Texas Wesleyan Law Review

Volume 19 | Issue 2 Article 23

3-1-2013

New Mexico Oil and Gas Update

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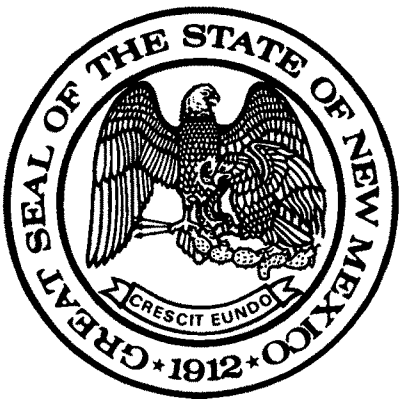

By: Derek V. Larson[1]

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I. NEW MEXICO SUPREME COURT

No opinions were issued by the New Mexico Supreme Court during the survey period relating to oil and gas law. However, on August 24, 2012, the New Mexico Supreme Court issued its opinions in *Edwin Smith, L.L.C. v. Synergy Operating*[2] and *ConocoPhillips Company v. Patrick H. Lyons*,[3] both of which involve oil and gas properties. The

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2. Edwin Smith, L.L.C. v. Synergy Operating, L.L.C., 285 P.3d 656 (N.M. 2012).

3. ConocoPhillips Co. v. Lyons, No. 32,624, 2012 WL 3711550 (N.M. Aug. 24, 2012).

DOI: https://doi.org/10.37419/TWLR.V19.I2.21

Lyons opinion touched on a number of significant oil and gas issues, including the implied duty to market and the marketable condition rule in New Mexico, but again declined to address the marketable condition rule as unnecessary given the statutory origin of the state lease forms at issue. Even more significantly, the New Mexico Supreme Court requested briefing on, but as of the date of this review has not yet ruled on, whether it will accept the case for reconsideration.

II. New Mexico Court of Appeals

A. Prather v. Lyons[4]

In *Prather v. Lyons*, the New Mexico court of appeals interpreted the meaning of "minerals" in a mineral reservation in a 1947 patent of state land and considered, before declining to adopt, the "surface destruction doctrine" in arriving at the conclusion that the parties to the original 1930 purchase transaction did not intend the subsurface metamorphic rock to be considered a mineral within the mineral reservation.[5]

The subject land was originally New Mexico state trust land, sold in 1930 to a purchaser who bought the land for grazing.[6] The original purchaser later received a patent in 1947.[7] The land contained surface and subsurface metamorphic rock. The character of the surface and its use for grazing did not change from 1930 to 1982 when the land was sold and the successor landowner's lessee mined, crushed, and sold the rock for use primarily as ballast for railroad beds.[8] The successor landowner, Prather, "sued the Commissioner of Public Lands of the State of New Mexico to quiet title to the rock when the Commissioner asserted ownership of the rock and a right to royalties based on a general mineral reservation in a 1947 patent."[9] Prather appealed the district court's ruling in favor of the Commissioner and requested the court of appeals to adopt and apply the "surface destruction doctrine" and to hold that the parties to the original 1930 purchase transaction did not intend the rock to be considered a mineral within the mineral reservation.[10] *Prather* relied in part on *Bogle Farms, Inc. v. Baca*,[11] which states that title to state trust land should be determined on a case-by-case basis considering the intent of the original parties and

4. Prather v. Lyons, 267 P.3d 78 (N.M. Ct. App. 2011).
5. *Id.* at 79.
6. *Id.*
7. *Id.*
8. *Id.*
9. *Id.*
10. *Id.*
11. Bogle Farms, Inc. v. Baca, 925 P.2d 1184, 1194 (N.M. 1996) (reciting the history of the transfer of land by the federal government to New Mexico when New Mexico attained statehood to be held in trust for schools and citing the Enabling Act).

not by a rule of property or by conveyance by implication.[12] The court of appeals declined to adopt the surface destruction doctrine and instead held that

> substantial evidence supported the district court's findings of fact under *Bogle Farms*' required analysis of the intent of the parties to the original sale transaction that the intent of the conveyance transaction was that the rock was included in the reservation of 'all minerals of whatsoever kind' in the patent.[13]

The court of appeals noted that

> [t]he district court found that in 1919 when there was a rush to obtain leases from the State for oil and gas exploration, the State Legislature authorized the Commissioner to classify the lands owned by the State as mineral or non-mineral. The State Land Office (SLO) Administrative Rule No. 1, 1919, dated April 4, 1919, designated and classified all New Mexico state lands as mineral lands. . . . [And it] was issued to afford the State "maximum protection from the purchase of lands as non-mineral, which may in fact be mineral lands or subject to classification as such.[14]

The district court also found that in 1925, the SLO issued regulations requiring the state to reserve all minerals when selling state trust lands and that prior to 1930, the land was owned in fee by the state, was uncultivated, was useful for pasture or grazing purposes, and was largely composed of Precambrian metamorphic rock.[15] When the landowner completed the form application for the purchase of the land from the Commissioner in 1930, he stated that the land was grazing in character; that there was no growing timber, coal, minerals, or oil and gas known to be on the land; that he intended to use the land to "graze sheep or raise cattle"; that "the land applied for . . . [wa]s essentially non-mineral land, and that th[e] application [wa]s not made for the purpose of obtaining title to mineral, coal, oil or gas lands fraudulently, but with the sole object of obtaining title to the land applied for grazing and agricultural purposes."[16] In the 1930 purchase contract, the landowner agreed that the land was being purchased

> for the purpose of grazing and agriculture only [and that] . . . while the land herein contracted for is believed to be essentially non-mineral, should mineral be discovered therein it is expressly understood and agreed that this contract is based upon the express condition that the minerals therein shall be and are reserved in the fund or

12. *Prather*, 267 P.3d at 79.

13. *Id.* at 80.

14. *Id.* (citing State *ex rel.* Otto v. Field, 241 P. 1027, 1030–32 (N.M. 1925) (recounting the history of Administrative Rule No. 1); N.M. STAT. ANN. § 19-1-1 (2006) (creating the SLO)).

15. *Id.*

16. *Id.* at 80–81.

> institution to which the land belongs, together with right of way to the Commissioner, or anyone acting under his authority, at any and all times to enter upon said land and mine and remove the minerals therefrom without let or hindrance.[17]

The 1947 patent, issued for the land by the Commissioner, reserved to the state by way of the mineral reservation, "all minerals of whatsoever kind, including oil and gas, in the lands so granted," and also reserved the "right to prospect for, mine, produce and remove the same, and perform any and all acts necessary in connection therewith[.]"[18] The land was re-sold in 1982, still for the purpose of using it to graze cattle, and the character remained unchanged until 1998, when the landowner entered into a license agreement to explore for quarry rock that might be suitable for railroad ballast, crushed stone, and other construction aggregates, and in 2004 when the landowner entered into a twenty-five-year lease agreement of the subsurface mineral estate for mining and which characterized the rock as minerals.[19] The lessee paid full royalties to the landowner until representatives of the SLO Commissioner asserted the state's mineral interest.[20] Thereafter, the landowner filed a complaint against the Commissioner for declaratory judgment, to quiet title, and for other monetary relief; the Commissioner counterclaimed seeking to quiet title in the mineral interest and for other relief.[21]

The court of appeals characterized the arguments on appeal as attempts "to provide a route for the elusive quests for (1) the understanding of what 'minerals' is intended to mean and include within the mineral reservation, and (2) the intent of the parties to the 1930 original purchase contract as to whether the rock was to be considered a mineral within the mineral reservation."[22] But before addressing the parties' arguments, the court first reviewed the history of *Bogle Farms*' mandated "intent-of-the-original-parties" test and rejection of case law establishing a "rule of property" governing reservation of mineral rights in state trust land sales which erroneously permitted conveyance of title by implication.[23] The court then listed the following pertinent *Bogle Farms*'s statements before concluding that "[w]hat material or substance comes within the word 'minerals' in the mineral reservation is not altogether clear":

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17. *Id.* at 81.

18. *Id.*

19. *Id.*

20. *Id.* at 82.

21. *Id.*

22. *Id.*

23. *Id.* at 82–84 (discussing Burris v. State *ex rel.* State Highway Comm'n, 538 P.2d 418 (N.M. 1975), which preceded and was overruled by Roe v. State *ex rel.* State Highway Dep't, 710 P.2d 84 (N.M. 1985), *overruled by* Bogle Farms, Inc. v. Baca, 925 P.2d 1184 (N.M. 1996)).

> In cases involving state trust land, the determination [of] whether a material or substance is included within a general mineral reservation must be done on a case-by-case basis. The issue is whether the parties to the original sale transaction intended that the State reserve the material or substance at issue. There exists a strong public interest in the protection of state land and its products, as reflected in the Enabling Act's requirement that no sale or other disposal [of state land or its natural productions] shall be made for a consideration less than the [appraised true] value. And title to state trust lands should not be conveyed by implication.[24]

The court of appeals acknowledged the district court's own difficulty in determining the meaning of "minerals" when it determined that the mineral reservation was ambiguous and noted that the New Mexico Supreme Court has referred to this ambiguity.[25]

After first reciting several of the district court's numerous findings of fact and conclusions of law relating to the issue of intent, the court of appeals then summarized the landowner's primary claim on appeal:

> [T]o follow the lead of most other states in adopting the 'surface destruction' doctrine, which holds that, in the absence of clear contrary intent, where materials alleged to be 'minerals' are plainly visible on the surface, and where the surface would have to be destroyed in order to 'mine' them, the parties could not have intended those materials to be 'minerals' because, if they were, the mineral reservation would swallow up the grant and render it worthless.[26]

The court of appeals noted the landowner's sympathy for the courts' difficulty in determining the "'true intentions' of the original parties"[27] and that the "[landowner] does not suggest that the surface destruction doctrine be applied without regard to intent; instead, according to [the landowner], it can be viewed as a doctrine 'designed to facilitate the [intent] inquiry mandated in *Bogle Farms*' and as a 'proxy for determining what the parties must have reasonably intended.'"[28] However, the landowner does not contend that the findings of fact are not supported by substantial evidence, and its primary complaint is that the district court erred in not applying the surface destruction doctrine and determining, based on the doctrine, that the parties did not intend the mineral reservation to include the rock.[29] The court of appeals observed that

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24. *Id.* at 84 (citing *Bogle Farms, Inc.*, 925 P.2d at 1190–91, 1194).

25. *Id.* (citing *Bogle Farms, Inc.*, 925 P.2d at 1189, 1194; Rickelton v. Universal Constructors, Inc., 576 P.2d 285, 286 (N.M. 1978); and numerous "Courts outside New Mexico").

26. *Id.* at 87.

27. *Id.*

28. *Id.* at 88.

29. *Id.* at 90.

> [a]lthough, over the years in New Mexico, what constitutes a mineral under a mineral reservation in patents, deeds, custom, and case law has become clear as to many, if not most, materials and substances, some materials and substances appear to have escaped a settled identification. Common or metamorphic rock presently rests among the unsettled.[30]

The court of appeals gives significant weight to New Mexico's public policy of reserving valuable minerals to the benefit of New Mexico's educational institutions in citing to the 1925 decision in *State ex rel. Otto v. Field*, wherein the New Mexico Supreme Court stated the following:

> [I]t cannot be supposed that the Legislature of New Mexico, after taking the precaution to provide in leases for reservations of minerals, oil, gas, stone, shale, salt, timber, and all other natural products of the land to be dealt with separately by the commissioner, intended that, when he went to sell grazing land or agricultural land, he would be powerless to reserve to the state and its institutions the great wealth which might flow from a future discovery of minerals in the land, merely because the circumstances had not permitted of his having made an adequate exploration in order to enable him to fully determine the exact character of the land.[31]

The court of appeals then asserted its view that the New Mexico Supreme Court's ruling in *Bogle Farms* "that title to state trust lands is not to be conveyed by implication" was intended to apply beyond the confines of its collateral estoppel analyses.[32] Since the court of appeals viewed the surface destruction doctrine as essentially espousing an intent to convey minerals by presumption, it then refused to import the doctrine into the intent analysis mandated by *Bogle Farms*.[33]

The court of appeals was not unsympathetic to the argument that substantial farm and ranch land would be at risk if it affirmed the district court's ruling, echoing the landowners' warning that, although the case at bar involved only a single section of land, "its implications are far more significant" and "could have grave consequences," in that

> the practical effect of the decision below would be that the [Commissioner and the SLO] will have the right to destroy and render useless for agricultural and grazing purposes any portion of the millions of acres it has sold to farmers and ranchers on the mere showing that the hard rock on their lands, which is pervasive throughout the State, has some current economic value.[34]

Still, the court of appeals did

30. *Id.* at 91.
31. *Id.* at 92 (citing State *ex rel.* Otto v. Field, 241 P. 1027, 1035 (N.M. 1925)).
32. *Id.* at 93 (citing Bogle Farms, Inc. v. Baca, 925 P.2d 1184 (N.M. 1996)).
33. *Id.*
34. *Id.*

> not feel a freedom to stray from the required *Bogle Farms*' intent-of-the-parties method of ascertaining the meaning of the mineral reservation. . . . [and did not] feel free to ignore *Bogle Farms*' apparent rejection of a rule or doctrine that creates a presumption or necessary implication of intent to convey minerals that in effect overrides or diminishes the significance of surrounding circumstances that indicate an intent to include rock within the mineral reservation.[35]

In the end, the court of appeals upheld the district court's *Bogle Farms* analysis and conclusion that the intent of the parties to the original "conveyance transaction was that the rock was included in the reservation of 'all minerals of whatsoever kind' in the patent."[36] But the court first noted that it would "leave it up to our [New Mexico] Supreme Court to consider whether *Bogle Farms*' clear rule requiring a determination of the intent of the parties to the original sale transaction can permit application of the surface destruction doctrine."[37]

B. Kysar v. BP America Production Co.[38]

Kysar is the third in a series of cases arising from a continuing dispute between the owner of an oil and gas mineral estate, BP America Production Company, successor in interest to Amoco, and successive owners of the surface estate along the Animas River in the San Juan Basin of northwestern New Mexico.[39] The northern and southern portions of the approximately 600 acres of what is now known as the Kysar Ranch were originally owned by different parties who executed separate oil and gas leases on their respective properties.[40] Through a series of transactions and assignments, the surface estate was unified, the minerals were severed from the surface estate, and a right of ingress and egress to access the oil, gas, and other minerals was reserved to the mineral lessees—ultimately BP.[41]

Following Kysar's acquisition of the ranch in 1983, its relationship with BP and its immediate predecessor, Amoco, was marked with discord.[42] A series of disputes were resolved by a settlement agreement in 2000 (the "2000 Settlement Agreement") between Kysar and Amoco.[43] Although the 2000 Settlement Agreement resolved damages to the Kysar Ranch caused by Amoco's operations, including unreasonable use of the surface and trespass, it did not address a major disagreement between the parties, which was Amoco's use of a Kysar

35. *Id.* at 93–94.
36. *Id.*
37. *Id.*
38. Kysar v. BP Am. Prod. Co., 273 P.3d 867 (N.M. Ct. App. 2012).
39. *Id.* at 869.
40. *Id.*
41. *Id.*
42. *Id.*
43. *Id.*

Ranch road to access wells located on Bureau of Land Management ("BLM") land outside, but adjacent to and communitized with, the Kysar Ranch.[44] Litigation of BP's access of the BLM wells across the Kysar Ranch resulted in two opinions referred to as *Kysar I* and *Kysar II*.[45] In *Kysar I*,[46] the New Mexico Supreme Court answered questions certified by the Tenth Circuit.[47] This was followed by *Kysar II*,[48] in which the Tenth Circuit decided the appeal after the New Mexico Supreme Court answered the questions certified to it by the Tenth Circuit in *Kysar I*.[49] These appeals determined that Amoco did not have a right to use the Kysar Ranch roads to access wells off the Kysar Ranch and that Amoco could not use the Kysar Ranch for this purpose.[50] After *Kysar I* and *Kysar II* were decided, the parties entered into a second settlement agreement in 2005 (the "2005 Settlement Agreement"), which granted BP an easement to access the E-1 Well on the BLM property through the Kysar Ranch.[51] However, the 2005 Settlement Agreement did not resolve BP's access to any other existing wells, on or off the Kysar Ranch, or any other matters, stating that the parties "expressly reserve whatever rights they may have concerning other wells, or any other matters, including any rights of the parties under other agreements or instruments heretofore executed by the parties, except as expressly covered in this Agreement."[52]

The extant case concerns the Kysars' subsequently filed suit in which they contended that BP had no right to use the "Back Gate" road crossing the northern portion of the Kysar Ranch to reach wells located on the southern portion of the Kysar Ranch.[53] The Kysars demanded a jury, and they sought damages and injunctive relief in several causes of action.[54]

After the jury was chosen, counsel for Kysar announced that he intended to publish blown-up excerpts of the opinions in *Kysar I* and *Kysar II* to the jury in his opening statement.[55] However, when BP objected, the district court prohibited Kysar's counsel from using or displaying the Kysar case opinions or mentioning them or their content to the jury during the course of opening statement.[56] Following additional discussion, Kysar's counsel stated he could not give an intelligible opening statement and asked the district court to certify an

44. *Id.*
45. *Id.*
46. Kysar v. Amoco Prod. Co., 93 P.3d 1272 (N.M. 2004).
47. *Id.* at 1273.
48. Kysar v. Amoco Prod. Co., 379 F.3d 1150 (10th Cir. 2004).
49. *Id.* at 1151.
50. *Id.* at 1156.
51. Kysar v. BP Am. Prod. Co., 273 P.3d 867 (N.M. Ct. Ap. 2012).
52. *Id.*
53. *Id.*
54. *Id.*
55. *Id.* at 870.
56. *Id.*

interlocutory appeal.[57] When the district court inquired if the request stemmed from the ruling on the opening statement, Kysar's counsel responded, "No, it's the culmination of all the rulings that have been made over the last two years which leave me with essentially no case and no ability to present it," referring to various *in limine* rulings made by the district court which prohibited Kysar from presenting certain evidence at trial.[58] Thereafter, the parties agreed that, in light of the *in limine* rulings of the district court, a stipulated order granting BP a directed verdict was appropriate and was approved by the district court granting a directed verdict to BP, while expressly preserving all of Kysar's claims on appeal.[59]

This third Kysar case presented an issue of first impression for the New Mexico court of appeals: when the parties to a dispute have stipulated that the plaintiff cannot make a prima facie case due to *in limine* rulings made by the district court, and the court approves the stipulation, may the plaintiff later appeal from the stipulated directed verdict if it has also reserved the right to appeal the *in limine* rulings.[60] The court of appeals characterized the order as a "stipulated conditional directed verdict," stated a general rule that a party cannot appeal from a judgment entered with its consent, then noted that most of the federal courts and some state courts have carved out exceptions allowing appeals from consent judgment in certain circumstances.[61] The court observed that all the federal circuits except the Fifth Circuit allow an appeal from a consent judgment if the party explicitly reserves the right to appeal a contested issue,[62] that some state courts also allow an appeal from a consent judgment if the party has expressly reserved the right in the judgment,[63] and that other states reach the same result when the trial court's rulings have effectively precluded the plaintiff from proceeding with the trial.[64]

The court of appeals observed that, in this case, the parties had stipulated that in light of the district court's decisions and evidentiary rulings, "a reasonable jury would not have a legally sufficient evidentiary basis to find for [the Kysars] on any of the claims raised by the [Kysars'] complaint."[65] The court emphasized that all parties and the district court had approved the stipulation and noted that requiring the Kysars to proceed with a trial when they cannot prove a prima facie case would result in a waste of judicial resources. The court then

57. *Id.*
58. *Id.*
59. *Id.*
60. *Id.* at 868.
61. *Id.* at 871 (citing E.H. Schopler, Annotation, *Right to Appellate Review of Consent Judgment*, 69 A.L.R.2d 755, §§ 3–5 (1960)).
62. *Id.*
63. *Id.*
64. *Id.* at 871–72.
65. *Id.* at 872.

declared, as a new rule of law in New Mexico, that an appeal will lie from a stipulated conditional directed verdict upon

> (1) rulings . . . by the district court, which the parties agree are dispositive; (2) a reservation of the right to challenge those rulings on appeal; (3) a stipulation to entry of judgment; and (4) approval of the stipulation by the district court.[66]

The court of appeals reasoned that "recognizing an exception to the general rule that an appeal will not lie from a judgment entered by consent when these conditions are satisfied conserves scarce judicial resources and preserves the constitutional right to appeal."[67]

Having concluded that it had jurisdiction to hear the appeal, the court of appeals then turned to the district court's pretrial rulings that the Kysars challenged on appeal.[68] First, the court noted that motions *in limine* are inherently difficult to review on appeal under an abuse of discretion standard unless a record is made of the evidence offered but denied at trial.[69] The court next reviewed New Mexico law on appellate review of evidentiary rulings and commented that motions *in limine* are merely preliminary determinations by a district court regarding the admissibility of evidence.[70] Finally, the court observed that, in this case, no offer of proof was made, and no evidence was ever presented to the jury.[71] Thus, the court of appeals was unable to review whether the district court committed reversible error in prohibiting the Kysars from even mentioning the *Kysar I* or *Kysar II* cases to the jury during opening statements.[72]

However, the district court had agreed with BP that Kysar had not properly pled misrepresentation, mistake, or fraud and, thus, had prohibited Kysar from offering any evidence or testimony that the consent Mr. Kysar had given Amoco–BP, to use the Back Gate road for access to wells on the Kysar Ranch, was fraudulently or mistakenly induced.[73] The court of appeals's review of the trial court record revealed several paragraphs in the complaint alleging, among other claims, (1) that BP falsely represented that it had the right to cross the Kysar Ranch even though it had no such express written conveyance, that it made knowingly false representations about its supposed right to do so, (2) that it refused to provide pertinent documents relating to the unitized or pooled tracts that affect the Kysar Ranch, which is not regularly tracked by title companies, and (3) that it had engaged in dilatory, hide-the-ball tactics when it had superior knowledge of the

66. *Id.* at 872–73.
67. *Id.* at 873.
68. *Id.*
69. *Id.* at 874.
70. *Id.* at 873–74 (citing Proper v. Mowry, 568 P.2d 236, 241 (N.M. Ct. App. 1977)).
71. *Id.* at 873.
72. *Id.*
73. *Id.* at 875–76.

unitization agreements and oil and gas leases.[74] The court of appeals noted that a complaint need not use words such as "fraud" or "fraudulent" to meet the pleading requirement of Rule 1-009(B) of the New Mexico Rules of Civil Procedure so long as "the facts alleged are such as constitute fraud in themselves, or are facts from which fraud will be necessarily implied."[75]

The court of appeals ruled that the Kysars' allegations were sufficient to raise issues of misrepresentation, fraud, and mistake and that it was error for the district court to exclude evidence that the consent the Kysars gave to Amoco–BP to use the ranch roads to access wells had been fraudulently or mistakenly obtained.[76] The court of appeals further ruled that evidence regarding BP's refusal to produce the documents it claimed gave it the right to access existing and future wells by crossing the Kysar Ranch "was relevant to the Kysars' claim that BP breached its duty of good faith and fair dealing."[77] Finally, the court of appeals ruled "[t]he 'Stipulated Order Granting Directed Verdict In Favor Of Defendant BP America Production Company' is reversed, and the case is remanded to the district court for further proceedings consistent with this Opinion."[78]

C. First Baptist Church of Roswell v. Yates Petroleum Corp.[79]

In *First Baptist Church of Roswell v. Yates Petroleum Corp.*, the court of appeals considered whether a division order provision purporting to waive interest on proceeds owed to mineral owners was rendered void by the New Mexico Oil and Gas Proceeds Payment Act (the "Act").[80] The court reversed the district court's ruling and concluded that the Act did not render such a contract void.

Yates Petroleum Corporation ("Yates") was the operator of the "Runnin' AZH Com. No. 1 Well."[81] The plaintiffs were the owners of "mineral rights to the well[ ] and contended that they were entitled to interest on the proceeds they received from production of the well."[82] Yates began "production from the well in August 2002, and when proceeds were obtained from production, [Yates] retained a title attorney to identify the apparent owners of the mineral rights to the well."[83] Pursuant to the title opinion, "division orders" were sent to the plain-

74. *Id.*
75. *Id.* at 876 (citing Romero v. Sanchez, 492 P.2d 140, 141 (N.M. 1971)).
76. *Id.*
77. *Id.*
78. *Id.*
79. First Baptist Church of Roswell v. Yates Petroleum Corp., 281 P.3d 1235 (N.M. Ct. App. 2012).
80. *Id.* at 1236.
81. *Id.*
82. *Id.*
83. *Id.*

tiffs to be signed and returned.[84] "A division order is a specialized contract developed for the petroleum industry that provides authorization to a purchaser of oil and gas to pay proceeds from production to the owners of production."[85] To protect against potential liability for improper payments, producers and purchasers "typically require each person who is entitled to a royalty share in the production proceeds to execute a division order that declares the portion of production to which he is entitled."[86] "Another typical feature of a division order is that until a satisfactory title determination is made, no interest is owed on withheld payments."[87]

The Yates division order listed the title requirements to entitle the plaintiffs to proceeds from the well, and it specifically requested that each plaintiff provide a copy of the trust document establishing its right to the interest claimed.[88] Each plaintiff signed and returned the division order without making any changes.[89] Despite the fact that the plaintiffs never provided Yates with the trust document, Yates placed the plaintiffs on pay status.[90] Even though the plaintiffs began receiving payments, they also demanded interest on the proceeds pursuant to section 70-10-4 of the Act because the payments had not been made within the time period set out in section 70-10-3.[91] Yates declined to pay interest on the proceeds because a clause in its division order authorized payment without interest if the delay in payment resulted from a question concerning the marketability of the plaintiffs' title.[92] The plaintiffs filed a class action lawsuit in the district court asserting their right to interest on the proceeds notwithstanding the clause in the division order. After certifying the case as a class action, the district court opined that the provision in the division order that waived interest violated section 70-10-4 and declared the provision void.[93] The court also entered a declaratory judgment requiring Yates to pay interest on all future proceeds paid after the deadlines.[94] Yates appealed, contending that section 70-10-4 does not prohibit "parties from contractually agreeing to forgo interest on payments if the delay in payment is a result of a question concerning the seller's marketable title."[95]

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84. *Id.*
85. *Id.* (quoting Murdock v. Pure-Lively Energy 1981-A, Ltd., 775 P.2d 1292, 1296 (N.M. 1989)).
86. *Id.* (quoting *Murdock*, 775 P.2d at 1296).
87. *Id.* (citing *Murdock*, 775 P.2d at 1296–97).
88. *Id.*
89. *Id.*
90. *Id.*
91. *Id.*
92. *Id.*
93. *Id.* at 1237.
94. *Id.*
95. *Id.*

The decision in this case turned upon whether the right to interest on the proceeds from production, as codified in section 70-10-4, outweighed New Mexico's strong public policy favoring parties' freedom to contract.[96] In reaching its decision, the court of appeals looked at the plain language and the history of the Act before concluding that (1) the plain language of the Act did not prohibit contractual agreements to waive payment of compensatory interest[97] and (2) neither the Act as originally enacted nor the 1991 amendments reflected a legislative intent to prohibit contractual agreements in division orders from abrogating compensatory interest while a title question is being resolved.[98] Additionally, the court in *Murdock* held that contractual agreements to waive compensatory interest during a title dispute were valid and enforceable and the 1991 legislative amendments to the Act did not address or change that holding.[99]

Based on the foregoing, the court of appeals concluded that the "contractual waiver of compensatory interest contained in the division orders did not violate New Mexico public policy and was enforceable."[100]

III. UNITED STATES TENTH CIRCUIT COURT OF APPEALS: *ABRAHAM V. BP AMERICA PRODUCTION CO.*[101]

Abraham v. BP America Production Co. is an underpayment of royalty case.[102] BP America Production Co. ("BP") appealed from a judgment based upon a jury verdict in favor of the plaintiffs, a certified class of royalty and overriding royalty owners ("the class").[103] The judgment included damages for failure to pay royalties consistent with the underlying leases and prejudgment interest.[104] The district court granted summary judgment in favor of BP on the class's punitive damages claim, and it refused to instruct the jury on BP's breach of the implied covenant of good faith and fair dealing.[105] The Tenth Circuit Court of Appeals had jurisdiction to hear the case under title 28, section 1291 of the United States Code and reversed and remanded for a new trial.[106]

The appeal was part of the most recent action in an ongoing conflict in the San Juan Basin.[107] The class alleged that BP breached two

96. *Id.*
97. *Id.* at 1240.
98. *Id.* at 1241.
99. *Id.*
100. *Id.* at 1246.
101. Abraham v. BP Am. Prod. Co., 685 F.3d 1196 (10th Cir. 2012).
102. *Id.*
103. *Id.* at 1199.
104. *Id.*
105. *Id.*
106. *Id.*
107. *Id.*

types of royalty contracts: one, a "market-value" lease and the other, a "same-as-fed" lease.[108] "Market value" leases have often been defined as contracts requiring royalty owners to be paid based on the value of raw gas as it emerges from the ground, with a key assumption being that a market exists for raw gas at the well.[109] "Same-as-fed" leases are contracts (often assignments of federal leases) that contain provisions directing that the royalty owners be paid on the same basis as the federal government pursuant to the same set of regulations utilized in calculating and paying royalties to the United States.[110]

Raw conventional natural gas produced from the San Juan Basin contains methane with entrained natural gas liquids ("NGLs") and impurities such as water, sediment, and trace amounts of carbon dioxide and other inert elements.[111] In order to market the gas, the NGLs, carbon dioxide, and other impurities must be removed and the gas stream must be compressed to a pressure sufficient to allow it to flow into the high-pressure interstate pipelines. In order to determine the market value of the unprocessed gas at the well, BP used a "netback" or "workback" method, which involves selling the residue methane gas and NGLs produced at the tailgate of the processing plant to establish a base sales amount, and then deducting from that amount transportation, processing, and other costs incurred to place the raw gas into a marketable condition.[112] BP employs this method to approximate the market value of gas where, as in the San Juan Basin, no market exists at the wellhead.[113]

The class took issue with two aspects of BP's calculation for what it characterized as "market-value-at-the-well" contracts: (1) BP's sales price for NGLs at the tailgate and (2) BP's charge for processing. Specifically, the class complained that BP sold refined NGLs at the tailgate of the processing plant to its affiliate company at a discounted, below-market price and that BP, as co-owner of the plant, deducted a processing fee in excess of its actual cost to process the gas.[114] BP's theory was that there is a market for raw natural gas at the wellhead in the San Juan Basin and that its netback method resulted in royalty payments in line with market values for interstate pipeline quality natural gas.[115] BP argued that it could demonstrate that a market existed for raw gas at the well and asserted that its royalty payments fell within a range of market values, therein satisfying its royalty obliga-

108. *Id.*
109. *Id.*
110. *Id.*
111. *Id.* at 1200 (citing Elliott Indus. Ltd. P'ship v. BP Am. Prod. Co., 407 F.3d 1091 (10th Cir. 2005)).
112. *Id.*
113. *Id.*
114. *Id.*
115. *Id.*

tions as a matter of law.[116] The class argued that because BP deducted costs in excess of those actually and reasonably incurred in its netback calculation, BP had breached its contractual obligation as a matter of law.[117] In cross-motions for summary judgment, both BP and the class argued that they were entitled to judgment as a matter of law.[118] Neither motion was granted, and the breach of contract matter was tried to a jury, which found unanimously for the class.[119]

The class also sought for the jury to decide whether BP had breached its implied covenant of good faith and fair dealing and to determine an amount of punitive damages, but the district court prohibited the class from presenting evidence on either claim.[120] However, the court did allow, over BP's motion *in limine*, the class to present evidence that BP's co-owner in the processing plant, ConocoPhillips, complied with federal regulations by only charging its royalty owners its actual costs of processing the gas, used an actual sales price (as opposed to an artificial affiliate transfer price), and did not pay itself a marketing fee as BP did.[121]

On appeal, the Tenth Circuit Court of Appeals held that neither party was entitled to judgment as a matter of law for the market-value leases based on the evidence in the record because BP presented evidence supporting its claim that there was a market value for raw, unprocessed gas at the well in the San Juan Basin and the class had presented evidence that no such market existed.[122] The court also held that BP was entitled to judgment as a matter of law on the class's same-as-fed breach of contract claims because the class had not presented any evidence that BP paid the same-as-fed class members any differently than it paid the federal government, or that BP paid the federal government incorrectly.[123] Thus, the court concluded there "was no way for a jury to determine that BP had underpaid its same-as-fed royalty holders and that the issue never should have been submitted to the jury."[124]

BP argued on appeal that ConocoPhillips's use of federal calculations for market-value leases should be excluded, and the class responded that BP "had made comparative netback calculations an issue in the case and that ConocoPhillips was the only truly comparable producer-processor in the San Juan Basin."[125] The court con-

116. *Id.*
117. *Id.*
118. *Id.*
119. *Id.*
120. *Id.*
121. *Id.* at 1202.
122. *Id.* at 1201–02.
123. *Id.* at 1201.
124. *Id.*
125. *Id.* at 1202.

cluded the district court had abused its discretion by admitting the evidence of ConocoPhillips's royalty payment practices.[126]

The class also argued that the district court committed error by refusing to instruct the jury regarding the class's claim for breach of the implied duty of good faith and fair dealing and that a breach of that duty would support the class's claim for punitive damages.[127] Specifically, the class argued that after BP agreed to settle an earlier, almost identical, class action royalty underpayment case regarding the same processing plant, it failed to change its practice of taking improper deductions from royalty payments, let alone adequately disclosing the nature of the deductions.[128] The court determined that it was "not well-equipped to review the district court's ruling on the class's proposed instruction without knowing why the district court acted as it did."[129] However, the court acknowledged the New Mexico Supreme Court pronouncements of New Mexico law, in *Davis v. Devon Energy Corp.*, as they relate to the apparently inconsistent decision reached by the 2005 Tenth Circuit Court of Appeals opinion in *Elliott Industries L.P. v. BP America Production Co.*[130] The court remanded the case and ordered the district court to vacate the judgment entered on the jury's verdict and the prejudgment interest award, enter partial judgment in favor of BP on the class's same-as-fed breach of contract claim, and provide an explanation of any ruling on the breach of the implied covenant of good faith and fair dealing.[131] Upon remand, BP agreed to settle the dispute.

IV. Revisions to the New Mexico Oil Conservation Commission Rules

Slush, drilling, or mud pits (hereinafter "pits") are un-covered, sometimes lined, earthen pits dug into the ground adjoining drilling rigs which are used to collect, cleanse, recycle, and reclaim the mud-like fluids pumped through a rotary drill bit into a wellbore to lubricate the bit, to flush the cuttings up and out of the hole, and to hold the wellbore open against sub-surface pressure and prevent collapse of the hole.[132] Regulation of pits has been an active and politically charged topic in New Mexico for the past decade.

New Mexico's Oil and Gas Act created an Oil Conservation Commission ("OCC"), which has concurrent jurisdiction and authority

126. *Id.* at 1203.
127. *Id.* at 1204.
128. *Id.*
129. *Id.* at 1205.
130. *Id.* (citing Davis v. Devon Energy Corp., 218 P.3d 75 (N.M. 2009); Elliot Indus. Ltd. P'ship v. BP Am. Prod. Co., 407 F.3d 1091 (10th Cir. 2005); Sanders v. FedEx Ground Package Sys., Inc., 188 P.3d 1200 (N.M. 2008)).
131. *Id.*
132. Williams et al., Manual of Oil and Gas Terms 578, 718, 911 (14th ed. 2009) (defining terms mud, pit, and slush pit respectively).

with the Oil Conservation Division ("OCD") of New Mexico's Energy, Minerals, and Natural Resources Department over all matters relating to the conservation of oil and gas and the prevention of waste of potash as a result of oil or gas operations in New Mexico.[133] Among its enumerated powers is the authority to make rules to regulate the disposition of water produced or used in connection with the drilling for or producing of oil, gas, or both and to direct surface disposal of the water, including disposition by use in drilling for or production of same in a manner that will afford reasonable protection against contamination of fresh water supplies, and to regulate the disposition of nondomestic wastes resulting from the exploration, development, production, or storage of crude oil or natural gas to protect public health and the environment.[134] In this regard, in December 2003, the OCD promulgated rules regulating pits, closed-loop systems, below grade tanks, and sumps at title 19, chapter 15, part 17 of New Mexico's Administrative Code.[135]

According to a 2004 report from the Oil and Gas Accountability Project, between the mid-1980s and 2003, New Mexico's OCD recorded nearly 7,000 cases of soil and water contamination.[136] In 2005, the OCD released data in studies commissioned by Governor Bill Richardson's administration purportedly showing that approximately 400 incidents of groundwater contamination had been documented from oil and gas pits.[137] However, former New Mexico Oil and Gas Association ("NMOGA") President Bob Gallagher stated that the records of the 421 cases of pit-related contamination were misleading. Mr. Gallagher further asserted that 143 of those sites are related to efforts by pipeline companies to eliminate dehydration at well sites and have nothing to do with drilling, workover, or completion activities; another twenty-three sites are located in Arizona; and yet another twenty-nine sites were related to other pipeline company activities and had nothing to do with drilling and production pits.[138] Environmental protection organizations advocated for what has been described as the most stringent oil pit rule in the United States.[139]

133. N.M. STAT. ANN. §§ 70-2-1, -4, -6 (West 1978).

134. N.M. STAT. ANN. § 70-2-12 (West 1978).

135. N.M. Code R. § 19.15.17.3 (LexisNexis 2007).

136. Lisa Sumi, *Pit Pollution*, EARTHWORKS, 19 (May 2004), http://www.earthworksaction.org/files/publications/PitReport.pdf.

137. *See Pit Rule*, EARTHWORKS, http://www.earthworksaction.org/issues/detail/pit_rule (last visited Oct. 26, 2012); Kristin Hincke, *Political Focus: Dispute over New Mexico Pit Rule Continues*, WELLSERVICINGMAGAZINE.COM (Jan. 2009), http://wellservicingmagazine.com/political-focus-dispute-over-new-mexico-pit-rule-continues; Sabrina Shankman, *Drilling Industry and Gubernatorial Candidates Move to Weaken Some State Regulations*, PROPUBLICA (Aug. 5, 2010), http://www.propublica.org/article/drilling-industry-and-gubernatorial-candidates-move-to-weaken-some-state-re.

138. Hincke, *supra* note 137.

139. *New Mexico Oil and Gas Pit Rule Roll Back*, N.M. ENVTL. LAW CTR., http://www.nmenvirolaw.org/index.php/site/case-docket/P30/ (last visited Nov. 1, 2012).

The OCD, during the administration of New Mexico's Governor Bill Richardson, gradually imposed stricter rules in oil field waste.[140] Following a two-year public process by a Pit Rule Task Force, which included four public outreach meetings, eighteen days of public hearings began in November 2007, and the OCC generated over 5,000 pages of transcript.[141] Finally, after months of deliberations, on May 9, 2008, the OCC unanimously approved an order in case No. 14015 granting the OCD application for repeal of existing Rule 50 (adopted in 2005) and the adoption of a new rule, New Mexico OCD Rule 17, more commonly known as the "Pit Rule," concerning oil field waste pits, below grade tanks, and the use of closed-loop systems during oil and gas operations.[142] The OCC found that the existing rule, section 19.15.2.50 of the New Mexico Administrative Code, which was based upon performance standards, did not provide specific technical standards for the OCD to enforce or for the regulated industry to follow.[143] The 2008 Pit Rule requires that all pits must be permitted with the OCD, prohibits the use of unlined pits for oil field waste, and requires the pit linings to be increased in thickness from twelve mills to twenty mills.[144] Further, closed-loop operations are required when the pits are close to water resources and homes.[145] The new rules also required that the abandoned pit waste be removed to a landfill and the pit site be restored, unless the operator demonstrated that the pit waste would not be detrimental to the environment.[146] On July 30, 2008, the Independent Petroleum Association of New Mexico ("IPANM") appealed the ruling, asserting that the OCD lacked the authority to regulate groundwater issues and that it did not perform any economic analyses.[147] The NMOGA also filed a separate appeal to the state district court.[148] And in response to industry pressure, on

140. Hincke, *supra* note 137.

141. *See id.*; *see also The Pit Rule – What it is, and Why We Need it*, EARTHWORKS, 2 (Jan. 2011), http://www.earthworksaction.org/files/publications/FS_NM-PitRule-WhyWeNeedIt-webres.pdf; *Draft – OCD Pit Rule Guidance (V 1.0)*, N.M. ENERGY, MINERALS, & NATURAL RES. DEP'T, 1 (Dec. 2010), http://www.emnrd.state.nm.us/ocd/documents/201012-16DraftOCDPitRuleGuidanceDocument.pdf.

142. Application of the N.M. Oil Conservation Div. to Replace Rule 50 with a New Rule Governing Pits, Case No. 14015, Order No. R-12939 (N.M. Energy, Minerals & Natural Res. Dep't May 9, 2008), http://www.emnrd.state.nm.us/main/documents/Adopted.Pit.Rule.pdf.

143. *Id.* para. 18.

144. *Id.* paras. 34–35, 41, 94, 95.

145. *Id.* paras. 58–65.

146. *Id.* paras. 69–81.

147. *New Mexico's Pit Rule*, INDEP. PETROLEUM ASS'N OF N.M., www.ipanm.org/images/library/File/Pit-Rule.pdf (last visited Nov. 11, 2012); Hincke, *supra* note 137.

148. *See* Susan Montoya Bryan, *New Mexico Judge Halts Pit Rule Appeals*, SANTA FE NEW MEXICAN, Jan. 10, 2012, http://www.santafenewmexican.com/localnews/N-M--judge-halts-pit-rule-appeals#.UlwNaoXgly4; Staci Matlock, *Oil and Gas Group Wants State 'Pit Rule' Eased*, SANTA FE NEW MEXICAN, Oct. 3, 2011, http://www.santafenewmexican.com/localnews/Oil-and-gas-group-wants-state-rule-eased#.UlwNalXgly4.

February 18, 2009, Governor Richardson announced he was directing the Energy, Minerals and Natural Resources Department to work with the oil and gas industry to develop amendments that would reduce the cost of compliance with the Pit Rule.[149] The OCD then proposed six changes to the Pit Rule to ease the financial burden of compliance with, and to allow oil and gas companies to better absorb the costs associated with, the stronger 2008 regulations.[150] On June 19, 2009, the OCC approved limited changes to sections 19.15.17.12 (operational requirements), 19.15.17.13 (closure requirements), 19.15.17.16 (permit approvals, conditions, denials, revocations, suspensions, modifications, or transfers), and 19.15.17.17 (transitional provisions) of the New Mexico Administrative Code to reduce the costs of compliance for oil and gas producers.[151] Even with these minor revisions, on July 30, 2009, the New Mexico Environmental Law Center appealed on behalf of its client, the New Mexico Oil and Gas Accountability Project.[152] Thus, by the end of 2009, there existed three appeals pending in the First Judicial District Courts for New Mexico: two on behalf of industry producers consolidated before Justice Barbara J. Vigil (then Chief Judge of New Mexico's First Judicial District) seeking to repeal the 2008 rules and the third appeal by environmentalist pending before Judge Raymond Ortiz seeking repeal of the 2009 amendments.

During New Mexico's 2010 gubernatorial race, both candidates featured the Pit Rule controversy in their campaigns.[153] Republican Susana Martinez said that the Pit Rules should be overturned because they drive jobs out of state.[154] And although Democrat Diane Denish said that she would not repeal the rules, she did say she was willing to "revisit them."[155] Costs to comply with the new Pit Rules were estimated at $35,000 to $250,000 per well.[156] Santa Fe's Democratic State Representative, Brian Egolf, proclaimed in his blog, "In fact, the truth shows that opponents of the pit rule are dead wrong."[157] In response to the OCD's claim "that there has not been a single case of ground-

149. Press Release, Bill Richardson, Governor of N.M., Governor Bill Richardson Proposes Modifications to New Mexico's Oil Field Pit Rule (Feb. 18, 2009), *available at* http://nmenvirolaw.org/images/pdf/GovernorNewsRelease2-18-09.pdf; *see also* Matlock, *supra* note 148.

150. Press Release, Bill Richardson, *supra* note 149.

151. James Monteleone, *State Commission Approves Pit Rule Change*, DRILLING SANTA FE (June 19, 2009, 12:00 AM), http://www.drillingsantafe.blogspot.com/2009/06/state-commission-approves-pit-rule.html.

152. N.M. ENVTL. LAW CTR., *supra* note 139.

153. Shankman, *supra* note 137.

154. *Id.*

155. *Id.*

156. *Id.*

157. Brian Egolf, *The Truth About New Mexico's "Pit Rule"*, BRIANFORSENATE.BLOGSPOT.COM (July 1, 2010, 10:58 AM), http://brianforsantafe.blogspot.com/2010/07/truth-about-new-mexicos-pit-rule.html.

water contamination since the passage of the [Pit] rule," the IPANM pointed out that there was not a single case of groundwater contamination due to a drilling reserve pit *before* the rule went into effect.[158]

Even while the 2008 and 2009 appeals were pending before the district courts, the controversy raged on in the media and before the OCD in 2010 and 2011.[159] The oil and gas industry continued to claim that the rule increased drilling costs, especially for small-scale operations and made New Mexico less desirable for drillers than adjoining states.[160] "The Pit Rule was among several environmental regulations that a task force appointed by New Mexico's newly-elected Governor, Susana Martinez, wanted axed or changed to make New Mexico more business-friendly."[161] On September 30, 2011, the NMOGA filed proposed changes to the Pit Rule that would allow for in situ reclamation and burial of pit lines when the distance to groundwater is sufficient to allow such safely while still protecting the environment.[162] In addition, the proposed changes provide for updates to the rules governing siting criteria, construction, and closure of below-grade tanks and other facilities.[163] The NMOGA described the changes as being "designed to make the oil and gas industry in New Mexico competitive with surrounding states for new drilling and development while maintaining groundwater and environmental protections."[164] The New Mexico Environmental Law Center, however, described the proposed amendments as "scrubbing almost any reference to closed-loop systems, including the requirement that there be any" and "entirely rework[ing] and replac[ing] requirements for closing waste-fluid pits, below-grade tanks, and closed-loop systems."[165]

On January 10, 2012, Justice Barbara Vigil postponed her consideration of the industry appeals from the Pit Rule so that the OCC could "revisit" the Pit Rule and consider proposed changes.[166] Later that month, on January 25, 2012, Judge Raymond Ortiz granted an order in the environmentalist group's case before him and entered a Writ of Prohibition against the OCC to prohibit it from reconsidering the Pit Rule until all the court of appeals cases have been resolved.[167] The

158. INDEP. PETROLEUM ASS'N OF N.M., *supra* note 147.

159. Matlock, *supra* note 148.

160. *Id.*

161. *Id.*

162. Press Release, N.M. Oil & Gas Ass'n, New Mexico Oil & Gas Association Proposes "Pit Rule" Changes (Sept. 30, 2011), *available at* http://www.nmoga.org/press-release-nmoga-proposes-pit-rule-changes.

163. *Id.*

164. *Id.*; *see* Matlock, *supra* note 148.

165. Matlock, *supra* note 148.

166. Bryan, *supra* note 148.

167. Kevin Robinson-Avila, *Court Halts State Hearings On 'Pit Rule'*, N.M. BUS. WKLY., Feb. 15, 2012, http://www.bizjournals.com/albuquerque/news/2012/02/15/court-halts-state-hearings-on-pit-rule.html?page=all.

Writ of Prohibition was issued on February 14, 2012.[168] The NMOGA escalated the issue by filing a Writ of Superintending Control to the New Mexico Supreme Court, which the environmental group responded to on March 23, 2012.[169] Judge Ortiz then quashed his own Writ of Prohibition on March 27, 2012.[170]

With the legal appeals stayed, hearings before the OCC went forward for five days during the week of May 14, 2012, and continued again on June 20–23, 2012, and August 28–30, 2012, while the media continued to ride the proverbial "dead horse" in the intervening weeks.[171] The OCC conducted public deliberations September 25–28, 2012, which continued through the first week of October. During New Mexico's 2013 Legislative Session, the Director of the Oil Conservation Division, Jami Bailey, testified to New Mexico's House Appropriations Chairman that the Commission would deliberate for one more day in February and that she expected the final order on the pit rule to be signed by the Commission in April, 2013. Regardless of those amendments, the Pit Rule controversy is almost certain to continue between the oil and gas industry and the environmental groups and in the media, if not in New Mexico's appellate courts. Look for latest developments in Texas Wesleyan Law Review's 2014 Survey of Oil and Gas Law.

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168. *Id.*

169. *New Mexico Oil and Gas Pit Regulation Appeal*, N.M. ENVTL. LAW CTR., http://nmenvirolaw.org/index.php/site/cases/new_mexico_oil_and_gas_pit_regulation_appeal/ (last visited Oct. 28, 2012).

170. *Id.*

171. *Changes to the "Pit Rule" Debated, Decision Due by End of the Week*, CAPITOL REPORT N.M., May 14, 2012, http://www.capitolreportnewmexico.com/?p=9522; Sarah Gilman, *It's the Pits*, HIGH COUNTRY NEWS (May 22, 2012, 8:34 AM), http://www.hcn.org/blogs/goat/its-the-pits; Staci Matlock, *Panel Hears Testimony in Pit Rule Challenge*, SANTA FE NEW MEXICAN, June 21, 2012, http://www.santafenewmexican.com/localnews/Panel-hears-testimony-in-pit-rule-challenge#.UI2h9sWHJuM; *Pit Rule*, N.M. OIL & GAS ASS'N, http://www.nmoga.org/pit-rule (last visited Nov. 1, 2012).