

JEROME P. McHUGH AND ASSOCIATES (ON RECONSIDERATION)

IBLA 87-533, 87-534, 90-434

Decided January 17, 1991

Petition for reconsideration of Jerome P. McHugh & Associates, 113 IBLA 341 (1990), which affirmed in part and set aside in part decisions of the New Mexico State Office, Bureau of Land Management, affirming, as modified, the Albuquerque District Manager's findings that drainage requiring payment of compensatory royalty had occurred from Indian oil and gas leases NOO-C-14-20-3022 and NOO-C-14-20-3023. Appeal from decisions of the Farmington, New Mexico, Resource Area Manager establishing an effective date for compensatory royalty assessment.

Petition granted and Board's decision in Jerome P. McHugh & Associates, 113 IBLA 341 (1990), vacated; BLM decisions in IBLA 87-533 and 87-534 set aside and referred for hearing; decision in IBLA 90-434 vacated.

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

Before the Bureau of Land Management may assess compensatory royalties against an oil and gas lessee for drainage by an adjacent well, it must demonstrate that the lessee knew, or that a reasonably prudent operator should have known, of the drainage. While a lessee who holds an interest in both the offending well and the drained Federal lease, is considered to have knowledge of drainage from the time he drills the offending well, under other circumstances the Department must show that a lessee knew or that a reasonably prudent operator would have known there was drainage.

2. Administrative Procedure: Hearings--Hearings--Rules of Practice: Appeals: Hearings

Where the record on appeal presents unresolved questions of fact or undecided, significant legal issues, under 43 CFR 4.415 the Board of Land Appeals has discretionary authority to refer the matter for a hearing.

APPEARANCES: Marla J. Williams, Esq., and Martha E. Cox, Esq., for petitioner/appellant Jerome P. McHugh and Associates; Margaret C. Miller, Esq., Office of the Field Solicitor, Santa Fe, New Mexico, and John L. Keller, Branch of Minerals Resources, Farmington, New Mexico, Resource Area, for the Bureau of Land Management.

OPINION BY ADMINISTRATIVE JUDGE ARNESS

Jerome P. McHugh and Associates (McHugh) has petitioned for reconsideration of the Board's decision in Jerome P. McHugh & Associates (McHugh), 113 IBLA 341 (1990). In that decision, the Board affirmed in part decisions of the New Mexico State Office, Bureau of Land Management (BLM), affirming, as modified, the Albuquerque District Manager's findings that drainage requiring compensatory royalty payments had occurred from Indian oil and gas leases NOO-C-14-20-3022 and NOO-C-14-20-3023. The Board set aside in part that portion of the State Office's decision requiring payment calculated from the effective date of the leases. McHugh also appeals from decisions of the Farmington Resource Area Manager, issued on remand and dated June 5, 1990, establishing liability for compensatory royalty payments beginning 6 months following issuance of the leases. 1/

The Board's McHugh decision first considered the requirement that McHugh prove error in BLM's determination that the leased lands were being drained by a well on adjacent lands. We held that McHugh did not successfully carry this burden. This conclusion was based, in part, on McHugh's refusal to provide core data supporting its contentions concerning net-pay thickness, pressure, and water saturation calculations. 113 IBLA at 347-48. We then considered when the lessee had become liable for compensatory royalty payments. We reviewed the rule that, where the draining and drained leases are held by a common lessee, there is an obligation to drill a protective well or pay compensatory royalty within a reasonable time after he learns there is drainage. In the instant case, we held that McHugh, because it has drilled the offending well, had knowledge of the drainage when the lease was issued. 113 IBLA at 349-50. We remanded the matter to permit determination of a reasonable time from lease issuance for completion of an offset well for purposes of calculating compensating royalty.

McHugh challenges both aspects of the Board's McHugh decision. First, McHugh argues that we improperly found that McHugh had participated in a "common lessee" relationship between the subject leases and the Federal lease where the offending well was located. McHugh states that it has never had an interest in either the adjacent Federal oil and gas lease or the offending well. McHugh argues that, as a result of this mistake of fact, it was improperly burdened with showing that either there was no drainage or that an offsetting well would be unprofitable prior to the time it received notice of drainage from BLM. Second, McHugh asserts that new evidence establishes that no drainage has occurred.

Subsequent to BLM's decision, McHugh reopened the well located on lease NOO-C-14-20-3022 (the Nassau 3) and recompleted it in the Gallup formation on May 20, 1987, after appeal was taken to this Board. McHugh now asserts that because this information was not available to BLM when the appealed decisions were rendered, the matter should be remanded so that BLM

1/ Docketed as IBLA 90-434.

can consider this new data. The data includes bottomhole pressure buildup readings, indicating a tight reservoir influenced by a nearby boundary, according to McHugh. McHugh argues that the differences in pressure and production between this well and the offending well suggest that a boundary exists between the two wells and, therefore, the subject leases are not being drained by the offending well. 2/

In response, BLM argues that, regardless of whether or not McHugh was a common lessee, as a prudent operator it should have known drainage was taking place. BLM asserts that it is not the Department's responsibility to provide notice of drainage, because a lessee's obligation to protect the lease from drainage requires the lessee to be aware of potential drainage situations. BLM also argues that the burden of proof to show that a protective well would not have been profitable properly rests with the lessee and that McHugh had ample opportunity to learn how to make this showing. In separate engineering and geologic reports offered in support of the decisions made in these cases, BLM concludes that the new data cannot support the theory that separate reservoirs exist between the two wells. BLM also explains that such differences as are found in the offered data likely result from either the fact that the offending well is in the gas portion of the Gallegos Gallup Pool while McHugh's Indian lease Nassau 3 well is on the oil-gas contact or because the drainage radius has not yet extended to McHugh's Nassau 3 well.

[1] After reviewing the case files for the subject leases, we conclude that McHugh was not a "common lessee" of the subject Indian oil and gas leases and the Federal oil and gas lease on which the offending well is located, nor did the company own any interest in the alleged draining well or lease. The only common lease ownership held by McHugh is the common ownership of the two Indian leases. Contrary to BLM's assertions, the distinction between a common lessee and third-party lessee does make a difference as concerns assignment of the burden of proof required to show drainage or liability therefor. In several recent decisions where the common lessee relationship was not present, the Board has reaffirmed the principle that the obligation to protect a lease from drainage by either drilling a protective well or paying compensatory royalty arises a reasonable time following notification that an adjacent well is draining the lease land:

2/ In addition, McHugh contends that BLM's attempt to assess compensatory royalties retroactively from the formal notice of drainage is barred by 28 U.S.C. § 2415 (1988) or by laches. The authority of the United States to enforce a public right or protect a public interest is not vitiated or lost by acquiescence of its officers or by their laches, neglect of duty, failure to act, or delays in the performance of their duties. 43 CFR 1810.3; Reo Broadcast Management Co., 98 IBLA 139 (1987). The cited statute of limitation, 28 U.S.C. § 2415 (1988), applies to collection of money through civil action.

In CSX [Oil & Gas Corp., 104 IBLA 188, 95 I.D. 148 (1988)], we concluded that the obligation to protect a lease from drainage will arise a reasonable time following notice to the lessee that an adjacent well is draining leased land, and that BLM may satisfy the notice requirement by showing that the lessee knew or a reasonably prudent operator should have known that drainage was occurring. We concluded that such a holding is consistent with a prudent operator's duty to exercise reasonable care and diligence in protecting the lessor against drainage." Id. at 198, 95 I.D. at 154. However, we held that where BLM sought to assess compensatory royalties for any period of time prior to when it gave formal notice of drainage, the "burden of proving that a lessee knew or that a reasonably prudent operator would have known of drainage rests with BLM." Id. at 199, 95 I.D. at 154.

Chevron U.S.A. Inc., 107 IBLA 126, 131 (1989).

In CSX, the lease in question was issued after the offending well had been producing gas for several years. BLM's notice of drainage was not issued until 8 months after lease expiration. We found in CSX that:

If we were to adopt the position urged by BLM and hold that notice of drainage is immaterial to an action for compensatory royalty, our holding would effectively erode the prudent operator standard and replace that standard with an absolute standard requiring an operator to warrant against any loss as a result of drainage. We expressly decline to do so.

104 IBLA at 196, 95 I.D. at 153. We then vacated BLM's decision, concluding that because BLM had not given notice of drainage during the life of the lease, and did not attempt to prove that appellants knew or that a reasonably prudent operator should independently have known of such drainage, that there was no foundation for an order requiring payment of compensating royalty.

In Chevron, supra, BLM had assessed the lessee compensatory royalty in 1985 for drainage from a well completed in 1978. Quoting CSX, we found that "if BLM is to assess compensatory royalties for any period prior to the time it gives formal notice, the burden of proving that a lessee knew or that a reasonably prudent operator should have known of drainage rests with BLM." 107 IBLA at 132. In Chevron, BLM had argued that the lessee was required to protect the lease from drainage beginning with completion of an offending well because the matter of production was public record. We concluded that "[m]erely providing an affidavit that establishes that a first production notice was a matter of public record is insufficient" and held that the record did not establish that the lessee knew, or that a reasonably prudent operator should have known, that drainage was occurring prior to notice. Id. We remanded the case to BLM to determine when the obligation to protect from drainage arose, consistent with the Board's conclusion that the duty to

protect from drainage arises upon notice and after passage of a reasonable time to take corrective action. 107 IBLA at 133.

[2] Thus, in the instant case, before BLM can consider compensatory royalty assessments for periods prior to 1985, it must show that McHugh knew or that a reasonably prudent operator would have known of drainage prior to the time notice of drainage was given by BLM. As we found in Chevron, the observation that a well exists on an adjacent tract or that such well is producing is insufficient to establish that there is drainage. 107 IBLA at 132. We find nothing to suggest, and BLM has not shown, that McHugh knew the Indian leases were susceptible to drainage from the adjacent Federal well. On the contrary, McHugh avers that the available data shows that the Indian leases are not vulnerable to drainage in the manner suggested by BLM.

In order to demonstrate imputed knowledge to a reasonably prudent operator, BLM must initially establish there is drainage of a portion of the oil or gas reservoir encompassed by the Federal lease said to be drained. We determined in our prior McHugh decision that, because of a lack of data to support the assertion that the Indian leases were not susceptible to drainage by the purported offending well, BLM's showing of drainage from the leases at issue was not rebutted. However, the petition for reconsideration is supported by additional data which, according to McHugh, demonstrates that drainage from the Indian leases did not, and will not, occur. The interpretation of new data supplied by McHugh is plausible. So are BLM's explanations of this new information. Under 43 CFR 4.415, the Board has discretionary authority to refer a case to an Administrative Law Judge for a hearing on an issue of fact. We have held that where the record presents unresolved questions of fact or significant legal issues to be decided, the Board will refer the case to the Hearings Division, Office of Hearings and Appeals, for a hearing on those questions. Norman G. Lavery, 96 IBLA 294 (1987); see also Ben Cohen (On Judicial Remand), 103 IBLA 316 (1988), aff'd, Sahni v. Watt, CV-LV-83-96-H&M (C.D. Nev. Jan. 12, 1990); First American Title Insurance Co., 100 IBLA 270 (1987); Woods Petroleum Co., 86 IBLA 46 (1985). The instant appeals raise significant issues that cannot be resolved by the Board on the records before us. Therefore, these consolidated appeals are referred to the Hearings Division for a hearing and decision on the issue of whether the oil and gas reserves under the subject Indian leases were drained, are being drained, or may be drained by the allegedly offending well.

Further, the issue of what a reasonably prudent operator would do under these circumstances is also a proper matter for review by hearing. See, e.g., Chevron U.S.A., 110 IBLA 216 (1989). If drainage is established, the Administrative Law Judge should also consider when a reasonably prudent operator would have learned of the existence of such drainage and, consequently, establish when the obligation to protect the well would have arisen. The decision of the Administrative Law Judge shall be final for the Department, absent a timely appeal. Consequently, the appeals from the decisions of the Farmington Resource Area Manager to assess compensatory royalty beginning 6 months after lease issuance are vacated, because those

decisions are dependent on the determinations to be rendered in the ordered hearing.

Accordingly, pursuant to the authority delegated to the Board of Land Appeals by the Secretary of the Interior, 43 CFR 4.1, the petition for reconsideration is granted, and the Board's decision in Jerome P. McHugh & Associates, 113 IBLA 341 (1990), is vacated. The New Mexico State Office's May 8, 1987, decisions are set aside and referred to the Hearings Division for a hearing consistent with the above discussion. The Farmington Resource Manager's decisions are vacated.

Franklin D. Arness
Administrative Judge

I concur:

Gail M. Frazier
Administrative Judge