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STATE OF NORTH DAKOTA

IN THE SUPREME COURT

STATE OF NORTH DAKOTA

Gadeco, LLC, Appellee, v. Industrial Commission of the State of North Dakota, Appellant, and Slawson Exploration Company, Appellee.	Supreme Court No. 20110131 Mountrail County No. 31-10-C-0143
Gadeco, LLC, Appellee, v. Industrial Commission of the State of North Dakota, Appellee, and Slawson Exploration Company, Appellant.	Supreme Court No. 20110140 Mountrail County No. 31-10-C-0143

Appeal from Order Reversing Decision of the
Industrial Commission of North Dakota

Dated February 28, 2011

District Court, Northwest Judicial District

Mountrail County, North Dakota

The Honorable Judge Richard L. Hagar, Presiding

BRIEF OF APPELLEE GADECO, LLC

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TABLE OF CONTENTS

TABLE OF AUTHORITIES

CASES

STATUTES

REGULATIONS

RULES

STATEMENT OF CASE

[1] This case originated before the North Dakota Industrial Commission (NDIC), which held a hearing to consider Slawson Exploration Company's ("Slawson's") application for an order, pursuant to N.D.A.C. § 43-02-03-88.1, pooling interests in a spacing unit for its Coyote #1-32H well and authorizing recovery of a risk penalty from nonparticipating owners under N.D.C.C. § 38-08-08. Gadeco, LLC ("Gadeco," pronounced gah-DEH-co) appeared before the NDIC to object, as a leasehold owner, to the assessment of a risk penalty against it. After its hearing on March 25, 2010, the NDIC ordered that Gadeco would be subject to the risk penalty.

[2] Gadeco appealed from the NDIC decision to the district court in Mountrail County, North Dakota. Several errors were specified below. The district court, Hon. Richard L. Hagar presiding, entered a memorandum order reversing the NDIC decision on February 28, 2011, and judgment upon that order was entered on March 22, 2011. Slawson and the State of North Dakota have appealed to this Court, seeking for the district court's judgment to be reversed and, instead, the NDIC decision to be affirmed.

LEGAL ARGUMENT

A. Standard of Review

[3] As the district court properly recognized, orders of the NDIC are entitled to a unique standard of review. They "must be sustained … 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. § 38-08-14(3). The NDIC's factual findings therefore must be sustained when supported by substantial evidence, which this Court has explained means less than a preponderance of the evidence. Hanson v. Industrial Commission of North Dakota, 466 N.W.2d 587, 590 (N.D. 1991). However, its legal conclusions must be sustained by the law, N.D.C.C. § 38-08-14(3), and therefore are susceptible to de novo review by this Court. Statutory interpretation is always subject to de novo review by this Court. M.M. v. Fargo Pub. Sch. Dist. No. 1, 2010 ND 102, ¶ 12, 783 N.W.2d 806.

[4] In other words, while the NDIC's findings of fact are entitled to greater deference than findings from other agencies, its conclusions of law may only be affirmed if they accord with North Dakota law.

[5] The NDIC argues that the Court must give deference to its interpretation of an ambiguous statute. (NDIC Br., p. 7) (citing Clapp v. Cass County, 236 N.W.2d 850, 856 (N.D. 1975)). However, no ambiguity in the statutes and administrative regulations involved in this appeal has been

pointed out by Slawson or the NDIC. Indeed, the NDIC points out in unequivocal terms that the regulation at issue in this case is "clear and unambiguous." (NDIC Br., p. 20.) There is no serious contention by any party that the regulation is ambiguous.

B. Risk Penalties

[6] A risk penalty may be imposed on nonparticipating owners within a spacing unit. N.D.C.C. § 38-08-08(3). The purpose of a risk penalty is to compensate the participating owners for the risk inherent in drilling a well. Ibid.

[7] Before a risk penalty can be assessed, a codified procedure must be followed. The owner seeking the penalty must give the nonparticipating owner a written invitation to participate in the risk and cost of drilling the well. N.D.A.C. § 43-02-03-16.3(1)(a). There are five items that the "invitation to participate in drilling must contain." Ibid. (emphasis supplied). None of the five items may be omitted and there is no provision in the law for any deviation from those items between the invitation to participate and the actual drilling of the well. Not even inconsequential changes are allowed for in the law—whether a change is substantial or not has no bearing on the assessment of a risk penalty. Gadeco respectfully agrees with Slawson when, in its brief, it argues that "the requirements of sections 38-08-08 and 43-02-03-16.3 must be strictly enforced." (Slawson Br., ¶ 20.) The conclusions that

Slawson and the NDIC ask this Court to reach fail to enforce those code sections strictly.

[8] The five items that are absolutely required in an invitation to participate are as follows:

> (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.

N.D.A.C. § 43-02-03-16.3(1)(a). These items are required without exception and are clearly specified in the regulation. The first three items contain factual information about the well: where it will be drilled from and to, when it will be drilled, and how much each line item expense of drilling will be. The other two items are simply boilerplate notice to the nonparticipating owner.

C. Slawson's invitation to participate in the Coyote well did not comply with N.D.A.C. § 43-02-03-16.3(1)(a)

[9] The name of the well is not one of the items required to be included in the invitation to participate. On July 8, 2009, Slawson sent to Gadeco an invitation to participate in a well named "Coyote #1-32H." (NDIC App., pp. 8-11.) As it relates to the three factual items required by the administrative code, the letter indicated the following: surface location in southwest quarter of southeast quarter (SW1/4SE1/4) of Section 32, Township 152 North, Range 92 West, in Mountrail County; estimated spud date of August 25, 2009; total cost of $4,219,256 itemized in an attached AFE (authorization for expenditures). (NDIC App., p. 9.) In a letter dated July 15, 2009, Slawson sent to Gadeco a letter that changed the surface location and estimated spud date of the well to a different section and more than a month later. (NDIC App., p. 13.) An updated AFE was not included, but the NDIC found that the actual well that Slawson drilled and named the Coyote #1-32H came in at $3.4 million, well below the estimated $4.2 million stated in its invitation to participate. (NDIC App., p. 46.) At the very least, Slawson has argued that the itemization of estimated costs changed, while the estimated total might not have, because it drilled the well from an existing well site after moving the surface location. Ibid.

[10] The NDIC argues that the evidence "supports the Commission's finding that Slawson met the requirements for a valid invitation to participate." (NDIC Br., p. 13.) This is accurate, as to the originally planned Coyote #1-32H well. However, no evidence whatsoever supports the conclusion that the well actually drilled met the specifications of the invitation to participate that was sent to Gadeco.

[11] In short, of the three factual items required in an invitation to participate, Slawson changed all three. Slawson did, indeed, invite Gadeco to participate in a well named the Coyote #1-32H—a well with a specific location, estimated spud date, and itemization of estimated costs. It later drilled a well bearing the same name but in a different location with a different estimated spud date and different itemization of estimated costs. The well that Slawson actually drilled was not the same well that it invited Gadeco to participate in. Slawson nevertheless argues that no changes were made and that Gadeco was invited to participate in the Coyote well. The language its brief emphasizes from the administrative code demonstrates clearly that the understanding of the code it urges on the Court is in error.

1. The actual location of the well is a mandatory fact to be included in the invitation to participate

[12] Slawson quotes the administrative code with emphasis on the word "proposed." (Slawson Br., ¶ 23.) In doing so, it incorrectly parses the language of the code. The risk penalty provisions apply to two kinds of wells: proposed wells that are to be spudded and existing wells that are to be reentered. The word "proposed" in the administrative code modifies the word "well"—not, as Slawson appears to suggest, the word "location." N.D.A.C. § 43-02-03-16.3(1)(a)(1). The actual location of the proposed well is not optional and not subject to change after the invitation to participate is sent. A new invitation to participate is required if the well location changes. There is no room in the administrative code for changes in the location of the well of any sort, even if a court finds that the changes are not substantial.

[13] There is no dispute that the Coyote #1-32H was not drilled in the SW1/4SE1/4 of Section 32, Township 152 North, Range 92 West, the location stated in the original invitation to participate. It was actually drilled in the NW1/4NE1/4 of Section 5, Township 151 North, Range 92 West, approximately one quarter-mile south of the original location.

[14] The NDIC argues that "[t]he change to the surface location might make a difference to Gadeco, but only if it increased the cost of the well." (NDIC Br., p. 20.) The NDIC cites no authority for this argument. The

regulation requires that the location of the well be stated in the invitation to participate. The invitation did not state the location of the well. It has no bearing whether changing the location would change the itemized cost of the well (which it actually did). Contrary to the NDIC's argument, Todd Slawson testified at the hearing that moving the location "saved money on the location, but [cost] a little bit extra money to… drill across the road." (NDIC App., p. 26.)

2. The itemization of costs cannot be changed after the invitation to participate is sent

[15] The administrative code requires that an "itemization of estimated costs of drilling and completion" be included in the invitation to participate. N.D.A.C. § 43-02-03-16.3(1)(a)(2). There is room for estimation of the actual value of each line item of cost as, in the real world of drilling oil wells and any other economic activity, some items will simply go over budget and others will come in below the budgeted cost. But the itemization itself cannot be estimated. The actual cost items that will be incurred in drilling and completing the proposed well must be specified in the invitation. It is undisputed that the itemization changed between the original invitation for the Coyote #1-32H well and the updated letter that Slawson sent to Gadeco on July 15, 2009, even if the estimated total did not.

[16] The NDIC points out that only the estimated costs must be stated in the invitation to participate. (NDIC Br., p. 20.) This is true, but the

itemization of costs itself changed when Slawson moved the well and changed the spud date. The actual itemization must be stated in the invitation to participate, although the actual numbers that are itemized may be estimated.

3. The approximate spud date may be an approximation but also cannot be changed after the invitation to participate

[17] The administrative code also allows room for the spud date to be an approximation. N.D.A.C. § 43-02-03-16.3(1)(a)(3). Delays in receiving equipment or personnel, the North Dakota weather, and any number of other factors may result in the well actually being spudded on a date other than the approximate one stated in the invitation to participate. There is no dispute that the approximate spud date was changed by over a month, from August 25, 2009 to September 27, 2009, after the initial invitation to participate was sent to Gadeco. (NDIC App., p. 13.) September 27, 2009 is not approximately the same as August 25, 2009 in the context involved here. From the date on which notice was mailed of the approximate spud date to the approximate spud date itself was only 48 days. The revised approximate spud date was 33 days later, an increase of 69%.

[18] On a geological timescale, dates about a month apart are approximately the same, but on an oilfield drilling timescale they are not. The approximate spud date was changed—an actual change that Slawson

acknowledged in finding it necessary to send a letter giving Gadeco the updated date.

D. The NDIC incorrectly applied the codified regulations in assessing a risk penalty against Gadeco

1. The interpretation of the administrative code must be reasonable and must respect the plain language of the code

[19] Slawson argues that the NDIC "has a reasonable range of informed discretion in the interpretation and application of its own rules." (Slawson Br., ¶ 28.) It points out that "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." Ibid. (citing In re Application for Permits to Drain Stone Creek Channel, 424 N.W.2d 894, 900 (N.D. 1988)).

[20] The latter part of this argument can be dismissed out of hand. The language in the administrative code relevant to this appeal consists of the following terms: location, itemization, and approximate date. None of these terms is so technical that a specialized agency is required to understand them—indeed, if they were, then they would likely fall short of due process requirements in informing parties by regulation what is required in giving and in responding to an invitation to participate. There is also no ambiguity to be found in these terms, on their own or in their context within

the administrative code. A location is where the well is drilled, and the SW1/4SE1/4 of one section is not the same location as the NW1/4NE1/4 of a different section. An itemization is a particularized list of items. (See Merriam-Webster Dictionary entries for "itemization" and "itemized.") Adding or removing items changes the itemization. An approximate date is a "nearly correct or exact" date. (See Merriam-Webster Dictionary entry for "approximate.") August 25 is not a nearly correct or exact way of saying September 27.

[21] In this instance, the NDIC's conclusions do not fit into its reasonable range of informed discretion. Those conclusions do not respect the plain language of the law and should be reversed.

[22] Slawson argues that "nowhere in section 43-02-03-16.3 does it provide for or reference a new well proposal or resetting the election time period." (Slawson Br., ¶ 30.) This is true and there is a reason for it: Section 43-02-03-16.3 sets the rules for giving invitation to participate in a proposed well. If a different well is proposed, then a different invitation is required under that section. Slawson's argument presupposes that omission from the code allows for its own omission of a new invitation when it changed every relevant fact about the proposed Coyote #1-32H well between inviting other owners to participate and drilling the well. By the same logic, Slawson would be allowed to assess a risk penalty when drilling any well anywhere in North

Dakota on any date and with any itemization of costs, so long as it named the well Coyote #1-32H. This is not a logical application of North Dakota law.

[23] The NDIC argues that its "conclusion that Slawson adhered to the requirements for a valid invitation is consistent with the clear and unambiguous language of the rule." (NDIC Br., p. 20.) It makes no attempt to explain how Slawson's changes to the location, itemization of costs, and spud date adhere in any way to the requirements for a valid invitation. Slawson's initial invitation adhered to those requirements for a Coyote #1-32H well drilled in the SW1/4SE1/4 of Section 32, Township 152 North, Range 92 West with the itemization of costs that it sent on July 8, 2009, with an approximate spud date of August 25, 2009. However, Slawson did not drill a well matching those specifications, but instead drilled a well of the same name in another location, with different itemized costs, on a different approximate spud date. Slawson's invitation to participate may have adhered to the regulatory requirements for one well, but it drilled a different well and it never gave Gadeco an invitation that adhered to the requirements for the well it actually drilled.

[24] The requirements of the administrative code are not optional and a reasonable interpretation is one that follows their plain meaning. Their plain meaning does not allow Slawson to change the location, itemization of costs, and approximate spud date of a well and still unilaterally assess a risk

penalty. The NDIC's argument that it is entitled to deference in allowing Slawson to do so finds no support in the plain, unambiguous regulation on risk penalties. That deference is tempered by the requirement that the NDIC's decision be sustained by the law. The NDIC's decision would be entitled to deference if it actually interpreted and applied the regulation to the facts before it—but its decision is not entitled to any special treatment when it utterly ignores the plainly worded regulation, as it did here.

2. The administrative code does not allow for changes, regardless of whether they are substantial

[25] Slawson makes the argument that the changes in the Coyote #1-32H well "would have no effect on a working interest owner's overall decision to participate in the drilling of the Coyote Well." (Slawson Br., ¶ 31.) What Slawson fails to do is provide even a scintilla of legal support for the implied proposition that only material, substantial changes that would have an effect on the decision to participate in the well require a new invitation to participate. Its only argument is that the NDIC has a reasonable range of discretion in interpreting its own regulations and that the NDIC imposes those requirements. This argument is without merit: The NDIC does have discretion in interpreting its regulations, but it cannot simply read in requirements that are not stated in the regulations on an ad hoc basis, as it has done here.

[26] The administrative code states, in plain English, what an invitation to participate must include. It does not allow for non-substantial or immaterial changes in wells. It does not allow for changes that would not have affected a nonparticipating owner's decision to participate. Its plain language allows for no changes at all. Slawson's invitation to Gadeco included a location, itemization of estimated costs, and approximate spud date that were all changed after the invitation and before the well was drilled.

[27] A reasonable interpretation cannot change the regulation to the degree that the NDIC's conclusions require. The reasonable interpretation of the regulation, based on its plain language, is that Slawson drilled a different Coyote #1-32H well than the one it invited Gadeco to participate in on July 8, 2009. Any other conclusion is not sustained by the law or any reasonable interpretation of the law.

3. Even if non-substantial, immaterial changes can be made, the changes here were substantial and material

[28] There is no legal support offered by either Slawson or the NDIC to support the legal proposition that changes must be substantial and material in order to require a new invitation to participate be sent as a prerequisite to assessing a risk penalty. Nevertheless, there is no evidence in the record to support a conclusion that the changes were neither substantial nor material.

There was no expert testimony showing that a well drilled from the new surface location to the same bottom hole location would not result in long-term changes in production or costs of production for the well. There was no testimony that Gadeco could not have taken other action, such as drilling its own well, in light of the changed spud date and location. There was conflicting testimony about the changes in the itemization of costs for the well. This included Todd Slawson's admission under oath that the changed location would result in different costs being incurred. (NDIC App., p. 26.) He later testified expressly that the July 15 letter represented a change to the AFE. (NDIC App., p. 31.) The well was estimated to cost $50,000 more to drill as a result of the changed location. (NDIC App., p. 35.) While Gadeco responded to the July 15 letter by seeking to obtain the new AFE, it never received one. (NDIC App., p. 37.)

[29] If the law offers any support for the conclusion that only substantial, material changes require a new invitation to participate, the evidence here offers no support for the conclusion that the changes in the Coyote #1-32H well were neither substantial nor material.

E. Slawson's argument that not imposing a risk penalty on Gadeco would create havoc in the industry is not supported on the record

[30] Slawson argues that "[p]ermitting 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." (Slawson Br., ¶ 33.) Its argument finds no support in the law or in the record before the Court and should not be considered. Moreover, Slawson is not the industry's spokesman—its argument on behalf of the industry is undermined by the simple fact that Gadeco, another member of the industry, is before this Court arguing for the opposite.

[31] However, if the Court does consider matters outside the scope of this appeal in reaching its decision, then it should certainly consider those matters in context. A well owner absolutely should be able to, at some point, know with certainty whether a risk penalty can be assessed against nonparticipating owners. However, the circumstances here do not conflict with that certainty, as Slawson argues. Slawson's point that, "[o]nce 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 changes in the drilling plans." (Slawson Br., ¶ 33.)

[32] What Slawson does not recognize is that it did not comply with the substantive and procedural requirements necessary to assess a risk penalty. Those requirements are set out in N.D.A.C. § 43-02-03-16.3. Slawson changed all of the substantive facts of the well after sending its invitation to participate to Gadeco. It also does not explain how a change in the drilling

plans can be both likely and unforeseeable. In this instance, the changes it made to the drilling plans were quite foreseeable—so much so that Slawson informed Gadeco of some of them (leaving out the updated AFE) in writing long before the well was drilled.

[33] Slawson's policy argument also ignores the right of nonparticipating owners to make an informed decision of whether or not to participate in a well and their right to have some certainty in the identity of the well that they are electing not to participate in. Slawson changed all of the substantive facts of the well after inviting Gadeco to participate in it. Not just the location, not just the itemization of costs, and not just the approximate spud date, but all of these things were changed. If Slawson's argument is accepted and the Court reinstates the NDIC's order, then future wells can be changed in even more drastic ways without any notice to the nonparticipating owners.

[34] If lack of certainty would create chaos in the industry—a conclusion that Slawson reaches with no support in the law or record—then well operators should be required to give nonparticipating owners some certainty in the well that their election not to participate applies to. Until that much certainty is reached, it is unreasonable for the operator to expect certainty of which owners will be participating and which will be subject to a risk penalty. The lack of the former type of certainty—Gadeco's certainty of

which well it is electing not to participate in—creates chaos earlier than the uncertainty that Slawson complains of. Moreover, the uncertainty that Slawson fears is created by Slawson's own actions in changing the location, cost, and spud date of the well. Punishing Gadeco with a risk penalty for Slawson's actions is an absurd result that the law will not permit. M.M., 2010 ND 102, ¶ 12 (quoting Kappenman v. Klipfel, 2009 ND 89, ¶ 21, 765 N.W.2d 716).

F. The reason why Gadeco did not elect to participate in the originally planned Coyote #1-32H is immaterial to this appeal

[35] Gadeco did not make a timely election to participate in the Coyote #1-32H well that was to be drilled on approximately August 25, 2009 in the SW1/4SE1/4 of Section 32, Township 152 North, Range 92 West, with the itemization of estimated costs that was provided in the form of an AFE with Slawson's July 8, 2009 letter. Both Slawson and the NDIC dedicate part of their arguments in this case to Gadeco's failure to make that election being due to the invitation to participate sitting on someone's desk without being acted upon. They both ignore the fact that Gadeco contacted Slawson to inquire whether an immediate, in-person delivery of the election to participate in the well and check to Slawson's Denver, Colorado office would be acceptable, to which Todd Slawson responded that Gadeco should send those items to its Wichita, Kansas office by Federal Express. (NDIC App., p.

39.) Despite Slawson's request for the check to be sent to its Wichita office, it returned the check to Gadeco. Ibid.

[36] The question before the Court is not whether Gadeco had a good reason not to elect to participate in the well. The issue for the Court to resolve is whether the July 8, 2009 invitation to participate was a valid invitation for the Coyote #1-32H well that was actually drilled on approximately September 27, 2009 in the NW1/4NE1/4 of Section 5, Township 151 North, Range 92 West with a different itemization of estimated costs. That decision should be made based on the law—a law that requires the location, itemization of estimated costs, and approximate spud date to be set forth in the invitation to participate. Gadeco was never given an invitation to participate in the actual Coyote #1-32H well, and therefore a risk penalty cannot be assessed against it.

CONCLUSION

[37] In contrast to NDIC's decision, the district court's review in this case was based on a reasoned review of the applicable law. Slawson's invitation to participate in the Coyote #1-32H well did not adhere to the plain language of N.D.A.C. § 43-02-03-16.3 when the invitation is read in terms of the actual Coyote #1-32H well for which Slawson seeks to impose a risk penalty against Gadeco. Because the invitation did not relate to the actual well, a risk penalty cannot be assessed. The NDIC's decision is not sustained by the law and was properly reversed by the district court. The district court's judgment, which is both reasonable and sustained by the law, should be affirmed.

Dated this 15th day of September, 2011.

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CERTIFICATE OF SERVICE

I hereby certify that, on today's date, I served the foregoing document on the following by electronic mail transmission, pursuant to N.D. Sup. Ct. Admin. Order 14(D):

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Dated this 15th day of September, 2011.

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