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Oil and Gas—Conservation—Proration: Continental Oil Co. v. Oil Conservation Comm'n, 70 N.M. 310, 373 P.2d 809 (1962)

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OIL AND GAS—CONSERVATION—PRORATION*—In 1954 the New Mexico Oil Conservation Commission prorated the Jalmat Gas Pool in Lea County, New Mexico, using a “pure acreage” formula. By the end of 1957, the pool apparently was unable to produce its allowable. Texas Pacific Coal and Oil Co., one of the producers in the field, petitioned the Commission to either terminate proration or change the proration formula. The Commission held hearings and issued orders changing the formula to one which included a “deliverability” factor. Seven producers in the pool appealed the orders to the district court where they were affirmed. On appeal to the Supreme Court of New Mexico in Continental Oil Co. v. Oil Conservation Comm’n, held, Reversed with directions to declare the orders invalid and void.

* Continental Oil Co. v. Oil Conservation Comm’n, 70 N.M. 310, 373 P.2d 809 (1962).

1. The “pure acreage” formula is:

\[ a_t = \frac{Ta}{Fa} (A) \]

where \( a_t \) is the allowable production from tract “t,” \( Ta \) is the acreage of tract “t,” \( Fa \) is the total acreage overlying the field, and \( A \) is the total allowable for the field.


4. Order No. R-1092-C (N.M. Oil Conservation Comm’n 1958) replaced, with one slight exception, the original order, Order No. R-1092-A (N.M. Oil Conservation Comm’n 1958).

5. The “deliverability” formula is:

\[ a_t = .25 \left( \frac{Ta}{Fa} \right) + .75 \left( \frac{Ta}{Fa} \right) (A) (d) \]

where \( a_t \) is the allowable production from tract “t,” \( Ta \) is the acreage of tract “t,” \( Fa \) is the total acreage overlying the field, \( A \) is the total allowable for the field, and \( d \) is the “deliverability” factor.

The “deliverability” factor is proportional to the amount of gas the well would produce if permitted to produce without restriction against a specified back pressure. Sullivan, Oil and Gas Law 334 n.99 (1955). This is essentially the same formula that was used in New Mexico’s West Kutz-Prichard Cliffs Gas Pool. See Conservation of Oil and Gas: A Legal History, 1958, at 161 n.43 (Sullivan ed. 1958).


7. Id. at 313, 373 P.2d at 811.

8. 70 N.M. 310, 373 P.2d 809 (1962).


The supreme court’s decision to invalidate the orders rather than remand the case to the district court was based upon the conclusion that the Commission failed to
The major portion of the supreme court's opinion was devoted to the Commissions Finding of Fact No. 5. Finding of Fact No. 6, although in issue, was not subjected to as complete an examination. Finding of Fact No. 6 was:

'That the inclusion of a deliverability factor in the proration formula for the Jalmat Gas Pool will result in the production of a greater percentage of the pool allowable, and that it will more nearly enable various gas purchasers in the Jalmat Gas Pool to meet the market demand from said pool.'

Appellees argued that Finding of Fact No. 6 related to the protection of make basic jurisdictional findings of fact. Commission Finding of Fact No. 5 was:

'That the applicant has proved that there is a general correlation between the deliverabilities of the gas wells in the Jalmat Gas Pool and the [recoverable] gas in place under the tracts dedicated to said wells, and that the inclusion of a deliverability factor in the proration formula for the Jalmat Gas Pool would, therefore, result in a more equitable allocation of the gas production in said pool than under the present gas proration formula.'

(The word "recoverable" in brackets above is the only change made by the Commission by its affirmatory Order No. R-1092-C.)

Id. at 317-18, 373 P.2d at 814.

To understand the problem involved, consider the hypothetical case where A and B each own equal surface acreage overlying a gas pool. Suppose each is allowed to produce from one well for twenty-four hours under the same operating conditions. If A produces twice as much gas as B, one possible inference is that there is more recoverable gas under A's tract than under B's tract. This was the inference made by the Commission in Finding of Fact No. 5. The finding was based upon expert testimony. There was also expert testimony that deliverability did not correlate with recoverable gas in place. It would seem from the supreme court's opinion that the Commission could properly decide which expert testimony to believe. Id. at 318, 373 P.2d at 814.

The supreme court's objection was not that the Commission's finding of fact was not supported by substantial evidence. It was that there was no basic jurisdictional finding of fact. The Continental court said that before the Commission could take jurisdiction, the following basic facts must be found:

(1) the amount of recoverable gas under each producer's tract;
(2) the total amount of recoverable gas in the pool;
(3) the proportion that (1) bears to (2); and
(4) what portion of the arrived at proportion can be recovered without waste.

Compare the pure acreage formula, note 1 supra, with the deliverability formula, note 5 supra. Both formulas give the proportion the supreme court indicated as basic fact No. (3). But both give the proportion indirectly rather than using basic facts Nos. (1) and (2). This is the usual procedure since any estimate of the total recoverable gas in a pool or the recoverable gas under each producer's tract is almost always an educated guess. See DeChazeau & Kahn, Integration and Competition in the Petroleum Industry 176 n.16 (1959). So the pure acreage formula is subject to the same failings as the deliverability formula. What the supreme court calls fact No. (3) is really the only one which is necessary for the protection of correlative rights.

11. Id. at 318, 373 P.2d at 814.
The Commission argued that the finding related to waste. The supreme court concluded that Finding of Fact No. 6 did not relate to the prevention of waste or to the protection of correlative rights. It is possible, however, that Finding of Fact No. 6 provides a basis for upholding the Commission's orders apart from any direct relationship to the prevention of waste or to the protection of correlative rights. Before developing this possibility, it will be helpful to review the fundamentals of proration in the oil and gas industry.

"Proration" is the process of (1) limiting production to some proportion of the amount which could be produced in the absence of any restrictions, (2) distributing the allowed production among fields in the same proration district, and (3) distributing the allowed field production among the producing wells within the pool. Proration is necessary to prevent physical waste by keeping the rate of production at or below the "MER" (maximum efficient rate), or to prevent economic waste by prohibiting production in excess of market demand.

MER is the "maximum efficient rate" or the "most efficient rate" at which a well can produce without impairing the efficiency of the reservoir energy with consequent physical underground waste. It is the upper limit on the rate of production beyond which any increase will mean a decrease in the amount of ultimate recovery. The MER has real significance when applied to oil pools or to water-drive gas fields, since production at too rapid a rate in these cases could result in the inefficient use of the reservoir drive. But the Jalmat Gas Pool is a dry-gas field. For practical purposes, all of the reservoir energy is supplied by the gas itself. There is no reason to limit the rate of production from a dry-gas pool to prevent underground waste since the rate of production can not injure the reservoir energy, i.e., the gas itself. For all practical purposes,

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13. Appellees reasoned that under N.M. Stat. Ann. § 65-3-13(d) (1953), the Commission has a duty to prevent unreasonable discrimination among pools. Where a pool is unable to meet its allowable because of the proration formula used, the result is that the pool as a whole is being discriminated against. Brief for Appellees, pp. 12-13.
14. The Commission made the general argument that all orders involve waste, implicitly or explicitly. Brief for Cross-Appellant, p. 5.
17. Id. at 315.
18. Id. at 27, 28.
19. Id. at 28.
20. The Champlin Case [Champlin Ref. Co. v. Corporation Comm'n, 286 U.S. 210 (1932)], however, is distinguished . . . because . . . the matter dealt with [in Champlin] was oil, and the court made it very clear that its finding was based upon the fact that physical waste . . . was indicated * * * * In the present case . . . there is an absolute lack of evidence to show physical waste.
production from the Jalmat Gas Pool, since it is a dry-gas pool, should be limited only to prevent production in excess of market demand.

Market demand is the demand for reasonable current requirements and for maintaining reasonable storage reserves. Restricting production to market demand is usually justified by arguing that such production leads to or causes physical waste. Excess production results in lower prices and over-production. Lower prices force marginal producers to abandon their wells, leaving large amounts of oil and gas underground. Over-production results in the storage of large amounts of oil and gas which are subject to evaporation and increased danger of loss from fire or other hazards. Statutes requiring production to

There is no water problem in this gas field, no evidence of channeling, coning, or entrapment, nor any other condition shown by the record which might involve physical injury to the gas structure there.


But see Kan. Gen. Stat. Ann. § 55-703 (1949); Sullivan, Oil and Gas Law 333 (1955). Limitations on gas production to some percentage of the total open-flow of the pool correspond in a general way with the MER restriction. Whether such limitations can be defended as logically as the MER restriction is open to question. New Mexico does not require gas production to be limited to a certain percentage of the open-flow production.


However, opponents of market demand statutes claim that “economic waste” when used to describe production in excess of market demand is an euphemism for price fixing. One court bluntly said:

[U]nder the thinly veiled pretense of going about to prevent physical waste the commission has, in co-operation with persons interested in raising and maintaining prices of oil and its refined products, set on foot a plan which, seated in a desire to bring supply within the compass of demand, derives its impulse . . . in the attempt to control the delicate adjustment of market supply and demand, in order to bring and keep oil prices up.

McMillan v. Railroad Comm'n, 51 F.2d 400, 404-05 (W.D. Tex. 1931).

There is little doubt, however, that production in excess of market demand can lead to physical waste. This is particularly true in the case of gas, since above ground storage of gas is difficult, if not impossible, without physical waste. But, it is also true that market demand statutes have tended to stabilize prices. A recent economic analysis of the oil and gas industry reported that:

[T]hough the Texas Commission has often denied any concern for price, it is clear beyond cavil that its exercise of control over supplies has had a major impact in snubbing crude-oil price declines.


This is not to say that stabilization of prices is wrong or harmful. Whether price stabilization through the use of market demand statutes is desirable is really a question involving economic and political, not legal, considerations.
be limited to market demand have been upheld in other jurisdictions.23

The New Mexico Oil Conservation Commission is authorized to restrict production to prevent waste.24 Waste is defined to include both the usual types of physical waste25 and production in excess of market demand.26 In Continental there was no suggestion of physical waste. Therefore, there was no reason to limit production except to prevent excess production.27

The total field allowable for the Jalmat Gas Pool was set in accordance with market demand. But, because of the proration formula in use, i.e., pure acreage,28 the field as a whole could not produce the allowable. In other words, production was limited to an amount less than market demand. Using this analysis it can be argued that the Commission had a duty to change the proration formula used in the Jalmat Gas Pool.

The Commission is only authorized to restrict production to prevent waste.29


27. The supreme court may not have recognized the significance of the lack of any element of physical waste apart from the physical waste associated with excess production. The court said:

[I]f the allowable production from the pool exceeds market demand, waste would result if the allowable is produced. . . . Conversely, production must be limited to the allowable even if market demand exceeds that amount, since the setting of allowables was made necessary in order to prevent waste. Continental Oil Co. v. Oil Conservation Comm'n, 70 N.M. 310, 320, 373 P.2d 809, 816 (1962).

The first sentence of this comment is true. But the second sentence is not true where the allowable is an amount less than the amount fixed by the MER. The Jalmat Gas Pool is prorated to prevent waste associated with production in excess of market demand. Production at or below market demand does not lead to waste. Therefore, if the field allowable is less than market demand, no waste is introduced by raising the allowable to meet the demand.

28. See note 1 supra and accompanying text.


It might be argued that the Commission does have power to restrict production solely to protect correlative rights. N.M. Stat. Ann. § 65-3-10 (1953), says: "The Commission is hereby empowered, and it is its duty, to prevent the waste prohibited by this Act and to protect correlative rights, as in this act provided." [Emphasis added.] The words "as in this act provided" are fatal to any argument that the Commission can restrict production merely to protect correlative rights. The Act only provides for the protection of correlative rights if production is restricted to prevent waste. In Continental, the Commission said: "Section 65-3-13(c), NMSA, 1953 Comp., clearly states that gas proration can be instituted by the Commission only to prevent waste." Brief for Cross-Appellant, p. 5.
In *Continental* waste was not in issue. Waste would only become an issue if production exceeded the market demand. Therefore, restricting production to some amount less than the market demand is not authorized by the statutes. The only valid restriction the Commission could impose would be one limiting production to market demand. The statutory duty to protect correlative rights only applies if the total field production is limited to prevent waste.

In the absence of waste other than the waste associated with production in excess of market demand, the Commission can not limit production below market demand since such a limitation would not prevent waste. In *Continental*, the Commission's Finding of Fact No. 6 clearly implies that production from the Jalmat Gas Pool was in fact limited to an amount below market demand. Therefore, the Commission had to either terminate proration or change the old proration formula to one which would permit the field, as a whole, to meet the field allowable.

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30. This assumes that waste does not include protection of correlative rights by definition. See Comment, 3 Natural Resources J. 178 (1963). But see Continental Oil Co. v. Oil Conservation Comm'n, 70 N.M. 310, 318, 373 P.2d 809, 814 (1962), where the court said: "the prevention of waste . . . is an integral part of the definition of correlative rights."

31. N.M. Stat. Ann. § 65-3-13(c) (1953); see note 29 supra.

The Commission, however, should be able to issue orders based solely upon correlative rights if the total field allowable is set to prevent waste. See, e.g., Corzelius v. Harrell, 143 Tex. 509, 186 S.W.2d 961 (1945). In a recent comment, it was assumed that the restriction on the Jalmat Gas Pool's total production did prevent waste, so that the separation of powers constitutional issue could be analyzed. In that comment the argument was that it should not be unconstitutional for the Commission to issue orders based solely upon correlative rights. See Comment, 3 Natural Resources J. 178 (1963). But see Continental Oil Co. v. Oil Conservation Comm'n, 70 N.M. 310, 324, 373 P.2d 809, 818-19 (1962). The present comment does not suggest that the Legislature can not constitutionally authorize the Commission to restrict production solely to protect correlative rights, but that the Legislature has not given such authority to the Commission.

32. Sims v. Mechem, 382 P.2d 183, 185 (N.M. 1963); cf. Railroad Comm'n v. Rowan Oil Co., 152 Tex. 439, 259 S.W.2d 173 (1953). See generally Note, 32 Texas L. Rev. 350 (1954); Conservation of Oil and Gas: A Legal History, 1958, at 234 (Sullivan ed. 1958). In *Rowan*, the court said that the Railroad Commission did not have the authority to limit production from wells where gas was not being wasted merely to protect the correlative rights of the owners of wells which could not produce without waste.