judge in accordance with this decision. The decision of the Administrative Law Judge shall be final for the Department in the

^{3/} PZ contends that in the Aug. 7, 1987, memorandum from the District Office petroleum engineer and geologist to the district manager, the drainage factor from PZ's Aug. 31, 1984, submission is misstated as 7.05 percent. It is true that in summarizing the history of this case that figure was misquoted (Aug. 7, 1987, Memorandum at 1). However, we fail to see any significance to this fact as there is no allegation or indication that BLM's technical experts misused this statistic in any calculation or relied on the wrong value in any way. Moreover, subsequent to its Aug. 31, 1984, drainage factor estimate of 6.299 percent, PZ submitted a document estimating the drainage factor at 11.3 percent, a figure which is higher than the statistic misquoted in the Aug. 7, 1987, memorandum.

absence of any further appeal to this Board by a party adversely affected thereby. 4/

John H. Kelly
Administrative Judge

I concur:

Will A. Irwin
Administrative Judge

4/ On Mar. 5, 1990, BLM filed a "Motion to Admit Appellee's Response" and "Appellee's Response to Appellants' January, 1990 Farmout Agreement." PZ and PI filed replies objecting to the motion on Mar. 28, 1990. Rather than ruling on the motion, we refer BLM's response to the Administrative Law Judge for whatever limited value it may have, in light of appellants' replies, in considering the issues we have referred for hearing and decision.