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INSIGHTS

PSA and Allocation Wells – The Current State of Play

October 13, 2016

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The Railroad Commission of Texas (the "RRC") routinely grants drilling permits to operators seeking to drill horizontal wells across multiple leased tracts (or existing pooled units) that are not formally "pooled" together under the pooling clauses in the applicable underlying oil and gas leases. Some of the more frequent situations in which these wells are drilled include instances where the pooling provisions of the underlying leases do not allow for pooled units of a sufficient size to support the full lateral length of the horizontal well in question or instances where the leases on which the well is drilled do not provide for the right to pool at all. While these wells present an "alternative" to formal pooling, they can create issues because they are drilled outside of the formal pooling construct which provides, among other benefits, an agreed upon method to allocate production from wells drilled within the pooled area to the tracts within that area.

Problems arise if one of the mineral owners or royalty owners in a tract traversed by one of these wells believes that its interests are being improperly pooled, or that the amount of production from the well that is being allocated to its tract (and which forms the basis of its royalty payment) is improper. One way to mitigate this problem is to have that interest owner sign a Production Sharing Agreement ("PSA") whereby the interest owner and the Operator/Lessee agree on an allocation scheme for production from the well in question, as that well relates to the tract in which it owns an interest. Problems arise when not all of the interest holders sign a PSA.

As discussed below, the RRC currently will issue a permit regardless of how many impacted interest owners have signed a PSA so long as the Operator has a valid working interest in all of the tracts at issue. If 65% or more of the interest owners have signed a PSA, the RRC permits the well as a "PSA Well." If less than 65% executes a PSA, then the RRC permits it as an "Allocation Well." As best we can tell, there is no legal impact or significance attached to which type of permit the RRC issues for the well.

PSA/allocation wells present many risks, logistical issues, and administrative issues from both a legal perspective and from a land management perspective. This is largely because there is no clear case law affirming (i) whether they are permissible under the typical oil and gas lease or (ii) what an Operator/Lessee must show to support its production allocation scheme and avoid liability to interest owners who believe they are being underpaid.

These risks are present because the law regarding PSA/allocation wells is incredibly unsettled. Unhappy interest owners recently found support in a Baylor Law Review article that lays out the

"Lessor" case against allocation wells. [1] The article argues that allocation wells (and presumably PSA wells to the extent they implicate a lessor who has not signed a PSA) constitute unlawful pooling—assuming the absence of pooling authority in the lease—and that the unlawful act should give rise to a slander of title cause of action and other relief, including injunctive relief, cancellation of drilling permits and even punitive damages.

In response to this article, UT professor Ernest Smith published an article this summer rebutting the Baylor article.[2] Professor Smith notes that there is nothing in a typical oil and gas lease that prohibits a Lessee from drilling across the full leased premises of the lease to connecting tracts, and that doing so is not pooling and certainly not wrongful pooling.

The positions staked out in these two articles are not aided by much case law, as the limited case law that has considered this issue has not provided any clear answers. The issue of whether the RRC can lawfully issue a permit for an allocation well came up through an appeal raised by a group of royalty owners, the Klotzman family, regarding an allocation well permit issued to EGO Resources, Inc.[3] Ultimately the parties to the dispute reached a settlement before the court opined on the issue, so there has been no final resolution on what limits, if any, exist as to the RRC's ability to grant these permits. Nonetheless, the RRC has continued to grant drilling permits for allocation wells and PSA wells and thus, from a regulatory perspective, allocation wells remain a viable option for operators who are unable to pool the tracts they need to drill horizontal wells.

In *Browning Oil Co. v. Luecke*[4] the Austin court of appeals addressed the issue of the standard an Operator/Lessee will be held to with respect to its method of allocation of production between un-pooled tracts. In *Browning* the lessee had a producing horizontal well that was drilled across several un-pooled tracts, and the court required the lessee to pay the lessors' royalties based upon "**a determination of what production can be attributed to their tracts with *reasonable probability***."[5]

Subsequent to *Browning*, EOG Resources, Inc. faced a claim regarding the viability of the allocation scheme it used for several allocation wells. In *Spartan Texas Six Capital Partners, Ltd., et. al. v. EOG Resources, Inc.*[6] production from horizontal wells drilled across un-pooled tracts was being allocated based on the portion of the productive lateral length of the wellbore that traversed a given tract. The lessors in *Spartan* challenged that allocation method and argued that an Operator should be held to the more stringent standard (a "reasonable certainty") previously articulated by the Texas Supreme Court in *Humble Oil & Ref. Co. v. West*,[7] rather than the "reasonable probability" standard that resulted from *Browning.* Ultimately the parties to this lawsuit settled all allocation related claims outside of court and thus this case does not provide any actionable holding regarding the standard that an Operator must meet in proving up its allocation method in these situations.

Finally, *Springer Ranch, Ltd. v. Jones*,[8] addressed the question of whether an Operator/Lessee was properly allocating production from a horizontal well traversing un-pooled tracts. But in *Springer* the court's decision was based upon the interpretation of specific language in an underlying contract and partition agreement that was not made available in the opinion. Thus *Springer* does not provide operable standards to apply to the situation where a lessee is simply drilling across un-pooled tracts without any contractual scheme to influence how the effected parties will share in production.

While the Texas Supreme Court has yet to address the issue directly, the ruling in *Browning* seemingly paves the way for allocating production on an un-pooled basis, so long as a lessee can prove with *reasonable probability* the amount of production that came from each un-pooled tract. No guidance is given on how to satisfy this standard – should the allocation be done based on the location of perforations, by the percentage of linear feet of the well bore within each tract, or a more detailed geological analysis of the formation? Or some combination of these factors?

Based on the dearth of case law and the recent dueling law review articles on allocation wells, there is concern that the Lessor-oriented bar is in the process of finding a test case for its theories against these wells. Areas like the Midland Basin, East Texas, and the Eagle Ford, where the common and somewhat dated leases are likely to not have pooling provisions, are prime areas for a potential test case.

While it seems evident that the principal risk associated with these wells is a potential claim by lessors (or other working interest owners) for misallocation of production, PSA and allocation wells also present additional land administration issues created by the fact that the well is not drilled on a pooled unit. For example, the well will only maintain leases on the tracts traversed by the wellbore. Areas outside of the tracts traversed by the PSA well or allocation well will remain subject to the lessee's obligations regarding payment of delay rentals and other lease burdens and its duties regarding implied covenants (i.e. to protect those areas from drainage). These issues can be onerous to deal with, especially where there is a very productive horizontal well that results in drainage of properties in the surrounding area. Also, spacing exceptions are needed with respect to portions of the horizontal wellbore that are within the setback distances from the property lines of traversed tracts in situations where the lessee is not the sole working interest owner in the lease.

Overall, while PSA wells and allocation wells present workable alternatives to pooling the tracts needed to drill a horizontal well, these alternatives are not without risk and will often create additional issues that should be considered in planning for the future development of an operator's underlying leasehold position.

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[1] Bret Wells, Allocation Wells, Unauthorized Pooling, and the Lessor's Remedies (forthcoming, Baylor Law Review), available at http://www.baylor.edu/law/lawreview/doc.php/265095.pdf.

[2] 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, available at http://www.oilandgaslawyerblog.com/files/2016/07/Applying-Familiar-Concepts.pdf.

[3] For a comprehensive discussion of the Klotzman dispute and the issues raised by the use of allocation wells see Clifton A. Squibb, The Age of Allocation: The End of Pooling as We Know It, 45 Tex. Tech L. Rev. 929 (2013).

[4] 38 S.W.3d 625 (Tex.App.--Austin 2000, pet. denied)

[5] *Id*. at 647

[6] *Spartan Texas Six Capital Partners, Ltd., Spartan Texas-Celina, Ltd., and Dion Menser v. EOG Resources, Inc.*, Cause No. 2011-27476, 11th Judicial District Court, Harris County

[7] 508 S.W. 2d 812, 818 (Tex. 1974) (The Texas Supreme Court's holding in *West* was based on the situation where a Lessee was comingling produced natural gas with native natural gas by injecting it into an underground storage facility. The *reasonable certainty* standard was thus developed to determine what standard of allocation must be met by a party that comingles goods such that the mixture thereof is incapable of proper division.)

[8] Springer Ranch, Ltd. v. Jones, 421 S.W.3d 273 (Tex. App.--San Antonio 2013).