Welborn Sullivan Meck & Tooley, P.C.

May 20, 1996

Patricia Beaver, Secretary
Colorado Oil and Gas Conservation Commission
Suite 801
1120 Lincoln Street
Denver, Colorado 80203

Re: Cause No. 1, Docket No. 5-11
Application of Barry Stout

Dear Ms. Beaver:

This law firm represents Vessels Energy, Inc. ("Vessels"), formally known as Vessels Oil & Gas Company, with respect to the application that Mr. Barry Stout ("Stout") filed with the Colorado Oil and Gas Conservation Commission ("Commission" or "COGCC") concerning mineral interests that Stout owns in certain property located in Garfield County, Colorado ("Application"). This letter addresses some of the issues that Stout has raised in his Application. We caution the Commission, however, that full resolution of these issues by the Commission cannot occur without prior and complete notification of the Application by Stout and/or the Commission to all interested and adversely affected parties, and we submit this letter without prejudice to Vessels' rights to fully brief any jurisdictional issues when they are properly before the Commission.

Pertinent facts and legal issues and an analysis of the legal issues are as follows:

1. Pertinent Facts.

Vessels is the successor unit operator for the federal oil and gas unit known as the Gibson Gulch II Unit Area (the "Unit"). The Unit Agreement ("UA") and the Unit Operating Agreement ("UOA") are both dated January 22, 1991 and cover approximately 23,600 acres of federal and non-federal mineral interests in Garfield County, Colorado.[1]

---

[1] A map of a portion of the unit area is attached as Exhibit 1.

Stout owns a 50% unleased mineral interest in 26.34 acres included within the Unit area ("Stout acreage" or "Stout mineral interests"). Vessels is the lessee or the assignee of the lessee for various oil and gas leases that cover the other 50% mineral interest in the Stout acreage. The Stout acreage is all located in the NE4NW4 of Section 30 in Township 6 South, Range 91 South.

Stout received notice in January 1991 that Torch Operating Company ("Torch") proposed to form the Gibson Gulch II federal unit. The Unit was approved by the Secretary of the Interior or his authorized officer on January 30, 1991. Stout has not at any time agreed to commit the Stout mineral interests to the Unit.

Vessels, at various times, has offered to buy or lease the Stout mineral interests, and it notified Stout that he could, in the alternative, participate in the drilling and completion of the Gibson Gulch Unit No. 14-19 well ("Well") which included the Stout acreage in the Unit drilling block. Stout has not agreed to sell his mineral interests to Vessels or to either lease his mineral interests to Vessels or participate in the drilling of the Well on terms that were acceptable to Vessels.

Vessels in its capacity as Unit Operator of the Unit drilled and completed the Well on January 10, 1996 in the Mesaverde Formation. The Well is located in the S2SE4SW4 of Section 19, Township 6 South, Range 91 West, approximately 420' directly north of the Stout acreage.

Vessels submitted an application dated April 10, 1996 to the Bureau of Land Management ("Vessels Application") for the BLM to approve what Vessels identified as the "Third Revision Mesaverde Formation Participating Area 'A.'" The Vessels Application referred to various wells drilled and completed in the Unit and outlined a participating area to be comprised of approximately 3422 acres.

Stout filed the Application with the Commission on March 2, 1996. Stout asks that the Commission in effect create a drilling and spacing unit to be comprised of the Stout acreage and the acreage on which the Well was drilled and that the interests under the

1. Space 26 acres

2. ~~[illegible]~~ Commission recognize
circle PA for this
well — Barry gets 2 ac WI

3. Do nothing.

drilling and spacing unit be pooled.[2] Stout also requests that the Commission make a determination that Commission rules and regulations apply to the Stout acreage in the Unit.

Richard Ryan, Petroleum Engineer for the Bureau of Land Management, submitted a letter to the Commission dated May 20, 1996 in which he objects on behalf of the federal government to any order by the Commission to space or pool lands in the Unit in a way that is contrary to the manner prescribed in the federal unit documents. As the authorized officer under the UA, Mr. Ryan has indicated to Vessels also that he has determined that the wells in the participating area that Vessels proposes are all capable of producing unitized substances in paying quantities and that he intends to approve the participating area that Vessels proposes in its application for the third revision to the participating area.

2. Pertinent Issues for the Commission to Consider.

A. Does the Application that Stout filed with the Commission comply with Commission rules and regulations of notice and procedure?

B. Does the Commission have jurisdiction to apply its spacing orders, rules and regulations to the Stout acreage or to any other acreage that is included within the Unit?

C. Is the Commission the proper forum in which Stout should bring his application to participate in revenues from production from the Well?

D. Does COGCC Rule 316 apply to the Gibson Gulch Unit No. 14-19 Well?

3. Stout did not comply with Commission rules and regulations of notice and procedure in the filing of the Application.

The gist of the application that Stout filed with the Commission is to request the Commission to space some amount of acreage that includes the Well and to pool the mineral interests under the acreage. Commission rule 508.b. identifies the parties who are required to receive notice of an application for an involuntary pooling order.

---

[2] Stout has not identified the size or shape of the tract of land that he proposes to include in the drilling and spacing unit; however, the unit would cross section lines and include at least the W2NE4NW4 of Section 30 and the S2SE4SW4 of Section 19.

Welborn Sullivan Meck & Tooley, P.C.

The applicant or the Commission is required to give notice of an application to pool interests to all parties who own any interest in the mineral estate in the tract of land that the applicant seeks to pool.[3] This means that all parties who own working interests and royalty interests in the affected tract must be given notice of the application.

In this case, the tract that is affected by the Application is the entire participating area for the Gibson Gulch II Federal Unit because all of the working interest owners and the royalty interest owners in the participating area have an interest in any tract of land which Stout could make the subject of his spacing and pooling application. This is because the federal unit agreement provides for the allocation of production from all of the wells in the federal unit among all of the mineral interest owners in the participating area, and they are all currently receiving payments out of production from the Well.

Neither Stout nor the Commission has given notice to all of the royalty interest owners in the participating area or even in any smaller tract that Stout might propose to space and pool. The Commission rules and the constitutional requirements of procedural due process mandate that the Commission or the applicant give adequate advance notice and the opportunity to be heard to royalty interest owners since an adverse Commission order would deprive at least some of them of the property interests they acquired in the Unit.[4]

4. The Commission does not have jurisdiction to apply its spacing orders, rules and regulations to the Stout acreage or to any other acreage that is included in the federal unit.

A. The state spacing and pooling order that Stout seeks is inconsistent with the spacing and pooling scheme in the federal unit and is preempted by federal law.

The Gibson Gulch Unit is a unit for the development of both federal and nonfederal mineral interests that was formed by the United States Secretary of the Interior ("Secretary")

---

[3] See COGCC Rule 508.b.

[4] See Mountain States Telephone and Telegraph Company v. Department of Labor and Employment, 520 P.2d 586 (Colo. 1974). See also Hagood v. Heckers, 513 P.2d 208 (Colo. 1973) holding that an overriding royalty is an interest in real estate under Colorado law because it was severed from a lessee's property interest.

pursuant to the authority granted to him by Congress under the Mineral Leasing Act of 1920, as amended. The formation of a federal unit requires a determination by the Secretary that unitization is necessary and advisable in the public interest and is for the purpose of more properly conserving natural resources.[5]

The federal unit agreement and unit operating agreement govern unit operations and the relationship among the parties with mineral interests that are committed to the unit. The unit agreement provides a mechanism to space wells to be drilled within the unit boundary by requiring that the authorized officer ("AO") for the Secretary approve the locations of all wells to be drilled in the unit.[6] In this way, the federal representative is given ultimate authority to control the number and location of wells, and, therefore, any spacing pattern for the unit wells.

The unit agreement also provides for the pooling of interests by prescribing the manner in which production from wells that are drilled in the unit is to be allocated among the various mineral interests in the unit through the creation of "participating areas" ("PA").[7] The designation of a PA and any revisions to it are subject to the approval of the AO.[8]

Pursuant to the terms in the unit agreement, Vessels has proposed and the AO has indicated he intends to approve a PA to include approximately 3422 acres with a spacing pattern of one well on approximately 640 acres using the circle-tangent method.[9] The UA provides that production from all of the wells in a participating area for unitized substances

---

[5] See 43 C.F.R. 3183.4(a).

[6] Unit Agreement, pp. 9, 10-11.

[7] Id., pp. 11-12.

[8] Id.

[9] Vessels submitted geologic information to the BLM to support the spacing pattern that it proposes in accordance with federal regulations at 43 C.F.R. 3183.5.

in a particular pool is to be allocated among all of the owners of mineral interests in the participating area so that each mineral owner takes a share of production from every well.[10]

Stout, on the other hand, seeks a spacing order from the Commission for a drilling and spacing unit to be carved out of the federal unit to consist of at least the W2NE4NW4 of Section 30 and the S2SE4SW4 of Section 19 and to allocate production from the Gibson Gulch Unit No. 14-19 Well ("Well") based on the mineral interest ownership of the parties in only the drilling and spacing unit he proposes. The effect of any drilling and spacing unit and pooling that Stout proposes for less than 640 acres would have the effect of depriving the federal government of a royalty interest in the Well and also other parties which own royalty interests in acreage outside the proposed drilling and spacing unit, but inside the PA. Note also that Stout cannot propose a drilling and spacing unit which does not include some amount of acreage that has been committed to the Unit.

General rules of law are that a state may assert jurisdiction over federal lands and federal leasehold mineral interests pursuant to its general police powers and that Congress has authority to make rules and regulations with respect to property that belongs to the United States.[11] The Supremacy Clause of the United States Constitution will require that the state law give way, however, in the event of a conflict between state and federal laws or regulations.[12] This means that state law may be applied to federal lands and federal leasehold mineral interests only to the extent that the application of the state law does not threaten a federal policy or interest or that there is no direct conflict between the laws of the two jurisdictions.[13]

---

[10] This means that all parties who own non-working mineral interests in the PA, including the federal government, will receive a royalty from production from each well in the PA, including the well identified as the Gibson Gulch Unit No. 14-19 ("Well").

[11] See, for example, Kleppe v. New Mexico, 426 U.S. 529, 49 L.Ed.2d 34, 96 S.Ct. 2285 (1976); Ventura County v. Gulf Oil Corporation, 601 F.2d 1080 (9th Cir. 1979) affd. 445 U.S. 947, 63 L.Ed.2d 782, 100 S.Ct. 1593 (1980).

[12] Id.

[13] Id; See also, California Coastal Commission v. Granite Rock Co., 480 U.S. 572, 94 L.Ed 2d 577, 107 S.Ct. 1419 (1987); Ohmart v. Dennis, 188 Neb. 260, 196 NW2d 181 (1972).

In this case, the spacing and pooling order that Stout seeks from the Commission for a state-ordered drilling and spacing unit and the allocation of production among mineral interests in the unit would be inconsistent with the PA that will be approved by the BLM that includes approximately 640 acre spacing within the PA and the allocation of production from all of the unit wells, including the Gibson Gulch Unit No. 14-19 well, among all of the mineral interest owners in the 3422 acre participating area. Such a state order could not stand and will be preempted by federal law because it would be inconsistent and in direct conflict with federal regulations as they are being implemented by the representative for the Secretary of the Interior through the documents that govern the federal unit.[14]

B. A federal lease cannot be pooled with private leases by state agencies unless the Secretary of the Interior gives his consent.

Courts have held that a federal lease cannot be included in a state drilling and spacing unit and cannot be pooled with private leases unless and until the Secretary of the Interior gives his consent.[15] In cases where consent is not given, the state spacing orders will have no effect on either the federal leases or the private leases that are included in the state spacing unit or that are sought to be pooled and the leases are interpreted as if no order applies.

We anticipate that the drilling and spacing unit for which Stout will seek approval from the Commission will not include any federal lease and will be less than 640 acres. We note, however, that, based on present information, 640 acres is the more appropriate size for a drilling and spacing unit for the Mesa Verde Formation in the geographic area of the Unit when you consider other Commission orders for the same geologic formation in and around

---

[14] Stout cites C.R.S. 34-60-120(1)(b) as authority for the Commission to space and pool lands within the federal unit; however, the state statute cannot be interpreted by the Commission in a way that is in conflict with the federal unit agreements and federal regulations because of Supremacy Clause of the United States Constitution.

[15] See, for example, 30 U.S.C. 226(j); Kirkpatrick Oil & Gas Company v. United States, 675 F.2d 1122 (10th Cir. 1982); Kardokus v. Walsh, 797 P.2d 322 (Okla. 1990); Shearn v. Ward Petroleum Corporation, 808 F.Supp. 1530 (U.S.D.C.Okla. 1992); Union Oil Company of California, 77 IBLA 32 (October 31,1983); Homestake Royalty Corporation, 130 IBLA 36 (July 12, 1994).

the Unit.[16] A 640 acre unit that consists of the S2 of Section 19 and the N2 of Section 30 would include federal leases that cover the NE4SW4 and the N2SE4 of Section 19. A state spacing order for 640 acres that includes the federal leases would have no effect without the approval of the Secretary or his authorized officer,[17] and it appears that a 640 acre spacing unit within the federal unit could not be found to be in the public interest since it could result in the dilution of the federal royalty interest.

Note also that the unit agreement and the unit operating agreement are contracts between private parties and the federal government. The effect of the state order that Stout requests would be to impair contract rights among the parties to the UA and the UOA each of whom has agreed to a method to share production from the participating area for all of the wells in the PA. This result is contrary to the Colorado and United States Constitutions which prohibit states from passing laws that impair contracts.[18]

5. The Federal Bureau of Land Management is the proper forum in which Stout should bring his request to participate in revenues from production from the Well or to protest the formation of the PA to include his lands.

The federal regulations and the unit documents contemplate a situation in which parties who own mineral interests in the federal unit area do not join the unit when it is initially formed.[19]

---

[16] See, for example, Cause No. 143 for the Divide Creek Field and Cause No. 191, Orders No. 191-31 and 191-4 for the Mam Creek Field.

[17] In the case San Juan Citizens Alliance et al., 129 IBLA 1 (March 14, 1994), the Interior Board of Land Appeals overruled a spacing order issued by the COGCC and held that the BLM had primary authority to establish spacing on Indian lands.

[18] See Colorado Constitution, Article II, Section 11 and United States Constitution, Article I, Section 10.

[19] For example, the Secretary is subject to the requirement that he can only approve a unit agreement where the signing parties can demonstrate that they "hold sufficient interests in the unit area to provide reasonably effective control" over operations in the unit. See also 30 U.S.C. 226(j); 30 C.F.R. 3181.3, 3183.4(a).

A party who does not initially commit his mineral interests in a federal unit to the unit and who believes that he is being injured by unit operations has remedies within the federal system. He may either join the unit or request an administrative review before the State Director of the Bureau of Land Management.

The decision by the authorized officer to approve the third revision to the participating area will trigger the right for Stout to appeal the decision pursuant to 30 C.F.R. 3185.1. The federal regulation provides that a person who is adversely affected by a decision under the regulations may request review of the decision before the State Director and has further rights of appeal.

The Gibson Gulch Unit Agreement and the Unit Operating Agreement also each provide for the joinder of parties after the unit has been formed. Section 28 of the Unit Agreement provides for the terms upon which parties which own working interests and non-working interests in the unit area may join the unit and the effective date of the joinder. Section 34 of the Unit Operating Agreement provides for the method by which parties who own working interests in the unit area may join the unit subsequent to the date that unit operations commence.

6. The setback requirements in COGCC Rule 316 do not apply in a case where, as here, a party who is the lessee of an oil and gas lease that covers a portion of the mineral interest participates in the drilling of the well.

COGCC Rule 316 requires that a well drilled to a common source of supply in excess of 2,500 feet in depth be located no less than 600 feet from any "lease line." Colorado does not have automatic statewide spacing,[20] and Rule 316 and its predecessor rules were written to provide control of the development of a common source of supply in the absence of spacing. The reference to the "lease line" in Rule 316 and its application is limited to cases where there is a complete division of mineral ownership between the parties who own mineral interests in the acreage where the well is to be drilled and those who own mineral interests in the acreage that adjoins the well location.

Here, Vessels is a mineral interest owner in the Stout acreage, and therefore a mineral cotenant with Stout, and Vessels could legally drill on the Stout acreage itself if it so

---

[20] See C.R.S. 34-60-116(2).

chose. That being the case, the 600 foot requirement does not apply and Mr. Stout's correlative rights are protected by his ability to join the Unit under federal law or by spacing and force pooling under state law, which ever applies.

Respectfully submitted,

Welborn Sullivan Meck & Tooley, P.C.

John F. Welborn
Molly Sommerville
Attorneys for Vessels Energy, Inc.

JFW/jc
Enclosure
cc: Thomas W. Niebrugge