

**STATE OF SOUTH DAKOTA
DEPARTMENT OF ENVIRONMENT AND NATURAL RESOURCES
BOARD OF MINERALS AND ENVIRONMENT**

IN THE MATTER OF THE PETITION OF)
LUFF EXPLORATION COMPANY, DENVER,)
COLORADO, FOR AN ORDER POOLING)
ALL INTERESTS IN A SPACING UNIT FOR)
THE SOUTH MEDICINE POLE HILLS FIELD)
DESCRIBED AS THE E/2 OF SECTION 33)
AND THE W/2 OF SECTION 34, TOWNSHIP)
23 NORTH, RANGE 4 EAST AND THE NW/4)
OF SECTION 3 AND THE NE/4 OF SECTION)
4, TOWNSHIP 22 NORTH, RANGE 4 EAST,)
HARDING COUNTY, SOUTH DAKOTA,)
AND TO AUTHORIZE THE RECOVERY OF)
RISK COMPENSATION IN ADDITION TO)
THE PRO RATA SHARE OF REASONABLE,)
ACTUAL COSTS FROM THE INTEREST OF)
ANY LESSEE OR UNLEASED MINERAL)
OWNER WHO ELECTS NOT TO)
PARTICIPATE IN THE RISK AND COST OF)
DRILLING AND COMPLETING A WELL ON)
SAID SPACING UNIT; AND FOR OTHER)
RELIEF AS THE BOARD DEEMS)
APPROPRIATE.

Case No. 28-2013

**FINDINGS OF FACT,
CONCLUSIONS OF LAW, AND
ORDER**

The South Dakota Board of Minerals and Environment, ("Board"), held a hearing in Pierre, South Dakota, pursuant to notice on October 17, 2013, upon the Petition of Luff Exploration Company ("Luff"), in the captioned matter. A quorum of the Board was present at the hearing. The Board, having considered the evidence and arguments offered by Luff, and having afforded other interested parties the opportunity to present evidence and arguments, now makes and enters the following:

FINDINGS OF FACT

1. Luff has petitioned the Board for an order pooling all interests in a 960-acre spacing unit for the South Medicine Pole Hills Field described as the E/2 of Section 33, the W/2 of

Section 34, Township 23 North, Range 4 East, the NW/4 of Section 3 and the NE/4 of Section 4, Township 22 North, Range 4 East, Harding County, South Dakota (the "Subject Lands") and to authorize the recovery of risk compensation in addition to the pro rata share of reasonable, actual costs from the interest of any lessee or unleased mineral owner who elects not to participate in the risk and cost of drilling and completing a well on the Subject Lands.

2. Ms. Linda Golden is an unleased mineral owner in the Subject Lands.
3. The relevant Well Name and Well Number is: Stearns Brothers B-33H.
4. Ms. Golden and Luff have a pre-existing relationship regarding oil and gas production on other lands in Harding County, South Dakota.
5. Luff operates the Buckley D-32H Well and Ms. Golden was an unleased mineral owner regarding that Well.
6. Ms. Golden chose not to lease or participate in the Buckley Well and thus was forced pooled with Luff carrying Ms. Golden's interest subject to the recovery of all of Luff's costs plus a risk compensation of one hundred percent (100%) of the cost of drilling and completing the Buckley Well.
7. Ms. Golden is represented in this matter by counsel who is experienced in oil and gas law.
8. It is apparent that Ms. Golden is familiar with the process of leasing mineral interests in the State of South Dakota and knowledgeable concerning her rights and opportunities available to her under the laws of the State of South Dakota whether as a leased mineral owner or unleased mineral owner.

9. On June 25, 2013, Clayton Chessman, Luff Exploration, sent an email to Ms. Golden acknowledging her mineral interest in the Subject Lands; outlining the history regarding the Buckley Well; explained why leasing rather than force pooling could be in her best interests; and offered that Luff would lease her interest for \$100 per net mineral acre with a 1/6 (16.666667%) royalty for a three year primary term. (Luff Exhibit 4).
10. Ms. Golden did not respond to Chessman's June 25, 2013 e-mail.
11. By Secretary's Order dated July 1, 2013, in Case No. 16-2013, the Subject Lands were designated as a 960 acre spacing unit for the South Medicine Pole Hills Field.
12. In Order No.16-2013 the Board established a spacing unit for the South Medicine Pole Hills field consisting of the Subject Lands (the "Spacing Unit"), and authorized the drilling of a horizontal well on the Spacing Unit.
13. There are six separately owned tracts within the Spacing Unit. There are also separately owned interests within each of these separately owned tracts. Ms. Golden owns a 50% mineral interest in the NW/4, which consists of Lots 3 and 4 and the S/2NW/4, of Section 3.
14. There is no voluntary pooling agreement covering all of the interests within the Spacing Unit. While Luff has obtained oil and gas leases from all of the owners of mineral interests in the spacing unit other than Ms. Golden, and those leases contain pooling clauses authorizing pooling by filing of a declaration of pooling, Ms. Golden's interest remains unleased.
15. On July 2, 2013 Luff submitted an Application for Permit to Drill regarding the Stearns Brothers Well. (Golden Exhibit 1).

16. On July 11, 2013 the Department issued Permit No. 2040. (Golden Exhibit 1).
17. On July 17, 2013 Chessman sent another email to Ms. Golden advising, among other things, that Luff would increase the lease bonus consideration to \$200 per net acre. (Luff Exhibit 4).
18. On July 17, 2013, Chessman sent a letter, Certified Mail Return Receipt Requested, to Ms. Golden enclosing an Authority for Expenditure regarding the Stearns Well should Ms. Golden decide to elect to participate and enclosing a Lease for \$200 per net mineral acre bonus consideration, three year primary term, with a 1/6th royalty rate. (Luff Exhibit 3).
19. Luff requested the Lease be returned within thirty (30) days from July 17, 2013. (Luff Exhibit 3).
20. Luff further advised that if Ms. Golden declined to grant Luff the lease under the terms proposed or elected not to participate in the cost and risk, it was Luff's intention to request the Board provide for the recovery of risk compensation. (Luff Exhibit 3).
21. Ms. Golden responded to Chessman's July 17, 2013 email, by email on July 18, 2013, indicating, "Thank you for your generous offer. I have spoken to my attorney, Scott Sumner, and decided that I want to continue my status as an unleased mineral interest." (Luff Exhibit 4).
22. Ms. Golden's response and position was clearly unequivocal that she wished to continue her status as an unleased mineral interest.
23. On July 25, 2013 the "Green Card" addressed to Linda Golden was signed for receipt by Siva Reddy, whose relationship to Ms. Golden is unknown by the Board.

24. Luff petitioned the Board for an order pooling all interests in a 960-acre spacing unit for the South Medicine Pole Hills Field on or about July 23, 2013. (See Petition).
25. Luff also mailed a copy of the Petition and the Notice of Hearing to Ms. Golden by certified mail and that certified mail receipt was signed on August 9, 2013.
26. Drilling of the Stearns Well commenced on July 28, 2013, and the rig was released on August 19, 2013, but the well was not yet operating or producing at the time of hearing on the Petition.
27. The Department caused proper notice of the time, date and location of the hearing to be timely published pursuant to SDCL 45-9-58.
28. With one exception, Luff gave proper and timely notice of the time, date and location of the hearing to those persons and entities who own interests in the mineral estate within the proposed spacing unit and whose interests are not already voluntarily pooled.
29. One leased mineral owner in the spacing unit was inadvertently omitted from the notice list for the hearing, but Luff filed with the Department a waiver of notice and right to intervene which has been executed by that owner.
30. On or about August 28, 2013, a Petition to Intervene was filed on behalf of Ms. Golden by her counsel, Scott Sumner.
31. There was no communication between Luff and Ms. Golden, or between Luff and Ms. Golden's counsel, between the time of her email of July 18, 2013 and the filing of the Petition to Intervene on or about August 28, 2013.
32. Golden did not respond to the Golden Notice within 30 days of July 17, 2013 and did not respond to Luff in any way until her attorney filed and served the Petition to Intervene on August 28, 2013.

33. Ms. Golden did not appear in person at the hearing but was represented by counsel at the hearing.
34. At the time of hearing, the Stearns Well had been completed and the drilling rig released but the Well had not been made operational and was not producing.
35. The only witness who testified at the hearing was Clayton Chessman, a landman employed by Luff and also, through Chessman Energy, LLC, a participant in the Well.
36. Chessman testified at the hearing and has more than 30 years experience as a landman, the last 16 of which have been with Luff.
37. Chessman testified that in his opinion and experience, the lease terms offered to Golden were reasonable. He also testified that in his opinion and experience, allowing another party 30-days to make an election to participate or lease was reasonable and in accord with custom and practice in the oil and gas industry.
38. Chessman testified that the model form joint operating agreement, which is the standard agreement used to participate in drilling oil and gas wells in the industry, allows 30-days for elections.
39. Chessman also testified that in his opinion wells targeting the Red River "B", which is the formation in which the Well was proposed, bore a certain amount of risk and identified wells which were drilled within ½ mile of good oil and gas wells and which did not produce any oil and/or gas.
40. Chessman also testified that all drilling activities were subject to mechanical risks and that many wells which are drilled and completed, as producers, will never recover the cost of drilling and completing the wells.

41. Chessman testified that in his opinion a risk compensation equal to 100% of the costs of drilling, completing and equipping the well to the point of the wellhead was reasonable and was less than the standard risk compensation in the industry of 200%.
42. Golden did not dispute the reasonableness of the lease terms offered by Luff.
43. ARSD 74:12:10:01 provides that risk compensation may be recovered from any person who elects not to participate in the risk and cost of drilling and operating a well.
44. ARSD 74:12:10:02 provides that risk compensation equal to two hundred percent of the share of reasonable actual costs of drilling, reworking, side-tracking, deepening, plugging, testing, completing and recompleting the well and the costs of newly acquired equipment in the well including the wellhead connection may be recovered out of the share of production attributable to the interest of an owner whose interest is derived from a lease or other contract for development.
45. ARSD 74:12:10:03 provides that risk compensation equal to one hundred percent of the share of reasonable actual costs of drilling, reworking, side-tracking, deepening, plugging, testing, completing and recompleting the well and the costs of newly acquired equipment in the well including the wellhead connection may be recovered out of the share of production attributable to an unleased mineral owner who does not agree to lease or participate in the risk and cost of drilling a well, exclusive of a 1/8 royalty interest.
46. ARSD 74:12:10:01 provides that before an order may be entered providing for the recovery of risk compensation, the applicant must (1) provide proof that an unsuccessful, good faith attempt was made to have the nonparticipating owner execute a lease or participate in the risk and cost of drilling and operating the well and (2) notify the nonparticipating owner with proof of service that the applicant intends to request the

Board to provide for the recovery of risk compensation and that the nonparticipating owner may object to the risk compensation provision by responding in opposition to the application for the compulsory pooling order.

47. The Golden Notice, particularly when combined with Luff's efforts prior to the Golden Notice to secure a lease from Golden, constituted a good faith attempt to have Golden execute a lease or participate in the risk and cost of drilling and operating the well.
48. Luff has drilled the Well as a horizontal well on the Spacing Unit and the Well is currently awaiting the installation of surface equipment which has been delayed as a result of weather conditions.
49. After listening to the testimony of Clayton Chessman, listening to the cross examination of Chessman by Golden's counsel, accepting the Department's file as an Exhibit, accepting Luff's Exhibits 1 – 5, accepting Golden's Exhibit 1, and listening to argument of counsel, upon proper motion duly made and seconded, the Board voted 6 to 1 to grant the relief requested by Luff in its Petition.
50. Any Conclusion of Law deemed to properly constitute a Finding of Fact is hereby incorporated herein by this reference.

CONCLUSIONS OF LAW

1. The Board has the authority to hear and decide this matter pursuant to SDCL Chapter 45-9 and ARSD Chapter 74:09:01.
2. All notices of the petition and the hearing were properly and timely given.
3. The petition is complete in all respects and contains all required and requested information.
4. Pursuant to SDCL Section 45-9-31, the Board is required to enter an order pooling all

interests in a spacing unit for the development and operation thereof, and for the sharing of production therefrom.

5. The Board has jurisdiction pursuant to SDCL Section 45-9-33 and ARSD Chapter 74:12:10 to include provisions whereby an owner who does not elect to participate in the risk and cost of drilling and operating a well may elect to participate in the drilling and operation of the well on a limited or carried basis, and has jurisdiction to authorize the recovery of risk compensation from the interest of a lessee or unleased mineral owner who does not elect to participate in the drilling and operation of a well.
6. Inherent in the drilling of *any* well is a risk of mechanical problems, price fluctuations, or insufficient production to cover costs. *Bennion v. ANR Production Co.*, 819 P.2d 343, 349 (Utah 1991). [Emphasis in original].
7. Risk compensation, also referred to in the oil and gas industry as “compensation risk,” “risk bonus,” or “risk penalty,” is intended to relieve the nondrilling interest owner from having to advance his/her proportionate share of the drilling costs but provide extra compensation from production to the drilling party that has advanced the entire drilling costs and who would absorb the entire cost of a “dry hole.” *Application of Kohlman*, 263 N.W.2d 674, 675 (S.D. 1978).
8. Risk compensation is designed to ensure that nonparticipating owners do not benefit from the successful outcome of risks they do not take. *Bennion v. ANR Production Co.*, 819 P.2d 343, 348 (Utah 1991).
9. The purpose of risk assessment is to balance the costs, benefits, and risks of drilling a well among the diverse parties. The nonconsenting parties, such as Ms. Golden, avoid any risk and the participating parties assume it. *Bennion v. ANR Production Co.*, 819

P.2d 343, 348 - 349 (Utah 1991).

10. Risk compensation is an integral part of the compulsory pooling process which protects the correlative rights of all the mineral owners consistent with the public policy as provided for in SDCL Chapter 49-5. See, *Bennion v. ANR Production Co.*, 819 P.2d 343, 346 - 347 (Utah 1991).
11. The Board is given the duty to perform all the necessary quasi-legislative and quasi-judicial functions necessary to carry out the purpose of SDCL Chapter 45-9. *Application of Kohlman*, 263 N.W.2d 674, 677 (S.D. 1978).
12. Assessment of risk compensation by the Board is in compliance with and furthers the public policy of the State as expressed in SDCL Chapter 45-9.
13. ARSD Chapter 74:12:10 has the force of law and is presumed valid.
14. ARSD Chapter 74:12:10, and particularly ARSD Sections 74:12:10:01 and 74:12:10:03 are administrative rules by which the Board has chosen to exercise the authority it is granted by SDCL 45-9-33 to provide alternatives whereby an owner who does not elect to participate in the risk and cost of drilling and operating a well may elect to lease, or surrender its leasehold on a reasonable basis and for a reasonable consideration or be carried on a limited or carried basis.
15. ARSD Chapter 74:12:10 was intended to provide certainty to parties wishing to drill oil and gas wells and thereby provide an encouragement to develop oil and gas resources in the State of South Dakota.
16. ARSD Chapter 74:12:10 was also intended to reduce the need for hearings to determine matters related to the recovery of risk compensation.

17. ARSD Chapter 74:12:10 ensures that the rights of non-participating owners such as Golden are protected by requiring that before the Board may enter an order providing for the recovery of risk compensation, the party seeking the risk compensation must provide proof that an unsuccessful, good-faith attempt was made to have the non-participating owner execute a lease or participate in the risk and cost of drilling and operating the well. In this case, Luff made an unsuccessful, good-faith attempt to have Golden execute a lease or participate in the risk and cost of drilling and operating the Well.
18. SDCL 45-9-36 contemplates instances where a well may be drilled and completed before a compulsory pooling order is entered.
19. Under the facts and circumstances of this case, Ms. Golden was the only remaining interested party who was unleased or a non-participant in the Well on the Subject Lands and spacing unit and she was given full opportunity prior to the Petition to participate or lease.
20. The public policy of SDCL 45-9 would be frustrated if one individual, such as Ms. Golden under the facts and circumstances of this case, was able to delay or defer drilling prior to the complete pooling of the interests by the Board upon Petition to the Board.
21. Based upon the facts and circumstances of this case and considering that the Board has such implied powers as are necessarily implied and reasonably necessary to effectuate the express powers granted to, or duties imposed upon it, the drilling of the well prior to the pooling of all interests in the spacing unit was valid in this instance.
22. Luff's actions in drilling the Well prior to obtaining a pooling order covering Golden's interest do not prevent Luff from recovering the risk compensation provided by ARSD 74:12:10:03.

23. Providing that each tract in the spacing unit be allocated a proportionate share of production from the well proposed to be drilled on the spacing unit equal to a fraction of the production from the spacing unit equal to the number of acres contained in each such tract divided by the total number of acres in the spacing unit will ensure that each owner will have an opportunity to recover or receive, without unnecessary expense, a just and reasonable share of the production from the spacing unit.
24. Allowing the recovery of risk compensation equal to one-hundred percent of the reasonable actual costs of drilling and completing the Well and the costs of newly acquired equipment in addition to the pro rata share of such costs from the interest of Ms. Golden is just and reasonable.
25. Any Finding of Fact deemed to properly constitute a Conclusion of Law is hereby incorporated herein by this reference.

ORDER

Based upon the foregoing Findings of Fact and Conclusions of Law, the Board does hereby order:

1. That the Petition of Luff as set forth above is granted and approved.
2. All interests in a spacing unit for the South Medicine Pole Hills Field described as the E/2 of Section 33, the W/2 of Section 34, Township 23 North, Range 4 East, the NW/4 of Section 3 and the NE/4 of Section 4, Township 22 North, Range 4 East, Harding County, South Dakota, including the interests of the Golden, are pooled for purposes of the drilling and operation of, and production from, the Well in accordance with Order No. 16-2013.

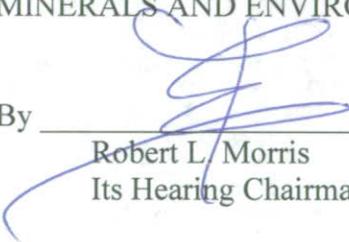
3. Luff is hereby designated the operator and is authorized to drill, equip, and operate said Well on the Spacing Unit.
4. All expenses incurred in drilling, equipping and operating said Well on the Spacing Unit, and all production from the Well, shall be allocated to the various tracts within the Spacing Unit on the basis of the ratio the number of acres contained in each separately owned tract bears to the number of acres in the Spacing Unit.
5. Operations incident to the drilling of said Well on any portion of the Spacing Unit shall be deemed for all purposes the conduct of such operations upon each separately owned tract in the spacing unit, and production allocated to each tract shall, when produced, be deemed for all purposes to have been produced from each tract by a well drilled thereon.
6. Luff, on behalf of the other working interest owners within the Spacing Unit who did share in the risk and cost of drilling and completing the Well, may recover from Golden's share of production from the Spacing Unit, exclusive of a one-eighth royalty, Golden's proportionate share of the reasonable actual costs of drilling, equipping and operating the Well until the market value of that production, exclusive of a one-eighth royalty, equals the sums paid by or charged to Ms. Golden's interest.
7. Luff, on behalf of other working interest owners within the Spacing Unit who did share in the risk and cost of drilling and completing the Well, may recover from Ms. Golden's share of production from the Spacing Unit, exclusive of a one-eighth royalty, risk compensation equal to an additional 100% of the reasonable actual costs of drilling, reworking, side-tracking, deepening, plugging back, testing, completing and recompleting the Well and the costs of newly acquired equipment in the Well including the wellhead connection. Such risk compensation may be recovered only out of

production from the Spacing Unit, exclusive of a one-eighth royalty.

8. In the event of a dispute as to the costs of drilling, equipping, or operating the Well, the South Dakota Board of Minerals and Environment shall determine the costs in accordance with SDCL 45-9-35.
9. Any of the parties' Proposed Findings of Fact or Conclusions of Law inconsistent with the Boards Findings of Fact and Conclusions of Law are hereby rejected and deemed denied.
10. Ms. Golden's Motion for Reconsideration is denied.

Dated at Pierre, South Dakota, this 2nd day of November, 2013.

SOUTH DAKOTA BOARD OF
MINERALS AND ENVIRONMENT

By 
Robert L. Morris
Its Hearing Chairman