

Appeal from a decision of the District Manager, Rawlins District, Wyoming, Bureau of Land Management, requiring an oil and gas lessee to pay compensatory royalty. 14-20-0258-2193.

Set aside and remanded.

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

A BLM decision requiring an oil and gas lessee to pay compensatory royalty for drainage resulting from an adjacent well will be set aside and the case remanded to BLM where BLM assessed royalty from the date of first production of the well, rather than from a reasonable time following notice to the lessee.

APPEARANCES: W. M. Balkovatz, Esq., Chevron U.S.A. Inc., Denver, Colorado, for appellant; Mary Katherine Ishee, Esq., and William R. Murray, Esq., Office of the Solicitor, U.S. Department of the Interior, Washington, D.C., for the Bureau of Land Management.

OPINION BY ADMINISTRATIVE JUDGE KELLY

Chevron U.S.A. Inc. (Chevron) has appealed from a letter decision of the District Manager, Rawlins District, Wyoming, Bureau of Land Management (BLM), dated July 7, 1986, notifying it of the requirement to pay compensatory royalty for drainage from Indian oil and gas lease No. 14-20-0258-2193 occurring as a result of production adjacent to the leased land from the Merrion No. B-2 well.

The record indicates that the Bureau of Indian Affairs (BIA), on behalf of the Shoshone and Arapahoe Indian Tribes of the Wind River Indian Reservation, Wyoming (hereinafter referred to as the Tribes), renewed Indian oil and gas lease 14-20-0258-2193, originally issued November 14, 1917, pursuant to the Act of August 21, 1916, ch. 363, 39 Stat. 519 (1916), for a term of 10 years, effective January 1, 1978. At the time of renewal, the lessees were the Gulf Oil Corporation (Gulf) and the Superior Oil Company (Superior), each holding an undivided 50-percent interest in the lease.

The lease covers approximately 280 acres of tribal land situated in the SW[^] sec. 15 and the N\ SE[^], SE[^] SE[^] sec. 16, T. 3 N., R. 1 W., Wind River Meridian, Fremont County, Wyoming. The lease provides in relevant part that the lessees are required "[t]o drill and produce all wells necessary to offset or protect the leased land from drainage, or, at the option of the Tribes, to compensate the Tribes in full each month for the estimated loss of royalties through drainage." At the time the lease was renewed, this requirement was also embodied in Department regulation 25 CFR 184.23 (1977), which required a lessee "to drill and produce all wells necessary to offset or protect the leased land from drainage by wells on adjoining lands not the property of the lessor, or in lieu thereof, compensate the lessor in full each month for the estimated loss of royalty through drainage." Chevron and the Mobil Oil Corporation (Mobil) are successors-in-interest to Gulf and Superior under the Indian oil and gas lease.

By letter dated July 18, 1985, the District Manager notified Gulf that Indian lease No. 14-20-0258-2193 was "subject to potential drainage" by the Merrion No. B-2 well situated in the NE[^] NE[^] NW[^] sec. 22, T. 3 N., R. 1 W., Wind River Meridian, Fremont County, Wyoming, immediately south of the leased land, which well was "[c]ompleted in the Muddy [formation], 1978." The District Manager stated that, pursuant to the requirement to protect the lease from drainage, Gulf was expected to drill a protective well on the leased land unless it could demonstrate either "that no drainage is occurring, or that a protective well would have little or no chance of encountering oil or gas in quantities sufficient to pay the cost of drill-ing and operating the well." In the latter instance, the District Manager stated that Gulf must demonstrate that "there has never been a point in time between the onset of production from the offending well until the present at which it would have been possible to have drilled an economic protective well." The District Manager required Gulf to take action either to protect the lease or submit the necessary information by September 20, 1985, failing which Gulf might be assessed compensatory royalty.

On September 23, 1985, Chevron, as successor-in-interest to Gulf, responded to the District Manager's July 1985 letter, noting that the Merrion No. B-2 well had been completed in the Muddy formation in 1978, having prior thereto produced from the Tensleep formation. Chevron stated that since July 19, 1951, with the exception of the period August 1983 to February 1985 when the well was shut-in, the Tribal No. A-4 well had produced from the Tensleep formation and that "[b]ecause it is not an acceptable completion practice to commingle an oil producing zone with a gas zone, we do not plan to test the Muddy formation in the Tribal A-4 until the Tensleep oil zone reaches its economic limit." Chevron then stated that it intended to "re-enter the temporarily abandoned Tribal [No.] A-1 well and test the Muddy [formation] for commercial gas." On May 20, 1986, Chevron reported to BLM the results of its testing in the Tribal No. A-1 well with respect to potential production from the Muddy formation: "Preliminary analysis of these tests indicate that the Muddy Formation has been pressure depleted to a current bottomhole pressure of approximately 300 psi. Estimated flow rate from the Muddy Formation was only 5 MCFD [thousand cubic feet per day] * * *. The Muddy was subsequently squeezed off and abandoned."

In order to determine whether the Merrion No. B-2 well was actually draining the leased land and whether an economic protective well could have been drilled on the leased land, BLM prepared an "Engineering and Economic Report" (Report). Initially, BLM calculated the total gas reserves available to the Merrion No. B-2 well and then, using an isopach map of the Muddy formation in the area of the well, BLM determined the areal extent of those reserves. Based on this determination, BLM concluded that 20 percent of the reserves were being drained from the leased land. BLM also determined whether an economic protective well could have been drilled on the leased land at the time of initial paying production from the Merrion No. B-2 well in 1965 based on costs for completing a well and gas prices at that time and the use of an econometric model. BLM concluded as a result of this analysis that a "protective well could have been economically drilled in 1965," with payout ranging from 2 to 8 years (Report at 2).

In his July 7, 1986, letter decision, the District Manager notified Chevron that Indian oil and gas lease No. 14-20-0258-2193 was being drained by the Merrion No. B-2 well and that, therefore, Chevron was required to pay compensatory royalty. The District Manager stated that compensatory royalty "will be effective from the first date of production, Nov. 1964, and will continue until the offending well ceases production," and that the Minerals Management Service (MMS) would bill Chevron for that royalty. ^{1/} Chevron has appealed to the Board from the District Manager's July 1986 letter decision.

This case raises two principal questions, viz., whether appellant is required to pay compensatory royalty on gas reserves drained from land leased under Indian oil and gas lease No. 14-20-0258-2193 and, assuming that appellant is liable for compensatory royalty, over what period of time royalty is due.

At the outset, while appellant makes a number of arguments, it is clear that appellant does not deny that the Merrion No. B-2 well has drained gas from the leased land. Specifically, appellant has not challenged BLM's determination that gas reserves available to the Merrion No. B-2 well extend under the leased land. Rather, it has been appellant's position, as expressed in its responses to BLM's notification of potential drainage, that testing of those reserves under the leased land discloses that a protective well could not economically be drilled on that land. On appeal, appellant describes those reserves as "noncommercial" and argues that,

^{1/} Subsequently, in a July 25, 1986, memorandum to the Royalty Evaluation and Standards Division, MMS, the District Manager reported that cumulative production from the Merrion No. B-2 well had been 662,053 MCF of gas from November 1964 to August 1985, with a drainage factor of 20 percent. According to Chevron's statement of reasons for appeal (SOR) at page 3, and BLM's Answer at page 36 n.8, \$20,000 worth of gas reserves had been drained from the leased land since November 1964.

because a prudent operator would not drill a protective well, appellant was not required to either drill a well or tender compensatory royalty, citing Nola Grace Ptasynski, 63 IBLA 240, 89 I.D. 208 (1982) (SOR at 2). 2/

It is clear from the record that BLM's determination regarding drain-age meant drainage from gas reserves in the Muddy formation. In assessing whether drainage was occurring as a result of production from the Merrion No. B-2 well, BLM relied on the areal extent of reserves in that formation using an isopach map of the "Muddy sand," concluding that those reserves extend under the leased land (Report at 1). In his July 18, 1985, notification to appellant of potential drainage, the District Manager stated that the Merrion No. B-2 well was completed in the Muddy formation in 1978. Thus, any drainage from the leased land as a result of production from that well would seemingly date from that year, at the earliest. However, in his July 1986 letter decision, the District Manager stated that compensatory royalty would be due from November 1964, the first date of production from the Merrion No. B-2 well, indicating that drainage from the leased land began at that time.

BLM explains this discrepancy by alleging in its answer that in meetings and correspondence following the July 1985 notification, BLM informed Chevron that the well was a Muddy producer from November 1964 and that BLM's report was prepared on that basis (Answer at 3). Thus, at the time it filed its answer, BLM's position was that the Merrion No. B-2 well began to drain gas reserves in the Muddy formation from the leased lands in November 1964.

[1] Appellant argues, however, that it was not required to either drill a protective well or pay compensatory royalty where a prudent operator would not have drilled such a well. The prudent operator rule was recognized in Ptasynski as an implied exception to the express obligation contained in Federal oil and gas leases to protect an oil and gas lease from drainage by either drilling a protective well on the leased land or paying compensatory royalty. In essence, a lessee must drill a well only if to do so would be profitable based on the reasonably anticipated recovery from that well. Atlantic Richfield Co., 105 IBLA 218, 227, 95 I.D. __, __ (1988).

2/ Appellant also argues that BLM was not entitled to require appellant to protect the lease from drainage where BLM failed to abide by certain "procedural requirements" in the lease directed to involving the Tribes in the decisionmaking process (SOR at 2). We reject this argument. BLM states that it obtained the concurrence of BIA to the collection of compensatory royalty in lieu of the drilling of a protective well "before deciding to assess compensatory royalties," in fulfillment of its primary obligation to the Tribes under the lease (Answer at 40). See Answer at 2. No objection by either BIA or the Tribes to any of BLM's actions in this case appears in the record.

In its SOR at page 2, appellant asserts simply that its testing of the Muddy formation in the Tribal No. A-1 well disclosed "noncommercial reserves." Appellant provided initial test results to BLM on May 20, 1986, indicating the existing bottomhole pressure and the estimated flow rate. By contrast, BLM has engaged in an economic analysis in its Report and concluded that an economic protective well could have been drilled on the leased land in 1965. Appellant has not challenged BLM's calculations; however, BLM's conclusion is relevant only if appellant's obligation to protect the lease against drainage arose in 1965.

We therefore turn to the question of when the obligation to protect Indian oil and gas lease No. 14-20-0258-2193 from drainage by the Merrion No. B-2 well arose. In its SOR at page 3, appellant argues that, consistent with our decision in Ptasynski, appellant could only be charged compensatory royalties beginning with "the time of the July 18, 1985 notice" which first informed appellant that the leased land was being drained by the Merrion No. B-2 well. In Nola Grace Ptasynski, supra at 256, 89 I.D. at 217, we concluded that the "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 adjacent well is draining the leasehold." We subsequently followed that ruling in Gulf Oil Exploration & Production Co., 94 IBLA 364, 372 (1986), 3/ and Bruce Anderson, 80 IBLA 286, 301, 91 I.D. 203, 211 (1984). In its answer, BLM challenges at length our ruling in Ptasynski, contending that the obligation to protect a lease from drainage arises upon the first date of production from the offending well, which in the present case, it argues, was November 1964, and not upon notice to the lessee that the leased land is subject to drainage. BLM requests the Board to overrule Ptasynski and its progeny in this respect. 4/

3/ We note that Gulf was modified by Atlantic Richfield Co., 105 IBLA 218, 225, 227 (1988), but that the modification did not affect this ruling.

4/ In the course of its argument, BLM alludes to an earlier statement made in its Response to Objection that we believe must be addressed. BLM stated that Board decisions are binding only in the context of the particular case appearing before the Board and "are not technically binding on other BLM cases involving different parties" (Response to Objection dated Mar. 20, 1987, at 2). We do not question the fact that our authority extends only to the adjudication of cases appearing before us. However, it 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.

After carefully reviewing BLM's arguments, we are not persuaded that Ptasynski was incorrectly decided, and, accordingly, reaffirm our conclusion 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 leased land. In Ptasynski, we held that while the Department could promulgate regulations providing that a lessee was required to protect a lease from drainage beginning at the time of completion of an offending well, regardless of notice of that drainage, it was "impossible to read the present regulation as encompassing this intent." Nola Grace Ptasynski, *supra* at 259, 89 I.D. at 219. Nothing that BLM has said on appeal herein persuades us that the applicable Departmental regulation can be read any other way, nor are we aware of any action by BLM to amend the regulation or like regulations. ^{5/} See 25 CFR 227.23; 43 CFR 3100.2-2 and 3162.2(a). Although BLM refers to policy pronouncements contained in BLM Manual provisions issued subsequent to Ptasynski, these provisions are clearly not binding on the Board. Gulf Oil Exploration & Production Co., *supra* at 372-73 n.13. Moreover, during the pendency of this appeal, the Board decided CSX Oil & Gas Corp., *supra*, which clarified our ruling in Ptasynski regarding what constitutes notification sufficient to give rise to the obligation to protect an oil and gas lease from drainage. In CSX, 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 _____. 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 _____.

In an addendum to its answer, filed after the Board's decision in CSX, BLM seeks to take advantage of that decision, stating that appellant should be considered liable for payment of compensatory royalty from July 1, 1965, *i.e.*, more than 6 months after production records of the Merriam

No. B-2 well became publicly available through the Wyoming Oil and Gas Commission (Commission), which BLM asserts was a reasonable time after a reasonably prudent operator would have known that drainage was occurring. BLM argues, citing CSX Oil & Gas Corp., *supra* at 199 n.10, 95 I.D. at _____ n.10, that the production records were sufficient to give rise to a duty to make inquiry and, thus, constitute notice of whatever a reasonable inquiry

^{5/} We note that the arguments advanced by BLM for overruling Ptasynski were incorporated by reference in BLM's brief in the recently decided case of CSX Oil & Gas Corp., 104 IBLA 188, 95 I.D. _____ (1988), and were briefly addressed in the Board's decision. See CSX Oil & Gas Corp., *supra* at 192-96, 197 n.7, 95 I.D. at _____ n.7.

would have disclosed, viz., that appellant's lease was being drained by the Merrion No. B-2 well. Accordingly, BLM requests that we remand the case to BLM so that it may amend the District Manager's July 1986 letter decision to indicate that compensatory royalty was due from July 1, 1965, rather than November 1964.

BLM indicated in its addendum that it would later submit written verification of when the production records of the Merrion No. B-2 well became publicly available. Subsequently, on November 4, 1988, BLM filed an October 26, 1988, affidavit of Charles W. Farmer, a petroleum engineer with the Commission, wherein Farmer states, inter alia, that information regarding well completions and recompletions and monthly production reports must be submitted to the Commission and are then, in accordance with the rules of the Commission, matters of public record. With respect to the Merrion No. B-2 well, Farmer reports that Skelly Oil, operator of the well, filed with the Commission on October 30, 1964, a notice that the well had been "recompleted to a Muddy Formation gas well" and subsequently filed a "first production report" on December 21, 1964 (Affidavit at 3). He concludes that to the best of his knowledge these submissions were "made publicly available at the time they were received by the Commission." Id.

As we stated in CSX Oil and Gas Corp., supra at 199, 95 I.D. at ___ "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." Merely providing an affidavit that establishes that a first production notice was a matter of public record is insufficient to satisfy that burden. The BLM file for the Merrion No. B-2 well indicates that although the well was perforated in the Muddy formation in 1964, there was no production in the absence of adequate pressure and the well was thereafter shut in, with no indication in the file that the well was ever reopened. Thus, the present record is insufficient to show that the lessee of the lease in question knew, or a reasonably prudent operator should have known, that drainage was occurring in November 1964. Without production, there can be no drainage and without drainage, the compensatory royalty obligation can not arise.

Nevertheless, it is clear that remand is necessary, since appellant has not denied that the Merrion No. B-2 well has drained gas from the leased lands. Thus, the question of liability for compensatory royalty still exists. ^{6/} What is clear, however, is that the obligation to pay compensatory

^{6/} Appellant has not raised the question of whether drainage was substantial. As we stated in Atlantic Richfield Co., supra at 223-24, 95 I.D. at ___, the Board has refrained from determining whether substantial drainage is part of BLM's cause of action for breach of the protective covenant or merely a restatement of the prudent operator rule. BLM appears to acknowledge in this case that it is responsible in the first instance for establishing substantial drainage when it states in its answer that this

royalty did not arise, as asserted by BLM in the July 1986 letter decision, in November 1964. Therefore, we must remand the case to BLM to allow it to determine when the Merrion No. B-2 well began to drain gas reserves from the Muddy formation underlying the leased lands in question. Next, BLM should determine when the obligation to protect the lease from drainage arose, consistent with our discussion and the Board decisions cited herein which establish that the obligation arises upon notice and passage of a reasonable time. If BLM finds that a prudent operator would have drilled a protective well, it may assess compensatory royalty; however, it should determine what person or persons are liable for such royalty and for what period of time. BLM should set forth with particularity in its decision all necessary findings and the basis for such findings.

Therefore, pursuant to the authority delegated to the Board of Land Appeals by the Secretary of the Interior, 43 CFR 4.1, the decision appealed from is set aside and the case is remanded to BLM for further action consistent herewith.

John H. Kelly
Administrative Judge

I concur:

Bruce R. Harris
Administrative Judge

fn. 6 (continued)

is a "threshold issue calculated to guarantee that drainage is actually taking place and that the need to protect is genuine," citing in part, 5 Williams and Myers, Oil and Gas Law | 822.1 (1985 Supp) (Answer at 36 n.8). In Atlantic Richfield Co., supra at 224, 95 I.D. at __, the Board stated that where the lessee maintains that substantial drainage is part of BLM's cause of action and that BLM has failed to demonstrate this fact, the lessee has the burden to define this term and to show error by a preponderance of the evidence.