

STATE OF NEW YORK
DEPARTMENT OF ENVIRONMENTAL CONSERVATION
625 BROADWAY
ALBANY, NEW YORK 12233-1010

In the Matter

- of -

the Proposed Field-wide Spacing and
Integration Rules for the

TERRY HILL SOUTH FIELD,

Pursuant to Article 23 of the Environmental
Conservation Law and Parts 550 through 559 of
Title 6 of the Official Compilation of Codes,
Rules and Regulations of the State of New
York.

DEC Project No. DMN-02-03

SECOND INTERIM DECISION OF THE ASSISTANT COMMISSIONER

June 7, 2007

SECOND INTERIM DECISION OF THE ASSISTANT COMMISSIONER¹

Staff of the Department of Environmental Conservation ("Department") commenced proceedings pursuant to part 624 of title 6 of the Official Compilation of Code, Rules and Regulations of the State of New York ("6 NYCRR"), proposing issuance of an order that would establish field-wide spacing and integration rules for the Terry Hill South natural gas field (the "Field"). Presently before the Assistant Commissioner is a joint appeal filed by petitioners for party status Buck Mountain Associates ("Buck Mountain"), Rural Energy Development Corp. ("Rural Energy"), Western Land Services, Inc. ("Western Land Services"), Florence Teed, Rae Lynn Ames, and Douglas J. Lustig, as trustee of the bankruptcy estate of Linda and Terry Zahurahnac,² (collectively "petitioners"). The appeal is from (1) a June 17, 2004 ruling on issues and party status issued in

¹ By memorandum dated April 14, 2006, Commissioner Denise M. Sheehan delegated decision making authority in this matter to Assistant Commissioner Henry L. Hamilton. The parties were so informed by letter dated April 18, 2006. By memorandum dated May 10, 2007, Commissioner Alexander B. Grannis reconfirmed the delegation of decision making authority in this proceeding to Assistant Commissioner Hamilton (see attached).

² By letter dated February 18, 2004, the ALJ was informed that the Zahurahnacs, who filed the original petitions for party status, have filed a bankruptcy petition and that bankruptcy trustee Douglas J. Lustig is pursuing, for the benefit of the bankruptcy estate, all claims of the estate for oil, gas and mineral rights.

these proceedings by Administrative Law Judge ("ALJ") Maria E. Villa ("Issues Ruling"), and (2) a July 2, 2004 ruling of the same ALJ denying Buck Mountain's motion for clarification and to extend the time to appeal ("Clarification Ruling").

On December 21, 2004, Commissioner Erin M. Crotty issued a first interim decision holding that no adjudicable issues concerning the establishment of spacing units in the Field were raised. Accordingly, Commissioner Crotty directed that an order establishing Field boundaries and the proposed spacing units within the Field be prepared pursuant to Environmental Conservation Law ("ECL") former § 23-0501.³

This second interim decision concerns the remainder of the issues raised on petitioners' appeal. For the reasons that follow, the ALJ's Issues Ruling is modified and the matter is remanded for further proceedings, including adjudication if necessary, for the compulsory integration of interests in the Field. In light of the foregoing, petitioners' appeal from the ALJ's Clarification Ruling is rendered academic.

FACTS AND PROCEDURAL BACKGROUND

The factual and procedural background of this proceeding are provided in the first interim decision and will not be repeated here (see Matter of Terry Hill South Field, First

³ In 2005, the Legislature substantially revised ECL article 23 (see L 2005, ch 386). This proceeding remains governed by ECL former article 23 (see id. § 10).

Interim Decision of the Commissioner, Dec. 21, 2004, at 2-5). For purposes of this second interim decision, the additional facts and procedural background are as follows.

After Fairman Drilling Company began development of the Ordovician Trenton-Black River gas bearing formations in the Field, Department staff entered into a stipulation dated October 9, 2002 with Fairman concerning procedures for the issuance of a Field-wide spacing and compulsory integration order pursuant to ECL article 23. Fairman subsequently conveyed its interest in the Field to Fortuna Energy Inc. ("Fortuna"), which continued to pursue establishment of the Field and the spacing units therein,⁴ and compulsory integration of interests in the Field.

The stipulation proposed compulsory integration of unleased mineral rights owners in the Field as 1/8th royalty interests. Specifically, the stipulation provided that "those parcels not under lease within the Spacing Unit shall be compulsory integrated on a non-surface entry basis and owners of such parcels shall receive royalty payments equal to the lowest royalty fraction, but no less than one-eighth, contained in any

⁴ The eight spacing units in the Field, and their acreage, are: Broz/Kimball #1 unit -- 639.7 acres; Clauss #1-A unit -- 323.1 acres; Gublo #1 unit -- 541.2 acres; Hammond #1 (formerly Colson #1) unit -- 537.8 acres; Hinman #1 unit -- 492.8 acres; Kienzle #1-A unit -- 578.0 acres; Lant #1 unit -- 620.2 acres; and Lant #2 unit -- 432.5 acres. Note that the well in the Kienzle unit is spelled "Kienzel" in the stipulation. This decision uses the spelling of Kienzle that appears on the maps attached to the stipulation.

oil and gas lease within the Spacing Unit" (Stipulation ¶ VII.F).

Department staff referred the matter to the Department's Office of Hearings and Mediation Services for adjudicatory proceedings pursuant to the Department's permit hearing proceedings (see 6 NYCRR part 624 ["Part 624"]). ALJ Villa was assigned.

Petitioners filed a joint petition for party status challenging, among other things, their proposed integration as royalty interests in the Field. In their petition, petitioners sought integration as full working interest owners as provided for in ECL former 23-0901(3). Petitioners also challenged whether the well costs incurred or to be incurred by Fortuna were appropriate, and whether Fortuna has an obligation to transport and market gas for the other working interest owners in the Field.

The ALJ conducted a Part 624 legislative hearing and issues conference, and authorized the submission of post-issues conference briefs. The ALJ thereafter issued the June 17, 2004 Issues Ruling. In that Ruling, the ALJ held that no adjudicable issues were raised concerning either the establishment of the Field and the spacing units therein, or the compulsory integration of interests within the spacing units. In concluding that no adjudicable issues were raised concerning compulsory integration, the ALJ relied upon a recent Declaratory Ruling

issued by the Department's General Counsel (see Matter of Western Land Servs., Inc., Declaratory Ruling No. 23-14, Jan. 29, 2004 ["DR 23-14"]). DR 23-14 was issued in response to a separate petition by petitioner Western Land Services seeking a declaratory ruling pursuant to 6 NYCRR part 619.

Buck Mountain subsequently filed a motion for clarification of the Issues Ruling and to extend the time to appeal. On July 2, 2004, the ALJ denied the motion for clarification, but granted the motion to extend the time to appeal (see Clarification Ruling). Petitioners then filed an expedited appeal pursuant to 6 NYCRR 624.8(d)(2) from the Issues Ruling and the Clarification Ruling. Department staff and Fortuna filed timely responses to petitioners' appeal.

As noted above, Commissioner Crotty issued a first interim decision that affirmed the ALJ's ruling that no adjudicable issues were raised concerning the size and configuration of the Field boundaries and the spacing units proposed for the Field. Accordingly, the Commissioner directed Department staff to prepare an order pursuant to ECL former 23-0501 establishing the Field boundaries and the proposed spacing units for the field, and releasing the escrowed royalties to the mineral rights owners in the Field other than petitioners (see First Interim Decision, at 15). The Commissioner reserved, however, on the remainder of petitioners' appeal, including the

terms of their compulsory integration (see id.). Subsequently, staff prepared, and the Commissioner issued, an interim order establishing the Field and releasing royalties to non-leased owners other than petitioners (see Interim Order of the Commissioner, Jan. 13, 2005).

Meanwhile, Western Land Services commenced a CPLR article 78 proceeding challenging certain provisions of DR 23-14. Both Department staff and Fortuna, among others, appeared as respondents in the article 78 proceeding. Supreme Court, Albany County (Malone, J.), granted Western Land Services' petition to the extent of annulling those portions of DR 23-14 declaring that the Department had the authority to limit an unleased mineral rights owner or non-operating mineral rights lessee to less than the full share of unit production attributable to acreage compulsorily integrated into a spacing unit after the unit operator recouped drilling costs and a 100-percent risk penalty (see Matter of Western Land Servs., Inc. v Department of Env'tl. Conservation, 5 Misc 3d 1013[A] [unreported disposition], 2004 WL 2563598 [2004]). Supreme Court otherwise dismissed the article 78 petition. On appeal, the Appellate Division, Third Department, modified Supreme Court's judgment by reversing so much thereof as invalidated a portion of DR 23-14, and as so modified, affirmed (see 26 AD3d 15, 21 [2005], lv denied 6 NY3d 713 [2006]).

While the article 78 litigation was pending, the Legislature amended ECL article 23 to substantially revise the procedures for establishing oil and gas well spacing units, and the compulsory integration of interests in those units (see L 2005, ch 386). As noted above, this proceeding remains governed by the former article 23 (see id. § 10).

By memorandum dated May 9, 2006, Chief Administrative Law Judge James T. McClymonds invited comment on the pending appeal in light of the Appellate Division's decision in Matter of Western Land Services, and the 2005 amendments to article 23. Comments and replies were filed by Department staff, Fortuna, and petitioners, respectively.

DISCUSSION

Lant #2 and Hinman #1 Units

Department staff indicates that the permit to drill issued by the Department for the Lant #2 unit expired on October 29, 2002, and the permit to drill for the Hinman #1 unit expired on November 6, 2002. Staff has forwarded an April 13, 2006 letter from Talisman Energy Inc. indicating on behalf of Fortuna that Fortuna has no plans to seek re-issuance of the expired permits. Accordingly, pursuant to ECL 23-0503(7), Department staff requests that Lant #2 and Hinman #1 units be extinguished, and that staff be directed to prepare a final order extinguishing

the units.

None of the parties filing comments object to Department staff's recommendations with respect to the Lant #2 and Hinman #1 units. Accordingly, staff's recommendations are accepted, and the units extinguished.

Gublo #1 and Hammond #1 Units

Department staff also requests that the Gublo #1 and Hammond #1 units be extinguished. Staff notes the well in Gublo #1 is unproductive and Fortuna has requested a permit to dispose of brine at the site. The Hammond #1 well is also unproductive.

None of the parties filing comments object to Department staff's recommendations with respect to the Gublo #1 and Hammond #1 units. Accordingly, staff's recommendations are accepted, and the units extinguished.

Because petitioners Teed and Ames have acreage only in the Hammond #1 unit and, thus, no longer have an interest in this proceeding, they withdraw the objections raised in their petitions without prejudice to any position they may assert in any other proceeding. Accordingly, petitioners Teed and Ames are denied party status without prejudice.

Broz/Kimball #1 and Clauss #1-A Units

Department staff indicates, and Fortuna agrees, that

all parcels in the Broz/Kimball #1 unit are controlled by Fortuna and none of the landowners in the unit raised objections to the spacing configuration or filed petitions for party status.

In response to staff's inquiry, Fortuna also confirms that all parcels in the Clauss #1-A unit are controlled by Fortuna and, consequently, compulsory integration is not required for this unit.

Accordingly, as per staff and Fortuna's request, compulsory integration is not required for the Broz/Kimball #1 and the Clauss #1-A units, and the record may be closed on the units.

Lant #1 and Kienzle #1-A Units

Petitioner Buck Mountain affirms that it is the lessee of two parcels in the Lant #1 spacing unit (see Petitioners' Reply Comments, Attachment A). In addition, Buck Mountain has assigned a portion of its interests, as a lessee, to petitioner Western Land Services, as a lessee (see Petitioners' Comments, at 7). Douglas J. Lustig, as trustee of the bankruptcy estate of petitioners Terry and Linda Zahurahnec, affirms that 50 percent of the mineral rights associated with 7.1 acres of property owned by the Zahurahnecs in the Kienzle #1-A unit are in the bankruptcy estate (see Petitioners' Reply Comments, Attachment A). Accordingly, the integration of the mineral interests of these

petitioners remains an issue that must be resolved.

The October 2002 stipulation proposed to integrate as a 1/8th royalty interest any owners in a spacing unit not under lease to Fortuna. In other words, instead of receiving any share of actual production of natural gas from the well in the unit, unleased owners were proposed to receive a monetary royalty equal to 1/8th the value of the production attributable to such owner's parcel within a unit. Such royalty would be paid free and clear of any liabilities associated with the operation of the gas well (see DR 23-14, at 17).

In their petitions for party status, petitioners sought to be integrated not as royalty interests, but as working interests. In other words, petitioners sought, pursuant to ECL former 23-0901(3), to share in the production of gas from the wells in the units in which their parcels are located, rather than have their share of production converted into a monetary royalty interest. Participation as a working interest would require the unleased owner to make arrangements to receive gas in kind or be subject to gas balancing provisions in the integration order (see id. at 18; see also id. at 7 n 11). Participation as a working interest also exposes the unleased owner to that owner's share of the risks and liabilities associated with operating a well.

In light of DR 23-14, the Appellate Division's decision

in Matter of Western Land Servs., and the major legislative revisions to Article 23, Department staff now proposes that petitioners be given the opportunity to make an election to be integrated as working interest owners or royalty owners, following receipt of a cost and revenue accounting by the well operator. Department staff asserts that it would not be just and reasonable to allow petitioners to participate as working interest owners without the application of a risk penalty, but that it would be just and reasonable to integrate petitioners as working interest owners subject to application of the statutory risk penalty. In the event petitioners decline integration as working interest owners, Department staff asserts that petitioners should be integrated as royalty interests, as originally proposed. Accordingly, staff requests that this matter be remanded to the ALJ for further proceedings.

In their comments, petitioners indicate that they are not seeking integration as working interest owners without a risk penalty -- that is, they do not seek integration as an "integrated participating owner" as that term is defined under the 2005 amendments (see ECL 23-0901[3][a][2]). However, they reiterate their request to be integrated as working interest owners subject to the risk penalty, that is, as "non-participating owners" as that term is defined under the 2005 amendments (see ECL 23-0901[3][a][1]).

Fortuna continues to assert that integrating petitioners as anything other than a royalty interest as originally proposed would not be just and reasonable. Nevertheless, Fortuna indicates that it might consent to petitioners' integration as non-participating owners subject to a risk penalty, depending on the specific terms and conditions of such integration, which have not yet been specified by Department staff.

I conclude that petitioners should be given the opportunity to elect to participate as a working interest, subject to application of a risk penalty. As indicated in DR 23-14, and as affirmed by the Appellate Division in Matter of Western Land Servs., uncontrolled owners are entitled to receive their proportionate share of production from a well as a working interest, subject to a risk penalty, and subject to terms of integration that are just and reasonable. Accordingly, this matter should be remanded to the ALJ for further proceedings. Those proceedings would include staff's proposal of the terms and conditions upon which petitioners would be integrated as working interests, and the opportunity for petitioners to so elect. In the event petitioners decline, or otherwise fail to elect, integration as non-participating owners, petitioners shall be integrated as a royalty interest.

Assuming petitioners elect integration as non-

participating owners, if Fortuna does not consent to petitioners' integration as a working interest, and to the extent Fortuna continues to object that petitioners' integration as a working interest is not just and reasonable, the issue will be subject to adjudication. Moreover, to the extent any party objects to the terms and conditions of integration proposed by staff, such objections will also be adjudicated.

With respect to the risk penalty, Department staff proposes to impose upon petitioners a 200-percent risk penalty (that is, costs plus 200 percent of such costs), as provided for in the 2005 amendments, and not the 100-percent risk penalty provided for under the pre-2005 statute (that is, costs plus 100 percent of such costs). Staff recognizes that the additional 100-percent risk penalty is not authorized under the pre-2005 statute. However, staff offers the additional 100-percent risk penalty as consideration for its proposal that Fortuna transport and market gas on behalf of any petitioner that elects integration as a non-participating owner.

Under the pre-2005 statute, the risk penalty is "twice the [non-participating owner's] share of the reasonable actual cost of drilling, equipping and operating, or operating the well, including a reasonable charge for supervision and interest" (ECL former 23-0901[3]; see DR 23-14, at 13-14). During the penalty phase, the well operator receives the non-participating owner's

share of production, subject to a royalty not to exceed 1/8th of that production to be paid to the non-participating owner.⁵ The statutory 100-percent risk penalty reflects a legislative judgment concerning the amount of penalty charged against non-participating owners sufficient to compensate a well operator for the risks involved in developing a well and to create an incentive for voluntary participation with the proposed operator on terms worked out in the marketplace rather than in the governmental context (see DR 23-14, at 13, 17).

As noted in DR 23-14, it could be debated whether the 100-percent risk penalty provided for in the pre-2005 statute was truly commensurate with the actual risk involved in drilling wells into the Trenton-Black River formation (see id. at 17). That debate was resolved in the 2005 amendments, which increased the risk penalty to 200 percent (see ECL 23-0901[3][a][1]). Notwithstanding the increase under the 2005 amendments, the 100-percent risk penalty under the pre-2005 statutes remains applicable to this proceeding as the legislatively-established balance of risks and incentives under the earlier law. As such,

⁵ The 1/8th royalty provided for in ECL former 23-0901(3) is different from the 1/8th royalty interest provided for in the stipulation. The former is a royalty paid to an unleased working interest owner during the risk penalty recovery period. The latter represents the conversion, pursuant to the Department's power to integrate unleased owners upon terms that are just and reasonable, of a working interest in gas production from a well, into a monetary royalty in lieu thereof free and clear of any liability associated with well operation.

the Department lacks the authority to impose a greater risk penalty (see Matter of Western Land Servs., 26 AD3d at 20).

Similarly with respect to the marketing and transportation of gas produced from a well, under the pre-2005 statute, the Department lacked the authority to compel a well operator to market and transport gas owned by others in the absence of a voluntary agreement to do so (see DR 24-14, at 14; Matter of Western Land Servs., 26 AD3d at 20). Thus, the Department lacks the authority in this case to compel Fortuna to transport and market gas owned by petitioners electing integration as non-participating owners on behalf of such petitioners. However, the Department does retain the authority under the pre-2005 statute to establish just and reasonable terms to allow petitioners to receive their share of production or otherwise compensate those petitioners who are incapable of receiving their portion of gas in kind at the well head (see DR 24-14, at 14-15; Matter of Western Land Servs., 26 AD3d at 20).

The parties remain free to negotiate and agree to the terms of integration they deem appropriate (see ECL former 23-0701). Thus, petitioners electing integration as non-participating owners may agree to a 200-percent risk penalty as consideration for an agreement by Fortuna to transport and market gas on petitioners' behalf, as Department staff has proposed. Absent such an agreement, however, any adjudication of the terms

of petitioners' compulsory integration will proceed against the backdrop of the Department's statutory authority, as established by the pre-2005 statute, and as interpreted by relevant Departmental Declaratory Rulings and Matter of Western Land Servs.

Fortuna asserts that the October 2002 stipulation binds Department staff, thereby preventing staff from recommending integration of petitioners as anything other than a 1/8th royalty interest. Fortuna overstates the binding effect of the stipulation. As previously noted in this proceeding, the stipulation serves the function in this proceeding that a draft permit serves in a permit hearing proceeding (see Matter of Terry Hill South Field, First Interim Decision of the Commissioner, Dec. 21, 2004, at 9). Unless all parties to the proceeding agree to a stipulation removing any or all issues from the hearing, the October 2002 stipulation remains subject to modification during the iterative administrative adjudicatory process.

Fortuna also argues that integrating petitioners as anything other than a 1/8th royalty interest owner is inconsistent with precedent and guidance respecting the Department's application of ECL former 23-0901. As noted in DR 23-14, however, Terry Hill South Field is one of the first cases where unleased owners sought integration on terms other than as 1/8th royalty interest owners (see DR 23-14, at 16 n 22).

Moreover, whether integration as a royalty interest is just and reasonable is determined on a case by case basis (see DR 23-14, at 17). The circumstance that it is just and reasonable in one case to integrate an unleased owner as a royalty interest, even where that unleased owner sought integration as a working interest, does not compel the conclusion that unleased owners must be integrated as a royalty interest in all other cases.

Thus, integrating petitioners in this case as a working interest is not inconsistent with agency precedent -- it would simply reflect case-specific circumstances. It would also reflect the legislative preference for integrating unleased owners based, in part, upon their own election, as provided for in the 2005 amendments. Although the 2005 law does not technically apply to this case, that legislative preference may inform the Department's exercise of its discretion under the prior law.

In sum, the matter should be remanded to the ALJ for further proceedings to resolve and, as necessary, adjudicate issues concerning the terms and conditions of petitioners compulsory integration. Accordingly, the petitions for full party status filed by Buck Mountain, Western Land Services, and Douglas J. Lustig, as trustee of the bankruptcy estate of petitioners Terry and Linda Zahurahnec, are granted.

Remaining Petitions for Party Status

In petitioners' June 9, 2006 comments, petitioners argued that petitioner Rural Energy Development Corp. should be granted full party status under 6 NYCRR 624.5(d) on the ground that it can make a meaningful contribution to the record regarding issues raised by petitioner Buck Mountain. In petitioners' June 23, 2006 reply comments, petitioner Rural Energy withdrew its objections and, thus, its request for full party status. Thus, the petition for full party status filed by Rural Energy is denied without prejudice.

CONCLUSION

In light of the foregoing, the petitions for full party status filed by Buck Mountain, Western Land Services, and Douglas J. Lustig, as trustee of the bankruptcy estate of Terry and Linda Zahurahnec, are hereby granted. The petitions of the remaining petitioners are denied without prejudice.

Department staff is hereby directed to prepare a final order extinguishing the Lant #2, Hinman #1, Gublo #1, and Hammond #1 units.

This matter is otherwise remanded to the ALJ for further proceedings consistent with this second interim decision. Development of the final terms of integration for the remaining units shall proceed pursuant to the procedures recommended by

Department staff and as modified by the ALJ, to the extent the ALJ deems such modification necessary or expedient. Modification of the procedures recommended by Department staff may be made by the ALJ upon application by the parties, or on the ALJ's own initiative. As provided herein, any remaining dispute among the parties concerning the terms and conditions of petitioners' integration into the remaining units shall be the subject of adjudication.

For the New York State Department
of Environmental Conservation

/s/

By: Henry L. Hamilton
Assistant Commissioner

Dated: June 7, 2007
Albany, New York