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COGCC Issues Significant Decision Thwarting End-Run Around Non-Consent Penalties

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Introduction

At its hearing on January 26, 2015, the Colorado Oil and Gas Conservation Commission (COGCC) heard an issue of considerable importance to operators and non-operators alike. The matter involved the imposition of the cost recovery provisions, or "non-consent penalties" of the Colorado Oil and Gas Conservation Act. The core issue of the hearing involved a lease and several assignments of overriding royalty interests that occurred shortly before the initial hearing authorizing non-consent penalties.

The COGCC denied the non-operator's application to declare that the lease royalty and overrides should be calculated free of the non-consent penalties. The following article provides a brief summary of the pertinent facts, the analysis used by the COGCC in making its decision, and some comment on what this decision means for the future of pooling and non-consent penalties in Colorado.

Factual Summary

Verdad Oil & Gas Corporation (Verdad) designated a wellbore spacing unit (WSU) in Weld County, Colorado, which was administratively approved by the COGCC on October 31, 2014. Renegade Oil & Gas Company, LLC (Renegade) owned an unleased mineral interest as well as several leases within the WSU. On November 17, 2014, Verdad filed an application to pool the WSU and authorize non-consent penalties as to all non-consenting interests. On November 19, 2014, Verdad provided to Renegade an election to participate, AFE, and offer to lease Renegade's unleased interest. COGCC Rule 530 deemed an owner nonconsenting if it did not elect to participate, in writing, thirty days after receipt of the required information from the operator or if the owner refused a reasonable offer to lease.[1] The 30-day period prescribed by Rule 530 expired without Renegade signing the lease offer or returning its election to participate. In January of 2014, Verdad drilled the well in the WSU.

[1] The rule has since been changed to provide 35 days for an owner to elect or lease. See COGCC Clean-Up Rulemaking, July 28, 2014, Greely, Colorado.

On January 12, 2015, Renegade protested the pooling application. On February 23, 2015, Renegade leased its unleased mineral interest to itself, as lessee, with a 25% royalty. On the same day, and subsequently on April 9, 2015, Renegade assigned to itself an overriding royalty in two leases equal to the difference between existing burdens and 25%. Renegade recorded the lease and the two assignments on April 9 and 10, 2015. On April 13, 2015, the COGCC heard the pooling application. Renegade protested the application at the hearing but did not provide any evidence of the lease or overrides to the COGCC. The COGCC approved the pooling application over Renegade's protest in Order No. 407-1277.

On October 8, 2015, Renegade filed an application with the COGCC requesting that it declare, clarify, and/or amend Order No. 407-1277 to provide that the lease royalty and overrides were not subject to non-consent penalties. After extensive briefing, on January 15, 2016, the COGCC's hearing officer issued a recommendation that Renegade's application be denied. The COGCC heard the matter on January 26, 2015. At the hearing, the parties stipulated to the facts of the matter, as outlined above, and neither side presented any witness testimony. Counsel for the parties were the only ones to speak at the hearing.

After counsel for the parties presented their cases, the COGCC voted unanimously to adopt the analysis and recommendations set forth in the Hearing Officer's recommendation and thus denied Renegade's application. Unusually, the Commissioners arrived at this vote without any deliberation.[2]

Analysis

The Colorado pooling statute allows consenting owners to recover a non-consent penalty equal to 100% of the cost of surface facilities and 200% of downhole costs.[3] The consenting owners can recover these costs out of the share of proceeds attributable to the non-consenting party, *exclusive of* "royalty or other interest not obligated to pay any part of the cost thereof.…" § 34-60-116(7), C.R.S. Thus, if a lessee with a lease subject to a 20% royalty rate elects not to participate in a well, the consenting owners can recover the non-consent penalty only out of the 80% interest attributable to that lessee, and must pay the full 20% royalty to the lessor starting with the date of first production. Obviously, this has a significant effect on the consenting owners' before-payout net revenue interest.

In this particular case, Renegade asked the Commission to determine that Verdad could recover the non-consent penalty only out of Renegade's 75% lessee interest and not Renegade's 25% royalty interest. Verdad argued that Renegade's conveyance was a blatant attempt to thwart the pooling statute's intent, which is to penalize non-consenting parties and compensate consenting parties who assume the extra risk and burden of drilling and completions. Arguably, Renegade's position might have swayed the COGCC if Renegade had leased to itself *prior* to the expiration of the 30-day election period (per the 2014 version of Rule 530). However, the analysis

[2] The Commissioners may have simply been weary of deliberations, having just concluded the fourth hearing on the Governor's Task Force Rulemaking at about 7:00 p.m. the night before.

[3] "Surface costs" and "downhole costs" are broad generalizations; the actual recoverable costs are set forth in § 34-60-117(b)(i) and (ii).

unanimously approved by the COGCC identified the expiration of the election period as the central factor in deciding Renegade's application:

> First, for purposes of Section 34-60-116(7)(a), C.R.S., is Renegade determined to be a nonparticipating working interest owner as of the date of the pooling hearing or the 35 days after receiving an offer to participate?
>
> Second, for purposes of Section 34-60-116(7)(c), C.R.S., is Renegade determined to be a nonconsenting unleased owner as of the date of the pooling hearing or the 35 days after the receiving an offer to lease?[4]

The analysis concluded that the non-consenting status of a party is determined as of the expiration of the 35-day period set forth in COGCC Rule 530, not as of the day of the hearing, as argued by Renegade. This applies to both working interest owners and unleased owners. The analysis expressly rejected the interpretation urged by Renegade, which would have forced Verdad to pay Renegade a 25% lessor's royalty interest and several overriding royalty interests beginning with the first date of production, in spite of the fact that Renegade did not record the lease and assignments until days before the pooling hearing. Taken to an extreme, this might allow an owner to lease or assign an override to himself on the day of the pooling hearing, despite the fact that the 35-day election period expired long prior. Moreover, the royalty could be 50%, or even 80%. This could allow an unleased owner, or even a lessee who did not want to participate in a well, to thwart the intent of the legislature in penalizing parties for not participating in the risky business of oil and gas exploration. Moreover, consenting parties would receive no reward for taking on the added risk of paying to develop the wells. The analysis adopted by the Commission was based partially on the canon that statutes should not be interpreted in ways that thwart legislative intent or lead to absurd results.

In addition to asking the Commission to adopt its interpretation of the timing issue under Rule 530, Renegade argued that its application be granted in the interests of fairness and equity. Renegade stated that it had a verbal agreement with Verdad that was not honored, but that by the time Renegade realized that the agreement would not be honored, it was too late to elect into the well. The analysis adopted by the COGCC soundly rejected this argument because Renegade failed to disclose the lease and assignments at the April, 2015 hearing, and one who seeks equity must seek it with clean hands. *Salzman v. Bachrach*, 996 P.2d 1263 (Colo. 2000).

Future Impacts

Many operators and practitioners have wondered what would happen if a non-consenting party were to attempt to an end-run around the pooling statute by conveying a large royalty or override to itself or a straw man. A 25% lessor royalty, and an override equal to 25% less burdens are certainly above average, although not egregiously so. The more important issue from this case is the timing. Although this decision from the COGCC was based on very specific facts and has

[4] The Hearing Officer's recommendation inadvertently referred to the post-rulemaking version of Rule 530, which imposes a 35-day election period.

limited precedential value, it is very instructive as to the date on which a party is deemed non-consenting. Moreover, it helps establish that once an interest is non-consenting it remains non-consenting until the subject well pays out and risk penalties are recovered, no matter how it is subsequently assigned, conveyed, leased, or otherwise carved up.

If you have questions, comments, or need advice about pooling, non-consent penalties, payment of royalties after pooling, or other general issues pertaining to regulation of energy in the Rockies, please contact James Parrot or Jill Fulcher.