

BEFORE THE INDUSTRIAL COMMISSION
OF THE STATE OF NORTH DAKOTA

CASE NO. 27124
(CONTINUED)
ORDER NO. 30789

IN THE MATTER OF A HEARING CALLED ON A MOTION OF THE COMMISSION TO CONSIDER THE APPLICATION OF MACH ENERGY, LLC AND M3 RESOURCES, LLC, FOR AN ORDER RESCINDING THEIR ELECTION TO PARTICIPATE IN DRILLING THE STR1 22-15 163-90 B WELL (NDIC FILE NO. 33148) AND REQUIRING PETRO HARVESTER OPERATING CO., LLC, TO ISSUE TO THE APPLICANTS A NEW INVITATION TO PARTICIPATE IN DRILLING THAT WELL; FOR AN ORDER DETERMINING THE PROPER COSTS TO TRANSPORT GAS FROM THE FLX1 22-15 163-91 D WELL (NDIC FILE NO. 32424) AND THE RIGHT TO CHARGE THOSE COSTS; AND FOR AN ORDER DETERMINING, IN THE OPERATIONS OF THE AFOREMENTIONED TWO WELLS AND IN THE OPERATIONS FOR THE PTL1 05-08 163-91 B WELL (NDIC FILE NO. 32993) AND THE PTL1 32-29 164-91 B WELL (NDIC FILE NO. 32992), THE PROPER REVENUES AND COSTS IN PROCESSING GAS AND THE PROPER COSTS IN DISPOSING PRODUCED WATER, WITH ALL THE WELLS BEING LOCATED IN BURKE COUNTY, ND AND FOR OTHER RELIEF AS MAY BE APPROPRIATE.

ORDER OF THE COMMISSION

THE COMMISSION FINDS:

- (1) This cause came on for hearing at 9:00 a.m. on the 6th day of November, 2019.
- (2) Case No. 27124 is an application of Mach Energy, LLC (Mach Energy) and M3 Resources, LLC (M3 Resources), for an order rescinding their election to participate in drilling the STR1 22-15 163-90 B well (File No. 33148) and requiring Petro Harvester Operating

Company, LLC (Petro Harvester), to issue to the applicants a new invitation to participate in drilling that well; for an order determining the proper costs to transport gas from the FLX1 22-15 163-91 D well (File No. 32424) and the right to charge those costs; and for an order determining, in the operations of the aforementioned two wells and in the operations for the PTL1 05-08 163-91 B well (File No. 32993) and the PTL1 32-29 164-91 B well (File No. 32992), the proper revenues and costs in processing gas and the proper costs in disposing produced water, with all the wells being located in Burke County, North Dakota and for other relief as may be appropriate.

(3) On August 8, 2018, Petro Harvester filed a motion to dismiss Counts One, Three, and Four of the Application. The Commission entered an order Denying the Motion to Dismiss on November 8, 2018. The Commission finds under NDCC § 38-08-08(2) the Commission has jurisdiction, and is required, to decide disputes over proper costs for the drilling and operation of a well. Whether gas processing fees is an operation cost is a question of fact and the Commission does not have sufficient information at this time to decide that issue. Therefore, dismissal of Count Four is not appropriate at this time.

(4) Commission Order No. 30282, signed December 2, 2019, continued the decision in this matter for an additional ninety (90) days or until further order of the Commission.

(5) Commission Order No. 30607, signed February 27, 2020, continued the decision in this matter for an additional thirty (30) days or until further order of the Commission.

(6) Petro Harvester is the operator of the subject wells. Mach Energy and M3 Resources have a working interest in the subject wells.

(7) The Commission makes no findings with regard to the specific acreage or percentage attributed to the separately owned tracts or interests.

(8) A pre-hearing conference was held on August 29, 2019. Prior to the pre-hearing conference, the parties submitted pre-hearing briefs and had exchanged potential hearing exhibits. At the pre-hearing conference, the parties narrowed down the issues to be determined to:

- (a) Count One: Whether Petro Harvester's decision to drill only one well invalidates the invitations to participate since estimated costs in the well proposal were based upon drilling two wells from the same pad, resulting in the invalidation of the election to participate, more specifically, whether the Authorization For Expenditure (AFE) amount included in the invitation to participate in the STR1 22-15-163-90 B well qualified as an estimate under NDAC § 43-02-03-16.3, when made, or if it did when made, whether it still qualified as an estimate when Petro Harvester made the decision to drill only one well; and whether such determination is within the jurisdiction of the Commission.
- (b) Counts Two and Three: Whether the water disposal fees and gas transport fees charged by Petro Harvester constitute "reasonable actual costs for drilling and operation of a well plus a reasonable charge for supervision" under NDCC

§ 38-08-08. More specifically, if the cost of capital is a reasonable actual cost for drilling and operation of the subject wells, and if it is a proper cost, what amount is reasonable?

(c) Count Four of the application was dismissed upon agreement of the parties.

COUNT ONE

(9) At the hearing Petro Harvester renewed its Motion to Dismiss Count One of the application. Count One of this application was brought pursuant to NDCC § 38-08-08 and NDAC § 43-02-03-16.3 as a request for the Commission to determine whether a valid invitation to participate in the well was provided by Petro Harvester.

(10) NDCC § 38-08-08 provides that owners in the spacing unit shall pay their share of the reasonable actual cost of drilling and operating the well, plus a reasonable charge for supervision. In addition to such costs and charges, if a lessee in a spacing unit elects not to participate in the risk and cost of drilling a well thereon, the owner paying for the lessee's share of the drilling and operation of a well may recover from the lessee a risk penalty of 200 percent of their share of the reasonable actual costs of drilling and completing the well.

(11) NDAC § 43-02-03-16.3(1)(a) sets forth the information that must be contained within an invitation to participate. "An election to participate is only binding upon an owner electing to participate if the well is spudded or reentry operations are commenced on or before ninety days after the date the owner extending the invitation to participate sets as the date upon which a response to the invitation is to be received." NDAC § 43-02-03-16.3(1)(d).

(12) The Commission has primary jurisdiction under NDCC § 38-08-08 to pool, determine costs of drilling and operating a well, and assessing a risk penalty. The Commission has exercised its jurisdiction to administer risk penalties by enacting NDAC § 43-02-03-16.3.

(13) The Commission has discretion and administrative expertise to evaluate compliance with the requirements for an invitation to participate. See Gadeco, LLC v. Industrial Com'n of State, 2013 ND 72, ¶ 17, 830 N.W.2d 535. The Commission concludes that it has jurisdiction to determine the validity of the invitations to participate.

(14) Invitations to participate were prepared and sent out by Petro Harvester relating to the subject wells. Mach Energy and M3 Resources returned invitations to participate in the subject wells and elected to participate in the subject wells. It is undisputed by the parties that Mach Energy and M3 Resources elected to participate in the wells. However, Mach Energy argues that the invitations to participate are invalid, as the AFE proposed costs which were based upon Petro Harvester drilling and operating the STR1 22-15 163-90 B on a two-well program with another well. Mach Energy further argued that the estimate included in the AFE was no longer a qualified estimate of the cost of drilling and completing the well due to the change to a one-well program for this well.

(15) NDAC § 43-02-03-16.3 requires that an invitation to participate must include: (a) location of the proposed or existing well and its proposed depth and objective zone; (b) an itemization of the estimated costs of drilling and completion; (c) the approximate date upon

which the well was or will be spudded or reentered; (d) a statement indicating the invitation must be accepted within thirty days of receiving it; and (e) notice that the participating owners plan to impose a risk penalty and that the nonparticipating owner may object to the risk penalty by either responding in opposition to the petition for a risk penalty, or if no such petition has been filed, by filing an application or request for hearing with the Commission.

(16) Mach Energy testified that when it elected to participate in the STR1 22-15 163-90 B well, it did so with the understanding that the estimated costs were based on each well being drilled on a two-well program as described in the drilling permit applications and due to the estimated costs associated with the cost to drill and operate the STR1 22-15 163-90 B well were identical to other invitations to participate in wells that were to be drilled on a two-well program. Petro Harvester did not dispute that the original intent was to drill these wells on a two-well program.

While the application for drilling permit set forth a two-well plan, the invitation to participate in the STR1 22-15 163-90 B well did not provide that the costs estimated in drilling the well were based upon a two-well program.

(17) After Mach Energy returned the election to participate in the STR1 22-15 163-90 B well, Petro Harvester decided not to drill the second well that was associated with the drilling permit for the STR1 22-15 163-90 B well. Mach Energy argued that due to these wells not being drilled on a two-well program, the increased costs for drilling and operating were a material change requiring a new invitation to participate. The estimated cost to drill and complete the STR1 22-15 163-90 B well listed in the AFE was a total of \$3,760,250. The actual cost to drill and complete the STR1 22-15 163-90 B well was \$5,070,000. Petro Harvester agreed that there are costs savings to drilling wells on a two-well program, however they provided further testimony of increased costs that were not attributed to drilling one well instead of two. Mach Energy contends that the estimated costs in the AFE were not a qualified estimate under NDAC § 43-02-03-16.3, due to the change in the drilling plans.

(18) The actual costs for drilling and completion of the STR1 22-15 163-90 B well were not in dispute.

(19) The requirement of the invitation to participate to include an itemization of the estimated costs of drilling and completion allows working interest owners to calculate their financial responsibility necessary to participate in the well. NDIC Order No. 19700. Petro Harvester included an AFE in its invitation to Mach Energy and M3 Resources. NDAC § 43-02-03-16.3(1)(a)(2) requires “an itemization of the estimated costs of drilling and completion.” “An AFE is an estimate of expected costs to drill and complete the well, but it is common place to have some costs overestimated or underestimated, due to various conditions encountered during the location preparation, drilling, and completion of the well.” NDIC Order No. 19700. “The plain language of N.D. Admin. Code § 43–02–03–16.3(1) [] allows flexibility in invitation to participate for “estimated” costs....” Gadeco 2013 at ¶ 15. An AFE does not provide an exact or actual cost for drilling and completing a well.

There was additional testimony that Petro Harvester credited Mach Energy and M3 Resources for the differences in the well costs that were estimated in the AFE’s and the actual

cost for STR1 22-15 163-90 B well. Therefore, Mach Energy and M3 Resources were only billed for the amount estimated in the AFE for drilling and completing the well.

(20) The Commission concludes that Petro Harvester has complied with NDAC § 43-02-03-16.3 providing an estimate of expected costs to drill and complete the STR1 22-15 163-90 B, that the AFE constituted an itemized estimate of the costs of drilling and completion pursuant to NDAC § 43-02-03-16.3(1)(a)(2), and the invitation to participate in the STR1 22-15 163-90 B was valid.

COUNTS TWO AND THREE

(21) At the hearing the parties informed the Commission that they had agreed to most issues relating to the water disposal fees and gas transport fees charged in operating the subject wells, except for the issue of the cost of capital, leaving the Commission to decide whether interest can be recovered for the use of capital, and if interest can be recovered for the use of capital, what is a reasonable percentage to attribute to the cost of capital.

(22) Petro Harvester charged a cost of capital being attributed to the costs of disposal of produced water and gas transportation costs for the subject wells. Mach Energy and M3 Resources argued that the cost of capital is not a reasonable actual cost in the drilling and operation of a well.

(23) Mach Energy's expert witness provided testimony that the cost of capital is a reasonable cost in the event that there is an actual cost to obtaining that capital. Mach Energy's expert witness also testified that absent actual evidence of Petro Harvester's cost of capital in his audit of the costs, he determined that the cost of capital should be 8%. In 1985, COPAS issued an accounting guideline, AG-4: Facility Rate Agreement, to present a methodology for calculating rates for use of operator-owned equipment and facilities, which provides guidance as to the reasonable actual costs an operator can charge a joint property. The facility rate calculation example included in the COPAS AG-4, which was issued in December 1985, utilizes a 15% return on investment, but at the time of issuance this 15% rate was approximately 1.5 times the 9.5% prime rate in effect at the time. Based upon the current prime rate of 5.5%, a reasonable return on investment would be approximately 8%, which is 1.5 times the current prime rate of 5.5%. The numbers presented were rounded by Mach Energy's expert witness.

(24) Petro Harvester provided testimony that they used internal capital that would have otherwise been invested in other projects in which a rate of return would have been realized. Since the capital was used for the drilling of the subject wells a cost of capital is an actual cost that can be attributed to the well. Petro Harvester provided testimony that they used 15% as their cost of capital. There was no testimony or evidence presented to provide how the 15% used by Petro Harvester was calculated or how it related to the rate of return Petro Harvester could have realized if the capital was used in another project.

(25) The Commission concludes based upon the testimony and information before it that the cost of capital, is a reasonable cost in drilling and operating a well. Petro Harvester did not provide an actual cost of the capital being used for the operation of the well and did not provide details describing how Petro Harvester arrived at the amount of 15%. The Commission finds that the reasoning provided by Mach Energy's expert witness for a basis to determine the cost of

capital more compelling. As such the Commission applied the formula to determine that 8.7% interest is a reasonable cost of capital (5.5% prime rate times 1.58).

IT IS THEREFORE ORDERED:

(1) Petro Harvester's Motion to Dismiss the request for an order invalidating the invitation for the STR1 22-15 163-90 B well is DENIED.

(2) The request for an order invalidating the invitation for the STR1 22-15 163-90 B well, requiring Petro Harvester to issue a new invitation to participate is DENIED.

(3) The cost of capital outlay in creating infrastructure for saltwater disposal and gas transport is a proper cost for the drilling and operation of a well. As provided herein, the Commission has determined that the reasonable actual cost of capital is 8.7% for the subject wells.

(4) Count Four of the Application is DISMISSED.

Dated this 9th day of March, 2020.

INDUSTRIAL COMMISSION
STATE OF NORTH DAKOTA

/s/ Doug Burgum, Governor

/s/ Wayne Stenehjem, Attorney General

/s/ Doug Goehring, Agriculture Commissioner