

**MEETING OF THE COMPULSORY POOLING STUDY GROUP  
NORTH CAROLINA MINING AND ENERGY COMMISSION  
MARCH 22, 2013  
MCSWAIN AGRICULTURAL CENTER, 2420 TRAMWAY ROAD  
SANFORD, NC**

**1. PRELIMINARY MATTERS**

Chairman Ray Covington called the meeting of the Compulsory Pooling Study Group of the Mining and Energy Commission (MEC) to order at approximately 9:00 am and read the ethics statement into the record.

Dr. Covington welcomed everyone in attendance. Panel members made up of the MEC Commissioners and the Resource Group members introduced themselves. The following persons were in attendance for all or part of the meeting:

**MEC STUDY GROUP MEMBERS**

Dr. Ray Covington  
Mr. Charles E. Holbrook  
Mr. Jim Womack

**STUDY GROUP RESOURCE MEMBERS**

Mr. Nathan Batts, N.C. Bankers Association  
Mr. John G. Humphrey, the Humphrey Law Firm  
Mr. Don Kovasckitz, Lee County Strategic Services  
Mr. Jonathan Lanier, N.C. Department of Agriculture and Consumer Services  
Mr. James Robinson, Rural Advancement Foundation International (RAFI)  
Mr. Spencer Scarboro, State Employees' Credit Union  
Ms. Lynne Weaver, N.C. Attorney General's Office, Consumer Protection Division

**DENR STAFF MEMBERS**

Ms. Layla Cummings  
Mr. Walt Haven  
Ms. Trina Ozer  
Mr. Toby Vinson

**OTHERS IN ATTENDANCE**

See attached sign-in sheets.

**2. REVISITING THE SURFACE USE POLICY STATEMENT**

The surface use policy statement from the last meeting was revised to address the concerns raised about the language and to vote on the statement as a recommendation of the Study Group. Chairman Covington explained the voting process and read the

following revised policy statement on surface use for the consideration of the Study Group:

No surface operations or disturbances to the surface of the land shall occur on a tract pooled by an order without the written consent of or a written agreement with the owner of the tract that approves the operations or disturbances.

Commissioner Womack commented that certain terms have varying legal definitions depending on the state statute and suggested that the Study Group develop an appendix of definitions to use in the final report. Commissioners Covington, Womack, and Holbrook voted to approve the language as a recommendation to the MEC.

### **3. INTRODUCTION TO COST SHARING STATUTES**

Ms. Layla Cummings of DENR gave an overview of the different statutory approaches to sharing the costs of development and the revenues of production of oil and gas under a pooling order (see attached presentation). Cost sharing statutes generally distinguish between the “working interest owner” and the “royalty interest owner.” A working interest owner is directly liable for a portion of the costs of exploration, drilling, and production. Working interest owners fully participate in the profits of any successful well. The royalty is the mineral owner’s proportionate share of production and royalty interest owners share in production revenues.

There are three main types of cost sharing statutes: (1) free ride; (2) risk penalty; and (3) surrender of the working interest. Free ride statutes allow the compelled owner to share in the profits of production after costs are paid without being responsible for the risk. This is the current law in North Carolina. The main criticism of the free ride statute is that it places all the risk on the operator which is a disincentive to development and may lead to more holdouts. To address those concerns, the risk penalty approach shares the risk among all parties. Risk penalty statutes provide that the non-consenting owner may be carried for cost and, if the well is successful, the operator can recover costs plus a penalty that is usually a percentage of costs accessed against the compelled owner. If the well is unsuccessful, the compelled owner has no liabilities. Finally, the surrender of working interest approach provides that the owner will assign his or her working interest in exchange for a bonus and/or royalty payment.

Many states allow the party subject to a pooling order to make an election between the following options: (1) paying costs upfront and participating as a working interest owner; (2) being carried for costs and subject to a risk penalty; or (3) surrendering the working interest for compensation. The compelled owner is usually given a specified period of time to make an election and the statute will designate a default election in the event the owner does not respond.

Ms. Cummings concluded that a few of the important considerations should be ensuring that compelled owners receive just and equitable compensation, encouraging voluntary

agreements between operators and landowners, and fostering development by sharing the risk among all parties.

#### **4. GROUP DISCUSSION OF COST SHARING OPTIONS**

Commissioner Womack cautioned that any decisions with regard to cost sharing policies may be premature before knowing how the state will regulate the formation of drilling units. The Administration of Oil and Gas Committee is responsible for the rules with regards to the boundaries of drilling units. Commissioner Holbrook, the Chairman of the Administration of Oil and Gas Committee, said that determining the boundaries of drilling units for unconventional plays is more difficult than in conventional oil and gas development because hydraulic fracturing creates artificial permeability in the rock. There will be a number of factors to consider when forming drilling units, including the geographic boundaries of the parcels and the shape of the natural reservoir. Chairman Womack suggested that the state may take a hybrid approach to the formation of drilling units and the Study Group should proceed with the assumption that there may be multiple ways to form a drilling unit.

Chairman Womack also noted that the rules being written will potentially apply to both horizontal and vertical wells. Mr. Humphrey suggested the Study Group consider whether there should be different regulatory pooling regimes for horizontal and vertical wells. Ms. Cummings noted that most states apply the same pooling laws to both horizontal and vertical drilling operations. Mr. Holbrook said that the length of the wellbore and the ability to drill various layers are additional factors to be considered. Mr. Humphrey agreed and said that the technology could make it more complicated to prorate costs if the wellbore can extend beyond the boundaries of the drilling unit.

Mr. Humphrey said that the Study Group needs to consider the relative bargaining power of all parties and the potential liabilities associated with development. Chairman Womack said that a bond will cover certain liabilities, but it cannot cover all potential liabilities. Ms. Cummings pointed out that some cost sharing statutes distinguish between the leased owner and the unleased owner due to their varying levels of sophistication with the industry. For example, Arkansas allows operators or leased owners who are pooled together to present a joint operating agreement to address liability between the parties at each stage of development. In Arkansas, an unleased owner will be carried with a risk penalty. The costs of development and production, including liabilities associated with drilling activities, will be the responsibility of the working interest owner or the operator. The leased owner is often an oil and gas company that has a solid working knowledge of the industry and the capital to contribute to the costs of operations. The unleased owner may be a landowner who should be shielded from potentially large losses and liabilities.

The Study Group also addressed the risk penalty approach. Ms. Weaver of the Attorney General's Office stated that it may be the preferable approach to the current free ride statute because it does not encourage holdouts. The free ride statute is outdated and more modern statutes offer elections. Ms. Weaver suggested that the Study Group consider offering elections because it can benefit all parties. Determining the risk penalty as a fixed percentage, however, may not be wise at this point when the risks are

largely unknown. Ms. Weaver advised that should the Study Group recommend a risk penalty approach, that the actual percentage be left to the discretion of the MEC to make on a case by case basis or determined at some point in the future when more is known about the risk.

Ms. Weaver also suggested that we allow “any interested party” to file a petition to pool. In that case, the small landowner who wants to join a pool but has not been offered a lease may also have a mechanism to join the pool. Mr. Robinson noted that this was actually the original intent of compulsory pooling laws in Texas. The panel was in agreement that it would be a good idea to allow any interested party to file a petition to pool.

Mr. Humphrey noted that the North Carolina Administrative Code does provide that DENR may assess a penalty if you are pooled. Thus, it is not clear that North Carolina is a purely free ride state or whether it does provide for a risk penalty. Mr. Humphrey recommended that the Study Group develop a regulatory scheme that encourages people to work together and that may be through the options approach, including a risk penalty option.

Chairman Womack said that most states wrote their laws after oil and gas development was already in place. North Carolina does not have existing industry and thus the Study Group should keep in mind regulations that will incubate the industry and will not be overly burdensome. It is likely that because of the shallowness of the shale in North Carolina, there is an elevated risk compared to other states. Due to that risk, North Carolina is likely to attract smaller, independent oil and gas companies.

Dr. Covington asked that DENR provide examples of the actual language of the statutes and the Study Group consider each regulatory regime. Ms. Weaver pointed out that some states provide for a bonus payment to the compelled landowner. Other states, such as Colorado, treat unleased owners differently and provide them with a 1/8th royalty payment as soon as production begins, free and clear of the costs and risk penalty. The cost and risk penalty are paid out of the other 7/8ths of the owner’s proportionate share of production. Whereas, under the North Carolina statute, the compelled owner is not entitled to payment until costs are paid.

A member of the audience asked whether independent operators have the same technology as the large oil and gas companies. Chairman Womack responded that it is all a matter of opinion—some small companies have a great reputation and some large companies have a bad reputation. Mr. Holbrook pointed out that often the big and small companies use the same subcontractors and there is not a notable difference in the technology. Mr. Holbrook also noted that the MEC is in the process of writing rules to ensure that all companies comply with specific standards.

Mr. Holbrook added, with regard to the risk penalty approach to cost sharing, that the risk could be tied to the price of natural gas and the profitability of the well. Dr. Covington asked that the panel look at the language of multiple options at the next meeting.

## **5. REVISITING THE MINERAL RIGHTS LEASE FLOW CHART**

Mr. James Robinson of RAFI presented an updated version of the flow chart representing the different stages in the lifecycle of a mineral lease (see attached handout). The presentation focused on the leasing period represented as Stage II on the chart. Mr. Robinson said that a landowner can be pooled in as a leased landowner or an unleased landowner. A leased landowner has negotiated terms of the lease with an operator and will be bound by those terms. An unleased landowner who is pooled will have a state established lease. Issues such as surface access, which was addressed by the policy statement discussed earlier in the meeting, will be controlled by the lease.

## **6. DISCUSSION OF UPCOMING POLICY STATEMENTS AND FINAL REPORT**

Mr. Ted Feitshans, a Resource Group Member, will give a presentation next meeting concerning indemnification issues. Mr. Feitshans will also recommend language for a policy statement concerning indemnification for the consideration of the Study Group.

Dr. Covington distributed an outline of potential issues for consideration of the Study Group to be addressed in the final report. Chairman Womack recommended that this outline be renamed to reflect that is a working draft outline of the final report. Dr. Covington agreed and said the list will evolve over the course of the following meetings and he will solicit the input of industry and others. Dr. Covington also asked that Resource Group Members begin to develop a list of definitions to be added as an appendix to the final report.

## **7. PUBLIC QUESTIONS AND COMMENTS**

Mr. Bob Brickhouse commented that the Study Group should ensure that certain lands like highway right-of-ways and churches are protected. Panel members agreed and said they will also consider policies to cover special lands including conservation easements and public lands.

The first question concerned how local public schools' water supplies will be affected and what procedures will be put in place to protect our students and our student athletes from water contamination. Dr. Covington encouraged audience members to attend other meetings that address water issues. Mr. Holbrook answered that it is the objective of the MEC to prevent any contamination of fresh water in North Carolina.

Ms. Lib Hutchby read a prepared statement in honor of World Water Day.

## **8. CLOSING COMMENTS**

The next meeting will be held on April 12 at 9 am at the same location in Sanford, NC. The Local Government Study Group meeting will be the same day at the Pinehurst Village Hall in Moore County at 1:30 pm. There will be enough time to travel to Moore County if anyone wishes to attend both meetings.

The meeting was adjourned at 11:30 am.