

*PSA's &  
ALLOCATION WELLS:  
SHARE AND SHARE ALIKE?*



# *Parallel Universes?*

## Regulatory World vs. Non-Regulatory World?

The Railroad Commission is the Texas agency which regulates the production of oil & gas. It does NOT, however, have the authority to adjudicate contract.

When the Railroad Commission is faced with adjudicating a contract, it ...

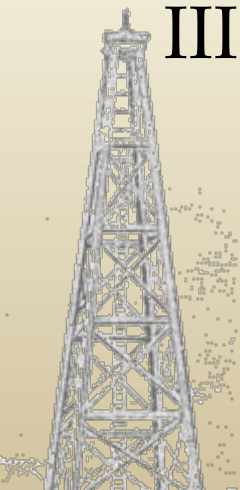
“...punts.”

The parallel universes typically co-exist peacefully; however, there are occasions when somebody tries to get creative and attempts to cross worlds.

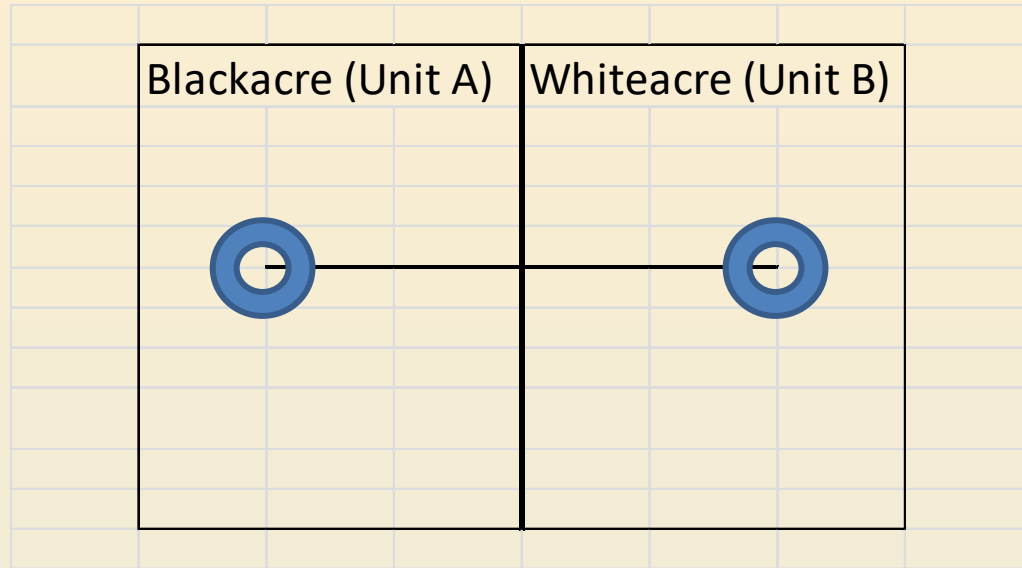
*So what happens when worlds collide?*

# *Topics to Discuss:*

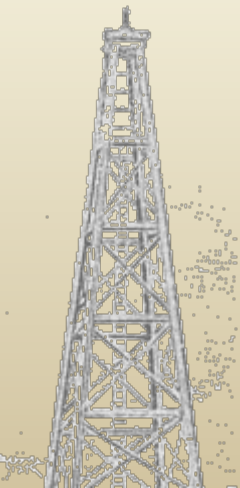
- I. What? What are allocation wells and production sharing agreement wells?
- II. When? When should you use them? What are the legal ramifications?
- III. How? If you move forward, what are the mechanics of using them?



# *I. What are PSA Wells & Allocation Wells?*

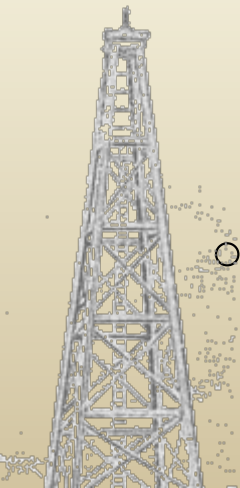


So you want to drill a lateral and you want to cross a boundary between already pooled units, *or* units with no pooling authority???



## *(A) PSA Wells*

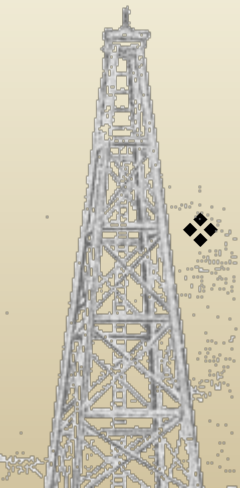
- ❖ How do you cross from one unit to another when pooled entities are already formed for vertical wells ... or when there are unpooled leases?
- ❖ You could re-form the unit – but if you are reducing the size or dissolving it entirely, that requires consent of all owners.
- ❖ What about those PSA's I've been hearing about?
  - Interest owners agree that production from horizontal well will be “shared” between the units by entering into “Production Sharing Agreement”, or PSA.
  - Production allocated to each unit will be treated for lease and royalty payments as if it was produced from the unit.



## *(A) PSA Wells*

Operators want to drill laterals that cross boundaries of pooled units or units, but they don't have pooling authority!

- ❖ The PSA well was created to deal with this situation.
  - It is a contractual agreement in two (or more) pooled units that allows horizontal well to be drilled with part of its productive drainhole under each unit
  - It generally affects only production from wells that cross leases or units, and purports to increase the ultimate recovery of hydrocarbons.
- ❖ QUESTION: Which policy is more important in the regulatory world – reduction of waste, or protection of correlative rights?

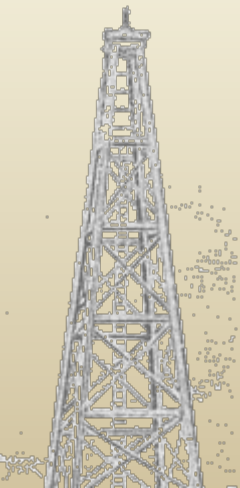
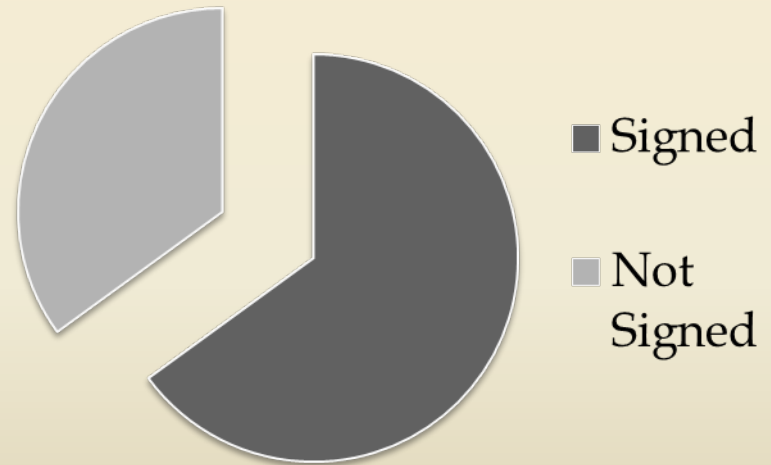


# (A) PSA Wells

## Railroad Commission Policy

- ❖ Informally, the RRC says the operator must represent in his permit application that he has PSA's from 65% of interest owners in both (or all) units
- ❖ Note that this policy means that a lessee can drill across boundary lines between pooled units *even when 35% of interest owners have not consented to a contractual method for sharing production*

## Sharing Agreement



## (A) PSA Wells

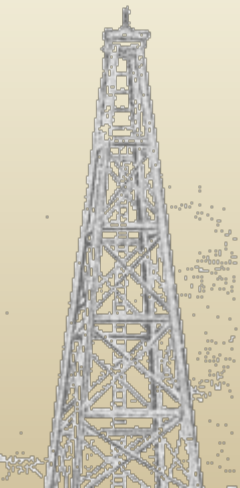
YEAR	RRC Policy/Procedure
1998	RRC first established procedure for permitting <i>vertical</i> PSA wells drilled on or near lease-lines
2006	RRC established procedure for permitting <i>horizontal</i> PSA wells
2007	RRC staff denied PSA well permit because less than 100% of interest owners were signed up. Devon appealed to Commissioners, who granted permit.
2008	RRC staff denied PSA well permit because less than 90% of interest owners were signed up. Devon appealed again and won. <i>Informal</i> RRC policy is permit approval with 65% of interest owners signed up.
2010	Devon Energy files well permit application for "Taylor-Abney-Obanion Allocation Well". Even though Devon did not have the requisite 65% of interest owners for a PSA, the RRC <i>still approved the permit</i> .
Late 2013 (most recent stats we could find)	RRC has issued over 184 PSA well permits and more than 60 Allocation well permits.



## ***(B) Allocation Wells***

- ❖ An allocation well is a horizontal well that traverses the boundary between two or more existing leases that have not been pooled, *and for which no agreement exists among interest owners as to how production will be shared.*
- ❖ Yes, emphasis added. Read that again.

**No. Agreement. Exists.**



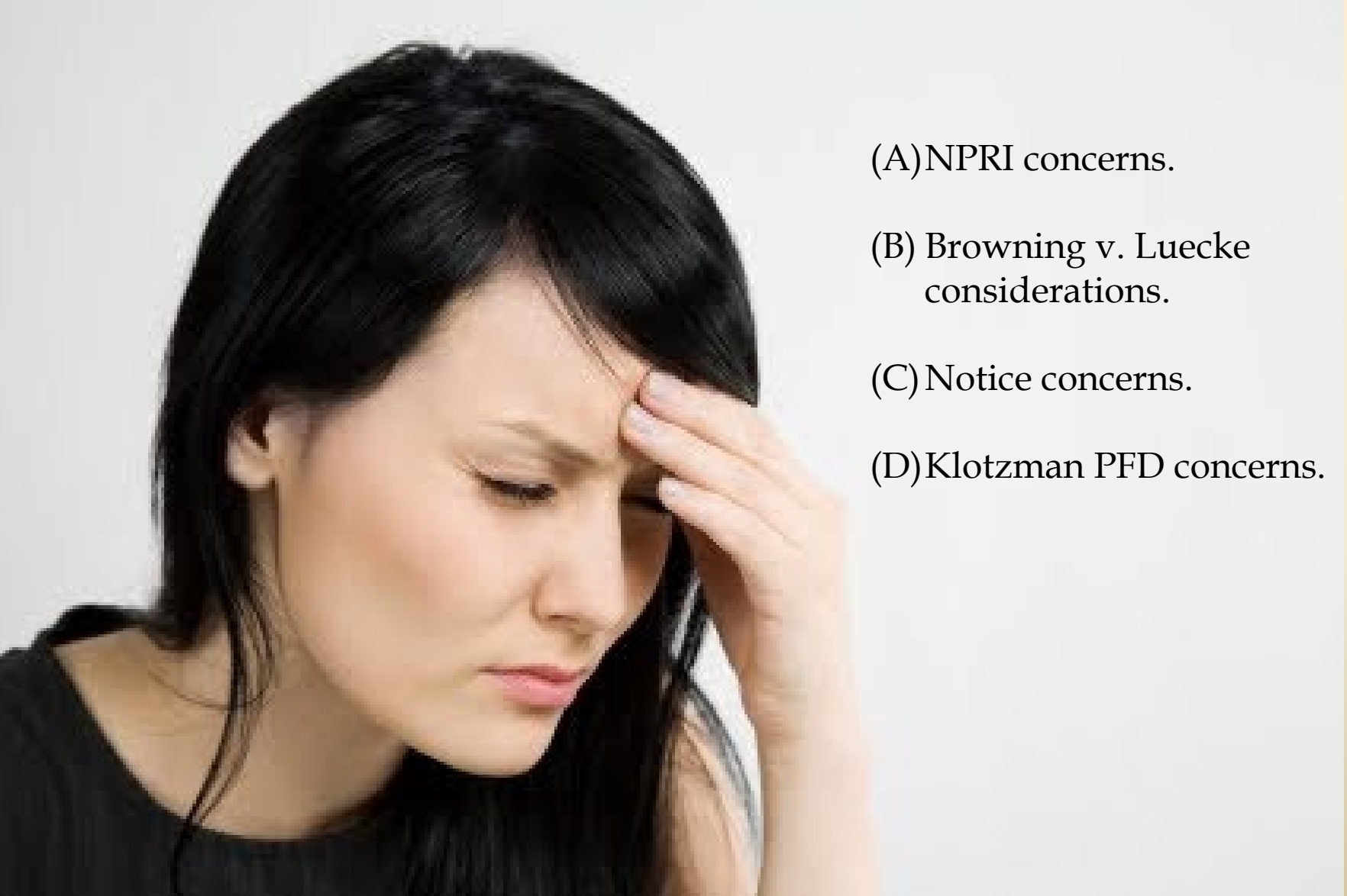
## ***(B) Allocation Wells***

- ❖ The RRC says that on “tracts” that have a valid lease, you can get an Allocation Well Permit without the qualifier that you have to provide for a PSA Well Permit – that 65% of interest owners have signed an agreement as to how production proceeds will be divided.
- ❖ However, the RRC notes that you cannot incorporate “tracts” into your Allocation Unit that the wellbore does not traverse.
  - Not an exclusion of tracts in an existing pooled unit that a proposed well did not traverse.

## ***(B) Allocation Wells***

- ❖ In 2009, Professor Ernest Smith was asked several questions by outside counsel for Devon Energy about a specific set of facts for horizontal drilling. One question was whether a PSA was *necessary* to drill a horizontal well?
- ❖ His answer walks a tightrope of Texas oil & gas law:
  - PSA is “highly desirable” to avoid litigation over royalties
  - Might be “logistically impossible” to find all royalty owners, or to get them to agree
  - So “the absence of such an agreement does not preclude drilling”!
  - But, “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.” (emphasis added)

## *II. When should I use them? What are the ramifications?*



(A) NPRI concerns.

(B) Browning v. Luecke considerations.

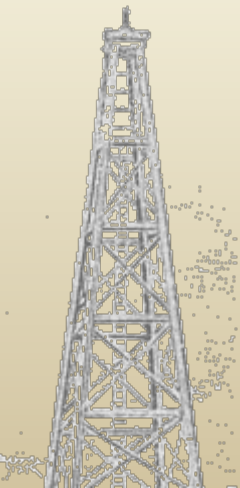
(C) Notice concerns.

(D) Klotzman PFD concerns.

## **(A) *NPRI concerns.***

*Altman v. Blake*, 712 S.W. 2d 117 (Tex. 1986)

- ❖ Right to develop;
- ❖ Right to lease;
- ❖ Right to receive bonus payments;
- ❖ Right to receive delay rentals; and,
- ❖ Right to receive royalty payments.



# (A) *NPRI concerns.*

## Restrictions on Pooling.

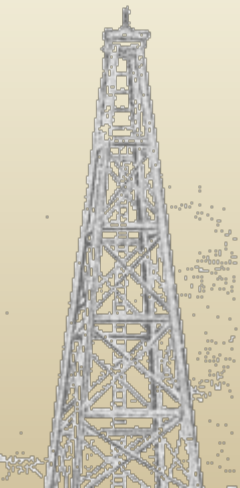
- Executive's power to lease on behalf of non-executive interests does not extend to pooling!!!!

“Pooling ... cannot be binding upon the non-participating royalty owner in the absence of his consent.” (*Montgomery v. Rittersbacher*, 424 S.W.2d 210 (Tex. 1968), citing *Brown v. Smith*, 174 S.W.2d 43 (Tex. 1943))

- Theory: to protect the non-executive from forced dilution.
- Consequence: Non-executive now has quasi-executive power – to either consent to pooling, or to refuse!

Consent = pooling is effective as to the non-executive's interest.

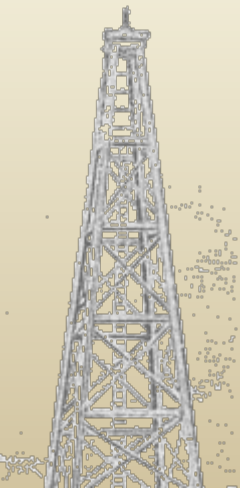
Refusal = non-executive is entitled to his *unpooled share of production!!*



## (B) *Browning v. Luecke* considerations.

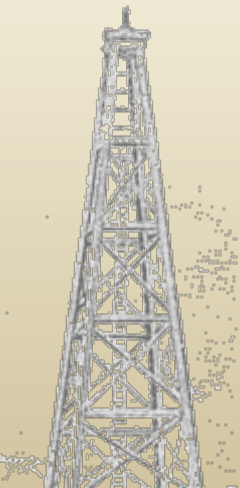
In the *Browning v. Luecke* case (38 S.W.3d 625 (Tex. App. – Austin, 2000)):

- ❖ Lessee was bound by an anti-dilution provision that restricted the quantity of lease acreage that could be pooled.
  - Lessee could not get amendment; filed a pooling instrument that did not comply with anti-dilution provision, and then drilled anyway.
- ❖ Lessors sued, saying that pooling was not effective *as to them*.
  - Said they were entitled to royalties based on all production.
- ❖ Court held that lessee must strictly comply with pooling provisions in the lease, and lessees must account to lessors for production on an unpooled basis.



## (B) *Browning v. Luecke* considerations.

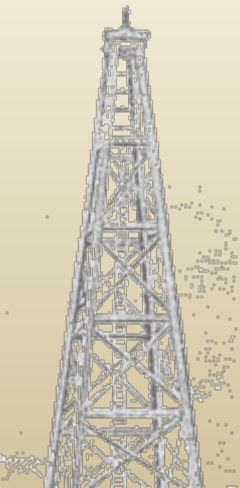
- ❖ Keep in mind also that the *Luecke* case was a Texas Court of Appeals case – the Texas Supreme Court still has not addressed this issue.
- ❖ Further, the case was remanded to the trial court to reassess damages, and the parties later settled.
- ❖ There are several unanswered questions:
  - What is considered “reasonable probability”?
  - Who has the burden of proof?
  - What is the measure of damages if “reasonable probability” cannot be ascertained?





## ***(C) Notice concerns.***

- ❖ Haven't oil companies been applying for PSA wells in horizontal situations since 2006?
- ❖ Surely the courts would have addressed this by now?
- ❖ Why haven't we seen more cases dealing with this issue?
- ❖ Why should we be concerned with the RRC Notice provisions?



## **(C) Notice concerns.**

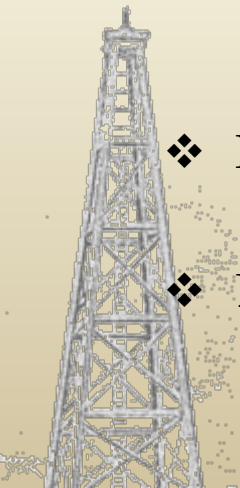
### ❖ 16 Texas Administrative Code, Section 3.37:

(A) When an exception to only the minimum lease-line spacing requirement is desired, the applicant shall file a list of the mailing addresses of all affected persons, who, for tracts closer to the well than the greater of one-half of the prescribed minimum between-well spacing distance or the minimum lease-line spacing distance, include:

- (i) the designated operator;
- (ii) all lessees of record for tracts that have no designated operator; and
- (iii) all owners of record of unleased mineral interests.

❖ No notice to Lessors, but money solves a lot of problems!

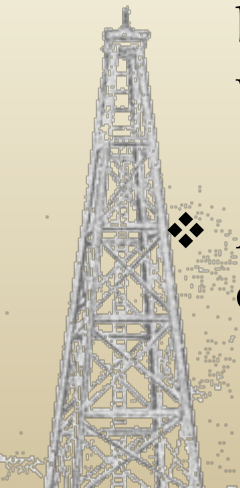
❖ Battle of the experts costs \$\$\$.



## ***(D) Klotzman Proposal for Decision.***

Klotzman (Allocation) #1H – Oil & Gas Docket No. 02-0278952

- ❖ On July 26, 2012, EOG Resources, Inc., submitted an application to the RRC to drill the Klotzman #1H in the Eagleville (Eagle Ford-2) field in DeWitt County.
- ❖ Application was for an allocation well, purporting to form an 80-acre unit with 40 acres from a 516.569-acre lease, and 40 acres from a 304.97-acre lease.
- ❖ Productive segment of the horizontal drainhole traversed the boundary between the two leases and would produce from points within each lease.
- ❖ Application requested a Rule 37 exception, but EOG was its own offset and waived the notice requirement and hearing.



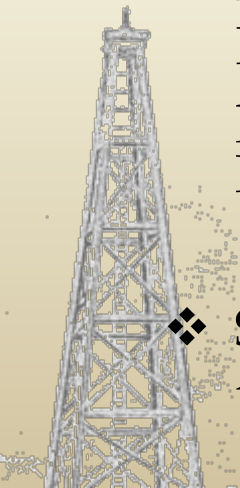
## ***(D) Klotzman Proposal for Decision.***

### ❖ Notice Questions:

- Generally only the parties designated under 16 T.A.C. 3.37 are entitled to notice of a Rule 37 exception.
- An offset-royalty owner (like an NPRI) is not entitled to notice as there is no right to lease – no executive right.

❖ However, four days after EOG's application was filed, the Klotzmans, as royalty interest owners, filed a protest with the RRC Drilling Permits Section nothing that there was no PSA in place, nor any other agreement, regarding the applied-for well. Further, the leases in question did not authorize pooling.

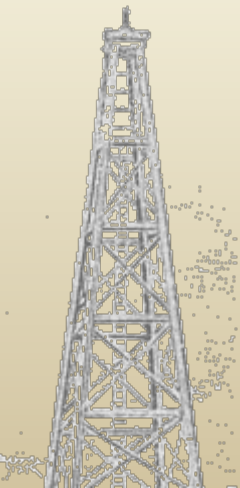
❖ So per the Klotzmans, EOG had no good-faith claim with which to drill the well.



## ***(D) Klotzman Proposal for Decision.***

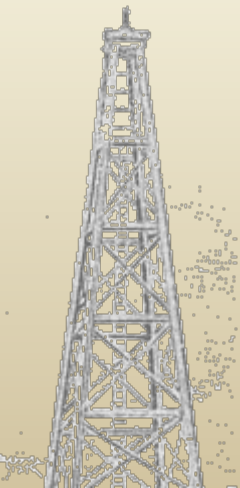
### RRC Examiner Opinion:

- ❖ Everything centered on the single issue of whether EOG had a “good-faith claim” to drill the well.
- ❖ No Texas statute, no Commission Statewide Rule or Final Order that “authorizes” allocation wells.
- ❖ No real Commission form at the time of the hearing in December 2012.
  - Now have Form PSA-12 and P-16, which address allocation wells but are not Allocation Well Forms or applications.



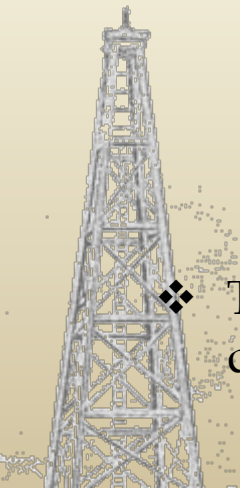
## ***(D) Klotzman Proposal for Decision.***

- ❖ In the hearing, EOG agreed that there was no pooling authority and noted that it tried to obtain such authority, but was unsuccessful.
- ❖ But then EOG stated that it was just taking acreage from two leases to form a separate unit – it was not pooling.
  - Pooling occurs where tracts from two or more leases are combined for the purposes of drilling a single well.
  - EOG's actions were the very definition of pooling!



## ***(D) Klotzman Proposal for Decision.***

- ❖ The examiners agreed that EOG was pooling, and had no authority to do so under the leases.
  - Texas courts say there is no power to pool without express authority, so EOG had no good-faith claim with which to drill the well.
- ❖ Further, according to the examiner, the RRC did not have authority to grant permits for allocation wells, as they are *just proposed wells with leased acreage lacking pooling authority*.
  - While the RRC has broad authority to prevent waste, they cannot take away a property right – in this case, the Klotzmans' pooling authority – and give it to an operator like EOG.
- ❖ Therefore, the examiners recommended that EOG's application be dismissed. **OVERRULED!**



## ***(D) Klotzman Proposal for Decision.***

EOG presents the Commission with a false dichotomy: an argument that the only choice is between lease wells on the one hand or “allocation” wells on the other hand. There is a third choice which EOG has worked hard to ignore and avoid: negotiation in good faith with the lessors for their retained property interest, which is pooling authority for oil. The acquisition of this property right would provide EOG the same developmental flexibility afforded by the use of “allocation” wells. If EOG chooses not to negotiate to obtain a property right it does not have, it cannot obtain relief at the Commission by asking the Commission to do what it has no authority to do, that is, transfer that same property right from lessor to lessee.

The examiners recommend that the application of EOG for its Klotzman (Allocation) Well No. 1H in the Eagleville (Eagle Ford-2) Field in DeWitt County be dismissed for lack of proper pooling authority and consequent lack of a good faith claim to drill the proposed well.



### *III. How? If you move forward, what are the mechanics of using them?*

Used to be a big pile of paperwork:

- ❖ Form W-1 Application
- ❖ Form PSA-12
- ❖ Authority Statement
  - Includes percentage of participation in unit
  - If less than 65% and for some reason you want to proceed with a PSA well instead of an allocation well, then you will need to request a hearing
- ❖ Acreage Allocation Worksheet
  - Breakdown of activity for each contributing unit
- ❖ Plat showing external boundary of all tracts contributing acreage to the proposed well

1. FIELD NAME(S)		2. LEASE / ID NO. (if assigned)	3. RRC District No.
4. OPERATOR P-5 NAME		5. OPERATOR P-5 NO.	6. WELL NO.
7. SHARING AGREEMENT NAME		8. API NO.	9. PURPOSE OF FILING
10. COUNTY		11. TOTAL ACRES	<input type="checkbox"/> Drilling Permit Application (Form W-1) <input type="checkbox"/> Completion Report

Description of Individual Tracts Contained Within the Production Sharing Agreement

TRACT/PLAT IDENTIFIER	TRACT NAME	ACRES IN TRACT	ACREAGE ALLOCATED TO WELL	INDICATE UNDIVIDED INTERESTS		
				UNLEASED	NOT-PARTICIPATING	NON-POOLED

**REMARKS:**

**CERTIFICATION:** I declare under penalties prescribed pursuant to §91.143, Tex. Nat. Res. Code, that this report was prepared by me or under my supervision or direction, that I am authorized to make this report, and that the information contained in this report is true, correct, and complete to the best of my knowledge.

Signature \_\_\_\_\_ Name (type/print) \_\_\_\_\_

Title \_\_\_\_\_ Date: \_\_\_\_\_ Phone No. \_\_\_\_\_

Email Address (Optional – See instructions for important information): \_\_\_\_\_

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1701 N. Congress  
P.O. Box 12967  
Austin, Texas 78701-2967

### Acreage Designation

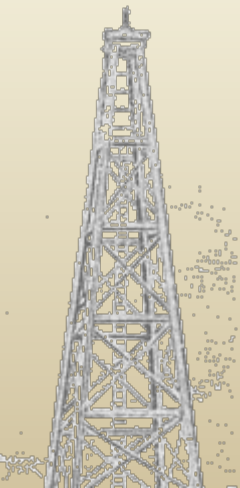
Filer is the owner or lessee, or has been authorized by the owner or lessee, of all or an undivided portion of the mineral estate under each tract for which filer is listed as operator below. For all leases operated by other entities, the number of assigned acres shown are reflected on current Commission records or the filer has been authorized by the current operator to change the assigned acreage of that operator as shown below.

SECTION IV. REMARKS / PURPOSE OF FILING (see instructions)

Signature	Name and title (type or print)			Email (include email address only if you affirmatively consent to its public release)		
Address	City	State	Zip Code	Tel: Area Code	Number	Date: mo. day yr.

# *Double-Assignment of Acreage?*

- ❖ You must comply with Statewide Rules 38 and 40!
- ❖ SWR 40(d)
  - (d) Acreage assigned to a well for drilling and development, or for allocation of allowable, shall not be assigned to any other well or wells projected to or completed in the same reservoir; such duplicate assignment of acreage is not acceptable, provided, however, that this limitation shall not prevent the reformation of development or proration units so long as no duplicate assignment of acreage occurs, and further, that such reformation does not violate other conservation regulations. (emphasis added)



Please take note of this presentation slide from our friend, Mr. Greg Bilbro, and note his comments on the pooling portion!

## Plats for PSA/Allocation Drilling Permits



-Pooling – a sidebar: Regardless of whether your PSA/Allocation Unit is composed of a pooled unit(s), when filling out “Field Details” on a W-1 application **NEVER** check the “Pooled/Unitized” check box. Remember, by definition what you are filing is not pooling.

Under Field Details tab

Distance	Direction
Surface Lease Line Perpendiculars: <input type="text"/> feet	from the <input type="text"/>
Pooled/Unitized: <input type="checkbox"/> (Check if yes)	
Well Type: <input type="text" value="Oil or Gas Well"/>	

Field Info on Review Screen

Distance to nearest Lease Line	SWR	Pooled/Unitized
1.0	SWR 36, SWR 37LL, SWR 38	N
Direction		
from the ne line		

# Form P-16

Total Allocated Acreage >

0

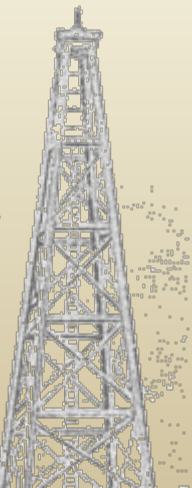
0

< Total Lease Acreage

Filer is the owner or lessee, or has been authorized by the owner or lessee, of all or an undivided portion of the mineral estate under each tract for which filer is listed as operator below. For all leases operated by other entities, the number of assigned acres shown are reflected on current Commission records or the filer has been authorized by the current operator to change the assigned acreage of that operator as shown below.

## SECTION VI. LISTING OF ALL WELLS IN THE APPLIED FOR FIELD ON THE SAME ACREAGE

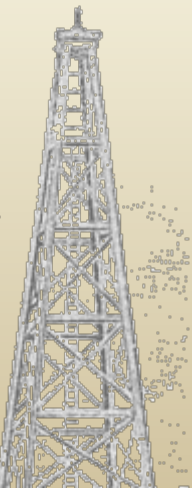
AS THE EAST OR WEST UNIT DESIGNATED FOR THE TRACTS LISTED IN SECTION V, FILER



# *RRC's Own Disclaimer*

“Commission Staff expresses no opinion as to whether a 100% ownership interest in each of the leases alone or in combination with a “production sharing agreement” confers the right to drill across lease/unit lines or whether a pooling agreement is also required. **However, until that issue is ruled upon by a Texas court of competent jurisdiction it appears that a 100% interest in each of the leases and a production sharing agreement constitute a sufficient colorable claim** to the right to drill a horizontal well as proposed to authorize the removal of the regulatory bar and the issuance of a drilling permit by the Commission, assuming the proposed well is in compliance with all other relevant Commission requirements.” (emphasis added).

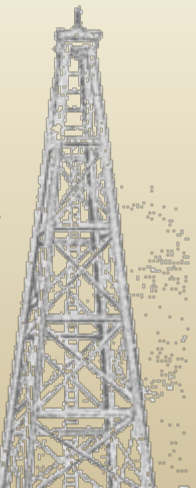
“Issuance of the permit is not an endorsement or approval of the applicant’s stated method of allocating production proceeds among component leases or units. All production must be reported to the Commission as production from the lease or pooled unit on which the wellhead is located and reported production volume **must be determined by actual measurement of hydrocarbon volumes prior to leaving that tract and may not be based on allocation or estimation.**” (emphasis added).





This language is now “boilerplate” at the RRC, and is added to all PSA/Allocation W-1 applications *automatically upon submission!*

“Payment of royalties is a contractual matter between the lessor and lessee. Interpreting the leases and determining whether the proposed proceeds allocation comports with the relevant leases is not a matter within Commission jurisdiction but a matter for the parties to the lease and, if necessary, a Texas court of competent jurisdiction. The foregoing statements are not, and should not be construed as, a final opinion or decision of the Railroad Commission.”



*Some final thoughts....*





*Thank you for your time! If you have any questions, please feel  
free to contact me via e-mail at:*

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*[www.PettrySinex.com](http://www.PettrySinex.com)*

