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Mines and Minerals - Contributions of Carried Parties to Expenses - Payment of Interest Are a Reasonable Actual Cost of Drilling and Operating a Well Pursuant to Section 38-08-08 of the North Dakota Century Code

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MINES AND MINERALS - CONTRIBUTIONS OF CARRIED PARTIES TO EXPENSES - PAYMENTS OF INTEREST ARE A REASONABLE ACTUAL COST OF DRILLING AND OPERATING A WELL PURSUANT TO SECTION 38-08-08 OF THE NORTH DAKOTA CENTURY CODE

In September 1981, Flying J Exploration and Production, Inc. (Flying J) completed the Skjelvik #4-35 well as a Red River producer.[1] On November 17, 1981, the Industrial Commission of the State of North Dakota (Commission) entered an order setting temporary spacing units for the development of the North Fork - Red River Pool at one well per 320 acres.[2] Imperial Oil of North Dakota, Inc. (Imperial) and Target Energies, Inc. (Target), who each owned oil and gas interests in the spacing unit, refused to share in the cost of drilling and operating the Skjelvik #4-35 oil well with Flying J.[3] On July 1, 1982, the Commission entered an order pooling all interests in the spacing unit for the Skjelvik #4-35 oil well.[4] Subsequently, on May 17, 1985 the Commission determined that pursuant to section 38-08-08 of the North Dakota Century Code, Flying J was entitled to reimbursement from Imperial and

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1. Imperial Oil of N.D., Inc. v. Industrial Comm'n, 406 N.W.2d 700, 701 (N.D. 1987).

2. *Id.* The Skjelvik #4-35 well was included in a 320 acre spacing unit as a result of the Commission's order. *Id.* The order precluded any other oil and gas interest owners within the 320 acre spacing unit from drilling additional wells in the spacing unit. *Id.*

3. *Id.* Unsuccessful attempts had been made by the parties to voluntarily "pool" the interest of Flying J, Imperial and Target in the well. *Id.*

4. *Id.; see* N.D. CENT. CODE § 38-08-08(1) (1987). Subsection 38-08-08(1) of the North Dakota Century Code provides in relevant part: "In 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 operation thereof." *Id.* Compulsory pooling has been defined as "[t]he bringing together, as required by law or a valid order or regulation, of separately owned (or separate interests in) small tracts sufficient for the granting of a well permit under applicable spacing rules." 8 H. WILLIAMS & C. MEYERS, OIL & GAS LAW, MANUAL OF OIL & GAS TERMS 166 (1987).

5. *Imperial Oil,* 406 N.W.2d at 701; *see* N.D. CENT. CODE § 38-08-08 (1987). Section 38-08-08 of the North Dakota Century Code, which deals with compulsory pooling, provides in relevant part:

Target for interest paid on money used to construct the well.[5] Section 38-08-08 provides, in relevant part, that when a pooling order is entered, the pooling order must provide "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...."[6] Imperial and Target, as carried parties,[7] appealed the Commission's order that Flying J was entitled to reimbursement of interest from Imperial and Target for their proportionate shares of the interest cost incurred by Flying J in drilling and operating the well.[8] The district court upheld the Commission's order.[9] The North Dakota Supreme Court reversed the district court and *held* that section 38-08-08 of the North Dakota Century Code does not authorize the Commission to issue a pooling order which permits the operator of a well to charge interest as part of the carried party's proportionate share of the cost of drilling and operating a well.[10] *Imperial Oil of North Dakota, Inc. v. Industrial Commission,* 406 N.W.2d 700 (N.D. 1987).

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1. . . . 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 operation 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, his just and equitable share....

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 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 ... 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 his proportionate share of such expenses....

Id. (emphasis added).

6. N.D. CENT. CODE § 38-08-08 (1987). For the relevant text of § 3-08-08, see *supra* note 5.

7. See 8 H. WILLIAMS & C. MEYERS, *supra* note 4, at 115. A carried party is defined as "[t]he co-owner for whom costs are advanced under a carried interest arrangement. If one concurrent owner develops a tract and obtains production without the joinder of another or others, the latter may be entitled to recover a share of the production less a share of the costs." *Id.*

8. *Imperial Oil,* 406 N.W.2d at 701; *see* N.D. CENT. CODE § 38-08-08(2) (1987). For the relevant text of § 38-08-08(2). See *supra* note 5.

9. *Imperial Oil,* 406 N.W.2d at 702.

10. *Id.* at 703; *see* N.D. CENT. CODE § 38-08-08 (1987). For the relevant text of § 38-08-08, see *supra* note 5. Imperial and Target appealed to the district court, which affirmed the Commission's order. *Imperial Oil,* 406 N.W.2d at 702. Subsequently, Imperial and Target appealed the district court judgment to the North Dakota Supreme Court and raised issues relating to the following: (1) The failure of Commission members to hear the evidence and to specify the evidence relied upon; (2) the retroactivity of pooling orders; (3) whether interest is an actual cost of drilling and whether there was evidence that Flying J was charged or paid any interest; and (4) whether the case should be remanded for consideration of new evidence. *Id.* The court stated, however, that the

Imperial Oil is the most recent of several cases which have reached the North Dakota Supreme Court concerning disputes between parties involved in a spacing plan or compulsory pooling order.[11] These North Dakota Supreme Court cases rarely dealt with factual disputes.[12] Rather, almost all concerned questions of law.[13] Prior to *Imperial Oil,* the North Dakota Supreme Court had not decided whether the Commission could issue a pooling order permitting an operator to charge a carried party for interest paid by the operator on money borrowed to drill and complete a well.[14]

Prior to the enactment of the current spacing and pooling laws, the development and operation of oil wells was governed by the rule of capture in almost all jurisdictions.[15] Under the common-law rule of capture, a landowner could drill for oil or gas at will without becoming liable to adjacent landowners.[16] The rule of capture made it economically imperative that each mineral owner drill and produce oil and gas from his land as rapidly as possible; otherwise his land would be drained of oil and gas by wells on adjacent properties.[17]

The inevitable result of the rule of capture was obvious: there was a tendency to deplete each pool as fast as it was physically

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dispositive issue was whether § 38-08-08 of the North Dakota Century Code allows the operator of a well to recover interest from carried parties as part of the reasonable actual cost of drilling and operating a well. *Id.; see* N.D. CENT. CODE § 38-08-08, *supra* note 5. An operator of a well is defined as "any owner of the right, in whole or in part, to search for and produce unitized substances within the...Field" and "[a] person, natural or artificial (e.g. corporate) engaged in the business of drilling wells for oil and gas." 8 H. WILLIAMS & C. MEYERS, *supra* note 4, at 662-63.

11. *See* Amoco Prod. Co. v. North Dakota Indus. Comm'n, 307 N.W.2d 839, 848 (N.D. 1981) (evidence was sufficient to support Industrial Commission's conclusion that stand-up spacing of oil wells was required to protect correlative rights); Schank v. North Am. Royalties, Inc., 201 N.W.2d 419, 430 (N.D. 1972) (a spacing order standing alone without a pooling order did not operate as a de facto pooling of all fractional interests under the drill site); Tenneco Oil Co. v. State Indus. Comm'n, 131 N.W.2d 722, 726 (N.D. 1964) (proceeding for review of order of State Industrial Commission denying exception to regular spacing pattern in oil field). Compulsory unitization or pooling is defined as "[t]he bringing together, as required by law or a valid order or regulation, of separately owned tracts (or separate interests therein) into a unit constituting all or some portion of a producing reservoir and the joint operation of such unit." 8 H. WILLIAMS & C. MEYERS, *supra* note 4, at 167.

12. Anderson, *The Conservation of Oil and Gas in North Dakota,* 1 U.N.D.L. FAC. J. 1, 15 (1982).

13. *Id.*

14. *Imperial Oil,* 406 N.W.2d at 700.

15. *See* 8 H. WILLIAMS & C. MEYERS, *supra* note 4, at 869-70.

16. E. KUNTZ, J. LOWE, O. ANDERSON, & E. SMITH, OIL & GAS LAW 56 (1986) [hereinafter OIL & GAS LAW]. "Under [the rule of capture], absent some state regulation of drilling practices, a landowner, however small his tract, or wherever located on the producing structure, may drill as many wells on his land as he pleases and at such locations as meet his fancy, and he is not liable to the adjacent landowners whose lands are drained as a result of such operations." H. WILLIAMS & C. MEYERS, *supra* note 4, at 869-70.

17. 8 H. WILLIAMS & C. MEYERS, *supra* note 4, at 870. Pursuant to the rule of capture, the owner of a tract of land acquired title to the oil and gas which he produced from wells drilled upon his tract, even though oil and gas may have migrated from adjoining lands. Hardwicke, *The Rule of Capture and Its Implications as Applied to Oil and Gas,* 13 TEX. L. REV. 391, 393 (1935).

possible for the wells to produce the oil.[18] Landowners would continue to drill until declining production of old wells indicated that drilling a new well would not be cost efficient.[19] These practices resulted in very close spacing of wells in areas rich with oil and gas and wider spacing in areas of lower yield.[20] In addition, the density of drilling had no relation to the number of wells actually required to recover the oil located in the particular field, and, thus, there was tremendous waste in the form of unnecessary development costs.[21] This waste and reduced market prices, resulting from unrestricted production under the rule of capture, threatened to ruin the economies of states dependent upon a healthy oil industry.[22] Eventually, the legislatures of most oil and gas producing states enacted oil and gas conservation acts that inter alia limited a mineral owner's unfettered right to drill wells under the rule of capture.[23]

One significant limitation on drilling is commonly known as well spacing.[24] Well spacing modifies the rule of capture by limiting the number of wells that can be drilled on a designated tract of land.[25] "The purpose of well spacing is to prevent surface, underground and economic waste and to protect correlative rights."[26]

The most difficult problem of well spacing is the problem of multiple interests within a spacing unit.[27] If there is more than one

18. AMERICAN INST. OF MINING & METALLURGICAL ENGINEERS, PETROLEUM CONSERVATION 249 (S. Buckley ed. 1951).

19. *Id.*

20. *Id.*

21. *Id.*

22. *Id.*

23. 1 R. MEYERS, THE LAW OF POOLING AND UNITIZATIONS § 1.03, at 29 (1967). The establishment of drilling units or "spacing units" was the first step in restricting the rule of capture because it limited the number of wells that could be drilled on each unit. *Id.*

24. OIL & GAS LAW, *supra* note 16, at 58.

25. *Id.*

26. *Id.* at 59. Well spacing prevents surface waste because fewer wells will occupy the surface. *Id.* The use of fewer wells means less leakage prone equipment such as valves, fittings, pipes, and storage tanks. *Id.* Also, there will be less environmental impact to the surface. *Id.* In addition, well spacing prevents *underground waste* because the construction of fewer wells will result in a more efficient use of the natural reservoir energy; thus, the field will be effectively drained of all the oil and gas that is recoverable by conventional production methods. *Id.* Moreover, well spacing protects *correlative rights* because adjacent working interest owners are given an opportunity to recover a fair share of the oil and gas by drilling wells in accordance with a uniform drilling pattern. *Id.* Therefore, well spacing prevents unfair drainage by establishing minimum distance requirements between wells and between wells and property lines. *Id.*

27. *See id.* For an example of the problems involving multiple interests, suppose Able owns Blackacre, a ten acre tract in an oil field that must be developed on a forty acre spacing unit. *Id.* Assume also, that Baker owns Whiteacre, a thirty acre tract which is adjacent to Blackacre in the same spacing unit. *Id.* at 59-60. In the majority of the oil and gas producing states, including North Dakota, Able and Baker would have to "pool" their interests and drill one well in accordance with the forty acre spacing unit pattern. *Id.* at 60; *see, e.g.*, N.D. CENT. CODE § 38-08-08 (1987). For the relevant text of § 38-08-08, see *supra* note 5. If Able and Baker could not agree to a voluntary pooling of their interests, the conservation agency would, upon the request of any interested party, "force

owner of oil and gas rights within a spacing unit, the owners may voluntarily "pool" their interests in order to drill one well.[28] The owners in a voluntary pooling agreement will share proportionately in the cost of drilling and operating the well and will share proportionately in any production from the well according to the terms of the agreement.[29]

If, however, the owners of oil and gas rights within a spacing unit cannot reach a voluntary agreement to pool their interests for the development of the unit, a majority of producing states, including North Dakota, will "force pool" their interests.[30] In North Dakota, the Commission has the authority pursuant to section 38-08-08 of the North Dakota Century Code to order the pooling of all interests in the spacing unit for development and operation of the spacing unit, upon the application of any interested party.[31]

The most important issue to the owners of oil and gas rights in a spacing unit who have had their interests involuntarily pooled is how the costs, burdens, and risks of development will be divided among them.[32] Often the determination of costs, burdens, and risks of development is the only issue.[33] A majority of the states which have "forced pooling" or "compulsory pooling" statutes provide that an operator (the party who drills and operates a well) may recover from production all reasonable actual costs of drilling and production before having to account to carried parties for their share of production.[34] In North Dakota, pursuant to subsection 38-08-08(2) of the North Dakota Century Code, the operator is granted a lien on the share of production accruing to the interest of each carried party for the payment of each carried party's share of the drilling and operating expenses.[35]

Some statutes in other jurisdictions, including those of New York, Ohio, Pennsylvania, and West Virginia, provide that if an owner of oil and gas rights in a spacing unit has had his interests pooled and elects to be a carried party, the operator is entitled to

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pool" their interests according to the provisions of a compulsory pooling statute. OIL & GAS LAW, *supra* note 16, at 60. Once pooled, Able and Baker would proportionately share in the cost and production from the well drilled on the spacing unit. *Id.*

28. *See* OIL & GAS LAW, *supra* note 16, at 60.

29. *Id.*

30. *Id.*

31. *See* N.D. CENT. CODE § 38-08-08 (1987). For the relevant text of § 38-08-08, see *supra* note 5.

32. Swan and Hallock, *The Comparisons, Contrasts, and Effects of Compulsory Pooling Statutes,* 28 ROCKY MTN. MIN. L. INST. 911, 935 (1983).

33. *Id.*

34. *Id.*

35. N.D. CENT. CODE § 38-08-08(2) (1987) (integration of fractional tracts). For the text of § 38-08-08(2), see *supra* note 5.

double the share of costs chargeable to that carried party.[36] This type of a pooling order provision is referred to in the oil and gas industry as a "compensation for risk," "risk compensation," "risk bonus," or "risk penalty."[37] The "risk penalty" is intended to provide extra compensation from production (if oil is found) to the operator who advanced the entire drilling costs and would have had to absorb the entire cost if there was a "dry hole."[38]

Several Midwestern and Rocky Mountain states' statutes also impose a "risk penalty" or a "risk compensation" exceeding the operator's total actual cost incurred in drilling, completing, and equipping the well.[39] The states of Colorado, Nebraska, New Mexico, and Wyoming require that 200% of the carried party's share of all drilling, completion, and well-equipping costs be assessed.[40] Similarly, Illinois allows a 150% recovery of drilling and completion costs.[41] Consequently, each of these states effectively transfers some of the risk of drilling to the carried party

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36. *See* N.Y. ENVTL. CONSERV. LAW § 23-0901(3) (McKinney 1984) (operators are entitled to twice the carried party's share of the reasonable actual cost of drilling and operating the well); OHIO REV. CODE ANN. § 1509.27(F) (Page 1986) ("[t]he total amount receivable hereunder shall in no event exceed double the share of costs charged to such nonparticipating owners."); PA. STAT. ANN. tit. 58 § 408(c) (Purdon 1964) (operator is entitled to double the share of the costs payable by or charged to the interest of the nonparticipating owner); W. VA. CODE § 22-8-7(b)(6) (Supp. 1987) (same).

37. 8 H. WILLIAMS & C. MEYERS, *supra* note 4, at 158, 847-49. At first glance, risk penalties, seem to unduly penalize a carried party who does not want to drill a well in the first place. Swan and Hallock, *supra* note 32, at 941. Swan and Hallock noted that risk penalties are less severe than penalties knowledgeable operators would agree to if they volunteered to establish a similar venture. *Id.* Furthermore, Swan and Hallock stated that "[w]ithout a [risk penalty], no compulsory pooling order would be, just and reasonable, in the sense of including terms which reasonable men would insist upon and agree to in a voluntary agreement entered into for the same purpose." *Id.* This proposition holds true when the statute specifically allows or requires such a penalty, and when the statute merely requires just, fair, equitable, or reasonable terms. *Id.*

38. *Id.* at 940. A risk penalty also has the effect of encouraging owners of oil and gas interests to voluntarily participate up front in the cost of drilling and operating the well. Anderson, *New Directions in Oil and Gas Conservation Law,* 14 ROCKY MTN. MIN. L. FOUND. 16 (1985). Professor Anderson stated that North Dakota remains one of the few major producing states that does nothing to "encourage" working interest owners to voluntarily participate up front in the drilling of a well by a co-owner in that North Dakota does not authorize risk penalties to be levied against carried parties. *Id.*

39. Swan and Hallock, *supra* note 32, at 940.

40. *See* COLO. REV. STAT. § 34-60-116(7)(b)(II) (1984) (200% of that portion of costs and expenses); NEB. REV. STAT. § 57-909(2) (1984) (200% of that portion of the costs and expenses); N.M. STAT. ANN. § 70-2-17(C) (1978) (charge for risk shall not exceed 200% of the nonconsenting working interest owner's or owners' pro rata share of the cost of drilling and completing the well); WYO. STAT. § 30-5-109(g)(ii) (1977) (200% of that portion of the cost and expenses of drilling). The South Dakota Supreme Court has authorized its conservation commission to include risk penalties in pooling orders even though the South Dakota conservation act does not specifically authorize such penalties. *See In re* Kohlman, 263 N.W.2d 674, 679 (S.D. 1978) (the Board's order providing 100% risk penalty was reasonable under circumstances of the case).

41. *See,* ILL. ANN. STAT. ch. 96½, § 5436(d) (Smith-Hurd 1979) (150% of such person's share of the actual costs and expenses of drilling, testing and completing the well).

in the form of a penalty.[42] In addition, such penalties are routine in voluntary pooling agreements.[43]

North Dakota is among the few major oil producing states that do not provide for such risk penalties.[44] North Dakota's forced pooling statute, section 38-08-08 of the North Dakota Century Code, merely provides that the operator may recover from production (if any) the proportionate share of the reasonable actual cost of drilling and operating the well from the carried parties.[45] Section 38-08-08 does not, however, define in specific terms exactly what constitutes a "reasonable actual cost."[46]

The issue of whether interest on money borrowed to drill and complete a well was a reasonable actual cost of drilling has been previously addressed by the Oklahoma Supreme Court in *Wood Oil Co. v. Corporation Commission.*[47] In *Wood Oil Co.*, the plaintiff, an operator of a well, appealed the Corporation Commission's order which refused to allow it to recover interest from the carried parties on the cost of drilling and operating the well.[48] The Oklahoma Supreme Court determined that interest was not recoverable by an operator who failed to show that it had paid or was charged any interest on the funds it used in operating the well or that such expense was in any way necessary to obtaining the production.[49] The court, however, did not decide the larger issue of whether an operator could recover interest from a carried party if the operator was able to show that it actually paid or was charged interest.[50]

In an article written by Oscar Swan and Joseph Hallock, interest on a debt related to developing and operating a well was

42. Swan and Hallock, *supra* note 32, at 940. In Oklahoma, a risk penalty provision is seldom used, but it has been incorporated in a pooling order when the carried party is not actively engaged in the oil business. *See, e.g.*, Wakefield v. Oklahoma, 306 P.2d 305, 308 (Okla. 1957) (commission can make an exception if order would confiscate property or produce an undue hardship). Generally in Oklahoma, an operator must participate in a drilling venture or suffer the forced sale of his interest. *See, e.g.*, Miller v. Corporation Comm'n, 635 P.2d 1006, 1007 (Okla. 1981) (Corporation Commission established a pooling order with a bonus of $75 per acre and one-eighth royalty interest to be paid owners in lieu of participation).

43. Swan and Hallock, *supra* note 32, at 937.

44. Interview with Owen Anderson, Associate Professor of Law, University of North Dakota School of Law in Grand Forks (Sept. 22, 1987).

45. *See* N.D. CENT. CODE § 38-08-08(2) (1987) (integration of fractional tracts). For the relevant text of § 38-08-08, see *supra* note 5.

46. *See id.*

47. 268 P.2d 878 (Okla. 1953).

48. Wood Oil Co. v. Corporation Comm'n, 268 P.2d 878, 885 (Okla. 1953). In *Wood Oil Co.*, there was no evidence introduced before the Commission to show that the plaintiff was charged or had actually paid any interest on the funds it used in obtaining production. *Id.* Thus, the Commission's order did not include interest as a cost of completing the well. *Id.*

49. *Id.* The Oklahoma Supreme Court concluded, that because Wood Oil did not introduce evidence that it had paid interest on the money used to develop and operate the well, the Commission committed no error in refusing, by its order, to add an interest charge to the well's actual operating cost for the purpose of the adjustment of obligations between the parties. *Id.*

50. *See id.*

identified as an item of actual cost recoverable by an operator in a forced pooling arrangement.[51] Swan and Hallock stated that:

> It seems...that the designated operator should be entitled to recover interest on money spent by him for the benefit of all in accordance with a pooling order. If he had not had to borrow the money on his credit both for his share and the nonparticipant's share, he could have invested what he put up for his uncooperative partner.[52]

The failure to allow reasonable interest under these circumstances, according to Swan and Hallock, would give a carried party an undeserved free ride.[53]

The North Dakota Supreme Court did not address the issue of whether interest, which was paid by an operator on money borrowed to drill and develop a well, may be recovered in a forced pooling arrangement as an item of reasonable actual cost until *Imperial Oil of North Dakota, Inc. v. Industrial Commission.*[54] Imperial and Target, whose oil and gas interests were involuntarily pooled with Flying J, contended that the Commission should not have allowed Flying J to recover interest as an item of reasonable actual cost pursuant to section 38-08-08 of the North Dakota Century Code.[55] The Commission contended that interest could be recovered by an operator who had been required to pay interest to develop the well and who had presented evidence of this cost.[56]

The North Dakota Supreme Court limited its discussion to whether section 38-08-08 of the North Dakota Century Code allowed the operator of a well to recover interest from carried parties as a part of the reasonable actual cost of drilling and operating a well.[57]

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51. Swan and Hallock, *supra* note 32, at 936.

52. *Id.*

53. *Id.*

54. 406 N.W.2d 700 (N.D. 1987).

55. Imperial Oil of N.D. Inc., v. Industrial Comm'n, 406 N.W.2d 700, 702 (N.D. 1987); *see* N.D. CENT. CODE § 38-08-08 (1987) (integration of fractional tracts). For the relevant text of § 38-08-08, see *supra* note 5.

56. *Imperial Oil,* 406 N.W.2d at 702. The Commission relied upon *Wood Oil Co.* for the proposition that the operator of a well may recover interest from a carried party as part of the reasonable actual cost of drilling and operating a well. *Id.* For a discussion of *Wood Oil Co.*, see *supra* notes 47-50 and accompanying text.

57. *Imperial Oil,* 406 N.W.2d at 702; *see* N.D. CENT CODE § 38-08-08 (1987) (integration of fractional tracts). For the relevant text of § 38-08-08, see *supra* note 5. Initially, the North Dakota Supreme Court analyzed the standard of review applicable to the Commission's order allowing for interest and held that administrative agency decisions on questions of law are fully reviewable on appeal. *Imperial Oil,* 406 N.W.2d at 702. The court determined that whether the Commission has the authority to order a carried party to pay interest to the operator of a well under § 38-08-08 of the North Dakota Century Code is a question of law and therefore, is fully reviewable. *Id.; see* N.D. CENT. CODE § 38-08-08 (1987) (integration of fractional tracts). For the relevant text of § 38-08-08, see *supra* note 5.

The court believed that an interest charge is in the nature of a "risk capital charge," a "nonconsent penalty," or a "risk penalty" and not a reasonable actual cost assessable to the carried parties pursuant to section 38-08-08 of the North Dakota Century Code.[58] The court rejected the Commission's argument that *Wood Oil Co. v. Corporation Commission* stood for the proposition that interest which was actually shown could be recovered.[59] The court stated that *Wood Oil Co.* did not determine whether an operator could ever recovery interest from a carried party, but rather only concluded that interest could not be recovered by an operator who had failed to show that he in fact incurred an actual interest expense.[60] Therefore, the court determined that absent a statute to the contrary, interest expense incurred by an operator in drilling and operating a well is an additional hazard (risk penalty) to the operator's payout in situations in which a carried party has had his interests in the spacing unit pooled against his will under section 38-08-08 of the North Dakota Century Code.[61]

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58. *Imperial Oil,* 406 N.W.2d at 703; *see* N.D. CENT. CODE § 38-08-08 (1987) (integration of fractional tracts). For the relevant text of § 38-08-08, see *supra* note 5. Risk penalty is a synonym for nonconsent penalty and is defined as follows:

> A penalty against a party to a joint venture, a joint operating agreement, or a pooling or unitization agreement who did not agree in advance to participate in the costs of drilling, reworking, deepening, or plugging back of a particular well by the operator or another party to the agreement.

8 H. WILLIAMS & C. MEYERS, *supra* note 4, at 849.

Chief Justice Erickstad, writing for the majority, pointed out that in 1985 the Legislative Assembly failed to pass a bill which would have provided for a 200% risk penalty. *Id.; see* H.R. 1655, 49th Leg. Assembly (1985) N.D. SEN. J. 1965 (providing for a 200% risk penalty). Chief Justice Erickstad made reference to this failed bill as evidence that the Legislature did not intend to vest the Commission, pursuant to § 38-08-08, with the authority to order a carried party to reimburse the operator of a well for interest paid by the operator in the development of the well. *Imperial Oil,* 406 N.W.2d at 703; *see* N.D. CENT. CODE § 38-08-08 (1987) (integration of fractional tracts). However, regardless of the intent of the 1985 Legislature, the failed 1985 bill is certainly not evidence of what the 1953 Legislative Assembly intended in passing the initial compulsory pooling statute. 1953 N.D. Laws 362-63.

In addition, Justice Erickstad cited an article by Professor Owen Anderson as authority for the proposition that an interest charge is similar to a risk penalty. *Imperial Oil,* 406 N.W.2d at 703 (citing Anderson, *Compulsory Pooling in North Dakota: Should Production Income and Expense Be Divided From Date of Pooling, Spacing, or "First Run?"* 58 N.D.L. REV. 537, 567 (1982)). Professor Anderson's article, however, concerns the retroactivity of pooling orders and does not deal with whether interest actually incurred and paid constitutes a reasonable and actual cost of production. *Id.* at 705-06 (Meschke, J., dissenting); *see* Anderson, *Compulsory Pooling in North Dakota: Should Production Income and Expense be Divided From Date of Pooling Spacing, or "First Run?"* 58 N.D.L. REV. 537, 563 (1982).

59. *Imperial Oil,* 406 N.W.2d at 702; *see Wood Oil Co.,* 268 P.2d at 885 (Okla. 1953) (interest not recoverable by operator who failed to show that interest was paid or charged). For a discussion of *Wood Oil Co.,* see *supra* notes 47-50 and accompanying text.

60. *Imperial Oil,* 406 N.W.2d at 702-03; *see Wood Oil Co.,* 268 P.2d at 885. It is important to note, however, that while *Wood Oil Co.* does not directly support the Commission's decision to order reimbursement for interest, it is also true that *Wood Oil Co.* would not directly support a contrary decision. *Imperial Oil,* 406 N.W.2d at 703.

61. *Imperial Oil,* 406 N.W.2d at 703; *see* N.D. CENT. CODE § 38-08-08 (1987) (integration of fractional tracts). For the relevant text of § 38-08-08, see *supra* note 5. The court rejected the argument that its decision in *Imperial Oil* will encourage some working interest owners to refrain from

The court, however, was not unanimous in its decision.[62] In his dissenting opinion, Justice Meschke asserted that interest on debt incurred for drilling and operating an oil well is a reasonable actual cost for the Industrial Commission to allocate to fractional operating interests pooled under section 38-08-08 of the North Dakota Century Code.[63] Contrary to the court's decision in *Imperial Oil,* Justice Meschke noted that the court has often recognized interest on related debt as a proper cost in computing damages in contract matters.[64] Therefore, Justice Meschke pointed out that nothing in the court's precedents was antagonistic to treating interest on related debt as a reasonable actual cost of commercial activities in the oil and gas industry.[65]

Justice Meschke recognized that Flying J was able to show "actual out-of-pocket costs" on money borrowed to finance the Skjelvik #4-35 well.[66] He believed that the failure to allow reasonable interest gave a carried party an undeserved free ride.[67] Justice Meschke agreed with Swan and Hallock that an operator should be entitled to recover interest on money spent by him or her for the benefit of all in accordance with a pooling order.[68] Furthermore, Justice Meschke concluded that when viewed in the larger context of "risk penalties" ranging up to 300 percent in other jurisdictions, interest of 12.72% as an actual cost charged to the fractional operating ownerships of Imperial and Target was surely reasonable.[69]

Justice Meschke further argued that there was no reason to confine the meaning of the statutory phrase "reasonable actual

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voluntarily pooling their interests for the development and operation of a spacing unit because carried parties would be able to get a "'free ride' on their proportionate share of drilling costs to the extent of interest expense incurred by the operator." *Imperial Oil,* 406 N.W.2d at 703. The North Dakota Supreme Court asserted that "owners who voluntarily pooled their interests and joined in a drilling venture would be able to control the costs of drilling and operating a well by contracting in regard to costs." *Id.* Consequently, the court believed that "[t]he opportunity to negotiate drilling costs in advance by participating in a drilling venture is an incentive to participate, even though no interest will be charged an owner who does not participate in the drilling venture." *Id.*

62. *See id.* at 704 (Meschke, J., dissenting).

63. *Id.* at 704; *see* N.D. CENT. CODE § 38-08-08 (1987). For the relevant text of § 38-08-08, see *supra* note 5.

64. *Imperial Oil,* 406 N.W.2d at 705 (Meschke, J., dissenting): *see, e.g.,* Hall GMC, Inc. v. Crane Carrier Co., 332 N.W.2d 54, 57 (N.D. 1983) (action brought for termination of distributorship agreement). Berg v. Hogan, 322 N.W.2d 448, 453-54 (N.D. 1982) (action for breach of contract against high bidder at auction who stopped payment on check).

65. *Imperial Oil,* 406 N.W.2d at 705 (Meschke, J., dissenting).

66. *Id.*

67. *Id.* at 706. Justice Meschke noted that the only detracting evidence against the conclusion that Flying J should be allowed to recover the interest paid in the development of the Skjelvik #4-35 well was that Flying J's interest was paid to its parent company, rather than to an outside creditor. *Id.*

68. *Id.* at 706; *see* Swan and Hallock, *supra* note 32, at 936.

69. *Imperial Oil,* 406 N.W.2d at 707 (Meschke, J., dissenting).

cost'' in section 38-08-08 of the North Dakota Century Code.[70] The Commission argued that it was a well recognized rule of statutory construction that words used in a statute are to be understood in their plain, ordinary meaning and that ''consideration should be given to the ordinary sense of statutory words, the context in which they are used, and the purpose which prompted their enactment.''[71] In addition, section 1-02-03 of the North Dakota Century Code provides that ''[t]echnical words and phrases and such others as have acquired a peculiar and appropriate meaning in law, or as are defined by statute, must be construed according to such peculiar and appropriate meaning or definition.''[72] Furthermore, Justice Meschke stated that great weight should be given to a reasonable construction of a regulatory statute adopted by the administrative agency charged with enforcement of the statute.[73] Accordingly, Justice Meschke determined that taken in its ordinary meaning, the term ''reasonable actual costs,'' as stated in section 38-08-08 of the North Dakota Century Code, should encompass the interest Flying J was required to pay to finance Imperial's and Target's proportionate share of the costs of the Skjelvik #4-35 well.[74]

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70. *Id.* at 704; *see* N.D. CENT. CODE § 38-08-08 (1987) (integration of fractional tracts). For the relevant text of § 38-08-08, see *supra* note 5.

71. Brief of Appellee, North Dakota Industrial Commission at 9, Imperial Oil of N.D., Inc. v. Industrial Comm'n, 406 N.W.2d 700 (N.D. 1987) (No. 11,222); *see* N.D. CENT. CODE § 1-02-02 (1987); *see also* Amoco Oil Co. v. Job Service North Dakota, 311 N.W.2d 558, 561 (N.D. 1981) (words are to be given their plain, ordinary, and commonly understood meaning during interpretation).

72. *See* N.D. CENT. CODE § 1-02-03 (1987); *see* Brief of Appellee, North Dakota Industrial Commission, at 9-10, Imperial Oil of N.D., Inc. v. Industrial Comm'n, 406 N.W.2d 700 (N.D. 1987) (No. 11,222). Webster's Dictionary definition of ''cost'' is the ''amount or equivalent paid or...charged...for anything'' or ''whatever must be given...to secure a benefit or accomplish a result.'' WEBSTER'S THIRD NEW INTERNATIONAL DICTIONARY 515 (1981). ''There can be no doubt that in this case the amount of interest paid by Flying J on borrowed funds was paid 'to secure a benefit or accomplish a result' (*i.e.,* the #4-35 well) and, therefore, the interest paid was a cost of drilling and operating the well.'' Brief of Appellee, North Dakota Industrial Commission, at 10, Imperial Oil of N.D., Inc. v. Industrial Comm'n, 406 N.W.2d 700 (N.D. 1987) (No. 11,222).

73. *Imperial Oil,* 406 N.W.2d at 704 (Meschke, J., dissenting). Justice Meschke believed that ''while an administrative decision on a question of law is fully reviewable on appeal, each ingredient of 'reasonable actual cost' ought to be a matter of fact for determination by the Industrial Commission.'' *Id.* at 705.

74. *See Imperial Oil,* 406 N.W.2d 700, 707 (Meschke, J., dissenting); *see* N.D. CENT. CODE § 38-08-08 (1987) (integration of fractional tracts). For the relevant text of § 38-08-08, see *supra* note 5. It can hardly be disputed that interest expense viewed from a technical sense by those involved in the oil and gas industry, as well as other businesses, are considered costs. The Financial Accounting Standards Board in *Statement of Financial Accounting Standards No. 34,* clearly recognizes that interest costs are costs of development. Brief of Appellee, North Dakota Industrial Commission, at 10, Imperial Oil of N.D., Inc. v. Industrial Comm'n, 406 N.W.2d 700 (N.D. 1987) (No. 11,22). The Financial Accounting Standards Board stated that based

> [o]n the premise that the historical cost of acquiring an asset should include all costs necessarily incurred to bring it to the condition and location necessary for its intended use,. . . the costs [interest] incurred in financing expenditures for an asset during a

Justice Meschke makes a convincing argument for treating interest as a reasonable actual cost of production.[75] Flying J was able to show that the Skjelvik #4-35 well had an average outstanding debt obligation of $2,228,718 upon which it incurred an average interest expense of $283,478, yielding a weighted average annual interest rate of 12.72 percent.[76] The interest paid by Flying J was "actual" in the sense that Flying J actually paid it and was able to show definite proof of expenditures for interest on the money borrowed to develop the Skjelvik #4-35 well.[77] In addition, the interest paid must have been "reasonable" since neither Imperial nor Target specifically objected to the rate of interest.[78] Moreover, as Justice Meschke pointed out, in light of past North Dakota Supreme Court decisions which recognize interest as a proper cost in determining damages in contract matters, it is difficult to understand the majority's opinion that interest could not be recovered as an element of actual cost in this situation.[79]

Consequently, as a result of the decision in *Imperial Oil,* carried parties in a compulsory pooling arrangement shall be given a working interest share of the production from a well but are not required pursuant to section 38-08-08 of the North Dakota Century Code to reimburse the operator for the carried parties' share of the reasonable and actual interest cost involved in the drilling and operation of the well.[80] This result discourages the drilling of co-owned property, has an adverse impact on the already depressed North Dakota economy, causes underground waste because the drilling of some "necessary wells" will not take place, and is not protective of correlative rights.[81] Therefore, in order to prevent these harmful consequences from materializing, the present

required construction or development period is itself a part of the asset's historical acquisition cost.

Id. at 11.

75. *See Imperial Oil,* 406 N.W.2d 700, 704-07 (N.D. 1987) (Meschke, J., dissenting). Justice Meschke believed that the majority had failed to provide any logical reasoning for treating interest as a risk penalty and not as an element of cost. *Id.* at 705. Justice Meschke, contrary to the majority, correctly interpreted Professor Anderson's article which merely addresses whether forced pooling should be retroactive to the date of first production and analyzes decisions concerning the retroactivity of pooling orders. *See id.* (citing Anderson, *Compulsory Pooling in North Dakota: Should Production Income and Expense Be Divided From Date of Pooling, Spacing or "First Runs?"* 58 N.D.L. REV. 537, 567 (1982)).

76. *Id.* at 701.

77. *See id.*

78. *See id.*

79. *See id.* at 705.

80. Imperial Oil of N.D., Inc. v. Industrial Comm'n, 406 N.W.2d 700, 704; *see* N.D. CENT. CODE § 38-08-08 (1987) (integration of fractional tracts). For the relevant text of § 38-08-08, see *supra* note 5.

81. *See* Anderson, *supra* note 38, at 16.

compulsory pooling statute should be construed contrary to the North Dakota Supreme Court's ruling in *Imperial Oil* so as to allow for the inclusion of interest and risk penalties;[82] in the alternative, the North Dakota Legislature should amend the compulsory pooling statute to expressly provide for interest and for risk penalties.

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82. *See Imperial Oil*, 406 N.W.2d at 704 (interest paid by operator is not a reasonable actual cost chargeable to carried parties).