ALLOCATION WELLS AND PSA WELLS

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What is an Allocation Well?

- 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. Clifton A. Squibb, The Age of Allocation: The End of Pooling as We Know It?, 45 Tex. Tech L. Rev. 929, 930 (2013).

- Another example of a horizontal well that must be permitted as an allocation well is one which traverses the boundaries of two existing pooled units without agreement among the royalty owners as to how production will be shared.
Pooling v. Allocation

- Pooling is a contractual arrangement between lessors and lessees whereby the lessor provides the lessee with authority to “pool” or combine the lessor’s lands with other lands.

- Most often, the pooling provision provides that production from any portion of the pooled unit will be considered as production from the leased premises.

- Furthermore, the pooling provision quite often provides that royalty will be allocated based upon the number of surface acres covered by the specific lease divided by the total number of surface acres included within the pooled unit.
The key principal of allocating production in a pooled unit is that all lessors (i.e., royalty owners) have agreed as to the allocation of production from the entirety of the pooled unit.

This agreement was accomplished in the oil and gas lease itself.
Unlike a well drilled in a pooled unit, with an allocation well, there is a wellbore that crosses one or more tract boundaries without a contractual agreement amongst the royalty owners regarding the allocation of production.

Tract boundaries signify differing mineral or royalty ownership in lands traversed by the wellbore. Differing surface ownership is generally irrelevant for purposes of allocating production from a well.
Operators generally drill allocation wells due to the absence of any or sufficient pooling authority.

An example of the operator not having sufficient pooling authority is the presence of anti-dilution provision similar to the *Browning Oil Co. v. Luecke* case. The pooling provision in *Browning v. Luecke* provided that not less than a specific percentage of any pooled unit be comprised of Luecke acreage.

An example of an operator with no pooling authority is found in the EOG/Klotzman matter. The lease at issue in that case did not contain a pooling provision.
The Texas Railroad Commission may not grant a permit if the operator applying for the permit cannot, in good faith, claim the right to drill the well for which the permit is sought. *Magnolia Petroleum Co., v. R.R. Comm’n*, 170 S.W.2d 189, 191 (Tex. 1943).

The Texas Railroad Commission has routinely approved permit applications for horizontal wells.

Devon permitted the first Allocation Well in 2010. Texas Railroad Commission Oil & Gas Docket No. 06-0262000. Devon’s permit application was supported by a letter from Ernest E. Smith, former Dean of the University Texas Law School and a renowned Texas oil and gas law scholar.

Noteworthy that Devon filed the permit for an allocation well after failing to garner enough support from royalty owners for a production sharing agreement.

Since 2010, RRC has approved hundreds of allocation well permits.
Arguments exist that each producing tract in a horizontal well should be entitled to royalty on all oil and gas produced from the well. Based on commingling concepts in Humble Oil v. West, 508 S.W.2d 812 (Tex. 1974).

In the Humble Oil case, Exxon and its predecessor, Humble Oil, commingled native and non-native gas in a storage facility. The Wests asserted a claim for royalty on all gas produced from lands in which the Wests owned a royalty interest, whether such gas was native or non-native.

Court held that royalty was owed on all gas produced from the lands unless the commingling party could prove with “reasonable certainty” what portion of the gas produced was native gas as opposed to non-native.

Case is essentially a commingling/confusion of goods case drawing on a long line of cases dealing with confusion of personal property such as cattle herds.
Case arose out of an anti-dilution provision. Purpose of the anti-dilution provision is to minimize the amount of acreage outside the leased premises with which the leased premises can be pooled.

- In Luecke, the lease said, “notwithstanding paragraph number 4 (the pooling provision), if any pooled unit is created with respect to any well drilled on the land covered hereby, at least sixty percent (60%) of such pooled unit shall consist of land covered hereby.”

- Operator wanted to drill a horizontal well that traversed multiple tracts, including Luecke land.

- Compliance with anti-dilution provision would have required drilling the well on an 80-acre unit, which the operator argued was not acting as a reasonably prudent operator.

- Court held the operator had two choices, get a lease amendment or not drill the well.

- Because the anti-dilution provision was not complied with, the Luecke tracts were not properly pooled.
After deciding that pooling was invalid as to the Luecke lands, court sought to determine what portion of production should be allocated to the Luecke’s.

Luecke’s argued that based on Humble Oil v. West commingling principles, royalty should be paid on all production from the entire length of the horizontal wellbore.

Court rejected the argument that royalty should be paid on 100% of production from the horizontal well.

Court said royalties must be allocated with reasonable probability.
Browning Oil Co. v. Luecke

- Only recorded Texas appellate decision dealing with royalty calculations in a horizontal well where the pooling clause was inapplicable and there was no other agreement amongst the parties as to how royalties should be paid.

- Allocation Method relied upon by the Court of Appeals was:
  - Length of portion of productive lateral crossing un-pooled lands DIVIDED BY the entire length of the productive lateral = Percentage of production allocable to the un-pooled lands
  - Must be noted that this is decision is a lower court decision that is not binding precedent.
  - Other courts may choose an alternative allocation method.

- Many lessees allocate royalties in an Allocation Well in the manner provided for in Browning Oil v. Luecke.

- However, if there is a better method of allocating production, there is no prescribed method.
Springer Ranch v. Jones

- Recent San Antonio Court of Appeals case. Commonly discussed in discussions about Allocation Wells.
- Distinguishable from Browning Oil v. Luecke because Springer Ranch interpreted a 1993 agreement written to allocate royalties from vertical wells. Controversy arose when horizontal well subsequently crossed two of the tracts covered by the agreement.
- Decision turned on parties’ agreement rather than analysis of the factors considered in Browning Oil v. Luecke.
Allocation Wells have generated much controversy over the last several years. Two cases, in particular, have been the focal point of that controversy.
Lease did not provide pooling authority.

In 2012, EOG submitted an application to drill the well.

EOG followed normal Rule 37 notice procedures and did not notify royalty owners.

Royalty owners learned of the application and sought a contested hearing.

During the contested hearing process, the Examiner at the RRC recommended the permit be denied under the premise that what EOG submitted was tantamount to forced pooling.

The Commissioners subsequently overruled the Examiner’s decision and approved EOG’s permit.

A lawsuit was filed by the royalty owners but that suit was settled out of court and no judicial determination was made as to the legality of Allocation Wells.
Another case involving EOG is Spartan Texas Six Capital Partners Ltd et al. v. EOG Resources, No. 2011-27476 (Nov. 6, 2012).

Case sought judicial review of royalty allocation in a horizontal well where there was no pooling or agreement as to allocation of royalty.

Royalty owners argued that under the Humble Oil v. West decision, there was illegal commingling of production from multiple tracts and royalty should be paid on 100% of production from the wellbore.

Spartan case settled in April, 2014. Therefore, there still has not been another judicial determination of this issue since the Browning v. Luecke case.
Other than MIPA, there is no forced pooling in Texas. MIPA is a seldom used remedy created in order to protect small tract owners, although it has, on one occasion, been used by an operator to force pool a small tract.

Outside of MIPA, pooling is a contractual arrangement between the parties.

The argument that Allocation Wells are tantamount to forced pooling is derived from several sources, (i) the confusion of goods theory used by the court in Humble Oil v. West, and (ii) the policy argument that Allocation Wells are obviating the need for contractual agreements between the lessor and lessee and therefore diluting the royalty owners’ property rights.

Proponents of Allocation Wells, however, will argue that an allocation well is merely a string of tract wells and that allocation of production from that wellbore is possible to a “reasonable certainty.”
What Are the Risks?

- Obtaining a permit to drill an Allocation Well does not protect an operator from a lawsuit by a royalty owner.
- The permit is a regulatory function which gives the operator the right to drill the well.
- If a court ultimately decides that Allocation Wells are illegal as an end-around forced pooling and fall under the confusion of goods theories set forth in *Humble Oil v. West*, damages to an operator could be extremely high.
- As an example, in Spartan, Browning, Springer Ranch and Klotzman, royalty owners made arguments that they were entitled to royalty on production from 100% of the wellbore.
A PSA in this context is a Production Sharing Agreement.

Defined as a private, contractual agreement between the operator of a proposed well and non-operating mineral interest owner in two or more leases or units that will be penetrated by a horizontal drainhole that provides for the sharing of production proceeds, but not for the pooling of the component leases or pooled units.

PSA’s are obtained when there is no pooling and when a well will traverse multiple existing pooled units.

If a PSA is entered into, operations or production from wells drilled under the PSA are treated as actual production or operations on each of the leases in the unit just as if a lease pooling amendment had been entered into.
Permitting PSA Wells

- The Texas RRC has adopted the 65% standard.
- RRC will permit a PSA well in which at least 65% of the royalty owners have signed the PSA.
- It is often a practical impossibility to get 100% agreement on the PSA.
- PSA must be obtained prior to filing for the permit.
- Other considerations such as Rule 37, good faith claim to produce, etc. are still applicable to the permitting process.
Typical Production Allocations

- Typical allocation factor is based on the length of the productive drainhole as divided by total productive drainhole length.
- Surface acreage is generally not a factor.
- Contractual arrangement so parties are free to contract as they see fit.
- Example, it could be argued that the number of take points is a more reasonable way of allocating production.
- Other alternatives are acre feet, oil in place, historical production, or formulas based upon oil tracers.
Downsides to Allocation and PSA Wells

- Judicial risk that future courts might disagree with the ability to (i) legally drill the well, or (ii) allocate production in the manner in which it is being done.
- Operations maintain only those leases upon through which the productive drainhole traverses.
- Some legal commentator perceive risk from non-drillsite NPRI owners that are deprived of the right to ratify a unit.
- Payment calculations can be more complex and cumbersome for internal accounting departments. Additionally, payment calculations are well by well rather than for an entire pooled unit.