

Pitfalls & Preservation:

*The Effect of the
Texas Railroad Commission's
Rules and Regulations on
Oil and Gas Contracts*

I. Introduction.

This presentation will attempt to:

- 1) Provide general background on Railroad Commission rules and regulations to keep in mind when preparing leases and agreements;
- 2) Warn of some of the pitfalls of using Railroad Commission rules and regulations in contracts; and,
- 3) Suggest a few tools which might help you avoid future problem areas.

II. Background of Railroad Commission Rules and Regulations.

Field Rules in Texas

- The Railroad Commission considers a “field” to be a “common source of supply” as determined by pressure communication. Texas Natural Resources Code (“TNRC”) §85.001.
- Fields are regulated by the Railroad Commission pursuant to field rules, which may be found under *Statewide Rules*, *Special Rules* and *District Spacing* (a.k.a. *County Regular*) *Rules* in the State of Texas.
- The vast majority of fields in the State of Texas are governed by Statewide Rules!

Statewide Spacing Rules

- Under basic Statewide Spacing Rules, a well must be located at least 467 feet from any property line, lease line, or subdivision line, and at least 1200 feet from another well on the same property that is completed in the same field. 16 Texas Administrative Code (“TAC”), §3.38, Well Densities.
- Under Statewide Rules of “467/1200”, the Railroad Commission requires 40 acres for each well from a single property and for each field, regardless of the depth or the well’s classification as an oil well or a gas well. 16 TAC §3.38, Well Densities.
- All wildcat wells in the State of Texas, EXCEPT those of 5000 feet or less in Railroad Commission Districts 7B and 9, and McCulloch County in District 7C, are subject to Statewide Rules.

County Regular Rules

- Under County Regular Rules, different spacing is applicable to counties in Railroad Commission Districts 7B and 9, plus McCulloch County in District 7C, where the wells are 5,000 feet deep or less.
- County Regular Rules are applicable only if there are no special field rules prescribed for the subject field, and only applicable to wells which produce from 5,000 feet or less.
- Unless Special Field Rules are applicable, wells which are deeper than 5,000 feet are subject to Statewide Rules. You should consult the applicable County Regular Rules to understand the spacing requirements if you are drilling a well in the following counties:

Archer (09), Baylor (09), Brown (7B), Callahan (7B), Clay (09), Coleman (7B), Comanche (7B), Coryell (7B), Denton (09), Eastland (7B), Erath (7B), Grayson (09), Hardeman (09), Haskell (7B), Hood (7B), Jack (09), Jones (7B), Knox (09), Lampasas (7B), McCulloch (7C), Nolan (7B), Palo Pinto (7B), Parker (7B), San Saba (7B), Shackelford (7B), Somervell (7B), Stephens (7B), Stonewall (7B), Taylor (7B), Throckmorton (7B), and Wichita (09).

Special Field Rules

An operator may request designation of Special Field Rules for a particular field which varies from the previously discussed requirements.

Special Field Rules require a Railroad Commission application where the correlative interval is identified via well logs on file with the Railroad Commission.

An application for Special Field Rules may prove useful for an operator because, among other things, it provides for:

- Creating larger pooled units if your lease correctly incorporates a “governmental authority” pooling provision;
- Assuring orderly and proper development of a field, thereby reducing unnecessary wells and risk of lessor claims of “failure to develop”;
- Increasing or decreasing allowables; and,
- Force pooling under the Mineral Interest Pooling Act.

Pooling

There are essentially two types of pooling in the State of Texas:

- 1) Voluntary Pooled Units are the combination of separately owned leases or tracts into a single unit, where a lessee's authority to pool is "derived solely from the terms of the lease" and a lessee has no power to pool absent express authority. *Browning Oil Company v. Luecke*, 38 S.W.3d 625, 634 (Tex.App.-Austin 2000, pet. denied). Voluntary pooled units make up the overwhelming majority of pooled units in the State of Texas.
- 2) "Forced Pooled" Units are achieved under Chapter 102 of the Texas Natural Resources Code (also known as the Mineral Interest Pooling Act or "MIPA"), where the Railroad Commission is authorized to force pool adjacent tracts and interests to achieve proration units of the size specified in the applicable field rules.

III. Pitfalls.

“Prescribed or permitted” in Texas.

- Pre-printed lease forms, such as the Pound forms, may allow pooled units “prescribed or permitted by governmental authority”.

- Such “governmental authority” provisions are intended to allow the lessee to form a larger pooled unit if the governmental authority, i.e. the Railroad Commission, adopts a larger unit size as part of Special Field Rules for the subject field.

- However, be aware of what this means!

Example:

Two Couyons Drilling Company (“Two Couyons”) is a Louisiana oil and gas company which wishes to break into that fancy Newark, East (Barnett Shale) play up in the Fort Worth area. As the new person in charge of land, you’ve been able to procure a sizable lease, line up rig availability, and even have the permit and financial assurance requirements at the Commission squared away. Two Couyons Drilling Company is planning on drilling a horizontal well with a horizontal displacement of 3,500 feet.

Your subject lease, however, includes the following language:

“...provided, however, that should governmental authority having jurisdiction prescribe or permit the creation of units larger than those specified, units thereafter may conform substantially in size with those prescribed by governmental regulations.”

Why is this a pitfall?

Because you may not be able to retain as much acreage as the rules actually allow!

- Under the Railroad Commission’s Special Field Rules relating to the Newark, East (Barnett Shale), an operator is allowed 320 acres per unit, plus Optional Rules.

- Under 16 TAC §3.86, Horizontal Drainhole Wells, however, the Railroad Commission allows additional acreage to be added based upon the horizontal displacement of the well, which in our example is 3,500 feet.

For Fields with a Density Rule Greater Than 40 Acres

Horizontal Drainhole Displacement	Additional Acreage Allowed
150 to 827	40
828 to 1,654	80
1,655 to 2,481	120
2,482 to 3,308	160
3,309 to 4,135	200
4,136 to 4,962	240
etc. - 827 ft increments	etc. - 40 acre increments

Thus, Two Couyons Drilling Company thinks it is entitled to retain at least 520 acres, i.e., the 320 acres plus the 200 additional acres based upon a 3,500 foot horizontal displacement.

However, see *Jones v. Killingsworth*, 403 S.W.2d 325, 326-327 (Tex. 1966):

“Lessee, at its option, is hereby given the right and power to pool ... in compliance with the spacing rules of the Railroad Commission of Texas, or other lawful authority, or when to do so would, in the judgment of Lessee, promote the conservation of oil and gas from said premises.... Units pooled for oil hereunder shall not substantially exceed 40 acres each in area, and units pooled for gas hereunder shall not substantially exceed in area 640 acres each plus a tolerance of 10% thereof, provided that should governmental authority having jurisdiction **prescribe or permit** the creation of units larger than those specified, units thereafter created may conform substantially in size with those **prescribed** by governmental regulations.” (emphasis added).

The court in *Jones v. Killingsworth* further held:

“The fact that the Railroad Commission may Permit a much larger unit cannot be read into the lease contract when, as here, the authority to create larger oil units is expressly limited to units of the size Prescribed by the Railroad Commission.” *Id.*, at 328.

Arguably, Two Couyons would be limited to the unit prescribed by the Commission, which would be 320 acres plus tolerance, rather than the unit permitted by the Commission, which would be 520 acres plus tolerance!

Changes in Gas-Oil Classification.

- 16 TAC §3.49, Gas-Oil Ratio: The “GOR” is defined as the ratio of “2,000 cubic feet of gas per barrel of oil produced”.
- 16 TAC §3.49(b): A gas well which produces from the same reservoir in which oil wells are completed and producing shall be allowed to produce daily only that amount of gas which is equal to the reservoir displacement of the gas and oil produced from the oil well in the same reservoir that withdraws the maximum amount of gas in the production of its daily oil allowable.
- In other words, this rule works as the Commission’s definition of what may be classified as a gas well versus an oil well.

Why is this a pitfall?

Because you may lose acreage!

By example, Two Couyons Drilling wishes to retain 320 acres under its lease pursuant to its subject gas well. It intends to recomplete in another gas formation in the same wellbore, but a change in its GOR results in a reclassification into an oil well. Under its lease, it is only allowed to retain 40 acres for an oil well.

In *Hunt Oil Company v. H.E. Dishman et al*, 352 S.W.2d 760 (Tex.App.-Beaumont 1961), the court encountered a situation such as this where the operator's well was initially classified as a gas well, but subsequently reclassified by the Railroad Commission as an oil well.

The operator's subject lease included the following language:

“... said lease shall terminate without further liability on First Party and First Party shall release the same of record, as to all the leased premises except forty (40) acres in as near the form of a square as practical around each producing oil well, and except 320 acres in as near the form of a square as practical around each producing gas well, in either case said well to be in as near the center of said acreage as is practical.”

- The court in *Hunt Oil Company v. H.E. Dishman* held that the change in classification, without adherence to the rework provisions of the lease, triggered the dissolution of the gas unit, and that the parties were entitled to only retain 40 acres.
- Arguably, Two Couyons would lose the extra acreage under the gas well unless it complied with other provisions of the lease such as continuous drilling, the acreage was otherwise held by production, or the leases were within the primary term.

Define Your Units!

- ✦ Under 16 TAC §3.38, a “drilling unit” is “the acreage assigned to a well for drilling purposes.” It is the acreage submitted with the Form W-1 drilling application (well permit) and is meant to show that the operator has sufficient remaining acreage to meet the density provisions of 16 TAC §3.38. It is a regulatory term of art. Drilling Units are no longer required on the Form W-1 for vertical wells.
- ✦ Under 16 TAC §3.38, a “proration unit” is “the acreage assigned to a well for the purpose of assigning allowables and allocating allowable production to the well.” A proration unit is *only applicable if there are Special Field Rules* which use acreage in the allocation formula. If the field is governed by Statewide Rules, proration units are not applicable.
- ✦ A “pooled unit” is “the acreage formed by joining separately owned tracts, usually to constitute a drilling or prorationing unit”. Ernest E. Smith & Jacqueline Lange Weaver, Texas Law of Oil and Gas, §10.1(B). This is the Unit Declaration filed in the official public records of the county where the land is located.

IV. Tools.

“Mineral Interest Pooling Act” as a bargaining tool.

- ❖ MIPA, as referenced above, authorizes the Commission to force pool adjacent tracts and interests under limited circumstances, to achieve proration units of the size called for in the applicable field rules.
- ❖ The MIPA is difficult at best, so why is it a “tool”?
- ❖ Because it may be used to increase an operator’s bargaining power and to bring parties to the table!

Purposes of MIPA under Commission rules.

Pursuant to the Texas Natural Resources Code, the MIPA may be employed for the purposes of:

1. Avoiding the drilling of unnecessary wells,
 2. Protecting correlative rights, or
 3. Preventing waste of hydrocarbons.
- ◉ It is REQUIRED under MIPA that the applicant must have first made a fair and reasonable offer to voluntarily pool, and that this offer was turned down.
 - ◉ For this reason, MIPA has been referred to as a “compulsory voluntary pooling act” which is effective because “it compels fair and reasonable offers to pool, which are usually accepted.” Ernest E. Smith & Jacqueline Lange Weaver, Texas Law of Oil and Gas, §12.1(B). If the offer is not considered fair and reasonable, the Commission is required to dismiss the application.

Who may apply under MIPA?

The Commission asserts that the following persons may apply for forced pooling:

- 1) In an existing unit, any mineral interest owner, including royalty owners; and,
- 2) In a proposed unit, any working interest owner or owner of an unleased tract (but not a royalty interest).

However, the Railroad Commission is not authorized to compel pooling on its own motion.

What are some of the limitations under MIPA?

- 1) Forced pooling is unavailable if the reservoir was discovered and produced prior to March 8, 1961.
- 2) Forced pooling is unavailable for land owned by the State of Texas or land in which the State has a direct or indirect interest.
- 3) MIPA may not be used to force pool an unleased mineral owner of a tract by a leased mineral owner of the same tract or his lessee, i.e. presumably because of the co-tenancy laws in the State of Texas.

Limitations under MIPA (Continued)

- 4) Forced pooling is unavailable in wildcat areas or in fields which are subject to Statewide Rules. The field in question must be subject to Special Field Rules. However, the Commission does allow applications for Special Field Rules to be filed simultaneously with a MIPA application.
- 5) Units under MIPA are limited to individual well proration units. The largest that a unit under MIPA may be is 160 acres for oil wells and 640 acres for gas wells, plus tolerance acreage allowed under the field rules.
- 6) The Commission may only pool acreage that reasonably appears to be within the productive limits of the reservoir. The burden is upon the applicant to show that all the proposed acreage is productive. If this burden is not met, the Commission may order the pooling of a smaller amount of acreage than that requested by the applicant.

Problems with Pits

Example:

Two Couyons Drilling Company is still wanting to operate in Texas, and as the point person, you've wrapped up the leases, the pooling provisions, etc. The problem is that when you go out to drill your well, you find that your ability to dispose of water-based drilling muds is restricted.

Surprise, surprise! The surface owner is not the mineral owner and, after he decided to retire out to his ranchette, he's pretty ticked that you're ruining his bluebonnets. Traditionally, you might have attempted to landfarm the water-based mud because it's cost prohibitive to ship it off site. Likewise, disposing of drilling muds via recycling of the fluids and/or injection of the water-based mud into the annulus of the wellbore are also cost prohibitive. With landfarming, however, under Railroad Commission rules, the surface owner's permission is required and that's not going to come any time soon. At least not for cheap.

What do you do?

16 TAC §3.8(D)(3)(C) holds:

...A person may, without a permit, dispose of the following oil and gas wastes by *land farming*, provided the wastes are disposed of on the same lease where they are generated, and provided the person has *the written permission of the surface owner of the tract where land farming will occur*: water base drilling fluids with a chloride concentration of 3,000 milligrams per liter (mg/liter) or less; drill cuttings, sands, and silts obtained while using water base drilling fluids with a chloride concentration of 3,000 mg/liter or less; and wash water used for cleaning drill pipe and other equipment at the well site (emphasis added).

16 TAC §3.8(D)(3)(D) holds:

...A person may, without a permit, dispose of the following oil and gas wastes by *burial*, provided the wastes are disposed of *at the same well site where they are generated*: water base drilling fluid which had a chloride concentration in excess of 3,000 mg/liter but which have been dewatered; drill cuttings, sands, and silts obtained while using oil base drilling fluids or water base drilling fluids with a chloride concentration in excess of 3,000 mg/liter; *and those drilling fluids and wastes allowed to be land farmed without a permit* (emphasis added).

Caveat: Check with your District Office representative!

*Permitting Matters-
A Rule 37 Horizontal Mambo?*

Every operator who drills an oil or gas well in the State of Texas must first obtain a valid drilling permit from the Railroad Commission. This is filed on a Railroad Commission Form W-1. Under 16 TAC §3.5(g), “[a]ny permit to drill, deepen, plug back, or reenter granted by the commission expires no later than two years after the date of original approval.”

However, if your well is not regular to the appropriate spacing and density rules, and you are unable to obtain a Rule 37 exception, you will not pass “go”.

Are there any situations where one might be able to enter a horizontal play such as the Newark, East (Barnett Shale) at an irregular location but still be considered regular?

Example:

Two Couyons Drilling Company wants to take advantage of the Newark East (Barnett Shale), which has lease line spacing rules of 330 feet. As the point person, you've gotten the leases squared away and lined up a rig with a limited window on availability. Unfortunately, your lease is an oddball shape that restricts well locations and your geologists state that you have to stake the well in a particular location to maximize reserves on your horizontal well.

Every spot on this horizontal wellbore from the penetration point to the terminus must be within the appropriate spacing rule, i.e. 330 feet from every property line. While the majority of the well will be regular to such property lines, the penetration point of the horizontal well is less than 330 feet from an offsetting property line and Two Couyon's Drilling will enter the Barnett Shale at a location that violates the Railroad Commission's spacing rules.

Your offsetting operators tell you it will be a cold day indeed before they waive any Rule 37 exception and that their fancy pants Austin lawyers assure them that they can defeat any Rule 37 application at the Railroad Commission. The drilling rig personnel also, not so subtly, remind you that time is money and when the window is gone, so are they.

What do you do?

Open hole or cased hole? Written rule, or unwritten?

If the horizontal well you are attempting to permit will be an *open hole*, the Permitting Section will look to where the well will penetrate the field and where the well will end, or the terminus. The “penetration point” is the point where the horizontal drainhole intersects the top of the correlative interval for that particular field.

If the horizontal well you are attempting to permit will be cased hole, the Permitting Section may look to where the well is initially perforated to the terminus.

In our situation, you may consider drilling the well under the cased hole method in such a way that your perforations would start at least 330 feet from the nearest property line. Such a tactic would alleviate your Rule 37 concerns. However, it is noted that the handling of cased versus uncased hole in the Barnett Shale is not codified per se; rather, it is an accommodation by the Railroad Commission. Further, other tight gas, horizontal fields may be handled by the Commission in a different manner.

Accordingly, you should be aware of this caveat, and always consult with the District proration analyst and/or permits coordinator to insure that this method is allowed.

Dueling Permits

As referenced previously, every operator who drills an oil or gas well in the State of Texas must first obtain a valid drilling permit from the Railroad Commission. However, what if your leasehold interest covers less than 100% of the mineral acreage, and you have another interest owner attempting to develop the same acreage?

Example:

Two Couyons Drilling Company has procured leases from the Arceneaux family which covers the minerals in Blanc Acre. Unfortunately, economic constraints dictated acquiring working interest partners, and 50% of your leasehold interest is owned by Dos Diablos Oil Company. While the relationship with Dos Diablos was initially a good one, they've disagreed with most of your choices and are now disputing several of the provisions of your Joint Operating Agreement. They've lawyered up and have decided to drill a well which is decidedly different from the well you have proposed.

Legal issues aside, the problem is that Dos Diablos' choice of well location will substantially harm your development plans. You have decided to permit the well immediately with your proposed location to head off Dos Diablos' plan, but have found out that they are simultaneously filing a permit for their alternate location.

What do you do?

Dueling Permits Cont.

The answer to your question may depend upon how quick you are.

- ⊕ Under the Commission’s rules, the Railroad Commission will allow simultaneous permits as long as both Two Couyons and Dos Diablos have a good faith claim to the Subject Lease.
- ⊕ Given that the Commission does not have the authority to adjudicate contractual issues such as Joint Operating Agreements, the “good faith claim” may be satisfied by an ownership interest in the Subject Lease, which both Two Couyons and Dos Diablos have.
- ⊕ In situations where there are “dueling permits”, *the first party to complete the well and file completion papers* will be assigned the acreage and allowable for that particular lease.
- ⊕ The second party drilling such a well would not be allowed to produce its well unless it complied with spacing and density rules, or otherwise obtained an exception to such rules.
- ⊕ Therefore, the current system at the Railroad Commission results in a “race”, where the first party to complete its well and file completion papers obtains the necessary acreage and allowable.

Railroad Commission Website-
www.rrc.state.tx.us

WARNING!



Plan ahead for your permits!



On August 31, 2006, an expedited permit for a well brought in before noon was processed before the end of business on the *same day*. A non-expedited permit was processed within four days.



As of the date of this presentation, expedited permits may take anywhere from one to three weeks to process.



Checking with the Commission's website will advise you of potential delays....

Railroad Commission Website-
www.rrc.state.tx.us

The website maintains an interactive data section which will provide:



Wells located within a field;



Wells, prior and current, along with pipelines found via the website's GIS mapping system;



Production information via "PDQ" system; and,



Allowables for particular wells.

It also provides the following useful information:



Form P5 Organization Report contact information and addresses for offsetting operators;




Notice of Commission hearings and public conferences; and,

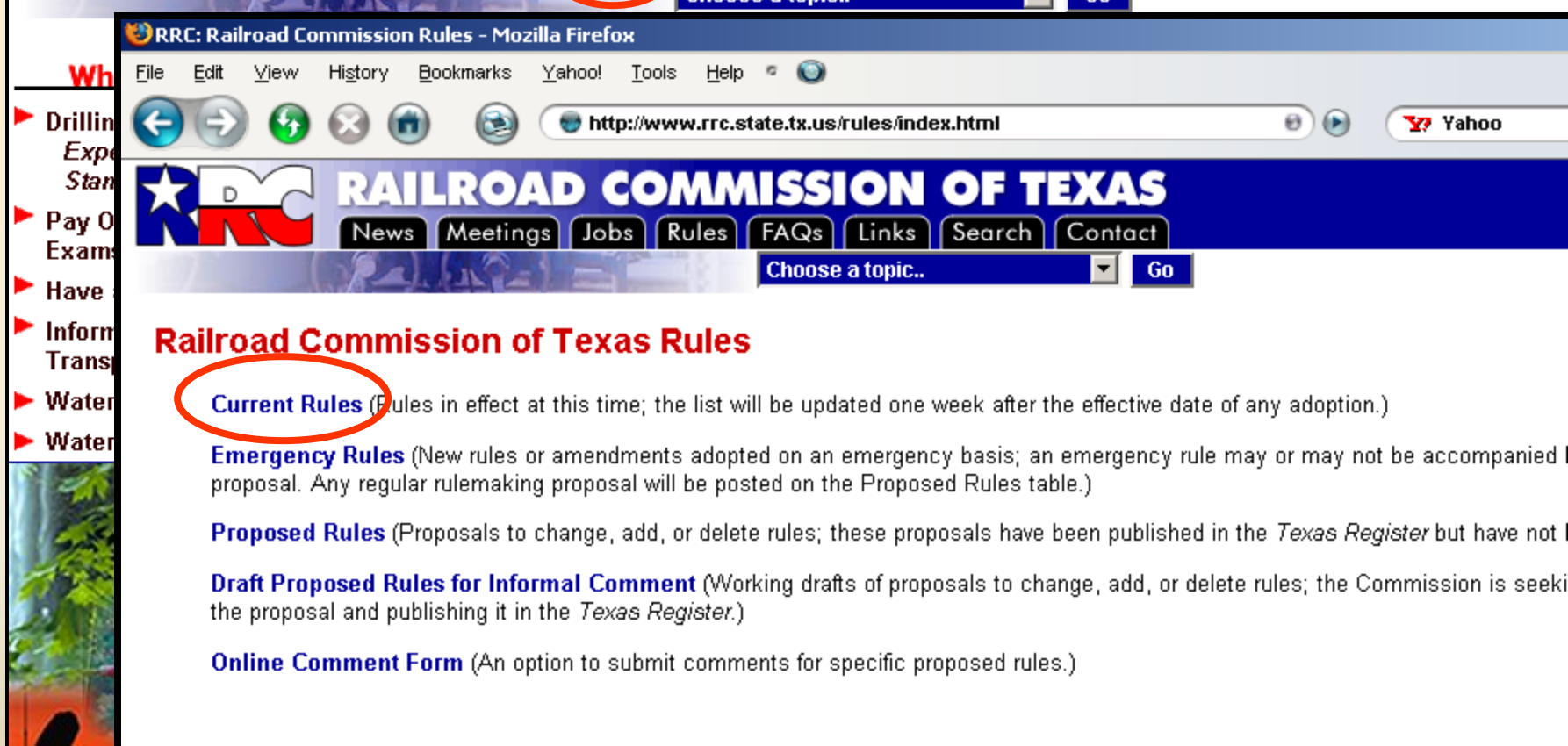


Links to the Railroad Commission's current rules and regulations, including rules discussed here today.

Rules and Regulations:



The top screenshot shows the main website navigation menu. The 'Rules' link is circled in red. The address bar shows 'http://www.rrc.state.tx.us/'.



The bottom screenshot shows the 'Railroad Commission of Texas Rules' page. The 'Current Rules' link is circled in red. The page title is 'RRC: Railroad Commission Rules - Mozilla Firefox'. The address bar shows 'http://www.rrc.state.tx.us/rules/index.html'. The page content includes a list of rule categories with descriptions.

Railroad Commission of Texas Rules

- [Current Rules](#) (Rules in effect at this time; the list will be updated one week after the effective date of any adoption.)
- [Emergency Rules](#) (New rules or amendments adopted on an emergency basis; an emergency rule may or may not be accompanied by a proposal. Any regular rulemaking proposal will be posted on the Proposed Rules table.)
- [Proposed Rules](#) (Proposals to change, add, or delete rules; these proposals have been published in the *Texas Register* but have not yet been adopted.)
- [Draft Proposed Rules for Informal Comment](#) (Working drafts of proposals to change, add, or delete rules; the Commission is seeking public input on the proposal and publishing it in the *Texas Register*.)
- [Online Comment Form](#) (An option to submit comments for specific proposed rules.)

| Site Map | Home | Webmaster |

Rules and Regulations Cont.:

RRC: Railroad Commission Rules - Mozilla Firefox

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http://www.rrc.state.tx.us/rules/rule.html

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Railroad Commission of Texas Rules

Texas Administrative Code (TAC) Title 16. Economic Regulation Part 1. Railroad Commission of Texas

The official rules of the Railroad Commission of Texas are maintained by the Office of the Secretary of State. The Railroad Commission's rules are located in the Texas Administrative Code.

Please send questions regarding the Railroad Commission's rules to the Office of the Secretary of State.

Below is the list of Railroad Commission rules.

Chapter 1: [Practice and Procedure](#)

Chapter 2: [Informal Complaint Process](#)

Chapter 3: [Oil and Gas Division](#)

Chapter 4: [Environmental Protection](#)

Chapter 7: [Gas Services Division](#)

- [Disposition Table](#)
Showing where the provision is located
- [Derivation Table](#)
Showing where the provision is derived from

Chapter 8: [Pipeline Safety Regulation](#)

Texas Administrative Code - Mozilla Firefox

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http://info.sos.state.tx.us/pls/pub/readtac\$ext.ViewTAC?tac_view=4&ti=

Texas Administrative Code

TITLE 16 ECONOMIC REGULATION
PART 1 RAILROAD COMMISSION OF TEXAS
CHAPTER 3 OIL AND GAS DIVISION

Rules

§3.1	Organization Report; Retention of Records; Notice Requirements
§3.2	Commission Access to Properties
§3.3	Identification of Properties, Wells, and Tanks
§3.4	Oil and Geothermal Lease Numbers and Gas Well ID Numbers Required on All Formations
§3.5	Application To Drill, Deepen, Reenter, or Plug Back
§3.6	Application for Multiple Completion
§3.7	Strata To Be Sealed Off
§3.8	Water Protection