

Allocation Wells & Forced Pooling

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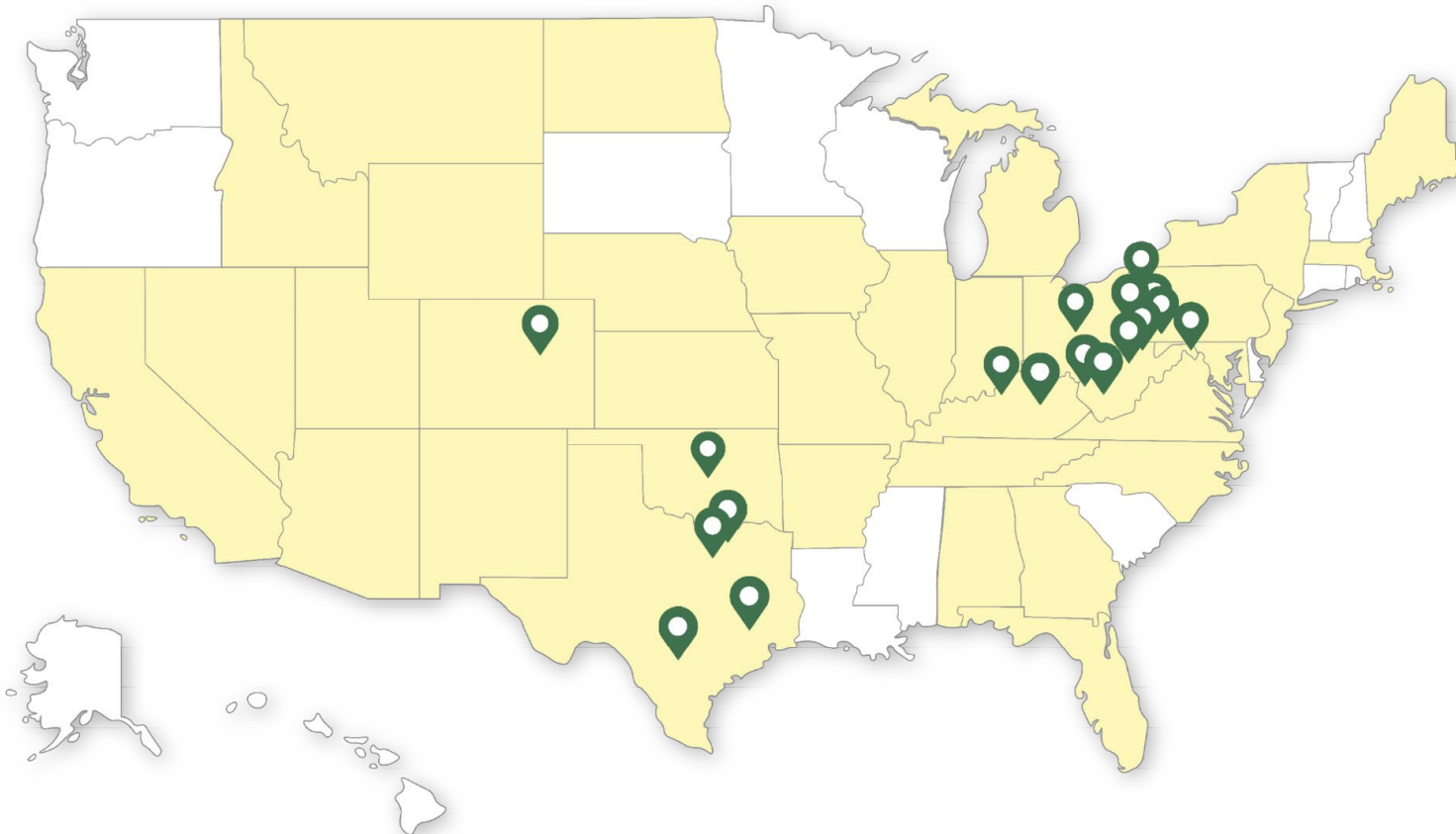
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- Texas and New Mexico Title: Understanding the Similarities and Differences (April 26, 2023)
- Litigating Oil & Gas Cases in Texas and New Mexico (May 24, 2023)
- Deals & Contracts in the Permian and Mid-Con (June 28, 2023)
- Legal Considerations for Renewable Energy Projects (July 26, 2023)
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Overview

- Overview of force pooling
- Why do we have allocation wells?
- Authority and case law regarding allocation wells

Force Pooling

Rule of Capture

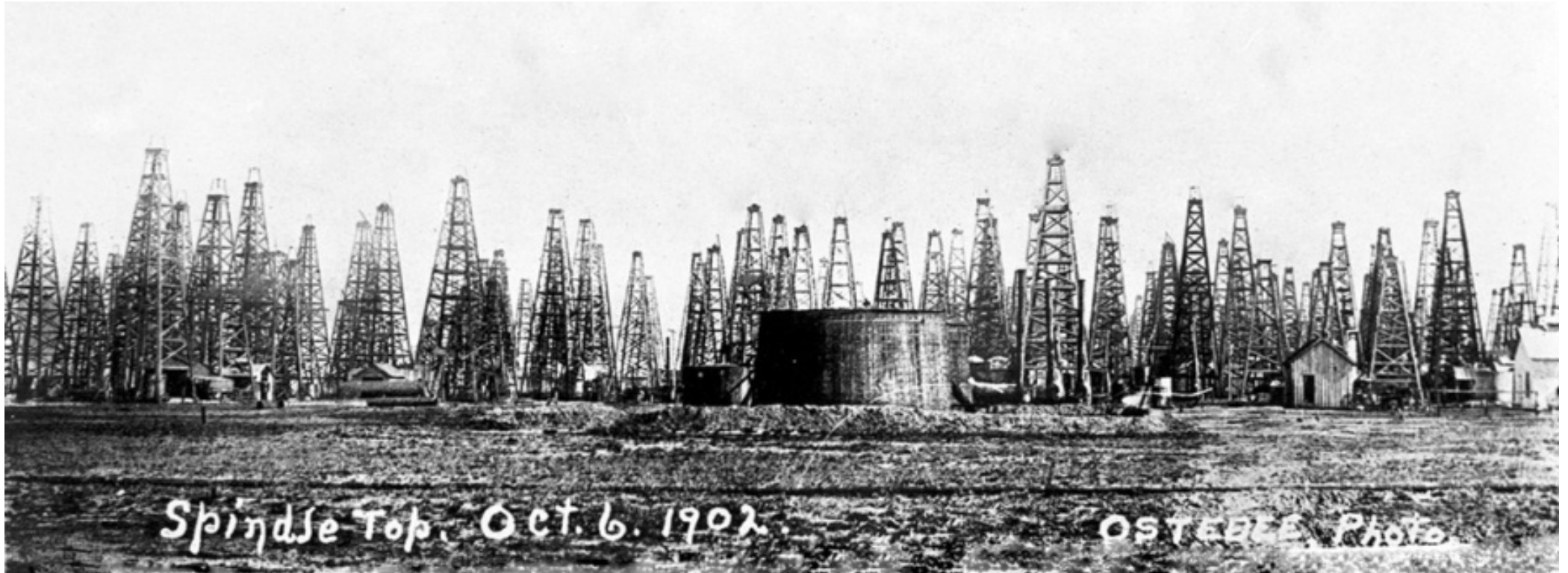
AD COELUM DOCTRINE – Fundamental property law. Stands for the idea that landowners own the soil “all the way up to Heaven and all the way down to Hell”

HOWEVER, most states recognize the **Rule of Capture**

- i. Originated in English common law regarding ownership rights of wild animals and later applied to the “capture” of natural resources.
- ii. When a common pool of oil or gas lies under the property of two or more neighboring landowners, the rule of capture applies unless it has been superseded by state statutes
- iii. The first person to gain control over (capture) the resource by extracting it from the ground gains exclusive ownership over that resource.

BUT – Various statutory and regulatory frameworks restrict this common law tradition, protecting the rights of landowners who are not the first to drill.

Why Regulations Exist



Purpose of Regulation (a Balancing Act)

- Maximizing production while preventing waste
- Protecting correlative rights
- Dealing with nonconsenting owners
- Allocating risk
- Spacing, density and pooling are different methods of achieving this balance

Spacing and Density

- Spacing regulations require oil and gas wells to be a certain distance from property/lease lines and other nearby wells
- Density regulations specify a minimum number of acres per well based on the number of acres that can be efficiently drained by a single well targeting a specified formation

Pooling

- Pooling addresses the situation where an owner's tract is not large enough to individually satisfy applicable regulations
- Pooling owners of contiguous tracts to combine acreage (voluntarily or involuntarily) to form "spacing" units that meet state's acreage requirements
 - **Drilling/Spacing Unit** = the minimum acreage necessary to drill a single well
 - **Proration Unit** = acreage determined by regulatory authority that can be efficiently and economically drained by a well at a particular depth or horizon
 - **Pooled Unit** = multiple tracts combined to meet state spacing requirements

Pooling vs. Unitization vs. Communitization

- **Pooling** = bringing together of small tracts sufficient for the granting of a well permit under applicable spacing rules
- **Unitization** = joint operation of all or some part of a producing reservoir (secondary or enhanced recovery units). Compulsory unitization may require a minimum ownership percentage.
- **Communitization** = federal equivalent of pooling; results in a communitization agreement (“CA”)
- **Community Lease** = a single lease covering two or more tracts executed by separate owners as if they were joint owners. “Pooled as a matter of law”

Voluntary Pooling

- A contractual agreement between landowners and/or lessees
- Authority usually set out in a lease or separate pooling agreement
- State regulation is minimal
- Some states hold that voluntary pooling effectuates a cross-conveyance of interests

Forced Pooling

Why is it necessary?

- Excessive drilling is wasteful because unnecessary wells are drilled (economic waste) and destruction of reservoir and pressure (physical waste)
- To prevent physical and economic waste, drilling of wells should be limited, and a uniform well spacing pattern established, *e.g.* one well per 20, 40 or 80 acres
- Correlative Rights - the owner of a tract too small to be granted a drilling permit should still have a fair chance to recover their hydrocarbons. Denying them the right would be confiscation but permitting a well on their small tract would be waste
- Dealing with the situation where multiple landowners or lessees want to pool their leases and lands for development, but others are holding out or are non-consenting

Forced Pooling



- Generally, forced pooling is **not** considered to effectuate a cross-conveyance
- Regulatory agencies are not permitted to adjudicate title, so pooling orders do not alter ownership (only allocate production). *See Nale v. Carroll*, 289 S.W.2d 745 (Tex. 1956)
- Nonparticipating royalty interests and overriding royalty interest generally **can** be force pooled

Elements of Forced Pooling

- Multiple landowners who require pooling
- Notice, hearing and order
- Elections to participate
- Risk penalties (varying degrees of oversight by regulatory agency). Owners are given a chance to participate or be carried and penalized.
- Timing – generally takes place after the well is drilled and/or production is established

Free Ride or Cost-Only Approach

- Alaska, Arizona, Indiana, and Missouri
- Louisiana for **unleased mineral owners**
- Similar to common law cotenancy
- Carried until payout, such that nonconsenting owner gets a “free ride”
- Nonconsenting owners have no risk (and no risk penalty), so there is little incentive to enter voluntary agreements
- May disincentivize exploration and production

Risk Penalty Approach

- North Dakota, Wyoming, Montana, New Mexico, Colorado, and Utah
- Louisiana for nonconsenting working interest owners. LA. R.S. § 30.10.
- Rewards operators for bearing risk of dry holes against nonconsenting owners
- Typically include a statutory operator's lien for recovering costs. These costs will generally be recovered out of production only.
- Varying degrees of discretion between states as to amount of risk penalty.
 - Statute may allow “up to” a certain amount

Calculating Payout

- Well **pays out** when costs have been recovered
 - A **risk penalty** on the other hand is an additional payout threshold that defines the point at which the nonconsenting owner gets to participate in the upside of a well
- Generally similar to law of cotenancy or good-faith trespass
- Will include reasonable costs of production including drilling, lifting and development. Will also include a reasonable charge for “supervision.”
- It may be a very long time until nonconsenting parties get paid (if ever)
- Disputes over costs and allocation of risk burden will generally be settled by administrative hearing. Courts give a great deal of deference.
- Exclusive of any royalty or overriding royalty

Providing Notice

- Must have made a good faith attempt to lease and provide an opportunity to sign an election ballot
 - Ex: **N.D. ADMIN. CODE § 43-02-03-16.3**
- Notice of risk penalties, election ballots, AFEs and lease offers must be in writing with proof of service
- What if you can't find an owner?
 - How much due diligence is enough to impose a risk penalty often lies within the discretion of the operator (wait and see approach)
 - If you want the regulatory commission's blessing, you will likely need to show a “**good-faith effort**” that is more than just sending certified mail to last address of record
 - May require publication notice in last known county of residence or county where well is located
 - May require a hearing and a waiver of notice requirement to impose a risk penalty

New Mexico

- Oil Conservation Commission order defines rights regarding owners who elect not to pay proportionate share. **N.M. STAT. ANN. § 70-2-17; N.M. ADMIN. CODE §§ 19.15.13.3, 19.15.13.8**
 - Reasonable actual expenditures, including supervision charge, and an optional risk penalty not to exceed 200%
 - Oil Conservation Division adjudicates cost disputes
 - Unleased mineral owners are given a deemed 1/8 royalty, with the remaining 7/8 deemed a cost-bearing working interest

Option Approach - Oklahoma

- Any owner who has not voluntarily joined the pooling unit has the choice to either (1) pay its proportionate share of costs (participate) or (2) receive a bonus and “assign” or “surrender” their interest
- If you elect or are deemed to have elected a surrender option, you are locked out of the upside of the well forever. Includes subsequent wells if at any time you go non-consent.
- **Practical effect**: well-capitalized operators can forcefully acquire the interests of under-capitalized companies on a unit-by-unit basis. An undercapitalized company’s only option is to give up any upside or attempt to find funding to participate.

The Process

- Under **52 OKLA. ST. RES. § 87.1**, an application to compulsory pool can be made after a spacing order, subject to notice and hearing
- Unleased owners will initially be treated under the statute as “leased” at 1/8 and treated as a “lessee” as to the remaining 7/8 interest
 - Lasts until such time as they make an election or are deemed to make an election not to participate under a pooling order
 - At that time, they will be deemed a “lessor” to the extent of the full royalty percentage elected under the pooling order
 - Note that the statute and orders are written around the concept of a “base” 1/8 royalty, whether leased or unleased. Everyone starts off with this 1/8 & 7/8 split, and the elections may shift certain burdens around (unless the owner elects to participate).

The Options

- Usually given three or four election options. These may vary considerably and are tailored to the specific pooled unit.
- A typical “Three-Way” Order:
 - Participate in the cost of drilling and completing or
 - Accept a specified bonus and/or royalty or
 - Be treated as a carried interest subject to a risk penalty
- Other common options may include multi-tiered bonus and royalty elections or an option to take an overriding royalty in exchange for your working interest

Examples

- **Option 1**: \$1,500 per acre “bonus” plus a total $\frac{3}{16}$ “royalty”
 - This delivers or “assigns” the remaining $\frac{13}{16}$ of your interest to the operator in return for the bonus “consideration” given above
 - If you are unable to deliver a full $\frac{13}{16}$ net revenue interest due to outstanding burdens (landowner royalty + overrides) you have to participate or make another election
- **Option 2**: \$1,000 per acre “bonus” plus a total $\frac{1}{5}$ “royalty”
 - This delivers or “assigns” the remaining $\frac{4}{5}$ of your interest to the operator in return for the bonus “consideration” given above
 - If you are unable to deliver a full $\frac{4}{5}$ net revenue interest due to outstanding burdens (landowner royalty + overrides) you have to participate or deliver the net revenue interest you owned at the time the application was filed

Forced Pooling in Texas?

- The Mineral Interest Pooling Act (“MIPA”), **Tex. Nat. Res. Code § 102**
- MIPA was intended to protect small tract owners from drainage when they could not get other tract owners to voluntarily pool
- The practical effect of MIPA is that it generally encourages voluntary pooling rather than acting as a statute to provide compulsory pooling

Prerequisites for a MIPA Application

1. The oil and gas field must meet certain requirements (*e.g.*, discovered after March 8, 1961)
2. Two or more tracts
3. Ownership interests and wells
4. Common reservoir
5. Size limitations
6. Productive acreage
7. Proper applicant
8. Proper purpose
9. Fair and reasonable offer

Fair and Reasonable Offers

- Under § 102.013, the applicant must make a fair and reasonable offer to pool voluntarily before the applicant can invoke the jurisdiction of the RRC to force pool
- “The offer must be one which takes into consideration those relevant facts, existing at the time of the offer, which would be considered important by a reasonable person in entering into a voluntary agreement concerning oil and gas properties.” *Carson v. Railroad Commission of Texas*, 669 S.W.2d 315, 318 (Tex. 1984).
- Whether an offer is fair and reasonable is to be evaluated from the standpoint of the offeree at the time the offer is made. *Windsor Gas Corp. v. Railroad Commission of Texas*, 529 S.W.2d 834 (Tex. Civ. App. – Austin 1975, writ dism’d).

Ammonite Oil & Gas Corp. v. R.R. Comm'n of Texas, 2021 Tex. App. LEXIS 8649 (Tex. App. – San Antonio 2021, n.p.h.)

- Ammonite sought a MIPA application to force pool its interest in State-owned riverbed acreage with adjacent oil wells operated by EOG, which application was denied by the RRC.
- MIPA, Tex. Nat. Res. Code § 102.011 requires the applicant to make a fair and reasonable offer to the operator to voluntarily create a pooled unit prior to filing a MIPA application.
- To obtain RRC approval of its application the applicant must also establish 1 of 3 that the proposed force-pooled unit would:
 1. Avoid the drilling of unnecessary wells;
 2. Protect correlative rights; or
 3. Prevent waste.

Allocation Wells

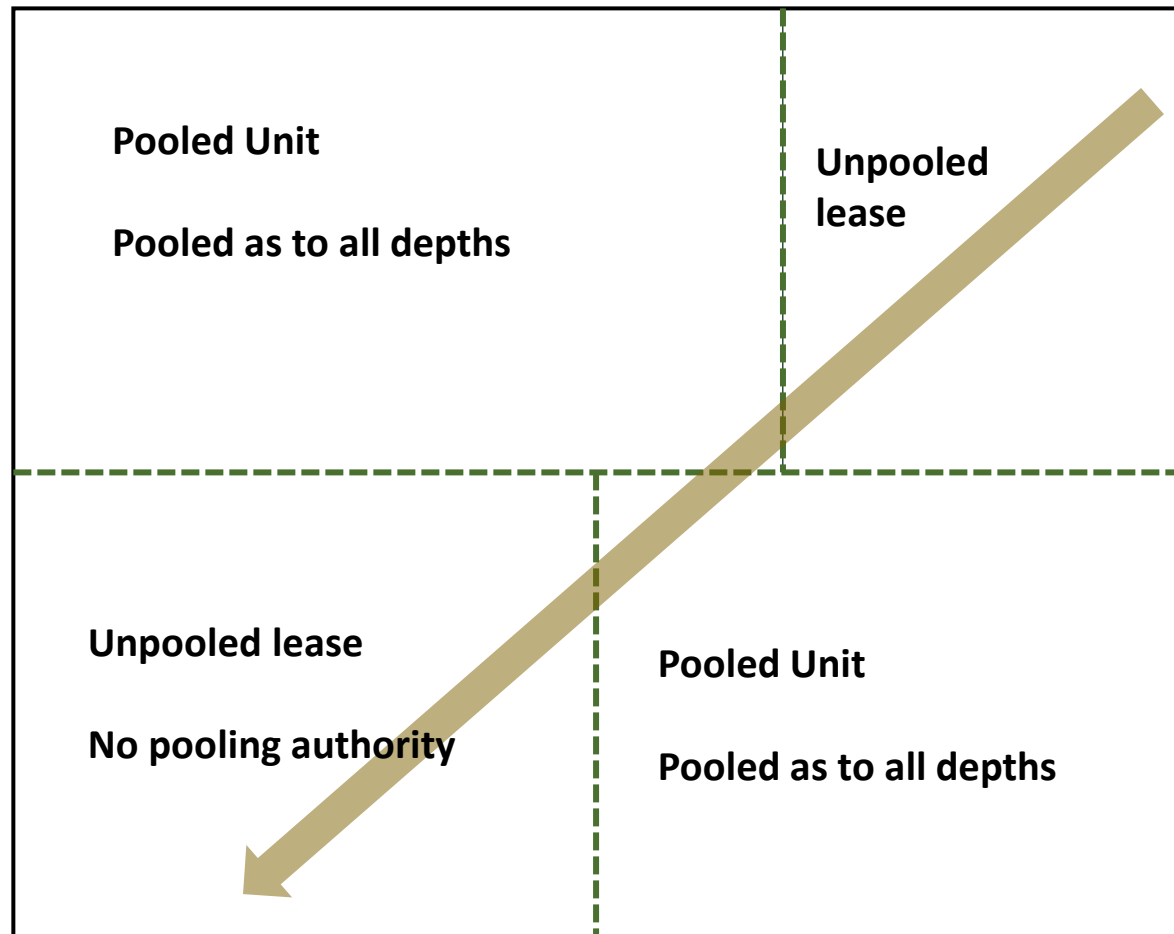
Authority for Allocation Wells

- There is no Texas statute or regulation addressing production sharing agreements or allocation wells
- *Cockrell v. Texas Gulf Sulphur Co.*, 299 S.W.2d 672, 675 (Tex. 1956) (explaining the doctrine of the greatest possible estate granted, which permits the lessee to drill anywhere on the lease, including border to border, unless expressly prohibited by the lease)
- *Magnolia Petroleum Co. v. Railroad Comm'n of Texas*, 170 S.W.2d 189 (Tex. 1943) (explaining that a “reasonably satisfactory showing of good-faith claim of ownership in the property” is what is required to obtain a drilling permit)

Allocation Wells

- An allocation well is a horizontal well that traverses the boundary between two or more leases that have not been pooled and for which no agreement exists among the royalty owners as to how production will be shared
- The ability to drill an allocation well is a valuable alternative to pooling when the lease does not grant pooling authority or restrictive pooling provisions make pooling difficult or overly burdensome

Why Do Allocation Wells Exist?



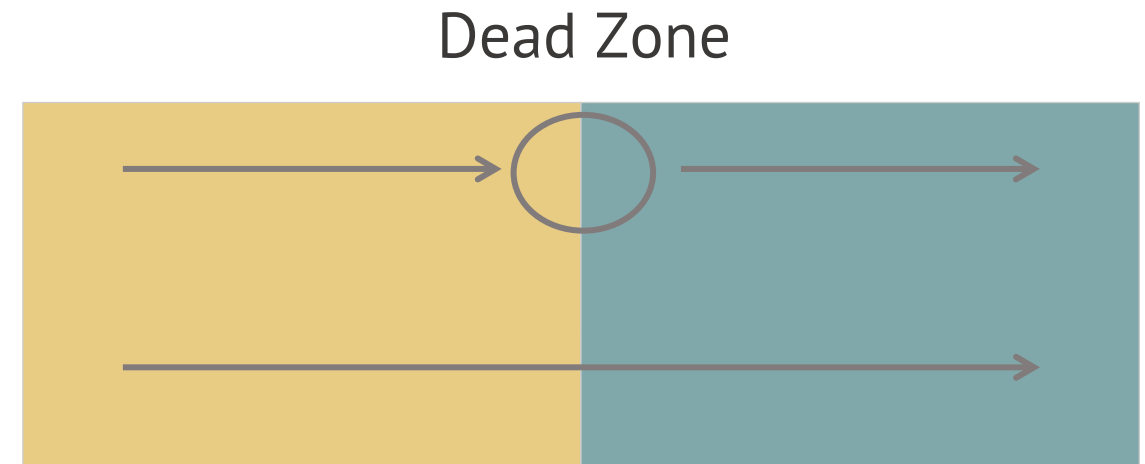
- Restrictive pooling provisions
- Lack of pooling authority
- Existing pooled units

The RRC's Position

- The RRC has authority to permit commingling
- Developed as a response to combine multiple tracts in the absence of pooling authority or the consent of the working interest or royalty owners
- The RRC will issue a permit to drill a horizontal allocation well where the applicant shows a good-faith claim of a right to drill, which is satisfied by holding leasehold or mineral rights
- The RRC includes a disclaimer on allocation well permits that includes:
 - “Issuance of the permit is not an endorsement or approval of the applicant’s stated method of allocating production proceeds among component leases or units.”
 - “Payment of royalties is a contractual matter between the lessor and lessee.”

Benefits of Allocation Wells

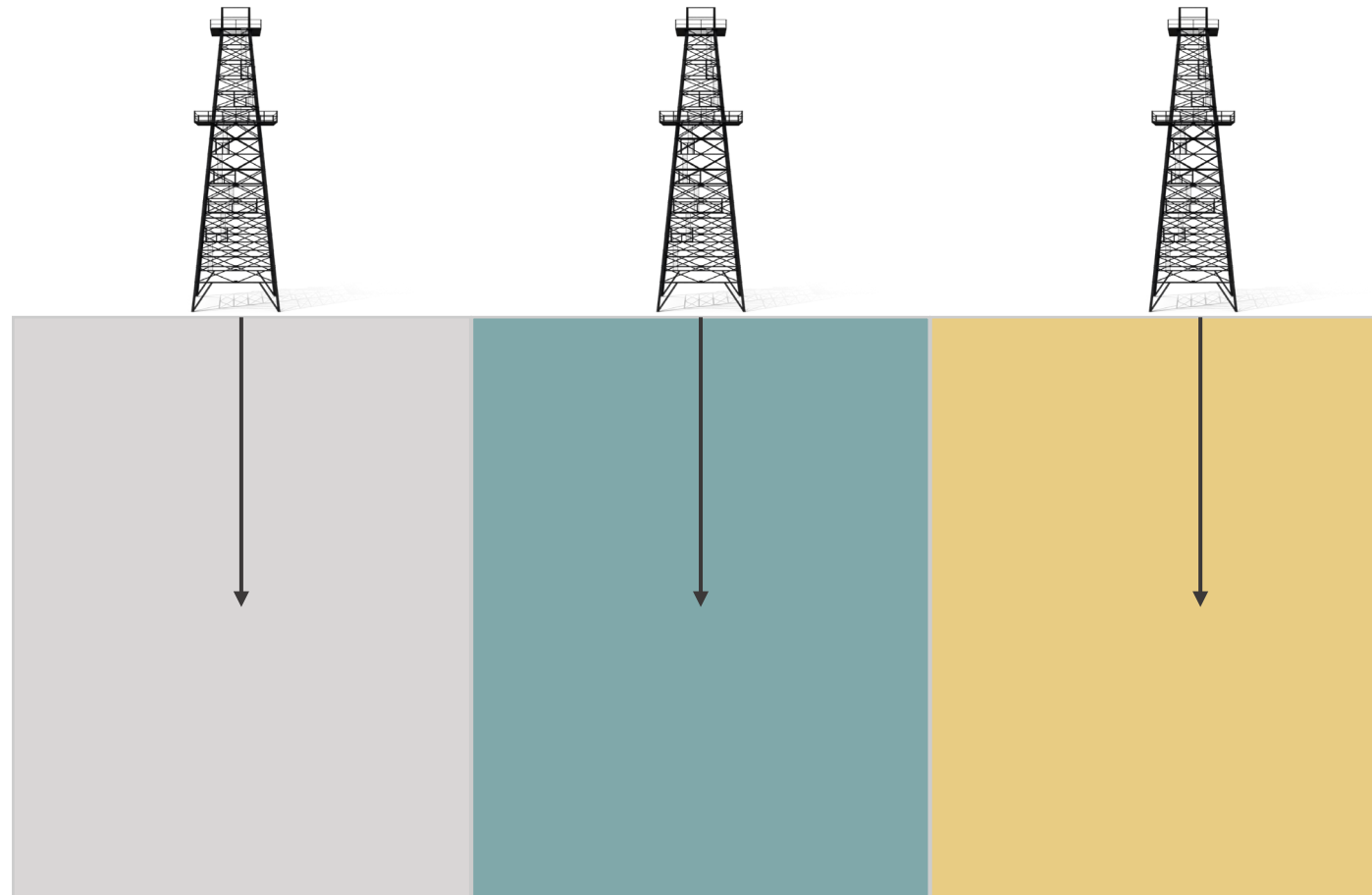
- Promotes conservation by precluding drilling separate wells
- Prevents waste of oil and gas through a loss of reserves in dead zones (or non perf zones) between tracts



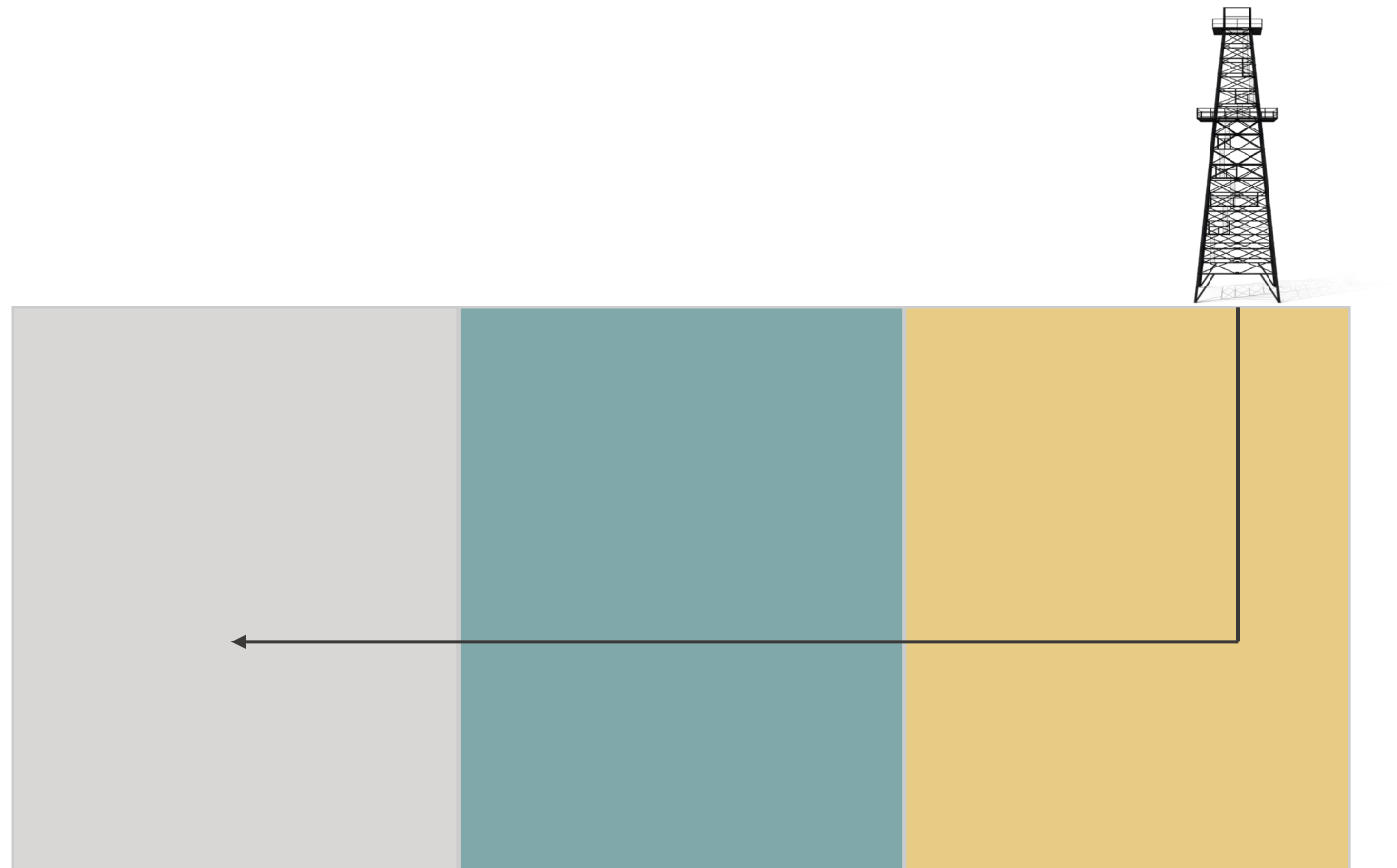
Authority to Drill an Allocation Well

- Pooling authority is not necessary
- A horizontal allocation well across multiple tracts is treated the same as a series of vertical wells on each tract
- Drilling a horizontal well that crosses lease lines does not constitute a type of pooling because the horizontal well alone does not result in a cross-conveyance of royalty interests or change the allocation of production
- Thus, an allocation well does not breach the terms of a lease that prohibits pooling (or fails to grant pooling authority)

Traditional Wells



Allocation Well



Allocating Production

- Production is allocated to each tract to recognize the production contributed by each tract
- *Humble v. West*, 508 S.W.2d 812 (Tex. 1974) (explaining that the burden of proof is on the commingler of gas to prove each party's share with "reasonable certainty" by expert testimony)
- *Springer Ranch v. Jones*, 421 S.W.3d 273 (Tex. App.—San Antonio 2013) (concluding that an expert's opinion that production from multiple tracts allocated on the basis of the horizontal well's distance between first and last take points within the correlative interval was reasonable)
- Contrast: When tracts are pooled, production from any tract in the pooled unit is treated as production from every tract in the pooled unit and is allocated on a surface acreage basis

Browning Oil Co. v. Luecke, 38 S.W.3d 625 (Tex. App. – Austin 2000)

- Luecke's oil and gas leases contained anti-dilution provisions. The lessee attempted to amend the anti-dilution provision, but the Lueckes refused.
- Lessee drilled two horizontal wells that did not satisfy the anti-dilution provision and the Lueckes filed suit asserting that the horizontal wells violated the pooling provisions in the lease
- Lueckes asserted that because their tracts were not validly pooled, they were entitled to royalty on all production resulting from the two horizontal wells
- Lessees proposed to allocate royalties based upon the shared production from the wells that could be attributed to Luecke's tracts (this resulted in a difference of approximately \$1,000,000 of royalties)

Browning Oil, cont.

- The appellate court concluded that “[t]he proper remedy for a breach of the pooling provisions may not ignore or exceed the ownership interest conveyed under the leases. The Lueckes contracted for a share in royalties based on total production from their land.”
- As a result, the Lueckes were allowed to recover royalties as specified in their lease, compelling a determination of what production can be attributed to their tracts with reasonable certainty.
- Confusion of Goods Doctrine:
 - Provides that if the operator cannot determine with reasonable certainty the amount of production coming from each of the tracts penetrated by a horizontal wellbore, then the operator may be required to account to each of the owners of each tract penetrated as if all of the production is allocable to each tract penetrated by the wellbore
 - To meet this burden, the operator would have to show by a preponderance of the evidence and with reasonable certainty the amount of oil and gas produced from each tract penetrated by the horizontal wellbore

Browning Oil, cont.

- *Browning* concluded that the pooling provision was breached because the lessee attempted to create a pooled unit that did not comply with the lease
 - Thus, a valid pooled unit was never formed
 - In the absence of a pooled unit, each lessor was entitled to be paid royalties on production from lessor's tract
- Concluded that each party in a horizontal well is entitled to its share of production attributed to each individual tract with "reasonable certainty"
- The breach of the pooling provision was not because the lessee drilled a horizontal well across lease lines

Klotzman v. EOG Resources, Inc.

- The productive segment of the horizontal drainhole traversed the boundary between a 515.569-acre lease and a 304.97-acre lease
- The application required a Rule 37 exception
 - Only offset mineral interest or working interest owners are entitled to notice of a requested exception
 - An offset royalty owner, as the owner of a nonpossessory interest, is not entitled to notice
- The RRC concluded that lease, which did not grant any pooling authority, did give the operator “a sufficient good faith claim to drill its proposed [allocation well]”

Monroe Properties, Inc. v. Devon Energy Production Co., L.P.

- RRC dismissed the complaint and explained:
 - RRC has a practice to allow the drilling of allocation wells
 - *Browning* does not establish that pooling authority is necessary to drill an allocation well
 - Suit filed in Travis County and subsequently dismissed on July 27, 2018

Opiela v. R.R. Comm'n of Texas, No. D-1-GN-20-000099, 53rd Judicial District, Travis County, Texas (May 12, 2021)

- Opiela challenged whether the RRC has the authority to issue permits for allocation wells
- EnerVest obtained a permit for an allocation well in Karnes County despite Plaintiffs' objections that EnerVest lacked authority to drill an allocation well because the lease contained no express authority allowing an allocation (the lease also prohibited pooling)
- The RRC granted the permit because all that was necessary to obtain a permit was a good faith claim of the right to drill and that RRC did not adjudicate title or interpret oil and gas leases
- The court concluded that the RRC wrongfully granted the permit because Magnolia (EnerVest's successor) failed to establish a good faith right to drill

Response to Allocation Wells

- Lessors including provisions in leases prohibiting wells from crossing lease lines without an agreement from the lessor specifying the allocation
- GLO Relinquishment Act Lease
- SMU Lease Form

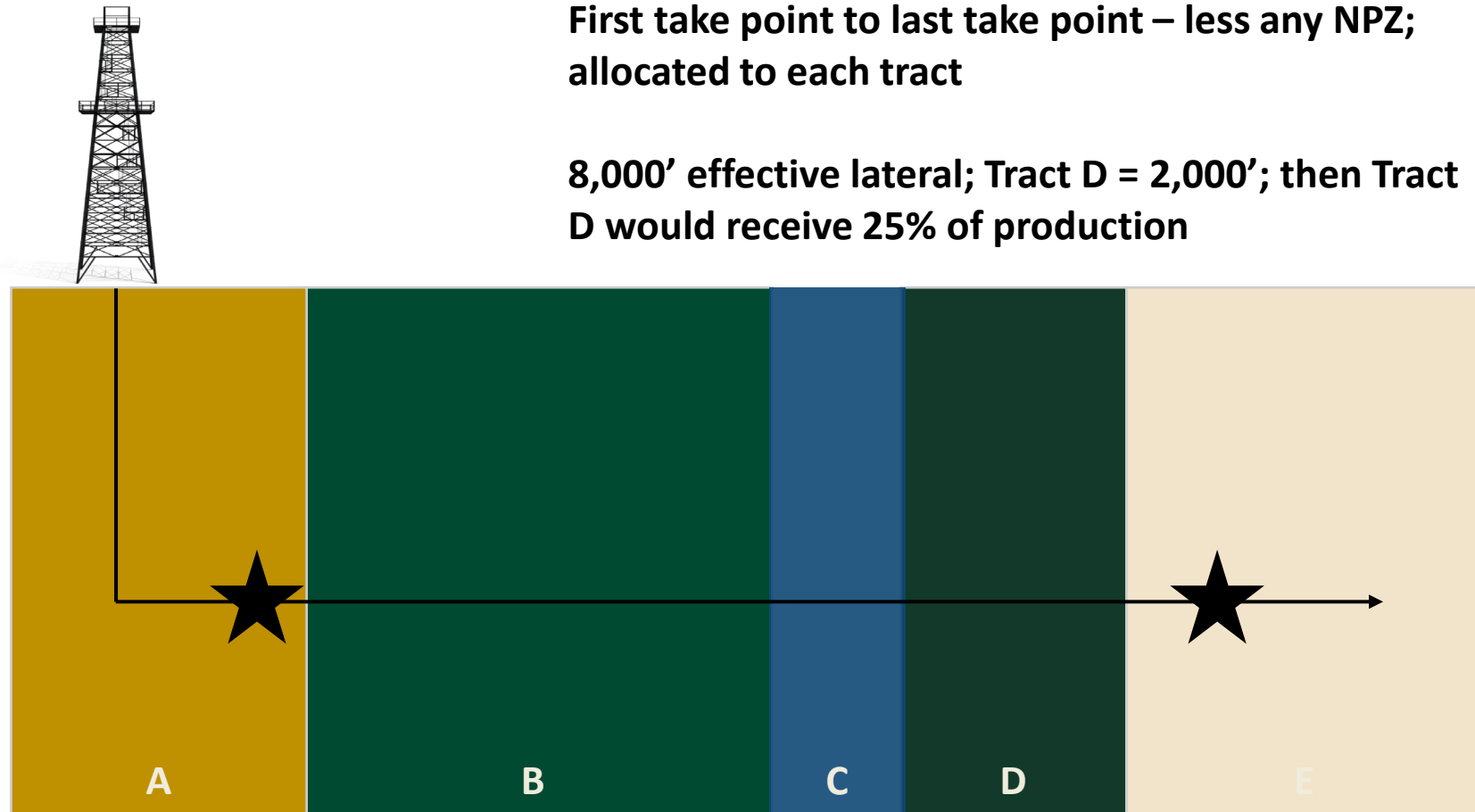
Methods for Calculating Interests

- Productive lateral length
- Percentage of horizontal lateral
- The number of take points within a tract compared to the total number of take points along the lateral
- Surface acreage

Productive/Effective Lateral Length

**First take point to last take point – less any NPZ;
allocated to each tract**

8,000' effective lateral; Tract D = 2,000'; then Tract D would receive 25% of production



***Regulatory
Considerations for
Allocation or
Production Sharing
Wells***

Permitting an Allocation Well

- Indicate horizontal wellbore type as Allocation
- Sections V & VI are completed on Form P-16
 - The P-16 Data Sheet will replace the information that would be on Form PSA-12, Proration Acreage List, and Form P-15
- Permit must include percentage of participation of all tracts contributing acreage to the PSA well
- With an allocation well, the proposed well cannot include tracts not traversed by the wellbore

Rule 37

- No well shall be drilled nearer than 1,200 feet to any well
- No well shall be drilled nearer than 467 feet to any property line, lease line or subdivision line
- A PSA well or allocation well will always require a Rule 37 lease/property line exception
- An exception may be granted by the commission to prevent waste or to prevent confiscation of property

Rule 37 Exception Hearing

- Notice of the proposed Rule 37 exception provided to:
 - The designated operator
 - Lessees of record for tracts with no designated operator
 - Owners of unleased mineral interests
- Can obtain waivers from interested parties
- RRC will hold a public hearing at least 10 days after notice
- Applicant seeking the exception bears the burden to show that the exception is necessary
- Penalty for failure to comply is that violating well is plugged

The background is a dark blue field filled with a complex network of thin, light blue lines connecting various points. These points are represented by small, glowing blue dots of varying sizes and brightness, creating a sense of depth and connectivity. The overall effect is reminiscent of a digital network or a molecular structure.

Questions?

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