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IN THE SUPREME COURT

FOR THE STATE OF NORTH DAKOTA

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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

REPLY BRIEF OF APPELLEE/APPELLANT SLAWSON EXPLORATION COMPANY

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INTRODUCTION

[¶ 1] The only question at issue in this appeal is whether the decision of the North Dakota Industrial Commission ("Commission"), to authorize a two hundred percent risk penalty pursuant to Section 38-08-08(3) of the North Dakota Century Code against Appellee Gadeco, LLC ("Gadeco"), is "sustained by the law and by substantial and credible evidence." N.D.C.C. § 38-08-14(3). Appellee/Appellant Slawson Exploration Company ("Slawson"), contends that the Commission's decision was supported by the law and substantial and credible evidence and must be affirmed. Slawson submits this brief in reply to the arguments made by Gadeco in its brief in this matter.

LAW AND ARGUMENT

I. Gadeco Misstates and Misconstrues the Applicable Standard of Review.

[¶2] Any party adversely affected by an order issued by the Commission may appeal first to the district court for the county where the property affected by the decision is located and then to the Supreme Court. N.D.C.C. § 38-08-14(1). The scope of review on appeal, however, is quite limited. "Orders of the commission 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). This is a more deferential standard than the legislature has afforded other state agencies under the Administrative Agencies Practice Act. *See* N.D.C.C. § 28-32-46. Indeed, this Court has explained that "substantial evidence" is "'such relevant evidence as a reasonable mind might accept as adequate to support a conclusion.' . . . [T]he possibility of drawing two inconsistent conclusions from the evidence does not prevent an administrative agency's finding from being supported by substantial evidence." *Amoco*

Prod. Co. v. N.D. Indus. Comm'n, 307 N.W.2d 839, 842 (N.D. 1981) (quoting *Citizens State Bank of Neche v. Bank of Hamilton*, 238 N.W.2d 655, 660 (N.D. 1976)).

[¶3] Notwithstanding the statutorily-mandated standard of review, Gadeco contends that the Commission's decision was purely legal in this case and therefore *de novo* review is appropriate. Gadeco Br. ¶ 3. Although Gadeco is correct that pure questions of law are often reviewed more stringently by this Court under the Administrative Agencies Practice Act, *see, e.g.*, *Geffre v. N.D. Dep't of Health*, 2011 ND 45, ¶ 26, 795 N.W.2d 681, Gadeco's argument ignores the applicable standard of review when reviewing an order issued by the Commission. In such a circumstance, the Commission's decision must be affirmed if its application of the law to the particular facts of the case is "sustained by the law and by substantial and credible evidence." N.D.C.C. § 38-08-14(3). Thus, even if the Commission's order is merely one of several "possible" conclusions, it must be affirmed. *Amoco Prod. Co.*, 307 N.W.2d at 842. It need not be the only rational decision that could be reached, or even, in the Court's view, the best decision. This Court has repeatedly emphasized its "reluctance to substitute its own judgment for that of qualified experts in matters entrusted to administrative agencies." *Id.* (quoting *Bank of Hamilton v. State Banking Bd.*, 236 N.W.2d 921, 925 (N.D. 1975)) (quotation marks omitted); *In re Bank of Rhame*, 231 N.W.2d 801, 811 (N.D. 1975); *see also Hanson v. Indus. Comm'n of North Dakota*, 466 N.W.2d 587, 590–91 (N.D. 1991).

[¶ 4] Here, the Commission's decision was not purely a question of law. Rather, the Commission made certain findings of fact and conclusions of law based on the evidence before it. Those findings must be sustained if supported by substantial and

credible evidence and supported by the law. Gadeco misstates and misconstrues the more deferential standard of review this Court must apply in this instance.

[¶ 5] This Court has described its procedure for reviewing a Commission decision as a three-step process: (1) Are the findings of fact supported by substantial evidence? (2) Are the conclusions of law sustained by the findings of fact? (3) Is the agency decision supported by the conclusions of law? *Amoco Prod. Co.*, 307 N.W.2d at 842. This Court is "required to accord greater deference to Industrial Commission findings of fact than we ordinarily accord to other administrative agencies' findings of fact." *Hanson*, 466 N.W.2d at 590. Pursuant to this more deferential standard, this Court must decide whether or not there was substantial evidence to support the Commission's conclusion that Gadeco is a non-participating mineral interest owner and Slawson is entitled to recover a risk penalty against it. Also, "[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. Slawson Complied with the Requirements of N.D.A.C. § 43-02-03-16.3(1)(a).

[¶ 6] Based on the substantial and credible evidence before it, the Commission determined that Slawson complied with all of the requirements necessary to impose a risk penalty against Gadeco. Despite Gadeco's implications to the contrary, the material facts, as set forth in Slawson's initial brief, are, in large part, undisputed. The applicable statute and rule provide that Slawson, as the operator of the Coyote Well, may collect a risk penalty from non-participating owners as long as certain requirements are met. Specifically, the Commission concluded that Slawson was required to, and did, in fact,

issue a valid well proposal, offering Gadeco an opportunity to participate in the cost of drilling the Coyote Well. The parties agree that the well proposal issued by Slawson contained each of the elements required by the rule:

> (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) (emphasis added). It is also undisputed that Gadeco did not respond to Slawson's invitation within the thirty-day time limit imposed by the rule. *See* N.D.A.C. § 43-02-03-16.3(1)(b).

[¶ 7] However, for the first time in its brief to this Court, Gadeco claims that Slawson's well proposal did not comply with N.D.A.C. § 43-02-03-16.3(1)(a). Gadeco Br. ¶¶ 9-11. More specifically, Gadeco asserts that while Slawson's well proposal contained all of the information required by Section 43-02-03-16.3(1)(a), it was nonetheless an invalid invitation because Slawson did not drill the well as proposed. *Id.* Not only is this a different position proffered by Gadeco before the Commission and the district court, it is wholly without merit.

[¶ 8] Gadeco contends that any changes to the drilling plan subsequent to the issuance of a valid well proposal, regardless of whether the changes have the potential to

impact the cost of drilling and completing the Coyote Well or the non-operating interest owner's decision to participate, necessitates a new invitation. Gadeco's contention is not supported by the law, and if adopted by this court, would have a profound and negative impact on oil and gas development. The Commission, which is charged with effectuating the public interest in oil development, promulgated Section 43-02-03-16.3(1)(a) and in doing so, allowed for a degree of flexibility in the information provided by the operator to the non-operating interest owners. Specifically, the rule requires the operator to provide the *approximate* spud date and an itemization of the *estimated* costs of drilling and completion. The Commission, in promulgating Section 43-02-03-16.3(1)(a), recognized that changes in drilling plans often occur for various reasons, most of which are unforeseen by the operator when well proposals are typically issued. The rule anticipates the types of changes that Slawson communicated to Gadeco in the July 15, 2009 letter. Gadeco is unable to identify any support or authority for its bald assertion that Slawson was required to issue a new well proposal in light of these changes. Nothing in the rule or statute calls for a new well proposal under the circumstances present here. Rather, the Commission, after weighing the evidence before it, determined that these changes did not justify or even play a part in Gadeco's admitted failure to timely respond with a written election to participate in the Coyote Well.

A. Rigid Information or Firm Numbers are Not Required.

[¶ 9] The plain language of Section 43-02-03-16.3(1)(a) demonstrates that a well proposal must contain estimates of the drilling and completion costs and spud date. Firm numbers and rigid information are not required as urged by Gadeco. Section 43-02-03-16.3(1)(a) requires an "itemization of the estimated costs of drilling." Although the

itemized costs of drilling the Coyote Well were modified because of a change in the surface location, the uncontroverted testimony before the Commission confirmed that the overall cost remained the same. (App. 33, II. 3-10; App. 34, II. 1-12; App. 35, II. 7-14). Drilling costs rose slightly, but that increase was offset by a reduction in costs because Slawson was able to reuse an existing wellpad that had been built for a neighboring well. (*Id.*). Moreover, a change of approximately $50,000 cannot be considered material, when such a change amounts to only two percent of the overall estimate of $4.2 million. This is particularly true where, as here, the overall cost of drilling the Coyote Well came in at $3.4 million, well below Slawson's estimate.

[¶ 10] Likewise, the delay in the spud date did not invalidate the well proposal. Again, the statute requires an "approximate" spud date. Even with the delay, Slawson began drilling operations well within the ninety-day deadline established by the rules. *See* N.D.A.C. § 43-02-03-16.3(1)(d). Gadeco has not presented any evidence that the change in the spud date affected the productivity of the well or the cost of drilling.

[¶ 11] Finally, as to the well location, it is undisputed that the rule provides that the well proposal must identify the location of the proposed well. However, contrary to the assertions made by Gadeco, the location of the proposed Coyote Well did not change. 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. 8-14). Slawson moved the *surface* location of the well to the south just across the section line into Section 5. (*Id.*). Section 32 continued to be the spacing unit for the well and the bottom hole and target location of the Coyote 1-32 H well remained unchanged. The July 15, 2009 letter from Slawson specifically advised Gadeco of the

same. (App. 13). Notwithstanding, Gadeco still failed to return a written election to participate within thirty days from receipt of the July 15, 2009 letter. (App. 10). Moreover, the decision to participate or not participate in the costs of drilling a particular well has nothing to do with the surface location of the well. It is the bottom hole or target location that matters, which did not change. Thus, the change in the surface location of the Coyote Well following the issuance of the well proposal did not necessitate a new invitation or 30-day period within which Gadeco could elect to participate.

B. The Commission Properly Determined that Gadeco is Subject to a Risk Penalty.

[¶ 12] The purpose of the risk penalty provisions is to compensate the participating owners for the risk inherent in drilling any well. If the well is dry, nonparticipating owners are out nothing. If oil and gas are discovered and extracted, participating owners receive a slightly larger share of the recovery to compensate them for the risk they took in putting up a share of the drilling costs at a time when it remained uncertain what the future production of the well would be. In short, the risk penalty provisions reduce the free-rider problem that can otherwise lower incentives to engage in costly mineral exploration. *See In re Kohlman*, 263 N.W.2d 674, 675–76 (S.D. 1978); Bruce M. Kramer, *Compulsory Pooling and Unitization: State Options in Dealing with Uncooperative Owners*, 7 J. Energy L. & Pol'y 255, 261–64 (1986).

[¶ 13] In order for the nonoperating owners to determine whether or not they wish to participate, the risk penalty regulations require the operator to provide a well proposal and give the nonoperating owners at least thirty days to consider whether or not to participate. Here, the changes made to the drilling plan would not affect the mineral owner's decision to participate. Indeed, Gadeco does not argue that the changes

impacted its decision—Gadeco simply missed the election deadline. Gadeco has adopted a creative litigation position in a desperate attempt to deflect attention away from its admitted failure to return a timely election. It was not necessary or required for Slawson to issue a new well proposal or restart the thirty-day clock based on immaterial changes in the estimates included in the well proposal. If the Commission intended to require firm numbers and rigid information, it would have drafted Section 43-02-03-16.3(1)(a) to require the same. It chose not to.

[¶ 14] The Commission is entitled to a reasonable range of informed discretion in the interpretation and application of its rules. *See Quarles v. McKenzie Pub. Sch. Dist. No. 34*, 325 N.W.2d 662, 670 (N.D. 1982). The Commission did not exceed its authority and was well within its discretion by determining that its own rules did not require a new well proposal or 30-day time period in which Gadeco could elect to participate. The Commission concluded that the changes to the surface location and the estimated spud date did not effect the costs of drilling the Coyote Well and thus, would have no effect on a non-operating owner's decision to participate. The Commission was well within its authority granted by the North Dakota Legislature and routinely recognized by this Court. This Court must refrain from substituting its judgment in place of the Commission's and affirm Order No. 14238.

CONCLUSION

[¶ 15] For the reasons explained herein, the Commission's Order No. 14238 must be affirmed.

DATED this 18th day of October, 2011.

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

I hereby certify that on October 18, 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
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Dated: October 18, 2011

/s/ Lawrence Bender
LAWRENCE BENDER

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