

Editor's note: 95 I.D. 235; Reconsideration denied by Order dated Feb. 8, 1989; Reconsideration subsequently granted; decision affirmed -- 110 IBLA 200 (Aug. 21, 1989); 96 I.D. 363

ATLANTIC RICHFIELD CO.

IBLA 87-173

Decided November 2, 1988

Appeal from a decision of the Montana State Office, Bureau of Land Management, upholding a Miles City District Office decision assessing compensatory royalty for oil and gas drained from lease M-60749.

Set aside and remanded.

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

Under the usual statement of the standard for prudent operation there is no obligation upon the lessee to drill an offset well unless there is a sufficient quantity of oil or gas to pay a reasonable profit to the lessee over and above the cost of drilling and operating the well. When BLM has established that a leased Federal tract is being drained by a well operated by a common lessee, 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 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 notice to the lessee that drainage is occurring. In a common lessee context, the lessee 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 lessee knew or that a reasonably prudent operator should have known that drainage was occurring. The common lessee is presumed to have knowledge of the drainage upon

first production from its offending well. This presumption is rebuttable by the common lessee, who bears the ultimate burden of persuasion as to notice of drainage.

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

If the cost of drilling and operating an offset well is greater than the value of the recovered oil and/or gas, there would be no breach of a lessee's duty to prevent drainage. However, if a lessee can make a reasonable profit by drilling the well, he should drill. The prudent operator test is applied looking to the reasonably anticipatable recovery from the offset well, rather than the oil and/or gas which would be lost if the offset well were not drilled.

Gulf Oil Exploration & Production Co., 94 IBLA 364 (1986), modified.

APPEARANCES: Gregory J. Nibert, Esq., Roswell, New Mexico, for appellant; Roger W. Thomas, Esq., Office of the Field Solicitor, Billings, Montana, for the Bureau of Land Management.

OPINION BY ADMINISTRATIVE JUDGE MULLEN

Atlantic Richfield Company has appealed from a decision of the Montana State Office, Bureau of Land Management (BLM), dated October 28, 1986, upholding a decision of the Miles City District Manager assessing compensatory royalty for oil and gas determined to have been drained from lease M-60749. This Federal lease is located within the N\ of sec. 5, T. 31 N., R. 59 E., Montana Principal Meridian, Sheridan County, Montana, 1/ and appellant is the lessee. Appellant is also the lessee of the adjacent private lands on which the offending well, the Hoffelt #2, is located. 2/

1/ Lease M-60749 was issued effective Sept. 1, 1984. Lands described therein are lots 1, 2, 3, 4, S\ NE^, SE^ NW^ sec. 5, T. 31 N., R. 59 E., Montana Principal Meridian.

2/ This well is located in SE^ SW^ sec. 32, T. 32 N., R. 59 E., Montana Principal Meridian.

In his decision of September 26, 1986, the Miles City District Manager found that the Hoffelt #2 well was draining Federal lease M-60749 by a drainage factor of 4.4 percent. Citing lease provisions and applicable regulations, the District Manager assessed appellant for compensatory royalty effective the date of first production from the Hoffelt #2 well and continuing until the date of last production, or the effective date of the relinquishment of affected portion(s) of lease M-60749, or the date on which production commences from a protective well. The record reveals that the Hoffelt #2 well was completed by appellant on January 2, 1985, and it reported production that same month. The record also reveals that production from the relevant (Gunton) formation has been shut off since July 1, 1986, and no protective well has been drilled by appellant.

In affirming the District Manager's decision, the Montana State Office held that an economic well could be drilled on lease M-60749. This conclusion was based upon a finding that recoverable reserves totalled 312,000 barrels of oil.

The lease terms referred to by the District Manager are found in section 4 of appellant's lease: "Lessee shall drill and produce wells necessary to protect leased lands from drainage or pay compensatory royalty for drainage in amount determined by lessor." The applicable regulations, 43 CFR 3100.2-2 and 43 CFR 3162.2(a), state in part, respectively:

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.

(a) 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.

Appellant observes that despite the regulations' clear direction to drill or pay, this obligation only arises after a determination that drainage is substantial and that a prudent operator would drill an offset well.

In support of its position that a lessee's duty to drill arises only if substantial drainage is occurring, inter alia, appellant cites 5 Williams and Meyers, Oil and Gas Law | 822 (1986), Gerson v. Anderson-Pritchard Production Corp., 149 F.2d 444 (10th Cir. 1945), and Cone v. Amoco Production Co., 87 N.M. 294, 532 P.2d 590 (1975). Appellant acknowledges that the term "substantial drainage" has not been quantified in the case law, but quotes with approval the view stated by Williams and Meyers that substantial drainage should remain as an element of the cause of action for breach of the protection covenant: "Where damages are measured by the amount of oil or gas drained away, the pecuniary award will be modest if not purely nominal. There is no reason to incur the expense of litigation to compensate modest losses, when such losses are established by evidence that cannot be exact." Id. at | 822.1 (footnote omitted).

Appellant contends that 4.4 percent of the Hoffelt #2 production can only be considered a modest loss which does not justify drilling a protective well or payment of compensatory royalty.

Appellant further argues that BLM cannot recover damages without proving that a protective offset well can produce in paying quantities sufficient to yield a reasonable profit after paying all drilling, operating, and administrative costs. Appellant alleges that BLM's proof in this respect is flawed because BLM has assumed an unrealistic production decline rate for a protective well. According to appellant, this error caused BLM to overestimate reserves recoverable by an offset well and to arrive at a conclusion that an economic offset well could be drilled. Appellant insists that an economic protective well cannot be drilled on lease M-60749 and submits data in support of its contention.

Finally, appellant takes exception with the District Manager's assessment of compensatory royalties for the period commencing with first production from the Hoffelt #2 well. Such a decision, appellant states, is contrary to Nola Grace Ptasynski, 63 IBLA 240, 89 I.D. 208 (1982). In Ptasynski this Board held that "[t]he obligation to protect a leasehold from drainage arises not upon completion of the draining well, but only after the passage of a reasonable time subsequent to notification by the lessor that an adjoining well is draining the leasehold." 63 IBLA at 256, 89 I.D. at 217. Having cited Ptasynski with approval, appellant argues that compensatory royalties should not commence until the lapse of a reasonable time, but in no event less than 6 months, after the date of first production from the offending well.

In response, BLM defends its decisions, noting that, even if substantial drainage is an element of its proof, this term has not been quantified

and is otherwise ill-defined. No BLM manager has the authority to waive royalties, however insubstantial, without good legal reason, BLM observes. Moreover, if substantial drainage were a requirement, BLM states, its loss of \$9,003 in royalties during the period through May 1987 is substantial.

BLM also maintains that it used an accurate production decline rate when estimating reserves for the protective well. Appellant's contention that a steeper decline rate is appropriate is misguided, BLM states, because there has been no physical deterioration of the reservoir. BLM further observes that a model protective well should be based on a minimum of 207,276 barrels of oil. In BLM's view, such reserves can support the drilling and operation of a paying protective well. Whether a paying protective well exists, BLM states, depends upon the sufficiency of reserves recoverable by the protective well and not, as stated in Gulf Oil Exploration & Production Co., 94 IBLA 364, 368 (1986), on the reserves under the Federal lease that are drained by the offending well.

Finally, BLM states that compensatory royalties are properly calculated from the date of first production of the Hoffelt #2 well because appellant, as operator of that well, knew of the potential for drainage at the time it completed the well. As a common lessee, appellant benefitted immediately from this well, BLM states, and had immediate knowledge of the drainage.

In Nola Grace Ptasynski, *supra*, this Board refrained from deciding whether substantial drainage was a part of the cause of action for breach of the protection covenant or merely a restatement of the prudent operator

standard. 63 IBLA at 250, 89 I.D. at 214. In the present case, it is not disputed that the Hoffelt #2 well has produced 77,055 barrels of oil and 44,966 MCF gas, of which 4.4 percent may be regarded as drainage from lease M-60749. Had the United States received royalty on these drained resources, it would have received \$9,003 in royalties, according to BLM's calculations. ^{3/} BLM has not used the term "substantial drainage" in its decision. If appellant maintains that substantial drainage is part of BLM's cause of action and that BLM has failed to demonstrate this fact, it is incumbent upon appellant to define this term in order that we might determine whether appellant's contentions are correct. As one seeking reversal of BLM's decision, appellant bears the burden of showing error in that decision by a preponderance of the evidence. Bender v. Clark, 744 F.2d. 1424 (10th Cir. 1984). By offering only an unsupported conclusion, appellant has failed to meet this burden.

[1] In the decision on appeal, the Montana State Office specifically found an economic protective well could be drilled on lease M-60749. This finding reflects BLM's application of the prudent operator rule in a common lessee context. This rule was previously applied to a common lessee in Gulf Oil Exploration & Production Co., supra, when this Board remanded a decision of the New Mexico State Office for application of the rule. In Ptasynski, the prudent operator rule was described as a limitation on a lessee's implied obligation to protect against drainage. Quoting from Olsen v. Sinclair

^{3/} Production from the Gunton formation has been shut off since July 1, 1986. Had production continued, BLM estimates, \$24,332 could ultimately be derived in Federal royalty income.

Oil & Gas Co., 212 F. Supp. 332, 333 (D. Wyo. 1963), the Board set forth the rule in these terms:

Under the usual statement of the standard for prudent operation there is no obligation upon the lessee to drill offset wells unless there is a sufficient quantity of oil or gas to pay a reasonable profit to the lessee over and above the cost of drilling and operating the well.

63 IBLA at 247, 89 I.D. at 212.

Upon review of our Gulf decision, we find certain refinements of that opinion to be in order. When BLM seeks to recover compensatory royalties from a common lessee, it must establish that a leased Federal tract is being drained by a well operated by the common lessee. However, BLM need not prove as a part of its cause of action that a protective well would be economic, i.e., profitable. Both the burden of going forward and the ultimate burden of persuasion on this issue must rest with the common lessee. These burdens are placed on the common lessee because of the possibility of unfair dealing and because the common lessee possesses the evidence necessary to prove that an economic well cannot be drilled. See 5 Williams and Meyers, Oil and Gas Law | 824.2 (1986), and Elliott v. Pure Oil Co., 10 Ill.2d 146, 139 N.E.2d 295 (1956). If the common lessee satisfies this burden of going forward on the issue of profitability, BLM must produce evidence on this issue or suffer an adverse ruling.

[2] Appellant's argument focusing on when compensatory royalties begin to accrue has been the subject of recent case law. In CSX Oil & Gas Corp., 104 IBLA 188, 95 I.D. ____ (1988), the Board cited Ptasynski with approval

for the proposition that compensatory royalties commence upon passage of a reasonable time following notice to the lessee that drainage is occurring. CSX clarified Ptasynski, however, by further explaining that if, in the absence of notice from BLM, BLM can prove that the lessee knew or that a reasonably prudent operator should have known drainage was occurring, the notice requirement was satisfied. 104 IBLA at 196, 95 I.D. at ____.

Neither CSX nor Ptasynski involved a common lessee, and hence these cases do not guide us in every aspect of the present appeal. In a common lessee context, the lessee who drills the offending well is in the best position to know that drainage is occurring. In such context, we find no reason for requiring BLM to assume the initial burden of going forward with evidence that the common lessee knew or that a reasonably prudent operator should have known that drainage was occurring. See Elliott v. Pure Oil Co., supra. The common lessee shall be presumed to have knowledge of the drainage upon first production from its offending well. However, this presumption is rebuttable by the common lessee, who bears the ultimate burden of persuasion as to notice of drainage.

[3] Having determined that the prudent operator rule does apply in the case of a common lessee, we turn to the test to be applied in such cases. The loss incurred by the lessor is an economic loss and, therefore, economics must govern the duty to drill. If the cost of drilling and operating the offset well is greater than the value of oil and/or gas recovered by such well, there would be no breach of the duty to protect against drainage. When entering into an oil and gas lease, the parties contemplate that a well

will be drilled by or on behalf of the lessee if the lessee can recover his costs and make a reasonable profit on his investment. If this cannot be done, the prevention of drainage by drilling an offset well is uneconomic, and need not be attempted. ^{4/}

Normally the application of the prudent operator rule to the duty to drill a well arises in two cases. The first is the case of the lessee's duty to develop the leasehold. The second case, such as that now before us, involves the duty to prevent drainage. As noted by Williams and Meyers, the application of the rule should be the same in both cases. If a lessee can make a profit by drilling the well, he should drill. See 5 Williams and Meyers, Oil and Gas Law | 815 (1986). Therefore, the test is applied looking to the reasonably anticipatable recovery from the offset well, and not the amount of oil and/or gas which would be lost if the offset well is not drilled. The statements to the contrary in Gulf Oil Exploration & Production, supra at pages 368 and 370, are incorrect. However, recovery must be reasonably anticipatable, and the mere possibility of being able to recover additional product from other strata should be given very little weight.

A strict application of the duty to prevent drainage would require the lessee to commence drilling an offset well at the same time an offending

^{4/} It also stands to reason that when an offset well is drilled and proves to be uneconomic because the cost of operating the well is greater than the return from the well, the operator need not continue production from the well in order to avoid paying compensatory royalties. A determination that the well is uneconomic should be based upon production (or anticipated production in the case of the decision to drill) and not the loss of revenue to the lessor occasioned by drainage from an adjacent well. The "profitability" determination is therefore subject to constant review, as would be the case for a well drilled for any other purpose.

well is being drilled. If he did not, the lessee would be required to pay compensatory royalties during the period the offset well is being drilled, i.e., commencing with first production from the offending well. Such anticipatory drilling is contrary to sound business judgment, and would prove wasteful in many cases. If the "offending" well is a dry hole, there would be no need to drill an offset well. As set forth in Ptasynski, the obligation to pay compensatory royalties commences only when a lessee fails to offset an offending well within a reasonable time after notice of drainage. Because the decision of the Montana State Office assessed royalties from the date of first production from the Hoffelt #2 well, that decision must be set aside. Compensatory royalties would begin to accrue only upon the expiration of a reasonable period of time after notice of drainage. 5/ See Bruce Anderson, 80 IBLA 286 (1984), and Nola Grace Ptasynski, supra. As noted above, in the case of a common lessee, notice is presumed at the time of first production from the offending well.

BLM's decision is also flawed in its application of the prudent operator rule. The record reveals that BLM based its conclusion that a prudent operator would drill an offset well on the anticipated recoverable reserves as of January 1, 1985. 6/ BLM should have used the anticipated recoverable

5/ The time it would take to complete a well is dependent upon a number of factors such as the depth of the well, the ability to obtain necessary permits, and the availability of equipment. For example, if an environmental impact statement were required prior to the issuance of a permit to drill a deep well, to commence compensatory royalties 6 months after completion of the offending well might be very unreasonable. Thus, the determination of what is a reasonable time must be made on a case-by-case basis.

6/ See Memorandum to Drainage File, dated June 17, 1986, and Reserve Analysis Report, dated Sept. 16, 1986, each by Jamie E. Connell, BLM petroleum engineer, at tabs F and K respectively.

reserves remaining at the conclusion of the reasonable period allowed for drilling the offset well. The recoverable reserves used by BLM when making its prudent operator determination will have been partially depleted during the interim, and the use of the higher figure casts doubt on this determination. The drilling costs used for the determination should also be the costs on the date a prudent operator would have commenced drilling and not the costs on the date of first production from the offending well.

The record further reveals that appellant and BLM are not in agreement regarding reserves in lease M-60749 which could be recovered by an offset well. The anticipated annual decline rate for the offset well will be a key factor in this determination. By setting aside the decision we are affording appellant and BLM an opportunity to resolve their differences on this issue.

The parties appear to be in agreement that 4.4 percent of the total production from the Hoffelt #2 well comes from the tract of land subject to lease M-60749. See Statement of Reasons, December 29, 1986, at pages 7 and 13. We believe that, as a starting point, BLM should determine what was a reasonable time from the date of completion of the offending well for completion of an offset well. After that determination is made, BLM should determine the amount deemed owing as compensatory royalties.

7/ If appellant is of the opinion that a prudent operator would not drill an offset

7/ The amount of the compensatory royalty should be based upon the amount of drainage that could be prevented, not the anticipated recovery from the offset well. The effect of factors limiting a lessee's ability to recover product being drained by the offending well (e.g., well-spacing requirements or geography) should also be considered. See 5 Williams and Meyers, Oil and Gas Law | 825.2 (1986).

well because such well would not be economically feasible, it should then submit evidence in support of that contention as well as any other evidence it believes will have a bearing on the date of notice, the prudent operator determination, or the amount of the compensatory royalty. BLM should then make its final determination of whether compensatory royalties are due based upon its information and the evidence submitted by appellant. The decision should clearly set forth the methods and assumptions used as well as an explanation of its rejection of any of the evidence submitted by appellant. That determination will be appealable to this Board.

Therefore, pursuant to the authority delegated to the Board of Land Appeals by the Secretary of the Interior, 43 CFR 4.1, the decision of the Montana State Office is set aside and remanded.

R. W. Mullen
Administrative Judge

I concur:

Bruce R. Harris
Administrative Judge