

# **EXPLODING ALLOCATIONS**

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**CHAPTER 4**

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Mr. Petry is a south Louisiana native and 1995 honors graduate of Louisiana State University. Upon graduation, he was employed as a field engineer for Sperry-Sun Drilling Services, where he provided real-time, downhole monitoring in electromagnetic wave resistivity, gamma radiation, radioactive source and position monitoring tools in the offshore oilfield environment. He is a 2000 graduate from the University of Texas School of Law, where he was research assistant to Professor Ernest Smith, Rex G. Baker Centennial Chair in Natural Resources Law.

His background in oil and gas led to a position as a hearings examiner with the Railroad Commission of Texas from 2000 to 2004. While an examiner at the Railroad Commission, Mr. Petry adjudicated oil and gas hearings, including lease line spacing and density exception cases pursuant to Statewide Rules 37 and 38, prepared legal recommendations to the elected Commissioners, and assisted the public with navigating the intricacies of Railroad Commission rules and regulations.

From 2004 to 2006, Mr. Petry was an oil and gas associate with Thompson & Knight, LLP, where he expanded his focus to include oil and gas transactional work, including oil and gas property acquisitions, due diligence reviews, title examinations, and preparation of oil and gas agreements. From 2006 to 2016, Mr. Petry was with Zukowski, Bresenhan, Sinex & Petry, L.L.P., where he advised his clients in all areas of oil and gas law. Beginning April 1, 2016, Mr. Petry created Petry & Sinex, Attorneys at Law, with his longtime friend and partner, Don Sinex, and effective January 1, 2020, expanded the firm to Petry, Rosie & Sinex, PLLC.

Mr. Petry advises his clients in all areas of oil and gas law, with special attention to oil and gas title and regulatory matters.

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Our readers who have worked in the oil patch or are familiar with the mechanics of oil and gas drilling know that explosions in the oilfield rarely just “happen.” Rather, when an explosion occurs it is usually the result of a litany of smaller errors that lead up to unintended consequences. The point of this paper is not to say that Allocation Wells will “explode” but that there is recent pressure in case law to which we should all pay attention before those unintended consequences occur.

In generic terms, when drilling for oil and gas, the drillhole is weighted up with “mud” to balance out any pressure that the drill bit encounters. The higher the pressure you are drilling into, the heavier the mud that the mud engineer is putting downhole. The idea is to keep the balance in your favor. Keep the mud weight heavier than the pressure you encounter downhole to keep a cap on things. If your mud is lighter than the pressure a well encounters, hydrocarbons rush up hole and, in the case of escaping gas, a lone spark can lead to disaster.<sup>1</sup>

It is a comparison that is apt for Production Sharing Agreement (“PSA”) Wells and their kin, Allocation Wells (referred to herein collectively as “Allocation Wells”). Drilling is an inherently risky process, and safeguards and caution are warranted. For the last sixteen years, I have advised clients that, similarly, Allocation Wells have risks that

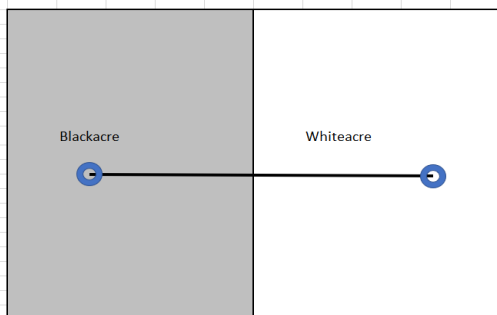
require safeguards and caution. While Allocation Wells are legitimate, helpful tools in the oil and gas industry, they should be used carefully, with full understanding of the background and risks, and with executed production allocation agreements by the relevant interest owners. In other words, like in drilling, stay on top of things and watch for increasing pressure.

Recent caselaw suggests that pressure is still being applied to the concept of Allocation Wells. The purpose of this paper is to outline some of the recent cases involving Allocation Wells as well as to provide background on the potential issues in Allocation Wells. To do that, this paper will address: (i) the history of Allocation Wells, (ii) recent case law, and (iii) best practices through the use of production allocation agreements.

### *I. History*

Texas has many older pooled units that continue to produce. With the advent of horizontal drilling, many operators were looking to horizontally drill across previously pooled units. The thought process was “You can drill a well on Blackacre. You can drill a well on Whiteacre. Why, for goodness’ sake, can’t you just drill one well from Blackacre to Whiteacre and allocate production? Doesn’t that produce more hydrocarbons? Doesn’t that make sense?”

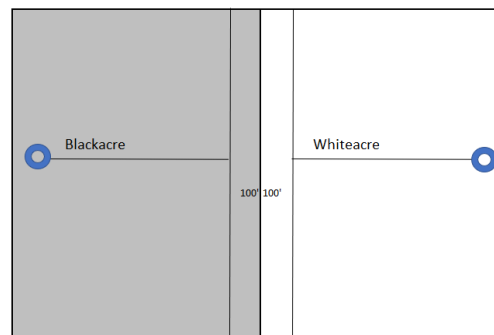
<sup>1</sup> The engineering of oil and gas is obviously more complicated than this and includes mechanisms like blowout preventers and rams, but it is used here as a metaphor.



Enter the concept of Allocation Wells. In general terms, Allocation Wells are regulatory creations to drill horizontal wells on or across multiple leases and/or units without pooling all of the leases traversed by the well. Production from these horizontal wells will be “shared” or allocated between the royalty owners on an allocation factor, such as productive lateral length. When a lessee drills an Allocation Well, “the lessee allocates production to the various tracts traversed by the horizontal wellbore by determining, to a reasonable probability, the amount of production that came from each such tract.”<sup>2</sup> A key recommendation is to obtain Production Allocation Agreements setting forth allocation methodology to mitigate disputes with royalty owners as to whether the method of allocation is appropriate and that payments are made in compliance with the relevant lessor’s leasehold royalty and pooling provisions.

The original Allocation Wells followed the Blackacre/Whiteacre scenario noted above. Ideally, mineral interest owners

executed Production Allocation Agreements, and all was well.<sup>3</sup> Theoretically, an Allocation Well across Blackacre and Whiteacre provided all interest owners with more production than a shorter well only on Blackacre and a shorter well only on Whiteacre. The reason for this is that every Allocation Well is actually a Rule 37 lease line exception. Using the Wolfcamp special field rules as an example, without a Rule 37 exception, the operator is required to be within 330’ from lease lines and 100’ from lease lines perpendicular to the wellbore. So, with two wells, rather than an Allocation Well, you would have the following:



With an Allocation Well, there may be some interest owners that are unhappy with the concept, but receiving large checks helps a good bit, plus many royalty owners are not willing to incur the high cost of litigation to determine if they should have gotten a larger hypothetical share of production than what they received.

<sup>2</sup> Ernest E. Smith, *Applying Familiar Concepts to New Technology: Under the Traditional Oil and Gas Lease, a Lessee Does Not Need Pooling Authority to Drill a Horizontal Well That Crosses Lease Lines*, 3 Oil & Gas, Nat. Resources & Energy J. 553, 565 (2017).

<sup>3</sup> Please note that some practitioners use “Production Allocation Agreement” whereas others use “Production Sharing Agreement”. Regardless of term used, both refer to an agreement whereby the royalty owner acknowledges and agrees how royalty will be allocated under a PSA Well or Allocation Well.

But the devil is in the details, or, at least, in your lease. Does the lease allow such a thing? Are you required to revisit the lease terms and reform your pooled units? Or are new legal interpretations required to address modern drilling methodologies? And should the courts support the facilitation of new technologies a la *Coastal Oil and Gas Corp. v. Garza Energy Trust*, 268 S.W.3d. 1, 13 (Tex. 2008)? The question of whether a traditional oil and gas lease does, or does not, allow Allocation Well methodology continues to be asked.

Proponents of Allocation Wells note that operators are faced with limited options to properly and fully develop oil and gas assets. Reformation of pooled units, even when the situation may benefit all parties, is often beset by suspicion and resistance. Larger units may also have conflicting pooling provisions as to what is allowed and many may have conflicting limitations on the size of the unit, making reformation a herculean task. One can legitimately argue that the pooling provisions on many of the underlying leases were entered into with a vertical well only mindset. Given this situation, proponents view Allocation Wells as a regulatory aid in adapting to the changing world of horizontal shale plays. One noted commentator has opined strongly that this regulatory creation is perfectly consistent with the rights granted under the lease.<sup>4</sup>

<sup>4</sup> Ernest E. Smith, *Applying Familiar Concepts to New Technology: Under the Traditional Oil and Gas Lease, a Lessee Does Not Need Pooling Authority to Drill a Horizontal Well That Crosses Lease Lines*, 3 Oil & Gas, Nat. Resources & Energy J. 553, 565 (2017).

Additionally, supporters of the process argue that Allocation Wells are necessary to prevent waste and protect correlative rights. With the advent of increased technology in horizontal drilling, there are existing oil and gas units that could produce more, but due to regulatory spacing and pooling concerns, those wells would not normally be drilled. This is wasteful. Please remember that the RRC's mission is to prevent waste and to protect correlative rights and the mission is the underpinning of all regulations at the RRC.

Most detractors, on the other hand, simply cannot get around the idea that Allocation Wells are an end run around pooling. We have had pooling for decades, why are we taking rights away from lessors? Weren't restrictive pooling provisions created to prevent exactly this type of situation? To such practitioners, Allocation Wells twist up the whole intent of the pooling provision. If you wish to drill a well across existing units, you should reform your units to allow it. Just because it may be difficult does not mean it cannot be done. For an interesting read generally against Allocation Wells, see Bret Wells' article, *Allocation Wells, Unauthorized Pooling, and the Lessor's Remedies*.<sup>5</sup>

#### 1. PSA Wells.

The concept of Production Sharing

<sup>5</sup> Bret Wells, *Allocation Wells, Unauthorized Pooling, and the Lessor's Remedies*, online at <https://www.baylor.edu/law/review/doc.php/271080.pdf>

Agreement (PSA) Wells and later, Allocation Wells, is an evolving one. For ease, this paper refers to PSA Wells and Allocation Wells collectively as "Allocation Wells", but please note that they are distinct creations. A Production Sharing Agreement well is a well where an operator and at least 65% of the interest owners have agreed that production from a horizontal well that crosses two or more existing leases or units will be "shared". Production allocated to each unit will be treated for lease and royalty payments as if it were produced from the unit.

Starting in 1998, the idea of a Production Sharing Agreement was first brought to the RRC for permitting vertical wells. Then in 2006, the process was applied to permitting horizontal wells. Under this process, a party had to get most of the interest owners on board via a Production Sharing Agreement. It is important to note, however, that the PSA Well processes were not adopted by standard RRC rulemaking processes that provide notice to the public, as discussed later in this paper. It started on an ad hoc basis, and arguably led to some moving targets. On October 23, 2007, the first horizontal PSA Well was approved by the RRC Commissioners via a 2-1 vote in Rule 37 Case No. 0253549. In this case, Devon had 98% of the interest owners signed up in one tract and 100% in the second tract.

Devon applied for a different PSA Well permit in 2008, but this time with less than 90% of interest owners signed up. RRC staff originally denied the permit, but Devon appealed this decision, and the Commissioners approved the PSA process so long as 65% of interest owners

signed up. Secondary recovery unitization hearings require 65%, but other than that, I am not aware of why the RRC considers this to be a magic number that protects correlative rights. However, this is the current threshold for a well to be considered a PSA Well.

## 2. Allocation Wells.

In 2010, the process evolved with the concept of an "Allocation Well". On April 21, 2010, the RRC approved Devon's permit application for the "Taylor-Abney-Obanion Allocation Well". For this well, the applicant Devon did not have the requisite 65% of interest owners for a PSA permit, but the RRC nevertheless approved it. Therefore, the RRC indicated that if you have less than 65% signed up (e.g., no interest owners) an operator may permit the well as an "Allocation Well" rather than a PSA Well.

This change at the RRC was supported by many practitioners and operators, who brought in industry experts to express support for the process. Specifically, Devon asked Professor Ernest Smith, the former dean of the University of Texas School of Law and co-author of the treatise on oil and gas law, if a PSA Well - and by extension an Allocation Well - was supported by oil and gas law and lease interpretation. His response was that PSA Wells are "highly desirable" to avoid litigation and that it might be logistically impossible to get royalty owners to agree. His letter, however, also stated that "...Devon's proposed method of allocating production to each Units on the basis of that Unit's percent of completed reservoir along the horizontal

wellbore appears to be fair and reasonable but is subject to attack on the ground that allocation must be done on the basis of actual production from each Unit.”

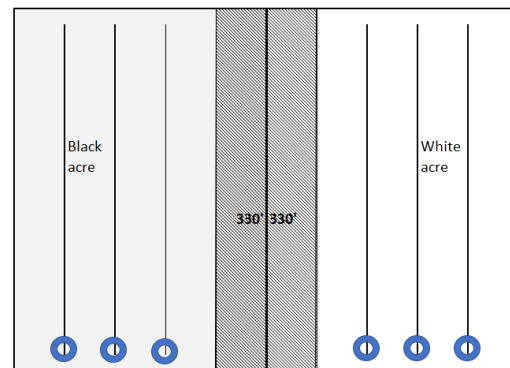
If an Allocation Well does not have an agreement with the interest owners, “[t]he absence of an agreed upon formula creates room for disputes over the operator’s allocation method.”<sup>6</sup> In an Allocation Well, the hydrocarbons are commingled, and all production come up the same wellbore. These issues are examined in the case law section below.

In any event, the RRC’s rationale is that even though it is not allowed under the Texas Constitution to adjudicate contract, as part of its rules it must determine whether an operator has a good faith claim sufficient to warrant the issuance of a drilling permit.<sup>7</sup> For the TAO Allocation Well, the RRC determined that the leasehold interest alone was sufficient to constitute a “good faith claim”. This issue has been contested both within and outside the RRC.

### 3. Lease Line Allocation Wells.

As operators continue to develop oil and gas assets, it is useful to think about Allocation Well development in terms of risk reduction. Using our Blackacre-

Whiteacre example, many operators may choose to develop horizontal wells to capacity in a particular unit or units before initiating an Allocation Well. A hypothetical is set forth below using Wolfcamp special field rules that require the operator to be within 330’ from lease lines and 100’ from lease lines perpendicular to the wellbore:



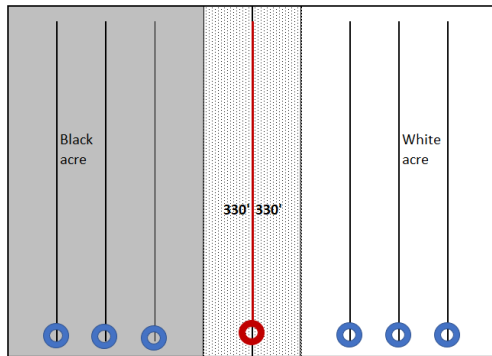
However, following this to its logical conclusion, due to spacing in the special field rules, you have a 660’ corridor going down the middle of the two units.

You have both units under lease, and you have the ability to obtain an Allocation Well permit. Enter the concept of a Lease Line Allocation Well. Lease Line Allocation Wells are Allocation Wells where an operator places the wellbore directly on the lease or unit line. Whereas many, if not most, of the prior Allocation Wells were wells perpendicular to unit lines, these are *on the unit or lease line* and bring with them some distinct issues.

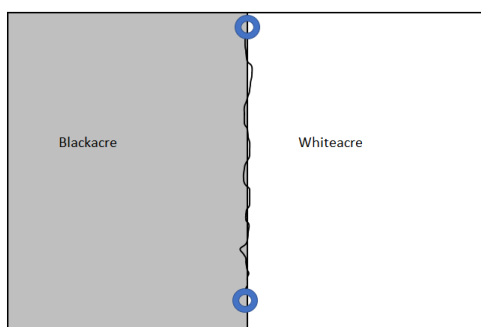
The idea is to drill something like this:

<sup>6</sup> *Clifton A. Squibb*, *The Age of Allocation: The End of Pooling As We Know It?*, 45 Tex. Tech L. Rev. 929, 930 (2013).

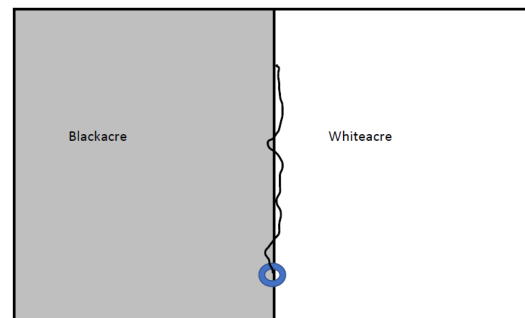
<sup>7</sup> 16 TEX. ADMIN. CODE §3.15(a)(5) holds that a “good faith claim” is a “factually supported claim based on a recognized legal theory to a continuing possessory right in a mineral estate, such as evidence of a currently valid oil and gas lease or a recorded deed conveying a fee interest in the mineral estate.”



The above proposed Lease Line Allocation Well looks clean on a permit map. It is a straight line. While arguments have been made that the “standard oil and gas lease gives the lessee all of the authority needed to drill a horizontal well that crosses lease lines” for Allocation Wells,<sup>8</sup> Lease Line Allocation Wells bring some additional concerns with respect to reasonable probability. Specifically, with Lease Line Allocation Wells there will inevitably be wellbore drift such that the well will rarely, if ever, actually be on the actual lease line. Corrections on a normal directionally drilled well may facilitate a lease line approximation that looks like the following:



However, what if the directional driller was having a particularly bad day at the office? It is entirely possible that due to unforeseen drift an operator may end up with a wellbore that is significantly more on one side of the lease or unit line than the other. What if, with corrections, the wellbore ended up as follows:



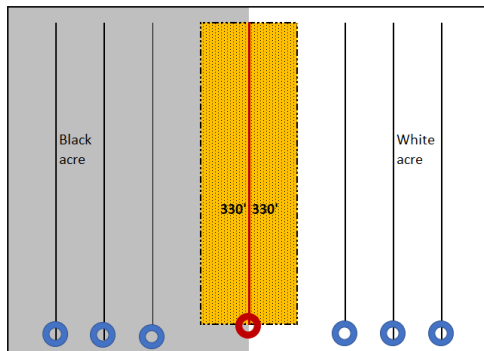
In the above example, approximately 80% of the wellbore is on the Whiteacre side of the unit boundary line. Further, suppose that there are no Production Allocation Agreements in effect. The operator may find itself subject to claims by the Whiteacre royalty owners to royalty on 80% of the production. The Blackacre royalty owners are demanding to be paid on 50% of the production. Where does “reasonable probability” for allocation fall when a party can prove that the wellbore is on its side of the unit line? Wellbore drift supports the need for Production Allocation Agreements.

If the operator has drilled the well without a Production Allocation Agreement, the essential question is, “How do you allocate the production?” There appear to be two methodologies that are gaining traction, but both should be done *with* Production Allocation

<sup>8</sup> Ernest E. Smith, *Applying Familiar Concepts to New Technology: Under the Traditional Oil and Gas Lease, a Lessee Does Not Need Pooling Authority to Drill a Horizontal Well That Crosses Lease Lines*, 3 Oil & Gas, Nat. Resources & Energy J. 553, 569 (2017).

Agreements. The first method is what some refer to as the “fifty fifty”. Simply enough, the production from the wellbore is shared 50% to the Whiteacre participants and 50% to the Blackacre participants. For many Lease Line Allocation Wells, the back and forth of a directionally drilled well would approximate 50% to either side. Usually, this methodology simplifies payment to royalty owners.

The second method is what some refer to as the “box rule”. Under the box rule, a box is typically drawn 330’ on each side of the proposed well and 100’ perpendicular to the first and last take points. The “box” may look something like this:



We say “typically” because some operators use different sized “boxes”. My recommendation is to have your box comport with the applicable field rules. In any event, production is allocated according to the surface acreage amounts in said box, regardless of the well’s ultimate location. Under the box rule, “threading the needle” down the lease line is less of a concern and accounts for wellbore drift. Both methodologies, however, should be done with Production Allocation Agreements.

## II. Dockets & Case Law.

Several of the cases discussed herein were fought both in the RRC’s administrative sphere and then in the district court. Prior to addressing the cases and dockets, however, I would note that several cases revolve around the “good faith claim” concept. In *Magnolia Petroleum Co. v. Railroad Commission*, the Texas Supreme Court noted that:

it seems to have been erroneously assumed that such a permit affirmatively authorizes the permittee to take possession of the land and drill. ...In short, the order granting the permit is purely a negative pronouncement. It grants **no affirmative rights to the permittee to occupy the property**, and therefore would not cloud his adversary’s title. It merely removes the conservation laws and regulations as a bar to drilling the well, and leaves the permittee to his rights at common law. Where there is a dispute as to those rights, it must **be settled in court**. The permit may thus be perfectly valid, so far as the conservation laws are concerned, and yet the permittee’s right to drill under it may depend upon his establishing title in a suit at law. In such a suit the fact that a permit to drill had been granted would not be admissible in support of permittee’s title...Of course, the Railroad Commission should not do the useless thing of granting a permit to one who does

not claim the property in good faith. The Commission should deny the permit if it does not reasonably appear to it that the applicant has a good faith claim in the property. If the **applicant makes a reasonably satisfactory showing of a good faith claim of ownership in the property, the mere fact that another in good faith disputes his title is not alone sufficient to defeat his right to the permit; neither is it ground for suspending the permit or abating the statutory appeal pending settlement of the title controversy.** (emphasis added)<sup>9</sup>

Statutorily, 16 TEX. ADMIN. CODE §3.15(a)(5) holds that a “good faith claim” is a “factually supported claim based on a recognized legal theory to a continuing possessory right in a mineral estate, such as evidence of a currently valid oil and gas lease or a recorded deed conveying a fee interest in the mineral estate.”

The *Magnolia* case is longstanding law, but what, exactly, is a “good-faith claim”? The RRC is not allowed to adjudicate contract, but it is allowed to look at contract to determine if a good faith claim threshold has been met. Does that mean any old paper that asserts a claim of ownership is good enough? How deep is the RRC required to look? If a lease disavows the use of Allocation Wells, would the RRC still grant the permit?

Most people do not deny that a lease, being a fee simple determinable, constitutes a continuing possessory right in a mineral estate provided that the lessee has complied with the lease terms. Most agree that the RRC, while it cannot adjudicate contract, has the right to look at the contract to see if it reaches a good faith claim threshold. But are Allocation Wells a “recognized legal theory”? Can the RRC look at a lease but ignore the pooling provisions in it when looking at the continuing possessory right in a mineral estate? What guidance is there as to what actually constitutes a “good faith claim”? Or is just what the RRC says it is? While *Magnolia* is valid case law, one can argue that it was decided in a vertical well era where horizontal well issues were not contemplated.

The issue of a “good faith claim” was central to RRC Oil & Gas Docket No. 02-0278952, styled *Application of EOG Resources, Inc. for its Klotzman Lease (Allocation), Well No. 1H (Status No. 744730), Eagleville (Eagleford-2) Field, Dewitt County, as an Allocation Well Drilled on Acreage Assigned from Two Leases*, for which a Proposal for Decision was issued June 25, 2013. The case and the issuance of the Proposal for Decision by the Hearings Examiners had a number of interesting points. In this docket, EOG wanted to drill a PSA Well where the “...proposed well would be on 80 acres, composed of 40 acres from the Georgia Dubose Glassell 516.569-acre lease and 40 acres from the Georgia Dubose-Pierce 304.97-acre lease. The two leases were entered into in 1956. EOG states it has 100% of the determinable fee mineral estate in each lease. However, the subject

<sup>9</sup> *Magnolia Petroleum Co. v. Railroad Commission* 170 S.W.2d 189, 191 (Tex. 1943).

leases do not grant pooling authority for oil".<sup>10</sup>

As referenced earlier, all Allocation Wells and PSA Wells are Rule 37 lease line exception issues. 16 Texas Administrative Code Section 3.37 is clear about who gets notice: (i) unleased mineral interest owners, (ii) the lessees of record for tracts that have no designated operator and (iii) the designated operator.<sup>11</sup> Given that EOG was its own offset, the leased mineral owners were not provided notice. However, the situation here was a little different because the mineral owner, who also happened to be an attorney, was aware of the application and protested at the RRC. The fact that the mineral interest owner was allowed standing to request a hearing shows that the RRC thought that there were notice concerns.<sup>12</sup>

In the hearing, the Klotzmans argued that EOG did not have pooling authority and therefore should not be granted a PSA Well permit. During the hearing, EOG acknowledged that there was no pooling authority and *stated* that it had tried to get the pooling authority but was denied. Instead, they argued that they were just

taking acreage from two leases to form a separate unit.<sup>13</sup>

The hearings examiner noted that "EOG's denial that it is pooling is untenable. Its actions are the definition of pooling."<sup>14</sup> He went on to assert that EOG was pooling, that it had no authority to do so under the leases, and that without the power to pool, EOG had no good faith claim to drill the well. Therefore, it was not entitled to a permit under the RRC rules.

Also, the examiner opined that there were no Texas statutes, RRC rules or any other final orders that authorized Allocation Wells. He stated that "[t]he Commission has no authority, by Final Order or rule, to legitimize permits for Allocation Wells insofar as they are wells composed of leased acreage lacking pooling authority." Citing caselaw, he further opined that "...the acts of the Railroad Commission cannot be said to operate effectively to extend the restrictive terms of a lease. The orders of the Railroad Commission cannot compel pooling agreements that the parties themselves do not agree upon. The Railroad Commission has no power to determine property rights." *Jones v. Killingsworth*, 403 S.W.2d 325, 328 (Tex. 1966) (emphasis added).<sup>15</sup> The hearing examiner in the Proposal for Decision

<sup>10</sup> Proposal for Decision, Oil & Gas Docket No. 02-0278952, Application of EOG Resources, Inc. for its Klotzman Lease (Allocation), Well No. 1H (Status No. 744730), Eagleville (Eagleford-2) Field, Dewitt County, Page 4.

<sup>11</sup> See 16 T.A.C. 3.37, found online at [https://texreg.sos.state.tx.us/public/readtac\\$ext.TacPage?sl=R&app=9&p\\_dir=&p\\_rloc=&p\\_tloc=&p\\_ploc=&pg=1&p\\_tac=&ti=16&pt=1&ch=3&rl=37](https://texreg.sos.state.tx.us/public/readtac$ext.TacPage?sl=R&app=9&p_dir=&p_rloc=&p_tloc=&p_ploc=&pg=1&p_tac=&ti=16&pt=1&ch=3&rl=37).

<sup>12</sup> At this point in the history of allocation wells, the examiners noted in their Proposal for Decision that the RRC had administratively approved 55 allocation well permits, and that the administrative approval was in large part because there were no protestants.

<sup>13</sup> Proposal for Decision, Oil & Gas Docket No. 02-0278952, Application of EOG Resources, Inc. for its Klotzman Lease (Allocation), Well No. 1H (Status No. 744730), Eagleville (Eagleford-2) Field, Dewitt County, Page 20.

<sup>14</sup> *Id.*

<sup>15</sup> *Id.* at Page 21.

recommended that EOG's application be dismissed.<sup>16</sup>

So, the hearings examiner analyzed the law in his Proposal for Decision and presented it to the elected Railroad Commissioners at public conference. As the hearings examiner in the Klotzman Proposal for Decision noted, the Commission has not been given the authority by the Texas Constitution to adjudicate property rights. The practice has been when there is a contract or property rights interpretation issue that the RRC "punts" the issue to the district court. In other words, for issues involving contract or property rights interpretations, the RRC routinely directs the parties to obtain a judgment and provide the RRC with same. Notwithstanding the position of the RRC's hearings division, the elected Commissioners granted EOG's permit anyway.

The RRC dismissed the contested claims by the Klotzmans and said that EOG's basis was enough to reach the threshold of a good faith claim. Basically, the RRC said that for the regulatory world, having a lease is good enough for a good faith claim, regardless of what the provisions of said lease, i.e., the pooling provision, may say. In other words, the RRC said the lease was enough to qualify for a good faith claim, but it did not need to examine the actual provisions thereof to determine if allocation wells were allowed.

In addition to the good faith claim,

<sup>16</sup> We note that the Examiner's PFD is not binding unless approved by the elected Commissioners. We include the legal analysis for informational purposes only.

another key issue with Allocation Wells is determining with "reasonable probability" what production comes from which unit or tract. Is the formation homogenous enough that payment according to productive lateral is reasonably prudent? What if there is a geological fault, such that production from Blackacre is more condensate rich than the production from Whiteacre? That is what the Klotzmans were arguing before the RRC as discussed in their hearing.

In an Allocation Well, the hydrocarbons are commingled, and all production come up the same wellbore. If it all comes up the same wellbore, how does one attribute what production came from what tract? Doesn't this violate 16. Tex. Admin Code §3.26(a)(2), which holds that "[a]ll oil and any other liquid hydrocarbons as and when produced shall be adequately measured ...before the same leaves the lease from which they are produced...."?

A. *Browning v. Luecke.*

*Browning v. Luecke* (38 S.W.3d 625 (Tex. App. - Austin, 2000), which forms the basis for many of the arguments of proponents of PSA Wells and Allocation Wells, had a subject lease with an anti-dilution clause such that if the Lessee was going to pool it had to pool a designated percentage of the acreage in the unit. The Lessee wanted the Lessor to change the lease provisions, but the Lessor refused. The Lessee ignored the issue and drilled their well anyway. In the following lawsuit, the Lessors argued that pooling was not effective as to them and that they

were entitled to royalties based on *all* production from the wellbore. The court addressed the advent of modern technology and held that each tract traversed by a horizontal wellbore should be considered a “drillsite tract”. However, the court also held that the Lessee must account to Lessors for production on an unpooled basis. Specifically, the court held that “[t]he better remedy is to allow the offended lessors to recover royalties as specified in the lease, compelling a determination of what production can be attributed to their tracts with **reasonable probability**.”<sup>17</sup> (emphasis added). However, *Browning v. Luecke* was not a Texas Supreme Court case and was remanded to the district court so the parties could determine what production came from what part of the wellbore. Unfortunately, this issue was not answered as the parties settled out of court.

B. *Springer Ranch v. Jones*.

While not an Allocation Well case *per se*, the San Antonio Court of Appeals in *Springer Ranch, Ltd. v. Jones* provided some insight to what is “reasonable”. In that case, parties disputed what royalties should be attributed to what portion of the wellbore. Springer Ranch argued that the distribution of production should be based on the entirety of the wellbore, whereas the other party’s expert testified that the apportionment should be from first take point to last take point. The court found that the expert’s opinion that production from multiple tracts allocated

on the basis of the horizontal wellbore’s distance from the first to last take points within the correlative interval was reasonable.

C. *Spartan Texas Six Capital Partners, Ltd. v. Perryman*

In *Spartan Texas Six Capital Partners, Ltd. v. Perryman*, Cause No. 2011-27476, 11th Judicial District Court, Harris County, the plaintiffs alleged that allocating production on productive lateral length should be held to a higher standard of “**reasonable certainty**” rather than the “reasonable probability” alluded to in *Browning v. Luecke*. This is informational only, though, given that *Spartan Texas Six Capital Partners, Ltd. v. Perryman* was also settled out of court.

D. *Monroe Properties*

In RRC Oil & Gas Docket No. 08-0305330, styled *The Complaint of Monroe Properties, Inc., et al. that Devon Energy Production Co, LP does not have a Good Faith Claim to Operate the N I Helped 120 (Alloc) Lease, Well No. 6H, Phantom (Wolfcamp) Field, Ward County, Texas*, the Complainants argued that Devon did not and could not have a good faith claim to drill its well. The Complainants argued that in order for Devon to have authority to drill the well, it had to have either a contractual lease basis, *i.e.*, pooling authority, or it had to have entered into a production sharing agreement. Devon did neither and Complainants claimed that it lacked a good faith claim as a result.<sup>18</sup>

<sup>17</sup> *Browning v. Luecke*, 38 S.W.3d 625, 647 (Tex. App. – Austin, 2000).

<sup>18</sup> RRC Oil & Gas Docket No. 08-0305330, Complaint of Monroe Properties, Inc., et al. that Devon Energy Production Co, LP does not have a Good Faith

The RRC summarily dismissed the Complaint. It said “[i]n the Klotzman case, the Commission has previously decided that it does not require proof of pooling authority for an applicant to show a good faith claim necessary to obtain a permit for an allocation well. There has been no change in the law since the decision in the Klotzman case... While the Complainants may have a bona fide lease dispute with Devon, the determination of whether there has been a breach and the appropriate remedy is outside the jurisdiction of the Commission.”<sup>19</sup> Finally, the RRC held that “[n]either pooling authority nor a production sharing agreement is required to establish a good faith claim for a permit to drill an allocation well.”<sup>20</sup> The RRC’s ruling was appealed to the District Court.

In *Monroe Properties, Inc. et al. vs Railroad Commission of Texas*, Cause No. D-1-GN-18-001111, 53<sup>rd</sup> Judicial District Court, Travis County, the plaintiffs noted that “[n]o Texas case has ever construed an oil and gas lease to permit the lessee to pay royalties on an estimated share of commingled production. The only method authorized by the Lease for commingling production from multiple tracts is by forming pooled units.”<sup>21</sup> It went on to assert that Devon did not therefore meet

Claim to Operate the N I Helped 120 (Alloc) Lease, Well No. 6H, Phantom (Wolfcamp) Field, Ward County, Texas, Order Of Dismissal, found at <https://www.rrc.texas.gov/media/43907/08-0305330-ord.pdf>

<sup>19</sup> Id.

<sup>20</sup> Id.

<sup>21</sup> PLAINTIFFS' ORIGINAL PETITION FOR JUDICIAL REVIEW in the 53<sup>rd</sup> District Court, Travis County. *Monroe Properties, Inc. et al. vs Railroad Commission of Texas*, No. D-1-GN-18-001111.

the RRC’s threshold of “colorable claim to the right to drill” (i.e., a good faith claim).

The Petition also noted that the RRC was failing to abide by its own rules. Plaintiffs asserted that the Allocation Well permit violated both Statewide Rule 40, Assignment of Acreage to Pooled Development and Proration Units, and Statewide Rule 26, Separating Devices, Tanks, and Surface Commingling of Oil. Per the Petition, “Devon’s proposed completion would render it impossible to measure all hydrocarbon production before it leaves the lease from which it is produced” and violates Rule 26’s requirement that “all ‘oil and other liquid hydrocarbons’ [are] to be measured before the same leaves the lease from which they are produced.”<sup>22</sup>

Separately, as one commentator has noted, the RRC’s rules on commingling of oil and gas and “the applicability of these rules to allocation wells is questionable.”<sup>23</sup> The commentator opines that “[r]egardless of their applicability, however, if extending them to allocation wells would achieve the policy objectives for which the rules were adopted, a strong argument can be made that the rules should apply. In any event, the novelty of allocation wells prompts consideration of the question of whether rules or statutes should be adopted to expressly regulate commingling within allocation wells.”<sup>24</sup>

<sup>22</sup> Id, at Paragraph 24 – 25.

<sup>23</sup> *Clifton A. Squibb*, *The Age of Allocation: The End of Pooling As We Know It?*, 45 *Tex. Tech L. Rev.* 929, 948 (2013).

<sup>24</sup> *Clifton A. Squibb*, *The Age of Allocation: The End of Pooling As We Know It?*, 45 *Tex. Tech L. Rev.* 929, 948 (2013).

The Petition in the *Monroe Properties* case pointed out some very real concerns about allocating production properly. However, like in *Spartan*, this case was settled out of court and should be looked at for informational value.

E. *The Opielas*

Similar issues related to a good faith claim were brought forward again in RRC Oil & Gas Docket No. 02-0315435, styled *Complaint of Elsie Opiela and Adrian Opiela Regarding Magnolia Oil & Gas Operating LLC's (521544) Audioslave A Lease, Well No. 102H, Permit No. 839487, Sugarkane (Austin Chalk) Field, Karnes County, Texas*. Per the examiners' Proposal for Decision, this case was distinct from *Klotzman* in that the *Klotzman* docket related to an Allocation Well, whereas the well in question here was a PSA Well.

In this docket, the Complainants pointed out that the Commission's own rules did "not define or mention PSA or allocation wells and consequently there is no authority for the Commission to issue PSA permits or allocation well permits".<sup>25</sup> The Complainants also pointed out that, since they did not sign a production allocation agreement, the operator could not measure what production came from which tract and that the operator necessarily had to estimate that production in violation of Statewide Rule 26, which requires that all liquid

<sup>25</sup> RRC Oil & Gas Docket No. 02-0315435, styled *Complaint of Elsie Opiela and Adrian Opiela Regarding Magnolia Oil & Gas Operating LLC's (521544) Audioslave A Lease, Well No. 102H, Permit No. 839487, Sugarkane (Austin Chalk) Field, Karnes County, Texas*, Proposal for Decision, Page 10, found at <https://portalvhdskzlf8q9lqr9.blob.core.windows.net/media/54400/020315435pfd.pdf>

hydrocarbons be measured before leaving a particular lease.<sup>26</sup> Complainants also asserted that the permit violated Statewide Rule 40, dealing with Assignment of Acreage to Pooled Development and Proration Units.

The RRC summarily dismissed this Complaint as well. According to the Examiners' Proposal for Decision, rulemaking for Allocation Wells was not necessary:

Commission rules require a permit to drill "any oil well." The Commission has adopted rules providing a process for obtaining drilling permits for wells. The standard for determining whether the operator can get a permit is whether the operator has a "good faith claim" to operate. This is in Commission rule and has been acknowledged by the Texas Supreme Court. The Examiners are not persuaded that the Commission has to adopt a rule to expressly address each type of documentation or contractual arrangement that can be utilized to show a good faith claim to operate a well. The Texas Supreme Court has already provided a standard for such demonstration. According to the Court—consistent with Commission rules—the standard for an operator to demonstrate a right to operate sufficient to obtain a permit is: "a reasonably satisfactory showing of a good

<sup>26</sup> *Id.*

faith claim” to operate the well. The Commission is not required to adopt rules specifying what qualifies as a good faith claim.<sup>27</sup>

The Complainants appealed.

In *Opiela v. Railroad Commission of Texas*, Cause No. D-1-GN-20-000099, 53<sup>rd</sup> Judicial District Court, Travis County, the court stated otherwise. In its May 12, 2021 judgment, the District Court held that: (i) the RRC failed to comply with the requirements of the Administrative Procedure Act, Tex. Gov’t Code § 2001.001 et seq.; (ii) the RRC erred in concluding that it had no authority to review whether an applicant seeking a well permit has authority under a lease or other relevant title documents to drill the well; (iii) the RRC erred in failing to consider the pooling clause of the lease when analyzing the good faith claim; and (iv) the RRC erred in finding that the operator had a good faith claim to drill the subject well. The case was reversed and remanded to the RRC for further proceedings.

The District Court basically said that the RRC could not put on blinders when looking at the good faith claim component and that part of the good faith claim component is considering the pooling clause of the lease. Again, it is my understanding that the Judgment is likely

to be appealed by the Commission but note that attacks on Allocation Wells are ongoing.

### III. Best Practices

Recommending executed production allocation agreements is the legal equivalent of ensuring that your mud weight is up. Some clients proceed cautiously and obtain the production allocation agreements. Some respond that obtaining executed allocation agreements from interest owners is just “hard”, and they usually point out that other operators are doing it without obtaining production allocation agreements. So why should they go through that effort? Some respond with something in between.

A Production Allocation Agreement is recommended for all Allocation Wells, but it is **strongly recommended** for Lease Line Allocation Wells. Arguments have been made that the “standard oil and gas lease gives the lessee all of the authority needed to drill a horizontal well that crosses lease lines” and Allocation Wells are perfectly valid under the authority in the underlying leases.<sup>28</sup> But an argument could be made that Lease Line Allocation Wells are different. As discussed earlier, it is entirely possible that due to unforeseen drift an operator may end up with a wellbore that is significantly more on one side of the lease line than the other.

Production Allocation Agreements head off most of the thorny issues before

<sup>27</sup> RRC Oil & Gas Docket No. 02-0315435, styled Complaint of Elsie Opiela and Adrian Opiela Regarding Magnolia Oil & Gas Operating LLC’s (521544) Audioslave A Lease, Well No. 102H, Permit No. 839487, Sugarkane (Austin Chalk) Field, Karnes County, Texas, Proposal for Decision, found at <https://portalvhdskszlf8q9lqr9.blob.core.windows.net/media/54400/020315435pfd.pdf>

<sup>28</sup> *Ernest E. Smith*, Applying Familiar Concepts to New Technology: Under the Traditional Oil and Gas Lease, a Lessee Does Not Need Pooling Authority to Drill a Horizontal Well That Crosses Lease Lines, 3 *Oil & Gas, Nat. Resources & Energy J.* 553, 569 (2017).

they arise. Indeed, “the lessee can address the question of production allocation by reaching agreement with affected royalty owners as to how production will be allocated among the various tracts....When a lessee drills a horizontal well pursuant to a PSA, the PSA is normally executed before the lessee drills the horizontal well. Thus, by the time the lessee obtains production from the horizontal well, the lessee already knows how that production will be allocated.”<sup>29</sup>

So, there are benefits to a Production Allocation Agreement, particularly in situations involving Lease Line Allocation Wells. Generally speaking, we have not encountered a “standard Production Allocation Agreement”. However, there are several key aspects that should be considered in a Production Allocation Agreement.

Here are some recommendations:

- The parties should analyze whether the proposed allocation method is as scientifically credible as possible and fair to the parties. *Springer Ranch’s* “first to last take point” in the correlative interval as part of the methodology would appear to be the most credible at this point. However, pay attention to the science in the specific area you are developing and whether same is homogenous. First to last take point is most often the most reasonable, but situations vary.
- The agreement should include as many pertinent parties as possible as a

risk mitigation approach. Remember that any signup, whether it is designated as a PSA (with >65%) or an Allocation Well (with <65%) gives added protection.

- Keep in mind the RRC’s legislative goals to prevent waste and protect correlative rights. A defensible allocation formula should support these goals.
- Do the underlying leases have retained acreage provisions? If so, consider addressing how this will be apportioned to the Allocation Well in the Production Allocation Agreement.
- If at all possible, the Production Allocation Agreement should include language that contemplates more than one Allocation Well, in the event that future Allocation Wells are on the drill schedule.
- The agreement should contain subsurface right of ingress and egress language in the event of subsurface easement claims by parties not in agreement with your Allocation or PSA Well.
- The agreement should be cognizant of offset drilling obligations and draft around them when possible.
- The agreement should include language that operations or production on an Allocation Well will be treated as operations or production from the subject leases (consider continuous drilling obligations).

<sup>29</sup> Id, at 567.

- The agreement should amend the leases as far as is necessary to allow the drilling of the Allocation Well. In the event a court of law were to ever strike down Allocation or PSA Wells on the basis that it violates pooling provisions, an argument could be made that the parties contractually agreed to allow it.

*IV. Conclusion. For now.*

Allocation Wells are here in the industry and operators see the benefits. As the industry grows and Allocation Wells and PSA Wells grow with it, we will continue to see adaptation to facts on the ground. Hopefully, this paper has provided some basic information on how the process came to be, where it is going, and how to proceed with caution when using Allocation Wells.