

DMN-1: Public Hearing Processes for Oil and Gas Well Spacing and Compulsory Integration

New York State Department of Environmental Conservation

DEC Program Policy

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I. Summary:

This policy provides guidance to Department staff for the initiation and conduct of public hearings for oil and gas well spacing and compulsory integration. The policy identifies the conditions under which hearings will be called and the procedures for conducting the hearings. The procedures herein apply only to spacing unit proposals and integration hearings associated with well permits issued on or after August 2, 2005. Furthermore, the procedures related to establishment of spacing units only apply to well permits for locations which are outside of pre-1981 oil fields and pre-1995 gas fields which are not being extended. However, the procedures herein may be implemented, to the extent applicable, for other pending and future proceedings related to spacing and integration.

II. Policy:

Article 23 of the Environmental Conservation Law, as amended by Chapter 386 of the Laws of 2005, provides a framework for key decisions to be made about participating in the costs and obligations of drilling an oil and/or gas well before the well is drilled. If well drilling and production in New York are to continue with reasonable certainty, the required agency review must be conducted promptly and with a frequency that neither prohibits appropriate consideration of risk by potential well participants nor hampers the industry's ability to maintain leases and contract for services.

Hearings pursuant to 6 NYCRR Part 624 are not automatic, because the law provides for statutory statewide spacing and clearly sets forth the integration process and options in considerable detail. As set forth below, referrals for adjudicatory hearings will only occur when the Division of Mineral Resources ("DMN") determines that a substantive and significant issue exists regarding a specific proposed non-conforming spacing unit or a proposed integration order, or when an owner who submits a timely and complete challenge to a proposed non-conforming spacing unit requests an adjudicatory hearing to review a DMN determination. An owner who requests an adjudicatory hearing bears the responsibilities and burden of proof assigned to an applicant in other Department permit proceedings.

A. Spacing Units

The statute requires that a spacing unit be established when the Department issues a well permit subject to Title 5 of Article 23. Effective August 2, 2005, the applicant for such a well permit must include a proposed spacing unit in the permit application.

1. Conforming units - Statewide spacing criteria include unit size and wellbore setbacks. These criteria are based on depth and, in some instances, the objective formation of the well. If the proposed

unit conforms to statewide spacing criteria set forth in the statute, then no spacing order or spacing hearing is necessary and the Department will issue the well permit after the required notice of intent is published. Issuance of the well permit for a well in a proposed conforming unit establishes the unit as a matter of law. The Department anticipates that most proposals will be for conforming units that do not require spacing orders and spacing hearings.

2. Non-conforming units - If the proposed unit does not conform to statewide spacing criteria, then the statute provides for notice and an opportunity for objections. There are two possible scenarios which can result in a referral to the Department's Office of Hearings and Mediation Services ("OHMS") and an adjudicatory hearing:

- DMN staff review any objections received and determine that a substantive and significant issue exists, or
- An owner who submits a complete and timely challenge to a proposed non-conforming spacing unit requests a hearing. The criteria and procedures by which an objecting owner may request a hearing are discussed herein.

Upon referral to OHMS, procedures of 6 NYCRR Part 624 will apply. Additional detail regarding the burden of proof at an adjudicatory hearing and hearing costs is set forth below.

B. Compulsory Integration

A public hearing must precede every compulsory integration order. DMN Compulsory Integration Hearings, convened by the Director of the Division of Mineral Resources ("Director") or a designee per 6 NYCRR 550.4(b), will be scheduled at 625 Broadway in Albany on a regular basis. The Department anticipates that each integration hearing will include a docket of several spacing units in a variety of locations statewide. By the time an integration hearing is convened, each spacing unit on the docket is already established by law or by order. Therefore, the spacing unit is not subject to challenge at the integration hearing.

At least 30 days prior to each integration hearing, the uncontrolled owners in each unit on the docket will receive, from the well operator: a notice of hearing; a Department form for electing how their interests will be integrated; and an estimate of costs more fully described in Section V(B) of this policy. Within 21 days of receiving the notice, owners must elect one of three options: integration as a participating owner, as a non-participating owner or as a royalty owner. The notice will include a draft integration order. Those who elect integration as participating owners will be required to pay their share of well costs prior to the conclusion of the hearing. Owners who do not make an election will be integrated as royalty owners and be compensated as such. Additional detail regarding the election options and procedures is set forth below. The purpose of the hearing is to ratify the elections, hear objections, including objections to estimated well costs and other contents of the notice, and finalize an order which identifies each unit interest and specifies how uncontrolled interests are integrated into the unit. By the date of the hearing, affected owners will have had 30 days to review the draft integration order and estimated well costs, and formulate any objections. The order will be signed and finalized at

the hearing, unless the Director or his/her designee determines in response to an objection that (1) a substantive and significant issue exists which requires adjudication, or (2) revisions to the draft order are required before it can be accurately finalized.

III. Purpose and Background:

Substantial revisions to the ECL provisions governing well spacing and compulsory integration were signed into law on August 2, 2005. Effective and efficient agency review is critical to the success of the new statute. The purpose of this policy is to provide guidance to Department staff for implementing the new hearing processes.

Chapter 386 of the Laws of 2005 significantly amended Article 23, Titles 5 (well spacing) and 9 (compulsory integration). Previously, spacing and integration rules were promulgated on a field-wide basis, after one or more wells were drilled in a newly discovered field. Because spacing units were not established prior to drilling, landowners often did not know whether their tracts were proposed for assignment to specific wells until after the wells were drilled, production had commenced and integration proceedings were underway. These procedures removed due consideration of risk from decisions related to participating in well costs and subsequent operations such as gathering and marketing the production. The resulting controversies complicated the Department's efforts to develop just and reasonable integration orders through a hearing process.

The 2005 revisions correct these problems by addressing spacing and integration as separate processes. A well permit will not be issued and integration proceedings will not commence until the spacing unit is established. Therefore, the acreage assigned to any well, and the owners therein, are identified before the well is drilled. This approach allows decision-making before the well is drilled, when an element of risk is appropriately still present. In addition, the previously mandated field-wide approach is replaced with an individual unit approach, so that controversy regarding one unit in a field does not hinder development, allocation of production and payments to owners situated in other units in the same field.

Following is a more detailed discussion of the key provisions of the new legislation.

A. Statewide Spacing

The law assigns specific spacing unit sizes and wellbore setbacks based on depth of the objective producing zone and, in some cases, the specific rock formation targeted for production. No spacing order is required when an applicant for a well permit proposes a unit which conforms to these unit sizes and setbacks. Issuance of the permit establishes the unit. In essence, the new statute represents an enhancement of the pre-existing regulatory statewide spacing requirement in 6 NYCRR Part 553. While the pre-existing regulatory statewide spacing established one setback and unit size by default regardless of depth or formation, the new statutory framework sets a system of defaults which recognizes the effects of depth and formation. Establishment of spacing unit sizes and setbacks by law when the well permit is issued eliminates the potential for lengthy post-drilling unit configuration disputes to delay participation decisions and the integration process.

Just as applicants could always request variances from regulatory statewide spacing, applicants under the new law may request approval of spacing units which do not conform to statutory statewide spacing. Such proposals must be supported by technical justification. The new law and this policy require that an equal level of support and technical justification be advanced by any affected owner who challenges the non-conforming unit. Challenges may lead to an adjudicatory hearing, where the challenging owner bears responsibilities and the burden of proof assigned to an applicant in other Department permit proceedings. The Department's objective is that only substantive and significant disputes will require adjudication, while well permits that do not involve substantive and significant disputes will be processed expeditiously, as is explicitly required by the legislation.

B. Compulsory Integration

The statute does not preclude owners and well operators from entering into leases, joint operating agreements or other voluntary agreements for developing resources within a spacing unit. However, issuance of a well permit triggers the compulsory integration process which culminates in a Department order to address those owners who have not entered voluntary agreements with the well operator. These owners are referred to as "uncontrolled owners" in the statute, and the compulsory integration process protects their correlative rights by offering them the three options described below.

1. Integration as an "integrated non-participating owner" - An owner who elects this option will receive the full share of production attributable to his or her acreage in the unit only after the well operator has recouped, from production, three times the costs attributable to that acreage. If the non-participating owner is a lessee, the well operator must pay the lessee a royalty during the recoupment or penalty phase. This royalty is on a graduated scale specified in the statute, and the well operator has no obligation to the lessor. The law does not provide for a royalty to an unleased owner during the penalty phase. After the penalty phase, an integrated non-participating owner is treated the same as an integrated participating owner with respect to subsequent expenses associated with operation of the well.
2. Integration as an "integrated participating owner" - An owner who elects this option pays the estimated costs attributable to his or her acreage in the unit up front, and receives the full share of production attributable to that acreage subject to a lien held by the well operator for any outstanding money owed. An integrated participating owner is liable for his or her share of additional costs associated with well operation for the life of the well.
3. Integration as an "integrated royalty owner" - An owner who elects this option will receive a royalty equal to the lowest royalty in an existing lease in the spacing unit, but no less than one-eighth, and shall have no obligations to the well operator or any other owner for any charges, taxes or fees associated with well operation. This is also the default election for any owner who fails to make a timely election during the allotted time period.

Because the above options and the ramifications of each are set forth in considerable detail in the new law, the Department expects that most proceedings held under the new statute will not require adjudication of disputes about the options available to uncontrolled owners.

C. Gathering and Marketing

For a productive well, the statute specifies that the well operator will provide integrated participating owners and integrated non-participating owners the opportunity to pay up front for their share of the gathering line. Owners who do not pay their share up front are subject to the well operator's recoupment of two times their share from production. The statute further specifies that owners may take their share of production in kind, but the well operator will market production for any owners who do not make arrangements to take in kind. These new statutory provisions eliminate the controversy caused by the previous lack of statutory language regarding transportation and marketing. Therefore, the Department does not anticipate gathering and marketing to arise as an issue for adjudication in proceedings held under the new law.

IV. Responsibility:

The Bureau of Oil and Gas Regulation in the Division of Mineral Resources is responsible for implementing this policy and for maintaining and interpreting this policy document, with appropriate assistance from the Division of Legal Affairs. The Office of Hearings and Mediation Services is responsible for conducting adjudicatory hearings on spacing units and integration orders that are referred by DMN in accordance with this policy.

V. Procedure:

Under Article 23 as revised in 2005, the spacing and integration processes are now separate. Therefore, the hearings for spacing and integration will no longer be combined and the pertinent procedures are discussed separately below.

A. Procedures for Spacing Hearings For Non-Conforming Units

When an applicant for a well permit proposes a non-conforming unit that does not meet statutory statewide spacing criteria, DMN must first conduct a technical review to determine if issuance of the well permit meets the policy objectives of Title 3 of Article 23. Upon an affirmative determination, the Department will publish a notice of intent to issue a spacing order and well permit in the Environmental Notice Bulletin. In addition, the Department will provide the notice of intent to the applicant for publication in a newspaper having general circulation in the area within which the proposed unit is located, as well as direct mailing no later than the date of publication to all owners within the proposed unit and the surface owner of the tract where the well will be located, which may be outside of the proposed unit. The notice will provide for a 30-day comment period which closes at 4:00 pm on the 30th day after the notice is published in the newspaper, or the next business day if the 30th day is on a weekend or state holiday.

The statute sets forth the required contents of any challenge to unit configuration that is submitted during the comment period. It must include presentation and interpretation of acceptable scientific data of sufficient substance and quality to challenge the scientific data and interpretation presented by the applicant for a well permit who is proposing the spacing unit. Acceptable scientific data includes, but is

not limited to: seismic reflection data, geologic data, well log data, reservoir engineering analysis and well-testing data.

DMN must review timely comments and unit challenges to determine whether any substantive and significant issue has been raised. A substantive and significant issue exists if the regulatory standards for such, as set forth in 6 NYCRR 624.4(c), are met and the owner raising the issue has complied with the requirements of ECL §23-0503(3)(c). DMN will convey its determination to the party(ies) who submitted the comments and/or challenges by certified mail. There are two scenarios which could result in an adjudicatory hearing conducted by OHMS.

Potential Hearing Scenario 1 - DMN will determine that a substantive and significant issue exists regarding a proposed spacing unit and/or adjustment of allowable production therein upon a demonstration by the person making the challenge that the spacing unit or adjustment of allowable production proposed by the applicant for a well permit may not meet the statutory criteria to prevent waste, ensure greater ultimate recovery of oil and gas, and protect correlative rights. Pursuant to ECL §23-0503(3)(c), the challenge must include a proposed alternative spacing unit. Accordingly, the applicant for a well permit and the challenger will share the cost of the hearing (see 6 NYCRR 624.11) and will each bear the burden of proof assigned to an applicant (see 6 NYCRR 624.9[b]) regarding the respective proposed spacing units.

Potential Hearing Scenario 2 - If DMN determines that no substantive and significant issue has been raised, then an owner who disagrees with this determination may request a hearing before an ALJ if the following criteria are met:

- The owner submitted a complete, timely challenge to the proposed spacing unit, and
- The owner's complete and timely challenge included a proposed alternative spacing unit that would result in the objecting owner's holding a different proportional interest in the proposed spacing unit than was proposed by the applicant for a well permit.

The objecting owner or owners must submit the request for a hearing to DMN within 10 business days of receiving DMN's determination that no substantive and significant issue has been raised. DMN will then expeditiously refer the matter to OHMS for proceedings pursuant to 6 NYCRR Part 624.

At the requested hearing, all owners, including an objecting owner who has met the above criteria and any non-objecting owner who wishes to participate in the hearing, are automatic parties pursuant to 6 NYCRR 624.5(a). The objecting owner(s) will bear the costs of the hearing (see 6 NYCRR 624.11) and will bear the burden of proof assigned to an applicant in other Department permit proceedings (see 6 NYCRR 624.9[b]).

Under either potential hearing scenario, the applicant for a well permit and any objecting owner may attempt to reach a private resolution prior to an adjudicatory hearing. The objecting owner and the applicant must inform the Department in writing if resolution is reached and the objecting owner agrees to withdraw its challenge. If all challenges are withdrawn, the Department will cancel the hearing and

will issue a well permit and spacing order for the spacing unit as originally proposed, unless the applicant proposes a revised unit. Any resulting proposed revised unit will be subject to notice pursuant to ECL §23-0503(3)(b) unless the proposed revised unit conforms to statutory statewide spacing.

If DMN does not receive a timely and complete request for a hearing, or if a challenge is withdrawn and no challenges to the proposed revised unit are received, then DMN will issue the drilling permit and a spacing order signed by the Director, Division of Mineral Resources. If an adjudicatory hearing is required, then the well permit and spacing order will not be issued until after the administrative hearing process is concluded. Spacing orders which follow adjudicatory hearings will be signed by the Commissioner of the Department.

B. Procedures for Compulsory Integration Hearings

The applicant for a well permit will inform DMN in the application whether compulsory integration is necessary for the proposed spacing unit. Upon issuance of a well permit in a unit wherein compulsory integration is required, DMN will take the following actions:

- Add the unit to the docket for the next available integration hearing date that allows sufficient time for notice and elections pursuant to the statute.
- Inform the well operator of the assigned hearing date. The hearing schedule will be posted on a DMN web page accessible via <http://www.dec.state.ny.us/website/dmn>, and the list of wells to be addressed at the next scheduled hearing will be added to the web posting at least 30 days prior to the hearing. The Department will arrange for the services of a certified reporter to produce a stenographic transcript of the hearing, the cost of which will be shared by all the well operators on the docket.
- Provide the operator with the notice of hearing required by ECL §23-0901(3)(c) and a draft integration order for publication and distribution. The election form which also must be distributed to uncontrolled owners will be available for download on DMN's website.
 - **Attachment 1** to this policy is the form of notice prescribed by the Department.
 - **Attachment 2** to this policy is the template for integration orders to be issued under the new statute.
 - **Attachment 3** to this policy is the compulsory integration election form that uncontrolled owners will be required to complete and submit.

At least 30 days prior to the scheduled hearing for any given well, the well operator is required to publish and distribute the notice of hearing to uncontrolled owners. The notice provided directly to uncontrolled owners must include an election form, a draft integration order and an Authorization for Expenditure ("AFE") prepared by the well operator which sets forth the estimated costs to drill, complete and plug the well, including a fixed rate charge for supervision of these activities. Prior to or contemporaneously with publishing and distributing the notice, the well operator must provide the

Department with a breakdown of tracts wholly or partially within the spacing unit, ownership status of each tract and estimated costs attributable to each uncontrolled tract.

The law provides uncontrolled owners with 21 days to inform the well operator and the Department of their elections. Those who elect to participate must pay the well operator the estimated costs attributable to their proportional interest in the unit, by cash or certified check, prior to the conclusion of the hearing, unless, as discussed below, there is a dispute about well costs which cannot be resolved at the hearing. Regardless of the existence of any dispute regarding well costs, however, an uncontrolled owner who wishes to participate must make that election within the mandated 21-day time period and be prepared to pay its share of well costs prior to the conclusion of the hearing. The order will require that these payments be held in an interest-bearing escrow account by the well operator until the expenses are actually incurred, with interest applied toward the integrated owner's share of costs.

The Hearing - All uncontrolled owners and other interested parties may attend the hearing. However, hearing attendance is only mandatory for uncontrolled owners who wish to raise an objection and those who elect to participate but do not pay their share of estimated costs prior to the hearing date.

At the hearing, the Director or a designee will proceed as follows:

- Identify the unit to be integrated and the well permit issued therein.
- State the dates of any spacing hearing and any spacing order issued for the unit, if such were necessary. State that the spacing order, or the statutory spacing unit if no order was required, fulfills the policy mandates of preventing waste and ensuring greater ultimate recovery.
- Confirm that the well operator gave due, proper and sufficient notice of the integration hearing by both publication and direct distribution to uncontrolled owners, and that all such owners have had 30 days to formulate any objections to the draft integration order.
- State the Department's position that compulsory integration pursuant to the proposed order will protect the correlative rights of all owners.
- Read the elections made by each uncontrolled owner, which will be recorded in the form of a completed Exhibit D to the integration order prepared prior to the hearing and available for review at the hearing.
- Verify that participating owners have made the required payments or are present at the hearing and prepared to make payments by the conclusion of the hearing.
- Identify any owners who did not make elections and are therefore integrated as royalty owners.
- Identify any tracts where the owners remain unknown or cannot be located after diligent attempts by the well operator.

- Ask for objections, and explain that only those which are substantive and significant will be referred to OHMS for adjudication. Objections to the contents of the notice, including estimated well costs, should be stated and will be reviewed at this time. A well cost dispute which is not supported by evidence will be resolved at the hearing in favor of the well operator. If evidence is presented which supports the dispute, the Director or his/her designee will hold the unit over pending private resolution of the dispute between the parties prior to or at the next hearing. Alternatively, if such resolution of the well cost dispute appears unlikely, the Director or his/her designee will determine that a substantive and significant issue exists and refer the matter to OHMS for adjudication. In the case of well costs, evidence which may support a dispute could include, but is not necessarily limited to, receipts for equivalent equipment or services purchased at similar wells, actual price lists for equivalent equipment or services, or actual AFE's for similar wells.
- Title disputes or tax map errors will not be referred to OHMS.

Potential Hearing Results – The possible conclusions regarding any specific unit are listed below.

- An integration order will be signed by the Director or a designee at the hearing if no substantive and significant issues have been raised, no unresolved disputes other than title disputes exist, and no changes are required to the integration order drafted prior to the hearing.
- If the Director or his/her designee determines that no substantive and significant issues or unresolved disputes exist but the draft integration order cannot be finalized because revisions are required, then the order will be revised accordingly and issued as expeditiously as possible after the hearing.
- If the Director or his/her designee determines that an unresolved dispute, other than a title dispute, exists which does not raise a substantive and significant issue, the order will be held over for the next integration hearing. The parties may attempt to reach private resolution prior to the next hearing.
- If the Director or his/her designee determines that a substantive and significant issue exists, then the matter will be referred to OHMS for an adjudicatory hearing. The objecting owner will bear the burden of proof assigned to an applicant in other Department permit proceedings. Compulsory integration orders which follow adjudicatory hearings will be signed by the Commissioner of the Department.

C. Post-Order Disputes

Although the compulsory integration order governs interactions among the parties, the Department has only a minimal ongoing role in such interactions after the order is issued. The Department's role is limited to jurisdiction over compliance with the order pursuant to ECL. An owner in the unit, or any other person, who believes a violation has occurred or is in progress should contact the Department and appropriate action will be taken pursuant to ECL Articles 23 and 71.

Disputes between the operator and the integrated owners which do not constitute violations of the order, such as disputes regarding gathering line costs or costs of subsequent operations, and payments therefor, are not properly resolved by or before the Department.

VI. Related References:

Oil, Gas and Solution Mining Law, ECL Article 23, Titles 5 and 9 as amended by Chapter 386 of the Laws of 2005

Mineral Resources Regulations, 6 NYCRR Parts 550 - 559

Permit Hearing Procedures, 6 NYCRR Part 624

Declaratory Ruling DEC #23-14: “Definition of Owner” and “Definition of Correlative Rights”¹

¹Declaratory Ruling DEC #23-14 is referenced *only insofar as it discusses the definitions of “owner” and “correlative rights.”* The statutory language regarding compulsory integration that was interpreted by DEC #23-14 was significantly amended by Chapter 386 of the Laws of 2005.