STATE OF NEW YORK
DEPARTMENT OF ENVIRONMENTAL CONSERVATION

In the Matter of the Integration of Interests within an Individual Spacing Unit Pursuant to Environmental Conservation Law ("ECL") § 23-0901(3) Known as,

DRUMM 1.

RULING

DEC Case No. DMN 06-09

Appearances:

-- Lipman & Biltekoff, LLP (Michael P. Joy of counsel), for appellant Western Land Service, Inc.

-- Nixon Peabody, LLP (David H. Tennant of counsel), for respondent-well operator Fortuna Energy Inc.

-- Alison H. Crocker, Esq., Acting Deputy Commissioner and General Counsel (Jennifer Hairie, Associate Counsel, of counsel), for staff of the Department of Environmental Conservation

RULING OF THE CHIEF ADMINISTRATIVE LAW JUDGE

Staff of the Department of Environmental Conservation ("Department"), Division of Mineral Resources ("DMN"), issued an order integrating interests within the natural gas spacing unit known as Drumm 1, over the objection of appellant Western Land Services, Inc. ("WLS"). WLS has filed a notice of appeal with the Department's Office of Hearings and Mediation Services ("OHMS") and inquired whether administrative proceedings are available to challenge the Drumm 1 integration order.

For the reasons that follow, and based upon the arguments presented, I conclude that no further administrative proceedings are available to WLS to challenge the Drumm 1 integration order. Accordingly, WLS's appeal is dismissed.

Procedural Background

On September 9, 2004, the Department issued to well operator Fortuna Energy Inc. ("Fortuna") a permit to drill the natural gas well known as Drumm 1 (API Number 31-101-23154-00-00), located in the Town of Bradford, Steuben County. Fortuna

subsequently proposed, and the Department accepted, a spacing unit for the well that conforms with Statewide spacing (see Environmental Conservation Law ["ECL"] § 23-0501[1][b], as amended by L 2005, ch 386, effective Aug. 2, 2005). The spacing unit was established after August 2, 2005.

Because the spacing unit for Drumm 1 contained "uncontrolled owners," a compulsory integration of interests hearing was noticed for May 30, 2006 (see Notice of Compulsory Integration Hearing, Order No. DMN 06-09, Exh C). "Uncontrolled owners" are mineral interest owners in a spacing unit who have not entered into a voluntary lease or participation agreement with the well operator (see ECL 23-0901[3][b]).

WLS sought to participate in the unit as an integrated participating owner ("IPO") (see ECL 23-0901[3][a][2]). WLS objected, however, to the inclusion of a risk penalty of 200 percent of well costs and a risk penalty of 100 percent of surface facilities costs in the computation of the amount to be paid Fortuna to participate as an IPO in the Drumm 1 spacing unit.

DMN staff, through a designee of the Director of DMN, conducted the integration hearing (see ECL 23-0901[3][b]). The Director's designee determined that no objections were stated at the hearing which raised a substantive and significant issue regarding notice, elections, or integration of interests in the spacing unit. Accordingly, the Director's designee issued Integration Order No. DMN 06-09, dated June 2, 2006. WLS's interest was integrated as a non-participating owner (see ECL 23-0901[3][a][1]; Order No. DMN 06-09, Exh D).

WLS sent a letter dated June 26, 2006 addressed to Commissioner Denise M. Sheehan and Chief Administrative Law Judge ("Chief ALJ") James T. McClymonds, inquiring whether any administrative remedies were available to WLS to challenge the Drumm 1 integration order. WLS also filed with OHMS what it deemed a "protective" notice of appeal.

Treating WLS's inquiry and notice of appeal as a request for a determination whether the Department's permit hearing procedures (see 6 NYCRR part 624 ["Part 624"]) are available under the circumstances presented, the Chief ALJ authorized the submission of comments and replies. Timely comments were received from WLS, Department staff, and Fortuna. Timely replies were received from WLS and Department staff. This ruling constitutes the ALJ's ruling on WLS's request (see 6 NYCRR 624.6[c]; 624.8[b][1][i]).

DISCUSSION

Applicability of Laws of 2005, Chapter 386

Effective August 2, 2005, the provisions of ECL article 23 ("Article 23") governing well permits and well spacing in oil and natural gas pools and fields were substantially amended (see L 2005, ch 386). The threshold question in this matter is which version of Article 23 applies, the law currently in effect (hereinafter, the "new law"), or the provisions of former Article 23 in effect prior to August 2, 2005 (the "old law").

The Drumm 1 well is considered by the Department to be a "transition well," that is, a well where the permit to drill was issued prior to August 2, 2005, but where compulsory integration was completed after that date. Department staff takes the position that where, as here, the spacing unit for the well was established after August 2, 2005, the new law applies to the compulsory integration of interests in the spacing unit.[1] WLS essentially agrees with staff that the new law applies.

Fortuna, however, concludes that the old law applies to the Drumm 1 well. Fortuna contends that this conclusion follows from the plain text of the 2005 amendments, the "physical impossibility" of applying the new integration options to wells that have already been drilled, and the legislative purpose behind the amendments. Fortuna argues that the legislative purpose of the new law was to require uncontrolled owners to elect the terms of their participation in a well prior to drilling and, thus, before it could be known whether the well was productive. Fortuna asserts that allowing uncontrolled owners to make the election after the well is drilled provides a "windfall" that eliminates the risks inherent in the new law.

I conclude that staff and WLS have the better argument. The new law contemplates that the spacing unit for a well will be established, either by law or by order, contemporaneously with the issuance of the permit to drill (see ECL 23-0503[2], [3]). The 2005 amendments, however, contain a transition provision that

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[1] Department staff distinguishes the situation where both the permit to drill and the establishment of the spacing unit occurred prior to August 2, 2005. In that circumstance, staff contends the old law applies to the compulsory integration of interests, even if completed after August 2, 2005. This circumstance is not before me and, thus, I have no occasion to pass on the correctness of staff's position.

applies to transition wells where the permit to drill has already been issued. That provision provides:

> "This act shall take effect immediately [August 2, 2005] and shall apply to any oil or gas well permit or spacing order issued on or after such effective date except as otherwise specifically provided in this act"

(L 2005, ch 386, § 10 [emphasis added]). The plain language of the 2005 amendments expressly indicates that they are applicable to either well permits issued after August 2, 2005, or where a spacing unit is established after that date. Fortuna's reading of section 10 would change the "or" to an "and" and, thus, ignores the express statutory language.

Staff's and WLS's reading of section 10 is confirmed by the new subdivision ECL 23-0503(5), a new provision added to Article 23 by the 2005 amendments. That provision provides:

> "For wells permitted prior to the effective date of this section [ECL 23-0503] where a spacing order is required but has not been issued, the department shall issue a notice of intent to issue a spacing order"

(ECL 23-0503[5]). Pursuant to this subdivision, a procedure is provided for under the new law that applies where the permit to drill was issued prior to the effective date of the amendments. This provision confirms that the Legislature intended to apply the new law to wells where the permit to drill was issued prior to the effective date of the amendments, but for which a spacing unit had not been established.

The new law provides that a spacing order is not required where the proposed spacing unit conforms to the Statewide spacing rules established by statute (see ECL 23-0503[2]; ECL 23-0501[1][b][1]). When, as in this case, the proposed spacing unit conforms to Statewide spacing rules, the spacing unit is established by law, not by separate order. Although ECL 23-0503(5) refers to spacing orders, and not spacing units established by law, nothing in the statute suggests that spacing units established by law should be treated differently from spacing units established by order.

Indeed, to subject spacing units established by law to proceedings under the old statute, while processing spacing units established by order under the new law would frustrate the

legislative goals of the new statute. Under the old law, proceedings to establish spacing units for a natural gas field were not initiated until one or more wells were permitted and drilled in a field, and demonstrated to be productive. The establishment of field-wide spacing units after wells were drilled had the potential for lengthy and costly disputes that could result in delay and inefficiency in the development of natural gas resources. The new law remedies this situation, and increases certainty and efficiency in the process, in part, by requiring the establishment of spacing units as early in the process as possible, and allowing for "automatic" approval of spacing units when such units conform to State-wide spacing criteria. To subject a conforming spacing unit, such as the one involved here, to proceedings under the old law would directly conflict with the legislative purpose behind the promulgation of State-wide spacing rules in the 2005 amendments.

Having concluded that the new law applies to a spacing unit established, whether by law or order, after the effective date of the 2005 amendments, it necessarily follows that the compulsory integration of interests in the spacing unit, which necessarily follows the establishment of the unit (see ECL 23-0901[3][b]), is also governed by the new law. As Department staff notes, common sense dictates such a conclusion, and nothing in the new law suggests that the old compulsory integration provisions would govern a spacing unit established under the new law.

To conclude otherwise would also contradict one of the legislative goals underlying the new law. Under the old law, the compulsory integration of interests of minerals rights owners in a field was guided by the "just and reasonable" standard. Again, to reduce uncertainty and improve efficiency, the new law, in addition to retaining the "just and reasonable" standard, establishes clear categories of interests, together with detailed delineation of the rights and obligations associated with each category, pursuant to which mineral interest owners would be integrated. To integrate interests in a spacing unit established under the new law pursuant only to the standards applicable under the old law would defeat the purpose of the new law. Moreover, the Department's authority to integrate interests upon terms and conditions that are "just and reasonable" is broad enough to encompass the category of interests delineated under the new law (see Matter of Western Land Servs., Inc. v Department of Envtl. Conservation of State of N.Y., 26 AD2d 15, 19-20 [3d Dept 2005], lv denied 6 NY3d 713 [2006]), thereby rendering academic any dispute concerning which law is technically applicable.

Fortuna is correct that allowing uncontrolled owners to elect the terms of their integration in a case where the subject well is already permitted, drilled and producing removes risk from the decision making process, thereby frustrating legislative purpose to some degree. As noted above, however, the Legislature contemplated this circumstance for transition wells, but nonetheless provided for establishment of the spacing unit and integration of interests under the new law. This must be viewed as a legislative determination that for those relatively few wells that fall into the transitional category, the interests of efficiency and certainty in the establishment of spacing units and the integration of interests therein outweigh the advantages uncontrolled owners would have in making choices with knowledge about the productivity of the subject well.

Moreover, as WLS notes, the new law does not mandate that compulsory integration hearings occur before well permits are issued and wells drilled. WLS indicates that Fortuna itself has obtained well permits and drilled wells under the new law prior to the conduct of the integration hearings on those wells. Thus, even under the new law, the circumstance might arise that uncontrolled owners will be able to make choices concerning the terms of their integration with information about the productivity of the subject well.[2] Accordingly, the circumstance that an uncontrolled owner may have that advantage concerning a transition well cannot be viewed as significantly at odds with the legislative purposes of the new law.

Availability of Part 624 Proceedings under the 2005 Amendments

Having concluded that the new law applies to the Drumm 1 integration order, the next issue is whether proceedings under Part 624 are available for review of the integration order by an ALJ and, ultimately, the Commissioner, absent a referral from Department staff.

The permit hearing procedures in Part 624 are the administrative adjudicatory proceedings the Department applies to a wide variety of Departmental approvals under various regulatory programs administered by the Department, including gas well spacing and integration proceedings (see 6 NYCRR 624.1[a][6]; Matter of Western Land Servs., Inc., Declaratory Ruling DEC #23-13, Jan. 29, 2004, at 4). Part 624 provides procedures that comply with the requirements for adjudicatory

[2] I take no view of how the risks and the penalties associated therewith should be balanced in such a situation.

proceedings established by article 3 of the State Administrative Procedure Act ("SAPA"), among other statutes (see Matter of Terry Hill South Field, Commissioner's First Interim Decision, Dec. 21, 2004, at 8). Proceedings under Part 624 are conducted before an ALJ independent of Department staff, and result in a decision based upon a record developed by the parties with the right to present legal argument and evidence, and to cross-examine witnesses.

Although Part 624 applies to gas well spacing and integration proceedings after referral to OHMS, the narrow issue presented is the available avenues for referral by which determinations made by Department staff are subject to review pursuant to Part 624. As Department staff notes, under the old law, spacing and integration were generally accomplished in a single proceeding. Staff generally referred all such spacing and compulsory integration proceedings to OHMS for hearings pursuant to Part 624. Such referrals were made even in circumstances where no party to the proceeding objected to the proposed spacing or the terms of integration (see, e.g., Matter of Bradley Brook Field, Commissioner's Decision and Order, Aug. 25, 2004).

Under the new law, proceedings to integrate interests in a spacing unit are separate from the proceedings used to establish the unit. Compulsory integration is accomplished initially through an "integration hearing" (see ECL 23-0901[3][b]). If no substantive and significant issues are raised at the integration hearing, the Department issues a final order of integration (see ECL 23-0901[3][e]). If, however, substantive and significant issues are raised during the integration hearing, "the department shall schedule an adjudicatory hearing" (ECL 23-0901[3][d]).

The Division of Mineral Resources Program Policy "DMN-1: Public Hearing Processes for Oil and Gas Well Spacing and Compulsory Integration" ("DMN-1") provides further guidance for the administration of the integration hearing provided for in the new law, and the policy underlying the guidance. Pursuant to DMN-1, the integration hearing is a staff-level, administrative proceeding conducted by the Director of DMN, or a designee thereof (see DMN-1, at 2). The officer conducting the integration hearing reviews the objections raised at the integration hearing and determines whether such objections present substantive and significant issues requiring adjudication (see id. at 3, 9). If the officer conducting the integration hearing concludes a substantive and significant issue requiring adjudication exists, staff will then refer the matter to OHMS for hearings under Part 624. DMN-1 makes no other provision for

referral of a compulsory integration proceeding for adjudicatory hearings.

In this case, the Director's designee concluded that, notwithstanding WLS's objection, no substantive and significant issue requiring adjudication was presented.[3] Accordingly, staff did not refer the matter to OHMS for hearings pursuant to Part 624. The determination of the Director's designee that no substantive and significant issues are presented is analogous to the determination Department staff makes under 6 NYCRR 621.8[4] for Departmental permits governed by the Uniform Procedures Act (ECL article 70). The determination of the Director's designee is not a ruling issued by an ALJ pursuant to Part 624 and, thus, is not appealable directly to the Commissioner under Part 624 (see 6 NYCRR 624.8[d]).

No party offers any argument under Part 624 or the new law, or pursuant to any other source of law, that would offer a basis for the assertion of jurisdiction by OHMS over this matter in the absence of a referral from staff. Not even WLS, who initiated this inquiry, argues that hearings are nonetheless required under the new law. Indeed, WLS expressly argues that without a referral from staff, proceedings pursuant to Part 624 are not available to challenge the Drumm 1 integration order. WLS filed the present request to determine whether administrative remedies have been exhausted.

Although Fortuna takes the position that hearings pursuant to Part 624 are required to review the Drumm 1 integration order, it does so solely on the ground that the old law and the procedures thereunder are applicable to the Drumm 1 unit. That argument has been rejected above, and Fortuna makes no argument under the new law. Thus, no party provides a basis for the assertion of jurisdiction by OHMS and, ultimately, the Commissioner, without a referral from Department staff. Absent an argument by an aggrieved party seeking proceedings pursuant to

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[3] Although the issue is not before me, the Department has generally viewed disputes between Department staff and the individual or entity seeking a Departmental approval or permit, concerning the terms or condition of such approval or permit, an adjudicable issue (see, e.g., 6 NYCRR 624.4[c][1][i]). It is not clear from the record before me the basis for the conclusion of the Director's designee that WLS's objection about terms of its integration as an IPO is not adjudicable.

[4] As amended Sept. 6, 2006.

Part 624 under the new law, for the purposes of WLS's inquiry, I decline to depart from the procedures enunciated in DEC Program Policy DMN-1.

Conclusion and Ruling

In sum, I conclude that the establishment of the spacing unit for the Drumm 1 well, and the compulsory integration of interests therein, are governed by ECL article 23, as amended by the Laws of 2005, Chapter 386, effective August 2, 2005. Pursuant to ECL article 23, as implemented by DEC Program Policy DMN-1, a challenge to a proposed integration order will be referred to OHMS for adjudicatory hearings pursuant to Part 624 only when Department staff determines that a substantive and significant issue requiring adjudication has been presented at an integration hearing. Department staff determined that WLS's objection to the terms of its integration into the Drumm 1 unit did not raise a substantive and significant issue. Accordingly, Department staff did not refer the matter for hearings, and the parties providing comment on WLS's request have made no argument concerning an alternative basis for such a referral.

For the reasons stated, and based upon the arguments presented, I conclude that no further administrative proceedings are available to WLS to challenge the Drumm 1 Integration Order.[5] Accordingly, WLS's appeal is hereby dismissed.

_____/s/_____
James T. McClymonds
Chief Administrative Law Judge

Dated: September 26, 2006
Albany, New York

TO: Service List (by e-mail and first class mail)

[5] WLS asserts that the Drumm 1 Integration Order is a final agency determination subject to review in a CPLR article 78 proceeding. It is not clear whether WLS seeks a determination from the ALJ on this issue. To the extend WLS does, I decline to address the issue on the ground that it is more appropriately answered by the courts.