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ENERGY IN THE LAW

Commission Orders No Payment Due to ORRIs During Cost Recovery Period

By: James Parrot

At its September 11th hearing in Durango, Colorado, the Colorado Oil and Gas Conservation Commission ("COGCC") considered, for the first time, an issue of great concern to any party who owns or pays an overriding royalty interest ("ORRI"). Specifically, the Commission determined that under Colorado's compulsory pooling statute (C.R.S. § 34-60-116(7)) ("Pooling Statute"), consenting owners *do not have to pay* ORRI owners whose interests derive from a working interest ("WI") that is nonconsenting until the consenting owners have recovered well costs.

Background

In this case, a party who owned leases ("Nonop") assigned various ORRIs in its leases to several individuals ("ORRI Owners"), which in aggregate were equal to 30.0%. The ORRI assignments were recorded. A second party who owned other leases in the same area ("Operator") established a drilling and spacing unit and planned to drill a well. Operator mailed packets to Nonop that contained an election to participate and authorization for expenditure. Nonop did not elect to participate in the well. Operator subsequently obtained a pooling order from the COGCC, which authorized cost recovery under C.R.S. § 34-60-116(7) for the well. C.R.S. § 34-60-116(7)(a) provides:

> As to each nonconsenting owner… the order shall provide for reimbursement to the consenting owners… of the nonconsenting owner's share of the costs and risks of such drilling and operating out of, and only out of, production from the unit representing his interest, *excluding royalty or other interest not obligated to pay any part of the cost thereof.*

(emphasis added). C.R.S. § 34-60-116(7)(b) further provides that the recoverable costs are equal to 200% of downhole and equipment costs and 100% of surface costs.[1]

Operator subsequently drilled the well and obtained production. Operator notified Nonop and ORRI Owners that it did not intend to pay the ORRIs during the pendency of the cost recovery period. In other words, Operator would pay no ORRIs until it had recovered 200% of

[1] This is a rough paraphrase of the various costs that are recoverable at either 200% or 100%—the statute is considerably more specific about such costs. For full details about what costs are recoverable at what percent, please consult C.R.S. § 34-60-116(7)(b) or contact us for further information.

downhole and equipment costs and 100% of surface costs. ORRI Owners objected and eventually filed an application to the COGCC to determine whether such costs could be withheld during the cost-recovery period.

The COGCC bifurcated the hearing into two issues. The first was whether consenting owners must pay ORRIs during the cost recovery period, which issue hinged on whether an ORRI is included in "*royalty or other interest not obligated to pay any part of the cost thereof…*" The second issue was whether the aggregate 30% ORRI was so egregious as to justify equitable relief under the Pooling Statute's requirement that every pooling order "shall be upon terms and conditions that are just and reasonable …" The COGCC stayed the equitable arguments and at the September hearing in Durango, considered only the first issue.

Arguments and Deliberations

ORRI Owners took the position that the plain language of the statute, "*royalty or other interest not obligated to pay any part of the cost thereof…*" includes ORRIs. Hence, Operator must pay ORRI Owners during the cost-recovery period. ORRI Owners argued that the language was unambiguous, *ergo* no further statutory interpretation would be necessary. ORRI Owners also argued that operators are free to drill or not drill and should make the choice partially on the basis of lease burdens. Finally, ORRI Owners argued that numerous individuals and families rely on ORRIs for income and it would be unfair to them to rule for Operator.

Operator argued that the language was ambiguous and therefore the Commission must consider other canons of statutory interpretation. Operator argued that the phrase "overriding royalty interest" is specifically used elsewhere in the Colorado Oil and Gas Conservation Act, C.R.S. §§ 34-60-101, *et seq.* (the "Act") and that its exclusion from the Pooling Statute was intentional. Operator also argued that a nonoperator could get around the cost-recovery provision of the Pooling Statute by conveying a 100% ORRI. Operator further argued that since an ORRI derives from and arises out of a WI, it is subject to the WI owner's decision to participate or accept a risk penalty. Finally, Operator argued that parties are free to negotiate ORRI assignments that allow an ORRI to have a say in whether the WI participates or not.

In deliberations, Commissioners found the use of "overriding royalty interest" elsewhere in the Act persuasive. They also agreed that it would frustrate the risk and reward mechanism of the Act if parties could avoid penalties by carving out ORRIs. The Commissioners voted to deny ORRI Owners' Application because the Pooling Statute does not require consenting owners to pay an ORRI that arises from a nonconsenting WI until the consenting owners have recovered their costs.

Implications

The COGCC's ruling may be appealed to district court and eventually the Colorado Supreme Court. If it is upheld on appeal, the obvious result will be that operators will move ORRIs that arise from nonconsenting WIs from the "before payout" column to the "after payout" column of their DOI decks. While the issue is being appealed, however, operators should consider suspending such ORRIs.

The COGCC's ruling will also have other repercussions. Assignments and reservations of ORRIs will become more complicated in Colorado, with the issue of well participation likely to become a key negotiating point. Existing ORRI owners may choose to bring actions to force participation or recover proceeds when WI owners do not participate. Operators may decide to bring actions to recover erroneously paid ORRIs, especially for wells that are not going to pay out 200%. Alternatively, an operator may decide to net out such an ORRI against other wells.

Conclusions

Outside of rulemakings, there have been few hearings in recent history that could have the impact of this ORRI decision. There will inevitably be additional consequences of the Commission's decision that will emerge over time. In the immediate future, operators, non-operators, and ORRI owners should begin planning for its effects. Operators may want to begin revising DOI decks. Nonconsenting WI owners may consider communications with ORRI owners about the possibility of diminishing, or even vanishing revenue streams. For any specific concerns about this decision, please contact either James Parrot or Jill Fulcher.