BEFORE THE CORPORATION COMMISSION OF THE STATE OF OKLAHOMA

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CORPORATION COMMISSION
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APPLICANT:	**SANDRIDGE EXPLORATION AND PRODUCTION, L.L.C.**	)
RELIEF SOUGHT:	**DRILLING AND SPACING UNITS**	) **CAUSE CD NO. 201101983**
LAND COVERED:	**SECTION 36, TOWNSHIP 27 NORTH, RANGE 5 WEST, GRANT COUNTY, OKLAHOMA**	)

REPORT OF THE OIL AND GAS APPELLATE REFEREE

This Cause came on for hearing before **Michael Norris**, Administrative Law Judge for the Corporation Commission of the State of Oklahoma, on the 21st day of July, 2011, at 8:30 a.m. in the Commission's Courtroom, Jim Thorpe Building, Oklahoma City, Oklahoma, pursuant to notice given as required by law and the rules of the Commission for the purpose of taking testimony and reporting to the Commission.

APPEARANCES: **Roger Grove**, attorney, appeared on behalf of applicant, Sandridge Exploration and Production, L.L.C. ("Sandridge"); **Richard Grimes**, attorney, appeared on behalf of Mark Reents and Randi B. Smith (collectively the "protestants"); and **Jim Hamilton**, Assistant General Counsel for the Conservation Division, filed notice of appearance.

The Administrative Law Judge ("ALJ") filed his Report of the Administrative Law Judge on the 21st day of October, 2011, to which Exceptions were timely filed and proper notice given of the setting of the Exceptions.

The Appellate argument concerning the Oral Exceptions were referred to **Patricia D. MacGuigan**, Oil and Gas Appellate Referee ("Referee"), on the 2nd day of December, 2011. After considering the arguments of counsel and the record contained within this Cause, the Referee finds as follows:

STATEMENT OF THE CASE

THE PROTESTANTS APPEAL the ALJ's recommendation to grant the application of Sandridge requesting the Corporation Commission to issue an order vacating existing 40-acre drilling and spacing units created by Order No. 237338 for the Red Fork Sand, Mississippi Chat and Mississippi Lime common sources of supply for the captioned Section 36; creating a 640-acre drilling and spacing unit be established for the Tonkawa, Cottage Grove, Cleveland, Oswego and Cherokee common sources of supply underlying Section 36; and establishing a 640-acre horizontal drilling and spacing unit for the Mississippi chat and Mississippi Lime formations underlying said Section 36.

Sandridge requested that Order No. 583317 be extended for the Tonkawa, Cottage Grove, Cleveland, Oswego, Cherokee, Mississippi chat and Mississippi lime underlying lands in the northwest offset adjacent to the subject land. The development or trend of development indicates that such common sources of supply also underlie Section 36 and the drilling and spacing units requested by Sandridge for such common sources of supply should be established by enlarging the area covered by previous Order No. 583317. The protestants take issue with the 640-acre spacing and argue that 320-acre spacing is needed to protect correlative rights.

PROTESTANTS TAKE THE POSITION:

(1) The express provisions of 52 O.S. Section 87.1(b) provide for the right of a leased owner of mineral rights to exercise a right which is not the creature of private leasehold rights reserved to a lessor, but is the product of the conservation statute. The so called "Statutory Pugh Clause" is a legislative expression of the fact that when the Commission acts within its police power to establish drilling and spacing units, the result of such forced action is assurance that the leased owner will be protected from the affect of that action. In light of that vested right created by statute, the Commission must carefully consider whether the evidence presented in support of the largest unit allowed by law actually justifies removing the guaranteed protection of Section 87.1 (b).

(2) The ALJ erred in his conclusion that the purpose of spacing is to vest affected owners with a right to share in a certain percentage of production revenues. The purpose of spacing is strictly related to the goal of efficient development of a common source of supply. The result of that spacing is the sharing of revenues, rather than the purpose of same.

(3) The ALJ erred in stating that Sandridge presented evidence to support 640-acre horizontal spacing. The "flexibility" needed in this unit is the ability to drill a lateral a certain distance north to south. That flexibility is provided by the 320-acre spacing. The broader east to west range of location provided by 640-acre spacing was not proven to be necessary.

(4) The engineer for Sandridge admitted there is no evidence in the area of Section 36 to allow a conclusion as to how many additional wells will be required after the initial well. He knew that more than one well would be required, but he did not know how many more wells would be required. He said you need more production data before a conclusion can be reached. In the light of that fact, digress to the purpose of a "Statutory Pugh Clause" as codified in Section 87.1 (b). That clause guarantees to a owner whose interest is leased that only the acreage contained in a properly configured unit will remain subject to a lease if additional drilling is not timely commenced on perpetuated leasehold. The reason for that result has nothing to do with "private rights". It is designed to assure the existence of a working interest owner prepared to drill the necessary number of wells to develop a common source of supply. It is a "waste" preventive provision. In the present case Sandridge cannot even speculate as to when it will drill additional wells, or if at all. Yet it seeks the 640-acre spacing with the design to perpetuate its leasehold. That is a "private rights" purpose.

(5) The Protestants therefore request that the recommendation of the ALJ be reversed, and, that 320-acre horizontal drilling and spacing units be established in Section 36, which result will prevent the potential of waste.

THE ALJ FOUND:

(1) After taking into consideration all the facts, circumstances, evidence and testimony presented in this cause it was the ALJ's recommendation that the application of Sandridge be granted.

(2) Sandridge established evidence of the conditions necessary for the requested spacing and drilling unit. It was established that the well spacing requested has been employed in the area in the common sources of supply. Sandridge established that the nature and character of the prospective producing formations were found throughout the area. The spacing unit requested follows the orders creating spacing for these formations throughout the area and therefore complies with the statutory requirement that spacing units are in approximately uniformed size and shape. It has been established that the Commission has the authority to enlarge or extend boundaries of a common source of supply when indications demonstrate that an additional area should be included therein.

(3) Sandridge presented evidence that these formations are best developed with horizontal drilling techniques and require the 640 acre spacing for the best opportunity of an economic well. They further demonstrated that the 640 acre spacing unit for these particular formations will help prevent waste.

(4) The Protestants argued for 320 acre spacing for this unit. However, their evidence focused on the language of 52 O.S. Annotated Section 87.1 (b). The protestants have a legitimate consideration about the expiration of the primary term of their oil and or gas lease and the means by which it may be extended. Obviously the Protestants want the most advantageous spacing to optimize their interests. However, the important interest of correlative rights is secondary to the prevention of waste. The evidence demonstrated that the Protestants will share in the same amount for a well that is drilled on 320 acre spacing or 640 acre spacing. There is no economic difference to them.

(5) The Protestants have a legitimate and obvious reason for arguing for 320 acre spacing. Unfortunately, the time frame of the expiration of the primary term of a lease is not the primary consideration in spacing applications.

(6) As stated, Sandridge submitted evidence that units in the surrounding area have uniformly been spaced on a 640 acre basis. They also gave persuasive argument that 640 acre spacing provides more flexibility which in turn allows a greater probability of preventing waste. Sandridge met the conditions for a spacing application, gave considerable regard to correlative rights, conservation and the prevention of waste. For these reasons it is my recommendation that the application be granted.

POSITIONS OF THE PARTIES

PROTESTANTS

1) **Richard Grimes**, attorney, appearing on behalf of Mark Reents and Randi B. Smith takes exception to the October 21, 2011 report of the ALJ establishing a 640 acre drilling and spacing unit.

2) Protestants assert that this matter presents a unique issue concerning the concept of waste, rather than an issue of drainage, location, or flexibility as relied upon by Sandridge.

3) Protestants contend that the drilling and spacing unit was approved by the ALJ in a cursory manner.

4) Protestants state that Mark Reents and Randi B. Smith are the owners of an undivided one-half interest in the S/2 of Section 36, T27N, R5W, Grant County, Oklahoma (320 acres). Protestants also state that Mark Reents and Randi B. Smith have leased their interests (including their working interests) in the acreage to Sandridge.

5) Protestants relate that there are two concepts of waste prevention: the prevention of the drilling of unnecessary wells and the maximization of recovery.

6) Protestants assert that the ALJ did not give proper consideration to the maximization of recovery, and that the ALJ misconstrued his waste argument (i.e., recovery maximization) as a property rights argument.

7) Protestants cite 52 O.S. § 87.1(b), the Statutory Pugh Clause, and contend that because the legislature codified this section within the conservation statutes, it must have a conservation purpose.

8) Protestants assert that if Sandridge is granted a 640 acre drilling and spacing unit, 52 O.S. § 87.1(b) will be inapplicable; however, Protestants also maintain that if 320 acre units are granted instead, 52 O.S. § 87.1(b) will be of importance.

9) Protestants claim that the engineer for Sandridge stated that a horizontal well in the Mississippian will not effectively drain a 640 acre unit. Protestants assert that both a 640 acre drilling and spacing unit and two 320 acre drilling and spacing units in the section would afford Sandridge necessary flexibility in drilling a horizontal well.

10) Protestants assert that the recovery maximization principle derived from the inclusion of 52 O.S. § 87.1(b) among the conservation statutes directs the Commission to elect two 320 drilling and spacing units in this section. Protestants also assert that if a 640 acre drilling and spacing unit is granted, Sandridge will have an inappropriate degree of control in the direction of the drilling of the section.

11) Protestants reference the Sandridge engineer's testimony regarding the disparate levels of recovery of horizontal wells drilled in the Mississippi.

12) Protestants claim the Sandridge engineer admitted that a 640 acre unit would defeat the recovery maximization principle of 52 O.S. § 87.1(b), and that the purpose of a 640 acre unit was flexibility.

13) Protestants contend that the Sandridge's purpose for seeking a 640 acre unit is to perpetuate both leases. Protestants assert that the purpose of spacing is not to ensure the equitable distribution of royalty, but to ensure that

a damaging number of wells are not drilled. Protestants assert that spacing units must be established in fair proportion to the acreage drained by a well.

SANDRIDGE

1) **Roger Grove**, attorney, appeared on behalf of Sandridge in support of its application to establish a drilling and spacing unit.

2) Sandridge states its agreement with the protestants concerning the dual concepts of waste addressed by the conservation statutes.

3) Sandridge asserts that the prevention of the drilling of unnecessary wells is Sandridge's concern in this matter, and that this concern is of primacy.

4) Sandridge claims that the record is replete with the Sandridge engineer's testimony in support of a 640 acre unit, despite the contrary contentions of the protestants.

5) Sandridge asserts that the Sandridge engineer, in his testimony, stated that though the Mississippi is in the early stages of development, it is predictable that a 640 acre unit will take three horizontal wells to effectively drain.

6) Sandridge contends that to easily and effectively drain the section, a horizontal well will need to be drilled in the middle of the section. Sandridge also contends that a 640 acre unit is necessary to expeditiously drill this middle well (i.e., to avoid additional administrative proceedings and protests).

7) Sandridge asserts that a 640 acre unit would support the protestants concern of maximization of recovery.

8) Sandridge asserts that the uncertainties regarding the Mississippi demand flexibility and support a larger unit, rather than a mandate from the Commission regarding the minimum number of necessary wells to effectively drain a unit.

9) Sandridge contends that by seeking a 640 acre spacing unit, its application intended to maintain uniformity in the spacing units of the common source of supply that the section overlies, and that no evidence was presented in support of the protestants contention that Sandridge sought a 640 acre unit for lease perpetuation.

10) Sandridge cites *Wickham v. Gulf Oil*, 1981 OK 8, 623 P.2d 613, which holds that the Oklahoma Statutory Pugh Clause (52 O.S. § 87.1(b)) is not retroactive. Sandridge asserts that the facts of that case support the notion that the Statutory Pugh Clause was designed to address correlative rights issues. If a farmer owned an interest in three or four sections, the lease would cover all of those sections. Thus, one well in one section would hold that acreage in other sections. The Statutory Pugh Clause addresses this issue. If spacing 160 acres or more then you will have 90 days after the expiration of the primary term to develop those lands outside the spacing unit or you lose the lease.

11) Sandridge contends that the appropriate basis for the establishment of a drilling and spacing unit is scientific testimony of experts, rather than inferences drawn from the Statutory Pugh Clause. The Statutory Pugh Clause is not a reason for creating a certain size unit. That is based on the scientific testimony of the experts as to the appropriate size for a unit. The Commission doesn't create units based on land issues or ownership.

12) Sandridge reasserts that the Statutory Pugh Clause functions to protect correlative rights.

13) Sandridge references the ALJ's recommendations, particularly noting and agreeing with his assessment that the lessees will be in equal economic standing whether a 640 acre unit or two (2) 320 acre units are established in the section.

14) Sandridge reasserts that a 640 acre unit provides the necessary flexibility in drilling a horizontal well in the Mississippi, and the Sandridge engineer's testimony supported this notion.

15) Sandridge contends that the protestants allusion to the Woodford is inapposite because of the significantly greater detail known about the Woodford.

16) Sandridge notes the cost of drilling horizontal wells in the Mississippi (more than $3,000,000 per well), and asserts economic waste created by the significant cost of over drilling should be avoided.

17) Sandridge asserts the protestants' aim in this matter is to allow the lease in the southeast quarter of the section to expire in order that the protestants might seek a more lucrative lease or additional bonus.

18) Sandridge contends that uniform ownership incentivizes development of the leasehold, whereas separated ownership might inhibit the section's development (e.g., because of the separation of saltwater disposal facilities).

19) Sandridge asserts that the variability in the drilling of horizontal wells requires the need for larger drilling and spacing units. Sandridge cites Commission Rule 165:10-3-28 E-3 and the Shale Reservoir Redevelopment Act in support of this contention.

20) Sandridge cites CD 2010-2870, Order No. 582934, in which Chesapeake Energy was granted a 640 acre unit in the Mississippi Chat and Mississippi Lime for oil, arguing the same points presented by Sandridge (i.e., that two (2) 320 acre units would be wasteful and make drilling the third, middle horizontal well unnecessarily difficult in the administrative arena).

21) Sandridge again notes their agreement with the ALJ in this matter, specifically noting the ALJ's conclusion that the timeframe for the expiration of the primary term of a lease is not a primary consideration in a spacing application.

22) Sandridge reasserts that scientific testimony by experts is the appropriate manner to establish the size of a drilling and spacing unit.

23) Sandridge contends that the Statutory Pugh Clause was not intended to be a basis for establishing the size of a drilling and spacing unit.

RESPONSE OF PROTESTANTS

1) Protestants reassert that this application for a drilling and spacing unit was approved in a cursory manner.

2) Protestants contend that Sandridge provided insufficient evidence to support the necessity of drilling three horizontal wells in the section.

3) Protestants assert that *Wickham v. Gulf Oil Corp.*, supra, supports nothing beyond the proposition that the Statutory Pugh Clause is not retroactive.

4) Protestants claim that Mr. Reents and Ms. Smith are interested in the maximization of development in the section.

5) Protestants assert that the Chesapeake case is inapplicable because much more was known about the ability of the wells to drain the unit in that matter.

6) Protestants assert that the degree of variance in the Mississippi makes the ALJ's recommendation improper when it is based upon the sparse evidence presented.

CONCLUSIONS

The Referee finds the Report of the Administrative Law Judge should be affirmed.

1) The Referee finds the ALJ's determination to grant Sandridge's application to vacate existing 40 acre drilling and spacing units created by Order No. 237338 for the Red Fork Sand, Mississippi Chat and Mississippi Lime common sources of supply in Section 36; establish 640 acre drilling and spacing units for the Tonkawa, Cottage Grove, Cleveland, Oswego and Cherokee common sources of supply underlying Section 36; and establish 640 acre horizontal drilling and spacing units for the Mississippi Chat and Mississippi Lime formations underlying Section 36 is supported by the weight of the evidence, by law and free of reversible error. The ALJ found that the prevention of waste is paramount in the Commission's duties and must override the protection of correlative rights when in conflict. The Oklahoma Supreme Court in *Denver Producing and Refining Company v. State*, 184 P.2d 961 (Okl. 1947) held:

> In most instances it is impossible to use a formula which will apply equally to all persons producing from a common source. In striking a balance between conservation of natural resources and protection of correlative rights, the latter is secondary and must yield to a reasonable exercise of the former.

The Referee believes the Sandridge position favors the prevention of waste, which is of paramount consideration.

2) The Commission derives its jurisdiction under the state's conservation laws primarily from the spacing statute, 52 O.S. Section 87.1. 52 O.S. Section 87.1 provides in relevant part:

> (a) To prevent or to assist in preventing the various types of waste of oil or gas prohibited by statute, or any of said waste, or to protect or assist in protecting the correlative rights of interested parties, the Corporation Commission, upon a proper application and notice given as hereinafter provided, and after a hearing as provided in said notice, said have the power

> to establish well spacing in drilling units of specified and approximately uniform size and shape covering any common source of supply, or prospective common source of supply, of oil or gas within the state of Oklahoma;...

3) 52 O.S. Section 86.1(c) defines the term "common source of supply" as it pertains to the spacing statute and provides:

> 3. "Common source of supply" comprises and includes that area which is underlaid or which, from geological or other scientific data, or from drilling operations, or other evidence, appears to be underlaid, by a common accumulation of oil or gas or both....

4) It is clear under the conservation laws that Sandridge, as an owner with an interest in the minerals or a right to drill in the common sources of supply covered by the application has the right to apply for spacing of either the actual or prospective Tonkawa, Cottage Grove, Cleveland, Oswego, Cherokee, Mississippi Chat and Mississippi Lime common sources of supply so that the development of those common sources of supply can be pursued, waste prevented, and correlative rights protected. *May Petroleum Inc. v. Corporation Commission of State of Oklahoma*, 663 P.2d 716 (Okl. 1982); 52 O.S. Section 87.1; *Cameron v. Corporation Commission*, 418 P.2d 932 (Okl. 1966).

5) The engineer for Sandridge admitted there is no evidence in the area of Section 36 to allow a conclusion as to how many additional wells will be required after the initial well. He testified that more than one well would be required but he did not know how many more wells. The engineer for Sandridge also testified that 640 acre spacing for the production of gas from the Tonkawa, Cottage Grove, Cleveland, Oswego and Cherokee is appropriate as each of these common sources of supply underlie all or substantially all of the Section 36. The Referee notes that the Commission frequently has to establish uniform size and shape spacing units that never conform to the actual common source of supply. The Oklahoma Supreme Court has addressed this problem of creating spacing units when there is a scarcity of knowledge. A portion of the land encompassed in a spacing order may not be underlain by the common source of supply. The purpose of preventing economic waste cannot be accomplished if one must know the boundaries of a formation exactly before a unit is established, because this exact knowledge is obtainable only by drilling, and that drilling is of itself one of the economic wastes sought to be prevented by the statute. See *Panhandle Eastern Pipe Line Co. v. Corporation Commission*, 285 P.2d 847, (Okl. 1955); *Ward v. Corporation*

Commission, 470 P.2d 993 (Okl. 1970). The Referee refers the Commission to the Court's further discussion of this concept in *Panhandle Eastern Pipe Line Co. v. Corporation Commission*, supra, where the Court concluded:

> ...No provision requiring a common source of supply to be exactly defined by drilling operations before a well-spacing or pooling order may be entered with reference to it, has yet been enacted by our Legislature. Perhaps, until some means other than drilling is devised to conclusively ascertain productivity, such a statutory provision would be desirable as more certainly precluding the owner whose interest may not be underlain by the spacing area's common source of supply, or the productive part of the producing sand or structure, from participating in its production. But this might, in many instances, defeat the purposes of well-spacing and pooling. Our Legislature has apparently thus far been persuaded that chancing the possibility of some owners receiving benefits, to which subsequent explorations indicate they have not been entitled, is preferable to such a result. As the matter now stands, the lesser hazard is tolerated in preference to the greater hazard to the greater number of owners, and to the State in the dissipation of its natural resources by excessive drilling.

6) The Referee points out that the protestants did not present any witnesses and Sandridge's engineering expert believes the prospective common sources of supply exist in the area that Sandridge seeks to space on a 640 acre basis. While there is a concern and belief in the present case by the owners who will contribute to and share in the production of a well thereto, that those owners who do not contribute to the production, should not share in the production, the State as the matter now stands, must tolerate the lesser hazard of a greater number of owners in preference to the greater hazard to the State in the dissipation of its natural resources by excessive drilling. See *Panhandle Eastern Pipe Line Co. v. Corporation Commission*, supra; *Ward v. Corporation Commission*, supra.

7) Further, the protestants argue that 52 O.S. Section 87.1(b), "the Statutory Pugh Clause" is a legislative expression which protects a leased owner when the Commission uses its police power to establish drilling and spacing units. If a 640 acre unit were created it would incorporate and encompass all of the lease held by the protestants. The protestants own the entire 320 acres in the S/2 of the proposed unit. Those minerals are leased to Sandridge. There are two leases that were executed for these minerals with the

interest of Randy Smith subject to one of the leases and the interest of Mark Reents subject to the other lease. If this unit were created as to standup 320 acre units then 52 O.S. Section 87.1(b) stating "[in] case of a spacing unit of one hundred sixty (160) acres or more, no oil and/or gas leasehold interest outside the spacing unit involved may be held by production from the spacing unit more than ninety (90) days beyond expiration of the primary term of the lease," would come into play with two 320 acre units. If a 640 acre unit is the correct unit in this cause, then any rights the protestants may have had under Section 87.1(b) no longer exist, because all of the minerals will be within one unit. However, as stated above, the correlative rights issue of the protestants maintaining the most advantageous spacing to optimize their interests is secondary to the prevention of waste.

8) The Referee agrees with Sandridge that the Statutory Pugh Clause is not a waste prevention provision but is a provision dealing with correlative rights. The Statutory Pugh Clause addresses a situation where if a farmer owned an interest in three or four sections and his lease covered all of those sections one well in one of those sections would hold all of that acreage in the other sections. That's what the Statutory Pugh Clause was designed to address in cases of spacing units of 160 acres or more, you will have 90 days after the expiration of the primary term of the lease to develop these lands outside the spacing unit. If you do not do so, the lease would expire. See *Wickham v. Gulf Oil Corporation*, 623 P.2d 613 (Okl. 1981). The Statutory Pugh Clause is not a reason for creating a certain size unit. A reason for creating a certain size unit depends on the scientific testimony of the experts as to the appropriate size unit. The Commission does not create units based on land issues or ownership. The prevention of waste is the first and foremost component of our Conservation Statute with correlative rights being appropriately considered. The Statutory Pugh Clause does not establish a reason for creating a certain size unit. The Statutory Pugh Clause is strictly to explain what the effect will be if certain sized units are established. It is not a factor to be used in establishing those drilling and spacing unit sizes.

9) 640 acre spacing is the best unit size to prevent waste of hydrocarbons and economic waste of drilling unnecessary wells. The Sandridge engineer's testimony was that three wells would be needed to be drilled and 320 acre spacing would not facilitate the drilling of three wells. If three wells were drilled somebody on one side or the other side would effectively lose hydrocarbons to the well that will be closer to the center. If four wells were drilled in order to protect the correlative rights of one of the 320 acre spacing units you would definitely have economic waste. A larger 640 unit size gives the flexibility of locating the wells in approximation to their reserve drainage capabilities allowing the drilling of the wells to be spaced appropriately. See *Gilmore Oil Company v. Corporation Commission*, 61 P.2d 22 (Okl. 1936). The purpose of 52 O.S. Section 87.1 is to prevent the drilling of unnecessary wells.

See *Atlantic Richfield Company v. Tomlinson*, 859 P.2d 1088 (Okl. 1983); *Ward v. Corporation Commission*, 501 P.2d 503 (Okl. 1972).

10) The evidence reflected that most of the surrounding horizontal development has been predicated upon applications for 640 acre spacing for the subject formations. Order No. 583317 for Section 25, T27N, R5W, Grant County, Oklahoma provided for 640 acre spacing for the Tonkawa, Cottage Grove, Cleveland, Oswego, Cherokee, Mississippi Chat and Mississippi Lime common sources of supply. Order No. 585912 provided for 640 acre spacing in Section 26, T27N, R5W, Grant County, Oklahoma for the Tonkawa, Cottage Grove, Cleveland, Oswego, Cherokee, Mississippi Chat and Mississippi Lime.

11) For the above stated reasons, the Report of the ALJ should be affirmed, as the ALJ's recommendation is the best method of development of the common sources of supply to assist in the prevention of waste at this particular time.

RESPECTFULLY SUBMITTED THIS 25th day of January, 2011.

Patricia D. MacGuigan
OIL & GAS APPELLATE REFEREE

PM:ac

xc: Commissioner Murphy
Commissioner Anthony
Commissioner Douglas
Jim Hamilton
ALJ Michael Norris
Roger Grove
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