IN THE SUPREME COURT

FOR THE STATE OF NORTH DAKOTA

Gadeco, LLC, Appellee, v. Industrial Commission of the State of North Dakota, Appellant, and Slawson Exploration Company, Appellee.	)	Case No. 20110131

Gadeco, LLC, Appellee, v. Industrial Commission of the State of North Dakota, Appellee, and Slawson Exploration Company, Appellant.	)	Case No. 20110140

Appeal from the Judgment entered on March 22, 2011
Civ. No. 31-10-C-143-1
County of Mountrail, Northwest Judicial District
Honorable Richard L. Hagar, Presiding

BRIEF OF APPELLEE/APPELLANT SLAWSON EXPLORATION COMPANY

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TABLE OF CONTENTS

TABLE OF AUTHORITIES

Paragraph

STATE CASES

STATE STATUTES AND ADMINISTRATIVE RULES

OTHER AUTHORITIES

STATEMENT OF THE ISSUES

[¶ 1] Whether the determinations of the North Dakota Industrial Commission ("Commission") that Gadeco, LLC ("Gadeco") failed to timely elect to participate in the Coyote 1-32H well and therefore, Slawson Exploration Company ("Slawson") is authorized to assess a risk penalty against Gadeco is supported by the law and substantial and credible evidence.

STATEMENT OF THE CASE

[¶ 2] This appeal arises out of an application filed by Slawson with the Commission by which Slawson requested the Commission, among other things, to enter an order pursuant to Section 38-08-08(3) of the North Dakota Century Code imposing a risk penalty against Gadeco. On or about April 22, 2010, the Commission issued Order No. 14238 granting Slawson's application and for the imposition of a two hundred percent (200%) risk penalty against Gadeco. The Commission found that Slawson had properly provided Gadeco with an opportunity to participate in the drilling of the Coyote 1-32H well (the "Coyote Well"), and that Gadeco had failed to elect to participate in the well within the time period allowed by statute and the Commission's rules.

[¶ 3] Gadeco appealed the Commission's decision to the Mountrail County District Court. Gadeco asserted that Order No. 14238 must be overturned because the Commission failed to find that Slawson was required to send a new well proposal to Gadeco as a result of alleged material and substantial changes to the location and the estimated spud date of the Coyote Well. Slawson and the Commission submitted briefs in opposition to the appeal contending that the Commission's findings and conclusions were supported by the law and substantial and credible evidence. The District Court issued an Order dated February 28, 2011, overturning the Commission's decision. In the

Order, the District Court erroneously ruled, without explanation, that because the surface location, estimated spud date and itemization of estimated costs associated with the Coyote Well had changed following the first well proposal, Slawson was required to send a new well proposal allowing Gadeco to have another thirty (30) days to respond.

[¶ 4] Slawson and the Commission appealed the District Court's decision to this Court. Because the decision of the Commission authorizing the imposition of a risk penalty against Gadeco is supported by the law and substantial and credible evidence, Order No. 14238 must be affirmed.

STATEMENT OF THE FACTS

A. Facts.

[¶ 5] Slawson is the owner of an interest in the oil and gas leasehold estate in and under real property located in Mountrail County, North Dakota described as Section 32, Township 151 North, Range 92 West ("Section 32"), and is the operator of the Coyote Well. (App. 5, 44)[1]. Gadeco is also an owner of an interest in the oil and gas leasehold estate in and under Section 32. (App. 9). Section 32 constitutes the spacing unit for the Coyote Well in the Big Bend-Bakken Pool. (App. 6).

[¶ 6] On July 8, 2009, in accordance with Section 43-02-03-16.3 of the North Dakota Administrative Code, Slawson sent to Gadeco and ten other working interest owners in the Section 32 (the spacing unit for the Coyote Well), a well proposal providing an invitation to participate in the cost of drilling and completing the Coyote Well (the "Well Proposal"). (App. 9-11; App. 42, II. 3-15). The Well Proposal sent by

[1] All references to "App." herein are references to the Appendix filed and served by the Industrial Commission of the State of North Dakota in connection with its Brief filed in Supreme Court No. 20110131 on June 7, 2011.

Slawson identified the surface location for the well as Section 32, Township 151 North, Range 92 West, Mountrail County, North Dakota, and estimated the spud date for the well to be August 25, 2009. (App. 9-11). Gadeco received Slawson's Well Proposal on July 10, 2009. (*Id.*).

[¶ 7] After the Well Proposal was sent, Slawson was forced to change the surface location of the Coyote Well to accommodate an irrigation system at the original surface location. (App. 26, II. 8-9). In order not to disturb the irrigation system, Slawson moved the surface location of the Coyote Well to the south just across the section line into Section 5, Township 151 North, Range 92 West ("Section 5"). (App. 26, II. 10-14). Section 32 continued to be the spacing unit for the well with the bottom hole and target location unchanged. (App. 31, II. 16-17). Also, the estimated cost of the well as provided for in the authorization for expenditure ("AFE") originally sent to Gadeco along with the Well Proposal did not change. (App. 33, II. 3-10; App. 34, II. 1-12; App. 35, II. 7-14). To advise all working interest owners in and under the Coyote Well of the new surface location and spud date, Slawson on July 15, 2009, sent a letter to Gadeco advising that the surface location and the spud date of the Coyote Well had changed. (App. 13). The letter specifically stated that while the proposed surface location of the Coyote Well has changed, the bottom hole and target location for the well would stay the same. (*Id.*). In addition, the letter indicated that the estimated spud date for the Coyote Well was moved back only thirty-five (35) days, from August 25, 2009 to September 29, 2009. (*Id.*).

[¶ 8] On August 19, 2009, thirty-nine days after receiving the Well Proposal from Slawson for the Coyote Well, Gadeco signed and returned the election to Slawson. (App.

10). Mr. Gene Webb, an employee/representative of Gadeco, contacted Mr. Todd Slawson, President of Slawson, by telephone to inform him that Gadeco had missed the deadline for election because someone was on vacation and was inadvertently not timely responded to as required by law. (App. 27, II. 13-18; App. 28, II. 14-18). On August 20, 2009, Slawson notified Gadeco that it had received Gadeco's signed election, but that the 30-day election period had already expired on August 10, 2009, ten days earlier. (App. 15).

B. <u>Procedural History</u>.

[¶ 9] On or about November 16, 2009, Slawson caused to be filed an application with the Commission requesting an order pooling all interests in a spacing unit for the Coyote Well and also authorizing the recovery of a risk penalty against Gadeco as a non-participating owner pursuant to N.D.C.C. § 38-08-08(3)(a). (App. 5-7). A hearing on Slawson's application was held before the Commission on March 25, 2010. (App. 44). Gadeco appeared at the hearing in order to object to Slawson's request that a risk penalty be assessed against Gadeco. (App. 45). Extensive testimony was taken and received by the Commission at the hearing. (App. 44-47). On or about July 16, 2010, the Commission issued Order No. 14238 pooling all interests in Section 32 and authorizing Slawson to impose a two hundred percent (200%) risk penalty against Gadeco as a non-participating lessee pursuant to N.D.C.C. § 38-08-08(3)(a). (*Id.*).

[¶ 10] On or about August 5, 2010, Gadeco notified the parties of its intention to appeal the Commission's Order regarding the imposition of a risk penalty against Gadeco to the Mountrail County District Court. (App. 48-54). Gadeco served and filed its brief in support of its appeal on or about October 5, 2010. (App. 56) On or about October 19,

2010, the Commission submitted a response brief. (*Id.*). Slawson served and filed a response brief on November 5, 2011. (*Id.*). The District Court heard oral arguments on the appeal on February 14, 2011. (*Id.*).

C. District Court's Determination.

[¶ 11] In its brief to the District Court and during oral arguments, Gadeco argued that changes made by Slawson to the surface location and spud date of the Coyote well were material and therefore, warranted a new Well Proposal and a new 30-day time period in which Gadeco could elect to participate. (App. 61).

[¶ 12] In response, the Commission and Slawson argued that the Commission's findings were supported by substantial and credible evidence in the record and its conclusions were supported by the law and therefore, must be affirmed. (App. 61). More specifically, Slawson and the Commission argued that Slawson adhered to all of the requirements set forth in N.D.A.C. § 43-02-03-16.3 with respect to its Well Proposal to Gadeco and that Gadeco admittedly failed to return its written election because the well proposal laid unattended to on someone's desk while that person was on vacation. (*Id.*). Nowhere in N.D.A.C. § 43-02-03-16.3 does it provide that a new well proposal and additional thirty (30) days is allowed for parties to elect to participate if they inadvertently neglect to timely respond or if the surface location and/or the estimated spud date of the subject well are changed with no effect on the overall costs and expenses of drilling the subject well. (*Id.*). Therefore, as Slawson and the Commission argued, the Commission's Order must be affirmed. (*Id.*).

[¶ 13] In its Order dated February 28, 2011, the District Court held, without explanation, that changes to the surface location, estimated spud date and the estimated

costs of the subject well required Slawson to provide a new well proposal and a new 30-day time period in which Gadeco could elect to participate in the Coyote well. (App. 56-61). The District Court overturned the Commission's decision on this basis without ever addressing the issue of whether the changes in the surface location and spud date were substantial changes. (App. 56-61, 62).

LAW AND ARGUMENT[2]

I. Review of the Commission's Findings and Conclusions on Appeal is Limited.

[¶ 14] When a decision of an administrative agency is appealed from the district court to the North Dakota Supreme Court, the Court reviews the decision of the agency and looks to the record compiled before the agency. *Consolidated Telephone Cooperative v. Western Wireless Corp.*, 2001 ND 209, ¶ 6, 637 N.W.2d 699; *Steen v. N.D. Dep't of Human Services*, 1997 ND 52, ¶ 7, 562 N.W.2d 83; *Amoco Production Co. v. N.D. Industrial Comm'n*, 307 N.W.2d 839 (N.D. 1981). The Court does not substitute its judgment for that of the agency or make independent findings. *Huff v. N.D. State Bd. of Medical Examiners*, 2004 ND 225, ¶ 8, 690 N.W.2d 221; *see also Bank of Hamilton v. State Banking Bd.*, 236 N.W.2d 921, 925 (N.D. 1975). Thus, the Court's review of administrative agency decisions is limited. *Id*.

[¶ 15] The standard of review in reviewing orders of the Industrial Commission is set out in Section 38-08-14(3) of the North Dakota Century Code. This is a specific statute dealing with appeals from the Industrial Commission. The Court shall sustain orders of the Commission if it "has regularly pursued its authority and its findings and

[2] Slawson joins in the arguments made by the Commission in its Brief dated June 7, 2011 and filed with the Court on even date in connection with Supreme Court No. 20110131 and incorporates the same as if fully set forth herein.

conclusions are sustained by the law and by substantial and credible evidence." N.D.C.C. § 38-08-14(3). The North Dakota Supreme Court in *Citizens State Bank of Neche v. Bank of Hamilton*, 238 N.W.2d 655, 660 (N.D. 1976), defined this as:

> such relevant evidence as a reasonable mind might accept as adequate to support a conclusion . . . . It must be enough to justify, if the trial were to a jury, a refusal to direct a verdict when the conclusion sought to be drawn from it is one of fact for the jury. . . . This is something less than the weight of the evidence, and the possibility of drawing two inconsistent conclusions from the evidence does not prevent an administrative agency's findings from being supported by substantial evidence.

Also, in *Hanson v. Industrial Commission of North Dakota*, 466 N.W.2d 587 (N.D. 1991), the court further observed that the substantial evidence test standard of review is not preponderance of the evidence as used with other agencies under the state Administrative Procedures Act (N.D.C.C. § 28-32-46). Under this test, the court said it was "required to accord greater deference to Industrial Commission findings of fact than we ordinarily accord to other administrative agencies' findings of fact." *Id*. at 590. The *Hanson* court also ruled that "[d]etermining the credibility of witnesses is a function of the administrative agency." *Id.* at 594. The Commission is free to accept evidence it deems credible and reject evidence it deems incredible. *Amoco*, 307 N.W.2d at 848.

II. The Commission Properly Authorized the Imposition of a Risk Penalty Against Gadeco.

[¶ 16] In this instance, for the reasons set forth below, the decision by the Commission to authorize the imposition of a risk penalty against Gadeco is supported by the law and substantial and credible evidence and, therefore, must be affirmed. In order to properly assess the evidence in the record and the Commission's decision based on the same, a brief summary of the history and purpose behind the statutory risk penalty is necessary.

A. History and Purpose of a Risk Penalty.

[¶ 17] Traditionally, the ownership of oil and gas resources was governed by the "rule of capture," which made it economically imperative that each mineral owner drill its land and produce as rapidly as possible or otherwise risk that an adjacent owner would drain the land. *See* 8 H. Williams and C. Meyers, *Oil and Gas Law*, p. 932. Pooling[3] and unitization[4] establish a contractual or statutory form of cotenancy among the parties who have the right to produce oil and gas in the spacing or drilling unit. *See* P. Martin & B. Kramer, The Law of Pooling and Unitization, § 12.01. In general, a cotenant may not remove minerals from the land concurrently owned without the consent of his concurrent owners. *Id.* Unless the statute or regulations of the state conservation agency (in this instance, the Commission) provide otherwise, the default rules of cotenancy generally apply. *Id.* That is, a cotenant may not remove minerals from the land concurrently owned without the consent of his concurrent owners. *Id.* In addition, the uncooperative cotenant has the upside benefits from the drilling of successful well and little or no downside from unsuccessful drilling. *Id.* Many would agree that this proposition seems manifestly unfair. In response to this issue, the legislatures in many states have modified the rules of cotenancy by enacting statutes and regulations which provide incentives to

[3] Pooling, or a pooled unit, generally describes the joining together of small tracts or portions of tracts of land for the purpose of having sufficient acreage to receive a well drilling permit, and for the purpose of sharing production by interest owners in such a pooled unit. *See* 6 P. Martin & B. Kramer, *Williams & Meyers Oil and Gas Law* 203.

[4] Unitization, or unit operations, on the other hand, refer to the consolidation of mineral or leasehold interests covering all or part of a common source of supply. The primary function of unit operations is to maximize production by efficiently draining the reservoir, utilizing the best engineering techniques that are economically feasible. *See* 6 *Williams & Meyer Oil and Gas Law* 203.

cooperative interest owners who participate in the drilling of wells and disincentives to the uncooperative interest owners. *Id.*

[¶ 18] Drilling an oil and gas well is generally a significant, expensive, and risky undertaking. A well may produce in great quantities, making adjacent interest owners eager to share in the fruits of production. However, the well may also result in a dry hole or non-commercial well, with all expenditures associated with drilling, which often total in the millions of dollars, producing absolutely no revenue or only a small amount revenue insufficient to cover the drilling and completion costs. In this scenario, very few, if any, neighboring interest owners would be willing to pick up a share of the costs. Thus, if an operator must absorb all losses, while at the same time forced to share all profits, such circumstances work a hardship on that operator whose efforts and risk-taking have led to production. In fact, such a situation would inevitably encourage those parties who might otherwise contribute towards the costs of drilling and completing a well in advance to hold out until the results of the drilling are known, alleviating all risk on their part. In other words, if an owner can get the benefits of production that flow from the well without sharing any of the inherent risks associated with oil and gas production, why participate?

[¶ 19] To solve the problem of benefiting from the risks taken by other owners, many states, including North Dakota, have adopted statutes giving the non-operator owner an opportunity to elect to participate in the drilling and put up cash for its share of the drilling costs in advance of drilling. *See* P. Martin & B. Kramer, *The Law of Pooling and Unitization*, § 12.02. If the non-operator owner fails or refuses to do so, the non-operator owner is subject to a risk penalty. *Id.* That is, if the operator is successful in

drilling the well, the operator may retain from production the non-operator's proportionate share of the costs of drilling and completing the well plus an additional sum as compensation to the operator for its risk. *Id*. The risk penalty promotes oil development while instilling fairness in the process and ensuring "that nonparticipating owners do not benefit from the successful outcome of risks they do not take." *In re Sam Oil, Inc.*, 817 P.2d 299, 302 (Utah 1991). The risk penalty recognizes "it would be unfair for a nonconsenting owner or nondriller lessee to be relieved of the costs and risks associated with drilling a producing well, but at the same time reap the benefits of another's efforts in extracting oil or gas from beneath his or her land." *Western Land Service, Inc. v. Dep't. of Envtl. Conservation*, 804 N.Y.S.2d 465, 467 (2005).

B. The Requirements of Sections 38-08-08 and 43-02-03-16.3 Must Be Strictly Enforced.

[¶ 20] In 1991, the North Dakota Legislature adopted risk penalty requirements in order to promote oil development in the state. Section 38-08-08(3) of the North Dakota Century Code provides, in pertinent part, as follows:

> 3. In addition to any costs and charges recoverable under subsections 1 and 2, if the owner of an interest in a spacing unit elects not to participate in the risk and cost of drilling a well thereon, the owner paying for the nonparticipating owner's share of the drilling and operation of a well may recover from the nonparticipating owner a risk penalty for the risk involved in drilling the well. The recovery of a risk penalty is as follows:
>
> a. If the nonparticipating owner's interest in the spacing unit is derived from a lease . . . , the risk penalty is two hundred percent of the nonparticipating owner's share of the reasonable actual costs of drilling and completing the well . . . .

Enforcement of the risk penalty requirements ensures that owners who have the right to drill and who wish to drill a well will not be unnecessarily delayed or discouraged in their

plans. The risk penalty statute set forth at N.D.C.C. § 38-08-08(3) simply authorizes the risk penalty in North Dakota and establishes the amount of the penalty. The Commission, which is charged with effectuating the public interest in oil development, has adopted administrative rules that establish specific requirements for imposition of a risk penalty. *See* N.D.A.C. § 43-02-03-16.3.

C. Slawson Issued a Valid Well Proposal Providing Gadeco an Opportunity to Participate in the Coyote Well.

[¶ 21] In this instance, Slawson complied with the Commission's rules and issued a valid well proposal to participate in the costs of drilling the Coyote Well. Gadeco, on the other hand, failed to comply with the Commission's rules for electing to participate in the well. Thus, Slawson is entitled to recover a risk penalty against Gadeco.

[¶ 22] Section 43-02-03-16.3 of the North Dakota Administrative Code governs the recovery of the risk penalty provided under section 38-08-08(3) of the North Dakota Century Code. By promulgating section 43-02-03-16.3, the Commission has adopted clear requirements for recovery of a risk penalty. The two broad requirements for imposing the risk penalty are: (1) a valid invitation to participate ; and (2) failure to elect within thirty days after receiving a valid invitation. In this case, it is clear that Slawson sent a valid well proposal offering all working interest owners an opportunity to participate and that Gadeco failed to properly and timely elect.

[¶ 23] In accordance with section 43-02-03-16.3(1), the owner seeking a risk penalty must give to the owner from whom the penalty is sought, a well proposal providing an invitation to participate in the risk and costs of drilling a well. On July 8, 2009, Slawson provided Gadeco with a well proposal providing it an opportunity to participate in the costs of drilling and completing the Coyote Well. The Commission's

administrative rules identify specific requirements for a valid well proposal. The well proposal must contain the following:

> (1) The location of the *proposed* or existing well and its proposed depth and objection zone.
>
> (2) An itemization of the *estimated* costs of drilling and completion.
>
> (3) The *approximate* date upon which the well was or will be spudded or reentered.
>
> (4) A statement indicating the invitation must be accepted within thirty days of receiving it.
>
> (5) Notice that the participating owners plan to impose a risk penalty and that the nonparticipating owner may object to the risk penalty by either responding in opposition to the petition for a risk penalty, or if no such petition has been filed, by filing an application or request for hearing with the commission.

N.D.C.C. § 43-02-03-16.3(1)(a) (emphasis added).

[¶ 24] Here, it is undisputed that on July 8, 2009, Slawson provided a Well Proposal which provided Gadeco the opportunity to participate in the costs of drilling and completing the Coyote Well. The July 8, 2009, Well Proposal contained all of the information specifically required under section 43-02-03-16.3(1)(a), including the location of the well, an itemization of the estimated costs, the estimated spud date, a statement that the owner would need to accept the opportunity to participate within 30 days, and notice that Slawson planned to impose a risk penalty if the owner failed to timely elect to participate in the well. (App. 9-11). Accordingly, it is undisputed that Slawson issued a valid well proposal providing an opportunity to participate in the Coyote Well to Gadeco.

D. Gadeco Failed to Timely Elect to Participate in the Coyote Well within the Statutory Time Period.

[¶ 25] On July 10, 2009, Gadeco received Slawson's Well Proposal. (App. 9). The Commission's administrative rules identify the time period for a valid election. A

working interest owner may avoid the risk penalty only if it delivers a written election to participate within thirty days. N.D.A.C. § 43-02-03-16.3(1)(b). Thus, Gadeco had until August 10, 2009, to choose to participate and to do so by delivering a valid election to Slawson.

[¶ 26] In this instance, Gadeco admits that it failed to return to Slawson its written election to participate in the drilling and completion of the Coyote Well within thirty days of receiving the July 8, 2009, Well Proposal as is expressly required by section 43-02-03-16.3(1)(b). Indeed, Gadeco admitted on more than one occasion that it missed the deadline for election while an employee was on vacation and the election form sat on a desk. (App. 27, II. 13-18; 29, II. 20-24; 41, II. 9-10). On August 19, 2009, thirty-nine days after receiving the Well Proposal from Slawson, Gadeco signed and returned the election to Slawson. (App. 10-11). On August 20, 2009, Slawson notified Gadeco that it had received Gadeco's signed election, but that the 30-day election period had already expired on August 10, 2009, ten days earlier. (App. 15).

III. The Changes to the Surface Location and the Estimated Spud Date of the Coyote Well did not Require Slawson to Send a New Well Proposal to Gadeco.

[¶ 27] In a futile effort to explain its failure to submit a timely election and to avoid the statutorily-provided risk penalty, Gadeco encouraged the District Court, as it did the Commission at the March 25, 2010 hearing, to read additional requirements into section 43-02-03-16.3(1)(a). Specifically, Gadeco asserted that Slawson was required to send a new well proposal and the time period permitted for election started anew when Slawson was forced to change the surface location of the well and, as a courtesy, notified Gadeco of the same by letter dated July 15, 2009.

[¶ 28] "Administrative rule-making power is predicated on the theory that in certain subjects of governmental regulation public interest is better served by delegating a part of detailed lawmaking to expert administrators who are especially familiar with the subject the legislature has directed them to regulate. *Gofor Oil, Inc. v. State*, 427 N.W.2d 104, 107 (N.D. 1988). While an administrative agency is bound by its own duly issued regulations, an agency nevertheless has a reasonable range of informed discretion in the interpretation and application of its own rules. *See Quarles v. McKenzie Pub. Sch. Dist. No. 34*, 325 N.W.2d 662, 670 (N.D. 1982); *Fercho v. Montpelier Pub. Sch. Dist. No. 14*, 312 N.W.2d 337, 341 (N.D. 1981); 2 Am.Jur.2d *Administrative Law* § 349 (1962). Thus, the courts generally defer to an agency's reasonable interpretation when the language is so technical that only a specialized agency has the experience and expertise to understand it or when the language is ambiguous. *In re Application for Permits to Drain Related to Stone Creek Channel Improv. etc.*, 424 N.W.2d 894, 900 (N.D. 1988) (citing *Resident v. Noot*, 305 N.W.2d 311, 312 (Minn. 1981).

[¶ 29] The North Dakota Legislature expressly granted the Commission the authority and duty to effectuate the public interest to encourage and promote the development of oil and gas in the State of North Dakota. *See* N.D.C.C. §§ 38-08-01 and 38-08-04. This includes the ability to promulgate and adopt rules to regulate the oil and gas industry. *Id.* The Commission promulgated and adopted N.D.A.C. § 43-02-03-16.3 to govern the recovery of a risk penalty pursuant to N.D.C.C. § 38-08-08 and is entitled to a reasonable range of informed discretion in the interpretation and application of the same. *See Quarles*, 325 N.W.2d at 370. The Commission did not exceed its authority and was well within its discretion by determining that its own rules, specifically

N.D.A.C. § 43-02-03-16.3, did not require a new well proposal from Slawson and a new 30-day time period in which Gadeco could elect to participate in the Coyote Well under the circumstances present here.

[¶ 30] First, nowhere in section 43-02-03-16.3 does it provide for or reference a new well proposal or resetting of the election time period under such circumstances. Gadeco has not and cannot provide any authority which would allow the Commission or this Court to do so. Rather, to the contrary, the Commission's rules provide a level of flexibility in light of the changes and/or adjustments that commonly and routinely occur in drilling plans in the industry. For example, section 43-02-03-16.3(1)(a) requires that the operator provide the "estimated" spud date and the "estimated" costs of the subject well.[5] The Commission's interpretation of its own rule under the circumstances is appropriate and sensible and is consistent with the purpose of the risk penalty statute.

[¶ 31] Second and more importantly, there is substantial and credible evidence in the record indicating that the changes to the surface location and the estimated spud date of the Coyote Well did not effect the costs of drilling the Coyote Well and thus, would have no effect on a working interest owner's overall decision to participate in the drilling of the Coyote Well. Mr. Todd Slawson, a representative of Slawson, testified repeatedly

[5] Moreover, N.D.A.C. § 43-02-03-16.3(1)(d) provides that "[a]n election to participate is only binding upon an owner electing to participate if the well is spudded or reentry operations are commenced on or before ninety days after the date the owner extending the invitation to participate sets as the date upon which a response to the invitation is to be received." This provision makes it clear that the Commission anticipated and expected that drilling plans and proposed spud dates, in particular, may change and therefore, provided flexibility in its rules to accommodate such changes. In this instance, the estimated spud date for the Coyote Well was moved back only thirty-five (35) days, from August 25, 2009 to September 29, 2009. (App. 13). As such, Slawson spudded the Coyote Well within the required ninety days. (*Id.*). Slawson notified Gadeco and the other working interest owners in the spacing unit for the Coyote Well of the change in the spud date as a courtesy only.

before the Commission that the changes to the surface location and estimated spud date of the Coyote Well did not increase the costs of the well. (App. 33, II. 3-10; App. 34, II. 1-12; App. 35, II. 7-14). Gadeco, despite repeated attempts, failed to elicit a different answer from Mr. Slawson on cross examination and did not offer any other evidence to the contrary to support the premise that the changes to the well increased the cost of drilling the same. (*Id.*). The implication that Gadeco did not return its written election to participate in the Coyote Well because it believed that a new well proposal and AFE were necessary or warranted due to the changes made by Slawson is disingenuous at best. Gadeco did not take the position that a new well proposal and AFE were required until after it attempted to return its signed election form based on the Well Proposal and AFE sent by Slawson on July 8, 2009, and was informed by Slawson that the election was untimely and would not be accepted.[6] (App. 17-18). At no time after receiving Slawson's Well Proposal and before returning its untimely election, did Gadeco inquire or express concern to Slawson as to any potential effect the changes to the surface location and estimated spud date would have on the costs of drilling the Coyote Well. (*Id.*).

[6] At the hearing before the Commission, Jack Grynberg, a representative of Gadeco, testified that after receiving the July 15, 2009, letter from Slawson notifying them of the changes to the surface location and the proposed spud date of the Coyote Well, Gadeco contacted Slawson on several occasions requesting a new AFE. (App. 37, II. 13-17). However, Todd Slawson, a representative of Slawson, testified that at no time after receiving the Well Proposal from Slawson and before returning its signed, untimely election, did Gadeco request a new AFE or inquire as to what, if any, impact the changes to the surface location or proposed spud date would have on the costs of drilling the Coyote Well. (App. 43, II. 2-25). In addition, Mr. Slawson testified that that the first contact he received from Gadeco by telephone was on August 18, 2009, more than thirty (30) days after Gadeco received the July 15, 2009, letter. (*Id.*). The Commission having the opportunity to observe the witnesses obviously found Todd Slawson's testimony more credible than that of Jack Grynberg.

[¶ 32] Despite this substantial and credible evidence to the contrary, Gadeco nevertheless continued to assert to the District Court without factual support that the changes to the surface location and estimated spud date of the Coyote Well were material and substantial and increased the costs of the drilling of the Coyote Well and thus, necessitated a new well proposal and 30-day election period. The District Court, arbitrarily and without any deference to the Commission's interpretation of its own rules, agreed with Gadeco's position and overturned the Commission's Order. It is well settled in North Dakota that courts must defer to a reasonable interpretation of a statute by the agency responsible for enforcing it. *Cass County Elec. Co-op., Inc. v. Northern States Power Co.,* 518 N.W.2d 216, 220 (N.D. 1994). Moreover, as stated previously, while an administrative agency is bound by its own duly issued regulations, an agency nevertheless has a reasonable range of informed discretion in the interpretation and application of its own rules. *See Quarles*, 325 N.W.2d at 670; *Fercho,* 312 N.W.2d at 341; 2 Am.Jur.2d *Administrative Law* § 349 (1962). In addition, courts generally defer to an agency's reasonable interpretation when the language is so technical that only a specialized agency has the experience and expertise to understand it or when the language is ambiguous. *In re Application for Permits,* 424 N.W.2d at 900. In this case, Gadeco's excuse for failing to timely respond to the Well Proposal was whether the change in the spud date or moving the surface location would significantly impact the drilling of a horizontal well. The Commission, based on its expertise and experience in the industry, as well as the extensive testimony taken from both sides in this matter, determined that the changes to the surface location and estimated spud date of the Coyote Well did not and would not impact a working interest owner's ultimate decision as to

whether to participate in the drilling of the well.[7] (App. 46). In doing so, the Commission was well within its authority granted by the North Dakota Legislature and routinely recognized by this Court. The District Court, rather than providing deference, impermissibly and improperly substituted its judgment in place of the Commission's. As such, this Court must affirm the Commission's Order No. 14238.

IV. Allowing Gadeco to Avoid the Risk Penalty under the Circumstances would Disrupt the Orderly Development of Oil and Gas and would Create Havoc in the Industry.

[¶ 33] Permitting Gadeco to avoid the risk penalty under the circumstances present here would not only disrupt the orderly development of oil and gas, but would likely create havoc in the industry. Once operators fulfill all the substantive and procedural requirements necessary to assess a risk penalty, they should not be left wondering whether the penalty is secure or will be affected by likely unforeseeable

[7] At the hearing, Todd Slawson, a representative of Slawson, testified that the change in the surface location of the Coyote Well did increase the drilling costs by approximately $50,000. (App. 33, II. 11-20). However, he also testified that because the new location was already built and existing for another Slawson-operated well, Slawson would not be required to build out the location as originally planed, which resulted in a savings of approximately $50,000, offsetting the increase in the drilling costs. (App. 34, II. 1-12; App. 35, II. 7-14). The AFE provided to Gadeco along with the Well Proposal on July 8, 2009, was all-encompassing and therefore, the change in the surface of the location of the Coyote Well did not result in any changes to the AFE. (*Id.*). Based on this and other substantial and credible evidence in the record, the Commission determined that Slawson was not required to provide Gadeco with a new well proposal or AFE. (App. 46).

Moreover, one only needs to review the AFE provided by Slawson along with the Well Proposal to understand the complexities involved in and the technical nature of the drilling of a horizontal well like the Coyote Well, as well as the significant costs associated with the same (in this case, the total estimated cost being $4,219,256.00). (App. 11). Thus, this Court must refrain from substituting its judgment in place of the Commission's, who with its extensive experience in and knowledge of the drilling of horizontal wells, is better equipped to determine whether or not certain changes in the proposed drilling plan would have a substantial and material impact on the costs of the drilling of a horizontal well and a working interest owner's ultimate decision to participate in the well.

changes in the drilling plans. An owner who wishes to drill a well needs certainty and a prompt response to its well proposal in order to devise and execute a drilling plan. It needs to know, one way or the other, whether the working interest owners will help finance its plan so that it can find other investors if some owners choose not to participate. If a nondrilling working interest owner is able to delay the election process and continuously extend the election period every time there is a slight change in the drilling plan without any resulting increase in or significant impact on the cost of the same, the operator no longer has certainty and promptness, which would then lead not only to the disruption of drilling plans, but of the overall development of oil and gas in the State of North Dakota. This type of activity, if condoned by the Commission and/or this Court, would inevitably lead to chaos in the industry.

[¶ 34] In this instance, Slawson did all that the law required. It sent a valid well proposal to Gadeco providing an opportunity to participate in the Coyote Well, which contained all of the information required by N.D.A.C. §43-02-03-16.3. At the end of the thirty-day response period, Slawson was entitled to conclude that there was no apparent obstacle to the risk penalty. Once the response period set forth in a proper invitation has expired without a timely reply from the mineral owner, the risk penalty attaches.

CONCLUSION

[¶ 35] For the reasons set forth above, it is clear that the Commission's findings and conclusions as set forth in its Order No. 14238 are supported by the law and substantial and credible evidence in the record. Accordingly, the district court's judgment should be overturned and the Commission's Order No. 14238 affirmed.

DATED this 19th day of July, 2011.

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ADDENDUM

N.D.C.C. 38-08-01. Declaration of policy.

It is hereby declared to be in the public interest to foster, to encourage, and to promote the development, production, and utilization of natural resources of oil and gas in the state in such a manner as will prevent waste; to authorize and to provide for the operation and development of oil and gas properties in such a manner that a greater ultimate recovery of oil and gas be had and that the correlative rights of all owners be fully protected; and to encourage and to authorize cycling, recycling, pressure maintenance, and secondary recovery operations in order that the greatest possible economic recovery of oil and gas be obtained within the state to the end that the landowners, the royalty owners, the producers, and the general public realize and enjoy the greatest possible good from these vital natural resources.

N.D.C.C. 38-08-04. Jurisdiction of commission.

The commission has continuing jurisdiction and authority over all persons and property, public and private, necessary to enforce effectively the provisions of this chapter. The commission has authority, and it is its duty, to make such investigations as it deems proper to determine whether waste exists or is imminent or whether other facts exist which justify action by the commission. The commission has the authority:

1. To require:

   a. Identification of ownership of oil or gas wells, producing leases, tanks, plants, structures, and facilities for the transportation or refining of oil and gas.

   b. The making and filing with the industrial commission of all resistivity, radioactivity, and mechanical well logs and the filing of directional surveys, if taken, and the filing of reports on well location, drilling, and production.

   c. The drilling, casing, operation, and plugging of wells in such manner as to prevent the escape of oil or gas out of one stratum into another, the intrusion of water into oil or gas strata, the pollution of freshwater supplies by oil, gas, or saltwater, and to prevent blowouts, cavings, seepages, and fires.

   d. The furnishing of a reasonable bond with good and sufficient surety, conditioned upon the full compliance with this chapter, and the rules and orders of the industrial commission, except that if the commission requires a bond to be furnished, the person required to furnish the bond may elect to deposit under such terms and conditions as the industrial commission may prescribe a collateral bond, self-bond, cash, or any alternative form of security approved by the commission, or combination thereof, by which an operator assures faithful performance of all requirements of this chapter and the rules and orders of the industrial commission.

   e. That the production from wells be separated into gaseous and liquid hydrocarbons, and that each be accurately measured by such means and upon such standards as may be prescribed by the commission.

   f. The operation of wells with efficient gas-oil and water-oil ratios, and to fix these ratios.

   g. Certificates of clearance in connection with the transportation or delivery of oil, gas, or any product.

   h. Metering or other measuring of oil, gas, or product related to production in pipelines, gathering systems, storage tanks, barge terminals, loading racks,

refineries, or other places, by meters or other measuring devices approved by the commission.

i. Every person who produces, sells, purchases, acquires, stores, transports, refines, disposes of, or processes oil, gas, saltwater, or other related oilfield fluids in this state to keep and maintain within this state complete and accurate records of the quantities thereof, which records must be available for examination by the commission or its agents at all reasonable times, and to file with the commission reports as the commission may prescribe with respect to oil or gas or the products thereof. An oil and gas production report need not be notarized but must be signed by the person submitting the report.

j. The payment of fees for services performed. The amount of the fee shall be set by the commission based on the anticipated actual cost of the service rendered. Unless otherwise provided by statute, all fees collected by the commission must be deposited in the general fund of this state, according to procedures established by the state treasurer.

k. The filing free of charge of samples and core chips and of complete cores when requested in the office of the state geologist within six months after the completion or abandonment of the well.

l. The placing of wells in abandoned-well status which have not produced oil or natural gas in paying quantities for one year. A well in abandoned-well status must be promptly returned to production in paying quantities, approved by the commission for temporarily abandoned status, or plugged and reclaimed within six months. If none of the three preceding conditions are met, the industrial commission may require the well to be placed immediately on a single-well bond in an amount equal to the cost of plugging the well and reclaiming the well site. In setting the bond amount, the commission shall use information from recent plugging and reclamation operations. After a well has been in abandoned-well status for one year, the well's equipment, all well-related equipment at the well site, and salable oil at the well site are subject to forfeiture by the commission. If the commission exercises this authority, section 38-08-04.9 applies. After a well has been in abandoned-well status for one year, the single-well bond referred to above, or any other bond covering the well if the single-well bond has not been obtained, is subject to forfeiture by the commission.

2. To regulate:

a. The drilling, producing, and plugging of wells, the restoration of drilling and production sites, and all other operations for the production of oil or gas.

b. The shooting and chemical treatment of wells.

c. The spacing of wells.

d. Operations to increase ultimate recovery such as cycling of gas, the maintenance of pressure, and the introduction of gas, water, or other substances into producing formations.

e. Disposal of saltwater and oilfield wastes.

f. The underground storage of oil or gas.

3. To limit and to allocate the production of oil and gas from any field, pool, or area and to establish and define as separate marketing districts those contiguous areas

within the state which supply oil and gas to different markets, and to limit and allocate the production of oil and gas for each separate marketing district.
4. To classify wells as oil or gas wells for purposes material to the interpretation or enforcement of this chapter, to classify and determine the status and depth of wells that are stripper well property as defined in subsection 8 of section 57-51.1-01, to certify to the tax commissioner which wells are stripper wells and the depth of those wells, and to certify to the tax commissioner which wells involve secondary or tertiary recovery operations under section 57-51.1-01, and the date of qualification for the reduced rate of oil extraction tax for secondary and tertiary recovery operations.
5. To adopt and to enforce rules and orders to effectuate the purposes and the intent of this chapter and the commission's responsibilities under chapter 57-51.1.
6. To provide for the confidentiality of well data reported to the commission if requested in writing by those reporting the data for a period not to exceed six months.

N.D.C.C. 38-08-08. Integration of fractional tracts.

1. When two or more separately owned tracts are embraced within a spacing unit, or when there are separately owned interests in all or a part of the spacing unit, then the owners and royalty owners thereof may pool their interests for the development and operation of the spacing unit. In the absence of voluntary pooling, the commission upon the application of any interested person shall enter an order pooling all interests in the spacing unit for the development and operations thereof. Each such pooling order must be made after notice and hearing, and must be upon terms and conditions that are just and reasonable, and that afford to the owner of each tract or interest in the spacing unit the opportunity to recover or receive, without unnecessary expense, that owner's just and equitable share. Operations incident to the drilling of a well upon any portion of a spacing unit covered by a pooling order must be deemed, for all purposes, the conduct of such operations upon each separately owned tract in the drilling unit by the several owners thereof. That portion of the production allocated to each tract included in a spacing unit covered by a pooling order must, when produced, be deemed for all purposes to have been produced from such tract by a well drilled thereon. For the purposes of this section and section 38-08-10, any unleased mineral interest pooled by virtue of this section before August 1, 2009, is entitled to a cost-free royalty interest equal to the acreage weighted average royalty interest of the leased tracts within the spacing unit, but in no event may the royalty interest of an unleased tract be less than a one-eighth interest. An unleased mineral interest pooled after July 31, 2009, is entitled to a cost-free royalty interest equal to the acreage weighted average royalty interest of the leased tracts within the spacing unit or, at the operator's election, a cost-free royalty interest of sixteen percent. The remainder of the unleased interest must be treated as a lessee or cost-bearing interest.
2. Each such pooling order must make provision for the drilling and operation of a well on the spacing unit, and for the payment of the reasonable actual cost thereof by the owners of interests in the spacing unit, plus a reasonable charge for supervision. In the event of any dispute as to such costs, the commission shall determine the proper costs. If one or more of the owners shall drill and operate, or

pay the expenses of drilling and operating the well for the benefit of others, then, the owner or owners so drilling or operating shall, upon complying with the terms of section 38-08-10, have a lien on the share of production from the spacing unit accruing to the interest of each of the other owners for the payment of the owner's or owners' proportionate share of such expenses. All the oil and gas subject to the lien must be marketed and sold and the proceeds applied in payment of the expenses secured by such lien as provided for in section 38-08-10.

3. In addition to any costs and charges recoverable under subsections 1 and 2, if the owner of an interest in a spacing unit elects not to participate in the risk and cost of drilling a well thereon, the owner paying for the nonparticipating owner's share of the drilling and operation of a well may recover from the nonparticipating owner a risk penalty for the risk involved in drilling the well. The recovery of a risk penalty is as follows:
   a. If the nonparticipating owner's interest in the spacing unit is derived from a lease or other contract for development, the risk penalty is two hundred percent of the nonparticipating owner's share of the reasonable actual costs of drilling and completing the well and may be recovered out of, and only out of, production from the pooled spacing unit, as provided by section 38-08-10, exclusive of any royalty or overriding royalty.
   b. If the nonparticipating owner's interest in the spacing unit is not subject to a lease or other contract for development, the risk penalty is fifty percent of the nonparticipating owner's share of the reasonable actual costs of drilling and completing the well and may be recovered out of production from the pooled spacing unit, as provided by section 38-08-10, exclusive of any royalty provided for in subsection 1.
   c. The owner paying for the nonparticipating owner's share of the drilling and operation of a well may recover from the nonparticipating owner a risk penalty for the risk involved in drilling and completing the well only if the paying owner has made an unsuccessful, good-faith attempt to have the unleased nonparticipating owner execute a lease or to have the leased nonparticipating owner join in and participate in the risk and cost of drilling the well. Before a risk penalty may be imposed, the paying owner must notify the nonparticipating owner with proof of service that the paying owner intends to impose a risk penalty and that the nonparticipating owner may object to the risk penalty by either responding in opposition to the petition for a risk penalty or if no such petition has been filed, by filing an application or request for hearing with the industrial commission.

N.D.C.C. 38-08-14. Party adversely affected may appeal to district court.

1. Any party adversely affected by an order entered by the commission may appeal, pursuant to chapter 28-32, from the order to the district court for the county in which the oil or gas well or the affected property is located. However, if the oil or gas well or the property affected by the order is located in or underlies more than one county, any appeal may be taken to the district court for any county in or under which any part of the affected property is located.

2. At the time of filing of the notice of appeal, if an application for the suspension of the order is filed, the commission may enter an order suspending the order complained of and fixing the amount of a supersedeas bond. Within ten days after the entry of an order by the commission which suspends the order complained of and fixes the amount of the bond, the appellant shall file with the commission a supersedeas bond in the required amount and with proper surety. Upon approval of the bond, the order of the commission suspending the order complained of is effective until its final disposition upon appeal. The bond must run in favor of the commission for the use and benefit of any person who may suffer damage by reason of the suspension of the order in the event the same is affirmed by the district court. If the order of the commission is not superseded, it must continue in force and effect as if no appeal was pending, unless a stay is ordered by the court to which the appeal is taken under section 28-32-48.
3. Orders of the commission must be sustained by the district court if the commission has regularly pursued its authority and its findings and conclusions are sustained by the law and by substantial and credible evidence.

N.D.C.C. 28-32-46. Scope of and procedure on appeal from determination of administrative agency.

A judge of the district court must review an appeal from the determination of an administrative agency based only on the record filed with the court. After a hearing, the filing of briefs, or other disposition of the matter as the judge may reasonably require, the court must affirm the order of the agency unless it finds that any of the following are present:

1. The order is not in accordance with the law.
2. The order is in violation of the constitutional rights of the appellant.
3. The provisions of this chapter have not been complied with in the proceedings before the agency.
4. The rules or procedure of the agency have not afforded the appellant a fair hearing.
5. The findings of fact made by the agency are not supported by a preponderance of the evidence.
6. The conclusions of law and order of the agency are not supported by its findings of fact.
7. The findings of fact made by the agency do not sufficiently address the evidence presented to the agency by the appellant.
8. The conclusions of law and order of the agency do not sufficiently explain the agency's rationale for not adopting any contrary recommendations by a hearing officer or an administrative law judge.

If the order of the agency is not affirmed by the court, it must be modified or reversed, and the case shall be remanded to the agency for disposition in accordance with the order of the court.

N.D.A.C. 43-02-03-16.3. Recovery of a risk penalty. The following govern the recovery of the risk penalty pursuant to subsection 3 of North Dakota Century Code section 38-08-08 and subsection 3 of North Dakota Century Code section 38-08-09.4:

1. An owner may recover the risk penalty under the provisions of subsection 3 of North Dakota Century Code section 38-08-08, provided the owner gives, to the owner from whom the penalty is sought, a written invitation to participate in the risk and cost of drilling a well, including reentering a plugged and abandoned well, or the risk and cost of reentering an existing well to drill deeper or a horizontal lateral. If the nonparticipating owner's interest is not subject to a lease or other contract for development, an owner seeking to recover a risk penalty must also make a good-faith attempt to have the unleased owner execute a lease.
   a. The invitation to participate in drilling must contain the following:
      (1) The location of the proposed or existing well and its proposed depth and objective zone.
      (2) An itemization of the estimated costs of drilling and completion.
      (3) The approximate date upon which the well was or will be spudded or reentered.
      (4) A statement indicating the invitation must be accepted within thirty days of receiving it.
      (5) Notice that the participating owners plan to impose a risk penalty and that the nonparticipating owner may object to the risk penalty by either responding in opposition to the petition for a risk penalty, or if no such petition has been filed, by filing an application or request for hearing with the commission.
   b. An election to participate must be in writing and must be received by the owner giving the invitation within thirty days of the participating party's receipt of the invitation.
   c. An invitation to participate and an election to participate must be served personally, by mail requiring a signed receipt, or by overnight courier or delivery service requiring a signed receipt. Failure to accept mail requiring a signed receipt constitutes service.
   d. An election to participate is only binding upon an owner electing to participate if the well is spudded or reentry operations are commenced on or before ninety days after the date the owner extending the invitation to participate sets as the date upon which a response to the invitation is to be received. It also expires if the permit to drill or reenter expires without having been exercised. If an election to participate lapses, a risk penalty can only be collected if the owner seeking it again complies with the provisions of this section.
2. An owner may recover the risk penalty under the provisions of subsection 3 of North Dakota Century Code section 38-08-09.4, provided the owner gives, to the owner from whom the penalty is sought, a written invitation to participate in the unit expense. If the nonparticipating owner's interest is not subject to a lease or other contract for development, an owner seeking to recover a risk penalty must also make a good-faith attempt to have the unleased owner execute a lease.
   a. The invitation to participate in the unit expense must contain the following:
      (1) A description of the proposed unit expense, including the location, objectives, and plan of operation.
      (2) An itemization of the estimated costs.

(3) The approximate date upon which the proposal was or will be commenced.
(4) A statement indicating the invitation must be accepted within thirty days of receiving it.
(5) Notice that the participating owners plan to impose a risk penalty and that the nonparticipating owner may object to the risk penalty by either responding in opposition to the petition for a risk penalty, or if no such petition has been filed, by filing an application or request for hearing with the commission.

b. An election to participate must be in writing and must be received by the owner giving the invitation within thirty days of the participating party's receipt of the invitation.

c. An invitation to participate and an election to participate must be served personally, by mail requiring a signed receipt, or by overnight courier or delivery service requiring a signed receipt. Failure to accept mail requiring a signed receipt constitutes service.

d. An election to participate is only binding upon an owner electing to participate if the unit expense is commenced within ninety days after the date the owner extending the invitation request to participate sets as the date upon which a response to the request invitation is to be received. If an election to participate lapses, a risk penalty can only be collected if the owner seeking it again complies with the provisions of this section.

e. An invitation to participate in a unit expense covering monthly operating expenses shall be effective for all such monthly operating expenses for a period of five years if the unit expense identified in the invitation to participate is first commenced within ninety days after the date set in the invitation to participate as the date upon which a response to the invitation to participate must be received. An election to participate in a unit expense covering monthly operating expenses is effective for five years after operations are first commenced. If an election to participate in a unit expense comprised of monthly operating expenses expires or lapses after five years, a risk penalty may only be assessed and collected if the owner seeking the penalty once again complies with this section.

3. Upon its own motion or the request of a party, the commission may include in a pooling order requirements relating to the invitation and election to participate, in which case the pooling order will control to the extent it is inconsistent with this section.

IN THE SUPREME COURT

FOR THE STATE OF NORTH DAKOTA

Gadeco, LLC, Appellee, v. Industrial Commission of the State of North Dakota, Appellant, and Slawson Exploration Company, Appellee.	)	Case No. 20110131

Gadeco, LLC, Appellee, v. Industrial Commission of the State of North Dakota, Appellee, and Slawson Exploration Company, Appellant.	)	Case No. 20110140 **CERTIFICATE OF SERVICE**

STATE OF NORTH DAKOTA)
) ss.
COUNTY OF BURLEIGH)

I hereby certify that on July 19, 2011, I electronically filed the foregoing with the Clerk of the North Dakota Supreme Court and served the same electronically as follows:

Mr. Dennis Edward Johnson	dej@ruggedwest.com
Mr. Todd A. Sattler	tsattler@nd.gov

Dated: July 19, 2011

/s/ Lawrence Bender
LAWRENCE BENDER

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