HORIZONTAL WELLS CROSSING UNIT LINES --- FROM PERMITTING TO THE DIVISION OF ROYALTIES

BY

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The proliferation in horizontal drilling over the last decade has given rise to new, complex legal issues. One area where the law has increasingly lagged behind the technology is in the calculation of royalties for horizontal allocation wells – in particular, the question of the division of royalties from horizontal wells crossing adjacent units has dogged the petroleum industry in recent years. While the issues of permitting and royalty apportionment have not been wholly resolved by Texas courts with regard to wells crossing adjacent unit lines, a review of existing Texas Railroad Commission orders and case law authority pertaining to wells crossing adjacent leases provides credible guidance.

I. Permitting horizontal wells as allocation wells with the Texas Railroad Commission ("RRC")

When sixty-five percent of the royalty interest owners within a pooled unit or units have approved a drilling plan and execute Production Sharing Agreement (PSA), the Texas Railroad Commission (RRC) will issue a PSA well permit. Production Sharing Agreements and PSA permitting has become an accepted means of conducting business around horizontal drilling. A bigger issue arises, however, when less than sixty-five percent of royalty owners fail or refuse to enter such an agreement.

While little case authority exists, the precursor to this issue originally arose with the RRC in the framework of whether pooling authority was required before a lessee could drill a horizontal well that crossed lease lines, where that lessee held leases on all tracts crossed by the horizontal well. The issue was presented to the RRC by EOG Resources Inc. for its Klotzman Lease (Allocation) Well NO. 1H (Status NO. 744730), Eagleville (Eagle Ford-2) Field, Dewitt County, as an Allocation Well Drilled On Acreage Assigned from Two Leases, Docket No. 02-0278952 (Sept. 24, 2013) (final order). EOG filed an application for a drilling permit for a horizontal well purporting to form an approximately eighty-acre drilling unit by utilizing 40 acres from two separate leases. EOG held a working interest in both leases. However, the lessors had not given EOG pooling authority under the leases, and the Klotzmans and Reillys (lessors) protested EOG's application for a drilling permit.

The lessors alleged the act of drilling across lease lines and producing from multiple tracts and leases constituted unauthorized pooling, despite the label attached to the permit application, and therefore, EOG Resources, Inc. had no good-faith claim to the right to drill the well. The lessors further argued that such a well would necessarily require the removal of captured minerals from the lease prior to measurement. In their view, the inescapable prospect of downhole commingling breaks down an analogy between an allocation well and a collection of wells isolating each lease. In the latter, production could be measured at the surface of each well, and no disputes would arise over what production is attributable to a particular lease. Lessors argued that the plain language of Rule 26 required measurement prior to removal of production from a lease.[1]

In response, EOG insisted that no pooling resulted from the drilling of an allocation well. Additionally, it asserted that Rule 26 had no applicability or relevance to downhole commingling. On the narrow question of whether it held a good-faith claim to the right to drill, EOG pointed to the leases, which indisputably granted the right to drill on and through the lands described in the leases. It argued that because the rights and duties under a lease are a matter of contract between a lessor and lessee, it maintained that interpretation of contractual rights is the province of courts rather than the Commission.[2]

The RRC ultimately determined that EOG was not required to demonstrate any pooling authority in order for the RRC to issue a permit to drill a horizontal well that crosses lease lines, where all the leases involved are held by the lessee. *Id.* The lessors filed suit in district court in Travis County, but the case settled before trial.[3] Moreover, in the wake of the "Klotzman" challenge, the RRC has continued to issue permits to drill horizontal allocation wells where the applicants show a **good-faith claim** of a right to drill, which is satisfied with a showing of leasehold or mineral rights. Texas case law has long held that the RRC has authority to determine whether an applicant has such a good-faith claim.[4]

A horizontal allocation well refers to: 1) a horizontal well that traverses more than one tract in which 2) less than sixty-five percent of the royalty interest owners have approved the drilling plan (thus failing the RRC's guidelines for issuing a Production Sharing Agreement or PSA well permit). Instead of conditioning the grant of a permit for a horizontal allocation well upon an affirmative representation by the applicant that it has pooling authority or has otherwise obtained the consent from its lessors to drill the multi-tract horizontal well, the RRC only requires the applicant to represent that it has the entire working interest for those traversed tracts without any further representation by the applicant that it has pooling authority or has obtained the consent of royalty owners for a multi-tract well.

It is important to note, however, that Texas courts have routinely held that the RRC's authority does not extend beyond the permitting process.[5] Once the permit has been issued, the parties continue to be bound by their existing contractual relationships and longstanding common law (i.e. tort law).[6] Moreover, Texas courts have yet to specifically address the applicability of

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[1] Rules 26(a)(2) and 27(a) provide that oil and gas are generally to be measured before leaving the lease from which they are produced. *See* 16 TEX. ADMIN. CODE §§ 26(a)(2), 27(a) (2012); see also Clifton A. Squibb, "THE AGE OF ALLOCATION: THE END OF POOLING AS WE KNOW IT?", 45 Tex. Tech L. Rev. 929, Texas Tech Law Review, Summer, 2013, fn. 21, 81-89 (citing closing briefs made before RRC).
[2] *Id.*
[3] *Reily. v. R.R. Comm'n of Texas,* No. D-1-GN-13-004306(98th Dist. Ct., Travis Cty., Tex. Dec. 23, 2013). EOG was also involved in another suit with similar issues. However, that suit has likewise been settled insofar the claims asserted against EOG's relating to the above issues are concerned. *Spartan Texas Six Capital Partners, Ltd. v. Perryman*, 494 S.W.3d 735 (Tex.App.—Houston [14th Dist.] 2016, aff'd as modified).
[4] *See Magnolia Petroleum Co. v. R.R. Comm'n*, 170 S.W.2d 189, 191 (Tex. 1943).
[5] *See FPL Farming Ltd. v. Environmental Processing Systems L.C.*, 351 S.W.3d 206 (Tex. 2011).
[6] *Id.*

the above analysis, the permitting of horizontal wells as allocation wells, to scenarios involving adjacent **units.**

Upon filing and paying the required fee, it has become the practice of the RRC to routinely allow a permit, originally issued as a horizontal allocation permit, to be amended to become a PSA permit should the required number of royalty owners execute PSAs.

II. Payment of Royalties under an Allocation Well

The RRC refers to a "horizontal drainhole well" as any well that consists of one or more horizontal drainholes.[7] A horizontal drainhole is defined as that part of the wellbore that deviates at more or less of a right angle from the vertical wellbore; it begins at the penetration point, where it penetrates the field at an interval capable of production, and ends at the terminus point, the point farthest from the penetration point but within the producing interval. *See id.* § 3.86(a)(2), (5), (6) (2000). For purposes of designating a proration unit and allocating production allowables, units are determined by the length of the horizontal displacement between the penetration point and the terminus point, i.e., the horizontal displacement of the drainhole.[8]

The first case addressing the consequences of drilling horizontal wells across unpooled interests was *Browning Oil Co. v. Luecke*, 38 S.W.3d 625 (Tex.App.—Austin 2000, pet. denied). Humble Exploration Company, Inc. Oil Company obtained three leases from the Lueckes in 1979.[9] Those leases were eventually assigned to Browning Oil Company, and in 1994, Marathon Oil Company and Browning Oil Company, Inc. entered into an operating agreement to develop the area which included the Lueckes' acreage under the leases. Although those leases contained pooling provisions, they also contained anti-dilution provisions restricting the quantity of lease acreage that could be pooled with the lease.[10]

In late 1994, Marathon approached the Lueckes seeking to amend the leases to allow pooling for horizontal wells. The effect of the proposed amendment would have nullified the anti-dilution provisions, and the Lueckes refused.[11] Nevertheless, in February 1995, Browning and Marathon drilled two successful horizontal wells across tracts, which included Luecke tracts. They filed a Certificate of Pooling Authority with the RRC, showing the location of the first well on a purported pooled unit consisting of 839.18 acres, 268.68 of which were owned by the Lueckes; and that the second well was located on a purported pooled unit consisting of 346.625 acres, 114.86 of which were owned by the Lueckes.

The Lueckes filed suit against Browning and Marathon, claiming that the purported "units" for the two horizontal wells violated the pooling provisions and the anti-dilution provisions in their leases. Following a jury verdict for the Lueckes, Lessees appealed. The Court

[7] *See 1*6 TEX. ADMIN. CODE §3.86(a)(4) (2000).
[8] *Browning Oil Co. v. Luecke,* 38 S.W.3d 625, 635 (Tex.App.—Austin 2000, pet. denied).
[9] *Id. at 636.*
[10] *Id. at 637.*
[11] *Id. at 638.*

of Appeals determined with ease that the pooling and anti-dilution provisions of the leases applied to the horizontal wells.[12]

The appellate court concluded that Lessees were required to comply with the lease provisions and that they breached those provisions. However, with regard to the Lueckes' claim that they were entitled to royalties for total production from the wells undiluted by distribution among other pooled landowners, the court disagreed. It concluded that because the breach rendered the pooled units invalid, the Lueckes were not entitled to receive royalties on oil and gas produced from tracts they did not own.[13] As the court plainly stated, **each tract traversed by the horizontal wellbore is a drillsite tract, and each production point on the wellbore is a drillsite.**[14] However, "[a]lthough the Lueckes' tracts are drillsite tracts, they cannot claim royalties for total production when they have no legal claim to oil and gas recovered from other lessors' drillsite tracts." [15] The better remedy is to allow them to recover royalties as specified in the lease, compelling a determination of what production can be attributed to their tracts with **reasonable probability**.[16]

The appellate court, though not explicitly addressing commingling, applied a "reasonable probability" standard to the allocation of production from un-pooled tracts. However, it expressly recognized the harm it could do to the burgeoning horizontal drilling industry and stated: "[d]raconian punitive damages for a lessee's failure to comply with applicable pooling provisions could result in the curtailment of horizontal drilling. **We decline to apply legal principles appropriate to vertical wells that are so blatantly inappropriate to horizontal wells** and would discourage the use of this promising technology." [17] Thus, the court awarded the un-pooled owners "royalties for which they contracted, no more and no less." [18]

More recently, the San Antonio Court of Appeals decided *Springer Ranch Ltd. v. O.F. Jones III. et. al.*[19] Springer Ranch brought suit against Rosalie Matthews Sullivan (its neighbor) and other owners of adjoining mineral estates. Springer Ranch sought a declaratory judgment with regard to a 1993 contractual agreement, originally executed to govern allocation of royalties with respect to vertical wells drilled on the parties' properties.[20] The lawsuit, however, arose years later following a dispute between the parties over allocation of royalties from a horizontal well. The horizontal well bore was located on Spring Ranch's land, crossed the boundary of Sullivan's land, and ultimately, ended on Sullivan's land. The trial court held that the 1993 contract required that royalties from the horizontal well in dispute, and any future horizontal wells crossing the parties' property lines, must be allocated based upon the productive portions of the well underlying the parties' properties.[21] An appeal followed.

[12] *Id. at 640.*
[13] *Id. at 645.*
[14] *Id. at 635.*
[15] *Id. at 646.*
[16] *Id. at 647.*
[17] *Id.*
[18] *Id.*
[19] 421 S.W.3d 273 (Tex. App.—San Antonio 2013, no pet.).
[20] *Id.* at 277.
[21] *Id.* at 277-78.

On appeal, the appellate court acknowledged the distinction between the manner in which production is obtained from horizontal wells, as opposed to vertical wells, and explained that a horizontal well only produces hydrocarbons from the part of the well that lies within the hydrocarbon-bearing reservoir, or "correlative interval."[22] It further explained that "[a]long the horizontal displacement are take points through which hydrocarbons flow into the well. A royalty, as a fraction of production, is only obtainable from the part of the SR2 well actually within the correlative interval. Despite Springer Ranch's argument that the calculation should be based on the whole length of the well, it is not the whole length of the well from which the production is obtained…. the royalties must be allocated on the basis that the productive portions of the SR2 well are situated on both Springer Ranch's and Sullivan's properties."[23]

These cases have generated a variety of methods employed by lessees/operators who must account to unpooled interest owners burdened by a portion of a horizontal well. Typically, these consist of calculating either: (1) the length of a horizontal drainhole within a tract relative to total length within the correlative interval; or (2) the number of take points within a tract relative to the total number along the entire horizontal drainhole. It appears that absent unusual operational circumstances, production from a horizontal well should be allocated to each drill site tract proportionately based upon each tract's share of the open wellbore in the pay zone. Nevertheless, the Supreme Court of Texas has not addressed what standard governs damages for production from unpooled interests along a horizontal well. Until it does, it appears that a lessee may allocate production on an unpooled basis, without liability under the commingling theory, provided it can establish with reasonable probability what production originates from the segment or segments of the drainhole within the unpooled lease.

III. Hypothetical

Gas Unit #1 and Gas Unit #2 are adjacent units in Reeves County, Texas. Both units and the leases within the units are currently held by production. Happy Oil Co. owns 100% of the leasehold interest in both units. Happy Oil Co. is in the process of drilling Big Gas Well -- a horizontal well with a lateral drainhole crossing both Gas Unit #1 and Gas Unit #2.

Ideally, Happy Oil Co. should obtain PSAs from the royalty owners in both of the existing units with attention paid to getting the PSAs from owners along the drill path on the horizontal well. Obtaining PSAs from these royalty owners adds contractual protection for Happy Oil Co., giving it specific contractual approval from those royalty owners of the method of allocation of production between the two existing units and among the royalty owners within each unit. Should Happy Oil Co. obtain the required 65% of royalty owners in both units, Happy Oil Co. could obtain a PSA permit from the RRC.

If it is unclear at the beginning of the process whether the requisite percentage of royalty owners in both units will execute Production Sharing Agreements (PSAs), approving the allocation of production between the royalty owners within each unit for Big Gas Well, Happy Oil Co. will then be faced with obtaining an allocation well permit. Given the facts surrounding the drilling of Big Gas Well, where the lessee, Happy Oil Co., owns 100% of the leasehold

[22] *Id.* at 285.
[23] *Id.* at 286.

interest in both units crossed by the horizontal well, the RRC would allow permitting of the well as an "allocation" well since the good faith claim of right to drill is satisfied. Therefore, it would be efficient and prudent for Happy Oil Co. to proceed with drilling this well under an allocation permit. And, if 65% of the royalty owners eventually execute a PSA, Happy Oil Co. could always amend its RRC permit from an allocation permit to a PSA permit (although, such additional efforts are probably unnecessary).

As to royalty allocation, Happy Oil Co. should allocate royalties among the owners in each unit in the amount each owner proportionately owns in the existing unit multiplied by the percentage that such unit's acreage occupies in the area covered by the measured horizontal wellbore. This method incorporates the methods that meet the specifications set forth thus far in *Browning* and *Springer Ranch*: (1) the length of a horizontal drainhole within a tract relative to total length within the correlative interval; or (2) the number of take points within a tract relative to the total number along the entire horizontal drainhole. Said method could also be committed to writing in the form of a PSA, which, as noted would provide additional contractual protection.

IV. Conclusion

Technology moves at a rapid rate. Unfortunately, cases move through the court system at a snail's pace. Thus, practitioners do not always have proper guidance when the case law lags behind. Nevertheless, although the permitting processes and royalty calculations for horizontal wells is still developing, there is enough authority from both the RRC and Texas courts that practitioners can now proceed with reasonable assurance that acceptable methods used in lease line cases will eventually be adopted for unit purposes as well.