Allocation Wells: An Operator’s Guide

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Operator Tools for Drilling Horizontal Wells

• Until recently, leases were taken, and pooled units were formed, without contemplating the acreage needs for long horizontal wells.
• Operators face difficulties in attempting to drill a horizontal well across:
  • Leased but unpooled tracts;
  • Multiple adjoining pooled units;
  • Unpooled tracts adjoining pooled units.
Operator Tools for Drilling Horizontal Wells (cont’d)

• Options for operators:
  • Negotiate to obtain or expand pooling authority
  • MIPA. Available only when unpooled tract is small. See TNRC § 102.014: The commission shall not require the owner of a mineral interest, the productive acreage of which is equal to or in excess of the standard proration unit for the reservoir, to pool his interest with others unless requested by the holder of an adjoining mineral interest, the productive acreage of which is smaller than such pattern, who has not been provided a reasonable opportunity to pool voluntarily. (Small tracts can be force-pooled by big-tract owners, but big tracts can be force-pooled only by small-tract owners – not by other big-tract owners.)
  • Drill multiple vertical or shorter horizontal wells
  • Drill an allocation well
Genesis of Allocation Wells – *Browning v. Luecke*

- *Browning v. Luecke*, 38 S.W.3d 625 (Tex. App.—Austin, 2000):
  - Three separate leases covering three tracts of land owned by lessors.
  - Leases contained anti-dilution provision requiring that 60% of any pooled unit consist of lessor-owned land.
  - Lessee attempted to form a pooled unit for horizontal wells that violated anti-dilution clause.
  - Lessor claimed that lessee owed royalty on 100% of production from the wells that traversed the leased tracts. (One horizontal well traversed two separate lease tracts. As to this well, lessor claimed that lessee owed 100% of production on each of the leases – in other words, “double full royalty.”)
  - Lessee sought to pay royalty based on what production it considered to be attributable to each of the tracts.
  - At issue: $1,080,210. (Lessor sought $1,283,242. Lessee offered $202,421.05.)
  - Court held that Lessee owed damages to lessors based on “a determination of what production can be attributed to their tracts with reasonable probability.”
Allocation Wells – Theory

- Allocation well: Absent pooling authority, operator, either unilaterally or by agreement with royalty owner, allocates production to tracts traversed by horizontal drainhole according to some formula. (Allocation wells may also be vertical wells where ownership varies between horizons.)

- As discussed herein, “allocation well” refers to scenario in which operator/lessee does not have benefit of agreement with royalty owner as to how production is to be allocated.

- Under the Rule of Capture, an operator may drill a vertical well one foot from boundary line of an adjoining lease. Geologically, there is arguably no difference between a series of vertical wells along a path that spans a lease line (which does not require pooling) and a horizontal well along the same path.

- Operators of allocation wells argue that whether they meet the Luecke standard is a private contractual matter between lessor and lessee.
Allocation Wells – Rule 37 Hurdle

• Rule 37(a)(1): “...no well shall be drilled nearer than 467 feet to any property line, lease line, or subdivision line...”

• For regulatory purposes, lease lines do not disappear unless leases are pooled. Therefore, an allocation well requires Rule 37 exception.

• A lessor or owner of royalty or other nonpossessory interest is not an “affected person” under Rule 37 and not entitled to notice of Rule 37 exception application. This is based on the theory that interests of lessor and lessee in preventing drainage are aligned.

• Lessee, as own working-interest offset, may waive its notice and obtain permit administratively.
Are Allocation Wells Illegal?

• In Klotzman dispute, royalty owner protested EOG’s application to RRC for a permit to drill a horizontal well traversing a pair of leases that did not provide pooling authority.

• Klotzman protesters argued that an allocation well is tantamount to pooling, and, absent pooling authority, an operator has no right to drill the well.

• Under this view, the applicant has no right to drill an allocation well, and the RRC therefore has no right to issue a permit for the well.

• Central issue: Does the drilling of an allocation well imply pooling?
Are Allocation Wells Illegal? (cont’d)

• Pooling: Bringing together small tracts or fractional interests to form a drilling or proration unit.

• Allocation wells fall within this definition. But, is there more to pooling?
  • Method of production sharing among leases
  • Lease perpetuation
Allocation Wells vs. Pooling – Method of Production Sharing

• Pooling establishes a method of sharing in production that is different than allocation.

• With pooling, there is typically either a cross-conveyance of interests among the pooled interests or a formula by which the pooled interests are entitled to production on a surface-acreage basis.

• Unlike an allocation well, in a pooled unit, the placement or location of the well has no bearing on the method by which production is shared.
Allocation Wells vs. Pooling – Method of Production Sharing (cont’d)

Well 1: 1/5th of wellbore beneath highlighted tract. If 4 leases pooled, highlighted tract gets royalty in 1/4th of production. If drilled as allocation well, highlighted tract gets royalty in 1/5th of production.

Well 2: 1/2 of wellbore beneath highlighted tract. If 4 leases pooled, highlighted tract gets royalty in 1/4th of production. If drilled as allocation well, highlighted tract gets 1/2 of production.
Allocation Wells vs. Pooling – Lease Perpetuation

• When a lease is pooled, operations or production anywhere on the pooled unit are deemed operations on the lease. Therefore, a lease may be perpetuated even without a well on or traversing the subsurface of the lease.

• In the allocation-well context, unless the well penetrates and produces from the subsurface of a lease, the activities associated with the well will not maintain the lease.
Allocation Wells vs. Pooling – Lease Perpetuation (cont’d)

If drilled in a pooled unit consisting of all 4 leases, well holds all 4 leases in force.

If drilled on an allocation basis, well holds only 2 leases traversed by drainhole in force.
Current RRC Posture on Allocation Wells

- In Klotzman dispute, RRC eventually ruled against protestant royalty owners and granted allocation permit to operator.
- RRC decision was appealed to district court, but the parties settled.
- Current RRC policy is that permits to drill allocation wells will be granted.
- RRC has adopted Form P-16, which may be filed in conjunction with W-1 in lieu of a P-12.
- Unless future permits are challenged and courts rebuke RRC policy, or unless Legislature intervenes, remedies of royalty owners will be limited to private causes of action.
Commingling and “Confusion of Goods” Theory

- **Spartan Texas Six Capital Partners, Ltd., Spartan Texas Six-Celina, Ltd., and Dion Menser v. EOG Resources, Inc.,** Cause No. 2011-27476, 11th Judicial District Court, Harris County.
  - Leases provide no pooling authority.
  - EOG allocated royalty on production from each horizontal well among different leases according to percentage of productive lateral length.
Commingling – *Spartan* case
Commingling – *Spartan* (cont’d)

- *Spartan* plaintiffs argued that *Humble Oil & Ref. Co. v. West*, 508 S.W.2d 812, 818 (Tex. 1974) controls.
- In *West*, the lessee began using nearly depleted acreage for gas storage. Lessee sought to pay royalty on its estimate of the quantity of native gas remaining in the reservoir. The royalty owner sought royalty on all gas. At issue was whether royalty owner was entitled to royalty on all gas removed from land when extraneous gas had been commingled with native gas.
- In *West*, the Texas Supreme Court stated: "The burden is on the one commingling the goods to properly identify the aliquot share of each owner; thus, if goods are so confused as to render the mixture incapable of proper division according to the pre-existing rights of the parties, the loss must fall on the one who occasioned the mixture.... Stated differently, since *Humble is responsible* for, and is possessed with peculiar knowledge of the gas injection, *it is under the burden* of establishing the aliquot shares with *reasonable certainty*."
- *Spartan* plaintiffs argued that *West*, rather than *Luecke*, controls. Therefore, they sought royalty on 100% of production from each well or an accounting based on allocation that met the “reasonable certainty” burden.
Commingling: *Luecke* or *West*?

- **Issue:** Does *Luecke* (reasonable probability) or *West* (reasonable certainty) control?

- **Arguments that *Luecke* controls:**
  - *Luecke*, unlike *West*, specifically involves unpoled leases traversed by horizontal wells.
  - *Luecke* court did not apply confusion-of-goods theory even though production was plainly commingled.
  - Supreme Court denied petition.
  - Promotes a policy of encouraging horizontal drilling.

- **Arguments that *West* controls:**
  - Commingling was not specifically raised in *Luecke*. An argument may be made that the reason the *Luecke* court did not apply confusion-of-goods theory is that it was not argued.
  - *West* is a Supreme Court decision, while *Luecke* is an appellate decision.
  - Promotes policy of encouraging lessees to use more sophisticated methods to evaluate sources of production.

- **Spartan** was settled as to all disputes relating to allocation.
Allocation Methods

• Typical allocation formulas:
  • Ratio that the length of the productive length of the well (measured from first take point to last take point) within the aerial boundaries of a tract bears to the entire productive length (from first to last take point). See Springer Ranch, Ltd. v. Jones. Assumes that production from each point between first and last take point is identical, regardless of locations of take points in between.
  • Ratio that the segment of the drainhole within a tract bears to the entire horizontal drainhole displacement. (Over-inclusive – ignores locations of first and last take points.)
  • Ratio that the number of take points within a tract bears to the total number of take points along wellbore. More consistent with Rule of Capture, but assumes that production from each take point is identical.

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Challenges to Fairness of Allocation Methods

• Most formulas presume fungibility. They can ignore factors that may create variations in productivity along length of wellbore.
  • Reservoir thickness
  • Density and pressure conditions of hydrocarbon deposits along wellbore
  • Strength of fracturing treatments projected through different perforations/stages
  • Cleanliness and size of perforations
  • Brittleness, permeability, porosity of rock along wellbore
  • Degree to which fractures in rock are pre-existing along wellbore
  • Degree to which fractures are propped open
  • Depletion by existing wells
  • Communication between wellbores
  • Faults
  • Changes in productivity over time
Challenges to Fairness of Allocation Methods (cont’d)

• Techniques exist to shed light on whether a particular allocation might be fair
  • Microseismic (fracture mapping and monitoring)
  • Tracers (flow measurement)
Challenges to Fairness of Allocation Methods (cont’d)

• *Springer Ranch, Ltd. v. Jones*, 421 S.W.3d 273 (Tex. App.—San Antonio 2013, no pet.):
  
  • Owners of subdivided tracts subject to single lease entered into contract providing that royalty payable to owner of surface estate on which well is located.
  
  • Operator drilled horizontal well spanning tract boundaries.
  
  • Plaintiff sought 100% of royalty from well because it owned surface estate containing the wellhead.
  
  • Court held that a well comprised of entire structure, not simply the wellhead.
  
  • Case upheld productive-length formula, but precedential value limited because plaintiff did not dispute operator’s proposed allocation formula.
  
  • Confusion-of-goods theory not relevant. (Lease covered lands before subdivision occurred; subdivision of mineral estate cannot enlarge lessee’s burdens or diminish its rights.)
Challenges to Fairness of Allocation Methods (cont’d)

• When royalty owner refuses to enter into allocation agreement or production-sharing agreement, and operator/lessee elects to proceed with allocation well, what are the relative merits of productive-length and percentage-of-take-point formulas?

• Productive-length formulas (from first to last take point) are often inconsistent with Rule of Capture.
  • Which formula is preferable turns on where production occurs. Does production occur when minerals enter fracture pathways or when minerals enter wellbore through the take points? Production attributable to a tract is arguably the production occurring through the take points on that tract.
  • Courts most frequently define “production” as the physical severance of minerals from a formation, or the removal of minerals from their captive state.
  • In Coastal v. Garza, the Supreme Court, in evaluating whether actionable trespass occurred, distinguished between fractures extending from wellbore and wellbore itself. This suggests that “production” does not occur until minerals enter drainhole.
  • Tract owner’s share of take points rarely matches its share of productive lateral.
  • Therefore, if production occurs when minerals enter wellbore through take points, productive-length formulas can result in over-allocation and under-allocation.
Challenges to Fairness of Allocation Methods (cont’d)

- Possible wrongful allocation under productive-length formula to thin tract with no take points:
Challenges to Fairness of Allocation Methods (cont’d)

• Possible wrongful allocation under productive-length formula due to irregular spacing of take points:
Challenges to Fairness of Allocation Methods (cont’d)

- Possible wrongful allocation under productive-length formula due to non-perf zone along segment of wellbore in Tract A:
Additional Traps in Drilling Allocation Wells

• Breach of Duty to Protect Against Offset Drainage
  • A lease carries an implied covenant to protect against offset drainage.
  • Under certain circumstances, take points may be arrayed in a manner that results in drainage from an adjacent lease also held by lessee.
  • Drained lessor may be made whole under a productive-length formula but not under a percentage-of-take-point formula.
Additional Traps in Drilling Allocation Wells (cont’d)
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• Exceeding the Implied Easement
  • Lessee has an implied easement to use as much of the surface estate as is reasonably necessary to develop the mineral estate.
  • This implied easement does not allow a lessee to use the surface of a lease for the benefit of another lease.
  • Absent pooling, surface estate in a lease is to be used only for the benefit of the mineral estate in that lease.
  • Portions of a horizontal well closer to the wellhead inherently benefit segments farther from the wellhead.
  • However, *incidental* benefit likely does not give rise to an actionable claim.
  • If allocation well necessitates a larger padsite or a more severe use than would be reasonably necessary for a well confined to the boundaries of lease, a surface-use agreement is particularly advisable.
Additional Traps in Drilling Allocation Wells (cont’d)

• Mixing Pooling and Allocation
Additional Traps in Drilling Allocation Wells (cont’d)

• Mixing Pooling and Allocation (cont’d)
  • Operator plans a horizontal well across parts of identically-sized Tracts A and B. A disproportionate share of lateral falls within Tract B.
  • Lease covering Tract A has a pooling provision. Lease covering Tract B has no pooling provision.
    • Lessor under Lease A: Royalty participation will be greater if land is pooled than if production is allocated under PSA. Therefore, lessor will likely refuse to sign PSA and insist that lease be pooled.
    • Lessor under Lease B: Royalty participation will be greater if production is allocated than if lease is pooled. Therefore, lessor will likely refuse to authorize pooling but will sign a PSA.
Additional Traps in Drilling Allocation Wells (cont’d)

• Mixing Pooling and Allocation (cont’d)
  • Unless operator is willing to allocate production under Lease A (in lieu of pooling), the combination of allocation and pooling will cut into NRI of working interest owners in the well.
  • RI owners cumulatively receive more than they would if either (i) both tracts were pooled or (ii) both tracts were governed by a PSA.
  • When two parties contribute separate leases to a JOA, this problem can give rise to JOA disputes if operator is not willing to allocate absent an agreement.
    • Model Form JOA does not address allocation.
    • Is it the operator’s responsibility to take the steps necessary to prevent diminution of NRI?
Practice Tips for Operators/Lessees

• Secure pooling authority, production-sharing agreements, or allocation agreements from as many owners as you can to minimize quantity and degree of exposure.

• The industry-standard production-sharing agreement (or allocation agreement) has room to evolve while still being workable for operators. Offer an allocation agreement that is more palatable to royalty owner.
Practice Tips for Operators/Lessees (cont’d)

• In absence of allocation agreements:
  • Understand that there is room for liability due to the number of factors that determine production (regardless of which formula used).
  • Design wells so that take points are evenly spaced on each side of tract boundary lines. This may minimize liability for breach of duty to prevent offset drainage.
  • Work with engineers and geologists to craft well-specific allocation formulas.

• Build protections into leases when possible.
  • When possible, define “reasonable certainty” or establish allocation formulas.
  • Be vigilant against subtle attempts to prohibit allocation (e.g., by defining pooling broadly such that allocation falls within a stipulated definition of pooling).
Practice Tips for Operators/Lessees (cont’d)

• Get division orders
  • In most cases, an under-allocation allegation is an allegation that another party is over-allocated.
  • With a proper division order in place, an underpaid party’s recourse is against an overpaid party.

• Interpleader
  • In absence of agreements and division orders, an action in interpleader may protect lessee from rival claims to proceeds.
  • May not be available if court holds that lessee caused the conflicting claims.
  • If interpleader granted and West controls, further involvement by lessee may be necessary to discharge “reasonable certainty” burden.
Legislative Developments: HB 1552

• Tom Craddick filed HB 1552 on February 18, 2015.
• Content of bill parallels Pennsylvania Oil and Gas Lease Act, 58 Pa.C.S. §§ 33.1, et seq.
• Bill provided:
  • Lessee may drill allocation well under a RRC permit.
  • In absence of an agreement determining allocation, “production shall be allocated to each tract in the proportion that the operator or lessee reasonably determines reflects the amount produced from each tract.”
  • Operator/lessee must notify affected parties of allocation.
  • Affected party may apply for RRC ruling on whether the allocation protects correlative rights, prevents waste, and accurately attributes a fair share to each affected owner.
• Bill died in committee
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Thank you for your attention.

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