Cause No. CD 202000984
Cause No. CD 202000986

DELIBERATIONS STATEMENT OF COMMISSIONER BOB ANTHONY

May 8, 2020

The Commission recently issued relief in two causes seeking to prevent waste of oil or natural gas. In Cause No. CD 202000323, Commissioners Hiett and Murphy issued on March 5, 2020, Order No. 709553, cutting the unallocated gas allowable for a capable well on a temporary basis, from sixty-five percent of absolute open flow potential to fifty percent of absolute open flow potential, for the period of April 1, 2020 through September 30, 2020. I dissented to Order No. 709553. In Cause No. CD 202000986, Commissioners Hiett and Murphy issued on April 22, 2020, Order No. 710884, a ninety-day emergency order allowing any well operator to shut-in or curtail any oil well due to economic waste arising from current low commodity prices. I did not participate in the signing of Order No. 710884.

On May 11, 2020, the Commission will conduct hearings on the merits in Cause No. CD 202000986 along with Cause No. CD 202000984, Oklahoma Energy Producers Alliance's application asking the Commission to reduce oil allowables statewide because of the oil price collapse. Concerning the three applications, this memo reaches the following conclusions: Cutting the unallocated gas allowable even for a limited group of wells raises the question of whether the proration procedure in OAC 165:10-17-11 complies with the *Conoco Decision* discussed below. Next, the Oklahoma Energy Producers Alliance application raises the question of how can the statutory scheme in Oklahoma do anything to counter a temporary but overwhelming global oil glut caused by foreign nations. Third, it remains to be seen if Order No. 710884, the emergency

order obtained by LPD Energy Company, LLC, is needed or has any effect on extending uneconomic leases, because the order makes curtailment subject to the well operator's discretion.

Two of the applications (CD Nos. 202000323 and 202000984) requested a production allowable. The concept of a maximum permitted rate of production described by Commission rules and orders as a production allowable originated in Oklahoma for oil with what is now 52 O.S. 2011 Section 274, enacted in the Oil Conservation Act of 1915. A companion Gas Conservation Act of 1915 enacted 52 O.S. 2011 Section 239, which is substantially similar legislation, later amended in 1992 and 1995. The 1915 legislation was designed to address then ongoing disputes between the independent producers and the integrated companies over limited market demand and non-ratable takes by oil purchasers. At the time, natural gas legislation was an afterthought, because gas markets were limited and local, before the development of seamless steel line pipe in the 1920s, and most natural gas was either vented or flared at the wellhead. The purpose of the allowable concept was to preserve through a uniform system of withdrawals each owner's correlative right to produce a proportionate share of a reservoir.

The allowable concept as a proportionate share of reserves stems from legal principles of mineral ownership. Oklahoma had rejected the theory of oil and gas ownership in place. Oklahoma is a qualified ownership state, meaning that while it does not recognize ownership of oil and gas *in situ*, it does recognize a mineral owner's standing to prevent injurious or wasteful operations to the reservoir. Under this ownership theory, the mineral owner owns the right to search for and reduce to his possession oil and gas at the surface. *Greenshields v. Warren Pet. Corp.,* 248 F.2d 61, 67, 70 (10th Cir. 1957). That principle comes from the adoption of the English common law Rule of Capture, which is a principle of non-liability and ownership where ownership of oil or gas first arises at the surface for the first person who reduces oil or gas to possession.

Oklahoma is a modified Law of Capture State, in the sense that Oklahoma adopted the Rule of Capture subject to state regulation and a Doctrine of Correlative Rights. Oklahoma adopted from groundwater law a Doctrine of Correlative Rights, which states that the mineral owner has legal privileges as against other owners in the common source of supply to conduct lawful operations on his land, limited by the duty to other owners not to injure the source of supply or cause waste and by a duty not to take an undue proportion of the oil and gas. *Samson Res. Co. v. Corp. Comm.,* 1985 OK 31, ¶9, 702 P.2d 19, 22.

The major legislative goals of the early Oklahoma Conservation Acts were to prevent physical and economic waste and to allocate limited market demand to protect correlative rights of owners in a common source of supply. The legal history of these Acts is discussed by W. P. Z. German in *Legal History of Conservation of Oil and Gas,* page 110 (Symposium of the Section of Mineral Law, ABA, December 1938). On production allowables, modern case law centers on *Conoco Inc. v. Corporation Commission*, 1988 OK 27, 764 P.2d 516, which sets out the Commission's authority to set allowables for oil wells and gas wells. In *Conoco*, the Oklahoma Supreme Court set aside Order No. 310755, which cut the unallocated capable gas well allowable from fifty percent of wellhead absolute open flow potential to 1,000 mcf/d plus twenty-five percent of wellhead absolute open flow potential above 2,000 mcf/d. Order No. 310755 cut the gas allowable in Cause No. RM 8, by amending OCC-OGR Rule 2-331, the predecessor to the current rule OAC 165:10-17-11.

By way of background, the Commission set up the unallocated gas well category as a default category for wells which did not have allowables set by either the Allocated Gas Rule or field rules sometimes called pool rules. In *Conoco*, most gas production in Oklahoma came from unallocated gas. At that time, the Commission had a general rule (Rule 2-331) which set the

allowable for all unallocated gas wells regardless of location and producing formation. Rule 2-331 set the allowable based on fifty percent of wellhead absolute open flow or 1,000 mcf/d. Status as a capable well arose from a tested potential of fifty percent of wellhead absolute open flow potential or more. Order No. 310755 addressed an oversupply problem by cutting only the capable well allowables, which had been fifty percent of wellhead absolute open flow since 1973.

The appellants in *Conoco* attacked Order No. 310755 from several angles. In its decision, the Court focused on a single fatal issue, namely whether the Commission had statutory authority to set a statewide gas allowable by rule, meaning without regard to common source of supply. The Court held that the Commission lacked such authority. In its analysis, the Court focused on the Commission's authority under 52 O.S. Sections 29, 239 and 243. From plain text, Section 29 sets legislative limits on production, while Section 239 authorizes setting of gas allowables, and Section 243 authorizes the Commission to adopt rules. In *Conoco*, the Court observed that the wording of 52 O.S. Section 239 was substantially the same as that of 52 O.S. Section 274 for oil. The Court had previously interpreted the Commission's authority under Section 274 in the *Wilcox Cases,* namely *H.F. Wilcox Oil & Gas Co. v. State*, 1933 OK 110, 19 P.2d 347, and *H.F. Wilcox Oil & Gas Co. v. Walker,* 1934 OK 280, 32 P.2d 1044. *The Wilcox Cases* required the Commission to set allowables by common source of supply, or on a pool basis. Consequently, the Court applied the same limitation to allowables set under 52 O.S. Section 239. With respect to 52 O.S. Section 243, which generally authorized the Commission to adopt rules implementing the 1915 Act, the Court found that Section 243 did not provide an independent basis to set allowables by rule. At the end of *Conoco,* the Court addressed 52 O.S. Section 29, referenced in OAC 165:10-17-11. The Court determined that 52 O.S. Section 29 set legislative limits on allowable production, but did not confer authority on the Commission to set gas allowables. Thus, the Oklahoma Supreme Court

in *Conoco* held that 52 O.S. Sections 29, 239 and 243 do not authorize the Commission to set a statewide gas allowable by rule and that the Commission must set allowables for each common source of supply.

The *Conoco Decision* seems to say that the Commission should shift back to setting gas allowable through field rules and periodic market demand hearings. Yet, that is not what happened next for several reasons. Producers did not want to pay for the costly land work to give the extensive notice required for a field rules application after *Harry R. Carlile Trust v. Cotton Pet. Corp.,* 1986 OK 16, 732 P.2d 438. Next, during the early 1980s, a substantial spot market emerged where those purchasers lacked any economic incentive to make nominations to establish market demand and allowables under typical field rules. Third, no one wanted the additional expense of the required production accounting associated with a monthly allowable schedule. As a result, OAC 165:10-17-11 gives lip service to the *Conoco Decision.* Its procedure periodically sets a statewide formula, which generally applies to all gas reservoirs. This procedure was never challenged, because the Oil and Gas Conservation Division consistently proposed high allowables which were uncontested. Therefore, OAC 165:10-17-11 remains untested in the appellate courts.

The question is now whether the cut by Order No. 709553 changed anything. The Order targeted a small number of capable wells. On its face, that is discriminatory and therefore fails to comply with *Conoco,* inasmuch as the Order departs from the "fair share of the reservoir" concept discussed above. However, it remains to be seen if anyone will attack it, given current, low net back prices for natural gas. It is submitted that such prices are below breakeven points of $45-50/b for the STACK, Merge, and SCOOP where the breakeven points are $45-50 per barrel.

At the merits hearing in Cause No. CD 202000323, proponents of the reduction in the capable well allowable contended that such a reduction would favorably influence gas prices. The

problem is that the prudent gas purchaser has some understanding of the gas market and most engineers employed by such a purchaser can build a market history and now have desktop software to harvest public and subscription databases for the data to estimate a financial well profile with items such as well deliverability, production decline, breakeven cost per barrel equivalent, levelized cost, and the z-point for the participating working interest investment. As a result, prudent gas purchasers can estimate supply and value. Generally, the well allowable is only a factor influencing market price where it significantly affects supply. Here, there is no evidence that supply is affected.

Opponents of Order 709553 contend that the allowable reduction discourages gas transmission line development. It is submitted that the current hurdles for pipeline development appear to be corporate debt during a recession and right-of-way issues such as groundwater pollution risk, endangered and threatened species, and NEPA and NPDES permits for stream and river crossings.

Turning to the OEPA application, we only have the pleadings at this time. The application essentially requests a reduction in statewide oil allowables because of economic waste due to market price collapse. Along that line, price decline is a national if not global problem, but no other state has thus far prorated oil wells to address current market oversupply. In fact, the Rail Road Commission of Texas recently declined to proceed with a proration plan after taking ten hours of expert testimony. Still, OEPA asks the Commission to go it alone. On that path, the central question is whether there is any remedy in the statutory quiver that will improve anything. As discussed above, the proration statutes assume that producers in a reservoir will share limited market demand during periods of oversupply. The remedy did not contemplate foreign governments flooding US markets. On April 30, 2020, the price of crude oil was below $16 per

barrel sending oil to at a 21-year low. The April glut resulted from Saudi Arabia and its Gulf allies opening the taps after collapse of an OPEC production pact. Currently, US refiners are reducing their purchases due to reduced demand for road and jet fuel because of the Pandemic. Nevertheless, 76 tankers carrying fifty million barrels are currently waiting to unload in U.S. ports: 25 million on West Coast and a similar load on the US Gulf Coast. Meanwhile, the Saudis have sent an additional 28 tankers carrying 43 million barrels. Commercial crude stockpiles stand at about 518.6 million barrels, nearly nine percent about the five year average for this time of year and just 16.9 million barrels away from hitting the record level of 535.5 million barrels teases during the spring of 2017. US refiners demand for crude has dropped over 3.0 million bpd during the last four-week period, but the EIA reports that oil production has only decreased by 800,000 bpd. Bulk storage in Cushing is full, and the commodity market may go negative in May.

The third application I will discuss was filed by LPD Energy in Cause No. CD 202000986. Rather than requesting the setting of allowables, LPD's application seeks a finding by the Commission ". . . that the production of oil in the State of Oklahoma under currently existing conditions may constitute economic waste, in some circumstances, as defined under 52 O.S. § 273." In addition, LPD's application seeks ". . . an interim order to assist in the prevention of waste and optimize production, which provides that operators may shut-in or curtail oil production from wells where the operator deems such action necessary in the current abnormal and volatile oil pricing environment." LPD also filed an application for emergency order seeking the same relief.

A hearing on LPD's application for emergency order was held on April 17, 2020, and on April 22, 2020, a majority of the Commission issued Order No. 710884 grating LPD's emergency application. I did not participate in the signing of this emergency order. I was not satisfied that

adequate notice of the hearing on the emergency application was provided to all affected parties, including mineral owners. There were no named Respondents in the application or the emergency application, and a Certificate of Service was not attached to the Notice of Hearing. In addition, there was no publication notice at that time. The Administrative Law Judge also raised numerous questions at the emergency hearing regarding notice. In the end, it was not clear to me that the basic requirements of due process had been met. Lack of notice of the emergency hearing is particularly concerning in this case due to the large number of parties who may be affected. The emergency order provides that operators and producers may shut-in or curtail oil production from wells where they determine such action is necessary and warranted to prevent economic waste. The order applies to all operators and producers in the State of Oklahoma, yet many of those operators and producers, as well as the corresponding royalty and mineral interest owners, were not provided with notice.

LPD asked for a voluntary order with statewide applicability for two reasons. First, LPD speculated that there may be well operators with contracts that make their wells economic and that there may be wells that have to be produce to maintain productive capacity and preserve ultimate recovery.

Next, LPD contended that it needed the voluntary order to preserve oil and gas leases statewide. LPD's argument is based on the testimony of LPD's witness Mr. Eddie Rongey about his oil and gas leases, which he did not provide for review. In any event, Mr. Rongey testified that he is losing money from producing oil, because he has to produce uneconomic wells to preserve his oil and gas leases. His theory is that for his oil and gas leases, the lease expires if the well is shut-in unless a regulatory order triggers a savings clause such as the prohibition against waste.

Case law shows that terms of oil and gas leases vary considerably because lessors and lessees are generally free to negotiate terms and conditions of lease provisions. Nevertheless, the Oklahoma Supreme Court has repeatedly ruled for lease extensions beyond primary term without production and without a Commission order like Order No. 710884. In *Hall v. Galmor*, 2018 OK 59, 427 P.3d 1052, the Court focused on lease extension through the cessation of production clause in an oil and gas lease and also discussed prior published cases involving lease extension of a non-producing lease through operation of the habendum clause as well as various other clauses common in oil and gas leases.

In a nutshell, a judicial finding of lease expiration for failure to produce in paying quantities consists of four elements: the accounting period, the revenue generated during the accounting period, the expenses incurred during the accounting period, and any equitable considerations that justify the lease maintaining an unprofitable lease. Here, Mr. Rongey failed to establish such details or that the requirements of his leases apply statewide.

The three applications discussed herein presented a common problem: the applicants have uneconomic operations due to oversupplied markets, and the applicants contend that regardless of the risk to jobs and revenue, cutting back production is to the general benefit or Public Good by preserving leases or influencing price. However, we have a 1915 era statutory program, which assumes that the Commission can control supply and allocate limited market demand. The problem is that Oklahoma oil products now compete on national and international markets, and that they are on the competitive fringe of oil markets dominated by national oil companies beyond the Commission's control. The ultimate question for oil is whether to just let supply and demand eventually return to balance, or risk loss of revenue, jobs and market share through curtailment, which gives other States and foreign nations an opportunity to fill in the gap left by curtailment in

Oklahoma. For gas, the proration advocates ask the Commission to adopt an untenable position which is to curtail one class of wells without regard to either correlative rights or the market glut contribution of minimum unallocated wells and associated gas from oil wells.